

The

ONE

secret

habit

What if I told you that there is one thing that you can do as a trader to guarantee trading success? What if I told you that *all* professional traders have ONE secret habit in common. Further, what if I told you that this secret habit allows these traders to trade RELAXED, that this habit allows these traders to ANTICIPATE THE FUTURE, because this habit teaches these traders what to expect and that this secret habit gives these traders incredible CONFIDENCE in their abilities to profit from the markets?

Wouldn't you like to know what this secret habit is?

What if I told you that even though this secret habit is by far the single best predictor of trading success, many traders do not adopt this habit.

This is the one thing that all successful traders have in common. This one habit is known by many traders, but adopted by only a few traders. Consequently, these few traders are often the most successful traders on the planet. This habit is the single most important thing to a trading success.....and many successful traders will emphasize this point.

And yet, many unsuccessful traders refuse to adopt this habit. It is true -many traders losing money *know* of this habit, but it remains a "secret." This is a secret that profitable traders hold dear, as it allows these happily successful traders to trade relaxed, anticipate the future and remain confident in their trading abilities.

This one secret habit, that all successful traders share is this: successful traders backtest their trading systems. They take the time to pour over data, using one of three methods, and thus they are more relaxed in their trading, because they have seen their trading system perform over years in thousands of situations. These traders can anticipate the future because they intimately understand the characteristics of their trading system. And finally, these successful traders have confidence that they will prevail in the markets because they have seen their trading system work in the past, and they know that it will work in the future.

It really is amazing that most traders refuse to adopt this simple habit, but remember, many more traders lose money trading a small percentage of traders are profitable, so it should not be that surprising.

Methods Of Backtesting

If you have decided that you would like to become a profitable trader, and you want to make backtesting your habit, you have a choice as to how you might make backtesting your habit.

1. Manually Backtest

Only one kind of system testing makes sense. It is slow, it is time-consuming, and it does not lend itself to testing a hundred markets at once, but it's the only method that prepares you for trading. It consists of going through historical data one day at a time, scrupulously writing down your trading signals for the day ahead, then clicking your chart forward and recording the trades and signals for the next day.

- Alexander Elder, [Come Into My Trading Room](#)

As Dr. Elder explains, manual backtesting is very slow, and can be boring. But the experience you gain from it is well worth the time spent. You not only learn what it is like to experience the ups and downs of your trading system, but you also can learn the importance of keeping good records, which helps the budding trader in his quest to treat trading as a business.

This type of backtesting is limited only by the amount of data that the charting software can hold in the chart. [Tradestation](#), [Intellicharts](#) and [Metatrader](#) both can hold enough data to make manual backtesting possible.

2. Backtesting Software

This is my favourite way to backtest systems. It is easier than manual backtesting, because the software records the data for the trades (thus it is usually faster than manual backtesting), and the backtesting experience is similar to trading a [Metatrader](#) account. The best backtesting software available is [forextester](#). This software makes it easy for you to “trade” the past. You can literally “trade” your trading system for years and learn what the system does well, what it doesn’t do well and what you can expect if you are to trade the system in real time.

I don’t make any money if you buy [forextester](#), but I strongly believe that most traders would make more money trading if they used this software to test trading systems.

3. Program Your Trading System

If you are a computer programmer, then this sort of backtesting will appeal to you. Basically you are going to ask the computer, through some software interface, to go back in time and take the trades according to your trading system rules. This is automated backtesting. While it may seem to be the easiest and best method to efficiently conduct backtesting, it is not without limitations.

There are several reasons why most traders, it probably is not the best choice. First, this sort of backtesting makes sense if you are going to let a computer take your trades for you, but unless you are comfortable leaving a trading robot to do your trading, then this type of backtesting is probably not going to replicate what you are going to do in real life, with real money. This is because once you start trading you are going to watch the chart unfold, and you may make your decisions based on what is happening in the market. With automated backtesting you do not see the trades unfold, you only see the end result of the trades. Second, it is often tricky to program the *precise* trading system that you would like to test. For example, if your system is designed to take trades during the European trading session, then you would certainly want to make sure that the program excludes trades triggered during the Asian session. This type of programming can be involved and difficult. Third, you will still need to manually check at least *some* of the trades to verify that the program tested your trading system rules precisely as you expected. Fourth and finally, when using software to program your backtesting, you need to be very careful to avoid *biases* in backtesting. These biases can come up in any method of backtesting, but are particularly easy to incorporate into automated backtesting.

Biases in Backtesting

There are many problems that can occur when you backtest your trading system, but most problems fall into one of three categories: postdictive errors, too many variables, or failing to anticipate drastic changes in the market. Each of these errors is explained, along with methods of avoiding errors.

1. Postdictive Error

The postdictive error is just a fancy way of saying that you have used information only available “after the fact” to test your system. Believe it or not, this is a very common error when testing trading systems.

This error is easy to make. Some software will allow you to use today’s data in testing a trading system, which is always a postdictive error (we do not know if today’s data is useful yet for predicting the future, but we certainly do know if it is useful in predicting the past). Wouldn’t you love to be able to use the closing price of the GBPUSD to predict what the market will do today? Of course you would, I definitely would, but unfortunately, this information is not available to us until the day is over. For example, you may have a system that incorporates the closing price, then this obviously means that the *trade cannot be initiated until the day is over*, otherwise this is a postdictive error. Another example may help illustrate the postdictive error, if you have a rule in your trading system about highest prices, then you will have a postdictive error. This is because highest prices are often defined by data that comes later, in the future.

The way to avoid the postdictive error is to make sure that when you backtest a system that only information that is available *in the past at that point in time* is used in backtesting. With manual backtesting or backtesting with [forextester](#) you can accomplish this quite easily, but with automated backtesting the postdictive error can sneak into your trading system.

2. Too Many Variables

This is also known as the “Degrees of Freedom” bias. This simply means that you have too many variables, or trading indicators in your trading system. It is very possible to come up with a trading system that can explain *past* price behaviour of a currency pair. In fact, the more indicators you add, the easier it often becomes. The problem arrives when you want to apply this system to the future.

Often when a trading system has too many indicators it can predict the behaviour of the market during a time period extremely well. But, that’s all the system is good for, because in the future the system falls apart.

The above statement is often difficult for traders to come to grips with, but it is true. Consider what William Eckhardt, of the [New Market Wizards](#) has to say about trading systems,

In general, the delicate tests that statisticians use to squeeze significance out of marginal data have no place in trading. We need blunt statistical instruments, robust techniques.

Obviously, he is warning against the degrees of freedom error and suggesting that simple trading systems are more likely to stand test of time. This is absolutely true.

Some of the most powerful trading systems available are extremely simple.

Keep this in mind as you trade, and as you attempt to find a profitable trading system. Most traders find that the longer they trade, the more they come to agree with this statement.

3. Drastic Changes in the Market

Many traders forget to anticipate unforeseen events that will occur in the future. It doesn't really matter that you don't know what is going to happen in the future – because you *do* know this: there will be times in the future when the markets will behave erratically. When this happens, you should have designed your trading system to remain functioning during these times.

Perhaps some examples may help with this: When Saddam Hussein was found (over the weekend), the currency markets reacted quite drastically on Monday's opening. When the global financial crisis started unfolding in September 2008, most currency pairs traded with much more volatility than had been seen for years.

The fact is that there will be unexpected events in the future, and these events will affect the markets, so the best thing you can do is to be prepared. How do you prepare for the unexpected? Consider these simple solutions:

- 1) Exaggerate your expected losses. If your backtesting reveals a maximum loss of \$5000, assume a maximum loss of \$10,000. Will your trading systems still be profitable under these conditions?
- 2) Decide on an appropriate level of risk for each trade. Remember that even this level of risk is likely to be exceeded. If you have decided to risk 1% on each trade, you should assume that sometime in the future, you may be in a trade and an unexpected event will occur, and your trade will not lose 1%, but instead 5% will be lost.
- 3) You should have a contingency plan set up. That is, how will you exit a trade if something bad happens and you cannot access your account? For instance, what happens if your trading platform is inaccessible and you desperately want out of

a trade? Most brokers offer a telephone line to traders for these instances. Do you have the phone number?

- 4) Do you have a maximum risk level set? This would be applicable if you have several trades open simultaneously. If you decide to risk 1% per trade and you have 7 trades open simultaneously, does this mean that you will be risking 7% of your account? Or have you decided on a maximum risk level of say, 3%? Keeping in mind that the unexpected will occur, you should probably have a maximum risk level for those times when you have several open trades.
- 5) What is the maximum drawdown (amount of money your trading system loses over an extended period of time) you are willing to tolerate? Keeping in mind that you (and you are not alone) are more likely to overestimate the severity of drawdowns that you can withstand, it is important to be realistic. If you lose 30% of your account will you stop trading? What about if you lose 50%? Or if you see 70% of your account disappear? Again, the best way to plan for drawdowns is to do extensive backtesting to find out what sort of historical drawdowns your trading system experiences and then plan for even worse drawdowns in the future.

Anticipating drastic changes in the markets is the single best way to preserve the equity in your account.

The Side Effects of Backtesting

So, you know what the one secret habit is. You know that backtesting separates the wealthy traders from those who lose money. You also know several ways of incorporating backtesting into your trading regime. And you know of the pitfalls – what to look out for – when you are backtesting, so that you can get the most out of the process. But, what exactly, will you get out of backtesting your trading system?

The answer is – plenty. By backtesting your system, you will become more relaxed in your approach to trading. You will know what to expect in the future, because you have seen your trading system in so many different market environments, and you will remain confident in your ability to make money from the markets. Let's look at these "side effects" of backtesting.

Relaxed

Traders who use backtesting to validate their trading strategies know that success is coming. Traders who do not backtest their trading strategy fall into the "circle of doom."

What is the "circle of doom?" This is simply the place that most traders are stuck in, where the trader trades a system for a while, then after a series of losses, gives up on the trading strategy, finds a new, 'better' trading strategy, trades the new strategy for a while, experiences several losses in a

row, then gives up on the trading strategy, searches for a new trading strategy, etc. The trader is doomed because the trader is not committed to a successful trading strategy. Even if the trader *does* have a successful trading strategy, the trader will not make money because it only takes a series of losses for the trader to give up on the trading strategy.

The trader with backtesting experience approaches trading from a much more relaxed perspective, knowing that, while there are no guarantees that a particular trade will make money, in the long run the trader will make money. This trader has no need to stress and frantically search for a new trading system after experiencing a series of losses.

Which way would you rather trade? As a relaxed trader or as a trader in the “circle of doom?”

Anticipate the Future

How can traders anticipate the future? By extensively backtesting their trading systems. Does this mean that the past market behaviour will be repeated? Of course not. But a trader who decides to backtest a trading strategy over many years, in various market conditions (uptrending, downtrending, very volatile and very quiet) will collect very important statistics on the trading strategy.

The most important statistics are as follows:

- + The percentage of winning trades – call this W%.
- + The percentage of losing trades – call this L%.
- + The average gain of a winning trade – call this Ave W.
- + The average loss of a losing trade – call this Ave L.

Here’s why these statistics are important – with just these four statistics you can find out how good your trading system is, and thus decide if it is worth it to trade the system with real money.

With these four statistics you can calculate *expectancy* of your trading system. The formula is as follows:

$$\text{Expectancy} = (W\% \times \text{Ave W}) - (L\% \times \text{Ave L})$$

The expectancy number tells you how much money you would expect to win over many trades. Perhaps the easiest way to illustrate expectancy is by an example.

Let's say that trader Jeff has a trading system that he backtests using manual backtesting, over 900 trades, and he gets the following statistics.

W% 30%

L% 70%

Ave W \$450

Ave L \$120

Calculating expectancy, Jeff sees that $(0.3 \times 450) - (0.7 \times 120) = \$135 - \$84 = \51

So, armed with this information, trader Jeff knows that if he takes 100 trades with his system, and the average winning trade is \$450, and the average losing trade is \$120, even though he is likely to have only 30 winning trades, he will still probably make \$5,100. How does Jeff know this? He knows this because he knows that $(30 \times \$450) - (70 \times \$120) = \$13,500 - \$8,400 = \$5,100$

This doesn't mean trader Jeff *will* make \$5,100. This only means that we would expect him to make \$5,100 over 100 trades. Of course Jeff's real results could be a little better or a little worse, but they are probably going to be very near \$5,100 after 100 trades.

This is what backtesting is all about, learning about your trading system, learning how to trade it, learning how it holds up in various markets, and learning how much money are you expecting to make from this system. Calculating expectancy will go a long way toward helping your confidence as a trader, a very important attribute to have.

Confident

Once you have seen your trading system perform over hundreds of trades, over years, in markets with vastly different characteristics, you begin to trust your trading system. Because if you have seen the trading system make money over hundreds of trades, in volatile markets and in quiet markets, and in everything in between, you know that the probabilities are in your favour.

That is really what trading is all about – probabilities. Once you gain confidence, you begin to see trading for what it really is - a game of probabilities. Each trade is not that important, but the overall sequence of trades is very important. Whether the current trade is a winner or not does not matter too much. But the fact that your trading system has been backtested, and has a positive expectancy, is very important.

This means that you will be able to trade your trading system daily in much the same way a casino operates. The casino has no interest in whether a particular bet makes money or loses money for the casino. The casino only cares that, overall, in the long run, the casino will make money. You as a trader will learn confidence, will learn to trade detached from the outcome of the current trade. You can be more confident in your trading when you *know*, you really *know* that over time you will make money.

You have become the casino. No go out and enjoy it!



[Jake Diamond](#) trades forex for a living, and so can you. When he is not trading forex he is usually eating Mexican food or backtesting on [forextester](#). To find out more about forex trading, visit Jake's website at www.FXjake.com