CHARLES LE BEAU
DAVID W. LUCAS

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COSTS OF DOING BUSINESS

1

The day trader enters and exits trades during the same market session, normally a period of only four to six hours from opening to close. The very short-term nature of day trading presents advantages and disadvantages to the trader. The major advantages are the lower margin requirements and the absence of overnight risk. The disadvantages are the bad odds, the time and effort required, the limited profit potential, and the burdensome costs of frequent transactions.

The transaction costs consist of commissions and slippage. The trader might have a mental image of trading at the prices shown on a computer screen, but in reality she must continuously buy at the offered price and sell at the bid price. The spread between the bid and offer becomes a substantial hidden cost of doing business. It is also unrealistic to expect stop orders to be filled at the stop price all of the time. The com-

missions are a large and much more obvious cost. In the meantime, to offset these unavoidable costs, the day trader is limited to only very small profits. Under even the most optimistic scenario, the day trader's potential profits are limited to only a portion of the price range occurring within one day of trading.

Let us assume that our day trader is paying $20 per trade in commission, and the spread between the bid and offer amounts to $10 buying and $10 selling. For the trader to complete a trade that nets $100, she must be smart enough to identify a move of $140 on the price screen that she watches. On the other hand, when her timing is wrong by only $140, she is going to lose $180. It doesn't take a Ph.D. in mathematics to figure this isn't an ideal business environment. In fact, even the professionals on the floors of the exchanges must be excellent, highly disciplined traders just to survive. The public does not realize how many of these professionals fail, in spite of the advantage of being on the floor and paying only minimal costs per trade. Imagine how small the odds for an off-the-floor be for an off-the-floor trader faced with the costs we have described.

To have any hope of success, the day trader must strive to maximize the profits on each trade so that he can overcome the tremendous disadvantage of the transaction costs. Unfortunately, the day trader has very little control of the potential profit to be obtained, because the price range during

the day so severely limits the maximum profit to be realized on an average trade. No trader can reasonably expect to buy at exact bottoms or sell at exact tops. A very good trader might hope to be able to capture the middle third of an intraday price swing. This means that to make $180 the total price swing must be three times this amount, or $540. How many futures markets have a daily price range of $540 or more? Very few. How many futures markets can produce a $180 net loss? Almost any of them.

Don't forget, the trader who is smart enough to find markets with $540 price swings and then smart enough to trade them so correctly that he nets $180 is only going to break even unless he has more winners than losers. To make money in the long run, the day trader must have a percentage of winning trades that is far better than 50 percent or he must somehow figure out how to make more than $180 on a $540 price swing. (Or best of all, do both.) This also assumes that the trader is smart and disciplined enough to harness his instincts and emotions and carefully limit the size of the losses.

TOUGH ODDS

As you can see, a day trader is faced with an almost impossible task. We would venture a very educated guess that less than one out of a thousand day traders makes money over any sustained time. Our advice is to not even attempt it. Your time and energy will be much better spent perfecting your