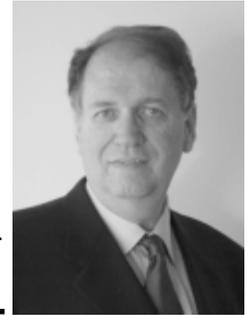


# Market Mastery



Putting Peak Performance to Work for You

## Peak Performance Trading Tip

By  
Van K. Tharp

These trading tips will help you get yourself in the best possible condition mentally to perform at a peak level. They are not necessarily new, but they are critically important.

So whether you've heard them before, or not, now is the time to employ them in your trading and in your life. Both will improve as a result.

### Tip #53: Market Selection is Very Important

I've long said that entry is not a very important part of a trading system. It's probably 5-10% of the system at most. However, there is an area (that sounds a lot like entry) that is very, very important. I call that particular area, Market Selection. But what do I mean by Market Selection?

Market Selection means finding those markets where the

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## How To Avoid Being Mislead by Advertising Hype

By  
Van K. Tharp

Within the past month, I've come across at least a dozen examples of trading system claims which seem almost too great to be true. And they are! In fact, whenever these claims are reframed as risk-to-reward parameters (what we've been calling R-multiples) an entirely different, and much more accurate, perspective arises.

I recently played the following game which was meant to simulate options trading. The game had 10 marbles in a bag. Seven marbles were 1R losses; one marble was a 1R win; another marble was a 3R win; and the last marble was a 5R win. Thus, it only had 30% winners, but the losses were limited – both of which are typical of options trading. If you add the R-multiples up and divide by the number of marbles, you end up with  $(-7R + 9R = +2R)$ . In other words, the sum of the R-values in the bag is 2R. Since there are 10 marbles in the bag, the expectancy of that game is  $1/10^{\text{th}}$  of that or 0.2R. This means that on the average, over many trades you would make 0.2 times your risk per trade. It's

not a great system, but it is not bad for this market climate.

In our game, the participants each started out with \$100,000. I asked them to simulate buying options contracts that we assumed would cost \$500 each. Thus, for each marble pull they could risk multiples of \$500 up to the maximum amount of their equity. So one contract would cost \$500, and 20 contracts would cost \$10,000. Thus, the game was somewhat realistic for options trading. We assumed that they would either lose 100% of their investment, or they would have a nice return of 100%, 300%, or 500%.

In our game, we had 30 marble pulls. The marbles were replaced after each draw. Thus, the expectancy was the same, 0.2R, for each marble pull. Approximately 200 people played the game and the final equities ranged from \$0 to \$386,000. My guess is that over half the audience lost money, playing the game, but I didn't have time to survey the entire audience.

What I usually say about such a game, is that "everyone got the

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## Market Mastery

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same trades, but the final equities were all over the place. And this huge variability of performance was only due to two factors – position sizing (how much was bet) and psychology.” That statement, of course, was true. Another lesson was that our sample pull had a positive expectancy, but over half the audience lost money. Again, this was a true statement and is pretty common for this sort of game. However, what I’d like to show this month is how one might distort the results of this slightly positive system to make it seem spectacular. Table 1 shows a distribution of the 30 marble pulls (see page 2).

If you look at the last row, you’ll see the R-multiple totals for every ten trials. And if you total all three columns, you’ll get the R-multiple total for the game. That total was +4R.

When you divide 4R by the total number of marbles, you get the expectancy of our sample which is 0.133R. Thus, our sample expect-

ancy isn’t quite as good as the over-all game. Nevertheless, it is pretty typical for options trading. We had 7 winners out of 30 which is 23.3% accurate. If you had risked \$500 for each of the 30 trades, you would have made \$2000.<sup>1</sup> This is a realistic assessment of its performance.

At this point, let’s look at our system. First, it wasn’t too bad. It probably did better than most traders did in 2002. You made 4R, so if you’d risked 1% on each trade you would have made about 4% for the trading period. At the same time it was by no means sensational if it represented a year of trading. Most of you might not be willing to risk your money on that system. However, what I want to cover in this article are twelve ways that you could represent this particular track record to make it look sensational. And, of course, our point is *that you must know the expectancy of the system you are trading*— whether it is your system or someone else’s system—to

**Table 1: R-Multiple Distribution of Our Game**

1. 1R Loss	11. 1R Loss	21. 1R Loss
2. 1R Loss	12. 1R Loss	22. 1R Loss
3. <b>3R Gain</b>	13. 1R Loss	23. 1R Loss
4. 1R Loss	14. 1R Loss	24. <b>5R Gain</b>
5. <b>5R Gain</b>	15. 1R Loss	25. 1R Loss
6. 1R Loss	16. 1R Loss	26. <b>5R Gain</b>
7. 1R Loss	17. 1R Loss	27. 1R Loss
8. 1R Loss	18. 1R Loss	28. <b>5R Gain</b>
9. <b>3R Gain</b>	19. 1R Loss	29. 1R Loss
10. 1R Loss	20. <b>1R Gain</b>	30. 1R Loss
Total = +4R	Total = - 8R	Total = + 8R

<sup>1</sup> Of course, you need to subtract slippage and the cost of trading which might be \$60 per trade. That would total \$1800 and give you a net profit of \$200.

*avoid getting taken in by these misrepresentations.*

### **Finding the Optimal Position Sizing.**

The most honest way to show this method in a good light is to use optimal position sizing. If you were to simply find the optimal amount to risk for this sample, it would be about 3%. And the net result would be that you would have a gain of \$6,226. In 2002, the SP500 was down by 23.5%. Consequently, you could use the typical mutual fund type of advertising and say that:

#### **(#1) We beat the SP500 by nearly 30% in 2002.**

However, there is an even better way to get a terrific sounding result. We could simply use a fixed number of option contracts throughout the game. Since it comes out with a positive number, the larger number of contracts you pick, the better you will do as long as you have enough to survive the biggest drawdown. You can see from the sample that the biggest drawdown occurs at the end of marble draw 23. At that point, you are down a total of 7R. If you were trading 24 contracts at a time (i.e., \$12,000), you'd be down \$84,000 at this point<sup>2</sup>. On the next trade, you'd gain 5R or \$60,000 and only be down \$24,000.

At the end of all of the trading, you would be up 4R. You can simply multiply 4R times \$12,000 (i.e., the value of 24 contracts) and you would be up \$48,000 at the end of the 30 trades. Thus, a hot promoter would simply advertise this system

as being up 48 % on the year. That's a far cry from being up \$2000 less commissions, but no one would ever get to the point of being up 48%. Why? Because you'd have to tolerate an 84% drawdown before making that 48%. Most people would stop trading way before the three 5-R trades came up.

There are a lot of ways to distort the system performance that don't have anything to do with possible portfolio performance. Instead, they have to do with looking at some other aspect of the results and emphasizing that. Let's look at a number of them.

#### **Using the Percentage Gain.**

Promoters frequently capitalize on the size of the gain produced. For example, what if I said,

#### **(#2) If you traded our system, you made gains of 100%, 300% and 500% all in the same day. Yes, it's possible to do that. Plus, if you did that day in and day out, just think how much you could make in a year.**

What happens when I say that. Chances are you get very excited. You think about your entire portfolio going up 300% or 500% several times each day. It really gets to the greed in people. It really excites those people who know the least about trading and who want to make back all of the money they've lost in this bear market.

And, of course, someone might add a statement like the following to the commentary:

#### **(#3) If you were do so that every day, you could make a million dollars, or perhaps even more, trading this year.**

Of course, this is about as likely as winning the lottery, but the key word in promoting this is to say, you could. That just means "it's possible." And, of course, almost everything is possible.

The problem with putting the results within the framework of the percentage gain, is that it has nothing to do with the gain in your portfolio. The only way you could have gains in your portfolio of 100%, 300%, and 500% day in and day out would be to risk everything in your portfolio on every trade – and that's a prescription for sure disaster. When the first loss occurs (i.e., on trade one), you are bankrupt.

These statements basically totally ignore position sizing. You are going to lose 100% on 70% of your trades. As a result, it is critical that such results be reframed in terms of R-multiples. What is the reward to risk ratio of the trade? Well, obviously, the 100% gain that seems so great is just a 1R return. The 500% return, which seems awesome, is really just a 5R return. If you bought a \$20 stock, with a \$1 stop, and the stock went up 25% to \$25, you would also have a 5R return.

I recently read every issue published last year of a newsletter that I find to be excellent. Although the editor did not publish a portfolio showing each individual trade with the amount gained, he did indicate that his own portfolio (trading similar items) was up over

<sup>2</sup> You could only afford one more \$12,000 trade at this point, so it must be a winner. And, you are now risking 75% of your equity to get it.

*“...you must know the expectancy of the system you are trading—whether it is your system or someone else’s system—to avoid getting taken in by these misrepresentations.”*

20% for the year – which was tremendous in 2002. That’s how much I respect this newsletter. Nevertheless, during the year I could not help but laugh at a discussion of a closed out trade in which the editor said, “We did really well with that trade because we were up 80% in it.” Sounds really good, doesn’t it. However, the editor had a 50% trailing stop on that particular trade. When you make an 80% gain and you were risking 50% to begin the trade, it translates into a 1.6R gain. That’s not that impressive if you were only risking a reasonable 1% of your portfolio on the trade. It says to me that “we’ve just closed out the trade and added 1.6% to our portfolio.” That sounds a lot different than saying we’ve made 80%, doesn’t it?

### **Focusing On A Few Trades**

A strategy that is even more distorted is to simply concentrate on a few trades in the sequence. In our game sample, of course, a great promoter would concentrate on

trades 24 through 28. And in doing so, one might hear:

**(#4) Three out of five of our trades made 500%.**

That sounds really impressive doesn’t it? You start to think, “Wow, I make five times my money in 60% of my trades!” Greed starts to sink in, but what you don’t know about is the overall

distribution of trades, the R-multiples of the trades, or the expectancy of the system. In reality, over thirty trades, you were behind 7R when the first 5R came up. You needed the first two 5Rs draws just to bring the system to positive. And the whole profit of the system was because of the last 5-R trade.

You could also focus on just the winners and do the same thing. For example, you might start saying.

**(#5) Trade AC<sup>3</sup> generated 300%**

**Trade AE generated 500%**

**Trade AI generated 300%**

**Trade AT generated 100%**

**Trade AX generated 500%**

**Trade AZ generated 500%**

**And Trade BB generated 500%**

**Isn’t that amazing—6 out of 7 winners generated at least 300%?**

Notice how enticing the advertising sounds. It’s almost too good to be true, and it is because it doesn’t mention expectancy or the R-multiple distribution at all.

### **Focusing on Probability**

Another way you could emphasize how good the performance was would be to emphasize the probability. The probability was terrible in the direction of the expectancy, but here’s how the advertising might read:

**(#6) If you had shorted our picks, you’d have made 100% in twenty-three out of thirty trades.**

Or how about this one...

**(#7) If you had shorted our picks, you’d have had 11 straight winners.**

Or one last possibility

**(#8) Our short picks were right 76.7% of the time.**

Notice that all of these statements sound promising. The reason is that we like to be right and equate it with winning. But probability is not equal to expectancy. In fact, the expectancy of this system, when shorted, is NEGATIVE.

### **Focusing on the Amount Risked**

Another interesting way to phrase performance in this system is to focus on the amount won versus the total amount risked. Let’s look at the example we used earlier when we risked \$12,000 per trade. Here’s how you might phrase that one to make it look really good:

**(#9) We started with \$12,000 and were up \$48,000 at the end of the year.**

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3 Rather than using trade numbers, which would give away how many trades there were, I used symbols (like stock symbols) to name the trades. Thus, you have no idea how many trades were actually made.

Notice that the statement is accurate – in this case the first risk was \$12,000 (every risk was \$12,000). In addition, the second statement was correct – they did end up with \$48,000 on the year. However, the conclusion that one might draw from the two statements was the system made 400%. However, that wasn't the case at all. To get these figures, we had a \$100,000 account and risked \$12,000 (i.e., 12%) on every trade. We suffered an 84% drawdown to get a 48% gain. That's a long way from being up 400%, but that's what people think when they see the statement.

You could even do this fairly ethically by starting out with a \$1.2 million dollar portfolio and only risking 1%. In this case, you'd only be up 4% on the year, but you could still reframe the results by making the statement that we started out with \$12,000 and were up by \$48,000 at the end of the year. Quite interesting, isn't it.

### **Focus on One Single Aspect of the Results and then Extend It**

One of the other examples I often see is to simply focus on the possibilities of one trade. For example, let's focus on trade BB.

**(#10) When we traded BB, we made 500%. Just think about it, 500% in a single day. That would amount to a return of 182,500% in just one year. That means that if you just started out with \$600, you'd be a millionaire in just one year.**

While those statements take our results to an extreme, they are still

accurate when you interpret them in a certain way. However, the interpretation is very misleading in that it doesn't represent the R-multiple distribution at all.

Here is another possibility:

**(#11) The average gain of the system was a whopping 385.7%. Imagine making 385.7%, on the average, every time you win with this system.**

If you add up the percentage gain for each of the seven winners and divide by seven, you get an average gain of 385.7%. Thus, the statement is totally accurate. Of course, from this statement you don't know that your average loss is 100% and that you only win 23% of the time. Your assumption is that your portfolio goes up nearly 400% every time you trade.

We could be a little more accurate by showing that the 30 trades occurred on one day and showing the returns of the entire 30 trades. In that case, you might say:

**(#12) The data showed that if you had invested a nominal \$2000 in every trade, you would have made \$8000 in a single day. If you could do that every day of the year, you could make over \$2 million. That's \$2 million by just investing \$2000.**

Remember that our total gain is 4R for the 30 trades. Thus, if we risked \$2000 on each trade, we would gain \$8000 over the 30 trades. This is an accurate statement. However, we are then taking a short term gain (i.e., these

result occurred in a day) and assuming that the results will continue over time. There are 260 days in the year and if you multiply 260 times \$8,000, you get this incredible result of making \$2,080,000. And, of course, there is never any guarantee of that. Furthermore, no commissions or slippage were taken into consideration in these results.

### **Bottom Line: You Must Pay Attention to R-Multiples and to Expectancy**

So far in this month's *Market Mastery*, we taken a simple result from a simulated option trading game, and shown what someone can do with clever manipulation of the results. We then presented twelve different headlines that one might make as a result of these manipulations. And they made the results look really impressive. Each one might be called a reframe, because the statements make the reader look at the data from a positive framework.

To protect yourself, I suggest that you always do the following seven steps whenever you see or hear anyone making a claim.

1) When you look at investment data, always ask yourself, "What is the risk to reward ratio is this trade? Am I being deceived by percentages, when the risk reward ratio is really quite small?" In other words, a 60% gain when compared with a 50% initial risk is only a 1.2R gain. **When you do this, imagine that a 1R gain only represents a 1% gain in your portfolio.**

2) Also try to determine what the entire distribution of R multiples might be. That would give you the clearest representation of what you might be dealing with in these results. If there is a high R-multiple, how rare is it? How much of the track record depends upon one rare trade? Do all of the R-multiples (both positive and negative) sum to a positive number?

3) *What is the expectancy of the system?* If you have the sum of all the R-multiples, you can simply divide by the number of trades to get the expectancy. Is it 0.5R or higher?

4) *Does the sample of R-multiples make sense?* Think about what is being done with the trading system. How does it trade? Are the stops tight? If so, you might expect high R-multiple winners, but not very many of them (i.e., perhaps 20-30% correct). Are the stops wide or non-existent? If so, then you might expect very low R-multiples, but perhaps a much higher percentage of positive trades. In other words, find out something about the way the system is trading and see if the R-multiples make sense based upon what you know.

4a) As a corollary, a very important question to ask yourself is, *“Have we seen the largest losing R-multiple that might be generated by this system?”* In our system, the answer was “yes” because we are taking 100% losses as 1R. But what if you had a system with tight stops and your largest loss was 1R? Chances are, under those conditions, that you have not come close to seeing the largest possible loss.

5) *Does the R-multiple sample represent the system R-multiples?* If the system is logical, then you must decide if it is representative of the system? If you have several hundred trades, then you may have a fairly good representation. However, if you have only 30 trades, as we did, then your sample may be way off. For example, our sample expectancy was only 0.13R, while the population (i.e., the marbles in the bag) expectancy was 0.2R. We had four 5-R trades, suggesting that this might occur 13% of the time, instead of 10% of the time.

In general, half of your samples will have an expectancy that is bigger than the system expectancy and half of your samples will have an expectancy that is below the system expectancy. However, the larger your sample is or the more samples you have, the closer you will come to knowing what to really expect from the system. As a result, you can easily see that taking one possible trade and using it to explain the system tells you absolutely nothing about what to expect from the system.

6) You need to ask yourself, *how many trades does this system generate per month? And what's the approximate monthly return if I risk 1% per trade.* In our example, our system actually looks very good here. It generated thirty trades in one day, making about 4% on a 1% risk per trade. This means, if you could play it every week, you might make about 20%. And every month, you might make 80%. Suddenly, a very weak system could be impressive, because this time we are making 80% re-

turns on the entire portfolio every month.

If those same 30 trades took one year to generate, then the return of 4% per year would be very weak. However, it did outperform the stock market last year.

7) Lastly, you need to ask yourself, *“What is the cost of trading this system? How much slippage can I expect per trade and how much will it cost in commissions?”* Our last example did not include trade costs. Let's assume that slippage and commissions average \$30 per trade – that is \$30 to enter the trade and \$30 to exit the trade. That amounts to a total cost of \$60. In the last example, we traded two contracts in each of the 30 trades, so our total cost is \$3600. Now our \$4000 profit in the last example becomes a \$400 profit or 0.4%. This means you'd now make 2% per week or 8% per month. It's still excellent, but it's no longer “too good to be true.”

The bottom line is **to be realistic in your trading expectations.** And by following these seven steps, you should be able to do that.



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Peak Performance Tip Continued from Page One

action is going to be for the next five to fifteen years. You need to know what is going on, on a macro-economic scale. There are many, many different types of markets, and you need to know where the action is. When I first started coaching traders, I would appear on the Financial News Network in Los Angeles. And despite the fact that my interview was broadcast to millions of investors all over the country, most of the people who contacted me were commodity and option investors. Why? That was where the action was. That's where most of the professional speculators were. We'd been having a huge inflationary period and commodity prices were in major trends. If you understood basic trend following principles and position sizing, you could make a fortune in futures contracts and many people did. Gold, silver, grains, oil, and many other commodities all had huge trends. And ironically, very few of my clients were equity investors even though a primary bull market had begun in equities in 1982.

Two major bull markets, each lasting two decades began in the early 1980s. The first one was in U.S. stocks and the second was in U.S. bonds. Neither one was very glamorous at the beginning. And by the time the public becomes aware of them, you have at most a few years left before switching to something else.

By the early 1990s the party was over for commodities. Most of the money was controlled by CTAs (commodity trading advisors) and those markets were not very big.

The huge trends had stopped and when a trend ended there was often a huge counteraction because of all of the CTAs getting out of their positions. Those who survived in the CTA business tended to do so because they were now in currencies. You could trade currencies as a commodity at the CME or CBOT, but the big markets were now the FOREX markets. A new trend had arisen. I remember a good friend of mine who simply started using his commodity trading methods on foreign currencies. His big advantage was that he had 24 hour data when few others had it. And within a few years his money under management went up ten fold. His performance was okay, but he had found the hot area at the right time.

The next major market emphasis was the huge emerging markets in Asia. Mark Mobius became famous for his prowess in making a fortune in the emerging market boom in countries like Singapore, Malaysia, Hong Kong, Thailand, South Korea, etc. If you were there at the right time, there was a fortune to be made. And those who did so carved their niche in investment history. But it was short lived. I gave a series of talks for Dow Jones in Asia in 1997. When I returned from that trip I wrote about the potential danger in Market Mastery. A major crash ensued in those markets after that.

While all of this was going on, we still had a major bull market going on in the United States (and in European stock markets). By 1999, most of our clients were stock market clients. Electronic day trading became the thing to do.

And the first electronic day trading book sold about 125,000 copies – a huge bestseller for a financial book. McGraw Hill asked me to write a day trading book because they said it would have a much wider audience that *Trade Your Way to Financial Freedom*. The logic of that statement still escapes me, but by the time *Financial Freedom through Electronic Day Trading* came out, the end of that market was very near. The main article in the March 2003 *Markey Mastery* issue details that mania quite well.

Now the tide is shifting again. Very few full time day traders remain, because spreads and volatility have gotten so low that what used to be profitable no longer has much potential. In fact, when we were considering mentors for a new program, I originally thought of four good equity mentors—two in the area of very short term equity trading. As of this writing, none of them now trade equities full time.

Are you beginning to understand the importance of market selection? If you want to make money as a trader, you must be in the markets (and understand our core risk control principles) of the future. Where are those markets today? The March *Markey Mastery* issue will give you some idea what is going on, and we're finding a lot of our clients are now in the area of futures again. I suspect the major markets of the next five years will be precious metals, forex markets (especially if you are betting against the dollar), and commodi-

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Peak Performance Tip Continued from Page One

ties in general if we have inflation. It will be much tougher if we have deflation.

Meanwhile, much of the wealth of American is still in the stock market and the hot area where everyone is looking for instant wealth is U.S. real estate. Beach front homes in Southern California and the Gold Coast of Florida

are going for multi-millions. However, I suspect that soon, if it isn't already going on, that the only people who'll sell their houses are those who have to sell (and at significant discounts from their asking price).

The bottom line is that market selection is very, very important to your financial well being.



## June Course Schedule

June 7-8, **Stock Mastery 101** with Van Tharp, Steve Sjuggerud, & D.R. Barton. Learn the fundamentals of stock trading!

June 20-22, **Peak Performance 202**, Cary, NC Experience a dramatic personal reinvention and create your own winning strategy.

June 27-29, **Advanced Stock**, Dennis Ullom presents methods of stock trading to boost your results and shows you how to trade in today's market.

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- An Interview with Steven O'Keefe, Part One: Analysts, Van Tharp, 12/02, #109
  - The Ten Key Factors in Great Trading, Van Tharp, 11/02, #108
  - When the Bubble Burst... Trading The Macro View, Brian June, 10/02, #107
  - Periodic Review Update: Tactics for Turbulent Markets, D.R. Barton, 9/02, #106
  - Personal Responsibility: The Core Concept of Successful Trading, Van Tharp, 8/02, #105
  - Self Sabotage Reexamined, Part Two, Van Tharp, 7/02, #104
  - Self Sabotage Reexamined, Van Tharp, 6/02, #103
  - Peak Performance Health, An Interview with Bruce Du Ve', Part Three, Van Tharp, 5/02, #102
  - Peak Performance Health, An Interview with Bruce Du Ve', Van Tharp, #101
  - Interview with Bruce Du Ve', Van Tharp, 2/02, #99-#100
  - Understanding Games We Play, Van Tharp, 12-01/1-02, #98
  - Ticker Tape Reading, Aly Mustakim and Robert Tharp, 11/01, #97
  - What is a Trading System, Van Tharp, 9/01, #95
  - Interview with Robert Tharp, , 8/01, #94
  - Shorting Strategies: Making Profits in a Falling Bear Market, Robert Tharp, 7/01, #93
  - Does Your System Still Work in Changing Markets, Van Tharp, 6/01, #92
  - Understanding the World of Professional Stock Trading, Robert Tharp, 5/01, #91
  - Stalking a Trade, Robert Tharp, 4/01, #90
  - Major Mistakes People Made in the 2000-2001 Bear Market, Van Tharp, 3/01, #89
  - Apply Dr. Tharp's Teachings, Part I: Know Yourself, Henry McKaskie, 2/01, #88
  - CPR for Traders, "Jake Hardesty", 1/01, #87
  - Charting A Course, Ron Ishibashi, 12/00, #86
  - Interview with Jack Schwager, V, 11/00, #85
  - Don't Ignore News, D.R. Barton, 10/00, #84
  - Using a Wide Stop Loss for Long Term Investors, Van Tharp, 8-9/00, #83
  - A Business Plan is Your First Step, Part II, Brian June & Van Tharp, 7/00, #82
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