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Any trades and/or results covered in this presentation are hypothetical trades unless otherwise specified.

-Part 3 – Slide 1-

The Trading Triangle Hawaii
The Art of Becoming a Long Term Successful Trader
Part 3 –Mastery and The Trading Business

Combining System, Business and Psychology to Create Outstanding Results.

John Locke

Locke in Your Success, LLC.

"Know what you want, make it happen!"

-Part 3 – Slide 2-

Mastery

- 10,000 Hour Rule – It takes 10,000 hour of the **appropriate** training, the **appropriate** practice and experience in order to become a master in **ANY** field
- Novice Driver

  ◦40 hours drive time

  ◦10 hours instructor drive time,

  ◦30 hours of classroom instruction

  ◦Pass written and practical exams

- Novice employee

  ◦Four years of college – 2000 hours

  ◦Part time work in chosen field – 1000 hours

-Part 3 – Slide 3-

Average Income Trader

- 30 to 40 hours of classes or training on some sort of directional trading
- 30 to 40 hours of productive experience
- Made average of about 3 to 6 trades on any given strategy before essentially giving up and trying something else (unless day trading)
- Holy grail – Income trading
- Little of this is relevant to income trading. The experience thus far was likely looking for the magic bullet that was going to make you rich rather than focusing on the common critical key elements that were going to make you successful in **any** kind of trading
- Call it 200 hours of somewhat relevant training and experience and 30 to 60 live trades

-Part 3 – Slide 4-

The Dark Side
(Income Trading)

- But we will count these 200 hours anyway as part of the “discovery” process
- 40 hours of education on “income trading”
- 40 hours of back trading
- +20 hour bonus for 300 total hours training
- Pretend we trade the exact same strategy for the next 3 years

  ◦Assume 1 trade per month at 10 hours per trade

    - 360 hours of real experience and 36 live trades

- 300 hours training + 360 hours experience = 700 hours?

-Part 3 – Slide 5-

Compare your 700 hours of training and experience to other fields

- Home inspection
    - Need at least 80 hours of training just so you'll know what to do
    - 75 real, live inspections that follow the system and rules
        - Considered "minimally competent"
    - Additional 250 real, live inspections that follow the system and rules
    - Need to do the same thing, properly 325 times to be considered "competent"
- 36 live trades done exactly to plan is NOTHING when it comes to mastery

-Part 3 – Slide 6-

Average Discussion

- How can I help you?
- Tell me about your strategy, how long have you been trading and what are your results thus far?
- Are you following some type of consistent process?
- How long have you followed this process?
- What's your plan for when your strategy stops working?

-Part 3 – Slide 7-

Average Discussion

- What's your net worth?
- How much is liquid?
- What are your yearly expenses?
- How much are money you going to trade with?
- What are your expectations?

- What are you planning to have for other sources of income?

-Part 3 – Slide 8-

Have you ever run a business before?

- Not a regular pay check
- You must budget carefully
- Poor budgeting and lack of capital are among the biggest causes of failure in **any** business

-Part 3 – Slide 9-

Your Trading Capital

- Must be maintained above a predetermined base level – Golden Goose
- Money cannot be taken out below your base level for **any** reason, in fact it has to be added to
- If you don't make enough money in a particular month or year, your expenses cannot be taken from trading account
- If you take a loss you need to re-fund the account to get back to the base level
- And still have enough left over to pay your expenses!!!!
- You need to be able to do this in a manner where if any of these things occur, you can keep an abundance mindset.

-Part 3 – Slide 10-

So you want to be a full time trader?

- Trading methodology that works and has a track record
- Know the weakness of the system
- Know what to do during times when methodology isn't profitable

    ◦Stop trading?

    ◦Reduce size?

◦Back up methodology?

◦Do you have a way to identify problematic environments?

-Part 3 – Slide 11-

Resources and Liabilities

- Net worth
- Liquid assets
- True expenses, keeping in mind they will increase

◦Taxes

◦Health insurance related expenses

◦Might need to fund retirement

◦Additional business expenses

-Part 3 – Slide 12-

Things to Consider

- Need to regularly contribute to…

◦Regular savings account

◦Account to “rebuild” trading account

◦The trading account itself to increase trading size

- You’ll need…

◦Net worth calculator

◦Personal budget sheet

◦Business budget sheet

◦Cash flow projections for trading business

-Part 3 – Slide 13-

Example

- Current income $100,000
- Trade strategy M3
- Budget $6,250 (spending and savings/retirement allotment)
- Net worth $500,000

◦$250K cash

◦$150K home equity

◦$50K additional assets

◦$100K retirement

◦(- $50K) revolving debt

-Part 3 – Slide 14-

Show Sheets

- Net Worth $500K
- Income/ Expenses 8K

-Part 3 – Slide 15-

How much can he trade with where he has a reasonable chance at success?

- $500K net worth with $250K cash, expenses cut to 5K per month
- Depends on type of trading (Assume typical high probability trades on indexes)
- $100K to 150K Maximum (Assuming stop loss of 10% in monthly strategies)

- Determine the expected M3 strategy cash flow… Average year, good year, bad year
- Determine the rate at which that cash comes in and flows out of the business (10 years live or properly back testing)

-Part 3 – Slide 16-

How much can I expect to make?

- 100K PC on M3 type of trade

  ◦Good year 90%

  ◦Bad year 20%

  ◦Average year 57%

- **Average** $60,000 per year average over time
- That's not enough! Why can't I simply trade with more money?

-Part 3 – Slide 17-

Can I trade with more?

- Could and should are 2 different subjects

  ◦Could use the rest of your cash (150K) and mortgage $100 out of the house and trade with $350K.

  ◦But should you?

  - Situationally dependent

    - What if…

      - Other reliable sources of income?

      - Waiting on a $10,000,000 inheritance and still to live off 5K per month?

      - Are you a true entrepreneur and willing to risk EVERYTHING?

- If your answer to the above is “yes” AND you truly know the trading business, then yes

-Part 3 – Slide 18-

What does this business look like from a cash flow standpoint?

- We now know:
    - ◦Personal net worth/resources
    - ◦Expenses / obligations
    - ◦Average returns of our system and year to year variability
- We need to find out
    - ◦Expected variability of cash flow
        - Need to make a cash flow sheet for the business

-Part 3 – Slide 19-

Buckets

- Personal
    - ◦Emergency Fund
    - ◦Savings
    - ◦Long term expenses
    - ◦Retirement
    - ◦Fun money
- Business
    - ◦Trade account 100K

◦Taxes (budgeted amount based on tax rate – example 30%)

◦Refund account 100K

◦Draw account 60K (assuming 5K personal draw) (when this account is gone it's a warning sign)

◦Short and long term business expenses (budgeted amount based on estimates – example $500/mo)

◦Method for increasing account size (any amount over personal budget goes here after other buckets are full)

-Part 3 – Slide 20-

Results?

- Show the expected income flow for this example
- Show good year
- Show bad year
- The cash flow projections show this business is going to fail

◦Trades larger size – if he has the resources…

◦Trade a more aggressive strategy – Will have larger cash flow fluctuations

◦Reduces expenses

- Remember, this trader has already cut his personal expenses from $8000 to $5000 so he is going to be living off a shoestring budget already

-Part 3 – Slide 21-

Other Things to Consider

- We may have some additional business expenses

◦Additional office expenses

◦Additional trading expenses

- Tax rate could be substantially different than today
    - May be taxed differently than job
    - Tax rates can change
- Health insurance and health related costs can increase drastically when self employed

-Part 3 – Slide 22-

Market Crash

- Have a well thought out predetermined plan with a back up plan

    - Never "improvise" when in highly emotional state, you will do something stupid and may lose much more than needed

    - It is OK to do nothing, wait it out or wait for some sort of hedging opportunity rather than trying to force yourself out of a position (assuming it is part of your plan)

- Realize once crash is underway, often the only viable option you'll have to hedge the position is with futures and even this is not guaranteed (In order to use futures your position size needs to be large enough to take a 100 Delta shift without over adjusting)

-Part 3 – Slide 23-

What about hedging all the time?

- What are you hedging against? (loss of a trade or loss of account?)
    - Delta?
    - Volatility?
- Hedging options positions is not like hedging stock
- Test your method and determine the cost
    - The only effective way to hedge IV is the same or forward month OTM puts

- Very expensive and protection needs to be continuously re-bought to be effective

  - You need to know what to do with the hedge when the market drops

    - Even this method is not guaranteed protection and can be particularly vulnerable near expiration

-Part 3 – Slide 24-

What about hedging all the time?

- Compare cost of hedging against the loss in long term returns VS simply self insuring by limiting trade size
- Remember: The only guaranteed way not to lose money in the market is to <u>not have it in the market</u>
- Note: I do encourage hedging as part of risk management on a situation by situation basis, specifically when position is particularly vulnerable to a normal market move but I do not suggest it all the time

-Part 3 – Slide 25-

What about the “free” hedge?

- Ratio Spread
- Creating a free tent far behind the market

  ◦Going to be expensive reg-t

  ◦With PM is cheap but the money is still at risk, could get margin called

  ◦Early in free trade, the position may not gain money with the hard down move and in fact is likely to add losses to the hedged position, particularly in low IV markets when IMO it is most needed

  ◦Mid trade the position may not gain much value and thus be little protection

  ◦Late in the trade the protection could be fantastic BUT only IF the hedge was close enough to the hedged position AND the market falls far enough for it to be effective

- Is the free tent behind the market a good “trade”? Maybe, it could even end up as a lottery ticket
- Could the free tent behind the market hedge a black swan? Maybe, if your timing is right
- Is the free hedge free? No

- Is the free tent behind the market a guaranteed hedge against your position? Absolutely not

-Part 3 – Slide 26-

Emergency Plans

- Power outage/internet failure
    - Generator
    - Cell phone
    - Alternate locations near you with WiFi
    - A trading buddy who can access your account
- Computer
    - Properly backed up data
    - Alternate computer with all needed software installed
- Analytics/data issues
    - Localized outage
        - Trading buddy that can provide data from another location
    - Widespread outage
        - Have a plan for extended periods of no data
- Platform failure
    - Account at an alternate broker where you can buy positions to offset current positions

-Part 3 – Slide 27-

Disasters Plans

- Total loss of account
  - ◦It will likely never happen but plan for it to happen and know how you will handle it
    - Broker out of business
    - Locked account
    - An undetected mistake
- Serious accident, sickness or death
  - ◦Make sure family knows how to close out positions and/or
  - ◦Contact someone, a trading buddy who can close out accounts
- House fire/flood
  - ◦Data backed up/computer in alternate location

-Part 3 – Slide 28-

Putting It Together

- To be an effective full time trader, long term, you must have:
  - ◦A good process that fits your personality
  - ◦A method for evaluating, adapting and improving your system (APM2)
  - ◦A method for evaluating adapting and improving your performance (APM2)
  - ◦The proper psychology/mindset and a way to monitor and improve it
  - ◦A long term sustainable business model that has:
    - Responsible risk parameters
    - Sufficient capital reserves to deal with the cash flow characteristics of a trading business
    - A focus on growth and system development
    - Good emergency and disaster procedures

-Part 3 – Slide 29-

End Part 3

-Part 3 – Slide 30-

I have been working with John for only a few months and he has already helped me become a much better options trader. I have tried a large number of option income strategies with mixed success. John's butterfly trading strategies produce a very good return with managed risk.

Bryan from IL