<u>**The Trap versus the True Meaning of Paper Trading**</u>

By Larry Schneider, Marketing Director for Zaner Group (www.zaner.com)

In Part 3 of <u>The Complete Guide to Day Trading</u>, Markus titled the last chapter, "How to Start Trading Without Risking a Single Penny." Of course, he is referring to a paper-trading account.

Trading simulators are everywhere. Their popularity could not be higher. My firm offers three for futures and two for FX trading. But the question is whether these are learning tools or instruments which can sometimes create a false sense of success and bravado. Allow me to illustrate with three anecdotal stories, the first two true, and the last an oft-told fable.

While working as a runner at the old CME trading floor in the 1960's, I paper-traded like all the other clerks. We'd glance at the blackboards as we moved orders between the pits and phone desks and jotted down our "trades" on the same type of soft cards that the floor traders used. That summer I don't think any of us lost. Can you imagine? Nearly every paper trade we made was a winner. I got so cocky that I started "trading" 10 contracts at a time. That is, until one of the senior clerks taught me a valued lesson. I had showed him my cards and my profits for the day, proudly pointing out how I had "bought" 10 contracts near the low of the day.   He asked me, "Why 10 contracts? Why not 20, or 100?" I said that 20 was too many. His comeback was that 10 was too many unless I had the risk capital sitting in my checking account to margin a real-life position of that size. His lesson was: "Paper trade in 1-lots only. It will help keep you slightly *less dishonest* about your paper profits and losses."

Recently, one of our brokers shared with me a conversation he had with a prospect. This gentleman was an experienced stock trader but a novice futures trader. We set him up with our platform designed for day-trading the e-mini contracts. After two days he told our broker that he was up $50,000 and that trading stock index futures online was "addictive."

Trap

Here is an April '08 COMEX Gold futures chart. If you trading without any fear of losses, would you have liquidated your $900 long position when Gold fell to $860, or rode out the 5 day bear market and stayed long until $1,040?

This is a 5-minute bar chart of the June S&P e-mini. If you bought on what looked like an upside breakout, would you have stayed long until 1350 or cut your losses when the market turned down just 15 minutes after you went long?

What does this tell us? For one thing, paper trading is fun. It's fast and furious and the winning positions tend to outnumber the losers. But if you trade, whether for a living or as a serious avocation, you know that it's not so easy. For one thing, real life trading requires real risk capital. Lose $50,000 on paper? Well, the brokerage firm will give you $50,000 more. So just where is the value in using a demo account?

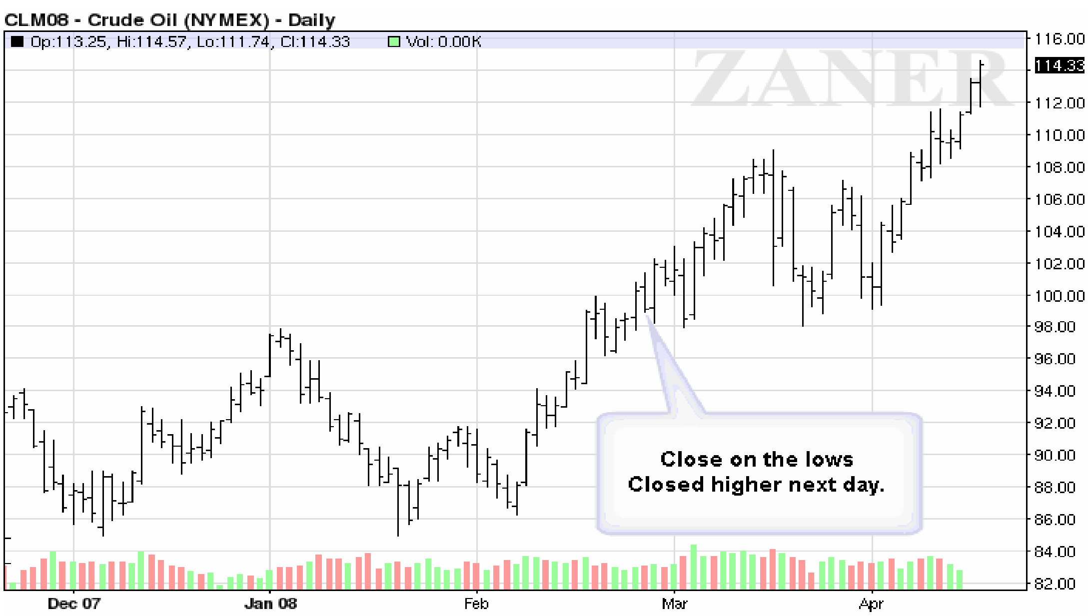
<u>The "best" reason for registering for a demo</u>

Permit me one unusual analogy: Does anyone go to an auto dealer and ask if they can learn to drive on one of their new cars? No. You demo a particular car because you want to see how it handles, where the blind spots are, what special maintenance might be required. Your test drive is to see if a model is right for you. On the other hand, you go to a drivers education school to learn to drive. You might sit in a simulator – it's better than a textbook but you also recognize it's pretend. The same holds for trading. So what are the best reasons for using a demo account:

- You are an experienced trader and you want to test drive the platform. Is a particular platform right for your style of trading? Maybe your current platform makes you cancel orders with a left-click. Perhaps the platform you're mock trading on has you cancel with a right-click. You use the demo to learn the nuances of the platform, not to learn how to trade. Two to three weeks tops and you should know if this is a platform that will help you be a more efficient trader. Imagine owning a Chevy Impala and then switching to a Chevy Corvette!

- You have not traded futures before and you want to get a real-time impression for price volatility. Let's talk about this use in greater detail.

You probably know that Crude Oil futures rose from $87.00/barrel to $111 between Feb. 6 and April 14 this year. But futures do not move in a linear fashion. A realtime simulator would have highlighted the two, short-lived but dramatic reversals during this time period. Furthermore, trading on a simulator on Feb 27 would have taught you that even in a no-argument bull market, on any given day a futures contract can open higher and close sharply lower. This kind of insight is best learned visually, another benefit a trade simulator offers.



Here is an example of what I was referring to. This chart illustrates June crude oil futures closing on the lows but rallying sharply the next day and closing at a high, higher than the previous day's high. A lesson like this is hard to get from reading price tables in a newspaper.

Let me ask you a question. Do you know what the typical bid/offer spread for Crude Oil futures is at Noon versus Midnight? You should, given that the NYMEX Crude futures trades on Globex almost 24 hours a day. Once again, mock trading in a simulator will teach this lesson better than any article.

So my advice to novice traders is to use a demo account as a tool to learn how the markets move – not as a contest to beat the markets.

E-mini Dow, 60 minute bar chart with Bolinger Bands. Mock trading can teach you to adjust your trading strategy from the April 28-29 price action to swings of April 30-May1

<u>And finally, the fable I promised</u>
The circus marksman bragged to the duelist that he could snap the stem of a wine glass at 100 paces. "Remarkable," replied the duelist, "but can you do it when the wine glass is holding a loaded pistol aimed at your heart?"

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