

The Essence of Trading Profit: Buy the Discount and Sell the Premium

It is worth reminding you of the strategic basis for making profits by trading in financial markets. In fact the basis for profit for any trading business whether it is in financial markets or in any other medium is to buy the discount and sell the premium. In any business not only do you have to buy well but also you have to sell well, hopefully at a price marked up much higher than you bought at.

This article is not directed to investors whose legitimate purpose is to buy and hold. Selling does not really come into the equation for an investor. But a trader is always alert for the opportunity and the necessity to sell to book the profit. In fact a professional trader would look prospectively to where he or she can sell before they implement the buy. A competent trader is always looking for a discount to buy and a premium to sell.

In essence the mission of a trader is to buy just after the discount is evident and sell just before the premium occurs to capture as much of the move between discount and premium as possible. Sounds easy! Yet although it is difficult to accomplish it can be done and is done by successful traders who are deservedly well rewarded for their effort.

Of course the reverse is true for trading the short side. Here you sell to open your position at the premium and buy back at a lower price, near the discount. For simplicity I will work with the long side for the remainder of this article.

An everyday phenomenon

Unfortunately most people who attempt trading do not achieve consistent and growing profits. Nevertheless what I am talking about is part of your everyday experience. Let me give you an example.

The price of petrol at the pump is not static over a week. At my servo petrol is the cheapest, that is most heavily discounted, on Wednesday afternoon. Drivers queue up for petrol all Wednesday afternoon because they know the price will shoot up on Wednesday night by about 10%. The servo is deserted on Thursday and trade picks up from Saturday morning when the price gradually declines until next Wednesday afternoon. The public knows that the best time to buy is at the time of maximum discount and plans accordingly.

Wouldn't it be wonderful if the petrol cycle between discount and premium was so obvious and regular in financial markets. Your purpose in buying petrol and financial products are different (you buy petrol to burn; you buy financial products to profit). However this example illustrates the basis for buying well. If you do it in everyday life then you should be able to adapt to the challenges that trading financial markets present.

The analytical challenge

To identify discounts and premiums in financial markets you have to watch price action.

The precursor for the formation of a discount is a decline in prices. But I am not saying that you buy just because the price is plummeting. Remember that if you buy a stock 80% below its peak and it falls further to 90% then you have lost half the capital you put into the trade. No, the analytical challenge is to identify the formation of the discount where there is confirmation the price is beginning to climb again.

There will be scant information that this is a discount, but enough for the trader to take action to buy some. The only thing that will confirm that this is indeed a discount will be prices moving up further as time goes on. And as it moves up it is building towards a premium.

After buying close to the discount after it forms, the analytical task for the trader changes. You are now looking for signs that a premium is forming so you can unload your position for a profit.

The psychological challenge

Psychological issues with respect to trading successfully emanate largely from the uncertainty about the future. Unlike the regular discounts that apply to the petrol market as we saw beforehand, the only thing we know is that discounts are followed by premiums which are followed by discounts and so on. The way each discount and premium forms together with the way markets move between discount and premium is variable.

The unfolding of price action in real time is the key, rather than your wishes about and expectations of the future. So you have to act according to price action, and it is uncertain.

Impulsiveness is a killer. Buying a falling market to pick the bottom before it occurs will chew up your psychological and financial capital. You have to wait patiently for evidence that the discount you have been anticipating has been formed. When the evidence is there you execute your buy immediately. Then you have to wait to see what happens. Patience is a primary characteristic for a successful trader.

To circumvent entry just as the discount has formed there is the temptation to wait for further confirmation. Procrastination is another killer. By hesitating you are saying that the uncertainty about the future price action is too daunting for you to handle. Of course the discount could falter and price recommences its downward journey. If this eventuates you simply exit the trade and wait for another entry, perhaps at a lower price. You are not trading your for ego or the need to be right, you are trading for profit.

By waiting for more information about the ascent of prices before you buy so that you feel the trade is 'safer', you will be buying closer to the premium and thus you are reducing the profit potential of the trade. In reality the quest for safety by delaying your entry is unsafe. Safety stems from your ability to act decisively and promptly on the price evidence the market is offering you.

Psychologically, work is not over even if you timed your entry well. As prices escalate upward there is the tendency to take the profit early just in case the price swings down again. If price does swing down, then do take the profit. But stick with the winner as long as it continues to extend the win.

In saying this you have to guard against complacency however. You might be feeling good about the trade. However prices will not go up for ever and anyway will move irrespective to what you think of feel. A premium will form sooner or later and you do have to take a profit. You must be vigilant here and not be tempted to take your eye off the ball. Remember selling close to the premium is essential for profit. Sudden sharp pull backs occur and will cause damage if you are in a heavily leveraged position.

The procedural challenge

What is the best way to go in buying discounts and selling premiums?

Initially you have to define your time frame. If you trade within a finite time frame such as a within a day or a week your task is to catch a significant proportion of the major move within that time frame.

If your approach is more open ended such a trend trading (higher discounts and higher premiums) then you have to decide whether you will trade the swings consistent with the trend, as well as the swings against the trend or the trend as a whole. The highest probability of success is to trade swings with rather than against the trend.

Consider this generic model. If you identify a discount why not immediately put a ‘tester’ into the market? That is buy a fraction of your total position. If the consequent price action deteriorates get out with a tiny loss. But if consequent action confirms your ‘tester’ then quickly and progressively load up to full position for the particular trade. As the price action continues upwards then sell down your position a bit at a time to book profit so that when the premium does occur you are holding a small fraction of your original position into the down move, if any at all.

This model is not mandatory and is just a template from which you can adapt to create your own trading style. Within your approach you have to quantify and develop procedures that are compatible with your personality and experience as you develop your trading business.

Conclusion

If you are not achieving consistent and growing trading profits now then you must not be doing the essentials as outlined in this article. You are probably closer to buying premiums and selling discounts and you will never prosper as a trader doing that.

Everybody has the same information about the flow of prices in the market. Discounts and premiums are there for you to identify as much as the best professional trader. It doesn’t really matter how you identify discounts and premiums. While there is a whole arsenal of methods available: technically, quantitatively or qualitatively based, it doesn’t take that much if you are alert to look out for them. The process can and will become intuitive.

What does matter is how you put the information about discounts and premiums to use. If you flawlessly and consistently buy just after discounts and sell into premiums you must profit.

The market is inviting you to learn the skills and procedures to profitably engage with it as it oscillates between discount and premium.