Trading Basics Series

HOW DO I TRADE STOCKS.COM

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Managing Expectations

One lesson of life that is pervasive in nearly every activity that we pursue is that we must all learn to manage our expectations of potential outcomes and the efforts that will be required.

We soon learn that winning the lottery or having a great job fall into our laps are foolish expectations to build a life strategy around, but the realization of a truth does not necessarily guarantee that we will be mindful of it when a new activity comes along. Many newcomers to stock trading have learned this lesson the hard way by failing in the first three months of trading, but every successful trader understands that managing expectations is at the heart of his disciplined approach to the market.

When constructing a trade make sure you understand the risks and have realistic expectations. The volatility is here to stay so traders need to make sure they are flexible and manage the trade once you're in the market.

Managing expectations is part of the psychology of trading, a new discipline that has received much attention in the past two decades. Self-awareness is key to understanding how we view the stock market and how we interact with it. Expectations can apply to each of these phases and should be addressed up front:

Your Self Image: Are you really cut out to be a trader? A number of points may contribute to answering this question. If you are losing sleep at night due to the intensity required or the necessity of accepting losses as part of market reality, then perhaps your approach needs a review. You do not have to be a “scalping” day-trading expert to win in online trading. Trading is also about discipline and following a set of rules to the letter. If your free spirit would rather not be so encumbered, then once again, trading may not match up with your personality type. If you feel comfortable with your trading style, then confirmation is always a good thing to have.

As a stock trader, you are engaged in speculation, plain and simple. Intrinsic value is nowhere to be found. Relative value is the name of the game, and no single trader has the resources available to outguess the market. You must ride the waves, gauge momentum, and rely on your technical tools. Losing trades will be plentiful. They are to be expected and accepted. Recent published statistics suggest that there are three losing trades for every winner! Experts may have a better track record than the average, but they, too, must manage expectations in this area. The Rule is simple – cut

your losers early, and let your winners run. One good winning trade will nearly always offset three small losing ones, if you manage the value of your losses in a tight fashion.

The act of trading must be very disciplined, according to a step-by-step trading plan that incorporates prudent risk management techniques. Instincts based on knowledge and experience may guide your effort, but shooting from the hip with no stop-loss orders in place is a recipe for disaster. Sooner or later, you may find yourself shooting at a tank with no opportunity for a return volley. Never risk capital in stock trading that you cannot afford to lose and follow the good money management rules.

I think a better goal is to strive to be profitable every month. If you end up with $1 more in your account at the end of the month from the beginning of the month, give yourself a pat on the back for being profitable. It is a series of monthly gains that can result in big returns. But you must treat trading as a business instead of a get rich quick scheme and keep your expectations realistic.

Avoiding Disappointment and Overleveraging Your Portfolio by Setting Realistic and Achievable Profit Targets

You have read a few good trading books, paper traded a virtual account, and jumped into the markets with real money, then the worst thing imaginable happened. You made money…you may start to see a large "S" blazoned across your shirt…

When a novice stock or option trader sees early success they understandably experience excitement and often a sense of euphoria. It does not take them long to begin extrapolating from their early successes how long it will take them to achieve their life's financial goals, but stock investing is a marathon not a sprint.

Every so often a new trader will question what they can reasonably expect to see in the way of returns from stock or option trading. When so confronted, I often find myself being the 'wet towel' or the proverbial 'rain on the parade' when I explain that the short-term returns they experienced cannot be relied upon as an accurate indicator of future earnings. Most often I am met with resistance, sometimes rudeness, but it is understandable because they so badly want to believe that financial salvation, perhaps even nirvana, is easily within their grasp.

Unfortunately, these unrealistic expectations are often reinforced and even fuelled by the popular media and aggressive marketing designed to sell investment and trading products. The reality is that trading is a difficult business and that the actual returns are typically much less exciting than what we might otherwise like to believe are possible.

Implementing Sound Money Management

Occasionally, the person asking the question has recently doubled their account in a short period of time and questions why it is not realistic to believe that they can continue doing so as the account grows in size. If they can continue to double their account each year, they calculate that their $5,000 account will exceed $150,000 in five years.

A prudent trader limits the risk on any one position. Typically, no more than 2% of their overall account. Often, a trader will not risk more than 1% of their available assets.

Experiencing losses is inevitable, however. Every trader will also experience a losing streak - a series of losses one-after-the-next. The larger position size risks financial destruction in the event of even a short losing streak. Novice traders who experience early profits are especially at risk. Their early success has allowed them to avoid grappling with the question of how to handle losses and eventual losing streaks.

Ultimately, a trader's job is that of a risk manager. The winning trades will come, but it is how a trader handles the losers that will determine their long-term results.

Setting Realistic Trading Expectations

An effective trader can average 20% to 25% per year. An exceptional trader might experience 30% average annual returns. While these numbers may sound paltry in comparison to what the marketers and media pundits may discuss, these are in fact stellar returns when achieved year-on-year and the power of compounding is permitted to work its magic.

By incorporating sound risk management into your trading, you will be better able to withstand the inevitable losses and return to profitability. Establishing a realistic expectation of long term performance will help keep you from overextending your capital once your account begins to grow.

Penny Stocks

You can make a lot of big promises about the financial benefits of investing in penny stocks. Many people will, especially online and especially if they can benefit by interesting you in their goods and services. Everyone will tell you that you can make your fortune by investing in penny stocks as long as you just use their formula. We hope you won't allow yourself to be tempted by wild promises though. The truth is that penny stock investing can be very lucrative for you as long as you can manage your expectations and learn to make sensible and well-researched investment decisions. Without that kind of self-control though, you will surely be disappointed by your investment ventures and likely wiped out.

The plenitude of websites that promote penny stock picks in my view use a strategy called Pump and Dump. They buy the stock the previous day, then blast their list and say buy at open. Of course with this many subscribers taking action on a “SUPER HOT” recommendation the stock gaps up in the morning, they sell for a tidy profit, and you’re left holding the bag. When there are no more buyers, usually at 9:35am! Everyone tries to take profits and the stock tanks, that is if you can even find a buyer for your stock and don’t have to hold it for a day or so till you can get rid of it at a substantial loss. Most don’t tell you about this part!

Successful investors in all kinds of markets must learn to manage their expectations in order to avoid making rash decisions about their finances. Unrealistic expectations of the gains to be had can fuel poor decision-making and cause you to lose your capital. A wise investor acknowledges that though the potential rewards are great with penny stock investments, the risks are just as great. He expects to purchase bad stocks and experience losses from time to time. Because he expects these events, he is prepared to handle them and minimize their impact. We never trade stock under $5, as we think that anything under $5 is less stable and is therefore a penny stock.

Conclusion

At HowDoITradeStocks.com we use a variety of systems to trade stocks. Some of which are completely mechanical. However, they all have strict rules and good money management strategies. We trade both long term and short term. We prefer medium to large cap stocks with very strong growth estimates. We do not set a specific annual rate of return and say that is our target. There will be years when we make + 100% and years when we don't even get close to that. But we expect to be profitable every year and that is all we can hope for.

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