Trading Basics Series

HOW DO I TRADE STOCKS.COM

Trading Basics Series

TRADER PSYCHOLOGY

Stock Trading Emotions – Learn to Conquer the Fear

Emotions have no place in a day trader, swing trader, or even long term trader's outlook on their investments. When we try and protect ourselves from fear, we end up resorting back to our habitual instincts to enter into a place of comfort, whether or not that place is reality. We stop taking responsibility for our own fears and start blaming others for our problems. At the end, we try and find an easy way out by searching for magic indicators, or Holy Grail solutions.

When I think back to early trading career, I remember the times where I continuously changed my trading techniques to achieve the result that I was looking for. No matter what technical indicator or stock trading system that I used, I would yield the same result, losses. It didn't matter what I did, I had to fix the real problem which was in my psyche.

Reviewing and Conquering Stock Trading Emotions

You will face strong resistance internally from yourself when you take your first step to creating a larger vision for your stock trading. This means you will need to let go of your bad habits and take a leap of faith and do what is required to reach your goals. I have seen many trader's who psyche themselves up and temporarily follow their stock trading vision. The problem arises when trader's experience the emotions of losing; many tend to lower their expectations and go back into their shell, going back to what they are used to. They start reverting back to old habits and going back to square one again.

Some trader's try psyching themselves up by screaming, shouting, speaking positive thoughts, working more, etc. Sure you need to be positive but by solely taking these steps, you are subconsciously reinforcing the idea that you are deficient in some aspect of trading that is preventing you from reaching that true level of mastery. They mask the underlying issues that you need to face up front and center.

Any time you make changes, you will face internal resistance from within, fear, fatigue, insecurity, and even opposition from family members or loved ones. You will most likely even receive negative energy from those around you who are threatened by what you are doing. Change does not happen overnight and you have to stick with your convictions in the face of self-doubt; be patient and allow yourself time to achieve the goals that you set out to reach. Don't allow yourself to become a victim of these negative thoughts. They will only serve to distract you from concentrating on what needs to be done. Again, we want to attack the root of the problem which is how you interpret these feelings. You will not necessarily be able to rid yourself of them; however, you can stop focusing on them. Focus on the future and on what you want out of it. It is key that you change your thought process when it comes to negativity.

To manage your risk and emotions, you have to accept the negative feelings that you internally attempt to suppress. Rather than ignoring them, face them and associate no significance or meaning to these feelings. Eventually, we will become what we resist similar to the way we say that we will never become like our parents. Most of us do. Therefore, by showing no importance or resistance to your negative feelings; you allow yourself to focus on your positive goals.

The Stress Effect

Stock trading brings its fair share of stress, as you all know. The question revolves around how you handle the stress. Some get physically sick, some start to panic, and some even go into depression due to the violent swings that the stock market can produce. Depending on the situation and the person, the stress reaction may be minor or very severe. Your bodies response to stress is physically and emotionally exhausting. As you continue to experience stressful situations, the more accustomed you become to the idea of the negative feelings that are associated with stress. These negative feelings turn conviction into doubt and nervousness. Practice yoga, meditate, play sports, exercise, spend time with your loved ones, work on your spiritual growth. You need to de-stress your mind and clear your mind. Obsessing over your trades will do nothing but burn you out and leave you on edge all the time. There is more to life than trading stocks. Don't let trading get you too emotionally high or low. The key to lowering stress levels is to be grounded and also to be confident that you can make the right decision when the time comes. That comes with experience so be patient.

Anger Management

Anger is another emotional response that has no place in a stock trader's heart. Figure out what is troubling you inside and learn how to deal with it immediately before it manifests inside as pent up anger which will show its ugly head sooner rather than later. Anger makes you vengeful and provokes bad decision making in the hopes of "getting back" at the market or forcing trades due to the frustration of losing. I can't tell you how many times this has happened to me when I was a junior trader and I never saw anything but losses stemming from it. Verbalizing and expressing your anger in the appropriate ways will allow you to drop the proverbial "baggage". You will sense a feeling of freedom internally from not having to cover up your past emotional experiences which have kept depression, panic, and anxiety alive.

Remember, the more you can disassociate yourself from your emotions, the better at stock trading you will become. (TradingSim - Investor Blog, 2011)

The Technical Aspects of Trading Emotions

Every seminar and book will tell you that controlling your emotions and having discipline in you're trading are essential to your success. But no one tells you how to achieve emotional control and personal discipline while trading the market. Every trader sees the market differently because our past, our current lives, and our perceptions are unique. Understanding those things about yourself and harnessing their effect on your trading will help you keep trading realities free of emotional debris. Here are some steps that will make a difference. You must take a technical approach to your emotions and discipline training just as you take a technical approach to analyzing a stock chart. But before we get into the logistics of how to control emotions, you must understand some basics of why some market participants have solid control of their emotions while others do not.

All price action in stocks is critically dependent on emotional reactions from varying market participants. Without emotions, price sits flat. There are many degrees of emotional surges, waves of euphoria and greed, and waves of panic and despair that drive prices up or down. And always within those waves are the killer rip-tides that come from those who have learned to control emotions, and wipe out those who do not have control. Ultimately, success in the market is a combination of anticipating the next move and the moves of all the other market participants who may enter that stock, and determining when you should participate. Unfortunately, most traders trade the market not as if they were playing chess with the complexity of the bluff of poker, but as if they were in Las Vegas, gambling on a roulette wheel.

In the world of stock trading there are Master Traders who have control over their emotions and then there are the Gambler traders who buy and sell based purely on emotion whether they realize it or not. A Master Trader combines the skill of a chess player who anticipates an opponent's moves and plans his own well in advance and also uses the poker player's bluff in never revealing his hand before he chooses to reveal it. A gambler is simply reacting to his emotions without logic or forethought in what he does.

Market participants who trade the market with the skill of a Master Chess Player–anticipating price action days, weeks, and months in advance; incorporating the 'never reveal your hand' aspect of poker–have the extreme advantage over gambler traders. They have control over their emotions and hence control over how they trade. The gambler trader is just throwing money at the market and hoping something will go their way.

It is also important to realize that you do not come to the market as a blank page. You come with the personal history of your life, what happened to you and more importantly, how you reacted to what happened. You have preconceived opinions and preset emotional trigger responses to each situation you will encounter in the market based on past experiences relating to money. You come to the market fully loaded with trigger points just waiting for the right conditions to fire. And they do.

Now you understand that even before you initiate a trade in the market; emotions are already underway–negatively impacting how you study the charts, learn a new strategy, or take a weekend seminar. Emotions are ruling your decisions, interpretations, and how you use what you have learned. The entire mechanism of emotions has begun to impact your trading before you ever enter an order. You are trading emotionally right now, at this moment. As you read this article, you are basing opinions about what you read on emotional reactions to what you have read before, how those articles helped or didn't help your trading, and what you are expecting or hoping to find now.

Of course, there are varying degrees of Master Traders and Gambler traders. Most of the time, the larger the capital base a trader has available to trade, the more emotional control and discipline a trader has developed. The giant institutional investor manager who trades billions of dollars has ultimate control and discipline. The odd lot trader who has only a couple of thousand dollars to trade has the least emotional control. Statistics show that the smaller the capital base, the less knowledge a person has and the greater risk they take.

That said, there are small retail traders just like you, out there trading, who remain calm, cool, and collected no matter what is going on with their trade at any given moment in time. A floor trader for a big market maker firm can be down in their account by a million dollars but still can stay calm and choose the right decision to turn trades around to his advantage. How you do achieve this kind of control?

Steps to Controlling Emotions and Gaining Trading Discipline:

1. Know what you are going to do before you do it.

A Master Chess Player is at least 6 moves ahead of his opponent at every step in the game of Chess. A Master Trader identifies the market participants in that stock at that moment, determines when the next level of market participants will buy, decides a specific price for entry, and has one or more exit strategies planned for that stock trade before he ever places an order. In other words: he knows what he is going to do before he initiates the trade and has all of his various strategies worked out for all the different scenarios that can happen to that trade. He is prepared for all situations and ready to trade.

2. Develop your own unique Trading Style.

Too often traders simply follow the crowd. Instead you should develop your own unique trading style. A trading style is not a strategy. It is a set of parameters or rules that you adhere to strictly, ignoring rare anomalies that occur in your trading from time to time that go against your rules. Your trading style should also ignore gimmicks, fads, and 'hot new strategies' that are constantly being promoted to crowd traders. If you establish a set of parameters for your trading, write those rules down, and follow them while ignoring the crowd mentality of most small retail traders, you will begin to establish strong emotional control in your trading decisions. The trick is writing the parameters down and then sticking to those rules. Emotions want traders to ignore rules.

3. Ignore the Money.

Don't trade for the money. Trade because you can't imagine doing anything else. Trade because it is the most enjoyable and rewarding profession you can do. You can have a passion for studying charts without letting passion rule your decisions. Highly successful people, in any career, do not do their job because of the money, they do it because they love what they are doing and can't imagine doing anything else. The money is secondary to doing the job that gives them purpose and self-esteem. Money is not the ultimate motivator, purpose and self-esteem are.

4. Don't count your profits before the trade is completed.

Most traders worry about their profits and check them every day. They get elated when a stock they are holding moves up a few points and get frantic when a stock they are in moves down. They constantly check their held positions and calculate their gains or losses during the trading day. This is one of the biggest mistakes traders make and it creates an emotional state of mind that lacks control. Checking your profits or losses constantly is obsessive, gambling mode trading. And it is not based on facts.

Most traders assume that if they are in profit in a held stock they have made that money. Conversely, if they are losing money, then they take the stance that this is just a momentary loss and not a real loss. This is how most traders think, but it is the opposite of what they should be thinking.

To gain control over emotions and to gain discipline in your trading you must view your stocks this way: When a stock moves against you, you immediately have a loss, even before you are taken out of that stock. If the stock moves a few points in your favor then you have the potential for profits. But until you exit that stock you do not have profits. Only when you sell that stock do you actually have profits. A loss is immediate, even before you sell. Approaching your held stocks in this manner is critical to maintaining the proper viewpoint when holding stocks.

If you view every stock this way, your emotional control is geared for correct responses and decisions for the condition of your trade. If you say to yourself that a losing trade is going to turn around, you immediately increase your emotional level so that instead of thinking logically, you are hoping and praying for a miracle that the stock will turn around. This will cause you to miss subtle chart patterns that are telling you to dump the stock and move on.

If you are in a profitable trade and you say to yourself "look at all the money I've made!" you are in an emotional euphoric state of mind. Euphoria makes traders feel invincible, and you will ignore weakening patterns. The result of this euphoric state of mind is that you will either hold a stock too long, or you will take greater risks in your next few trades that will result in losses due to poor analysis dominated by emotions and a false sense of invincibility.

Solution to euphoria: First recognize it. Traders are never brilliant. It is only an ideal trade during great market conditions for that trade. To quell the euphoria, do not trade after you have made a huge profit. Take a few days to settle down. This is not gambling where you can say to yourself "I'm on a roll!" You are most definitely NOT on a roll. Trading takes logical analysis, not super-heated emotions of feeling brilliant. If you stop trading and let your emotions calm down, you will see huge improvements in your consistency of profitability. This is the reality of trading the stock market.

5. Know your risk tolerance.

Two chronic complaints from traders is that Market Makers are 'out to get them' and that stop losses don't work. Both are fallacies steeped in conditions that create deep emotional trading patterns. First let's get rid of 'The Market Makers are out to get the little guys Syndrome'. The truth is the Market Makers primary role is to keep the markets orderly by buying or selling their own inventory of stock IF there are no buyers or sellers for an order. That is something that occurs only in large lot activity or illiquid stocks.

If you are trading under 5000 (five thousand) shares, then you are trading what is considered a small lot in today's market where billions of shares trade hands each day. The reality is that small orders under 10,000 share lots are routed to computer processing systems. These computer programs fill small lot orders automatically when received from the brokerage houses. Market Makers never see these small orders. NASDAQ has its SuperMontage automated order processing system and NYSE has Archipelago. The Market Makers don't even know you exist. If your stop loss gets taken out and then the stock moves up (or down) this is not because a Market Maker saw your stop loss and decided to take you out of your tiny share lot trade, it occurred because too many small traders all used the same percentage stop loss and thereby accidentally created an imbalance of order flow that triggered a series of automatic selling that caused you to be taken out.

The second myth: Stop losses don't work. The problem is that you are trading way beyond your risk tolerance. Risk tolerance is different for each trader. Most traders don't even know what their risk tolerance is nor do they consider this when entering a trade.

The common scenario: A trader places a stop loss that is obviously too tight for the stock's normal price action patterns because he is afraid to lose money. He thinks that if he keeps a very tight stop, then he is only risking a small amount of money. Often these stop losses are based on a specific dollar amount that has nothing to do the with the chart price action.

The trade is too high risk for his risk tolerance but instead of discarding the trade in search of a trade within his risk tolerance, he trades emotionally by convincing himself the trade will make him a lot of money and that if he just keeps a tighter stop then it is okay. The reality is that by keeping a tighter stop than the stock price action pattern indicates is correct, he is actually increasing his risk for that trade as the normal price action will wipe out that stop loss quickly. And that trader's normal emotional response is that stop losses don't work.

Rule for stop losses: Do not use common and popular percentage stop losses. Use proper stop losses based on solid support levels for that stock.

Properly placed stop losses do work. They protect you from the occasional trade that goes against you. And they tell you if the risk of the trade is too high–a common condition of an overextended stock ripe for profit taking by large lot traders. Improperly placed stop losses increase your risk and are an indication that you are trading outside of your risk tolerance. You are therefore trading emotionally.

How to control emotions: Determine your risk tolerance and only trade stocks that are within that range. Usually the lower your capital base the lower your risk tolerance will be. As your capital increases, your risk tolerance should also increase as well. Never trade beyond your risk tolerance because you will trade with a heightened state of emotion and your decisions will be based upon greed or fear rather than logic.

6. Know your Financial Self-Worth.

Financial Self-Worth is probably the least known and least understood aspect of trading emotionally. Most traders don't even realize or accept how much it impacts their trading. The most common symptom of this problem is the trader who suddenly makes some good trades and profits and is feeling great about his trading but the next few trades are disasters that leave him feeling bewildered and frustrated. If this has happened to you on more than one occasion, one of the reasons may be due to the influence of your financial self-worth.

Your financial self-worth is a culmination of many years of your professional adult work experience, your childhood experiences, your general feelings about money, and your educational experiences which create your perception of your worth to the society you live in. These perceptions are a major emotional constraint in your trading. It is not created by your trading, but has been with you for many years prior to even thinking about becoming a trader. It influences your life far more than you probably realize. It can keep you from earning more money. And it can thwart and hinder your trading profitability. It keeps you from making a higher income and it sabotages your trading whenever you exceed your financial self-worth. It is the primary reason some traders make a lot of money while others have mediocre results.

Fortunately, financial self-worth is easy to determine and easy to adjust upward. Taking the Financial Self-Worth Test will give you a basis that tells you critical information about yourself. Once you have assessed this aspect of your trading, it will lower emotions and give you more control. You can increase your financial self-worth and in doing so will increase your profitability, while eliminating that seesaw effect of gains followed by losses. You will have the tools to stop sabotaging your own trading profits.

7. Treat it like a Business.

If you want to make trading a full time career, you must treat it as any professional would in any career. View trading as a business rather than just a hobby and your entire emotional level will change. Set up an office that is quiet, well organized, and far away from distractions. Keeping your trading computer in the family room is just asking for poor trading results. Maintain accurate records of every transaction you make. Document all of your trading efforts in a Trading Journal. All professionals keep journals or logs to track their performance over time. All serious traders should also have journals or logs that detail what they have done. That way you can easily go back and study what happened before and compare to current patterns.

Professionals never stop learning. They know that being a professional requires constant training and education to continue to hone skills and expertise and to keep up with the ever changing world we live in. Nothing is stagnant, life is constantly changing and so is the stock market.

Be a Specialist. The highest paid and most successful professionals in any field are Specialists. For example, doctors who specialize make far more money than a general practitioner. Traders who specialize also make far greater returns than those who dabble and experiment with every new gimmick and strategy. Choose an area of stock trading and become exceptional in that area.

8. Paper Trade on an ongoing basis.

Test Theories before implementing them. Too often traders learn a new strategy or think of a new theory about trading and then rush in to the market without testing that theory or strategy. The end result is loss, often huge losses. A doctor wouldn't test a theory on a live patient. Theories are tested in the lab for many years before they are used successfully on patients. The ideal way to test your theories or ideas is to simulate trade the current market for a period of time. Many traders attempt to back-test theories but the problem is that the market is constantly changing. The market we have had in the past 4 years is quite different than the market of the late 1990's so back-testing your theory on the market of the 1990's will give you different results than what you will have for this current market.

Reminder: It takes at least 100 trades to fully test a theory. Many traders test a theory on a few trades and then go live in the market only to have disappointing results.

9. Get rid of Traderitis.

Most retail traders trade too often. They react to the market instead of anticipating the market. Brokers, clearing houses, the news media, stock and options seminars, the exchanges, etc all benefit from retail traders activity. The more trades you do, the more profits your broker, clearing house, news media, and others make. They want you to trade as often as possible and they don't care if you make money or lose money so long as you trade, trade, trade. Traderitis is compulsive trading. It is grounded in the false belief that trading more often will result in more profits. It is a falsehood promoted by those who make money from your trading.

In the stock market less is more. If you made money 9 out of 10 trades and those trades were highly profitable with the one having a small loss, versus 100 trades where 55 trades were losses, and 45 were profitable, which group would make you more take home profits? Remember: quality, not quantity. Every time you trade, there are costs involved. If you have many losing trades it is more than just the loss of that trade, it is the cost of the order, the time you spent on it, and the overhead you incur when trading as a business.

Too many traders have Traderitis and are obsessed with trading and those who benefit from this kind of trader continually feed and nourish the fallacy that you must trade every day. You don't. In fact if you only trade a few ideal patterns with low risk and strong profit potential you will be way ahead of your peers who trade hundreds of times every month. This is a proven statistical fact that nobody wants you to know.

10. Be Self-Reliant and take responsibility for your trades.

When a trader lacks self-confidence, they run around trying to find someone else to make their decisions for them. They buy dozens of newsletters that recommend stocks, watch news on TV that recommend stocks, and listen to numerous "gurus" touting great picks. This is the realm of insecure traders and their performance and success in the stock market is dismal.

To be highly successful at anything, you must take responsibility for your own actions. You must learn to depend upon yourself and your ability to make sound decisions. If you are a novice trader, just starting to trade with limited experience, choose one mentor to guide you while you develop your self-confidence and skills for trading. Don't listen to every guru and TV commentator as this will only confuse you. Find someone who can help you develop your own unique trading style and wants to teach you to becoming self-reliant.

If you are experienced but have gotten into the bad habit of getting angry after a bad trade, and blame the market, your broker, your trading buddy, your spouse, or whatever for that bad trade, then you need to work on taking charge of your trading. This is the symptom of someone who lacks self-confidence in their own trading decisions. If you are not confident you can choose good stocks, then you should not be trading live in the market. This usually means you didn't paper trade or simulate trade long enough when you were first learning to trade.

Solution: Go back to the simulator and stop trading live in the market. It doesn't matter whether it takes a few weeks or a few years. Until you are confident that you and you alone, are fully capable of consistently choosing good trades, you will never be successful as a stock trader or options player. If you aren't successful paper trading or simulator trading then you will not be successful trading live in the market.

Professional traders make their own choices and their own decisions. They select one or two websites they use for stock and fundamental analysis, they have one primary charting program, and one to two internet brokers they use. They are comfortable and confident with every trade they enter and they remain calm and secure with their decisions even when the occasional trade goes against them. One bad trade doesn't ruin their self-confidence. And they always use stop losses to minimize the risk of a large loss. They know that nothing is 100% in or out of the market and that being prepared for all contingencies is the best way to maintain consistent success. They rely upon their own technical skills to select stocks and ignore the crowds that are chasing stocks from "recommended" lists.

In Summary:

Most small retail traders are not held in high opinion by the professional traders of the market. The reason is simple. Most retail traders lack emotional control and discipline. They ignore sound trading rules and rush into the market to get rich, thinking it is easy if they only find that perfect strategy. But those few retail traders who do succeed and become successful are held in high regard by the community of traders. If you want to join this group, follow these simple rules:

Practice, experience, and skill will create self-confidence. You can't over-practice trading. Behave professionally and treat your trading as a business. Develop your own unique trading style and don't follow the crowd. Be self-reliant and develop self-confidence before trading live in the market. Know your financial self-worth and risk tolerance and strive to continually improve both of these areas. Realize that trading is a process and that you will always be in a professional learning mode. Have a passion for what you do but don't allow passion to rule your trading decisions.

If you do all of these things, you will trade with controlled emotions and will have consistent success as a stock or options trader. (Stokes, 2007)

Sources:

tradingsim.com/blog/stock-trading-emotions - Stock Trading Emotions – Learn to Conquer the Fear

http://www.day-trading-mind.com - The Technical Aspects of Trading Emotions