Lecture № 16

Trading Psychology

This lecture is devoted to a discussion about the trader's working psychology and the psychoanalysis behind their actions.

The psychology of human behavior is the key to understanding the current situation on the financial markets. You can be a perfect analyst, able to predict the price and time orientation points to the ticks, but that does not make you a trader. All ordinary and everyday feelings and aspirations emerge in severe market conditions like a chemical solution on litmus paper. Feelings inherent to us (such as fear, greed, hope, etc.) in a fast stock exchange sometimes exert a crucial influence on the trader's behavior. The weak and the self-confident, the extremely greedy and the sluggish are all fated to be market victims. The market crowd impact is able to transform the trader from an outsider into a winner, and from a lucky person into a vanquished one. An awareness of your own abilities, preferences and limitations can help you avoid the collapse. If you add to this an adequate evaluation skill of one’s own psychological state as well as the proper market participants’ behavior, then success is guaranteed.

Thus, your main motivation for taking part in speculative market operations is greed (strange as it may seem). If your greed is inconspicuous you will not make many deals, missing a lot of good opportunities. But if your greed knows no boundaries you will try to make as many deals as possible, essentially putting your head into the lion's mouth. In the first case it is recommended to get on with a calmer business; in the second case it's better to play in a casino. Greed must be under cultivation like a useful plant. That is how you will be able to use it and keep it at bay when needed. It is important that greed does not hinder you from making decisions when executing deals. The outcome from greedy actions will serve as motivation when making the deals.

There are two types of motivation:

- Rational motivation usually pertains to beginning traders prior to the first market intromission and also to professionals. It is expressed in an emotional cool when making decisions.
- Irrational motivation is expressed in the player's chaotic actions and it happens to almost everyone. Although some people might be able to control this hazard, others are the slaves of their emotions and almost certain to fail.

The next factor prompting the trader to make deals is the hope to gain profit. Naturally, any job’s aim is to earn money. However, when the hope supersedes the calculation, you are risking overestimating your possibilities during situation analysis and making a big deal out of small prospects. You have to control your hopes by taking into account a calculation and greed. Big hopes are what leads beginners to collapse.

A trader who relies on hope alone is doomed.

Hope determines the trader's behavior in just two cases:

a) At the moment of assessing the market (only the hope of making profit can make a person act in a certain way on the financial market);
b) at the moment of loss-making, when there appears a hope for the situation to change for the better.

If in the first case everything is clear, in the second one hope goes over three steps of its development and existence. In the first step, when losses are not so significant, hope is inevitable and may be reasonable in some measure if you are following a certain scheme planned in advance. During the second phase, if the stop loss is cancelled or isn't set up with rising losses, the hope reaches its peak. At that moment it is the hardest for a trader to distinguish hopes from real market actions. A solution is to close the losing position or let it sweat — this would mostly depend on how well the trader's mind controls his desires and if the trader is able to evaluate the situation adequately. The third stage is characterized by critical losses, when hope leaves the trader and is replaced with despair. This frequently occurs with weak and beginning traders. A great many market participants including successful ones know this sense of emptiness, when it seems that the whole world works against you. In reality nobody knows about you, so the market malignancy is too exaggerated. Still, you cannot miss the fact that the trader's main goal is to earn at the expense of another trader. A person who has overcome the last stage of hope can rightly call himself an accomplished trader. Perhaps in further trading the events from the third stage will appear as a market fright. In order not to face neither despair, nor fear it is necessary to bear responsibility for the decisions that you make. Remember that our weaknesses are mental food for stronger players in a sense.

The following risks can be pointed out:

a) Human beings tend to come under the influence of the crowd and take communal non-individual decisions.
b) The decisions made by the masses are provoked, as a rule, by the least clever participants.
c) Question the references of the analysts who make much less money compared to banks and individual investors.

Keep in mind one rule which will probably help you to evaluate the situation in a proper way:
The absolute majority of financial analytics begin massive publications about the current trend continuation at the moment of its strong correction or its end.

This may occur because most analysts are the employees of financial establishments, which always (or almost always) follow the rule that the trend is the trader's best friend. On the other hand, intentional misinformation may take place as part of the accumulated strong currency needs to be thrown away.

Needless to say, on one hand, you mustn't go against the crowd, as it shapes up the main market trend; on the other hand, you mustn't follow the crowd's opinion as most likely it would be wrong. Tracing the crowd's actions, you have to figure out if you are on the winning side or looking at the crowd of vanquished people. The winners can be seen because of the increasing deals volume and rising ADX tendency. Other technical analysis indicators (such as MACD, RSI, etc.) move sharply along with the price. It is different with those who lost. Hereby, you have to distinguish for yourself one essential rule:

Taking part in the market and speculative trades you must always leave those who lost and join the winners.

A trial to apply knowledge will possibly lead you to a contradiction with other traders and analysts. These contradictions are caused not by our vision of events, but by the psychological discomfort that other traders and analysts don't support your point of view (despite the fact theirs is based on the same knowledge). To handle this question remember one of the main trading psychology rules:

Don’t be afraid to learn in new ways from the viewpoints of traders and analysts.

Before we move onto psychoanalysis, you should also remember one more important remark found by asking traders: *We are inclined to take a risk when the stakes are high, but we are afraid to take a risk when there is no real threat.*

Psychoanalysis of the trader's actions serves for reducing your own weaknesses and helps in getting rid of them. In accordance with well-known statistical data, more than 90% of individual traders finish their careers at the very beginning, not achieving any results. Applying this to the theory of probability, this indicator appears to be overstated. In theory the number of ‘losing’ traders cannot exceed 50%, even excluding the traders with zero activity effect. What is the reason for such a significant contradiction between theory and practice? The traders who quit most easily blame the small deposit sums for their mistakes, the absence of qualitative information regarding speed and volume, the malignancy of the opposition — brokers or dealers, commissions and spreads, etc. These traders are partially right: the reasons listed above don't help with money-making for sure. Still, the main reason for losses is in us — it's our ego. Unfortunately, you can test the real ego qualities without a professional psychoanalyst only amid violent market or other extreme conditions.

Unfamiliarity with your own ego is the main risk factor.

Learning about a person's real qualities, their ego can be a long and strenuous process. An individual investor has no time for this. That is why he/she has to call on a professional psychologist or enter the market as an unstudied trader. To bring to light your true qualities, above all, you should find out if you are dealing with an active or a passive trader (even if it is you).

Prior to position opening everyone is equal. Some are so sure in their choice that they are ready to persist in their opinion vehemently. Others are quiet; they listen to outside opinions but act as they want to. A third type of person can discuss everything, talking non-stop for 24 hours, day and night.

A little bit after the position opening (5-10 minutes for a short-term position or one day for a long- term one) it becomes clear whether the deal you carried out was right or wrong. Right not only when it comes to position opening direction, but also right about the price and timeframe for deal execution. As you know, the outcome can follow three scenarios: profit, loss or zero (no change). Among them, only the first one demands positive emotions, while the other two are charged with negative energy. Thus, in a short time it can be defined how the trader behaves when experiencing positive and negative emotions — aggressively or passively. Finally, you can complete the following table for each trader:

The trader's reaction to an event	Passive	Active (aggressive)
Making profit		
Sustaining losses		
Zero result		
Total (reaction amount):		

An active reaction for the trader consists of sharp movements and opinion alertness regarding the current situation. A passive reaction shows itself in a lasting inaction, regardless of what is happening. The result of the completion of this table will be the first component in the determination of the final table.

The second element is the behavior causality, i.e.: whether the trader is instinctive, intuitive or intelligent:

Trader's behavior reasons	Instinct	Intellect	Intuition
When opening a position			
When closing a position			
Maintaining a position			
Total:			

Now we would trace briefly how these characteristics appear.

Any initial action of the trader is considered an instinctive wish to cater to different material interests. As trading is considered work (so it is psychologically hard), you have to make deals to earn money. That is to say, we can conclude that the trader's instinct makes itself evident in the fact that at work you have to do much more than sitting in front of the screen.

The trader's intellect consists of the ability to comprehend logically what is happening with him and with the general situation around him, and in reference to this take the simplest and the most beneficial decision. If the instinct acts unwittingly using some generic memory (teachers' advice, simple rules), then the intellect tries to understand this advice and rules in accordance with the trader’s own world view in the new external conditions. It is intellect that helps traders look for the way out of a possible dead end - somewhere you can find yourself if you follow old rules. The intellect can also give its own financial markets view and thus, survive within it more successfully.

Trader's Type	Active (aggressive)	Passive
Instinctive	*Negative*: excessive emotionality; Strong susceptibility to a sense of fear, hope, etc. *Positive*: very resilient. *Recommendations*: calm down and take your time.	*Negative*: downcast emotionality; contumacy; Reticence. *Positive*: merit factor of actions. *Recommendations*: take it easy more often; “touch and go” (concerning the deals closing).
Intuitive	*Negative*: stress-susceptible; needs permanent control. *Positive*: good reality apprehension; able to make decisions amid full uncertainty. *Recommendations*: incessant control; take it easier.	*Negative*: too strong failure susceptibility; Ability to accumulate negative energy; meditativeness. *Positive*: keeps their hair on. *Recommendations*: outdoor activity; make deals more often; discuss your actions with other traders, but adopt a decision by yourself.
Intellectual	*Negative*: gets tired fast; needs long rest; disruptive reaction to the fundamentals.	*Negative*: very drowsy; contumacy; thinks too long; self-analysis inclination;

	Positive: able to take objective measures quickly; Self-analytical. *Recommendations*: practice hardiness; At the first signs of attention easing take a break.	excessive sense of fear influence; diffidence. *Positive*: thinks twice; insistence on goal achievement. *Recommendations*: accelerate the pace and calm down; Be cautious about others recommendations.

To conclude the discussion about psychoanalysis it is worth noticing that it is almost impossible to change an adult person. As a matter of fact, by the time we are 5 years old the core of our ego has already formed. However, it is possible and even necessary to educate and correct some character features helpful for traders. Therefore, the primary objective of the trader's behavior psychoanalysis is psychological deficiency outcrop, which can lead to financial losses, and also freedom from disadvantages. If the trader's negative features avoid correction, then it is better to recognize that trading on the financial markets is not for you, the chosen way was wrong and you should seek actualization in other activities.

The recommendations given below will help beginning traders avoid a lot of mistakes and wrong actions when operating on the Forex market.

Inspect your motives. Think over your real reason for trading. A discrepancy between your motivation and the kind of activity results in conflicts. If you cannot make up your mind, the game is over before it began.

Matching your trading method and your personality. It is crucial to choose a method which suits your individuality and convenience level. If it is unbearable for you to lose a significant part of the current profit in an open position, then a long-term approach suggesting the trend movement will turn out to be catastrophic for you, as you will never be able to follow it. If you don't want to (or cannot) sit in front of the screen looking at quotations all day long, avoid intraday trading. If you can’t stand the emotional pressure when making trading decisions, try to develop an automatic system for market playing. The method used must suit you and you must feel comfortable.

Control your emotions. From time to time, all traders go through stress and suffer losses. Worry, disturbance, depression and sometimes despair are all a part of the market job. Part of risk management is the ability to control your emotions. Don't let emotions handle your trading. Focus on the matter at hand. Trade on the basis of informative rational decisions rather than emotions or fantasies.

Communication with other traders is one of the ways to control your emotions. Other traders understand the problems which you have faced and they can provide essential moral support when you lose courage. This helps in showing you that you are not alone and that others have faced such problems and managed to sort them out.

Your trading methods must be profitable on average. You cannot win even having the best financial management skills in the world and the strictest discipline if your trading methods are loss-generating on average. If you don't have a trading privilege, then all that money management and discipline can give you is a warranty that your bankruptcy process will roll on slowly. If you don't know what your trading privilege is, it means that you don't have it.

Create a method. To have a trading advantage you have to have a method. The type of the method is not important. Some trader pros use only fundamental analysis, others play by reference to graph examination, and others use a mixed approach. The main thing is that the method to be profit-making.

Craft or hard work. The general rule is that absolute efficiency requires native ability, as well as hard work allowing to externalize the potential. If an innate talent is not enough, hard work can develop professionalism, but it won't be perfect. The same principles are applicable for trading. Practically, everyone can become a trader making profit, but just some of them are born with a talent, allowing them to achieve superb results. For this reason you can learn a successful trading craft, but to a certain level. Be realistic in your goals.

Discipline. Discipline is absolutely necessary to manage risks effectively and to use your method without hesitating which deal to handle. A beginning trader has no protection from bad trading habits, and the best that you can do is to inhibit them. As soon as you become lazy and negligent they will come back.

Be aware of your responsibility. The responsibility for results rests with you. Even if the losses were suffered due to broker's advice, advisors' recommendations or bad system response, ultimately the responsibility will rest with you, as you decide to take it to heart and act.

Independence. You should think by yourself. Don't let yourself fall for crowd hysteria. Besides, independence means individual decision making. Never hold by others' opinion. Even if they help with one or two deals occasionally, at long last it will cost you money, needless to say about that it changes your view of the market.

Confidence. Strong confidence in your own ability to win on the financial markets appears to be a universal quality among successful traders. Their peculiarity is an assurance that they "have won the game before it starts."

Losses are the part of the game. Great traders recognize in full measure that losses are an element inherent in the trading game. Recognizing this fact strengthens their confidence in themselves. As outstanding players are sure that they will win in the long-term, separate loss-generating deals, which turn out to be a necessary evil, do not frighten them. There is no shorter way to the downfall than the fear of losing. If you don't like losing, then either finish trading sustaining big losses, or miss great trading opportunities — both of these are enough to wipe off any chance of success.

Advice search. A desire to get advice means you lack confidence. As was said by Linda Rashke, “If you feel temptation to know somebody's opinion regarding the deal, usually, this signals that you should better leave your position.”

Patience is power. Expectation of favorable opportunities raises the probability of success. You don't have to be in the market all the time. As explained by Edwin Lefevre in his best-selling book *Reminiscences of a Stock Operator*, “There are usual fools, who act wrong at all times and in all places, but there are Wall Street fools, who think that they must trade all the time.”

Enter and exit the market in steps. There is no need to open or close the whole position simultaneously. The position can be increased or contracted gradually, which makes your trading more flexible and gives you space for maneuver in case of unexpected market situations. Most traders sacrifice such flexibility without contemplating it due to a desire to be right - something common to everyone. A lot of traders notice that the stepwise market outgo method allows them to keep a part of long-term winning positions much longer than otherwise.

Being right is more important than being a genius. Think about your gain without trying to be a hero. Forget about attempts to evaluate trading success by a reference to how close to the minimum you bought. It is better to draw attention to how often you choose deals with favorable ratios of profit and risk. The result of the trading is essential, not the impeccability of the deals.

Do not be afraid to look like a fool. Don't clutch too hard onto your past wrong forecasts. Recollect all your forces to revise the situation afresh and make the right decision.

Sometimes, the action is more crucial than prudence. Wait for a price correction to open a position — sounds charily, but more often than not, it is wrong. If your analysis, technique or intuition says that you must buy, don’t wait for the correction — do it.

It is also nice to catch the part of movement. Even if you have missed the first part of a new trend you still have an opportunity to earn in its middle part (if you are able to determine the reasonable point for protective stop).

Learn to be disloyal. Never keep loyalty to a position. Often, a beginning trader is too loyal to their initial position. Hoping for the best, they will ignore the signs of market situation changes and drive the deal to huge losses. A more versed trader who realizes the importance of risk management will leave the market as soon as it is be clear that the deal is to fail. However, a really experienced trader will be ready to make a 180 degrees reversal, changing the position to the opposite one, if the market behavior points to such an operation method.

Fix part of the profit. Take part of earnings from the market to protect the trading discipline from regeneration in complacency.

Hope is a spoke in wheel. Hope makes traders stick around while they should be dropping out of a losing position; it doesn't let them enter the market in expectation of a correction for opening a position at a better price. Often, hope for correction leads to the loss of potential profit from huge market movements. Don't rely on it — open a position in accordance with the trend as soon as there is an opportunity to define a proper protective stop level.

You cannot win if you are obliged to. There is an old proverb on Wall Street: scary money never wins. The reason is rather simple: if you risk money which you do not presume to lose, all emotional traps of trading become much more dangerous. The market rarely absolves the levity concerning the deals which come out of despair.

Searching for an adrenaline buzz on the market is too expensive. An adrenaline buzz is related to market trading, but that does not mean a success on the market.

Identify and exclude stress. Stress during trading is a troubling sign. If you feel stressed, think why that might be, and then do something to sort out the problem. For example, you have found out that the main source of stress is uncertainty about closing a losing position. One of the ways to settle this matter is to start setting up a protective stop-order every time you open a position.

Listen to your intuition. Intuition is a gathered experience which lies in the subconscious. The market analysis objectivity made up rationally may be compromised by other people's suggestions (for instance, regarding the current market position, an unwillingness to change the previous forecasts). The subconscious is not restrained by such pressure. Unfortunately, we are not able to push through our subconscious easily. However, when it emerges as intuition, the trader should pay attention to it.

The prices are not occasional — it is possible to win on the markets. Bringing to mind the academics trusting in the occasional nature of market prices, Monroe Traut, futures trading advisor with one of the best track records of risk and profit ratio says "Perhaps that is why they are professors and I earned money doing what I used to do."

Don't lock yourself into the market. There is more to life than trading.

To summarize the whole course of lectures, we can say that successful and effective work can take place only in case it includes four essential elements:

- **Price forecasting** is used for determining the further market direction (upwards or downwards). It is the first crucial step prior to decision-making. Price forecasting helps the trader be aware of his actions' tune. In other words, whether he works at the upturn or downturn of the prices. The upcoming market development pattern gives the answer to the main question the trader is faced with - which way to enter the market — long or short. If the price forecast turns out to be wrong, all previous and further efforts will go to waste.

- **Trading tactics** determines the precise moment to enter and leave the market. Its role is especially crucial on the Forex market, as the marginal loan is rather low and consequently, the leverage is high, which gives the trader the right to make some slips. It often happens that the decision regarding the movement direction is right, but due to a delay in making the deal the trader suffers losses. As a rule, the trading tactics have an exclusively technical performance. Thus, even if the trader prefers the fundamental approach, further into his market work he will have to use the technical instruments to determine the certain points of going in and out of the market.

- **Capital management** summarizes most questions concerning the trader's funds investment. This includes the optimal portfolio formation (for significant amounts), diversification, investment size estimation particular to the chosen sector, the amount of risk (for significant amounts), using stop-orders, the correct measurement of possible profit and loss ratios, choosing a behavior tactics after success and failure periods and a certain workstyle - conservative or aggressive.

- **Psychological preparation**. Each of us has their own character traits, emotional singularity and habits. Cognition of yourself, correction or, in other words, adaptation of your ego to the market requirements appears to be one of the most essential factors for prosperous trading. A trader can achieve good results in forecasting, develop a perfect trading scheme and capital management strategy, but the absence of discipline, the fear of the market and a lack of self-confidence may diminish all achievements, not giving you a chance to obtain the desired result.

To succeed then, it is perhaps better to follow the proverb that the true winner is one who has mastered himself, not others.