



# **Magic Carpet Trading™**

**How to Trade Like  
a Professional**

**By Richard W. Friesen**

# Magic Carpet Trading

## Introduction

### Preface

...I was the  
worst trader  
he had ever  
trained

Because I blazed the trail, you have a clear path to success.

My road to profitable options trading started as a futures broker with Merrill Lynch. After getting a real world education on how the retail clients fared, I went to the exchange floors trading for CRT (Chicago Research and Trading) under the genius of Joe Ritchie. I went inside the financial “engine,” trading on the floors of the Chicago Mercantile Exchange, the Chicago Board of Trade and the options floor of the Pacific Exchange.

From the first day on the floor, it was apparent that I wasn’t an intuitive trader. In fact James, my trainer at CRT, complained that I was the worst trader he had ever trained. When I mentioned this discouraging comment to the firm’s founder, Joe Ritchie, he said that while the trainer’s view might be true in the short term, it didn’t reflect my tenacity and ability. Well, both James and Joe were correct.

Taking Joe’s comments to heart, I headed back to the floor and began the process of mercilessly noting all of my mistakes on trading cards and stuffing them in my jacket pocket. After hours I would review these cards and reflect. As my pile quickly grew, I realized what a relentless and valuable teacher the market is for those who will listen.

Because options have very short cycles, the feedback for psychological behavior, trading philosophy and strategies

...every  
mistake was  
written on  
the cards

comes often and sometimes harshly. These fast feedback loops provide an instant laboratory for testing of trading philosophy, behaviors and strategies. A new options trader can get experience in a wide range of market conditions, each of them capable of ripping through every emotional weakness. Results are instantaneous.

As I became more comfortable on the floor and began hitting my stride executing trades, my ideas about strategies came faster and faster. To reinforce my thinking, I continued the habit of keeping blank trading cards in the pocket of my trading jacket. Whenever I had a thought, it went on the card. Sometimes it would be just one word to jog my memory, at other times I would write a whole paragraph in small print.

But I put it all down: when I did badly, when I did well, when I saw a constant principle in play, when another trader did something dumb. After a few years I had a stack of about a hundred stained and smudged cards written on both sides. In this way, through every kind of conceivable market, I added trading principles to my arsenal one at a time.

As I became a seasoned veteran, I started my own trading firm, Trade Management, in San Francisco. We traded options on the floor of the Pacific Exchange and the CBOE. Soon it was my turn to train new traders. Looking at my stack of trading cards, I realized that I had a gold mine of information and tricks of the trade locked away in those tiny words and phrases.

I went to work using the outline feature of Microsoft Word™. Card by card, I entered the results of years of trading experiences, first one thought, then the second, then the next. As soon as I had several comments on the same topic, I would create a new heading and drag them there. I repeated this process over and over. Once it was all in the computer, I started to organize, expand, and clarify.

Everything I  
wrote comes  
from real  
world  
experience

What developed from this outline was a process of “relationship trading” that could be visualized as a “Magic Carpet.” This *Magic Carpet* became the basis for a trade-secret training manual which I made available to all aspiring new traders who joined my firm. To view my manual, they had to sign a non-disclosure agreement to protect the intellectual property rights of my trade-secret materials.

Everything I wrote that evolved into the *Magic Carpet Trading System* for options comes from my own real world experience and was forged by years in the fires of truth on the trading floor. It is the basis for a trading system that always made money, year after year, with minimum returns of 100% on my capital but typically, many times more.

These insights were critical to my success as I sent new traders to the floor, risking my own capital earned by using the *Magic Carpet Trading System*. Because I documented my path and captured it, you can take advantage of my experience. Because I taught others to use the *Magic Carpet Trading System*, you can learn to visualize and understand these ideas.

When seat prices hit all time highs on major options exchanges, I began to sense a change. For years floor traders were protected from the ravages of off-floor competition with limited access, transaction speed and cost of execution. I predicted that electronic access by the public and competition from new electronic exchanges would change this dynamic.

I sold my trading firm and founded ePIT Systems, a software company building electronic exchanges aimed squarely at the regulated markets and exchanges who wanted to add an internet marketplace. Building an internet company through the boom and collapse of the dot com world was an incredible, once in a generation experience

that I was fortunate to participate in. The technology I designed is operating around the world.

Since the sale of ePIT's system to a major Japanese technology company, I am looking ahead to the next major paradigm shift. Floor traders on futures, options and stock exchanges have gone through excruciating pain as electronic competition from the ISE (International Securities Exchange) and the coming of Eurex in the futures markets has escalated. Electronic trading, in combination with the effects of decimalization, higher costs including payment for order flow, new scandal driven regulations, and the drop in retail order flow volume, has forced many small and medium trading firms either out of business or into consolidation.

Electronic  
Trading  
opens the  
door to you

As the electronic revolution continues, the next opportunity will be for the trader who is able to grasp "relationship trading" and trade from home or office as electronic executions open doors that have been locked for decades. The off-floor trader, focusing on a few assets or "customer created derivatives," will be able to use the principles in this manual to do what only floor traders have been privy to until now.

Mission of this  
training manual

The mission of this manual is to give you all the components necessary for a successful trading experience.

This manual is comprised of three major sections.

First it is designed to give you a firm foundation in the principles and philosophy of trading. These principles were built on the most complex product: stock options. As a result they apply as well to the simpler exchange trading contracts because they are fundamental in nature and are able to simplify the most complex products.

The mission:  
philosophy,  
psychology,  
theory and  
strategy

The next  
opportunity  
is off-floor  
trading

Secondly it gives you an opportunity to look at yourself and what you personally contribute to your successes and failures. In my experience training floor traders, I have learned that understanding trading theory by itself is useless unless traders understand themselves, their goals and their limitations.

On this foundation, the *Magic Carpet Trading* visual will give you the mental model necessary to create your own relationship trading strategies. These visualizations of asset and risk relationships allow you to understand pricing and values, and how to profit as they change.

## Chapter Summaries

### Philosophy

The *Magic Carpet Trading* philosophy. Visualization of the relationship between assets.

*CORCO* (Choice of Opportunity and Risk Components)  
Moving to areas of manageable opportunities and maintaining distance from areas of unwanted risk.

Options trading as a business. Redefining trading as a business with a role and a mission.

“No free lunch.” Solving the problem of low risk and high returns.

Market turns. Understanding the reality/perception teeter-totter.

Market principles. Learning the eternal truths.

Doing good. How making money trading options is good for the economy and reduces poverty. Make money without guilt.

A core  
philosophy is  
a core  
compass

## Psychology

Recognizing your internal landscape. We all want to avoid this process; however, facing our fallibilities is invigorating.

Your purpose in trading. How to drill down to what you are really about.

Trading is counter intuitive. If you keep doing what feels good you will keep losing money.

Your brain is wired wrong to trade. But, you can compensate.

Everything is fallible: you, the markets, your information systems, order executions. All are fallible, but you can still make money.

Hubris is the invisible disease of successful traders. You don't know you have it until after it has cost you.

Unrecognized internal limits. These glass ceilings can cap you income.

Predicting the future. This can poison your mind.

Getting rich. The harder you try, the lower your net worth.

Status Quo Bias. Do you really want that position?

Being a contrarian. How schizophrenia can work for you.

The oracle of  
Apollo at  
Delphi had  
GNOTHI  
SEATON,  
"Know  
Thyself",  
inscribed at  
the top of her  
temple.

## Trading with Options

Years of  
option  
experience  
in one  
graphic

*The Magic Carpet*: Using it to visualize options pricing and position risk.

Selling premium is the only way to make money in the long term. In the long term, we are all dead.

CORCO and parsing risk. Choosing risk and opportunity components. Learn what you are good at and stay in that arena. How to beat the big boys.

We buy and sell options. We really trade implied volatility.

Options risk buckets. Understanding them all and filling up the ones you like.

Normal distribution. How it effects the price of options.

Your options values. How to get them and use them trading.

The Greeks. Why these guys will become you buddies.

Retail option customers. What did P.T. Barnum say?

How floor traders make money. This is the complete list.

## Trading Equities and Futures

The line between equities and futures has been erased by the Commodity Futures Modernization Act of 2000.

New products such as Single Stock Futures allow the serious trader to use the *Magic Carpet* on these new products.

## Environment

The trader's world is changing. For the first time, you can move off of the bleachers.

Technology updates. How you can have the information the pros have.

Regulatory changes. Why they are working in your favor.

New products. Improving your CORCO with derivatives.

The  
Internet has  
changed  
everything

“Richness and Reach.” How the breakdown of this trade-off radically alters your personal environment.

Changes to come. What the market place is demanding.

*Magic Carpet Trading.* Now possible for the off-floor trader.

## Trading Strategies

The key factor. All trading of everything boils down to this single issue. All strategies are built on this answer.

Pattern changes. Why the greatest profits can be made when there is a shift in market perception.

Musical Chairs. When the music stops, here is how you reserve a chair.

Daily charts. They may not predict direction, but they give you solid information about what behavior you can expect tomorrow.

Opening and closing. Placing orders and how these two events are very different in character.

Screen prices. Why you should understand that they are just pixels on a computer screen.

Chaos is terrifying. It is also where the money is.

Limit orders. Every limit order comes with a free option. Heads I win, tails you lose.

Hedging with Single Stock Futures. This product will change how options are valued.

Adverse selection of your orders. This can change the odds and cripple your results.

Plus many more....

## Money Management

The stomach calibrator. Why your own stomach helps set money management rules.

What money really is. Managing money for its real value.

Good bets to avoid. Why money management will stop you from making a highly probable bet.

## Trading Mechanics

Types of orders. What you get and give.

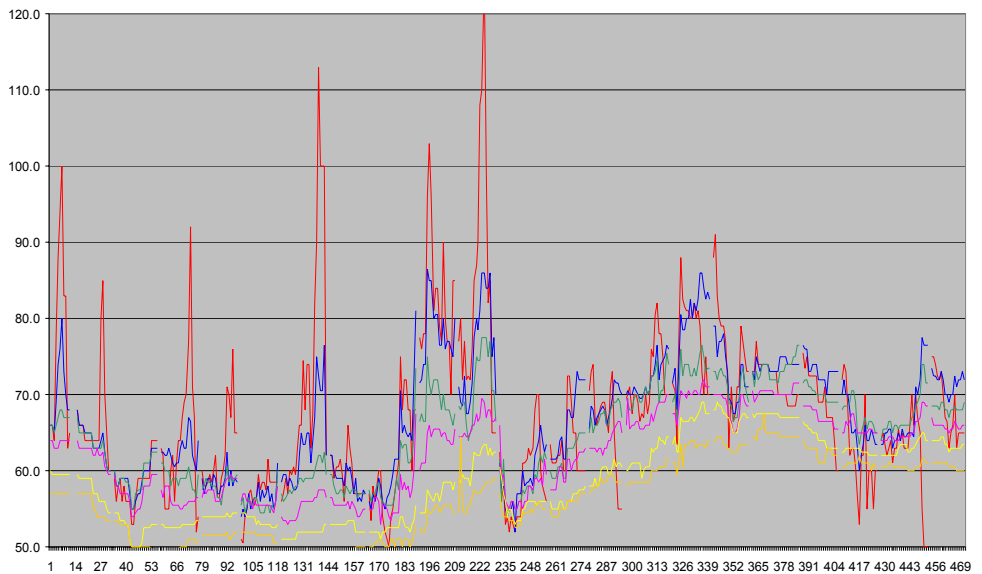
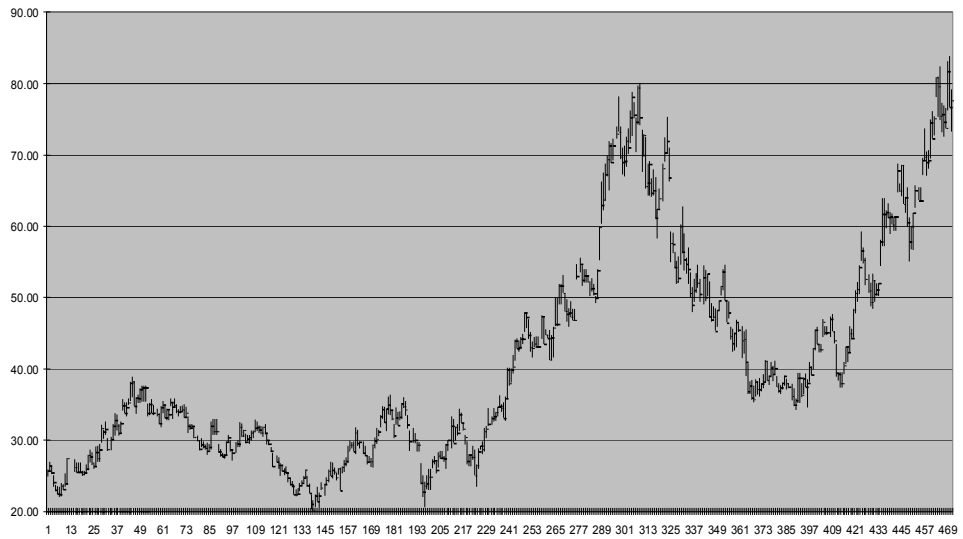
Bid/offer spreads. Understanding the market principles.

Order execution. Each market is different.

## Graphical Analysis

We analyze our graphical, historical data to understand how the *Magic Carpet* undulates with time. You will see why you shouldn't attempt relationship trading without the information in the charts below.

To trade options you must understand implied volatility



## Reference Section

### Tools

Tools that you can use. This gives you the list.

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