

Paper Trading Stinks: Here's a Much Better Way

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*"Practice does not make perfect.
Only perfect practice makes perfect."
-- Hall of Fame Football Coach Vince Lombardi*

Warm-up

I'm pretty sure the two boys were speaking English. After all, one of them was my son. And aside from a touch of Latin this year in 7th grade, he has had no training in foreign languages. But the words being uttered were certainly Greek to me...

"L1 right arrow L1 left arrow analog stick right".

This was a complete and comprehensible sentence to the two guys in my basement. I whipped out my "English to 12-year old boy" dictionary, and found that the phrase meant either, "I'm hungry - do you have any Cheetos?" Or, "In video game football, this is the series of keystrokes required to blitz a linebacker when you're in a prevent defense..."

Video games are a huge part of most children's (and many adults') lives these days. The boys were playing a video game called "Madden 2007". This is state-of-the-art football gaming. The graphics and action are so life-like; it's almost like watching an actual game on TV.

My son Josh and one of his school friends were enjoying a heated game of video football. And Josh, though not a bad video gamer, was a bit under-matched against his school friend, who is a self-declared video addict. He spends most of his non-school time parked in front of a PlayStation 2 game console. And he's really good at most of the games, including video football.

A funny thing occurred when we went out into the yard with a real football. Josh's video addict friend couldn't catch a ball even if it hit him right in the hands. For all of his skill on the video console, he had no practical experience playing the real game! And it showed in his results. In contrast, Josh glided around the yard snatching balls out of the air with ease. All because **he had practiced with a real ball and played in real games.**

Many beginning traders and investors find themselves in the same position as Josh's friend. They've practiced and practiced using a technique called *paper trading*, but when they start trading for real they find that the vast imaginary wealth they amassed while paper trading has very little to do with trading in the real world.

Let's take a look at the why paper trading is a poor way to practice. And then I'll suggest some simple but effective ways to make big improvements in the way you play the trading and investing game.

Everyone's A Genius When They Paper Trade

I've heard countless stories of people who racked up fantasy fortunes while paper trading. There's nothing wrong with that. The problems come when people put real money in the market after their magical run-up in the paper world. Let's look at why paper trading often does more harm than good.

I believe that that I've developed a very useful model for understand the process of trading and investing. There are three pillars to this model: **trading psychology**, **trading systems** and **trading craft**.¹

Let's look at how paper trading prepares you, for better or worse, in all three areas.

Trading craft - trading too big, too soon.

The place where I believe that paper trading does the least to prepare a trader is in the area of tradecraft. I consider position sizing and trade execution to be parts of this broad area. The #1 problem with paper trading is that it gives people a false sense of security. They see huge profits racked up and then jump right in with huge positions, looking to grow their account as quickly as possible. As we discussed previously in Trader's U #109, this is the exact opposite of the best trading practices. And it has led many accounts to a quick demise if other problem areas pop up while these huge positions are on.

It's also easy to see that paper trading does little to help you learn the execution side of the business. Learning a trading platform and how to enter orders is not rocket science. But almost everyone I know (including me!) has hit the buy button when they meant sell or vice versa, or entered 5,000 instead of 500 shares. These kinds of mistakes cost real money. But the real execution costs that are not captured in paper trading are slippage (the difference between the price you wanted and the price you actually got) and the cost of not getting executed at all. While these costs can be estimated in paper trading, most people don't have a good feel for the effect these costs have on the bottom line. And until you get caught trying to get out in a fast market that's moving against you, it's hard to really understand the frustration of watching money slip away.

Trading psychology – you can't learn to control your emotions if you never have any.

In the area of trading psychology, paper trading falls far short as a teaching tool. You really won't know how it feels to trade until you have some money on the line. There is a huge difference between writing down a trade on paper and seeing it move against you, and *watching* a real loss rack up against you. Many people feel that the most important aspect of trading and investing is maintaining discipline through the emotions that are generated while trading. You just don't get even 1% of those feelings when you are paper trading.

And speaking of discipline – when paper trading, it is far too easy to fudge the data, give yourself favorable fills, play the “I meant to do that” game and take advantage of other hindsight biases that make your trading results much better than they would have been in real life. **Let's face it, when paper trading, we yearn to succeed.** We want to prove how smart we are, and that we can conquer this difficult task. And this leads to conscious and subconscious bending of the rules. And all of the problems that come up in real trading can easily be overlooked by skipping an entry on the trade log or by a quick flick of the eraser.

¹ For more information on this model, see the SmartTradePro website at www.smarttradepro.com.

Applying system rules – at last a place where paper trading is useful!

The last pillar of good trading is developing and applying a trading system or strategy. And finally, we see the one area where paper trading is helpful. But to make paper trading a beneficial tool here, it really needs a new name, and a modified function. Let's call it paper testing. And let's use it to track system performance in real time **using some other measure than money**. I like to track points when I'm following a new set of system rules to see how it performs in real time. I can track points in stocks, commodities or Forex trading. And when I'm compiling my data and looking at points won or lost, I can be more objective because my mind doesn't immediately think about the house at the beach I can buy with all of those paper profits!

A Much Better Alternative To Paper Trading

So if paper trading isn't the best way to test a new system, what should you do? Try this five-step approach:

1. Develop and back test your system or strategy. This can be done with computer software or by hand, looking back at charts.
2. Do real-time testing on live data. Keep track of points won or lost and not dollars and cents!
3. Instead of paper trading, use real trading, in very small size, to practice. Stock traders can trade 10 share lots. Commodity traders can trade e-mini contracts and forex traders can trade mini forex contracts.
4. Once you have been consistently profitable, only then can you ramp up your trading size.
5. Ramp up slowly! Don't go from small size to big in one step!

Paper trading is not evil. It just isn't the best way to practice trading. And like Josh's video-playing friend, you can only learn the real game if you step onto the field.

Great trading,
D.R.

Tips & Tricks

- One trading simulation that I can highly recommend is Van Tharp's "Secrets of the Masters" game. This is a fantastic tool for learning and applying position sizing principles. You can download a free trial copy or buy the full version at <http://www.iitm.com/pos-siz-game.htm>
- For those who want to practice their execution skills, there are loads of trading simulators, both free and fee-based, available on the Internet. Please be aware that these simulators suffer from many of the drawbacks that haunt paper trading, but they can help on the execution side. A Google search for "trading simulators" produced 16,000 results... I may report on some of the more useful simulators in a follow-up article, so if you have had a positive or negative experience with any products out there, please send an e-mail to me at admin@smartradepro.com and put "Trading Simulator" in the subject line.

One simulator I can recommend is the free one offered by Cybertrader at <https://www.cybertrader.com/GettingStarted/GuestRegistration.aspx?DT=S>