

Trading Psychology

Some years ago I organised a panel session at an Australian Technical Analysts Association meeting in Sydney. The idea was that some of the more experienced professional traders in the association would field questions from less experienced members. We invited questions in writing, so that the panel could consider them before the meeting and so give better answers.

This was some time ago and I have forgotten all but one of the questions. That one was simply this: Please tell us how you decide what and when to buy and when to sell. However, there was a rider to the question: Please do not go into the psychology behind the process, just stick to how you make the decisions.

Now, this has stuck in my mind, because it brought home to me how important psychology was in trading. This member was not an inexperienced trader. What came through to me was that he was in denial about his real problem – psychology. He somehow wanted us to give him rules that would solve his problem. Yet his problem was not just a lack of the right decision rules. It was not how to manage his trades. It was how to manage himself.

Some people come to trading as a way to solve the problems in their life. Here is an occupation that promises potential unlimited profits, without the usual constraints of having a boss, having to go to work at set times, do all the unpleasant and boring things most jobs entail and so on. In a word, these people are looking for the markets as a place to escape all the things that are currently wrong with their life.

Well, they always get the same wake-up call from the market. If there is a problem in your life, the market will find it like a heat seeking missile and expose it in all its ugliness. You cannot run away from problems in the market.

I recently came across a very interesting quotation that is relevant to this situation and to most people's lives and the way they live them:

We often think that happiness involves things being different. We believe we will be content when a relationship changes; we get a new job, change our place of living or acquire another material possession. The hero knows we can each be happy here and now. The difference isn't in the world in which we live, but in how we see that world. Margot Cairnes

The message from all of this is that it is the psychology that matters in trading. Most beginners do not even know that that they do not know this. Sooner or later it becomes clear to them. Most of them will deny it and sooner or later fail at trading and leave it for good. A few will confront the problem and go on to become successful traders.

And just in case you investors out there are reading this and thinking it does not apply to you – think again. You see, both trading and investing are about decision-making. Making decisions is not easy. It requires discipline. Most people lack discipline, in all of their life. However, we cannot just pluck discipline out of the air. There is a way to develop it in trading.

The first step, of course is to realise that all decisions must be made in a framework. There must be a plan that we are following. That plan must have an objective that is clear and unambiguous. Then there must be strategies that we are going to follow to reach that objective. Finally, we must have some clear tactics that we will use in the execution of those strategies. This is what I call a trading plan.

In developing a trading plan we need to frame it in such a way that it suits our tolerance for risk, our personality, our attitudes and our belief systems. In simple terms, if we are uncomfortable with the plan, then we will never be able to follow it.

Now, having been telling people this for years, I found that the message was not getting through. On asking why people did not have a plan, I found that many did not know how to start writing one down. This is when I started to teach my trading plan. I taught it, not for students to take and use as it was, but as a model that could be adapted to their needs.

In my trading plan I explain what risks I am managing, how I manage them and why I do it the way I do. It is then much easier for students to take my plan and vary it in ways with which they are comfortable.

This leads into the second step and that is to test the plan. The first level of testing is what is called “paper trading”. This is where we trade in theory, without risking real money. We get to see how the plan works in real markets as they unfold. We build up real experience. At least we should, but most people do not bother with this step. The call of instant gratification that runs through modern society is too strong. They buy a computer, open an account with a broker and “just do it”.

They “do it” all right – at least they “do” their money. You see, the market is a ruthless teacher. It charges a high price for using ignorance. If you do not do your learning before you start trading, the market will give you lessons. And the cost of those lessons is called losses.

Why is paper trading so important? Because it enables us to develop some confidence in our plan. That it works. That it will make losses, but that they are controllable. And when we make profits they should be larger than the losses. Only when we have this confidence in our plan will we be able to stick with it under pressure. What most people do under pressure is to start doubting and then rethinking on the run the very plan itself. This is the road to trading disaster. Discipline is gone. Losses are inevitable.

Finally, we need to start developing real experience. We have to start trading in a small way. As we are successful – and that may not be at first – we can start to commit greater funds to the market. Trading is not an easy way to make a living. It is a hard way to make an easy living. But it has many rewards. These rewards need to be earned though. They are not just there to be plucked.

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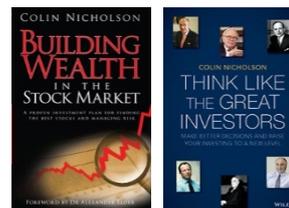
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