Psychology of Trading

Aiming for the Right Target in Trading
By
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When trading goes right, it can be a great feeling. When trading goes wrong it can be a nightmare. Fortunes are made in a matter of weeks and lost in a matter of minutes. This pattern repeats itself as each new generation of traders hit the market. They hurl themselves out of the night like insane insects against some sort of karmic bug-light; all thought and all existence extinguished in one final cosmic "zzzzzzt". Obviously, for a trader to be successful he must acknowledge this pattern and then break it. This can be accomplished by asking the right questions and finding the correct answers by rational observation and logical conclusion.

This article will attempt to address one question:

"What is the difference between a winning trader and a losing trader?"

What follows are eleven observations and conclusions that I use in my own trading to help keep me on the right track. You can put these ideas into table form, and use them as a template to determine the probability of a trader being successful.

OBSERVATION # 1

The greatest number of losing traders is found in the short-term and intraday ranks. This has less to do with the time frame and more to do with the fact that many of these traders lack proper preparation and a well thought-out game plan. By trading in the time frame most unforgiving of even minute error and most vulnerable to floor manipulation and general costs of trading, losses due to lack of knowledge and lack of preparedness are exponential. These traders are often undercapitalized as well. Winning traders often trade in mid-term to long-term time frames. Often they carry greater initial levels of equity as well.

CONCLUSION:

Trading in mid-term and long-term time frames offers greater probability of success from a statistical point of view. The same can be said for level of capitalization. The greater the initial equity, the greater the probability of survival.

OBSERVATION # 2

Losing traders often use complex systems or methodologies or rely entirely on outside recommendations from gurus or black boxes. Winning traders often use very simple techniques. Invariably they use either a highly modified version of an existing technique or else they have invented their own.

CONCLUSION:

This seems to fit in with the mistaken belief that "complex" is synonymous with "better". Such is not necessarily the case. Logically one could argue that simplistic market approaches tend to be more practical and less prone to false interpretation. In truth, even the terms "simple" or "complex" have no relevance. All that really matters is what makes money and what doesn't. From the observations, we might also conclude that maintaining a major stake in the trading process via our own thoughts and analyses is important to being successful as a trader. This may also explain why a trader who possesses no other qualities than patience and persistence often outperforms those with advanced education, superior intellect or even true genius.

OBSERVATION # 3

Losing traders often rely heavily on computer-generated systems and indicators. They do not take the time to study the mathematical construction of such tools nor do they consider variable usage other than the most popular interpretation. Winning traders often take advantage of the use of computers because of their speed in analyzing large amounts of data and many markets. However, they also tend to be accomplished chartists who are quite happy to sit down with a paper chart, a pencil, protractor and calculator. Very often you will find that they have taken the time to learn the actual mathematical construction of averages and oscillators and can construct them manually if need be. They have taken the time to understand the mechanics of market machinery right down to the last nut and bolt.

CONCLUSION:

If you want to be successful at anything, you need to have a strong understanding of the tools involved. Using a hammer to drive a nut in to a threaded hole might work, but it isn't pretty or practical.

OBSERVATION # 4

Losing traders spend a great deal of time forecasting where the market will be tomorrow. Winning traders spend most of their time thinking about how traders will react to what the market is doing now, and they plan their strategy accordingly.

CONCLUSION:

Success of a trade is much more likely to occur if a trader can predict what type of crowd reaction a particular market event will incur. Being able to respond to irrational buying or selling with a rational and well thought out plan of attack will always increase your probability of success. It can also be concluded that being a successful trader is easier than being a successful analyst since analysts must in effect forecast ultimate outcome and project ultimate profit. If one were to ask a successful trader where he thought a particular market was going to be tomorrow, the most likely response would be a shrug of the shoulders and a simple comment that he would follow the market wherever it wanted to go. By the time we have reached the end of our observations and conclusions, what may have seemed like a rather inane response may be reconsidered as a very prescient view of the market.

OBSERVATION # 5

Losing traders focus on winning trades and high percentages of winners. Winning traders focus on losing trades, solid returns and good risk to reward ratios.

CONCLUSION:

The observation implies that it is much more important to focus on overall risk versus overall profit, rather than "wins" or "losses". The successful trader focuses on possible money gained versus possible money lost, and cares little about the mental highs and lows associated with being "right" or "wrong".

OBSERVATION # 6

Losing traders often fail to acknowledge and control their emotive processes during a trade. Winning traders acknowledge their emotions and then examine the market. If the state of the market has not changed, the emotion is ignored. If the state of the market has changed, the emotion has relevance and the trade is exited.

CONCLUSION:

If a trader enters or exits a trade based purely on emotion then his market approach is neither practical nor rational. Strangely, much damage can also be done if the trader ignores his emotions. In extreme cases this can cause physical illness due to psychological stress. In addition, valuable subconscious trading skills that the trader possesses but has no conscious awareness of may be lost. It is best to acknowledge each emotion as it is experienced and to view the market at these points to see if the original reasons we took the trade are still present. Further proof that this conclusion may have validity can be seen in even highly systematic traders exiting a trade for no apparent reason, and pegging a profitable move almost to the tick. Commonly, this is referred to as being "lucky" or being "in the zone".

OBSERVATION # 7

Losing traders care a great deal about being right. They love the adrenaline and endorphin rushes that trading can produce. They must be in touch with the markets almost twenty-four hours a day. A friend of mine once joked that a new trader won't enter a room unless there is a quote machine in it. Winning traders recognize the emotions but do not let it become a governing factor in the trading process. They may go days without looking at a quote screen. To them, trading is a business. They don't care about being right. They focus on what makes money and what doesn't. They enjoy the intellectual challenge of finding the best odds in the game. If those odds aren't present they don't play.

CONCLUSION:

It is important to stay in synch with the markets, but it is also important to have a life outside of trading. It is a rare individual who can do anything to excess without suffering some form of psychological or physical degradation. Successful traders keep active enough to stay sharp but also realize that it is a business not an addiction.

OBSERVATION # 8

When a losing trader has a bad trade he goes out and buys a new book or system, and then he starts over again from scratch. When winning traders have a bad trade they spend time figuring out what happened and then they adjust their current methodology to account for this possibility next time. They do not switch to new systems or methodologies lightly, and only do so when the market has made it very clear that the old approach is no longer valid. In fact, the best traders often use methodologies that are endemic to basic market structure and will therefore always be a part of the markets they trade. Thus the possibility of the market changing form to the extent that the approach becomes useless, is very small.

CONCLUSION:

The most successful traders have a methodology or system that they use in a very consistent manner. Often, this revolves around one or two techniques and market approaches that have proven profitable for them in the past. Even a bad plan that is used consistently will fair better than jumping from system to system. This observation implies that stylistic foundations of a trader's market approach must be in place before consistent profitability can occur.

OBSERVATION # 9

Losing traders focus on "big-name" traders who made a killing, and they try to emulate the trader's technique. Winning traders monitor new techniques that come on the trading scene, but remain unaffected unless some part of that technique is valuable to them within the framework of their current market approach. They often spend much more time looking at how the market seeks and destroys other traders or how traders destroy themselves. They then trade with the market or against other traders as these situations arise.

CONCLUSION:

Once again, we can note that the individuality of a trader and his comfort level and knowledge regarding his system are far more important than the latest doodad or Market guru.

OBSERVATION #10

Losing traders often fail to include many factors in the overall trading process that affects the probabilities of overall profit. Winning traders understand that winning in the markets means "cash flow". More cash must come in than goes out, and anything that effects this should be considered. Thus a winning trader is just as thrilled with a new way to reduce his data-feed costs or commissions as he is with a new trading system.

CONCLUSION:

ANYTHING that affects bottom line profitability should be considered as a viable area of study to improve performance.

OBSERVATION #11

Losing traders often take themselves quite seriously and seldom find humor in market analysis or the trading environment. Successful traders are often the funniest and most imaginative people you will ever meet. They take joy in trading and are the first to laugh or relate a funny story. They take trading seriously, but they are always the first to laugh at themselves.

CONCLUSION:

Its no wonder that one of the first things psychiatrists test for when treating a patient is whether or not the patient has any sense of humor about his affliction. The more serious the tone of the individual, the more likely that insanity has set in.

SUMMARY OF CONCLUSIONS AND OBSERVATIONS

Both winning and losing traders consider trading a game. However, winning traders take the game not as a diversion but as a vocation which they practice with an intensity and dedication that rivals the work ethic of a professional athlete. Since the athletic metaphor seems appropriate, I will sum up on that note.

If trading were a game like basketball perhaps novice traders would realize more readily that what appears as effortless ease of the professional trader in sinking three-point shots is in fact the product of endless hours spent shooting hoops in deserted back yards and empty playgrounds.

As in sports, the governing factors are internal and external. We deal with the market and ourselves. Both are like weapons and they can be used proactively or destructively. Each and every trade should be taken with professional care and planning

In order to bring these observations home in an even more compelling form, lets add an element of ultimate risk to life and limb and say that our "sport" is more like target practice with a handgun. While it is certainly important to hit the target, it is more important to make sure the gun isn't pointed directly at ourselves when we pull the trigger.

Minute differences in how we take aim in the markets can have amazing impact on the final outcome. The difference is clear: One method is accurate target practice. The other is Russian Roulette.