

TradeMentor

Chapter 3.4

Trading Psychology

TRADING PSYCHOLOGY

Stock and CFD traders have to not only compete with other traders in the stock and CFD markets but also with themselves. Often as a stock or CFD trader you will be your own worst enemy. We, as humans, are naturally emotional. Our egos want to be validated - we want to prove to ourselves that we know what we are doing and that we are capable of taking care of ourselves. We also have a natural instinct to survive.

All of our emotions and instincts can combine to provide us with trading successes every now and then. Most of the time, however, our emotions get the best of us and lead us to trading losses unless we learn to control them.

Many stock and CFD traders believe it would be ideal if you could completely divorce yourself from your emotions. Unfortunately that is next to impossible and some of your emotions may actually help improve your trading success. The best thing you can do for yourself is learn to understand yourself as a trader. Identify your strengths and your weakness and pick a trading style that is right for you.

In this section, you will learn about the following four psychological biases that may be affecting your trading results and what you can do to overcome them:

Contents	Overconfidence bias
	Anchoring bias
	Confirmation bias
	Loss aversion bias

OVERCONFIDENCE BIAS

Overconfidence bias is an over-inflated belief in your skills as a stock or CFD trader. If you ever find yourself thinking to yourself that you have got everything figured out, that you have nothing more to learn and money is yours for the taking in the stock or CFD market, you probably suffer from an overconfidence bias.

Dangers of Overconfidence

Overconfident traders tend to get themselves into trouble by trading too frequently or by placing extremely large trades as they go for the home run. Inevitably, an overconfident trader will end up either trading in and out then in and out of trades - churning their account - or risking too much on the one trade that goes bad and wipes out most of the trader's account.

Are You Overconfident?

If you want to know if you have any overconfidence tendencies then ask yourself "Have I ever jumped right back into a trade I had just been stopped out of not because I saw another entry opportunity but because I couldn't believe I was wrong?"

You can also ask yourself "Have I ever put more on a trade than I normally would because I was just sure this trade was going to be the one?" If you have then you need to be aware of those tendencies.

Overcoming Overconfidence

The best way to overcome an overconfidence bias is to establish a strict set of risk-management rules. These rules should at least limit the number of markets you are investing in and the number of stocks or CFDs you are trading at one time, how much of your account you are willing to risk on any one trade, and how much of your account are you willing to lose before you take a break from trading and re-evaluate your trading strategy.

By limiting the number of trades you are willing to be in and the amount of risk you are willing to take, you can spread your risk out evenly over your entire portfolio.

ANCHORING BIAS

Anchoring bias is a propensity to believe that the future is going to look extremely similar to the present. When you anchor yourself too closely to the present you fail to see the dramatic changes that are possible as currency pairs fluctuate and the underlying fundamentals shift.

Dangers of Anchoring

Anchored traders tend to get themselves into trouble by convincing themselves that the current trend will never end and that a reversal in the fundamental strength of a particular company is next to impossible. Alas they become emotionally attached to the previous trend of a stock or CFD, and they continue to place trades that go against the new current trend. With each trade they lose more and more money because they are bucking the trend.

Are You Anchoring?

If you want to know if you have any anchoring tendencies then ask yourself "Have I ever lost money because I couldn't accept that the trend had ended?" If you have then you need to be aware of that tendency.

Overcoming Anchoring

The best way to overcome anchoring is to look at multiple time-frames on your charts. If you usually trade on the hourly charts, take a look at the daily and weekly charts every now and then to see where some of the long-term levels of support and resistance are and what the long-term trends look like. You should also take a look at the short-term charts to see when the short-term trends are reversing.

Broadening your perspective will help you to avoid anchoring yourself to any one point.

CONFIRMATION BIAS

Confirmation bias is a propensity to look only for the information that confirms the beliefs that you already have. For instance if you believe the price of Google (GOOG:xnas) is going to go up, you will look for the news, the technical indicators and the fundamental factors that support your belief.

Dangers of Seeking Confirmation

Traders who over-actively pursue confirmation of their beliefs tend to miss key warning signs that would normally have protected them from unnecessary losses. In an attempt to build a case for their beliefs, traders miss the facts. Ultimately, this leads to them fighting trends and losing money with each ill-conceived trade.

Do You Seek Confirmation?

If you want to know if you have any confirmation bias tendencies then ask yourself “How often do I look for signs that I may be wrong in my analysis?” If your answer is rarely or never then you may be a confirmation seeker and you need to be aware of those tendencies.

Overcoming Confirmation Bias

The best way to overcome confirmation bias is to find someone, or a group of people with whom you can speak about your trading. Hopefully the person, or people, with whom you speak about your trading will not always agree with you. Talking with traders with diverse perspectives and ideas will help you look at your trades from multiple angles. Sometimes you will strengthen your convictions by talking with other traders. At other times talking with your trading partner will cause you to change your mind.

Keeping an open mind will help you catch new moves and avoid holding on too long to redundant beliefs.

LOSS AVERSION BIAS

Loss aversion bias is based on the theory that the pain caused by losing \$1,000 is greater than the joy that comes from gaining \$1,000. In other words fear is a more powerful motivator than greed.

Dangers of Loss Aversion

Traders who fear losses are much more likely to hold onto losing positions than traders who are able to accept short-term losses and move onto other more-profitable trades. Holding onto losing positions jeopardizes the stability of your portfolio because you will not only incur more severe losses but this behaviour will also keep you out of better investments.

Do You Fear Losses?

If you want to know if you have any loss aversion tendencies then ask yourself "Have I ever held onto a losing trade past the point where I knew I should have sold because I hoped the stock price would turn around and wipe out my losses?" If you have, you need to be aware of those tendencies.

Overcoming Loss Aversion

The best way to overcome a loss aversion bias is to trade with physically set stop-loss orders. Many traders tell themselves that they will trade with a mental stop-loss - a stop-loss level that they think about and promise themselves they will act on if the stock or CFD ever reaches it. All too often, however, traders fail to act on their mental stop-losses. They let their emotions get in the way and they start rationalizing their choice to stay in the trade until it turns around.

As soon as you enter a trade you should set your stop-loss order. Don't give yourself any opportunity to be emotional.



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