

JIM CRAMER
PRESENTS

10

Commandments

of Trading

Commandment 1: Keep It a Trade

Never turn a trade into an investment.

That's the number-one commandment of trading, and yet, no matter how many times I say it, no matter how many times I scream it, people just don't listen.

When I came up with the Ten Commandments of Trading, which I detail in *Jim Cramer's Real Money*, I did so after analyzing literally billions of dollars in losing trades. Remember, I am a lab — no, I am the lab, because of the millions of trades I have made in the last 25 years and my insanely rigorous method of analyzing any bad trade north of \$5,000.

The sheer magnitude of the sample alone made it worth my while. My tremendous masochistic streak made it doubly worth my while. I would analyze positive trades only when they generated \$20,000 in profit, but anything that generated more than \$5,000 in losses got the microscope, big time.

The commonality of many of those losses? They started out as trades, a stock bought for a specific event, a specific catalyst, and I turned them into investments, because I failed to wipe the trade off the books the moment it got busted. The bigger the loss, the more I rationalized. I would buy the equivalent of a Research In Motion for the era in advance of the quarter. The results would come out, and I would say, "You know, I am really in it not for the results but for the new Blackberry iteration, so let's buy more." I would dig in my heels. I was more likely digging my grave.

Or, I might say, "This time Alcoa's got to get it right. I would put some on." Then the quarter would come out and it would be a stinker, but on the conference call management would say how things were looking up in aerospace. Suddenly, it would be an aerospace play! Buy more!

How do you decide not to go down this path? By declaring right up front that the position is a trade and noting exactly why you are buying the stock and when the catalyst is going to occur. The stock comes off no matter what after that catalyst.

This is a brutal rule. It is so easily disobeyed that we seem to do so instinctively. But if you are like me and you sit there and are obsessed with the losses, you just don't have time to keep disobeying this rule. It's just too darned damaging to your psyche in the long-term.

Start the process today. You buying the Yahoo! (YHOO - news) for the quarter? After that quarter is reported, you skedaddle, no matter what.

Promise?

At the time of publication, Cramer was long Yahoo!.

Commandment 2: First Loss is Best

Good trading, no matter what it's based on, technicals, fundamentals, the stars, the news, requires a level of discipline that goes against human nature. We are taught in life to be patient, to let things work out, not to be hasty, yet none of that works when it comes to trading. You have to be willing to cut and run, to use that "flight," not fight, instinct that we supposedly are born with but suppress wholeheartedly when we are grown up.

That's what the second commandment of trading is about, and that's why it is the second commandment of trading:

Your first loss is your best loss.

I genuinely believe that most trades need to work almost immediately for them to be right. I am willing to put a trade on and take it off immediately even if it doesn't feel right. There's a simple reason why that is so. When I trade, I try to trade for points, or for at least a point. Less than that is too hard.

But if I am willing to have a trade go more than a half of a point against me, then it will be almost monumental to get back to even. So I like to stop myself out quickly.

(Notice how different this all is from investing, where I expect the stock to go "against" me and welcome it so I can improve my basis.)

So, let's say that I bought Starbucks (SBUX - news) Wednesday because I figured the comp numbers would have improved. You have to believe that wherever that stock trades after that number comes out and you have digested it, you are at risk to having a very big loss.

So, you take that first loss. And you move on.

Rather than fight it.

That's how you have to think, every day, about every trade.

Commandment 3: Take Your Losses

It's OK to take a loss when you already have one.

So many investors who call me on my radio or television shows have big losses on stocks. They stay in, though, because they genuinely believe that they don't have a loss until they take it.

That, of course, is ridiculous. It's another flaw of human nature, another flaw that hurts long-term performance.

If we played with unlimited capital, it wouldn't matter that we're hanging on to Applied Materials (AMAT - news) because it once traded at \$30. We could keep our positions in Nortel (NT - news) and JDS Uniphase (JDSU - news) because, what the heck, they aren't that much capital.

But the investing process takes time, inclination and capital that most people don't have. You can't find the next Sears Holdings (SHLD - news) if you are stuck in EMC (EMC - news) waiting for it to come back. You can't do the homework needed to learn Ultra Petroleum (UPL - news) if you are keeping up with the Verizon (VZ - news) and BellSouth (BLS - news) spending plans that could revitalize or trash JDS Uniphase.

That's why I always tell people that it's OK to take the loss, especially if you already have it. The opportunity cost of staying with losers is always either misunderstood or chronically underestimated by investors.

Go through your portfolio. Kick out that AMR (AMR - news) that's been hanging there all these years because you bought it much higher. Sell the Delta (DAL - news) you picked up at \$11 because you thought the asset too valuable to sell.

And start learning new stories. That's the way to make bigger money than you are now.

Commandment 4: Trading Gains, Not Investment Losses

When you mark something as a trade, you should not expect to make as much money on it as you would as an investment. A trade, like buying something into a quarter, is not about trying to make money over a long period of time.

Let's take Apple Computer (AAPL - news). I think that Apple's a good trade into the quarter on Wednesday. I genuinely believe there is enough good news there that this \$42 stock can ramp to \$45.

But if there isn't?

I would be gone either way. I am not going to buy the stock for the quarter and then, if it doesn't work out, switch it into the investment file because I like the Tiger operating system's prospects for next quarter, or because the iPod Shuffle's a really cool gizmo.

And, most important, if it works and the stock goes up the next day, I am not going to say "You know what, this Apple's one good long-term story. I am going to stick it out."

I can't do that, because I had earmarked Apple for a trade before I started it. I can't tell you how many times I have bought something for a trade, had it go up and then held on to it only to lose the trading gain and come up with an investment loss. Hence my commandment:

Never turn a trading gain into an investment loss.

This year, in particular, I am talking to a lot of people who bought stocks for a trade and then ended up carrying them as a loss into the investment column. I recently spoke to one investor who had bought Valero (VLO - news) for a trade on gasoline prices, quickly picked up 7 points, and then rode it all the way back to where he bought it because he decided he "liked" Valero.

What does that mean?

You don't like Valero; you like the profit Valero generated. Never confuse the two.

Or you most certainly will give back the profit.

Commandment 5: Tips Are For Waiters

It's pithy and the interviewers love it, so whenever I'm asked about my new book, Jim Cramer's Real Money, the fifth of my Ten Commandments of Trading comes up:

Tips are for waiters.

"What does it mean, Jim?" they ask. Actually, it means that human nature and securities are a potent and devastating mix. People can whisper in your ear that Nokia (NOK - news) is going to buy Research In Motion (RIMM - news), and you believe, you genuinely believe, because you want the big score. You know that the best moves are takeovers and you are convinced that if you can catch one, it will make up for all the bum steers and bad bets you have made. Tips are winning lottery tickets in most people's eyes.

That's the reason I've had to default to a simple analogy, tips are for waiters, to remind myself how stupid tips really are. Does it occur to you, on hearing the tip, that if the person telling you that Nokia is going to buy RIM really knows that's going to happen, the person is an insider and is breaking the law, and you could get in trouble, too? Does it occur to you that if the person isn't an insider, he doesn't know? There simply is no way a tip like that can work. Leave it for the waiter.

It gets more sinister. Most rumors start for a reason: Someone's in a bad position. Instead of thinking, "Sure, Cisco (CSCO - news) is going to buy Nortel (NT - news)," after you are given that particular tip, you should be thinking "Man, is this guy wearing a ton of Nortel and what won't he do to get rid of it."

I know that cynicism isn't a particularly positive attribute, but when it comes to tips, it sure is. Leave them for the waiter.

Commandment 6: No Sale? No Profit

The game's tough right now. So tough that you have to be thinking, "It's just not worth it. When 50,000 people close accounts at Ameritrade (AMTD - news) in a quarter, you have to know that you aren't suffering your misery all by your lonesome.

It's always that way when you are rooting for bad news. It's always that way when you are playing defense.

This is one of those moments when people are looking at some rather huge gains in sectors that may be giving way and they don't want to ring the register.

All of you in that situation, I want you to remember one of my most important Trading Commandments:

You don't have a profit until you sell.

The way this market looks right now, if you have a big gain in one of these heavy cyclical stocks, you need to think about whether that gain is going to get wiped out or not.

Let's take Phelps Dodge (PD - news). I genuinely feel that those who bought Phelps Dodge in the \$60s and \$70s believe that they are so far away from where they bought the stock that they have the gain. You do not have the gain until you take it. And some needs to be taken.

If we truly are in rotational hell — which I think we are, by the way — you have got to take some of the cyclical winnings off the table, you just have to. Right now, right here.

Stop thinking that you have it in the bank. Instead, put it in the bank. And accept the fact that the offense has made about all it can here and you have to be defensive to play the next move correctly.

Commandment 7: Control Your Losses

Losses do you in. They always do you in. Controlling losses is the most important thing you can do. I don't really care how you do it. If it is to put on stops in trading, then so be it. If it is to decide that you are never going to let a position run a point against you, then fine. But you must heed the seventh of my 10 Commandments of Trading:

Control losses; winners take care of themselves.

Let's say you bought Apple (AAPL) for a trade. As soon as that number comes out, that's the trade, for better or for worse. If you own it the next day, you are making an investment, and you didn't buy it for an investment. The loss must be taken.

It's the same if you buy IBM (IBM) today because you think it is down too much. You have to stop yourself out at \$79, or else that, too, becomes an investment, and an investment by default is a very vulnerable place.

What's amazing about loss control is that it works in every season. Loss control would have saved you a fortune back in 2000. Loss control would have gotten you out of pharma much higher, only to get in now, when pharma's finally right.

The only time loss control doesn't work is when you are picking a position as an investment to start. Then you are rooting for the market and the stock to go down, so you can buy it right. Loss control there means that you don't buy too much at one level so that you don't find yourself under water big and then helpless as the stock rallies because you didn't buy any stock at lower levels to trade around with.

When I review portfolios, I constantly see those that are rocked by one position. In other words, someone let one bad position go against them and go against them and go against them some more. That's because the person didn't recognize that you must be an activist about your losses; you must recognize them, remove them, contain them.

If you do, you will be shocked at how often the good positions will make you fortunes that don't get taken away.

Commandment 8: Don't Fear That You Will Miss Anything

We always fear that we will miss the next move. We fear that unless we act now, something is going to happen that is going to injure our finances permanently if we don't make a trade.

Those fears are wrong, and they're the reason for my eighth commandment of trading:

Don't fear missing anything.

Sure, there are moments where the train genuinely feels like it is leaving the station without you. But you know what? I have been trading for 25 years, and believe me, there is always a train behind that last one.

Two weeks ago, for example, it was impossible to stand on the sidelines and watch the oils go up without you. But the oils had been moving up for 18 months; what you were witnessing was more of a buying panic than anything logical. Now these stocks are down huge and nobody wants them. If you feared missing the next move in oil, you might have bought then and no doubt are selling now.

That's the reason this impulse must be controlled.

We have seen it happen endlessly in tech over the last few years. One company would report a good number, say, Yahoo! (YHOO - news), and the market would take up all other Net stocks without thinking, including those of companies that Yahoo! was killing!

That was the fear instinct at work again. Invariably, people who acted on it lost money.

What I like to tell myself is, "OK, I missed that Yahoo!. I should have bought it yesterday. Now, rather than play catchup, I will just work harder to find the next Yahoo."

Control your instincts. There is always another train. Never forget it.

At the time of publication, Cramer was long Yahoo!.

Commandment 9: Don't Trade Off Only the Headlines

If I didn't know any better, I would think that headlines are written to pick off errant traders who don't know enough. Watch tonight, watch when Intel (INTC - news) reports. I guarantee you that whatever headline is written for the competing wire services, it won't tell you what to do. If anything, it will throw you off the scent.

That's because the headline writer's job is antithetical to the process of investing and trading. You trade when you have knowledge of outlook, but the outlook comes out after the raw number, which isn't enough to trade on.

That's why I always say (and why my ninth Commandment of Trading is):

Don't trade headlines.

Wait for the story. Believe me, you will rarely, if ever, make money if you do nothing but react to the headline.

How bad can it be? Consider Apple (AAPL - news). I think that, looking back on the headlines after that company reported, you most definitely would have taken stock rather than sold it, because the headline was written with insufficient information.

Wait for the story. Don't trade the headline. Resist the quick trigger. You will do much better and generate far more winning trades this way.

Commandment 10: Don't Trade Flow

Watching the tape is a loser's game, unless you remember that there are sellers as well as buyers at work. I point this out because I really and truly think that most people see "takes," or buys of stocks, and they want to go take those stocks themselves.

Wrong!

Trading flow, trading off of takes or hits, is dicey for even a seasoned professional. Most of the time when you see flurries of buying, it's Wrong! That's the reason my tenth trading commandment is:

Don't trade flow.

Recently, I saw takes of Morgan Stanley (MWD - news) all the way up to \$60 off of news of some defections. The stock just snowballed as the "crowd," which is almost always wrong, figured something big was going to happen.

It sure did. The big happening was that you caught a couple of downgrades as the Street recognized that real revenue producers were abandoning the stock in droves.

Lots of times, the tape reveals sucker plays. Lots of times, people just take because emotionally it feels right. If I were you, I would turn off the ticker. Unless you are a junkie like me and just like to see the ebbs and flows, it really is a meaningless exercise at best and a losing one at worst.

Don't be sucked in.

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