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Classic Articles
Written by
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1. Why Traders Lose Their Discipline

When traders lose money, they often attribute the problem to a lapse of discipline. Such a lack of consistency, however, is actually the result of many different problems--not the cause. Traders lose discipline with trading for the same reasons that dieters lose discipline with dieting or people getting in shape lose discipline with exercise. Quite simply, our moods, needs, and mind states of the moment tend to overwhelm our longer-range intentions. We pursue short-term pleasures (and avoid short-term discomfort) at the expense of longer-term rewards.

Here are some common reasons why traders (and most other human beings!) fall short of being fully intentional:

• Environmental distractions and boredom cause a lack of focus - All of us have limits to our attention span and these are easily taxed during quiet times in the market;

• Fatigue and mental overload create a loss of concentration - The demands of watching the screen hour after hour make it difficult to be sharp, creating fatigue effects that are well-known to pilots, car drivers, and soldiers;

• Overconfidence follows a string of successes - It is common for traders to attribute success to skill and failure to situational, external factors. As a result, a string of even random wins can lead traders to become overconfident and veer from trading plans--especially by trading too frequently and/or trading excessive size;

• Unwillingness to accept losses - This leads traders to alter their trade plans after trades have gone into the red, turning what were meant to be short-term trades into longer-term holds and transforming trades with small size into large trades by adding to losers;

• Loss of confidence in one's trading plan/strategy because it has not been adequately tested and battle-tested - It is difficult to tolerate even normal draw downs unless you have confidence in your methods. This confidence does not come from mere positive self-talk. Rather, it is a function of testing your methods (historically and in real-time) and seeing in your own experience that they truly work;

- Personality traits that lead to impulsivity and low frustration tolerance in stressful situations - Psychological research suggests that some individuals are more impulsive than others and less conscientious about adhering to plans and intentions. These personality traits often are accompanied by stimulation-seeking and a high degree of risk tolerance: a deadly combination.

- Situational performance pressures - These include trading slumps and increased personal expenses that change how traders trade and lead them to place P/L ahead of making good trades. By worrying too much about how much money they make, traders can no longer follow markets with a clear head;

- Trading positions that are excessive for the account size - This is much more common than is usually acknowledged. It creates exaggerated P/L swings and emotional reactions that interfere with cool, calm planned behavior;

- Not having a clearly defined trading plan/strategy in the first place - Interestingly, many traders do not consider themselves to be discretionary traders, but in fact do not have a firm, explicit set of trading rules that they follow. It is difficult to be consistent with a plan (and to evaluate your consistency), if you don't have the plan clearly laid out;

- Trading a time frame, style, or market that does not match your talents, skills, risk tolerance, and personality - All too often, traders veer from their plans because those plans are ones that they feel they *should* follow, but that don't truly come naturally to them. These departures from discipline are actually unconscious attempts to trade in a style that is more in tune with the trader's skills and talents.

As you can see, not all discipline problems have their origins in the trader's psychology. Many times, the loss of discipline reflects problems with trading itself. Discipline in trading is not so different from "discipline" in a romantic relationship: if you're doing the right things, there's little need or desire to stray. But if your trading is not meeting your needs, it's all too easy to break your trading vows!

2. Risk and Success

Sometimes you hear people debate whether trading success is attributable more to trading techniques or psychology. The answer, of course, is both—but the point where the two intersect is risk management. A huge percentage of trading success or failure can be laid at the doorstep of risk management. A recent book on risk management (that I'll be reviewing next week) observed that, across different traders and trading firms, 90% of all profits were attributable to 10% of all trades. While traders would like to think of themselves as making money on a majority of their trades, the reality for frequent traders is that a minority of trades are winners—and it is the few large winners that produce a favorable profit/loss statement (P/L).

The book goes on to observe that, if 10% of trades account for a majority of profits, it follows that a large percentage of trades have to be "scratched". A cardinal skill in trading is recognizing that a trade is wrong before it hurts the P/L. Time and again, I have seen good traders exit trades when the trades fail to move in their direction; bad traders exit only after the trade has moved against them.

And yet it is equally true that, if 10% of trades are going to account for the lion's share of profits, traders must be willing to milk very good trades. This not only means finding the sweet spot where you can "cut your losses and let your profits run"; it also means being willing to trade sufficient size to maximize returns from a good trade. The worst traders I know put on their maximum size when they're trading at their worst. Typically, they have just lost on one or more trades and now are trying to get the money back. The best traders are able to identify superior trading opportunities—and are patient in waiting for those—and will put size on to take advantage of these. This is how 10 good trades more than make up for 90 scratches and losers.

A favorite trading story that I tell concerns a very successful trader. He promised to tell me the secret of trading success. Of course, my curiosity was piqued and I asked, "What is that?" He responded with a question: "What the ratio of your largest position size to your normal size?" "Three-to-one", I told him. He smiled. "Consider 20-to-1," was his advice and his success formula.

I completely believed him. The reason he was successful had nothing to do with finding a better oscillator, regression analysis, or chart formation. He was successful because he had the ability to identify—and wait for—particularly profitable opportunities and then take maximum advantage of those. While 20:1 position sizing is—and will always be—rich for my blood, I think the principle is valid: success is partly a function of putting size on for the logical, not psychological, reasons.

This is one reason trading is so difficult. It is an unusual blending of traits that allows someone to be prudent with risk, scratching trades that don't move promptly as expected, while at the same time milking opportunity. It is easy to find traders who are risk-averse and stick with their one and five lot positions; it is also easy to find traders who will swing size freely, including times when they are frustrated with the trade. What is rare is to find the mix: the ability to accept and limit the 90% of occasions that don't work, and yet act aggressively on those 10% of times when there is a move to be exploited.

What is true for size is also true for time. Much can be learned simply by identifying how long a trader has held onto winning vs. losing trades. If a trader is quickly exiting trades that aren't going in the desired direction, the average holding times for such trades should be quite low. Conversely, with the good traders, it's not unusual to see a trading log that registers 10% of trades that are held for a lengthy period of time. Invariably, these are the winners that contribute significantly to the overall P/L.

The truly unsuccessful traders will also display a minority of trades with long holding times—and these will be the losers. I recently asked a trader why he hung onto a long position for an unusually long period of time. He looked at me somewhat quizzically and replied, "Because I had the bottom!" He was willing to sit through a choppy trade as long as it went in his direction and as long as nothing happened to convince him that he didn't identify the bottom. That one trade made his entire day.

Perhaps this is a truism in all of life. The people who I have seen who have been very successful in dating and relationships have been willing to go on very many first dates, but not so many second and third ones. They "scratch" the unpromising dates and then focus their energies on the 10% that look worthwhile. The same is often true with respect to career and company success. A successful individual may take on ten projects over the course of a year, but focus efforts on a single initiative when it yields promise.

A company may roll out ten products and quickly pull nine, making significant money on the one that finds ready acceptance in the marketplace. Even successful artists and inventors, researcher Dean Keith Simonton found, tend to churn out creative efforts, deriving their fame from the small minority of works that attract the attention of an appreciative world.

Successful traders risk manage their market exposure. Successful individuals risk manage their life exposures. It is not just how much we undertake, but how much we scratch in life that determines our ability to benefit from the episodes of promise that come our way.

3. Controlling Emotions is Not the Goal of Trading Psychology

Pick up a book or magazine article about trading psychology and you're likely to find prescriptions for success based on controlling emotions and increasing discipline.

Yes, emotional arousal can interfere with performance, but does that mean that elite performance is a function of dampened emotions?

When you look at some of the greatest performers in sports--and in trading--you'll find highly competitive individuals. They are quite emotional and don't take well to losing. Lance Armstrong? Michael Jordan? Tiger Woods? Muhammad Ali? All were quite intense, emotional individuals who managed to channel their emotional drive into victory.

Conversely, I've encountered many well-balanced individuals who have sought success in trading. They don't blow up, they follow rules faithfully, and they have no intense, competitive emotional flame burning within. I've never yet seen one go on to become successful.

Can anyone watch the really successful American college basketball coaches--Coach K., Jim Boeheim, Bob Knight, Tom Izzo--and attribute their success to emotional restraint? Yes, there have been emotionally reserved winners--think John Wooden and Dean Smith--but one suspects their emotionality was that of a warm mentor, not that of a cold fish.

The important ingredient in success is not emotional dampening per se, but the enhancement of concentration and focus. That is what enables people to act with sustained purpose and stay rooted in their goals.

When we review the lives of great individuals across a variety of fields--the research of Dean Keith Simonton and K. Anders Ericsson stands out in this respect--what we find is that the greats have prodigious capacities for work. They are hugely productive. They sustain effort hours at a time, day after day, week after week, year after year.

Only the ability to regularly access "the zone"--that flow state of consciousness that comes from being wholly absorbed in an activity that captures our interests, skills, and talents--can account for the amazing dedication of the Olympic athlete, the great career scientist, or the chess grand master.

Indeed, such exemplary performers can use emotion to access the zone. Michael Jordan used to provoke players on opposing teams so that they would argue and fight back. That would arouse Jordan's competitive instincts and elevate his game.

When we operate outside that "zone" and lose our focus, we are no longer activating that executive center of our brains--the frontal lobes--that control planning, judgment, and reasoning. Left with a weak executive center, we become like the person with Attention Deficit Disorder: prone to wandering attention, reduced self-control, and impulsive behavior.

That makes it look as though "emotion" and "lack of discipline" cause our trading problems.

In reality, however, these are the results of the problem; not the causes.

The goal of trading psychology is to build consciousness, not reduce emotion. The goal is to create regular access to the flow state of heightened learning and focus. Talking to a trading coach, in itself, won't accomplish that; nor will well-intentioned efforts to calm oneself or take breaks from trading.

We can only build consciousness by working on consciousness. That is why I find meditation, heart rate and galvanic skin response biofeedback, self-hypnosis, and newer methods such as hemoencephalography to be valuable tools for traders and emphasized their use in my book on the psychology of trading.

These methods don't eliminate emotion; they build minds. If we can exercise for 30 minutes per day and build our cardiac fitness and our physiques, maybe--just maybe--a similar commitment could strengthen our abilities to operate within life's "zone". I'll be posting more re: my personal experiments with mind training in the near future.

4. The Greatest Emotional Problem Facing Traders

Recently, I suggested that traders faced a greater emotional hurdle than either fear or greed: overconfidence. Overconfidence is what leads us to take on too much risk for too little reward. It is what allows us to wager our hard-earned money on untested and unproven market signals. Indeed, almost by definition, beginning traders start their trading careers in an overconfident state. After all, in what other performance field—sports, music, or chess—would a newcomer enter a competition with experienced professionals and truly hope to compete?

Research reviewed by Scott Plous in his book The Psychology of Judgment and Decision Making suggests that overconfidence is greatest in situations where individuals have no better than chance odds of being correct in their judgments. One of the reasons for this is called the Gambler's Fallacy. A person who guesses market direction once a day and has a 50/50 chance of being correct will encounter, on average, about six occasions per year in which he or she is correct five times in a row. Some of these random traders will, by sheer good fortune, hit this streak early on in their career. According to researcher Ellen Langer, early (but random) experiences of success lead individuals to be highly confident in their ability—even when the task is guessing the outcome of coin tosses! This is because they are more likely to attribute success to internal factors—skill—than to situational reasons or chance. The gambler who experiences a (random) streak of wins becomes convinced that he has a hot hand and raises his bets accordingly. The result is predictably disastrous.

Do traders behave differently from gamblers? Research suggests not. Terence Odean found that traders who were most confident in their decision-making traded the most frequently—and lost more money than other traders because of the increased transaction costs. A provocative study from the London Business School presented traders with price data and asked the traders to make trading decisions based on the data. Traders were not informed that the data were generated randomly. The traders who expressed the greatest confidence in their decisions, not surprisingly, were also the ones who, on average, lost the most money. The "illusions of control" demonstrated by these traders can reach extremes bordering on the absurd. In Langer's studies in which coin tosses were presented as tests of "social cues", for instance, 40% of all subjects insisted that their ability to guess the outcome of the coin tosses could be improved with practice—and 15% believed that enhanced concentration and an absence of distractions would improve their results.

A different kind of overconfidence can be seen in surveys of traders and investors, asking them for their expectations for the market. Traders feel better about their ability to call market direction than is warranted. For example, in such surveys as those conducted by Investors Intelligence, over 70% of respondents pronounce themselves either bulls or bears—despite the fact that the majority of time the market is rangebound. Research cited by

Hersh Shefrin, in his review of behavioral finance studies entitled Beyond Greed and Fear, finds that traders are most bullish after extended rises—with inexperienced traders most bullish of all. That is paradoxical, because market returns historically have been greatest following years of decline, not years of strength. Similarly, it is not uncommon to see put-call ratios elevated after a five-day period of decline, despite the fact that returns, on average, are superior following five days of weakness than after five strong days. Quite simply, traders extrapolate from the past to the future—and confidently act upon these (false) expectations.

Is it possible to immunize oneself from overconfidence? My personal therapy for treating overconfidence has been to test out my trading ideas and calculate: a) precisely how often the pattern would have been successful if used in the past; and b) how much of a P/L edge was present over that time. Those statistics, which I report on my blog, ground me in the inherent uncertainty of markets and prepare me for the very real possibility, with any trade idea, that I will be wrong. This, in turn, has helped me greatly with risk management, as I am unlikely to wager a large proportion of my trading stake on any uncertain proposition—even when the odds are in my favor. The past is hardly a guarantor of the future, but by assuming that the future won't be better than the past, we can soberly assess the downside and avoid overconfidence.

The best trades, I find, have enough of a historical edge to make me feel confident about the idea, but also enough potential downside to prevent me from feeling overconfident. Planning for each trade being a potential loser may seem counterintuitive, but it keeps risk management sharp and overconfidence at bay. And that makes a world of difference to the bottom line.

Bonus - Market Psychology Questionnaire

Instructions: The following questionnaire describes 24 emotional states. Please use the scale that appears below to describe how you have felt during the last two weeks of trading. Please do not read further into this article until you have completed the questionnaire.

1 = almost never; 2 = rarely; 3 = sometimes; 4 = often; 5 = almost always

1) Happy _____	9) Joyful _____	17) Cheery _____
2) Pleased _____	10) Content _____	18) Satisfied _____
3) Energetic _____	11) Enthusiastic _____	19) Lively _____
4) Affectionate _____	12) Caring _____	20) Warm _____
5) Sad _____	13) Melancholy _____	21) Depressed _____
6) Nervous _____	14) Stressed ______	22) Edgy _____
7) Frustrated _____	15) Angry ______	23) Irritated _____
8) Regretful _____	16) Guilty _____	24) Self Doubting ____

Explanation of the Questionnaire

Please note that this is not a mental health questionnaire. It is not intended to diagnose or identify emotional problems. Instead, it is a snapshot of your state of mind during the past two weeks.

The purpose of the questionnaire is to assess the relative balance between your positive emotional states (psychological well-being) and your negative emotional states (psychological distress).

All of us experience emotional stresses. Indeed, a high degree of stress is built into many life situations (raising children in a two career family; short-term, highly leveraged trading; etc.). The challenge is not to reduce stress, since the demands we face at work and home are part and parcel of what make life meaningful. Rather, the goal is to ensure that stress does not generate distress; that our lives have a favorable balance between states of well-being and states of distress.

Every challenging situation we face is a source of stress. Every challenging situation we face is also a potential source of well-being—and a potential source of distress.

If we reduce our stress by eliminating life's challenges, we also reduce our avenues for well-being and fulfilment. A great example of this for many people is retirement. Once retired, people face few of the demands from work and raising a family. They also may experience few of the joys associated with productive work and family attachments. Without these sources of well-being, life can become dull, routine, and meaningless—which generates distress!

It is not well appreciated by most people that many “psychological symptoms” result, not from great conflicts, deficits, or problems with self-esteem, but from a relative absence of well-being. Abraham Maslow was one of the first psychologists to recognize that we need positive emotional states to function optimally.

This questionnaire can thus serve as a quick and dirty way for you to identify where you stand with respect to both distress and well-being. We commonly recognize that emotional states are most likely to sabotage trading if distress is high. Equally important, however, is the interference with trading that results from an absence of well-being.

In my own student counselling practice, two-thirds of all the people I have met with have no diagnosable emotional disorder whatsoever. They are dealing with normal life challenges—and very often the goal of our work is to expand their well-being; not “treat” their distress. Those students come to counselling asking, “What is my problem?”, hoping to stop doing something wrong. Instead, they should be asking, “What makes me happy and fulfilled?” and start doing more of the right things.

What percentage of your life is spent doing the things that truly make you happy? So much of what gets people in trouble in life—addictions, extra-marital affairs, excessive debt—is a (poor) compensation for the happiness that is missing in their lives. So much of what gets people in trouble in trading is trying to use trading (or the results of trading) as a substitute for the gratifications otherwise missing in their lives. Trading can be immensely fulfilling, but it will not fill a vacuum.

Scoring the Questionnaire

To score the questionnaire, you’ll be adding your responses for the three items in each of the eight rows. This will give you a total of eight subscale scores.

Row One (Items 1, 9, 17):	This is your happiness score.
Row Two (Items 2, 10, 18):	This is your satisfaction score.
Row Three (Items 3, 11, 19):	This is your energy score.
Row Four (Items 4, 12, 20):	This is your attachment score.

Now add all four of the above scores together. This is your total score for well-being.

Row Five (Items 5, 13, 21):	This is your depression score.
Row Six (Items 6, 14, 22):	This is your anxiety score.
Row Seven (Items 7, 15, 23):	This is your anger score.
Row Eight (Items 8, 16, 24):	This is your guilt score.

Now add all four of the above scores together. This is your total score for distress.

Interpreting the Questionnaire Results

The first thing you should look for in the results is the overall ratio of your well-being score to your distress score. This is a gross measure of your emotional balance over the past two weeks.

The average person reports more well-being than distress. If your ratio is 2:1 or greater, your balance is favorable. As the ratio approaches 1:1, it's saying that you're experiencing as much negative emotion as positive. That raises the odds that distress will interfere with life activities, including trading. A ratio where distress is greater than well-being suggests that something in your life is out of whack. It may be a temporary factor, such as a loss in a relationship, or it may be an ongoing state of affairs. If ongoing, some efforts at change might be in order.

Again, please realize that the questionnaire is not identifying emotional disorders. A person can have an unfavorable balance of emotions for a variety of reasons. It is when this negative balance persists over time that it becomes a potential impediment to trading, relationships, creative work, etc.

Simply looking at the balance between distress and well-being is somewhat misleading. A person might have a relatively favorable balance, but be low in both well-being and distress. In such a case, the relative absence of well-being is not (yet) generating emotional consequences, but may be worth addressing. Conversely, someone who is high in distress and in well-being may be in emotional turmoil, but handling it quite effectively.

In addition to the overall scores, it is helpful to examine each of the eight subscale scores closely. Because each question is scored on a 1 – 5 scale, a subscale score below 9 is relatively low, and a score of 12 or above is relatively high. By identifying your highest and lowest scores, you can assess where you are most generating distress and where you might be missing well-being. For instance, your well-being scores for happiness, satisfaction, and energy might be high, and your distress scores for guilt, anxiety, and anger might be low. The lower score on the dimension of attachment and the higher score on the dimension of depression might suggest that fulfilment in relationships is missing—and perhaps becoming a source of negative feelings about oneself.

Ideally, you would take this snapshot at intervals throughout the year, tracking your scores over time. This would give you a sense of whether ups and downs in your emotional states are situational or continuous. A series of scores would also tell you how your life is going overall, if your investments in life's activities are generating acceptable emotional returns. You wouldn't settle for 1% savings account returns on your retirement funds. Why settle for paltry emotional returns in life?

About Brett

Brett N. Steenbarger, Ph.D. is Associate Clinical Professor of Psychiatry and Behavioral Sciences at SUNY Upstate Medical University in Syracuse, NY and author of The Psychology of Trading (Wiley, 2003). As Director of Trader Development for Kingstree Trading, LLC in Chicago, he has mentored numerous professional traders and coordinated a training program for traders.

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