Trading Basics: Friend and Foes

The business of trading is littered with pot-holes. It is not a "random walk", and if you trade without an edge often enough you will not come out even, you will come out broke. The reason for this is that the fixed costs associated with trading, plus the variable costs associated with every trade, can substantially skew the probabilities in one's disfavour.

The independent trader looking to make a living from trading must view this endeavour purely from a business standpoint. It is therefore essential to quantify one's costs and to ascertain one's trading edge to determine the likelihood of long-term success. It is also important to recognize one's friends and enemies before playing the game:

FRIENDS

Discipline

A trader's best friend is the discipline he uses in his endeavour. Trading needs to be a highly predictable and ritualised daily activity, with set routines and checklists. This is where a systematic approach to trading becomes essential.

Low Overheads

Modern computer systems and reliable internet connections have become inexpensive, and trading platforms these days are either free or at least relatively affordable. These costs must be kept low, else they become a significant hurdle to profitability.

Renting an office is also unrealistic until one's account size warrants it. A $1000 monthly office lease over 12 months requires a trader with a $100,000 account to generate 12% return just to cover rental costs. This is why the majority of small independent traders work from home.

A PPP Edge

A proven, persistent and profitable trading edge is a trader's best friend. Without a proven back-tested and forward-tested edge, a trader will certainly blow up his account. Without an edge which is fairly consistent over time, the trader may well lose hope during a drawdown period and give up. And without a sufficiently profitable trading edge, the trader will be unable to cover fixed and variable trading costs.

Note that even the sharpest trading edge will be outdone by poor trading discipline and/or high trading costs. On the other hand, strict discipline and contained overheads can keep a relatively blunt edge profitable in the long term.

Small Position Sizes

Trading small size allows traders to jump in and out of positions relatively easily. It usually means a better fill when placing a market order, and lower slippage costs during a stop run.

Position size if of course relative. A 1000 share lot in a very illiquid stock could be viewed as substantial, while the same lot size in a high volume S&P100 blue-chip might be insignificant.

FOES

Commissions

Commissions represent the variable cost of trading. The fierce competition among discount brokers since the late 1990's has resulted in low fees, typically $0.01 per share or less. Moreover most brokers offer volume discounts, further lowering per share costs.

Spread

The bid-ask spread should be one of the major considerations when selecting what instrument to trade. A large spread will dramatically hamper a punter's ability to trade profitably. The higher the average daily trading volume, the lower the spread, so traders should as much as possible focus their search on high-volume stocks.

Slippage

For a buy at market order, slippage is the difference between the last printed ask and the price at which the order is actually filled. Similarly, for a sell at market order, slippage is the difference between the last visible bid price and the sale price actually obtained.

Slippage is the one cost with the greatest potential impact on a strategy's profitability. Here too, low volume stocks are the most likely to suffer from slippage. But even stocks with a 1c/share spread can "slip" by 10c or more in fast-moving markets, particularly when prices are heading south.

The problem here is that back-tests and real-time trading simulators are not good at estimating slippage, so it needs to be factored in "manually" when evaluating a system.

Execution & System Errors

These are inevitable and are almost never to the trader's advantage. They can range from "fat-finger" trades (wrong size, wrong symbol, wrong entry/exit price) to system issues (PC problems, internet outage, etc). Again, a systematic approach to trading is essential to keep these to a minimum.