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12 Essential Lessons Every Trader Should Know

Learn the most important lessons most new traders neglect

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12 Essential Lessons Every Trader Should Know by T. Livingston

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Lesson 1: Don't worry about how much you may make. Worry about how much you may lose.

The number one mistake most traders make is that do not consider how much they can lose when trading. Before they even make a trade, they have already started calculating how much money they are going to profit on a given trade. They can see the mansions, the Ferraris, the parties, the beautiful women-it's going to be great!

There's one problem. The stock market doesn't work that way. There's no such thing as easy money on Wall Street. Bad things can and will happen. You will have trades where you lose money. It happens to everyone. This is why you must guard against ruin and respect risk. If trading was easy, everyone would be rich. It just does not work that way. There's a long line of people who were totally wiped out trading. Don't let that happen to you.

Would you drive 120 mph on the highway without brakes? Of course not. You know that this type of behavior can have serious consequences. It's the same thing with trading. However, most people do not consider the risks involved in trading.

Mathematically, losses work against you. If you place $10,000 in a stock and it falls 50%, you will need to double the remaining $5,000 just to get back to breakeven. Don't let that be you. Whenever you enter a trade, define your risk before entering the trade. Know how much you are willing to lose and exit if the stock falls to that point. It's a simple step that will make a world of difference in your trading.

Lesson 2: Go by the chart. Not how you feel.

The next lesson you must learn is to focus on charts, not how you feel. In April 2020, the entire world was on edge due to the COVID-19 pandemic. Businesses were closed, students were sent home from school, and unemployment rose drastically. The charts of leading stocks such as Amazon, Tesla, Shopify, and Zoom, however, were telling a completely different story. While the news was all gloom and doom, strong action across the board by innovators were telling the story of a new bull market.

I've seen this happen time and time again. People get so scared and caught up in emotion, that they wind up missing the opportunity of a lifetime. It can be easy to be convinced by others' opinions or by television news stories. However, the only opinion that matters is price since it's the only thing that pays.

Not using a chart can also lead you to buying extended securities. When everyone is making money in a high-flying stock, it is human nature to let greed take ahold of you and jump along. However, without a chart, you cannot fully assess the situation. The stock may be drastically extended and in fact topping. This happened to famed physicist Sir Isaac Newton. After losing what would amount to over $3 million in today's economy speculating in the South Sea Company, he exclaimed, "I can calculate the motions of the heavenly bodies, but not the madness of the people."

Charts let you time your entries, manage your risk, and get a sense of when it's best to exit the market. They let you see the collective mindset of the entire market. Don't get caught up in your feelings or opinions. Focus on what the market is telling you. You can see this plain as day through charts and technical analysis.

Lesson 3: Don’t be a jack of all trades.

Have you heard the phrase “jack of all trades, master of none?” We all know people like this. They try to do everything. They want to fix their car, do their own plumbing, and redesign their bathroom all on their own. In the end, they wind up exhausted, frustrated, and with little to show for all their effort.

Don’t be like this in trading. Rather than selling covered calls, while day trading, swing trading, and opening iron condors, stick to one system. Most traders try to do too much. Although they have the intention of wanting to make money, they confuse themselves by taking on more than they can handle. They try to master multiple complex systems. They’re looking for shorts to day trade while running iron condors on an index while simultaneously buying weekly calls on Apple. It just gets too complex. When you throw too many balls in the air, one of them is bound to drop.

Have you ever watched baseball? The best pitchers usually don’t hit too many homeruns. Why is that? Because their focus is on their pitching. It would be a waste for them to practice their base stealing and their outfield defense. The idea is to stick to what you do best. Same thing with football. Tom Brady doesn’t worry about his field goal kicking. It’s just not wise to scatter your time and energy over too many different areas.

While trading, it is best to stick to one strategy. I’ve made every mistake in the book and one of the costliest for me was trying to master many different strategies. I’ve tried debit spreads, buying calls, iron condors, short selling, and countless other techniques. My trading drastically improved when I decided I would just stick to buying stocks. I don’t implement any more advanced options strategies anymore or even go short. By making my trading more focused, I can discipline myself to take the best setups. When you scatter your focus too widely, you are bound to make mistakes. Remember, it’s not about who does the most trades or has the most complex system. It’s making money.

Lesson 4: Stock Selection Matters

Would you rather pick a stock that goes up 10% or a stock that goes up 80%? Obviously, you would want to pick the stock that offer the larger reward. When the market is strong, one of the biggest mistakes you can make is to waste your time and money on a weak or underperforming stock. You need to capitalize on golden opportunities while they last. The inability to do so can result in you literally missing out on a fortune.

Take a look at these two stocks, Zoom and Royal Caribbean Cruises. During the same time period, they had completely different returns. The key to finding stocks that will outperform is based on two important steps. First, look for stocks that are innovators and totally changing people's way of life. Zoom is a perfect example of this. Zoom has drastically changed the way people conduct work meeting, chat with friends, or even take workout classes. Second, use a chart to help you identify when a stock is in a strong uptrend or making a new high. If I took away the names of the two companies, you could clearly see that the stock on the top is in a strong uptrend while the second stock has had a precipitous decline. Charts give a huge indication as to what is going on.

Let charts help you determine which stocks to buy. Don't buy a company just because you like the product or are familiar with it. Go with strongest trends. It will make a big difference in your portfolio.

Lesson 5: What Goes Down May Go Lower

Do you like getting discounts? Get excited for 50% off sales? Great. Keep your bargain hunting for shopping, not trading. The stock market is not like shopping. You know what an iPhone is worth and thus can buy one at a discount when the opportunity arises. The same thing goes with clothes. You know what a particular brand of jeans sells for and thus can access if you are getting a deal or not. The stock market does not work this way.

Just because a stock has fallen 20%, does not mean it is a bargain and will return higher. In fact, a tumbling stock is showing weakness and may be headed for a steep decline. Remember, there are many brilliant minds on Wall Street. If a stock is going down, there is a reason behind the selling. Let's look at FANG as an example. Does it look like a bargain at $73?

How about now at $61?

What about at $48? It just can't possibly go any lower!!!

Down 44% to $26!!!! This is insane. This must be the bottom.

Down again to $20!

The problem with searching for bargains on Wall Street is that trends can go much farther than expected. A stock can very quickly fall and once that happens to you the math starts to work against. You. For instance, let's say you bought FANG at $40 thinking it was a bargain. If you still owned it on March 17, 2020, at $20, you would need FANG to double just to get back to breakeven! That's a long road just to get your money back. Do yourself a favor. Keep you bargain hunting for your next shopping trip and not on your next trade.

Lesson 6: Low-Priced Stocks Are Low For A Reason

While shopping, many people look for bargains. They like to buy the cheapest items at a store, reasoning they are getting a huge discount. Never do this in the stock market. Traders are often scared of higher-priced stocks, but in fact these stocks are priced at these levels for a reason: people are buying them.

Many people are afraid of higher-priced stocks, but that's where you will often find the best stocks. As of this writing, Tesla is trading at $1,387 and Amazon is at $3,051. Shopify is over $1,000 and Chipotle is over $1,100. If you had a rule to buy only stocks below $2, you would have believed Amazon was too high at $500 only to see it go to $3,000. Amazon, Tesla, Chipotle, and Shopify are at those levels because the big money is behind them. Institutions do not buy penny stocks or thinly traded over the counter securities. Instead, they look for the big boys. Think about it. If you had millions of dollars to invest, would you buy up all the shares of one tiny stock or would you prefer to purchase some of the shares of well-established companies? The answer is fairly straight forward.

We can also look at this from a mathematical point of view. Amazon is currently priced around $3,000 with an average daily volume of 4.73 million shares. If we multiply the price by the average daily volume, we get $12.9 Billion. TTOO, T2 Biosystems, is currently trading at $1.32 with an average volume of 16.93 million shares a day. When we multiply the price by the average volume, we get $22.34 million. There is a lot more big-money going into Amazon. It's as plain as day. In addition, many traders think that it is better to buy smaller stocks since you can buy more shares. Again, let's look at this mathematically. Let's say you have $1,000. You could buy 1,000 shares of a $1 stock or you could buy 10 shares of a $100 stock. Either way you still have invested $1,000.

Penny stocks are notorious for being volatile and difficult to handle. The companies behind the tickers are often not worth much. While they may have rapid moves upwards, they also can be hit hard and drop extremely quickly. It's just not worth the aggravation. Why deal with beaten-down stocks that have fallen drastically from old highs? Doesn't it make more sense to buy stocks of prominent companies that are rising in price? I make it a rule to stick to stocks with prices above at least $5, but most of the stocks I buy are far above this level. Don't focus on beaten-down penny stocks. They may have large one day moves on occasion, but the real trends and real moves are with the larger, higher-priced stocks.

Lesson 7: Forget About PE Ratio

PE ratio is the most overrated metric in stock selection. In fact, I think using PE ratio to evaluate a stock will cause you to miss out on some of the biggest gainers the market has to offer. This is because PE ratio is based on the past (current price / earnings per share). The stock market does not care about the past; it cares about the future. The stock market is always looking forward towards the next six months. A company may not be making as much money now because it is investing towards the future. Smart money knows that.

Take Amazon for as an example. It's currently trading over $3,000 a share with a PE ratio of 145.9. This far exceeds the standard rule of buying stocks with a PE below 15. Did having a high PE ratio affect Amazon's performance? Take a look at its chart from July 2020.

Zoom had a PE ratio of 1,576 in July 2020. Let’s look at how it performed.


ZM Zoom Video Communications, Inc. Nasdaq GS + BATS
© StockCharts.com
8-Jul-2020 3:58pm
Open 263.80 High 268.53 Low 261.29 Last 266.25 Volume 5.3M Chg +4.15 (+1.58%)
RSI(14) 73.21
ZM (Daily) 266.25
MA(50) 202.30
MA(200) 118.21
EMA(20) 245.09
Volume 5,272,921
MACD(12,26,9) 17.529, 18.702, -1.173
Volume 5.27M, EMA(50) 11.42M
13 21 27 Feb 10 18 24 Mar 9 16 23 Apr 6 13 20 27 May 11 18 26 Jun 8 15 22 Jul 6

Delta Airlines, (DAL), had a bargain basement PE ratio of 5 during the same time. Notice it drastically underperformed.

Don't overly complicate your stock selection. Focus on the chart, not the PE ratio.

Lesson 8: Turn Off CNBC

Do yourself a favor-turn off CNBC. It boggles my mind how there are still people who use this as a means to make trades. The flashing prices changes, scrolling symbols, and shouting matches are there for entertainment, not for education. The problem is they overanalyze every tick of the stock market. In order to gain attention and ratings, everything has to be to the extreme. “This stock is a can’t miss” or it’s “the biggest point drop in history!” They even have show names like “Fast Money” and specials like “The Market is in Turmoil.”

These types of shows are of no value to a trader since they never discuss other aspects of trading such as risk management, when to take profits, and trading psychology. To be a successful trader, you must never rely on someone else’s tips. First, you won’t have the conviction to stick to the system when it goes through periods where it does not work. Second, even if you did, you may not be able to get in touch with the tipster when it is time to make the decision to sell.

If you want to make money trading, forget all the hype and get down to business. Come up with a sound plan so you know how to manage your risk and handle various market scenarios. If you need help with your entries, position sizing, selling rules, risk management and psychology, seek a mentor to help put you on the path to success.

Lesson 9: Dividends Don't Help You When A Stock Cuts in Half

So many investors are obsessed with dividends. I get it. They like the idea of getting paid quarterly as a stock appreciates in value. It's the best of both worlds: cashflow and appreciate. But does it always play out that way?

The problem with focusing on dividends is they don't help you if a stock gets into major trouble. Let's say a stock pays a healthy 4% dividend. That's useless if the stock falls 30%. Why take a large loss just because you get a paltry 4% dividend? In addition, if a company gets in major trouble, they may wind up cutting their dividend all together.

Moreover, many of the innovative tech stocks do not pay dividends. This is because they are putting money into research and development rather than paying it out to shareholders. Even though they do not pay a dividend, that does not mean they do not offer the potential for serious gains. Which stock would you rather own: a blue chip with a 3% dividend that goes up 12% or a tech stock that rises 80% and does not pay a dividend? The answer is simple.

Take a look at TDOC. I'm sure those who own it are not too concerned with its lack of dividends.

Focus on stocks that have the potential to go on strong moves. If you play them right, you will vastly outperform those who buy and hold blue chip dividend stocks.

Lesson 10: Options: Get Poor Quickly

Options appeal to traders because they seem to offer the opportunity for massive gains. It sounds so easy. I bought these calls for $50 and turned them into $2,000 in one week! For every one of those stories that you hear, there are literally thousands that you won't. These are stories of get-rich quick gamblers who lost fortunes overnight.

Option pricing is based on volatility, time, and the price of the underlying stock. I've found that time decay is what does most traders in. Let's say your option expires in two weeks. You bought calls with the $125 strike and the underlying stock is at $115. You need the stock to move above $125 before the option contract expires. If the stock moves sideways over the next few weeks, you will lose your entire investment since the option will expire out of the money. That's one of the biggest drawbacks to option trading. Whereas in stock trading, you are not going to be hurt if a stock moves sideways, with options, time decay can eat up at your premium very quickly.

Another drawback to options is that there is a realistic chance you can lose your entire investment. If I put $5,000 into Apple, there is an extremely small chance Apple will go out of business and turn into a $0 stock. Now, there is a chance I will lose money, but it is extremely unlikely that I will lose my entire investment.

However, let's say Apple was trading at $385, and I bought the $400 strike calls for at $200 with six days to expiration. I decide to buy ten contracts for a total of $2,000 ($200 x 10). In this case I would need Apple to rise above $400 (the strike price) within that timeframe or I would lose my entire investment of $2,000. Even if Apple were to rise to $398, I would still lose my entire investment of $2,000 since it did not reach the strike price of $400. If Apple did indeed move to let's say $440, but it took three weeks I would still lose my entire investment since the contract would have already expired by then. That's what makes option trading tricky. You need to time it just right.

Why overcomplicate things? Why lose on a trade that goes sideways? Why put all this undo pressure on yourself? Legendary traders like Nicholas Darvas, William O'Neil, and Jesse Livermore didn't need options to become millionaires. Worry about making money in the long-term, not about trying to get rich overnight.

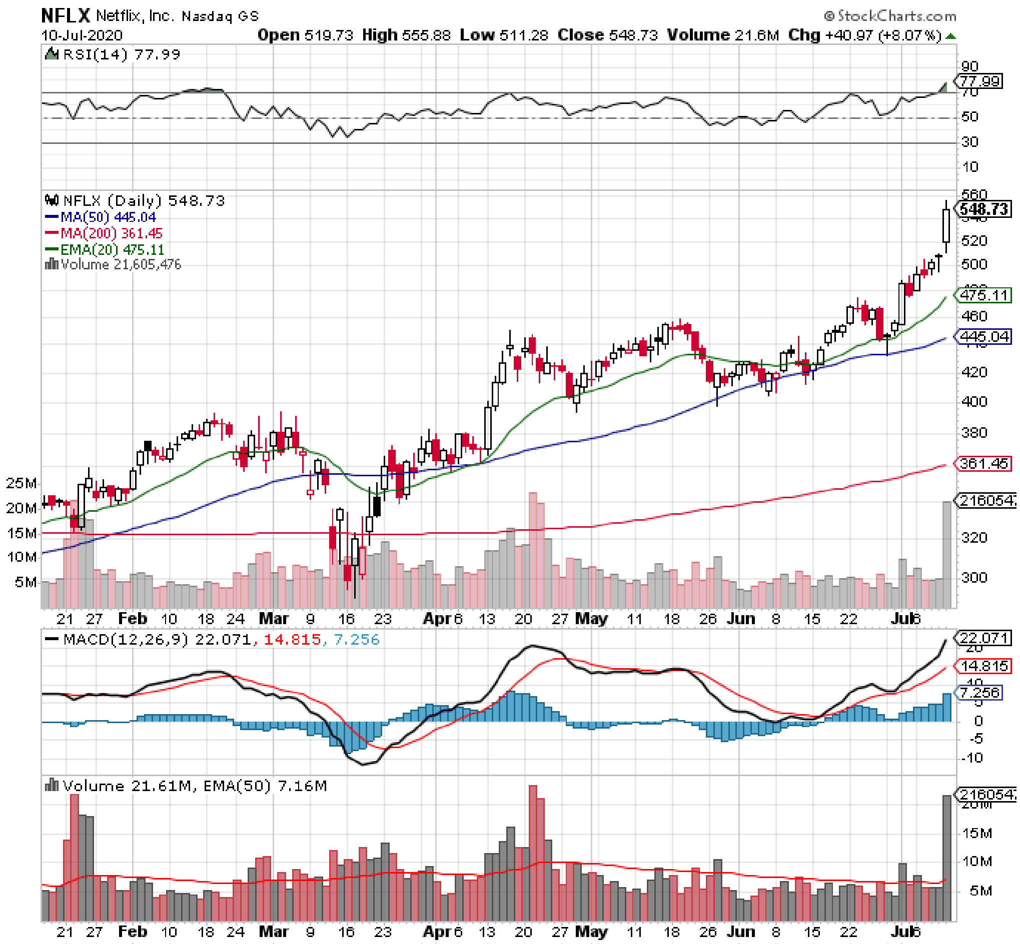
Lesson 11: Look to the Innovators

It can be easy to go to old familiar names. However, the big money is made when you buy innovators. What do I mean by innovators? I mean companies that are revolutionizing the way we do things. For instance, Amazon has changed the way people shop. Zoom has changed the way people hold meetings. Tesla has changed what it means to own a car. These are the companies you want to own.

Wall Street is all about the future, not the past. Because of this, we want to invest in companies that have the potential for massive growth. Finding these innovative leaders really isn't that hard. Think about companies that were not around 20 years ago that you and your friends use all the time.

How do you listen to music? Do you listen on the radio or on Spotify? If you moved from a user to an investor, you'd be quite happy.

How about your favorite tv shows and movies? Did you go to Blockbuster or did you watch them on Netflix?



I'm not advocating blindly buying Netflix, Spotify, or any other company just because you use it. What I'm saying is start looking around at well-known, innovative companies that are changing our way of life. Once you find these companies and combine them with a sound trading plan of entries, exits, and risk management, you will have the potential of extremely large returns in the stock market.

Lesson 12: Moves Can Go On Much Longer Than Expected

One of the biggest mistakes the inexperienced trader makes is thinking a stock must go down because it has recently risen drastically or must go up because it has recently fallen. The truth is, trends can go on much longer than expected. When I say much longer, I mean much, much, much longer than expected. Sometimes, a stock will go on a strong move because the company is doing extremely well or the general environment is favorable for stocks in their industry. Sometimes, a stock will continue to fall because it is deteriorating. Sometimes, it has nothing to do with the company and traders just decide to “throw the baby out with the bathwater,” meaning that they are making the decisions to raise cash and thus are selling everything.

The key is not to predict or try to figure out what is going on. Instead, just stick with the trend. Let the market tell you when to enter or exit. Let’s take a look at Zoom.

I owned Zoom in April 2020. I was told by another trader that it had topped and was due for a reaction. His logic was that it was near the top of the Bollinger Band and he saw a large down day on massive volume. I knew that there was a possibility that he was right, but I must trade with my system and experience. I know that trends can go on much longer than expected and I don't sell blindly. I know that in a bull market, major market leaders can make moves that boggle the mind. Over the next few months, look at what Zoom did.

How about Netflix from 2017? Doesn't it look like it has topped?

Look at what it did over the next year.

Don't overcomplicate things or try to figure everything out. Instead, let the market tell you want to do and stick with the trend until it ends.

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