DAY TRADING BASICS

by Sunny J. Harris

Human nature! What a continual marvel. Everyone wants something for nothing, or at least fairly cheap. Quick fixes, free lunches, easy riches. Not to mention the "for dummies" books to tell you how to do it in 21 minutes.

That is what this article is not about.

While this article addresses that very same audience, it is with a great deal of concern for these people that I write as often as I can to get the word out about the realities of trading.

It is my hope that you will read on and realize several things: Trading is not for everyone, you can lose lots of money trading and trading can make you lots of money, if you plan, study and work hard.

Instant Gratification

The appeal of day-trading and its overwhelming popularity of late stems from its easy accessibility and WYSIWYG (what you see is what you get) profits. Nothing appeals to the masses more than the promise of easy money and get-rich-quick schemes. Just look at the advertisements. They don't say "danger, danger," they say "profit, money, %-return, easy." Day-trading is the junk food, drive-thru answer to investing. It happens quickly and satisfies the customer's craving for instant gratification.

There are few jobs at which it is more difficult to make a living than trading! Most people would make more money working at McDonald's for minimum wage than trading. Estimates are that 80% to 90% of all those who begin trading today will lose their trading capital within the next 12 months. That said, let me now get to the fun part - the homework. If you study diligently, read the works of "the masters," plan your work and work your plan, you can make a decent living trading right from your desk at home. With your computer, that is.

The Internet, offering instant communication for everyone across the world, has lifted barriers to transportation as dramatically as the airplane did earlier in the last century. In this new millennium, we tackle transportation issues by telecommuting in every imaginable walk of life. We talk over the Internet, order food, computers, clothing, movie tickets and bid for everything imaginable online at eBay auctions. And now, we are doing away with stock exchanges and replacing them with online electronic negotiations.

Officially, "day-trading" is the act of trading during the daily market hours and closing all of your trades before the market closes each day. You don't "take a trade home." That is, you have no open positions at the end of the day. The fundamental premise of day-trading is that the market (whatever you are watching) will move enough during the day for you to make a profit. Not too long ago, the Dow Jones Industrial Average might have moved 20 or 30 points in a week. Now, if it only moved 20 or 30 points in a day, it was a pretty flat day. To make a living at day-trading, you need the large daily point moves. This is referred to as volatility. Without volatility, a day-trader cannot make money.

The typical day-trader looks for a few points movement in a few stocks and trades them several times during the day. They "make it up in volume." So, if you traded 1,000 shares of eBay on July 28, 1999, and you had caught all the ideal trades, you would have bought 1,000 shares at 99 and sold a few minutes later at 102. A few minutes would have passed, and you would have bought 1,000 shares again at 99 and sold them an hour later at 106. Later in the afternoon, you would have bought the same 1,000 shares again at 103, and sold them at 106.

In this example, you would need a sizable account, with at least $99,000 in it. (They don't usually tell you this part when they call it "easy money.") But, by the end of the day you could have made a tidy $13,000 profit, for a hefty 13% return. Not bad for a day's work.

If you could do that every day, you would turn an incredible 3,000% return per year. That's where the excitement and glamour comes from. We all want to believe we will win the lottery.

What if you have a smaller account, can you still play? Sure. Most brokerage firms, and that includes the day-trading firms, have a minimum account size they will accept. Many firms require $100,000 to open an account, but some have lowered the requirement to $25,000. Let's look at the example above with a smaller account in mind.

With $25,000 you would be trading 250 shares at a time, not 1,000. You have still turned the same 13% profit for the day, because your $3,250 profit is on an account size of $25,000. But now, your dollar earnings look meager in comparison to the $13,000 per day of the first example.

Keep in mind that you have not accounted for fees and commissions in this imaginary trading day. With each trade you will pay about $30 per transaction. There are six transactions in our example; a buy and a sell make 2 transactions. Whether we are trading 1,000 shares or 250 shares we still have to pay the same transaction fees. At $30 per transaction, our account gets reduced by $180. That leaves a $3,070 net profit at the end of the day.

How Much Is Enough?

Before entering into the day-trading (or even the trading) arena, it is advisable for you to create a business plan for your new venture. Don't start counting your chickens before the eggs have hatched. (Which reminds me to take a second look at my Egghead Software [EGGS] stock.)

Do you know how much a million dollars per year is? There are approximately 250 trading days in a year, so $4,000 per day would net you $1,000,000 per year. Taken with that view, it seems a more achievable goal.

Crystal Balls and Soothsayers

You will never be able to predict the market. You might make a few holes-in-one, but you won't do it every time. You won't even do it regularly. No one can. So, your best bet is to follow the market, because you certainly aren't going to lead it.

Somehow, novice traders think they can come to the market unprepared and beat the pros, who have been doing this for years. Believe me: we will use all the education, experience and computer power we have to see that we walk away winners at the end of the day.

Your trump card in day-trading consists of two components: discipline and method. The most difficult practice for every trader is discipline. If you can master this single element, you will be ahead of 99% of all traders. Having the discipline to repeat your proven strategy, day after day, is the single most important facet of successful trading.

If you can develop a simple method that will produce a steady, though small, profit regularly - and follow it religiously - you will be the trader who walks away consistently winning.

Ockham's Razor: "Pluralitas non est ponenda sine neccesitate." Attributed to William of Ockham (1285-1349) this saying loosely translates to "keep it simple, stupid." The true translation is more like "plurality should not be posited without necessity." Another frequently seen corollary to this axiom is "the simpler solution is the truer solution." But, it just means, don't make things more complicated than they need to be.

The simpler the solution to a problem, the more likely it is to continue working into the future. Complex, intricate solutions rarely continue to work as the market makes its inevitable changes as time marches on. The simpler your solution is, the more likely you are to follow it. And, the simpler your solution is, the less the classical elements of fear and greed will enter into your trading.

What's Next?

If you are willing to take the time and do the homework, day-trading can become a profitable venture. Getting there is just like getting to Carnegie Hall: practice, practice, and practice. And know that every time you take a trade you are putting your money at risk. Trading is a risky business that should only be done with money you can afford to lose. Most people spend the first year or so of their trading careers "paying tuition to the University of Wall Street." That's what we call that first year's losses. Everyone does it, so don't be surprised if at some point you do too.

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