Trader Psychology and Risk Control – Using Trading Rules to Eliminate Your Worries

Most people find the market very intimidating. They don't understand the market. But even those who do still can be nervous about putting their money to work. There is good reason for this. Statistics show that the average investor is a stock market loser. Terrance Odean, an assistant professor at the University of California, did a fascinating study of investor success rates back in the 1990's.

Odean received the trading history of over 60,000 accounts that where active been 1991 and 1996 from a discount broker and used the data to study the trading behaviors of online investors. Not surprisingly, most of them underperformed the stock market and only a small minority beat the market. In fact only half of active traders managed to just break even. Most simply made a little or lost a little. Professional investors do not fare all that much better as half of all mutual funds fail to beat the S&P 500 index every year.

Only a small minority of individual investors produced outstanding returns. The top 5% for instance had an average return over 2.41% a month and only 1% had a return over 4.86% a month. These are huge returns over the course of a year. The statistics show a few elite investors and traders making all of the money and everyone else breaking even or losing.

The failure rate of investors and traders is a different picture than that which is portrayed by online and traditional brokers through their advertisements. In fact if most people actually lose money in the stock market, then the market is more like a pyramid scheme in which wealth is simply transferred from the masses and given to the brokers, stock manipulators, market makers, and a small super trading elite at the top than the get rich fantasy that is so often presented. A view that some might find romantic would picture it as a pure Darwinian survival of the fittest and leave out the part about the manipulators.

One would need more data to confirm if either of these views are true. A study on how many trading accounts are opened and closed would prove or disprove this. If brokers must continually recruit new accounts to replace ones closed due to losses then these two pictures of the market are correct. Money earned outside of the market is brought into it and given to professionals and manipulators. Just like a ponzi scheme, more money has to be recruited to keep the engine running. For a pyramid to continue new blocks must be placed on it. No matter how the market is structured, what is more interesting is trying to figure out why it is that many people lose money and a few make a lot of money in the stock market. What can we learn from that to increase our own returns?

How do most people lose money? Odean’s trading data shows that almost all individual investors generate poor returns by selling winning stocks too soon and holding on to losers. He argues that they do this because they are "overconfident." They consistently believe that their losers will come back and the market ends up proving them wrong. I think it is safe to assume that many of these investors hold on to their losers during full stage four declines. When they have a winner they sell them too soon, fearing that it will join the rest of the stocks in their holdings and become a loser too.

Odean’s study provides a great resource about the behaviors of active investors. However, any conclusions about motivations that can be drawn from the data are merely theoretical and cannot be proven. This isn’t his fault; it’s simply the nature of proof and evidence. There is no way one can extrapolate the motivations of thousands of individuals by studying numeric data and one doesn’t have the resources to ask all of these people about their motivations. One can only manufacture logical explanations from the data.

This isn’t a bad thing. You can learn a lot by thinking in that manner. My guess is that people do not lose money in the markets because they are stupid or because they aren’t pros. Remember that most mutual funds also underperform the stock market. I believe the primary difference between winners and losers is psychological. Winners and losers are presented with the same set of information, however the winners take different actions.

What guides their actions? From my own history of losing and then making a lot of money in the stock market and a study of general and trading psychology I’ll try to come up with some explanations. I believe that the actions of losing traders are

guided by fantasy and a fear of losing while winning traders are guided by confidence. Without the proper mindset and attitude you cannot make money in the stock market. It's not a guarantee to being successful, but it's a prerequisite. However, the stock market is an environment that makes it difficult for most people to obtain this proper mindset, let alone maintain it.

environment -> senses -> beliefs -> identification -> motivation -> actions

The human mind gathers information about the outside world through the uses of its senses. It recognizes the information and then processes it. It then identifies it and responds to it with a whole host of beliefs, unconscious and subconscious. Based upon a person's motivations and interpretations of what is taking place he carries out an action. The key is that actions that people take are based upon their own set of associations with what is going on in the world outside of them. These associations are based upon past experiences and a person's beliefs about himself and the task at hand. The world consists of inputs that make people feel and they respond accordingly.

To relate this to trading, winning traders and losing traders experience the trading environment differently. It makes them feel different and as a result their actions consistently vary. In psychological terms, they interpret the market differently because they have a separate belief system in the way that they see themselves relative to the stock market.

Let's list these beliefs and actions below:

Belief statements that different traders can make:

Winning Traders

The markets provide an opportunity

The markets exist to give me profits

If I get stopped out then I have to reevaluate the trade

If the market doesn't do what I expect then I must reconsider

I'll take one trade at a time.

I don't have to be perfect, I just have to do my best.

Money is not that important

Losing sometimes is part of the process of making money

Trading is a game, I know I can win

Every setback provides me with new market information

I can wait for an opportunity to come

Losing Traders

I must be in the market now

If I lose on this trade I am a loser

If I wait for my trading rules I'll miss out

If I get stopped out I have bad luck

I can't lose money

The market makers got me again

I'm an idiot, how could I lose money

What will they think when I tell them I lost money on this one?

The stock market is rigged

It's impossible to get a good order execution

I cannot take a loss

If I take my profit then I am right

These different beliefs create different characteristics of winning and losing traders:

Winners:

Get pleasure from trading the market as an end in itself

Not motivated primarily by money

Confident that they can make money in the market

Not afraid to take a loss

Patient - waits for opportunities

Uses a highly planned strategy

Is well prepared, done his homework

Measures the risk/reward ratio of every trade

Losing Traders:

Never define a loss

Are locked into a narrow belief system

Hesitate to make a trade

Do not stick to a system

Trade by whim

Trade by emotion

Have no consistent strategy

Do not practice risk management

Are more interested in proving themselves right then being a success

Financial markets are structured in such a way that make it very difficult for someone to approach them with a confident psyche; and that is why it is so difficult for most people to make money trading them. Almost all environments - the workplace, family, and friends - provide external forces that limit a person's behavior. They provide a set of rules of what is right and wrong and what actions are to be rewarded or punished. This is not true for the stock market.

The stock market does not care if you make or lose money. The market has no control over you. Since the market does not exert any external control over your actions you have to fashion your own system of rules and have the discipline to obey them in order to be successful. No one else will do it for you. You have to have the confidence to take this responsibility yourself. It takes enormous self control and discipline.

Most people cannot take this approach. Instead they construct a fantasy in which the market provides them with future riches. They transplant these fantasies on to the individual stocks that they purchase and have difficulty confronting the reality of being wrong. When events don't match their illusions they simply ignore them. If a stock they bought drops below their purchase price they refuse to reject the fantasy that their decision to purchase the stock will make them money and instead convince themselves that it is a winner that merely isn't in favor yet.

However, stocks do not make successful traders money. They do it themselves. Instead of believing in the power of stocks, they believe in the viability of their own trading strategy. They have faith that their own disciplined interaction with the stock market will make them money and not the other way around. The decision making freedom the stock market gives ruins most active investors, but handsomely rewards the few prudent traders.

As I said earlier it takes extreme confidence to execute a well planned trading strategy and most people cannot find it. Instead, they often experience intense anxiety in the market. They may come to believe that the markets are rigged against them. The market doesn't cause this. It's their lack of strategy that twists them into emotional knots.

What one has to do to move from a fear stricken psyche to one capable of building enough confidence to make money in the market is to first believe in oneself and develop a strategy that consists of the type of tactics you have learned from this course and strict money management techniques. I'll discuss how I have done this later. But, once you have a strategy in place you have to have the fortitude to continue to believe in it when you suffer losing trades. Losses are a part of the game. The way to make money is to accept them and to use money management techniques to keep your winners larger than your losers.

You have to move away from a mindset that stocks will make you rich and believe that your trading method will make you money. Then you must come to realize and hold the belief that being

right or wrong on each individual trade does not matter. You have to be able to move through the adversity of losing trades and hold the faith that you will make money in the long run. This is why people find it so difficult. People focus too much on the individual trades and hold unrealistic fantasies about them, while they cannot take responsibility for the decisions that go wrong. The worst ones take it personally. Most never understand what is required to succeed.

The bad news in all of this is that if you are trying to generate large percentage returns on your account the odds are stacked against you. The odds of someone starting small and making a lot of money in the stock market are probably the equivalent of a rookie league baseball player making it into the big leagues. The good news is that most people trade recklessly, on pure emotions, and with little or no strategy so the competition isn't so hot. Dedication and following a sound strategy is all it takes to make the difference. I try to demonstrate that and encourage you in that direction in this course and through the WSW Power Investor service.

Risk and money Management

Instead of being tossed around by the forces of the market, I want you be able to step outside of them and look at them a little more objectively. That is the only way to be a successful investor or trader. Instead of acting on fears and hopes you will then act on reality.

We use strategies that make money. And discipline to control risk. The tough truth is that investing and trading is a zero sum game. When you lose money on a stock someone is making money. When you make money that money comes out of somebody else's pockets. That is the brutal reality of the financial markets.

Ameritrade used to have an index that would show you what their customers were doing. It would tell you what percentage of orders were buy orders and what percentage were sell orders. It would also keep track of the top ten stocks that they bought and sold. If you watched this index you would have seen that Ameritraders are consistent stock market losers. They tend to buy at market tops and sell at market bottoms. Ameritrade seems to know this because they included this in their disclaimer for the index: "You should be aware that just because certain Ameritrade customers bought or sold a particular security does not mean that you should do the same thing." And just in case

you don't heed their advice, Ameritrade warns you that "in no event shall the liability of Ameritrade relating to Your use of the Website, the Index or the Services, in any event exceed $100.00."

Ameritraders are the most desperate and wild gamblers in the stock market. They think that the only stocks worth buying are technology stocks because they move a lot. They buy stocks with poor fundamentals after they watch them go up. They seem need to the reassurance of knowing that thousands of other people are buying at the top also. Once the inevitable slide comes they panic and sell into the smart money as its buys. The Ameritraders get tossed around every which way and end up doubling down to recoup their losses.

They are not atypical. The average investor is a loser when it comes to the market. He buys after the market goes up and people on TV say that it has bottomed and sells when it falls and really hits a bottom. He just takes wild gambles and hopes for the best. If he makes money he thinks he is really smart and when he loses he blames it on the stock market or some sinister outside forces.

These people are no different than the rubes who sit in front of slot machines and put quarter after quarter into them in the hopes that they'll hit the big jackpot. Gambling is an acceptable vice for some people, but a hopeless addiction for others. At least in Las Vegas you can get free booze and meet pretty women. When it comes to buying and holding during bear markets all you have is a picture of Maria Bartiromo staring at you from the television set talking about how stocks are going to go up while you realize that every single position in your portfolio is colored red.

On any given day millions of dollars are made in Las Vegas while billions are made and lost at the New York Stock Exchange and the electronic Nasdaq network. In Las Vegas it isn't the gambler that makes money. It is the house that is. The stock market is no different. If you want to make money in the stock market you need to operate like the casinos do.

A casino is a business. If you wanted to open a casino you would find out how they work. You would either hire people to teach you how they operate one or else pay someone to operate it for you. This is common sense. If you have a toothache you go to the dentist to fix it. You don't go to the plumber. If a

construction company decides to build a house the first thing they do is start with a set of floor plans.

But when people decide to speculate in the stock market they almost never seek out expert guidance or else fail to begin with a strategy to build a sound foundation from. Instead of using a trading strategy they buy on what they believe is inside information, false tips, messages board hype, crazy rumors, and gamble in penny stocks. They put their trust in the jackal pack of manipulators that exist on Wall Street. They trade on the promises and hopes of con men: people with an agenda and who will do anything for money. Others just watch prices fluctuate and try to guess bottoms, a guess no one can consistently make accurately and makes losers out of those who try. These are the Ameritraders who buy high and sell low. They are the perennial losers who help line the pockets of brokers, market makers, professional traders, and manipulators.

You need to think like a casino operator. What casinos do is minimize their risk. At any moment someone could walk in the casino and clean the entire house out. Yet the casinos consistently make money. Although the casino can lose money on any given hand in the long run they come out winners. The odds are in their favor. Winning traders do the same thing. They do not expect to make money on every trade. They know that they do not have to. They realize that events that have probable outcomes can be used to produce consistent results. Unlike the average investor, they think in probabilities instead of trying to make it all on one big play, such as buying and holding a mutual fund for the rest of your life thinking that it is going to make you rich.

Any trading strategy that succeeds in the stock market has at its core money management principles. It is these very principles that catapulted me out of the loser category and made me a success in the markets. I don't care if you use a tactical trading strategy that is at odds with mine, if it is successful you will use money management tactics.

For any business, not only a casino, to succeed it must generate more revenues than expenses. Businesses generate expenses by paying for such things as advertising, wages, and goods. Your trading account's expenses consist of commissions, margin rates, and losing trades. Successful traders see losing trades as expenses and nothing more - they are not signs that you are an idiot or are unlucky.

What the successful trader does though is make sure that his account generates surplus profits over time just like a business ledger. As this surplus grows his net worth grows. The main way this is done is through money management and risk control. I cannot repeat this enough.

A system that generates successful trades 90% of the time and does not practice risk control will eventually blow up. Strict money management can create a surplus profit even when most of the trades in the system fail. You can be wrong most of the time and still be a net winner. That's how you put the odds in your favor and get on top.

Let's play with some numbers so that I can show you what I mean. If you have $10,000 dollars and lose $500 per losing trade and make $1,500 per winning trade, you only have to be successful with a small percentage of trades to generate a surplus. This would be risking %5 a trade with an average gain of 15% on the winners. With these type of odds if you lost on 7 trades and only made 3 successful ones(30%) you would still make $1,000. That is the magic of money management.

If you aren't playing with these types of odds then you are at an extreme disadvantage and are making things very difficult for yourself. Every successful trader develops strict rules to manage their equity in their account to create odds such as those above.

All of these rules have one basic function which is to protect your equity. This is the lifeline of your account. You make money with money. If you lose all of your money then you are finished just like any other bankrupted business. You protect your equity by limiting your losses and generating a surplus.

This means that you have to be patient and wait for the best opportunities to arise. Every year there are plenty of chances to gain from the stock market, but the average person squanders their equity on low percentage trades and lets the best of opportunities go by. But, more importantly it means in every position you enter the risk to return ratio must be calculated. You must figure out how much you are willing to risk on the trade. At what point will you take a loss and get out? Not asking this question will only put you in a position in which you will be unable to make the correct decision to get out. If you do not plan every investment or trading decision you will be caught in the trap of making decisions based upon emotion

instead of common sense. Once that happens you would be better off going to the craps table.

In order to be a successful investor you have to have a tactical strategy. If you have taken all of the lessons in this course and thought about them then you should have one by now. The second thing you must do is come up with your own set of money management and risk rules. You need to decide how much money you are willing to risk on any given position. Once you enter a position you must then sell out at a loss if the size of the loss reaches the limit you set in your trading rules. Do these two things and you will become a successful investor or trader.

There isn’t a perfect set of money management and stop loss rules. I can’t simply hand you a bunch of rules, because every person must create a group of rules that matches their personality and investment style. Luckily it isn’t that complicated.

These are same basic rules any money management system should be built around:

1)Limit all losses to a maximum 5% of your equity. Never risk more than this in any single position. Using the 5% rule it would take 20 losing trades in a row to put you out of business. That's not very likely to happen. If you have a large amount of equity lower the maximum risk size to 2.50% or even less.

2)Use a stop loss order on your positions in order to enforce the first rule. Don't trade until you can discipline yourself to do this and not be fazed by getting stopped out.

3)Never average down on a losing position. If you make a trade and it goes against you then you are wrong. Why put more money into a losing position? Averaging down is for schmucks.

4)Never let a good profit run into a loss. It's hard work to get a profit, the worst you should do is break even. That's not the end of the world; just don't let a highly profitable position turn into a loser.

5)Distribute the risk - divide up your trading capital into at least two or three sectors or markets. The more money you have the more positions you should have. If you are investing and holding positions for the long term then you should be more conservative. Investors should hold less than 10% of their

equity in any single position and 5% is the recommended rate. 5% would mean 20 positions and if any of them fell in half then the effect on your whole account would be minimal. By using ETF’s or mutual funds you can raise the 10% maximum to 20%.

There is a simple formula that you can use to manage your account. It is called the risk of ruin formula. It is used to calculate the odds of losing everything in your account. If you do nothing else you should use it after you read this message and apply it to your own investing.

The formula factors in the size of your capital and the amount of money that you risk per trade. This is the formula:

(1 - [% winning trades - % losing trades] / (1+ [% winning trades - % losing trades) raised to the power of the % of your total account that you are willing to risk per trade.

To give you an example. If 60% of your trades are winners and you are willing to risk 10% of your money on a single trade your risk of ruin factor would be .017:

(1 - [.60 - .40 = .20] / 1+ .20) raised to the power by 10 = 017%. That’s around 2%. The chances that you will lose all your money with those kinds of odds are very slim. If you risk 5% per trade they are even slimmer.

However, if you decide that you want to try to risk 25% of your account per trade than you will have a 20% chance of losing your entire account even if 60% of your trades are winners. Now do you see why position size and having rules about cutting losses are so important? The reason why most investors are losers is, because they refuse to think about this at all.

Figure out what percentage of your trades have been winners and losers and see what results you get when you factor that into this formula. If you don't like what it tells you then play around with your position size and risk levels.

To sum all of this up: don't expose a large amount of your capital to risk to loss in any single trade. Take small risks. Do this and you will put the odds in your favor. You won't trade on fear or wild hopes because no single trade will be important. What will be important is the long run. And as long you put the odds in your favor the longer you trade and invest the more profitable it will become. And then you will invest with no worries!