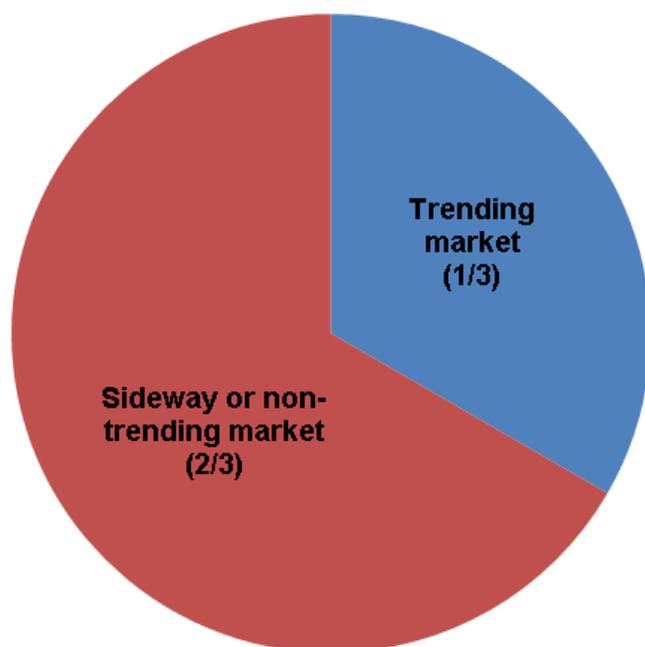


## ***How Profits and losses unfold in the real world***

Most amateur traders simply have no idea how the markets work in the real world, and as such have no idea of how their profits and losses are anticipated to unfold. There are many software packages that allow you to develop and back test various strategies and as such generate trading reports. However, because these are just a simple statistical analysis of trading results, they can often be misleading, especially when you just view them in the context of a bare analysis of just a set of numbers, without any understanding of how the markets really unfold.

Therefore, in this chapter I would like to take a look at how the markets unfold, and therefore show you how profits and losses fit into the real world.

Over time, markets can unfold in three basic ways, they can either go up, or they can go down, or they can move sideways. Most of us are familiar with rising markets, and more recently with falling markets, but in reality a sideways market is far more common. Typically markets will spend about 2/3rds of their time going sideways, and about 1/3rd of their time in a trend (either moving strongly up or down). Most trading strategies, rely on a market actually moving (either in an uptrend or a downtrend) to make money. Therefore, typically, you should only anticipate making profits about 1/3 of the time.



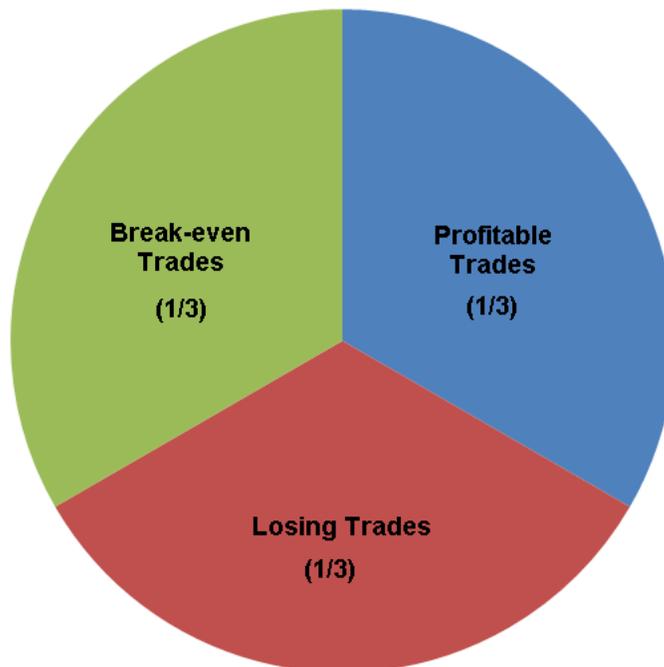
However, most trading strategies, or statistics about profits and losses, do not take into account that the markets are only in a position where profits can be made about 1/3 of the time. Therefore, profit and loss statistics are very misleading, particularly once the amateur trader starts trading for real.

So what should you really anticipate as far as profits and losses?

Well, over the last 20 years that I've been involved in the markets, and from seeing many hundreds of different trading systems, typically I have seen that profits and losses and breakeven (no profit or loss) trades tend to unfold in approximately equal 1/3rds. Or put another way, about 1/3 of the time you'll be making losses, about 1/3 of the time you'll be making breakeven trades, and about 1/3 of the time you'll be making profits.

Let's take a look and see what that looks like in a picture

Distribution of profits and losses



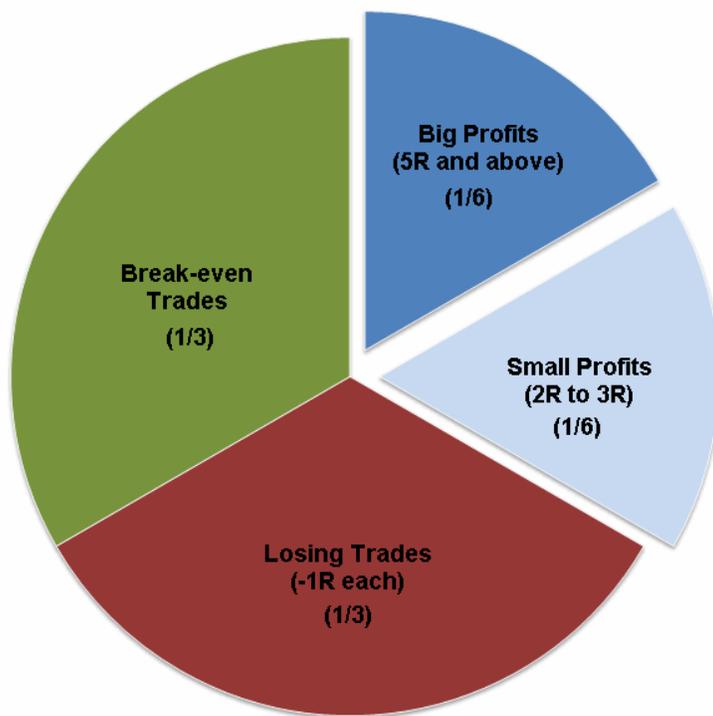
Instantly, I hope you will all see that how you treat your breakeven trades has a very large effect on how you report the percentage of winners. For example, if I count the breakeven trades as losing trades, then you could have a system that is 66.6% losses and only 33.3% winners. In other words your profitability could quite easily be reported as 30-40% winning trades. On the surface, this does not look good and I know puts off many amateur traders.

However, what happens if you now count the breakeven trades as winners (for example, if each breakeven trade was actually just a \$1 winner). Instantly you would now turn the system in the last paragraph on its head and suddenly have a system that has 66.6% winners and 33.3% losers. Not surprisingly, this system is far more appealing to most traders.

As you see, this is where statistics can be very misleading and as such you need to look into them in far greater detail.

As I have already said, typically trading seems to unfold in equal 1/3rds where 1/3 of the time you will have losing trades, 1/3 of the time you will have breakeven trades, and the remaining 1/3 will be profitable trades. But is that where the story ends? Well not quite, because in reality the profitable 1/3 very often splits down into another 1/2 where 1/2 of your profitable trades are small profits (the example 2R or 3R) and the other 1/2 half is where your large profits (5R and above) fall. What this actually means is you only tend to make your largest profits about 1/6 (1/2 of your profitable 1/3) of the time. And this is where most amateur traders fall down.

#### The distribution to expect in the real world

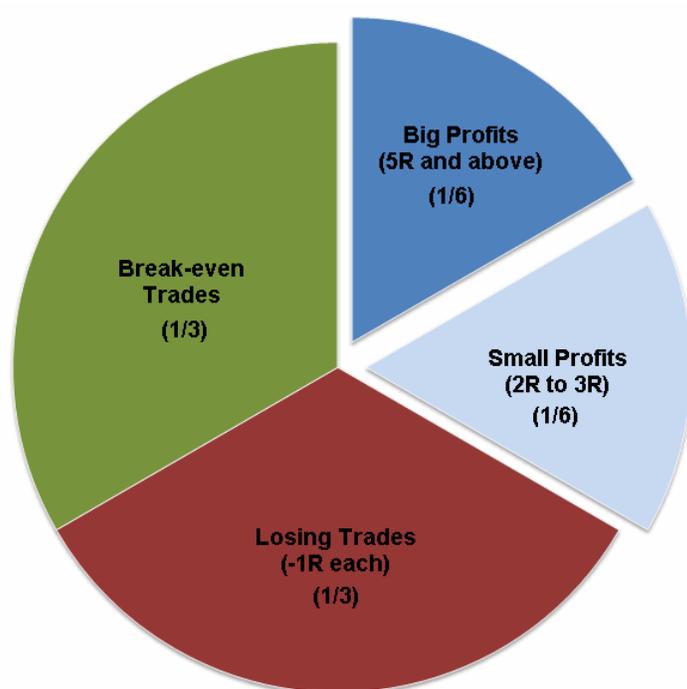


In reality 2/3 of the time you'll be spending either making losses (albeit small) and breakeven trades, only about 1/6 of the time will you be making the big profits. Most amateur traders find it very difficult to deal with this psychologically. The reason for this is most amateur traders (because this is basic human nature) want to be right all of the time and as such have big profits all of the time. So what happens in practice is that the amateur trader will have 2, 3 or 4 losing or breakeven trades, then as soon as they get one winner, they tend to come out of that winner too early (not managing it correctly) and as such cut one of their big profitable winners into a small winner. This can have a devastating result on their profitability because you need the big winners to make the money overall. So I am sure that you can all understand that by not allowing these big winners to develop, and banking profits too early, you miss out on the big winners.

It is quite strange that becoming a successful trader sometimes has more to do with dealing with yourself on a psychological level, mainly by allowing your winning trades to run further, rather than actually learning how to trade. I guess, this is why 97% of amateur traders end up losing, and only 3% end up becoming a successful and profitable professional trader.

This is why I want to show you how markets unfold in the real world, so you can understand why it is so important to let your big winners run. And also, to understand that to be a successful profitable trader actually means trading water (small losses and breakeven trades) most of the time waiting for the few big winners to come through. And in reality, you will not have that many big winners but, these are vitally important to your overall success as a trader.

So let's summarise by looking at what a successful professional trader should anticipate by the way of profits and losses:



As you can see, typically you should anticipate about 1/3 of the time you will be making losses (but keeping and small at just -1R), 1/3 of the time making breakeven trades, and the remaining 1/3 profitable, with the profitable 1/3 splitting into 1/2 of the time small profits and 1/2 the time large profits. So in reality you should only anticipate having large profitable trades about 1/6<sup>th</sup> (16-17%) of the time.

If you are going to become a successful professional; trader then by understanding this you have a far better chance of being able to manage your trades as such letting the big profitable trades run, which are vital for your overall trading success.

Amateur traders expect to be right all the time, and as such make big money all the time, in reality nothing is further from the truth. in reality the big profits only unfold about 16-17% of the time.