

# THE DAILY TRADING COACH

101 LESSONS FOR  
BECOMING YOUR OWN  
TRADING PSYCHOLOGIST



**BRETT N. STEENBARGER**



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# **The Daily Trading Coach**

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# The Daily Trading Coach

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*101 Lessons for Becoming Your  
Own Trading Psychologist*

**BRETT N. STEENBARGER**



WILEY

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*What? A great man? I always see merely  
the play-actor of his own ideal.*

—Friedrich Nietzsche





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# Preface

**T**he goal of *The Daily Trading Coach* is to teach you as much as possible about coaching, so that you can mentor yourself to success in the financial markets. The key word in the title is “Daily.” This book is designed to be a resource that you can use every day to build upon strengths and overcome weaknesses.

After writing two books—*The Psychology of Trading* and *Enhancing Trader Performance*—and penning more than 1,800 posts for the *TraderFeed* blog ([www.traderfeed.blogspot.com/](http://www.traderfeed.blogspot.com/)), I thought I had pretty well covered the terrain of trading psychology. Now, just three years after the publication of the performance book, I’ve once again taken electronic pen to paper, completing a trading psychology trilogy by focusing on the *process* of coaching.

Two realities led to *The Daily Trading Coach*. First, a review of the traffic patterns on the *TraderFeed* blog revealed that a large number of readers—about a third—were accessing the site during the hour or so immediately prior to the market open. I found this interesting, as most of the posts do not offer specific trading advice. Rather, posts deal with topics of psychology and performance—ones that should be relevant at any hour of the day.

*When I asked a group of trusted readers about this pattern, they responded that they were using the blog as a kind of surrogate trading coach.* Reviewing the posts was their way of reminding themselves of their plans and intentions before going entering the financial battlefield. This was confirmed when I gathered statistics about the most popular (and commented upon) posts on the blog. The majority were practical posts dealing with trading psychology. Most were uplifting in content, even as they challenged the assumptions of readers. It seemed as though traders were looking for coaching and finding some measure of it in the blog.

The second reality shaping this book involves digital publication and the rapid changes sweeping the publishing world. To this point, relatively few electronic books (e-books) have been offered to traders. When those books are available, they are little more than screen versions of the print

text. Despite the allure and convenience of electronic publishing, few traders I consulted actually sought out or used e-books. The most common complaint among traders was that they did not want to spend hours devouring information in front of a screen after a full day of trading. I quickly realized that participants in the financial markets don't use the electronic medium in the same way that they engage print text. That led me to think about writing a different kind of book, one better suited to publishing's electronic frontier, but also useable in print.

When you overlay these two observations, you can appreciate the vision that led to this text: *a "trading coach in a book" that can be as easily read on the screen as on paper. The goal was to integrate blog and book content by creating practical "lessons" that help traders become their own trading coaches.* There are 101 lessons in *The Daily Trading Coach*, averaging several pages in length. Each lesson follows a general format, identifying a trading challenge, an approach to meeting that challenge, and a specific suggestion or assignment for working on the issue. The chapters are independent of one another: you can read them in order, or you can use the table of contents or index to read, each day, the lesson that most applies to your current trading. *Unlike a traditional book, the idea is not to read it through from front to back in a few sittings.* Rather, you take one lesson at a time and apply it to guide your development as a trader. Like the blog, it's an on-screen reminder of what to do when you're at your best, but—more than the blog—it's also a roadmap (and practical set of insights and tools) for discovering and implementing the best within you.

My ambition has been to pack into these 101 lessons more useable information and practical methods than might be found in any number of expensive seminars and coaching sessions, at far less expense. Too often, the goal of the seminar providers and coaches is to convert you into ongoing clients. The intent of this book is just the opposite: *to give you the tools to become your own coach*, so that you can guide your own professional and personal growth. In other words, this is a manual of *psychoeducation*: a how-to guide for improving yourself and your performance.

One thing I particularly like about the electronic format is that it enables a writer to link the book content to a vast array of material on the Web. I will be adding material to *The Daily Trading Coach* via a dedicated blog called *Become Your Own Trading Coach* ([www.becomeyourowntradingcoach.blogspot.com](http://www.becomeyourowntradingcoach.blogspot.com)), so that this book will grow over time. You will need only to click the e-book links to access free updated information and methods on the *Become Your Own Trading Coach* site. There is one master page on the blog for each chapter of this book containing the links relevant to that chapter's material. At the end of each chapter, there is also a resource page that alerts readers to further links and readings. I will be adding audio and video content to the new blog over time, which should be



particularly helpful for those who learn best by seeing and hearing ideas. Once publishing becomes electronic, there's no reason that every text can't be a multimedia learning experience.

You'll notice from the table of contents that each of the 10 chapters contains 10 lessons. Those chapters cover a range of topics relevant to trading psychology and trading performance, including specific lessons for utilizing psychodynamic, cognitive, and behavioral brief therapy methods to change problematic behavior patterns and instill new, positive ones. The final two chapters are especially unique: Chapter 9 consists of self-coaching perspectives from 18 successful trading professionals who share their work online. Chapter 10 fulfills a long-standing promise to *Trader-Feed* readers, walking traders through the basics of identifying historical patterns using Excel. Each lesson is accompanied by homework activities and suggestions ("Coaching Cues") to help with application of the ideas. Major ideas are set apart within the text for quick review and scanning. At the end of each chapter is a list of resources to guide your further inquiry into the book's topics and ideas.

Yes, the aim of the book is to help you become your own trading coach, but a glance at the chapter and lesson titles reveals that the broader purpose is to help you coach yourself through life. The challenges and uncertainties we face in trading—the pursuit of rewards in the face of risks—are just as present in careers and relationships as in markets. Techniques that help you master yourself as a trader will serve you well in any field of endeavor. *In that sense, the goal is not just to make money in the markets, it is to prosper in all of life's undertakings.* I will be gratified and honored if this book is a resource toward your own prosperity, in and out of financial markets.

BRETT STEENBARGER



# Acknowledgments

If, as the saying goes, it takes a village to raise a child, it takes a small army to write a book. The last lesson of the book is dedicated to my mother, Constance Steenbarger, who passed away last year. My deepest hope is that this book carries forward the nurturing spirit that she brought to her family and students.

If my mother represented nurturance in my life, my father, Jack Steenbarger, has embodied the virtues of hard work, achievement, and love of family. From the earliest days of my training as a psychologist, I have been fascinated by the psychology of exemplary achievement: what makes highly successful people tick. There's no question where that passionate interest originated, and it gives me the greatest of pleasure to acknowledge my father for that inspiration.

None of this would be possible, however, without the understanding, love, and support of my wife Margie. In 1984, I traded bachelorhood for a life with Margie and her family; to this day, it remains my one superlative trade. Twenty-five years later, I'm pleased to report we're still riding that trend, having taken no heat whatsoever!

I'm saddened, but happy at the same time, to be able to dedicate this book to the memory of my uncle, Arnold Rustin, MD, who also passed away during the year. A consummate teacher, Arnold represented everything I've admired and enjoyed in the world of academic medicine. It's the support of Arnold and his wife Rose, even amid their own challenges, which made the greatest impression on me, however. I hope their inspiration finds expression in this book.

Thanks, too, to Debi, Steve, Lea, Laura, Ed, Devon, and Macrae, the kids who aren't kids any more, but who have been remarkably understanding of my hours on the road meeting with traders and my even greater hours online, keeping up with a blog and dozens of e-mail and phone calls daily. I would not be so grounded without family, including my brother Marc and sister-in-law Lisa and our three feline friends: Gina, Ginger, and Mali.

To the traders and authors who contributed to Chapter 9, my deepest thanks and appreciation for your great work. You provide unparalleled

resources for developing traders. Acknowledgments are also due to those whose work has inspired my own: philosophers Ayn Rand, Brand Blanshard, Colin Wilson, and G. I. Gurdjieff; the many psychologists and researchers who have contributed to the brief therapy and positive psychology literatures; and the traders who were formative in my development: Victor Niederhoffer, Linda Raschke, Chuck McElveen, and the many hedge fund traders I've been privileged to work with in the past few years. My colleagues at Upstate Medical University have been inspirational and supportive throughout my second career; special thanks to Mantosh Dewan, MD; Roger Greenberg, PhD; and John Manring, MD.

This is also my opportunity for a shout-out to those who write and play the music that kept me company through the writing of this book: Edenbridge, Armin van Buuren, Ferry Corsten, Cruxshadows, Assemblage 23, VNV Nation, and many others that you may discover on the *Become Your Own Trading Coach* blog.

Deepest thanks, as well, to the Wiley production staff and my fantastic and supportive editors, Pamela van Giessen, Kate Wood, and Emilie Herman. They've been tremendously helpful in bringing this book to life. My appreciation also goes out to the many readers of the blog, particularly those who have actively participated with their comments and insights. I hope this book contributes to your continued happiness and trading success.

# Introduction

**T**oo few of us are play-actors of our own ideals. We have strengths and talents, dreams and aspirations. But when we look hour-by-hour, day-by-day, not many of these ideals are concretely expressed. The days become months, then years, and—at some sad juncture—we look back on life and wonder where it went.

That could be you: the middle-age person looking back on how “I could’ve been a contender.” Or, you could live a different life script. You could become the actor of your ideals and live their realization.

If you’re thinking this is a strange introduction to a trading text, you’re right. This book doesn’t start with supply and demand, trading patterns, or money management. It begins with you and what you want from your life. Trading, in this context, is more than buying, selling, and hedging: it is a vehicle for self-mastery and development.

Every trader, whether he consciously identifies it or not, is an entrepreneur. Traders open their business and compete in a marketplace. They identify and pursue opportunity, even as they preserve their capital. Traders refine and expand their craft; they take calculated risks. As entrepreneurs, traders start with the premise that they bring value to the marketplace. Amid the inevitable disappointments and setbacks, the long hours and the limited resources, the risk and uncertainty, it can be difficult to sustain that optimism. It is so much easier than to keep one’s visions on a shelf and forego the daily efforts of enacting ideals.

Some traders, however, cannot shelve their aspirations. Like the moth, they’ll pursue distant lights even if it means an occasional singe. To those noble souls, I dedicate this book.

When I work with traders and portfolio managers at hedge funds, proprietary trading firms, and investment banks, I don’t tell them how to trade. Most of them trade strategies different from my own and know far more about their markets than I ever will. Rather, I figure out their strengths. I learn what these traders and managers do well and how they do it, and I help them build a career out of what they’re already good at. Just as fish cannot comprehend water, being immersed in it from birth, we typically

lack an appreciation of our personal assets. Each of us is a curious mixture of skills, talents, strengths, conflicts, and weaknesses. But just as a new business must capitalize on the strengths of its founders, a career in the markets crucially hinges on the assets—personal and monetary—of the trader. As a coach, my role is to take traders out of their psychological water and help them see what has been around them all along: the assets that can provide a lifetime of dividends.

Never has self-coaching been more important for traders. As I write this, we have witnessed levels of market volatility unseen in the post-World War II period. Price volatility brings potential opportunity, but also risk. Traders who could not step back, recognize unfolding developments, and make adjustments have lost significant money. Those who have used the crisis to step out of the trading water, limit risk, and find fresh opportunity are the ones who are poised to reap those career dividends.

The book you are reading is intended to be your companion in this trading journey. It is organized in 101 lessons. Each lesson outlines a challenge and proposes a specific exercise for moving yourself forward with respect to that challenge. The lessons are intended as meditations to begin your trading day—coaching communications to help you enact the best within you. Eventually, as you read and live these lessons, the coaching communications become your own self-talk. You begin by play-acting the book's ideals and end up living them and shaping them into your own. *You become your own trading psychologist.*

If reading a short passage each day and planting the right ideas into your forebrain helps you prioritize your life and trading goals—and if that in turn helps you make one less bad trade per week and take the one good one you would have otherwise missed—think of how you will personally and financially profit. But just as pills can't work when they stay in a bottle, no one learns from an unopened book. The first step in becoming your own trading psychologist is to set time aside for self-mentorship—every day, every week—because that's how behavior patterns turn into habits. The great individual is simply one who has made a habit of self-development.

So there they are, staring at you from the shelf across the room: Your ideals, all those things you've wanted to do in life. You look longingly toward the shelf, but you can't reach it from your comfortable chair. Yet you hold a book in your hands. Perhaps that book can make that chair just a little less comfortable, place the shelf just a bit closer.

You turn the page.

The next step is ours.

## CHAPTER 1

# Change

### *The Process and the Practice*

*The mind has exactly the same power as the hands;  
not merely to grasp the world, but to change it.*

—Colin Wilson

**Y**ou are reading this book because you want to coach yourself to greater success in the financial markets. But what is coaching? At the root of all coaching efforts is change. When you are your own trading coach, you are trying to effect changes in your thoughts, your feelings, and your behavior. Most of all, you are trying to change how you trade: how you identify and act upon patterns of risk and reward, supply and demand.

There is a rich literature regarding change, grounded in extensive psychological research and practice. If you understand how change occurs, you are better positioned to act as your own change agent. In this chapter, we will explore the research and practice of change and how you can best make use of its sometimes-surprising conclusions. *Coaching is about making change happen, not just letting it happen.* It's about making the commitment to being a change agent in your own life, your own trading.

First, however, let's learn about the process and practice of change.

## LESSON 1: DRAW ON EMOTION TO BECOME A CHANGE AGENT

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For some of us, the status quo is not enough. We experience glimpses into the person we're capable of being; we yearn to be more than we are in life's mundane moments.

That yearning starts with the notion of *change*. We desire changes in our lives. We adapt—we grow—by making the right kinds of changes. All too often, however, we feel stuck. We're doing the same things, making the same mistakes again and again. Do we wait for life to change us, or do we become agents of our own life changes?

The easy part is initiating a change process. The real challenge is *sustaining* change. How many times does an alcoholic take the initial steps toward sobriety, only to relapse? How often do we start diets and exercise programs, only to return to our slothful ways? If we focus on starting a change process, we leave ourselves unprepared for the next crucial steps: keeping the flame of change burning bright.

The flaw with most popular writings and practices in psychology and coaching is that they are designed to initiate change. These writings and practices leave people feeling good—until it becomes apparent that different efforts are needed to sustain change. Successful coaching doesn't just catalyze change: it turns change efforts into habit patterns that become second nature. The key to successful coaching is turning change into routine; making new behaviors become second nature.

That's where emotion comes in.

For years I had attempted—unsuccessfully—to sustain a weight loss program. Then, in the year 2000, I was diagnosed with Type II diabetes. My diet *had* to change; I needed to lose weight. If I didn't, I realized with crystal clarity, I could lose my health and let my wife and children down. Literally that same day I began a dietary regimen that continues to this day. My weight dropped 40 pounds (I shed the pounds so quickly that friends were concerned that I had a wasting illness) and I regained control of my blood sugar.

What was the catalyst for the change? Years of telling myself to eat differently, exercise more, and lose weight produced absolutely no results. A single emotional experience of the necessity for change, however, made all the difference. I didn't just *think* I needed to change: I *knew* it with every fiber of my being. I *felt* it.

So it is with traders.

Perhaps you've told yourself that you need to follow your rules, that you need to trade smaller, or that you should avoid trading during certain market conditions or times of day. Still you make the same mistakes, lose



money, and build frustration. Like my initial efforts at weight loss, your attempts at change fail *because they lack emotional force*.

Research into the process of successful versus unsuccessful therapy finds that emotional experience—not talk—powers change. No one ever felt valuable and lovable by standing in front of a mirror and reciting self-enhancing statements. The experience of a meaningful romantic relationship, however, yields the deepest of affirmations. Yes, you can tell yourself you're competent, but experiencing success in the face of challenge provides a lasting sense of efficacy. Pleasure, pain: nature hardwires us to internalize emotional experience so that we can pursue what enhances life and avoid what harms us. That ability to internalize our most powerful emotional experiences helps us to sustain the changes we initiate.

The enemy of change is relapse: falling back into old, unproductive ways of thinking and behaving. Without the momentum of emotion, relapse is the norm.

Are you going to work on yourself as a trader today? Are you going to use today as an opportunity to learn and develop yourself, regardless of the day's profitability? If so, you'll need a goal for the day. What are you going to work on: Building a strength? Correcting a weakness? Repeating something you did well yesterday? Avoiding one of yesterday's mistakes?

An important first step is to set the goal. We cannot succeed as change agents if we don't perceive a clear path from the person we are to the person we wish to become. A valuable second step is to write down the goal or talk out loud into a recorder. This step helps cement desired changes in your mind. But will the pursuit of your goal truly possess emotional force? Will it transform you from one who thinks about change to one who truly becomes a change agent?

*The secret to goal setting is providing your goals with emotional force.* If your goal is a want, you'll pursue it until the feeling of desire subsides. If your goal is a must-have—a burning need, like my dietary change—it becomes an organizing principle, a life focus. You won't become a better trader because you want to be. You will only coach yourself to success when self-improvement becomes your organizing principle: a must-have need.

Try this exercise. Before you start trading, seat yourself comfortably and enter into a nice slow rhythm of deep breathing. Imagine yourself—as vividly as you can—starting your trading day. Watch the market move on

the screen; watch yourself tracking the market, your day's trading ideas at your side. Then turn your goal for the day into part of your visualization: imagine yourself performing the actions that concretely put that goal into practice. If your goal is to control your position sizing, vividly imagine yourself entering orders at the proper size; if your goal is to enter long positions only after a pullback, imagine yourself patiently waiting for the pullback and then executing the trade. As you visualize yourself realizing your goal, recall the feeling of pride that comes from realizing one of your objectives. Bask in the glow of living up to one of your ideals. Let yourself feel proud of what you've accomplished.

*It's important not just to have goals, but also to directly experience yourself as capable of reaching those goals.* Psychologists call that self-efficacy. You are most likely to experience yourself as a success if you see yourself as successful and *feel* the joys of success. You don't need to imagine yourself making oodles of money; that's not realistic as a daily goal. But you can immerse yourself in images of reaching the goals of good trading and experience the feelings of self-control, mastery, and pride that come from enacting the best within you.

We are most likely to make and sustain changes when we perceive ourselves as efficacious: capable of making those changes.

Many traders only get to the point of self-coaching after they have experienced harrowing losses. The reason is similar to my experience with my diagnosis: it was the vivid fear of consequences—the intense *feeling* of not wanting to ruin my life—that drove my dietary change. Similarly, after traders lost a good deal of their capital, they never want to experience that again. They trade well, not because they talk themselves into discipline, but because they feel the emotional force of discipline's absence.

Contrary to the teachings of proponents of positive thinking, fear has its uses. Many an alcoholic maintains sobriety because of the fear of returning to the pain of drinking's consequences. Emotion sustains the change.

With guided imagery that you feel as well as see, you can create powerful emotional experiences—and catalyze change—every single day. That's when you become a change agent: one who sustains a process of transformation. The key is adding emotional force to your goals. Your assignment is to take those lifeless goals off the piece of paper in your journal and turn them into vivid, powerful movies that fill your mind. Try it with one goal, one movie in your head, before you start trading. It is not enough to set goals; *you must feel them to live them.*

**COACHING CUE**

To each of your goals, add an *or else* scenario. Vividly imagine the consequences of *not* sustaining your change. Relive in detail specific failure experiences that resulted from the faulty behavior you want to change. When you add an *or else* condition to your goal setting, you turn fear into motivation. The brain is wired to respond first and foremost to danger; you will not gravitate toward the wrong behaviors if you're emotionally connected to their danger. To this day, my diet is firmly in place. Fear has become my friend.

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**LESSON 2: PSYCHOLOGICAL VISIBILITY  
AND YOUR RELATIONSHIP WITH YOUR  
TRADING COACH**

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If you are to be your own trading coach and guide your trading development, we have to make you the best coach you can possibly be. That means understanding what makes coaching work—and what will make it work for you.

*Research informs us that the most important ingredient in psychological change is the quality of the relationship between the helper and the person receiving help.* Techniques are important, but ultimately those techniques are channeled through a human relationship. Studies find that in successful counseling, helpers are experienced as warm, caring, and supportive. When helpers are seen as hostile or disinterested, change processes go nowhere. There's a good reason for this: relationships possess magic.

The magic of relationships is that they provide us with our most immediate experiences of visibility. I recently took a phone call from a reader of the *TraderFeed* blog. Many readers have provided valuable feedback about the blog, but this caller went far beyond that. He read every single post and then explained to me why he was drawn to the site. He put into words the very values that have led me to publish some 1,800 posts in the space of less than three years: *the vision that, in cultivating our trading, we develop ourselves in ways that ripple throughout our lives.*

At the end of that conversation, I felt understood: I was visible to another human being. When my mother died, I kept my composure until I approached her gravesite; then I lost it. My two children instinctively reached out to comfort me. It's something I would have done for another person in that situation. At that moment, I saw a bit of myself in my children. Once again, I was visible.

An unfulfilling relationship is one in which we feel invisible. We can feel invisible because we're misunderstood or mistreated. We feel invisible when the things that matter most to us find no recognition among others. I recall one particularly unfulfilling relationship with a woman. We were on the dance floor at a club and I suddenly stopped dancing altogether. She didn't notice at all. She was in her own world. It was a perfect metaphor for everything I was experiencing at the time: I was there as a kind of prop, a rationale for being on the dance floor. No one was really dancing with me. The profound, wrenching emptiness that I felt at that time was a turning point; never again would I settle for invisibility.

In Iggy Pop's classic song, invisibility is a kind of "Isolation." But if there's anything worse than being isolated—crying for love—when you're with someone, it's being isolated from yourself. We are truly lost when we're invisible to ourselves.

Many traders don't really know what they do best; they're invisible to themselves.

All of us have values, dreams, and ideals. How often, however, are these explicitly on our minds? To live mired in routine, day in and day out, estranged from the things that matter most to us: *that's a form of invisibility*. To compromise the things you love in the name of practicality, to settle for second best out of fear or convenience: those, too, leave us in isolation—from ourselves. Strange as it may seem, we spend much of our time invisible to ourselves. The day-to-day part of us dances away, oblivious to the other self, the one that thrives on purpose and meaning.

It's a real dilemma: How can we possibly coach ourselves to success if the very strengths that would bring us success are invisible to us? After all, the single best predictor of change is the quality of the helping relationship. What, then, is our relationship to ourselves? If we are to be our own trading coaches, the success of our efforts rests on our ability to sustain visibility and draw on the magic of a fulfilling relationship with ourselves.

To coach ourselves successfully, we must be visible to ourselves and sustain the vision of who we are and what we value. But how can we do that? There's a simple strategy that can build a positive, visible relationship with your inner trading coach: identify a single trading strength to express as a goal for the coming day's trading.

One way I do that when I coach others (and when I work on my own trading) is to ask traders to identify what they did best in yesterday's trading that they want to continue today. *Set a positive goal, based on strengths, to keep you in touch with the best within you.* It affirms your competencies and keeps these visible, even during challenging market times. Too many of our goals are negative: we declare that we won't do

X or that we'll do less of Y. Instead, frame a goal for today that says: "Here is what I'm good at, here's what I did best yesterday, and here's how I'm going to make use of that strength today."

Trading goals should reflect trading strengths.

In the relationship between you the trader and you the coach, the quality of the relationship will play an important role in your development. *The best relationship is achieved when goals are linked to values and express distinctive strengths.* Relentlessly identify, repeat, and expand what you do best—even (and especially) after the worst of trading days. Only through repetition can we turn positive behaviors into habit patterns. When you are in the habit of identifying and building strengths, you will then be truly visible to you. The magic of that relationship—and the confidence it brings—will sustain you through the most challenging times.



#### COACHING CUE

Review the last week's entries in your trading journal. Count the number of positive, encouraging phrases in your writings and the number of negative, critical ones. If the ratio of positive to negative messages is less than one, you know you aren't sustaining a healthy relationship with your inner coach. And if you're not keeping a journal, your coach is silent. What sort of relationship is that?

### LESSON 3: MAKE FRIENDS WITH YOUR WEAKNESS

The notion of change is a challenge and a trap. It challenges us to aspire to more than who we are, but it can also trap us in self-division. When we entertain the notion of change, we divide ourselves into qualities we like and those we don't. We parcel ourselves into strengths and weaknesses, good and bad, acceptable and unacceptable.

Once we make such a division, it is only natural to embrace the good and avoid the bad. We dismiss our shortcomings as mistakes, bad luck, or exceptions. That helps us identify with a partial image of ourselves and keep our frailties from our conscious awareness. Thus banished from the front of our minds, those frailties cannot guide our learning. *We do not sustain the motivation to grow, because we only contact the parts of ourselves that are relatively whole.*

Suppose I manage a position poorly because of frustration and I exceed my loss limit on the trade, leaving me in the red for the day. I finish flat

for the week, however, and instead focus on that fact. The loss is soon forgotten. It doesn't bother me, but I also don't learn from it. The next time frustration hits, I repeat my earlier behavior and lose even more money. Disgusted, I decide to take a break from the markets and come back with a positive mindset. In reality, however, I merely return in denial, once again banishing the losses from my mind. Eventually those trading shortcomings catch up to us, forcing us to face them squarely.

Such self-division is often maintained with the fiction of positive thinking. By focusing on positive thoughts, we don't have to think about what we've done wrong; we don't have to achieve contact with the parts of ourselves we don't like. We become like rooms where the clutter is increasingly swept under the rug. Eventually our rooms bulge with mental clutter, making them uninhabitable.

The motivation for much positive thinking is a denial of weakness.

Our daughter Devon was born with a "strawberry" beside her nose: a hemangioma that was a bright red bump on her skin. We were told that it would eventually recede on its own, that no surgery was needed. During her early years, however, baby Devon had a large red mark on her face. We could have put a patch over the mark or insisted on surgery, but we didn't. It was *her* mark, and it was part of what made her who she was. When you love someone, even her personal blemishes become endearing. Before I was a parent, I used to wonder how I'd tolerate changing dirty diapers. When the time came, I actually enjoyed it. It was something I was doing with and for my child. The changing of the diaper became an opportunity for bonding.

So it should be when we deal with our own dirty diapers. Your weaknesses are part of you; someone who loves you will love the whole package, frailties and all. *And if you love yourself, you can reach that point of acceptance in which you are fully aware of your shortcomings and appreciate your very humanness.* Indeed, as with the diapers, those shortcomings become opportunities—to reach out to yourself and guide your own development. For the longest time, I was unsure of myself in social situations and avoided most of them. Then, in a college dorm party I pushed myself to organize, I noticed a few people standing around not talking with others. In a flash, I saw myself in them. I made a beeline for the stragglers, included them in the gathering, and introduced them around. Ever since, I've been able to reach out to that reticence in myself and use it as a prod to engage others. My development occurred not through positive thinking, but through an embrace of my vulnerability.

Have you lost money recently? Have your trading weaknesses cost you money and opportunity? Consider embracing your flaws: every losing trade



is there to teach you something. At the close of today's trading, create a chart with three columns. The first column is a description of the losing trade you made; the second column will be what you can learn from the losing trade; and the third column will be how you will improve your trading the next day based on what you learned. What you learned from the losing trade might be an insight into the market—perhaps it was range-bound when you assumed it was trending. That insight could help you frame subsequent trades. Alternatively, what you learn from the losing trade might be something about yourself; perhaps an insight into how you can manage risk more effectively. *Either way, your losing trade is never a total loss as long as you embrace it and learn from it.*

Much of self-coaching success is finding the opportunity in adversity.

When you create a trading diary, you bring yourself face to face with your worst trading and turn it into opportunity. It doesn't matter if blemishes mar your account statement. It's your account, red marks and all. You make yourself stronger when you reach out to your flaws. Embrace who you are and you take the first step to becoming the person you are capable of being.



#### COACHING CUE

As we'll see in the next chapter, the research of James Pennebaker suggests that giving voice to stressful events—in a journal or out loud—for at least a half hour a day is instrumental in our putting those events into perspective and moving beyond them. When you experience a horrific trading day, give it voice. Talk it through and sear its lessons in your mind. If you're in touch with how badly your trading makes you feel, you're least likely to repeat your errors. There can be gain in embracing pain.

### LESSON 4: CHANGE YOUR ENVIRONMENT, CHANGE YOURSELF

Human beings adapt to their environments. We draw on a range of skills and personality traits to fit into various settings. That is why we can behave one way in a social setting and then seem like a totally different human being at work. One of the enduring attractions of travel is that it takes us out of our native environments and forces us to adapt to new people, new cultures, and new ways. *When we make those adaptations, we discover*

*new facets of ourselves.* As we'll see shortly, discrepancy is the mother of all change: when we are in the same environments, we tend to draw upon the same, routine modes of thought and behavior.

A few months ago I had an attack of acute appendicitis while staying in a LaGuardia airport hotel awaiting a return flight to Chicago. When I went to the nearest emergency room at Elmhurst Hospital outside Jackson Heights, Queens, I found that I was seemingly the only native English speaker in a sea of people awaiting medical care. After some difficulty attracting attention, I was admitted to the hospital and spent the next several days of recuperation navigating my way through patients and staff of every conceivable nationality. By the end of the experience, I felt at home there. I've since stayed at the same airport hotel and routinely make visits into the surrounding neighborhoods—areas I would have never in my wildest dreams ventured into previously. In adapting to that environment, I discovered hidden strengths. I also overcame more than a few hidden prejudices and fears.

*The greatest enemy of change is routine.* When we lapse into routine and operate on autopilot, we are no longer fully and actively conscious of what we're doing and why. That is why some of the most fertile situations for personal growth—those that occur within new environments—are those that force us to exit our routines and actively master unfamiliar challenges.

In familiar environments and routines, we operate on autopilot. Nothing changes.

*When you act as your own trading coach, your challenge is to stay fully conscious, alert to risk and opportunity.* One of your greatest threats will be the autopilot mode in which you act without thinking, without full awareness of your situation. If you shift your trading environment, you push yourself to adapt to new situations: you break routines. If your environment is always the same, you will find yourself gravitating to the same thoughts, feelings, and behaviors. We are mired in repetitive patterns of thought and behavior because we are mired in routines: the same emotional and physical environments. Indeed, we repeat the same patterns—for better or for worse—precisely because those patterns are adaptations to our current settings.

So how can we change our trading environments? The key is recognizing that our physical settings are only a part of our surroundings. Here are a few routine-busting activities that can alert us to risks and possibilities:

1. **Seek Out Divergent Views.** Conversations with traders who trade differently from you—different time frames, markets, or styles—can often help cement your views or question them. Similarly, reading



materials from fresh perspectives puts your ideas in a different light and pushes you to question your assumptions. I remained relatively bullish on the stock market's longer-term picture into the final quarter of 2007. Only when I pushed myself to read informed views that clashed with my own—and consulting data that did not fit my framework—did I modify my perspectives and avoid significant losses.

2. **Examine the Big Picture.** It's easy to get lost in the market's short-term picture; how it is trading that minute, that day. I find it important to periodically zoom out to longer-term charts and place the current action into context. Indeed, some of the best trading ideas start with a big picture view and then proceed to shorter-term execution. I especially find this to be the case when looking at longer-term support/resistance, trading ranges, and Market Profile value areas. Often, shifting my field of vision will help me avoid an ill-informed, reactive trade based on the market's last few ticks. If something seems obvious in the market, switch time frames and generate an entirely new perspective. What looks obvious from one view may well be obviously wrong from another.
3. **Examine Related Views.** Sometimes the action of a single stock or sector will illuminate what's happening in the broader market; one currency cross will break out ahead of others. Are we seeing a broad fixed income rally, or is the yield curve steepening or flattening? Looking across instruments and asset classes keeps us from getting locked into ways of thinking. I find myself tracking sector ETFs during the trading day to see if stocks are moving in a single direction (trending) or are taking different paths within a range. If I see bond traders fleeing to safety or assuming risk, I can anticipate selling or buying stocks. Seeing the entire financial playing field helps keep us from becoming wedded to preconceived ideas.
4. **Take the Break.** Just as we take vacations to return to work refreshed, a break from the screen can help us generate fresh market views. It is easy to become focused on what is most dramatic and salient in markets. Pull back and clear out the head to help you see what's not obvious and then profit by the time it's recognized by others. I find breaks especially helpful following losing trades, enabling us to reflect on the losses and what can be learned from them.

If your environment is comfortable, it probably isn't conducive to change.

*In short, it's the mental routines—the mental environment—that we most need to change to break unwanted and unprofitable patterns of thought and behavior. When you're your own trading coach, you learn to*

think, but also to think about your thinking. Incorporate a fresh look at self and markets each day to inspire new ideas, challenge stale ones, and tap sources of energy and inspiration that otherwise remain hidden in routine. As with my adventure in Queens, you may find that the most exotic changes bring out your finest adaptations.



### COACHING CUE

Many times it's the market views we most scorn that we need to take most seriously, because at some level we're finding them threatening. Seek out commentary from those you most disagree with and ask yourself what you would be seeing in the markets if that commentary proves to be correct. If you're quick to dismiss a market view, give it a second look. You wouldn't need to be so defensive if you didn't sense something plausible—and dangerous—in the views you're dismissing.

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## LESSON 5: TRANSFORM EMOTION BY TRACE-FORMATION

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When traders seek coaching, they are usually troubled by a particular emotional state that affects their decision-making: anger, frustration, anxiety, or doubt. Their goal is to change how they feel, but they don't know how to accomplish that. Sometimes traders even view their emotions as fixed and unchanging aspects of personality: "It's just the way I am."

It is true that our traits and temperaments affect how we experience the world. They also play an important role in defining the range of our emotions. Some people feel things—good and bad—very strongly; others are quite even-keeled. Neuroticism, the tendency to experience negative emotions, is one of the big five personality traits identified by researchers. Like all such traits, it has a strong hereditary component. Though we like to think of ourselves as masters of our fates, the sobering reality is that much of our emotional experience is hardwired.

Does that mean we can't change how we feel in particular situations? Not at all. If psychological methods can help people overcome post-traumatic stresses and anxiety disorders, they certainly can help us master our feelings in normal life situations. For the most part, we cannot change personality, but *we can change how our personalities are expressed*.

The trap many traders fall into is trying to control feelings with thoughts. We attempt to talk ourselves into feeling better or differently. Rarely does that work. When people are grieving over losses, telling them they'll be okay doesn't really touch what they're experiencing. The

feelings express a psychological reality; asserting a logical reality ignores the personal meaning and significance of the situation. Feelings are surprisingly refractory to willpower: if wanting to feel different—and talking ourselves into feeling different—were possible, there would be many fewer psychologists in the world.

If you serve as your own trading coach, *a great place to start is with the perspective that feelings contain information*. Research in cognitive neuroscience finds that emotion is an essential component of rational decision-making. When the brain is damaged and becomes unable to engage in emotional processing, the result is profoundly distorted behavior. Your coaching goal is not to banish the feelings associated with difficult trading—a strategy that only prevents resolution—or to blindly act upon them. Rather, the most constructive step you can take to change a feeling is to give it full acknowledgment and extract its vital information.

Feelings inform us about our appraisals of self, others, and world.

The research of James Pennebaker, a professor at the University of Texas, is quite relevant here. He and his colleagues found that writing in a journal or talking aloud for a half hour a day had a powerful effect on enabling people to cope effectively with challenging emotional circumstances, including traumas and crises. When we make implicit feelings explicit, we view them from different angles and place them into a different context. For example, someone who has been angry and frustrated with himself over poor trading performance might journal about these thoughts and feelings at length. As he is writing—and reading over his writings—he suddenly realizes, “Whoa; I’m being awfully hard on myself. I’m not that bad!” With that, he is able to throttle back his negative self-talk and turn his attention back to markets.

When we fail to acknowledge emotions, we lose their information and thus the opportunity to shift perspectives. The frustrated, angry trader who brushes aside his tensions and forges blindly ahead finds them easily triggered the next day. This is particularly the case when the frustrations are triggered initially by trading mistakes. I recently met with a trader who fought a market trend all morning, built frustration through the day, and then blew up in the late afternoon. Had the trader used the frustration to examine his trading, he could have ridden the trend and made significant money. Brushing emotions aside doesn’t change them. Ironically, acknowledging and accepting them, giving them free expression, sets the stage for transformation.

Does that mean that we should give full vent to whatever we’re experiencing? No, psychological research also suggests that unbridled expression

of emotion interferes with concentration and performance. Simply yelling when we're angry or pouting when we're discouraged does nothing to alter the feelings—and certainly does not place us closer to resolving the situations responsible for the upset in the first place. The trader from my example, for instance, spent much of his afternoon fuming, but never resolving his anger. Reflexive acting on such emotions only reinforces them; you can't overcome frustration by behaving in frustrated ways.

Blindly venting or acting on emotion is as unproductive as blinding ourselves to emotion; both prevent learning from the information in our feelings.

*The idea, then, is to transform feeling, not ignore it and not revel in it.* One way to do this is to replace one emotional state with another: to substitute feeling for feeling, not thought for feeling.

In my *Psychology of Trading* book, I explained how I used the early music of Philip Glass to enter a meditative state and trance-form experience. Actually any stimulus that evokes calm, focused attention can be effective as a tool for shifting emotions. The key is to evoke and sustain the Yoda state—the calm focus—during periods of high frustration or discouragement. Biofeedback can be especially useful in this regard, as computer-based applications provide real-time feedback about your success in sustaining the altered state. It is virtually impossible to sustain a worked-up state—anger, anxiety, and stress—when keeping yourself calm and focused. Even better, in the relaxed state, you'll arrive at perspectives and insights that remain unavailable while you're immersed in the flight-or-fight mode.

One exercise I recommend to traders is to draw two thermometers side by side on a sheet of paper and then run off a number of copies of the paper. One thermometer records your emotional temperature with respect to frustration; the other records your temperature with respect to confidence. The sheet stays by your trade station; all you need to do is make a mark on each thermometer to indicate how frustrated and confident you're feeling at the time.

When we're most frustrated, but also most overconfident, we're likely to make our worst decisions and violate our trading principles. If you require yourself to "take your emotional temperature" during each trading session, you create a mechanism for catching your state of mind before it can disrupt trading performance.

Once you identify an elevated frustration temperature, a valuable, automatic rule is to take a few minutes away from the screen and enter into a trance-formation. This can be done by regulating your breathing—making

it particularly deep and slow—and fixing your attention on something that captures your attention: music, imagery, or a picture in front of you. If you slow your body and take your attention away from the situations that may be elevating your emotional temperature, you shift your state and make it easier to act calmly, in a planned fashion. With practice, this can be accomplished in a matter of minutes, short-circuiting many disruptive patterns before they lead to poor trading decisions.

The key is to keep yourself aware of your emotional state throughout the day. The thermometers are an easy, visually arresting way of becoming your own observer—and coach.



#### COACHING CUE

Check out the insights about breathing in Chapter 9. Mike Bellafiore of SMB Capital explains how he and partner Steve Spencer teach the traders at their prop firm how to breathe as part of training them to trade. As practitioners of meditative disciplines understand, emotional self-control begins with physical control.

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### LESSON 6: FIND THE RIGHT MIRRORS

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A mirror is an object that shows us our own image. Thanks to mirrors, we know what we look like. Far more goes into our self-image, however, than our physical reflection. *That is because virtually all of our experience serves as a psychological mirror.* We see ourselves reflected in the impacts we have upon the world around us. As a result, much of self-esteem—our sense of worth and competence—follows from finding the right mirrors in life.

Let's start with romantic relationships. When we select the right partner, we choose someone who knows and values the person we are. That love and support is ongoing; consistently reflected to us, it is a deep affirmation of self. In a similar fashion, parents constantly mirror a child's identity: "You're such a good boy!" and "What a smart girl!" *Our self-talk is born of just such early life conversations: we internalize the voices from significant relationships.*

This is why abusive relationships are so damaging. To share life with a spouse who attacks or demeans us—or who just doesn't care—or to endure parents who are neglectful is to continually face a distorting mirror. Over time, children absorb the distorted images and no longer feel lovable, secure, and important. Out of such twisted self-images, they select future partners that validate their identities, sadly finding others who repeat the

messages and experiences of the past. That is how abused children find themselves in abusive relationships; how insecure people land in insecure marriages.

While relationships may be our most powerful psychological mirrors, given their emotional intensity and ongoing influence, they are far from the only determinants of self-image. The Devon Principle that I wrote about in the *TraderFeed* blog captures the understanding that *everything* we do is a psychological mirror. When my daughter Devon tackled work that she didn't like, she found the work frustrating and felt inadequate as a result. When she pursued work that she loved so much that it didn't feel like work, she felt fulfilled and gained confidence. The best work speaks to our interests and values, matching our abilities with challenges. Day after day, performing efficaciously at work that is important to us generates mirror-experiences of competence and worth. Conversely, when we're performing meaningless work that doesn't challenge our skills, it is difficult to feel anything other than boredom and meaninglessness. *A large portion of career success consists of finding the right mirrors*; it's much easier to get to the top when you're climbing the right ladders.

For more on the Devon Principle, check out my blog: <http://traderfeed.blogspot.com/2006/12/devon-principle.html>

For my work as a psychologist, nothing is a more powerful mirror than having a meaningful, positive impact upon people's lives, particularly when I get to know those people well and care about them. I enjoy giving a talk for a large audience or writing an article that's widely read, but the real joy is hearing back from someone who thought the ideas were of genuine value. And, to be honest, I find far more reward in helping a single person in counseling or coaching than in giving a keynote address for a large conference. When a person transforms her life via coaching or counseling, a mirror is created that validates and enhances both participants in the helping relationship. I have been most successful when I've immersed myself in these positive mirroring experiences, least successful when I have pursued activities that, ultimately, offer a limited sense of self.

When you serve as your own coach, your challenge is to structure your learning and development so that trading itself becomes an experience that mirrors your growing confidence and competence. Many traders limit their self-coaching to keeping a journal, and then limit their journaling to recounting all the things they've done wrong. As a result, self-coaching becomes little more than self-criticism. What is mirrored to a trader when the journal focus is so negative? What would be mirrored if we hired a teacher or coach who only offered criticism? Over time, such coaching would fail, reinforcing a sense of incompetence and failure.



One of the best means for creating positive mirrors is the structured pursuit of goals. When we create challenging, meaningful, and doable goals, we generate potential experiences of mastery and success. *When we make goal setting an ongoing feature of our self-coaching means, we continually construct opportunities for powerful, self-affirming emotional experiences.* We know from psychological research that such emotional episodes are processed more deeply and enduringly than normal, daily experience. A good therapist creates vivid experiences that challenge clients' old patterns; similarly, a good coach generates emotionally powerful and positive mirroring experiences for traders.

Your goals should set yourself up for success and a building of confidence.

So here is your assignment: Each day this week your trading journal should include a specific goal for work that particular trading session, concrete actions that you will take to achieve that goal, and a self-evaluation at the end of trading to gauge your success in reaching that goal. *The goal should be a trading process that you wish to improve (i.e., something you have control over), not a profit target (which you ultimately don't control).* For example, your goal might be to increase your trading size incrementally, to implement a strategy for exiting trades in stages, or to limit trades to setups that align with the larger market trend. At the end of the day, you will give yourself a report card based solely on how well you achieved the goals you set for the day. These report cards can be displayed beside your monitor to reinforce your performance and progress. If you fail to achieve a good grade, improvement on that activity becomes your goal for the next day. If you receive a fine report card, you generate fresh goals for the next session. The idea is to never trade without consciously working on some aspect of your trading.

It is not enough to set goals; you need ways of tracking your progress toward those goals and feeding that information into future goals.

Many traders only engage in such goal setting when they're trading poorly or losing money. The idea, however, is to make self-coaching and self-improvement an ongoing part of your trading career. Why? Because it's not just about making money, it's about creating the experiences that will sustain your sense of competence and confidence. Think of a young child: you don't offer positive feedback only when the child is hurting. Rather, your support and love are continuous, enabling the child to

sustain a consistent self-image. As a developing trader, you are like that young child. Your ability to create powerful mirroring experiences will make a difference in your ability to sustain the optimism and courage to weather drawdowns and aggressively pursue opportunity.

Please take note of the following principle: If you limit your losses, pursue your strengths, and take concrete steps toward mastery, every single trading day can be a positive experience, even when you're not making money. You cannot eliminate losing days, but there should never be days that leave you feeling like a loser.



### COACHING CUE

When you construct your report cards, grade yourself based on your improvement, not based on an abstract (or perfectionist) standard of success. If you manage your trades better today than yesterday, that merits a good grade. Your goal is to improve; by focusing on improvement, you create powerful mirrors of self-development. Relative, not absolute, goals will get you to your desired endpoint, and they will ensure an enjoyable and empowering journey.

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## LESSON 7: CHANGE OUR FOCUS

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A valuable psychological rule is that if you wish to change the doing, you must change the viewing. How we see the world colors how we respond to life events. We don't just react to markets, but also to how we process those markets. Our thoughts are the filters between trading and trader.

Many times we respond in exaggerated ways to markets, not because there's anything unusual going on in the instruments we're trading, but because a set of negative thoughts have intruded into our performance. Let's say, for instance, that I notice that the ES futures are unable to surmount their overnight highs during the opening minutes of trade despite a few flurries of buying. I then observe that large traders are coming into the market hitting bids. I hypothesize that we cannot sustain strength and that the overnight highs will not be breached. I further infer that we will trade back into yesterday's price range and hit the average trading price from that session. I wait for a bounce higher in the NYSE TICK that cannot make a fresh price high and use the occasion to sell the futures. As the position moves my way, however, the thought enters my mind that I should take quick profits because I've had a losing week thus far. A buy program then hits the market and my position ticks higher, eroding some paper profit. Now especially concerned, I take a small profit—only to see the market weaken notably and eventually hit my initial price target.



What has happened in this scenario? Anxiety has interfered with my performance, turning a good trading plan into bad trading. But the anxiety has nothing to do with the behavior of the market: the market did absolutely nothing to disconfirm my idea. Indeed, when the buy program lifted the index futures briefly, the market was giving me a perfect opportunity to add a second unit to my trade! Not only did I miss an opportunity to profit from a good idea, I also missed an opportunity to hit a home run. Often, keeping losing trades small and hitting those few home runs generates profitability over the long run.

Many traders' problems show up in how they handle opportunity, not loss.

Sometimes anxiety is a legitimate and appropriate response to a market that behaves in violent and unexpected ways. After all, as I note in the blog, anxiety is our body's adaptive response to perceived danger. But danger can be a function of perception, not objective reality. I begin my trade immersed in market activity, framing hypotheses and executing an idea well. At some point, however, my thoughts veer from the present market and instead focus on how much money I've lost during the week thus far. That focus on loss creates a sense of danger and threat. Instead of responding to the market, I'm now reacting to my own concerns regarding profitability. My thought process has taken me out of the market immersion—and ultimately takes me out of my game.

In a cool, calm moment, I can see clearly that the validity of my trade idea/plan has absolutely nothing to do with how I've traded the past several days. If I introduce worries over profitability into my trading, however, I've now allowed the viewing to affect the doing. I'm no longer absorbed in the market; my focus is gone. I'm responding to my own uncertainties and insecurities.

How can we change our focus and stay grounded in our plans and in objective market activity? The first step is to recognize our triggers. These are the performance thoughts and worries that typically intrude during trading. Concerns over profitability are one trigger; excitement over anticipated profits could be another. Anything that gets you thinking about how well or poorly you're doing while you're doing it is a trigger that can nudge you out of your zone. When you know your triggers, you're in a much better position to intercept them when they occur and treat them the same way you would treat any ordinary distraction, such as road noise outside your window.

In other words, *it's not the thoughts of performance that take you away from your focus, but your identification with those thoughts.* This

is an important distinction. Everyone experiences distracting thoughts at times. When we identify with those thoughts, however, they—not our markets, not our plans—become our focus.

Negative thoughts are inevitable; the question is whether you buy into them.

Meditation can be a very helpful exercise. One purpose of meditation is to help people create a quiet mind by sustaining a single point of concentration and brushing aside all distracting internal dialogue and impulse. A simple adaptation of meditation for you to try is to take 15 minutes before the start of trading and seat yourself in a comfortable position, breathing slowly and rhythmically from the diaphragm. While in that position, focus your attention on quiet instrumental music played through headphones. You want to be as absorbed as possible in the music: as soon as your mind wanders, bring it back to the music and the sounds of the different instruments.

Once you've been able to sustain that focus for a few minutes, you then purposely bring to mind your greatest performance concerns—*while you stay seated, focused, and breathing rhythmically and deeply*. You evoke one concern at a time (for example, thoughts or fears about your recent profitability) and then dismiss the thoughts and bring yourself back to the music. Instead of having the thoughts intrude on you unexpectedly, you intentionally call them to mind and practice and then put them away, as you stay calm and focused. You might even guide yourself through imagery as you're breathing deeply and slowly, imagining your negative thoughts as trash that you decide to put in a garbage pail. Instead of avoiding your negative thoughts, bring them to mind as your own, inner trash-talking—and then visualize yourself taking out the garbage.

Do this every day for a few minutes and you can train yourself to gain control over negative thought patterns. Most importantly, you develop the capacity to become an observer to those thoughts, rather than to identify



#### COACHING CUE

Whenever you catch yourself thinking about your P/L during trading—how much you're making or losing—call a brief time-out; take a few deep, rhythmical breaths and talk out what you're seeing in the markets at the time. Your goal is to be market-focused, not self-focused. By repeatedly pairing a calm, relaxed state with an intense market focus, you can develop a positive habit pattern and ensure that the body keeps the mind in check.

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with them. If you can observe something about yourself, you immediately introduce an element of psychological distance. Even the most negative thoughts and feelings cannot trigger unwanted behaviors if you don't identify with them. Daily meditation is a powerful strategy for building your own Internal Observer and sustaining a change process.

## LESSON 8: CREATE SCRIPTS FOR LIFE CHANGE

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There is a bit of a chicken-and-egg challenge associated with making changes in our lives. To change a behavior pattern, you have to be able to exit that pattern. If, however, you had the ability to avoid enacting those patterns, you wouldn't need to change in the first place.

This dilemma is a common barrier for traders who would like to be their own trading coaches, but don't know how to stand apart from the problem patterns that they repeat week after week, month after month.

To appreciate how we can shift ourselves out of old, problem patterns and into new, positive ones, we need to understand something about drama. Specifically, it's helpful to *start thinking about life in terms of the different roles that we enact during our life's performances*. "All the world's a stage," Shakespeare observed, and we are the sum of the roles that we play on that stage.

Some of our life roles have an automatic, scripted quality to them. Typically we learned these roles early in life and, for years, they may have worked well for us. As a result, these roles have become *overlearned*. For instance, we may have learned to gain attention from parents by complaining or by acting up and breaking rules. Over time, those behaviors can crystallize into fixed roles: we automatically find ourselves whining or acting out of frustration during times of personal conflict. What worked in childhood by bringing us attention now works against us, interfering with careers and romantic relationships.

Many trading problems have just such a scripted quality: We enact the same patterns repeatedly. We start by trading carefully and conscientiously. Then we lose money and become frustrated. Out of frustration we break trading rules, ignore stop-loss points, and undergo serious losses. Then we feel tremendous relief at exiting the losing positions and redouble our determination to trade carefully and conscientiously—until the next frustration comes around. Is this really so different from couples that are determined to get along with each other, then encounter frustrations, argue and fight to the point of being ready to break up, only to experience relief as they make up and vow ever stronger to stop hurting each other? Or the person who swears that he will stop gambling, only to make a few

exceptions, lose money, and then out of relief step away from the casino once again, insisting that he won't go back?

Trading requires a mind free to process data and select appropriate action. But we no longer have a free will if we are mechanically reliving scripts from the past.

A dramaturgic perspective suggests that these repetitive patterns are enactments—cyclical reenactments—of *roles* that we have learned in the course of life: the role of the down-and-out person who presses for success, the role of the aggrieved spouse, the role of the independent person who refuses to be bound by rules, and so forth. One trader I worked with grew up in an overprotective and controlling home. He rebelled as a teenager and subsequently found himself chafing at any constraints on his behavior. His violation of rules in relationships (monogamy) and trading (the risk-management rules of the firm) led to one failure after another. He was living out a script that could only provide unhappy endings.

But if we can acquire scripts through our relationship experiences, then surely we can cultivate new ones by placing ourselves in different roles. One trader I worked with experienced himself as sloppy and undisciplined. It showed not only in his trading, but also in his physical condition and the state of his apartment. His breakthrough occurred when he joined a fitness club and engaged a personal trainer. The regular series of classes and exercise sessions got him into shape and imposed a structure on his efforts at self-improvement. As he experienced more energy—and felt better about himself for getting in shape—he spontaneously took the initiative in cleaning his apartment and honing his trading rules. The sessions with a trainer provided him with a new script and positive experiences that mirrored a fresh identity. *By enacting a new role, he experienced himself in a new manner—and this infiltrated a variety of areas of his life.*

Here's another example: For years I tended to be impatient—with myself, with others, with trading, and even with the pace of change among people I met in therapy. When Margie and I had two children, however, I found myself in a new role that did not allow me to be impatient if I were going to be a good parent. Because it was clear that both our children had personalities very different from mine, I had to figure out ways to communicate with them on their terms. The new role as a patient parent provided me with a discrepant set of experiences; I subsequently found myself more patient in a variety of situations, whether it was behind the wheel of a car or during counseling work with a client who felt stuck. The new role generated novel, positive scripts. With the favorable mirroring over years of parenting, I've actually changed how I see myself. I now experience myself

as a relatively calm, patient person: it has become an integral part of my identity.

For more on how new experiences generate new roles and scripts, check out my blog: <http://traderfeed.blogspot.com/2006/11/cross-cultural-journey.html>.

So here's your challenge and your assignment: Identify the person you would like to be and then throw yourself into a structured social activity—a role—that requires you to enact those ideals. If you want to be more disciplined, take on a discipline: martial arts, work with a personal trainer, etc. If you want to be more patient and focused, undergo meditation training or work with young children that you care about; if you want to become more socially confident, immerse yourself in public speaking; if you want to trade more aggressively, join a trading room that mirrors the style you want to adopt and actively participate in its discussions. *Create the roles that mirror your desired identity; live scripts of your choosing.* If you can place yourself in situations where you routinely practice being the person you want to be, you'll rapidly make that person your own. Change begins with novel experience, but is sustained through repetition.



#### COACHING CUE

To be the trader you want to be, consider taking on a student/trainee. When someone is observing you and learning from you, you'll be on your best behavior. With the teaching script, you'll access behavior patterns that you would never enact in isolation. Alternatively, take on a peer mentorship role. The social motivation to live up to your best for your trading buddies will enable you to access your best behavior patterns.

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## LESSON 9: HOW TO BUILD YOUR SELF-CONFIDENCE

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Trading is one of the most challenging occupations, because traders routinely face working conditions that they cannot control. Psychological research suggests that one important basis for self-confidence is self-efficacy: the perception that we can control outcomes that are important to us. But how can we sustain self-confidence as traders if we cannot control whether we make money from day to day?

A trader recently called and expressed frustration with his performance. Markets were moving well and, for the most part, he was catching the direction correctly. He entered positions aggressively, but then was stopped out at the worst times when the market made sharp, short countertrend moves. When we reviewed his trading statistics, we found that his average win size exceeded his average loser, but that he had many more losing trades than winners. The steady drumbeat of losing trades was eroding his self-confidence.

So what was the problem?

Our trader was waiting for markets to begin moving in the anticipated direction and then entering with full size. By the time he lifted an offer or hit a bid, the market had already made a short-term move and was ripe for profit taking by scalpers. His full size made these countertrend moves intolerable, and his risk management rules ensured that he had no staying power with his ideas. The market was controlling him; he was not in control of his trading. The loss of self-confidence was inevitable.

*The key to regaining self-confidence in such a situation is to turn the focus from making (or losing) money to the actual process of trading.* We initiated a simple unit-sizing rule in which the trader could only enter positions with one unit (his maximum size was three units). If the position went his way, but then experienced a normal retracement, he added a second unit. If the position did not go his way, he maintained a defined stop-loss point and ensured a minimal loss, given that his size was one-third his maximum. The trader could not control the market's movement, but he *could* control his position sizing. This process focus promoted a sense of self-efficacy, which was essential to recapturing his confidence.

You control how you trade; the market controls how and when you'll get paid.

This is one reason that trading with rules is so important. You can't control your P/L statement, but you *can* control whether you adhere to trading rules. Your focus becomes one of trading well, not one of making money. Every rule followed—every market traded well—is a success experience in the process sense. Over time, profits result (as long as the rules are sound!), but the confidence comes from self-mastery.

Another powerful source of self-efficacy is preparation. When you prepare your trading ideas for the day or week, you generate a sense of mental mastery. This is particularly the case when your preparation includes what-if scenarios that guide your decision-making under a variety of market possibilities. Successful experience is a powerful source of mastery, and the mental rehearsal of trading plans under various contingencies generates



a form of experience. As a psychologist, I am impressed by the degree to which traders who prepare rigorously feel as though they *deserve* to win. That same sense is missing among those who casually scan newspapers, charts, or web sites and then plunk themselves down at the trade station to place their orders.

Many traders confuse self-confidence and positive thinking. *Self-confidence is not expecting the best; it's knowing, deep inside, that you can handle the worst.* The self-confident trader can look a stop-loss level in the eye and know that he will be okay if it is triggered. The self-confident trader knows that loss is part of the game—and that some of our best market information comes from good trade ideas that don't work out. Self-confidence is not cockiness, nor is it viewing the world through rose-colored glasses. It's the quiet sense of, "I've been here; I can handle this."

Confidence doesn't come from being right all the time; it comes from surviving the many occasions of being wrong.

Nothing is so important in building self-confidence as successful experience in the face of adversity. When you serve as your own trading coach, a major task you face is generating your own positive trading experience. Just this morning I read an e-mail from a trader who had experienced harrowing losses in the markets over the past two years. Now he was having difficulty sustaining the optimism needed to weather normal losses. His failure was not as a trader, but as his own trading coach. When we traumatize ourselves, we generate negative experience. We create a sense of helplessness, rather than mastery. We create deep emotional connections between trading and loss, rather than between trading and self-efficacy. We undercut self-confidence.

A great way to build self-confidence is to focus on how you trade when you're in the hole. If confidence comes from successfully navigating adversity, you can build your confidence by working on how you trade when trades go against you. The idea is to focus on trading well by giving yourself a chance to dig out of the hole by not exiting a losing trade prematurely, but also to not allow the losing trade to move so far against you that it creates trauma. Every planned loss that you take provides you with an experience of control; every drawdown that you battle back from is an experience of mastery. When you come back from losses, you reinforce your emotional resilience. You can't control whether you win or lose on a particular trade, but you can control how much you lose and how you lose it.

Every trader needs a plan for losing. *Your stop-loss is your plan for a losing trade.* Cut your size after a series of losing days and focus your

efforts on your highest probability trades as your plan for a drawdown period. In Ranger school, the Army exposes recruits to the most harrowing physical conditions possible. Once recruits have completed their training, they have the deep conviction that they can handle any and all battle conditions. You want to view your losing trades and your losing periods in markets as your Ranger School, your trial by fire.

Your losing trades and losing periods are your trials by fire that build resilience and confidence.

How will you handle a significant losing trade? How will you handle a significant losing day? Week? Month? How will you ensure that you can draw upon your strengths and come back from these losses and build your resilience? Your assignment is to develop your plans for losing, to always know—and mentally rehearse—what will get you out of trades and out of markets, so that you can retool your efforts.

In psychology, crisis does offer opportunity: it shakes up our assumptions and forces us to make changes in how we think and act. Your challenge as your own coach is to find the opportunity in your crises by generating and rehearsing plans for anything and everything that can go wrong. To prepare for hurricanes and tornadoes, communities not only draw up disaster plans, but also conduct drills to put these into practice. Change is a function of preparation and training: drilling the right responses, so that they are second nature when market disaster looms.



#### COACHING CUE

Just before I wrote this section of the book, a savvy trader contacted me and explained that he broke some of his rules and lost the profits from the prior week. He was very upset and wrote a memo to himself to ensure that he learned from the experience. He sent the memo to me and insisted that we talk in a few days to ensure that he followed up on the memo. It's a great example of how a trader takes a losing situation and turns it into an opportunity for self-improvement. He won't let the issue go until he's rectified his errors.

That's how traders turn losing experiences into confidence builders. Next time you blow up in your trading, write yourself a detailed memo that explains what went wrong, why it went wrong, and what you will do to avoid the problem going forward. Then send the memo to a valued trading buddy for follow up to hold yourself accountable. That way, every big mistake becomes a catalyst for meaningful change.

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## LESSON 10: FIVE BEST PRACTICES FOR EFFECTING AND SUSTAINING CHANGE

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The first two years of my career as a psychologist, I worked in a community mental health center, helping individuals, couples, and families with the full array of emotional disorders, from depression to drug abuse. The following year I shifted my practice to student counseling at Cornell University, which afforded my first opportunity to work with a relatively healthy population dealing with normal, developmental issues. I then took the community and student experiences to Upstate Medical University in Syracuse, New York, where I coordinated the counseling and therapy for medical, nursing, and other health sciences students and professionals for 19 years. It was in this latter setting that I learned to apply brief therapy methods to the challenges of young people who were in high-stress, high-achievement occupations. That experience would prove invaluable to my work with traders in the financial markets.

During my time in Syracuse, I met on average about 150 students a year for about eight sessions each. Multiply that times 19 and you have a sense for the changes I've seen happen and not happen. The shining successes, the disappointing failures: all stand out in my mind as if they occurred last week.

When you've worked with that many people over the course of a career, you develop a good sense for change processes and what makes them click or stall. It doesn't matter if you're working with a victim of abuse in the community, a student with test anxiety at an Ivy League school, or a medical student dealing with the first loss of a patient. Change has a particular structure and sequence; there are factors that speed it up and those that impede it. Below I share five of the most important change elements that affect my work as a trading coach. When you harness those elements, you will be well positioned to succeed in your self-coaching:

- 1. Timing and Readiness.** Timing is everything, in psychology as in trading. The research of Prochaska and DiClemente suggests that people are most likely to make changes when they're *ready* to make changes. Many times we're conflicted about change; we're not really sure that we want to abandon old ways. I talked with a trader recently who lost much more money than he should have (and than his plan called for) because he simultaneously traded three positions with full size when those positions were highly correlated. He was wrong and he blew out. But when we reviewed the unit sizing by trade idea rather than simply by position, it was clear that he wasn't sure he wanted to make smaller bets. He was upset because he was wrong on the

idea, not because he had violated risk-management discipline. My job was then to help him become more ready for the change he needed to make, just as an alcohol counselor must help an alcoholic become more ready to commit to sobriety. *You will change when you're ready to change, and you'll be ready to change when you recognize that you need to change.* As we saw earlier, by becoming more emotionally connected to the consequences of our behavior, we cultivate that need to change.

2. **Ready, Steady, Go.** One of the traps that eager traders fall into when they start coaching is that they want to make many changes all at once. As a result, traders overload themselves with too many goals, water down their focus, and never adequately follow through with any of them. If you have a list of five changes to make, select the one that you're most ready to make (as noted above): the one that you're most committed to taking action on. *Work on that one goal intensively and daily until you make and sustain significant progress; then move to the next change.* The momentum from your success with the first effort will carry over and help your work with the others. If you begin with a goal that you should work on, but aren't fully committed to, you'll stall out on your entire coaching effort. Keep your work doable, but keep it steady. Build momentum and success, and that will help with your later change efforts

When you coach yourself, focus your efforts and let one success fuel others.

3. **Double Down.** When you first make a desired change, don't let up. Rather, focus on what you did to make that change and redouble your efforts. Make your goal to sustain that change. All too often, traders let up once they make an initial improvement. That's like hurting your opponent in a boxing ring and then not moving in to finish him off. You want progress to double your motivation, not let your bad habits off the hook. *We've seen that the enemy of change is relapse:* all of us too easily fall back into old patterns if we're not making conscious and sustained efforts to build new ones. The key to change is relapse prevention: repeating new patterns so often that they become natural to us. Any change worthy of pursuit is worth repeating 30 times in 30 days. In Alcoholics Anonymous, a committed new member will attend 90 meetings in 90 days; "bring the body in and the mind will follow" is the slogan. Make the change consistently enough and it will be your change.

Successful coaching means working as hard at maintaining changes as initiating them.

4. **Stay Active.** The research literature in psychology finds that change is most likely to occur when we are active in its pursuit. That is, we change by enacting new patterns—by *doing* new things—not simply by talking about change or thinking about it. I often joke that traders approach coaching like many people treat church: they go once a week to feel virtuous and forget about it for the next six days. A truly religious person wants to live their beliefs every day; if you're going to get the religion of virtuous trading, it's no different. That is why each goal should be accompanied by specific daily activities that help you make progress. If your goal is better risk management, then you want to work on managing the risk of every trade. If your goal is a better mindset, then you want to perform specific exercises each day to keep calm and focused. You won't change your behavior by changing your mind; you'll start thinking differently once you enact new behavior patterns.
5. **Stay Positive.** "If it ain't broke, don't fix it," is the philosophy of those who fail to work on trading until they're broke. *If you're trading well, that's one of the best times to coach yourself.* Your goal isn't to change what's working; it's to become even more consistent in your efforts. Doing more of what works is a valuable goal that helps you press your advantage when you're doing well. The alternative, sitting back on your laurels when you're making money, will bring comfort, but not elite levels of success. I recently met with a prop trader who was trading very well on relatively small size. A quick look at his Sharpe Ratio and trading results suggested that he could be making much more money simply by running more risk in his portfolio and sticking to his bread-and-butter setups and markets. We developed a plan for doing that and he turned good success into outstanding success. By formulating positive goals—focusing on changes that involve doing more of the right things—he made the most of his strengths. It's for that reason that I often tell people that the best time for coaching is when you're doing really well and really poorly.

The best traders, I find, are those who have made self-improvement a way of life. Such traders are driven in their work lives, their physical fitness, and their recreations. They derive great meaning and satisfaction from being the best they can be. The same is true of great athletes: they love working out; they constantly challenge themselves. It's when change is

a lifestyle that we see exemplary performance. At that point, self-coaching becomes a life philosophy—an organizing principle—not just a discrete activity among many during the day or week.



### COACHING CUE

What is the one change you most want to make *outside of trading*? Develop a daily plan for action on the goal that will help your trading efforts. It's all about strengthening the coach within you, whether you're working on your finances, your relationships, your physical conditioning, or your chess game. The goal is to become a change agent, a master of change across all spheres of life. Working on your nontrading life is a way of building your self-coaching as a trader.

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### RESOURCES

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The *Become Your Own Trading Coach* blog is the primary supplemental resource for this book. You can find links and additional posts on the topic of change at the home page on the blog for Chapter 1:

<http://becomeyourowntradingcoach.blogspot.com/2008/08/daily-trading-coach-chapter-one-links.html>

Some changes—particularly of problems that have been longstanding and that interfere with relationships and/or work in a significant way—may require more than self-coaching. Here is a referral list for cognitive therapists that I've found helpful:

<http://www.academyofct.org/Library/CertifiedMembers/Index.asp?FolderID=1137>

For a detailed, research-based summary of the literature on change, check out *Bergin and Garfield's Handbook of Psychotherapy and Behavior Change*, published by Wiley and in its fifth edition (2003). Of particular relevance are the chapters in Section 2, dealing with "Evaluating the Ingredients of Therapeutic Efficacy."

For an overview of short-term approaches to change, check out my chapter on "Brief Therapy" in the *Handbook of Clinical Psychology*, Volume 1 edited by Michel Hersen and Alan M. Gross, also published by Wiley (2008).

A worthwhile collection of creative approaches to change can be found in *Clinical Strategies for Becoming a Master Psychotherapist* edited by William O'Donohue, Nicholas A. Cummings, and Janet L. Cummings (Academic Press, 2006), including my chapter on "The Importance of Novelty in Psychotherapy."

## CHAPTER 2

# Stress and Distress

### *Creative Coping for Traders*

*If you plan on being anything less than you are capable of being, you will probably be unhappy all the days of your life.*

—Abraham Maslow

**W**hen traders seek coaching, one of their most frequent requests is help with reducing stress. The assumption is that less stress is better and, if they could eliminate stress, trading would go well. But is that true?

In this chapter we'll take a look at stress and distress, as well as the difference between the two. We'll also explore coping and what makes for effective and ineffective responses to stressful situations.

One of the great challenges of coaching in a high-intensity, competitive field is making sure that normal, expectable stress doesn't turn into performance-robbing distress. In practice this means distinguishing between the stresses that are part and parcel of the trading profession and those that we unwittingly place on ourselves.

Let's take a look at how you can make stress work for you in your self-coaching efforts.

## **LESSON 11: UNDERSTANDING STRESS**

It's common to hear suggestions that traders eliminate or greatly minimize psychological stress. This, of course, is impossible. The very act of trading requires daily encounters with risk and uncertainty. Psychological stress is

assured when we operate in such environments. If minimal stress is your objective, trading should not be your vocation or avocation.

Many traders—and trading coaches—confuse stress and distress. *Not all psychological stress brings distress, and not all psychological stress is bad.* If you are going to coach yourself for trading success, it's important that you understand stress: how it helps performance, and how it can become distress and interfere with decision-making.

So let's start with an everyday example. You're driving on a highway on a long trip, and you're feeling a bit bored. Suddenly the wind picks up and snowfall becomes heavy. Your visibility is greatly reduced, and you can feel the road becoming slippery. Before you know it, you're hunched over the steering wheel, staring intently through the windshield and reducing your speed. Your boredom has quickly turned into alertness. You're no longer operating on auto-pilot.

This is psychological stress: a heightened physical and cognitive state that prepares us for dealing with challenges. It's been called the flight or fight response, because it mobilizes mind and body to avoid challenging situations or to face them head on. Muscle tension, alertness, and the flow of adrenaline: these are but a few cues that we've entered a state of stress.

Note that this is an adaptive state in the example of driving in the snowstorm. Had you remained on autopilot, you might not have slowed your speed and taken measures to avoid an accident. The state of stress has mobilized your energy—shifted you from your boredom—to cope with the immediate situation. You can appreciate how silly it is to talk of minimizing stress in such a situation: when you're in a blinding snowstorm in a moving vehicle, your mind and body *should* mobilize!

Stress is a mobilization of mind and body; it can facilitate performance.

But let's take our example one step farther. I lived in the Syracuse, New York, area for more than 20 years, so the snowstorm is challenging, but not unfamiliar. I've experienced similar conditions before, and I know what to do when they arise. My stress never becomes distress, because I never perceive the storm as an acute threat.

Suppose, however, I am from Florida and have never experienced such a storm. I've heard of cars getting into pileup accidents under those conditions, and I'm worried that my tires will lose their grip. The storm is highly threatening for me; I don't feel capable of mastering it. My stress quickly becomes distress, as alertness turns into anxiety.

The simple example of the car illustrates that perception and experience make the difference between stress and distress. When I was an undergraduate at Duke University, David Aderman and I performed an



experiment. We had two groups of subjects deliver a speech. Both groups received negative feedback about their performance. The first group was told that speaking ability was linked to personality and could not be changed. The second group was told that they could improve their speaking skills relatively easily. At the end of the session, the first group reported significantly more distress than the second group. *It wasn't getting the negative feedback that generated distress; it was the perception that they were not competent to change the negative situation.*

Our interpretations of situations turn normal stress into distress.

So how does this relate to trading? When you put your capital at risk, you're like the driver on the snowy road. You will be alert, processing information in real time to make quick mid-course corrections if needed. If you view losing as a natural part of trading, have experienced and bounced back from losses before, and have mechanisms in place to limit your losses, stress is unlikely to become distress. The losing trade is a mere annoyance, like having your trip delayed by a snowstorm.

If, however, you don't accept losing as normal and natural—and especially if you don't have position size limits and stop-loss levels in place to control your losses—the stress of a trade going against you is more apt to become distress. Your ability to focus and make those rapid mid-course corrections will become impaired. You'll be like the Florida driver in the Northeast snowstorm.

*Position size limits, trading plans, and stop-loss levels are like snow tires on your vehicle: they may not seem to do a lot for you when things are going well, but they certainly help you deal with adverse conditions.* A panicky driver in the snow doesn't feel that he can control his car; an experienced winter driver knows that he can. Similarly, the panicked trader feels unable to control losses; the experienced trader knows that losses can always be limited.

Your challenge as your own trading coach is to embrace stress—and always ensure that it does not become distress. A fantastic goal to work on for your trading is to start the day with position sizing guidelines, per-trade loss limits, per-trade price targets, and daily loss limits that you can readily live with. The amount of risk you're willing to take on each trade should be meaningfully smaller than the reward potential built into your profit targets. The amount of money you're willing to lose each day should be a fraction of the money you make on your best days. If you're a frequent trader, no single loss on a trade should prevent you from making money on the day; no single daily loss should be so large that you can't be profitable on the week. *Preparation and familiarity keep stress from becoming distress, because they enhance your sense of control.* If you plan

your loss levels and review those plans thoroughly, they become familiar and you become prepared. (See the brief questionnaire in Figure 2.1 to assess whether your stress is turning into distress.)

If you are prepared for adversity, you will respond with normal stress, not distress.

Trading will always be stressful, but self-coaching ensures that it won't be filled with distress. Remember, your job is to maintain a mindset that keeps your confidence and motivation high: under those conditions, you'll

Please respond to the following questions with the scale below:

- 1 = rarely or never**
- 2 = occasionally**
- 3 = sometimes**
- 4 = fairly often**
- 5 = most of the time**

How often do the following interfere with your work and/or your relationships?

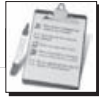
- 1) Nervousness or anxiety? —
- 2) A downbeat or depressed mood? —
- 3) Frustration or anger? —
- 4) Guilt or self-blame? —
- 5) Alcohol or other substances? —
- 6) Arguments or fights? —
- 7) Fatigue or exhaustion? —
- 8) Sleep problems? —
- 9) Headaches, stomachaches, muscle tension? —
- 10) Worry, negative thinking? —

**Note:** Even a single score of 4 or greater merits attention and possible consultation with a professional (see Resource page at the end of this chapter), particularly if the problem is long-standing (greater than one year in duration). Several scores of 3 or greater are also worthy of attention. Chapters 4 through 6 of this book will outline specific brief therapy techniques that can be useful in addressing these problems, particularly when these are situational, not chronic.

**FIGURE 2.1** Brief Distress Questionnaire



work harder, learn more, and grow your trading account over time. *That doesn't mean repealing stress; it means creating active firewalls between stress and distress.* Risk management is one of the best psychological firewalls of all.



#### COACHING CUE

Plan for every possible glitch in your trading: if your broker can't be reached; if you lose your online connection; if your equipment fails; if your data vendor goes down. My own trading station is small, but there is redundancy in each of these areas. I have multiple brokers, multiple online connections, multiple computers, and multiple data streams. There's always a rehearsed Plan B if something fails when I have a position on. The glitches still cause stress, but not distress.

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### LESSON 12: ANTIDOTES FOR TOXIC TRADING ASSUMPTIONS

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What we expect from life shapes our emotional experience. If we expect good things, we tend to be optimistic and energetic. If we expect negative outcomes, we tend to feel anxiety. If we expect that success will elude us, we'll feel discouraged and depressed. If we expect perfection, we'll be continually disappointed with reality.

*To no small degree, our emotions are barometers of the degree to which we are meeting or falling short of our expectations.* That is an important principle, because psychological research suggests that, if our expectations are biased, we're likely to experience skewed emotions.

The relationship between emotion and expectation is particularly important for the developing trader. If you are your own trading coach, one of your overriding priorities is to foster the kind of positive experience that will sustain your motivation and learning efforts. Discouraged, defeated, and fearful learners are not effective learners. If you are going to maintain that zone of focus and concentration that maximizes learning efforts, you have to be *absorbed* in markets. No one can be absorbed if they're also battling emotional distress.

In the spirit of Ayn Rand, who encouraged people to “check their premises” when they arrived at contradictory conclusions (“I should be happy” but “I shouldn't be selfish”), I'll now ask you to check your expectations—particularly if you're finding that distress is interfering with

your learning and development. The following expectations are among the most trader-toxic:

1. **A Good Day Is a Winning Day.** Here's an assumption and expectation that ensures that our emotional experience will rise and fall with our P/L. We generally expect to have a good day; by equating a good day with a winning day, we set ourselves up for disappointment when the normal uncertainty of markets leaves us in the red. *A good day is one in which we follow sound trading practices, from skilled execution to prudent risk management.* Some good days will bring profits, others will not. We can trade poorly and stumble into a profit; we can place a trade with a two-thirds probability of success and lose money as often as an all-star baseball hitter gets a hit. We *should* expect to have good days, if those are defined by sound trading practice. If sound practices don't generate profits over time, we may need to tweak those practices. But going into trading expecting profits each day is a formula for emotional letdown.

Never set a goal if you're not in full control of its attainment.

2. **Working Harder at Trading Means Trading More Often.** This assumption is that, if you trade more, you'll learn more and build skills more quickly. The result is overtrading and a likely forfeiture of profits over time to market makers and brokers. *Every trade starts as a loser.* You're losing the bid-offer spread if you buy and sell at the market, and you certainly lose a transaction fee. A loss of a single tick per trade due to execution, on top of a substantial retail commission, easily ensures losses of thousands of dollars to day traders who otherwise break even on their trades. As we trade more often without a distinct edge to each trade, our broker becomes richer and we become broker. Pointing and clicking to execute trades is a small part of the process by which traders develop expertise. The lion's share of development occurs by tracking patterns in simulation and real time, practicing executing and stopping out trades on paper (and in simulation mode) prior to risking capital, and researching trading ideas. By expecting trading itself to generate learning, we ensure that our motivation for learning will lead to overtrading—and a loss of both capital and motivation.
3. **Success Means Making a Living from Trading.** Here is another expectation guaranteed to generate frustration and discouragement. No developing professional makes their living from their performances during the early years of expertise building. A golfer or tennis player may spend years on a college team and as an amateur before even starting the pro circuit. Star actors or actresses typically spend years

in lessons and regional theaters before they see their names under the Broadway lights. Before surgeons make a living from their trade, they spend four years as a medical student, four more years as a surgical resident, and even more years in subspecialty training. Expecting to make a sustainable living from trading within the first years of exposure to markets is wholly unrealistic. More realistic expectations would be to keep losses to a reasonable level, cover one's costs with regularity, and improve trading processes. *There is no path to expertise that doesn't first require time to develop mere competence.* If you expect to make a living from trading much more quickly than people in other fields are able to sustain a livelihood, you are setting yourself up for frustration and failure.

An excellent antidote to these toxic assumptions is to write out your expectations as part of keeping a trading journal. This includes your expectations for each day of trading—your goals for trading well—but *also your expectations for your development over time.* My goal for my own trading performance is relatively modest: I want to earn more than the riskless rate of return after trading costs, and I want to do that by risking less than that proportion of my capital. In other words, I'm targeting positive risk-adjusted returns; that integrates my performance and process goals. I will be very happy if I average one percent returns on my portfolio per month by risking significantly less than that.

By focusing on risk-adjusted returns, not just absolute profitability, we blend process and outcome goals.

This may not be a realistic target for you, depending on your level of development and your risk appetite as a trader. What is important is not my target numbers, but rather the fact that I have developed realistic, attainable objectives for my trading. If I achieve my expectations, I feel a sense of pride and accomplishment. If I fall short, I can quickly identify that fact, pull back my risk exposure, and make necessary corrections.

A formula for positive trading development is: *Always expect success, and always define success so that it is challenging, but attainable.* Writing out your expectations for the day, week, month, and year—and ensuring that they're doable—is a powerful lever over your emotional experience as a trader.



#### COACHING CUE

A great entry in a daily trading journal: "What would make my trading day a success today, even if I don't make money?" That simple question leads directly to process goals—the things you can best control.

## LESSON 13: WHAT CAUSES THE DISTRESS THAT INTERFERES WITH TRADING DECISIONS?

We become anxious and exit a good trade before it has an opportunity to reach its price target. We become frustrated and take a trade that completely contradicts our research and planning. We're afraid of missing a trade and enter at the worst possible time. We're reluctant to take a loss at our designated stop point and wind up with a much larger loss.

All of these are examples of trading behaviors for which all of us as traders can truly say, "been there, done that." In trading, as in much of life, we learn by making the mistakes our parents and mentors try to protect us from. *The key to longevity is making those mistakes early in your development, before you have too much on the line.* Mistakes in dating can lead to a great marriage. Mistakes on a simulator can lead to solid real-time performance. Making your errors when your risk is lowest is a large part of success.

But what causes these mistakes, in which the arousal of distress interferes with prior planning and consistent, sound decision-making? Perhaps if we can figure that out, we can shorten the painful learning curve just a bit.

The fields of behavioral finance and neuroeconomics have illuminated how emotions affect financial decisions; check out references at the end of this chapter.

To hear traders talk, distress in trading is caused by markets. A market turns slow and range-bound: that is the supposed cause of a trader's boredom and overtrading. A market reverses direction: that allegedly generates frustration and impulsive trades for the trader. Because their emotions are triggered by a market event, traders assume that the market must be responsible for their feelings. A moment's thought, of course, dispels this notion. After all, if the market had the power to compel emotional reactions, we would see *all* traders respond identically in a similar situation. That, however, is not what happens. Not all traders respond to a slow market with boredom and overtrading; not all traders become frustrated and make impulsive decisions when a position reverses against them. There is more to the cause of our emotions than external events.

*In order for a market event to generate a negative emotional response, we have to view it as a threat.* Let's say that I'm a trader watching my market become slow and range-bound at midday. If I view that as an opportunity to update some of my ideas and prepare for the afternoon, the slow market will not trouble me in the least. Similarly, I may view the choppy, thin action as an opportunity to get away from the screen, clear

out my head, and start the afternoon fresh. Again, the slow action affects neither my feelings nor my trading behavior.

If, however, I start my day telling myself that I must make at least several thousand dollars each day, then I'll now perceive the slow market as a threat to my trading goal. The narrow, whippy action translates into lack of opportunity, which translates into lack of profit, which translates into lack of success. It's easy to see, with that mental framework, how I could wind up viewing slow markets as threats to my career. It's no wonder that the slow market would trigger my distress and overtrading.

But, of course, it's not merely the slow market that is generating my negative mood and behavior; it's my *perception* of that market. Perception is the filter that we place between events and our responses to events. If we place a distorting lens over our eyes, we will see the world in distorted ways. If we adopt distorted perceptions of markets and ourselves, we'll experience trading in distorted ways.

Can we alter our perceptions? Chapter 6 deals with cognitive approaches to change that restructure thought processes.

So how do we change the filters that turn normal trading experience into abnormal events?

The rule is simple: if you don't know your filters, you cannot change them. Becoming aware of the expectations and beliefs that shape your perception is essential to the process of shifting your perception.

Here's a simple exercise that can aid you in becoming more aware of any distorted perceptions you might hold:

*Every time you experience a distinctly negative emotional reaction to a market event, consciously ask yourself, "How am I perceiving the current market as a threat?"* This turns your attention to your perceptual processes, giving you a chance to separate perceived threat from real threat.

A simple example comes from my recent trading. I really wanted to finish the week on a high-water note in my equity curve and found myself with a nice profit on a Friday morning trade to the long side. As the trade moved my way, I moved my stop to breakeven. The trade continued to go my way a bit before making a small reversal. It then chopped around for a few minutes. I found myself becoming nervous with the trade, as if it were on the verge of plunging below my stop point.

I quickly asked myself, "Why am I nervous with this trade? Why am I perceiving the trade with so much uneasiness?" A moment's reflection and review of the market told me that the trade was perfectly fine and progressing according to plan. It was my desire to end the week profitably (after an extended flat period of performance, I should add) that turned

the potential reversal of a winning trade into a threat. If all the market can do after the run-up is chop around in a flat way, perhaps this is an opportunity to *add* to the position, I reasoned. I calibrated my risk/reward on the added piece to the position (and for the position overall, given my new average purchase price) and added a small portion to the trade. The added increment wasn't large enough to dramatically affect the profitability or risk of the trade, but it was an important psychological step: I turned a perceived threat into opportunity.

The key here is to distinguish between *actual* threats—markets that truly are not behaving according to your expectations—from *perceived* threat. That requires reflection about markets and about personal assumptions. Once I saw that the trade was proceeding normally, I was free to challenge the filters that were leading me to become nervous with a good trade.

When you think about your thinking by adopting the perspective of a self-observer, you no longer buy into negative thought patterns.

After you identify a perception that turns a normal event into a threat, the next challenge is to find opportunity in that normal event. I might feel threatened by a difference of opinion with my wife, but that threat can be turned into an opportunity for fruitful communication and problem solving. We might feel threatened by a trade that starts modestly profitable but then stops us out, but that threat can be turned into an opportunity to flip our position or reassess our views of that market.

*Identify the perceived threat; turn the perceived threat into an opportunity: that is a two-step process that addresses the true cause of emotional reactions that distort trading decisions.* By keeping a journal specifically devoted to your thinking and perceiving, you can structure this two-step process and turn it into a habit pattern that you activate in real time.



#### COACHING CUE

When you talk or IM about the day's trading, pay attention to how you describe the markets: good, bad, quiet, active. Listen especially for the tone of your descriptions. Many times, your tone and language will give away whether you're in tune with markets or fighting them. If you become caught up in what you think the market *should* be doing, you're most likely to fight it when it does something else.

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## LESSON 14: KEEP A PSYCHOLOGICAL JOURNAL

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When I first began trading, I kept a journal in the form of multiple annotated charts. I looked for every major turning point in the stock market and then investigated the patterns of indicators and price/volume patterns that could have alerted me to the changes in trend. After a while, I found that certain patterns recurred. It was out of those early observations that I learned to rely on patterns of confirmation and disconfirmation among such measures as the number of stocks making new highs versus lows, the NYSE TICK, and the various stock sectors. Later, as I gained new tools, such as Market Delta ([www.marketdelta.com](http://www.marketdelta.com)), I added to those patterns. For me, the journal was a tool for pattern recognition. Only after an extended time of recognizing patterns on charts, could I begin to see them unfold in real time. It was also only after an extended period of real-time observation that I felt sufficiently confident to actually place trades based on those patterns.

When we keep a psychological journal, the learning principles are not so different. *At first, the journal is simply a tool for recognizing our own patterns as traders.* These include:

- **Behavioral patterns**—Tendencies to act in particular ways in given situations.
- **Emotional patterns**—Tendencies to enter particular moods or states in reaction to particular events.
- **Cognitive patterns**—Tendencies to enter into specific thinking patterns or frames of mind in the face of personal or market-related situations.

Many of our trading patterns are amalgamations of the three patterns: in response to our immediate environment, we tend to think, feel, and act a certain way. Sometimes these characteristic patterns work against our best interests. They lead us to make rash decisions and/or interfere with our best market analysis and planning. It is in such situations that we look to a journal (and other psychological exercises) to help us change our patterns of distress.

For more on keeping trading journals: <http://traderfeed.blogspot.com/2008/03/formatting-your-trading-journal-for.html>

But why do such patterns exist? Why would a person repeat an unfulfilling pattern of thought and behavior again and again, even when

she is aware of the consequences? Sometimes traders are so frustrated with their repeated, negative patterns that they swear that they are sabotaging their own success. This pejorative labeling of the problem, however, doesn't help the situation. It only serves to blame the frustrated trader, magnifying frustrations.

*As I stressed in my Psychology of Trading book, maladaptive patterns generally begin as adaptations to challenging situations.* We learned particular ways of coping with difficult events and those, at first, may work for us. As a result, these patterns become overlearned: they are internalized as habit patterns.

A good example is the tendency to blame oneself when there are conflicts with others. A child in a home fraught with arguing and fighting might adapt to the situation best by blaming himself for problems rather than risk conflict by blaming others. Later in life, with that pattern ingrained, even normal conflicts may trigger self-blame and depressed mood. Such a person, for example, might spend more time and energy beating up on himself after a losing day than learning from his losses.

*When we repeat patterns in trading that consistently lose us money or opportunity, the odds are good that we are replaying coping strategies from an earlier phase of life: one that helped us in a prior situation but which we've long since outgrown.* The task, then, is to unlearn these patterns—and that is where the psychological journal becomes useful.

Just as I used the trading journal to become keenly aware of market patterns, our psychological journal can alert us to the repetitive patterns of thinking, feeling, and acting that interfere with sound decision-making. Such a journal, like the annotated charts that I mentioned, begins with observation: we want to review our trading day and notice all of the patterns that affected our trading. The initial goal is not to change those patterns. Rather, we simply want to become better at recognizing the patterns, so that we'll eventually learn to identify their appearance in real time.

The psychological journal is a tool for developing your internal observer: learning to recognize what you're doing, when you're doing it.

A favorite journal format that I use divides a normal piece of paper into three columns. The first column describes the specific situation in the markets. The second column summarizes the thoughts, feelings, and/or actions taken in response to the situation. The third column highlights the consequences of the particular cognitive, emotional, or action patterns.

The first two columns help us recognize the situational triggers for our patterns. This makes us more sensitive to their appearance over time. The third column emphasizes in our mind the negative consequences to our



patterns. Those negative consequences could include emotional distress, losing money on a trade, or failure to take advantage of an opportunity. *When we clearly link maladaptive patterns to negative consequences, we develop and sustain the motivation to change those patterns.* That third column should spell out in detail the costs of the recurring pattern: how, specifically, the pattern interferes with your happiness and trading success. The clearer you are about the pattern and its occurrence and the more strongly you feel about the costs it imposes on you, the more likely you'll be to catch the pattern in real time and be motivated to interrupt and change it.

For now, however, your goal should be to identify your repetitive patterns and their consequences—not to try to change those patterns all at once. *You cannot change something if you're not aware of it.* The psychological journal is a powerful tool for building that awareness and understanding what is generating your distress. Keep the journal for 30 consecutive days to help you see just about every variation of your most common patterns. It will also begin the process of turning self-observation into a habit pattern—a positive pattern that can aid you in your personal life and in your trading.



#### COACHING CUE

Begin your psychological journal by tracking your individual trades and focusing on those situations in which your mindset took you out of proper execution or management of those trade ideas. In other words, these will be instances in which you failed to follow your trading rules, not ones in which you followed the rules and just happened to be wrong on your ideas. Replay these trades in your mind—or, better yet, consider videotaping your trading and observing those trades directly—and then jot down what set you off (Column A); what was going through your mind (Column B); and how it affected your trading (Column C). Zero in on how much money that trigger situation cost you. With practice, you'll build your internal observer and start noticing these situations as they are occurring. That will give you an opportunity to create a different ending to the script.

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### LESSON 15: PRESSING: WHEN YOU TRY TOO HARD TO MAKE MONEY

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Traders call it pressing: forcing trades in an attempt to make money. Sometimes it takes the form of trading too large; other times traders press by trading too often. The hallmark of pressing is trying to *make things happen*. This is 180 degrees from a mindset in which you trade selectively,

when odds are with you. In the latter frame of mind, you let the market come to you and wait for your opportunity. In the mindset of pressing, you want things to happen and you want it now.

The irony of pressing is that it is often the most successful traders—those who are competitive and driven to succeed—that fall victim. They so hate losing that they’ll do anything to win—including trading poorly!

Trading is a bit like flying a fighter plane or playing chess: it requires highly controlled aggression. In trading, the control element comes from knowing when markets present opportunity and when they don’t. One of the best ways of instilling this control is to trade with rules. These may be rules related to position sizing, stop-loss levels, when to enter markets and when to stay out, trading with trends, etc. *When rules are repeated and followed over time, they are internalized and become mechanisms of self-control.* We can observe this process among children. They so often hear rules about respect for elders or cleanliness that (eventually!) those behaviors become automatic.

The right trading behaviors start as rules and evolve into habits.

These automatic behaviors are important because they don’t require effort and a dedication of mental resources. If we have to *make* ourselves follow rules each time we confront situations, we will be taxed—and our full attention will not be on those situations. One of the great strengths of the human mind is its ability to automatize rules, so that mental and physical resources can be fully devoted to challenges at hand. This enables us to face those challenges under self-control (i.e., under rule governance).

So how do we make our trading rules automatic? The answer is to turn them into habit patterns. At one time in our lives, “brush your teeth in the morning” might have been a rule that our parents had to impress on us. With repetition, it became habit; most of us need no reminder of the rule or special motivation to follow the rule. This is the kind of automaticity we aim for in trading: where our rules become so much a part of us that they require no special attention or effort.

When we’re pressing to make money, the need to put on trades overwhelms our rule governance. Pressing normally occurs in situations in which we’re frustrated with our performance. Perhaps we’ve lost money, missed out on opportunities, or are just going through a period of flat equity curve. The frustration leads us to try to *create* opportunities rather than respond to those presented by markets.

*In our dance with markets, we want the market to lead.* When we attempt to lead the market—when we try to *anticipate* what may happen instead of *identify* what is happening—we’re most likely to be out of step

with the next price movements. When we are pressing, we are trying to lead the markets, and that has the potential to turn normal losses and flat periods into veritable slumps.

So how do we make trading rules automatic? As with the tooth brushing, it is through repetition. By repeating your rules many times, in many ways, you gradually internalize them and turn them into habits. You will still experience the normal stresses of markets—no one can repeal risk and uncertainty—but you will be so grounded in your decision-making that you cannot fall prey to distress.

When you coach yourself, you can create opportunities for repetition before and during the trading day. This is a several step process:

1. **Make a list of your most important trading rules.** These rules should include, at minimum, your rules for risk management; taking breaks after large or multiple trading losses; entering at defined signal points; and preparing for the market day. *You can't expect to internalize trading rules if you haven't first made them explicit.*
2. **Create a routine before trading begins to review the rules.** Mental rehearsals are powerful vehicles for creating repetition. Every one of your trading rules can be captured as a visualized scenario that you walk yourself through mentally while you keep yourself calm and focused. You actually visualize yourself in different trading situations reminding yourself of rules and following those rules. The more extended and detailed the visualizations, the more likely it is that you'll internalize them as realistic experience.

The more you think about rules and rehearse them, the more they become part of you. Repetition creates internalization.

3. **Create a break in your trading day to review your rule-following.** Midday break, when markets tend to slow down, is a perfect time to clear out your head, assess your trading to that point, and remind yourself of what you need to do in the afternoon. By turning your list of rules into a checklist, you can simply check yes or no for each rule depending on whether you followed it during the morning. If you did not follow a particular rule, you jot down that rule on a separate piece of paper, tape it to the monitor, and make it an explicit focus for the afternoon trade.
4. **Use the rules at the end of the day as a report card.** An end-of-day review will tell you how well you performed in your preparation for trading, your entries, your risk management, and your exiting of

positions. Each rule should receive an A, B, C, D, or F grade. Anything less than a B is a candidate to become an explicit goal for the next day's trading. In this way, the rules you most need to work on are assured of getting the most attention.

This approach undercuts the tendency to press during periods of frustration by helping you catch yourself in the act of deviating from rules. As a result, frustration is unlikely to escalate into ever-greater violations of sound trading principles. When you cement your rules through repetition, however, you also serve as your own trading coach by preventing frustration from affecting trading in the first place. After all, we can start our day on a frustrating note (perhaps we oversleep), but that won't lead us to shatter our rule-habits of morning personal hygiene. Behavior patterns, once overlearned, stick with us regardless of our emotional state. That is true self-control.

*Good self-coaching is the ability to correct trading problems. Great self-coaching is to develop routines to prevent problems from occurring in the first place.* You'll see the results in your mood—and in the dramatic reduction of large losing trades, days, and weeks.



#### COACHING CUE

Don't work at internalizing too many rules at one time. Start with the most important rules that will keep you in the game: entry rules (getting good prices); position-sizing rules (limiting risk per position); and exit rules (setting clear profit targets and stop-loss levels). These three, along with the basic rationale for your trade, can be written down or talked aloud as a trade plan that becomes your guide for trading under control instead of pressing.

### LESSON 16: WHEN YOU'RE READY TO HANG IT UP

One of the most difficult manifestations of distress that traders face is despair. I've seen it happen to the best of traders: you work hard, you feel as though you're on the brink of a positive breakthrough, and then you take several steps backward. It feels as though you're getting nowhere. You're tired of being wrong, tired of losing money. That excitement that used to greet the start of the market day is replaced with dread. It's difficult to sustain the research and the morning routines of preparation. If your body could talk, its posture would say, "What's the use?" You're ready to hang it up.

Let's face it: for many, there *is* a time to give up trading. I know quite a few traders who have been at it for years and have never developed the skills (and perhaps who never had the talent) to simply reach a point of competence where they cover their costs. *If you are meant to do something—something that speaks to your talents, skills, and interests—you will display a significant learning curve in the first year or two of effort.* If such a learning curve is not apparent, it's probably not your calling. Hang it up and pursue something that genuinely captures your distinctive abilities. It's not quitting, it's not being cowardly. It's cutting a losing position and getting into something better: a course of action that is as sound in life planning as in trading.

If, however, you've progressed steadily and have displayed genuine ability over time, discouragement and depression are your emotional challenges during difficult periods. Becoming your own trading coach requires shepherding yourself through the dark times.

One of my professors in graduate school, Jack Brehm, theorized that depression is a form of motivational suppression. When we perceive that meaningful goals are within our reach, we naturally experience a surge of optimism and energy. This surge helps us make those extra efforts to achieve our goals. Conversely, when we see that valued goals are beyond our reach, nature has provided us with the means to suppress that motivation. After all, it would make no sense to redouble our efforts in the face of unachievable ends. That motivational suppression, taking the form of discouragement and even mild depression, is unpleasant, but it is adaptive in its own way. It turns us away from ends we should not be pursuing, which frees us up for more energizing efforts.

In that sense, the feeling of wanting to give up contains useful information. It is not just a negative emotion to be overcome or minimized. *Discouragement tells us that, at that moment, we perceive an unbridgeable gap between our real selves (who we are) and our ideal selves (who we wish to be).* We no longer perceive that we have control over our future: our ability to attain goals that are important to us. If we are going to be effective coaches of our trading, we need to address this perception.

Our real selves are always distant from our ideals: the question is whether we perceive ourselves to be competent to bridge the gaps.

The first way to address the real-ideal gap is to consider that, in its context, it may point to something based in reality. Perhaps an edge that we had counted on in trading is no longer present. Perhaps market patterns have changed, such that what was once working for us no longer has the same potential. In that event, our hang-it-up feeling is alerting us that maybe, temporarily, we *should* hang it up and instead focus our efforts

in figuring out what is working in our trading and what isn't. The key word in that last sentence is *temporarily*. Just because we're discouraged doesn't mean we should feign optimism: perhaps there's good reason for our motivational suppression. By stepping back, we can investigate possible market-based reasons for our feelings.

Other times, our discouragement may be providing us with information that our expectations are too unrealistic. If, in the back of our minds, we're hoping or expecting to make money each trading day, we're setting ourselves up for considerable disappointment when we undergo a streak of losing trades or days that is entirely expectable by chance. In such cases, our motivational suppression provides a clue that we need to investigate, not just markets, but ourselves. When we expect the best, we leave ourselves poorly prepared for the worst.

There's a third source of reduced drive and motivation, and that's burnout. Psychological burnout occurs when we feel overwhelmed by the demands that we face. Very often, among traders, burnout signifies a lack of life balance: becoming so immersed in the stresses of trading that recreational, social, creative, and spiritual outlets are lost. While such immersion is possible—and sometimes necessary—for short stretches of time, the immersion leaves a trader impaired over the long run. This is not so much motivational suppression as motivational exhaustion. It is difficult to sustain energy and enthusiasm when we're operating on overload.

Burnout occurs when we feel that the demands on us exceed our resources for dealing with them.

In each scenario, the trader who serves as his own coach treats the lost drive as *information*. Maybe it's a reflection of changes in markets; maybe it's a sign of unrealistic self-demands or a signal that life is out of balance. If you feel discouraged about your recent trading, your first priority is to identify what that feeling is telling you, so that you can take appropriate action.

If market trends, themes, or volatility have shifted, altering the profitability of your trading setups and ideas, then your action should be a reduction in your risk-taking while you see which patterns, markets, and ideas are working, so that you can focus efforts on those. You also want to review your most recent trading performance to see if you can identify markets and patterns that have continued to work for you, even as others have shifted. *Reduce your risk, reassess your trading, and you preserve your capital and turn discouragement into opportunity.*

If the feeling like giving up is more a function of your own self-demands, then your challenge is to redouble your efforts at goal setting, making sure that each day and week starts with realistic, achievable goals. When basketball players get into slumps, their coaches will set up plays for



high-percentage shots to get the players back on track mentally. Similarly, you want to set yourself up for psychological success by setting achievable goals that move you and your trading forward.

Finally, if burnout is contributing to the lack of optimism, then the challenge is to consciously structure your life outside of trading by ensuring proper time for physical exercise, social activity, and overall time away from markets. *An excellent strategy for achieving psychological diversification is to have significant life goals apart from trading.* If all the psychological eggs are in the trading basket, it will be difficult to sustain energy and enthusiasm when profits are scarce.

Being your own trading coach doesn't mean talking yourself into feeling good. Sometimes there are good reasons for lacking positive emotion. The superior coach will listen for those reasons and turn them into prods for constructive change.



#### COACHING CUE

How psychologically diversified are you? How much stress and distress are you experiencing in your social life, your family life, and in your general emotional state? How much satisfaction are you experiencing in each of these areas? What sustains you when trading goes poorly? What problems from your personal life creep into your trading day? How is your physical fitness? Your quality of sleep and concentration? Your energy level? It's worth evaluating the nontrading aspects of life as well as your market results with monthly reviews. If the other parts of your life are generating distress, it's only a matter of time before that compromises your focus, decision-making, and performance.

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## LESSON 17: WHAT TO DO WHEN FEAR TAKES OVER

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Fear is a normal emotional response in the face of danger. Under conditions of fear, we are primed for flight or fight: running from the source of danger or confronting it. As we've seen, sometimes the dangers we respond to are not objective sources of threat, but ones that we interpret as threats. When we are prone to perceiving normal situations as threats, fear becomes anxiety. We experience the full flight or fight response, but there is nothing to run from or fight. The danger is in our perception, not in the environment.

*When we feel nervous in a trade or feel nervous about putting on a trade, it's important to know whether our response is one of fear or one of anxiety.* Is there a genuine danger in the market environment, or is the danger in our head?

Let's say that I am short the S&P 500 index (SPY) and we get to a prior level of support. There is a bout of selling as the NYSE TICK moves sharply to -500. SPY hits a marginal new low for the move, but I notice that other indexes—the NASDAQ and Russell—are not making fresh lows. The -500 TICK is well above the prior lows in the TICK for that move. I see signs that the selling is drying up. Nervously, I wait to see if any fresh selling will come into the market. My order to cover the position is ready to go, and my finger is poised over the mouse to execute the order. A few seconds go by and the market moves down a tick, up a tick, down a tick. Volume declines, my nervousness with the trade increases. In a flash, I act on my emotion and cover the position. The odds of the support holding, I decide, are too great to risk losing my profit in the trade.

In this scenario—based on a trade I made just a day ago—fear was adaptive. There was a real danger out there. (The market subsequently moved significantly higher over the next half hour). I knew to trust my feelings and act on my fear, because I could point to specific sources of danger: the established support level, the drying up of volume and TICK, and the nonconfirmations from the Russell 2000 and NASDAQ 100 indexes. Years of experience with intraday trading told me that moves are unlikely to extend in the short run if they cannot carry the broad market with them on increasing downside participation (volume, TICK).

Fear is the friend of trading when it points to genuine sources of danger: a felt discomfort with a trade will often precede conscious recognition of a change in market conditions.

Note that had I identified fear as a negative emotion and tried to push past or ignore it, an important discretionary trading cue would have been lost. *When you are your own trading coach, your goal is not to eliminate or even minimize emotion.* Rather, your challenge is to extract the information that may underlie those emotions. This means being open to your emotional experience and, at times, trusting in that experience. Blind action based on emotion is a formula for disaster, particularly when what we're feeling is anxiety and not reality-based fear. But to ignore emotional experience is equally fraught with peril. When you ignore feelings, you cannot have a feel for markets.

So what do you do when nervousness enters your decision-making process?

In *The Psychology of Trading* book, I liken such feelings to warning lights on the dashboard of a car. The nervous feeling is a warning, a sign that something isn't right. When you see the light go on in your car, you don't ignore it or cover it up with masking tape. Rather, you use the warning to figure out: What is wrong? What should I do about it? Depending on the



specific dashboard light, you might want to stop driving altogether and take the car into a repair shop. That's like exiting the market: the risk is just too great to proceed.

*When nervousness hits, the first thing you want to do is simply acknowledge that fact.* Saying to yourself, "I am not comfortable with the trade right now," cues you to extract the information from your experience. The next step is to ask, "Why am I not comfortable? Has something important changed in the trade?"

This latter question is crucial because it helps you distinguish realistic fear from normal anxiety you might feel in an unfamiliar or uncertain situation. I recently bumped up my average trading size per position and, at first, felt some nervousness in my trades. When I asked myself, "Why am I nervous?" I couldn't find anything wrong with the trades: they were performing as expected. This led me to acknowledge that I was just feeling some anxiety about the increased risk per trade. I reassured myself of my stop levels and overall trading plan, so I was able to weather the anxiety and benefit from the increased risk. I needed to carry out that internal dialogue, however, to see if my body's warning light—the nervousness—was based on a market problem or a problem of perception.

Fear is a warning light; not an automatic guide to action. It is our mind and body's way of saying, "Something doesn't look right."

Similarly, if you're experiencing fear about entering a position, you want to ask, "*Why* am I uncomfortable with this idea? Do I really have an edge in this trade?" This questioning prods you to review the rationale for the trade idea: Is it going with the market trend? Can it be executed with a favorable reward-to-risk balance? Is it a pattern that I have traded successfully in the past? Is it occurring in a market environment with sufficient volume and volatility?

When I work with a trader in live mode (i.e., coaching them while they are trading), I have them talk aloud so that I can hear their thought process regarding a particular trade idea. I mirror back to traders the quality of their thinking about their decisions, so I can help them figure out when nervousness is warranted (the trade doesn't really have favorable expectancies) and when it might not be (it's a good idea, but you're feeling uncertain because you're in a slump).

When you are your own trading coach, you can place yourself in talk-aloud mode as well or—if you're trading in a room with other traders, as at many prop firms—you can use a brief checklist to review the status of your idea or trade. The checklist would simply be a short listing of the factors that should either get you into a trade or keep you in a trade. It's your way of using the nervousness to differentiate discomfort with a good idea and

discomfort with an idea because it isn't so good. Many times, fear is simply fear of the unknown, the byproduct of making changes. As Mike Bellafiore notes in Chapter 9, that doesn't mean you shouldn't take the trade.

I have been trading for long enough that my checklist is well established in my mind. There was a time, however, when I needed to have it written out and in front of me. Is volume expanding in the direction of my trade? Is more volume being transacted at the market bid or at the offer? Is a growing number of stocks trading at their bid or at their offer? Even a very short-term trader can review such criteria quickly, just as a fighter pilot would check his gauges and radar screen in a dangerous combat situation. A fear response cues you to check your own gauges, to make sure you're making decisions for the right reason.

You can use your fear as a cue to examine your trade more deeply and adjust your confidence in the idea, up or down.

*If you can use fear in this way, even negative emotions can become trading tools and even friends.* Your homework assignment is to construct a quick checklist that you can talk aloud or check off during a trade (or prior to placing a trade) when you are feeling particularly uncertain. This checklist should prod you to review why you're in the trade and whether it still makes sense to be in it. In this way, you coach yourself to make your best decisions even when you're at your most nervous. Confidence doesn't come from an absence of fear; it comes from knowing you can perform your best in the face of stress and uncertainty.



#### COACHING CUE

Find a positive change in your trading that makes you nervous and then pursue it as a trading goal. As I describe in *The Psychology of Trading*, anxiety often points the way to our greatest growth, because we feel anxiety when we depart from the known and familiar. Trading a new market or setup, raising your trading size, holding your trades until they reach a target—these are nerve-racking situations that can represent great areas of growth and development. In that sense, fear can become a marker for opportunity.

### LESSON 18: PERFORMANCE ANXIETY: THE MOST COMMON TRADING PROBLEM

Imagine you're about to give a presentation to a group of people as part of a job interview process. You very much want the job, and you've prepared

well for the presentation. You're nervous going into the session, but you remind yourself that you know your stuff and have done this before.

As you launch into your talk, you notice that the audience is not especially attentive. One person takes out his phone and starts texting while you're talking. Another person seems to be nodding off. The thought enters your mind that you're not being sufficiently engaging. You're losing their interest, and you fear that you might also be losing the job. You decide to improvise something original and attention grabbing, but your nervousness gets in the way. Losing your train of thought, you stumble and awkwardly return to your prepared script. Performance anxiety has taken you out of your game, and your presentation suffers as a result.

*Performance anxiety occurs any time our thinking about a performance interferes with the act of performing.* If we worry too much while taking a test, we can go blank and forget the material we've studied. If we try too hard to make a foul shot at the end of a basketball game, we can toss a brick and lose the game. The attention that we devote to the outcome of the performance takes away from our focus on the process of performing.

This is a common problem among traders, probably the most common one that I encounter in my work at proprietary trading firms and hedge funds. Sometimes the performance anxiety occurs when a trader is doing well and now tries to take more risk by trading larger positions. Other times, traders enter a slump and become so concerned about losing that they fail to take good trades. A trader may feel so much pressure to make a profit that she may cut winning trades short, never letting ideas reach their full potential. As with the public speaker, the performance anxiety takes traders out of their game, leading them to second-guess their research and planning.

More on performance anxiety and how to handle it: <http://traderfeed.blogspot.com/2007/04/my-favorite-techniques-for-overcoming.html>

As we've seen in this chapter, our distressful emotions don't just come from situations: they are also a function of our *perception* of those situations. If I'm convinced that I'm a hot job candidate and believe that I have many job options, I won't feel unduly pressured in an interview or presentation. When I came out of graduate school, I went to a job interview in upstate New York and was asked by the clinic director to identify my favorite approach to doing therapy. I smiled and told him that I preferred primal scream therapy. That broke the ice, we had a good laugh, and the interview went well from there. I knew that, if this interview didn't work out, other opportunities would arise. That freed me up to be myself.

Had I told myself that this was the only job for me and that I *needed* the position badly, the pressure would have been intense. I would have been far too nervous to joke in the interview and probably would have come across as wooden and not very personable. If I had viewed the possibility of losing the job as a catastrophe, I would have ensured that I could not have interviewed well.

Traders engage in their own catastrophizing. Instead of viewing loss as a normal, expectable part of performing under conditions of uncertainty, traders regard losses as a threat to their self-perceptions or livelihood. When traders make money, they feel bright about the future and good about themselves. When they hit a string of losing days, they become consumed with the loss. Instead of trading for profits, they trade to not lose money. Like the anxious job interviewer, traders can no longer perform their skills naturally and automatically.

A common mistake that traders make is to try to replace catastrophic, negative thoughts with positive ones. They try repeating affirmations that they will make money, and they keep talking themselves into positive expectations. What happens, however, is that they are still allowing a focus on the outcome of performance to interfere with performing itself. *The expert performer does not think positively or negatively about a performance as it's occurring. Rather, he is wholly absorbed in the act of performing.* Does a skilled stage actress focus on the reaction of the audience or the next day comments of reviewers? Does an expert surgeon become absorbed in thoughts of the success or failure of the procedure? No, what makes them elite performers is that their full concentration is devoted to the execution of their skills.

Thinking positively *or* negatively about performance outcomes will interfere with the process of performing. When you focus on the doing, the outcomes take care of themselves.

What gives these expert performers the confidence to stay absorbed is not positive thinking. Rather, they know that they are capable of handling setbacks when those occur. If a given night's performance doesn't go quite right, the actress knows that she can make improvements in rehearsal. If a surgery develops complications, the surgeon knows that he can identify those rapidly and take care of them. By taking the catastrophe out of negative outcomes, these experts are able to avoid crippling performance anxiety.

One of the most powerful tools I've found for overcoming performance anxiety in trading is to keep careful track of my worst trading days and make conscious efforts to turn those into learning experiences. This turns losing into an opportunity for self-coaching, not just a failure.

Let's say that you have a very reliable setup that tells you that a stock should be heading higher. You buy the stock and it promptly moves your way. Just as suddenly, however, it reverses and moves below your entry point. You note that the reversal occurred on significant volume, so you take the loss. In one frame of mind, you could lament your bad luck, curse the market, and pressure yourself to make up for the loss on the next trade. All of those negative actions will contribute to performance pressure; none of them will constructively aid your trading.

Alternatively, you could use the loss to trigger a market review. Are other stocks in the sector selling off? Is the broad market dropping? Has news come out that has affected the stock, sector, or market? Did your buy setup occur within a larger downtrend that you missed? Did you execute the setup too late, chasing strength? All of these questions offer the possibility of learning from the losing trade and quite possibly setting up subsequent successful trades. For instance, if you notice that a surprise negative earnings announcement within the sector is dragging everything down, you might be able to revise your view for the day on the stock and benefit from the weakness. When you are your own trading coach, you want to get to the point where you actually *value* good trading ideas that don't work. If a market is not behaving the way it normally does in a given situation, it's sending you a loud message. If you're not executing your ideas the way you usually do, you're getting a clear indication to target that area for improvement. A simple assignment that can instill this mindset is to identify—during the trading day (or during the week, if you're typically holding positions overnight)—at least one very solid trading idea/setup that did not make you money. That good losing trade is either telling you something about the market, something about your trading, or both. Your task is then to take a short break, figure out the message of the market, and make an adjustment in your subsequent trading.

*By acting on the idea that losses present opportunity, you take a good part of the threat out of losing.* That keeps you learning and



#### COACHING CUE

If you track your trading results closely over time, you'll know your typical slumps and drawdowns: how long they last and how deep they become. Know what a slump looks like and accept that they will arise every so often to help take away their threat value. Many times you can recognize a slump as it's unfolding and quickly cut back your trading and increase your preparation, thus minimizing drawdowns. Most importantly, if you accept the slump as a normal part of trading, it cannot generate performance anxiety. Indeed, it is often the slumps that push us to find new opportunity in markets and adapt to shifting market conditions. Much of success consists of finding opportunity in adversity.

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developing, and it keeps you in the positive mindset that best sustains your development. Every setback has a purpose, and that's to help you learn: to make you stronger. Performance anxiety melts away as soon as it's okay to mess up.

## LESSON 19: SQUARE PEGS AND ROUND HOLES

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One of the central concepts of *Enhancing Trader Performance* is that each trader can maximize his development and profitability by discovering a niche and operating primarily within it. A trading niche has several components:

- **Specific Market and/or Asset Classes.** Markets behave differently and are structured differently. Some markets are more volatile; some are more mature and offer more market depth; some offer more information than others. *The personality of the market must fit with the personality of the trader.* Someone like myself, who thrives on data collection and the analysis of historical patterns of volume and sentiment, can do quite well in the information-rich stock market; not so well in cash currencies, where volume and moment-to-moment sentiment shifts are more opaque.
- **A Core Strategy.** The trader's core strategy or strategies capture her ways of making sense of supply and demand. Some traders gravitate toward trend trading; others are contrarian and more countertrend in orientation. Some traders rely mostly on directional trade; others on relational trades that express relative value, such as spreads and pairs trades. Some traders are highly visual and make use of charts and technical patterns; others are more statistically oriented and model-driven.
- **A Time Frame.** The scalper, who processes information rapidly and holds positions for a few minutes, is different from the intraday position trader and even more different from the swing trader who holds positions overnight. A portfolio manager who trades multiple ideas and markets simultaneously engages in different thought processes from the market maker in a single instrument. Your time frame determines what you look at: market makers will pay great attention to order flow; portfolio managers may focus on macroeconomic fundamentals. Time frame also determines the speed of decision-making and the relative balance between time spent managing trades and time spent researching them. My personality tends to be risk-averse: I trade selectively over a short time frame. I know many other, more aggressive traders who trade frequently and others who hold for longer periods and larger



price swings. Time frame affects risk, and it determines the nature of the trader's interaction with markets.

- **A Framework for Decision-Making.** Some traders are purely discretionary and intuitive in their decision-making, processing market information as it unfolds. Other traders rely on considerable prior analysis before making decisions. There are traders who are structured in their trading, relying on explicit models—sometimes purely mechanical systems. Other traders may follow general rules, but do not formulate these as hard-and-fast guidelines. My own trading is a combination of head and gut: I research and plan my ideas, but execute and manage them in a discretionary fashion. Each trader blends the analytical and the intuitive differently.

What you trade and how you trade should be an expression of your distinctive cognitive style and strengths.

My experience working with traders—and my own experience in the school of hard trading knocks—is that much of the distress they experience occurs when they are operating outside their niche. Ted Williams, the Hall of Fame baseball slugger, offers a worthwhile metaphor. He divided the plate into a large number of zones and calculated his batting average for each zone. He found, for instance, that pitches low and away provided him with his lowest batting average. Other pitches, those high and directly over the plate, provided sweet spots where his average was quite high. With certain pitches, Williams was a mediocre hitter. With others, he was a superstar. *The source of his greatness, by his own account, was that he learned to see the plate well and wait for his pitches.*

A trader's niche defines his sweet spots. Certain markets I trade well, others I don't. Certain times of day I trade well; others fall short of breakeven. If I extend or reduce my typical time frame, my performance suffers. If I trade patterns outside my research, I suffer. Like Williams, I trade well when I wait for my pitches. If I swing at the low and away balls, I strike out.

One theme that emerges from the experienced traders in Chapter 9 is that they know which pitches they hit, and they've learned the value of waiting for those pitches.

*The implication is clear: Our emotional experience reflects the degree to which we're consistently operating within our niche.* That is true in careers, relationships, and in trading. When there is an excellent fit between our needs, interests, and values and the environment that we're operating

in, that harmony manifests itself in positive emotional experience. When our environments frustrate our needs, interests, and values, the result is distress. Negative emotions, in this context, are very useful: they alert us to potential mismatches between who we are and what we're doing.

When you are your own trading coach, your job is to keep yourself within your niche, swinging at pitches that fall within your sweet spots and laying off those that yield marginal results. This means knowing when to *not* place trades, *not* to participate in markets. Equally important, it means knowing when your advantage is present and making the most of opportunities. A common pattern among active traders is that they will trade too much outside their frameworks, lose money, and then lack the boldness to press their advantage when they find genuine sweet spots. It's easy to see careers lost by blowing up; less visible are the failures that result from the inability to capitalize on real opportunity.

I recently talked with a day trader who was convinced that he would make significant money if he just held positions for several days at a time. Though it looked easy to find spots on charts where such holding periods would have worked, in real time that trade was much more difficult. It was not in the trader's wheelhouse; it was outside his niche. Calibrated to measure opportunity and risk on a day time frame, he found himself shaken out by countertrend moves when he tried holding positions longer. Worse still, he mixed his time frames and tried to convert some losing day trades into longer-term holds. Outside his niche, he began trading like a rookie—with rookie results.

What is your wheelhouse? What do you do best in markets? If you could trade just one strategy, one instrument, one time frame, what would these be? Do you really *know* the answers to these questions: have you truly taken an inventory of your past trades to see which work and which have been low and outside?

There is nothing wrong with expanding your niche in a careful and thoughtful way, much as a company might test market new products in new categories. But just as management books tell us that great companies stick to their knitting and exploit core competencies, we need to capitalize on our strengths in our trading businesses. As we will see in Chapter 8, you are not just your own trading coach: *you are the manager of your trading business*. That means reviewing performance, allocating resources wisely, and adapting to shifting market conditions.

The greatest problem with overtrading is that it takes us outside our niches—and therefore out of our performance zones.

Here's a simple exercise that can move you forward as the manager of your trading business. At the time you take each trade, simply label it as A,



B, or C. A trades are clearly within your sweet spot; they're your bread-and-butter, best trades. B trades are your good trades: not necessarily gimmes or home runs, but consistent winners. C trades are more marginal and speculative: they're the ones that feel right, but are clearly outside your wheelhouse.

Over time, you can track the profitability of the A, B, and C trades and verify that you really know your niche. You can also track the relative sizing of your positions, to ensure that you're pursuing the greatest reward when you take trades in your sweet spots and assuming the least risk when you're going after that low, outside pitch.

*The more clearly you identify your niche, the less likely you are to get away from it.* That clarity can only benefit your profitability and emotional experience over time.



#### COACHING CUE

If you categorize your trades/time frames/setups/markets as A, B, or C as outlined above, you have the start for good risk management when you go into slumps. When markets do not behave as you expect and you lose your edge, cut your trading back to A trades only. Many times, slumps start with overconfidence and getting outside our niches. If it's the A trades that aren't performing, that's when you know you have to cut your risk (size) and reassess markets and trends.

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## LESSON 20: VOLATILITY OF MARKETS AND VOLATILITY OF MOOD

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I recently posted something important to the *TraderFeed* blog. I took two months in the S&P emini futures (ES) market—January and May, 2008—and compared the median volatility of half-hour periods within the months. During that period, overall market volatility, as gauged by the VIX, had declined significantly. The question is whether this day-to-day volatility also translated to lower volatility for very short time frame traders.

The results were eye-opening: In January, when the VIX was high, the median 30-minute high-low price range was 0.60 percent. In May, with a lower VIX, the range dwindled to 0.28 percent. In other words, markets were moving half as far for the active day trader in May than January.

Let's think about how that affects traders emotionally. The trader whose perceptions are anchored in January and who anticipates much greater movement in May will place profit targets relatively far away. In the lower volatility environment, the market will not reach those targets in the time frame that is traded. Instead, trades that initially move in the trader's favor will reverse and fall well short of expectations. Repeat that

experience day after day, week after week, and you can see how frustration would build. Out of that frustration, traders may double up on positions, even as opportunity is drying up. I've seen traders lose significant sums solely because of this dynamic.

Alternatively, the trader who is calibrated to lower volatility environments will place stops relatively close to entries to manage risk. As markets gain volatility, they will blow through those stops—even as the trade eventually turns out to be right. Once again, the likely emotional result is frustration and potential disruption of trading discipline.

Both of these are excellent and all-too-common examples of how poor trading can be the *cause* of trading distress. It may look as though frustration is causing the loss of discipline—and to a degree that is true—but an equally important part of the picture is that the failure to adjust to market volatility creates the initial frustration. Any invariant set of rules for stops, targets, and position sizing—in other words, rules that don't take market volatility into account and adjust accordingly—will produce wildly different results as market volatility shifts. For that reason, the market's changes in volatility can create emotional volatility. We become reactive to markets, because we don't adjust to what those markets are doing.

Poor trading practice—poor execution, risk management, and trade management—is responsible for much emotional distress. Trading affects our psychology as much as psychology affects our trading.

Personality research suggests that each of us, based on our traits, possess different levels of financial risk tolerance. Our risk appetites are expressed in how we size positions, but also in the markets we trade. When markets move from high to low volatility, they can frustrate the aggressive trader. When they shift from low to high volatility, they become threatening for risk-averse traders. *The volatility of markets contributes to volatility of mood because the potential risks and rewards of any given trade change meaningfully.* In the example from my blog post, that shift occurred within the span of just a few months.

Note that traders can experience the same problem when they shift from trading one market to another—such as moving from trading the S&P 500 market to the oil market—or when they shift from trading one stock to another. Day traders of individual equities will often track stocks on a watch list and move quickly from sector to sector, trading shares with different volatility patterns. Unless they adjust their stops, targets, and position sizes accordingly, they can easily frustrate themselves as trades get

stopped out too quickly, fail to hit targets, or produce outsized gains or losses.

Many traders crow about taking a huge profit on a particular trade. All too often, that profit is the result of sizing a volatile position too aggressively. While it's nice that the trade resulted in a profit, the reality is that the trade probably represents poorly managed risk. Trading 1,000 shares of a small cap tech firm can be quite different from trading 1,000 shares of a Dow stock, even though their prices might be identical. The higher beta associated with the tech trade will ensure that its profits and losses dwarf those of the large cap trade. That makes for volatile trading results and potential emotional volatility.

Risk and reward are proportional: pursuing large gains inevitably brings large drawdowns. The key to success is trading within your risk tolerance so that swings don't change how you view markets and make decisions.

Do you know the volatility of the market you're trading right now? Have you adjusted your trading to take smaller profits and losses in low volatility ones and larger profits and losses when volatility expands? If you're trading different markets or instruments, do you adjust your expectations for the volatility of these? *You wouldn't drive the same on a busy freeway as on one that is wide open; similarly, you don't want to be trading fast markets identically to slow ones.*

One strategy that has worked well for me in this regard is to examine the past 20 days of trading and calculate the median high-low price range over different holding periods: 30 minutes, 60 minutes, etc. I also take note of the variability around that median: the range of slowest and busiest markets. With this information, I can accomplish several things:

- As the day unfolds, I can gauge whether today's ranges are varying from the 20-day average. That gives me a sense for the emerging volatility of the day that I'm trading. This helps me adjust expectations as I'm trading. For instance, the S&P e-mini market recently made a 12-point move during the morning. My research told me that this was at the very upper end of recent expectations, a conclusion that kept me from chasing the move and helped me take profits on a short position.
- When I see that volatility over the past 20 days has been quite modest, I can focus on good execution, place stops closer to entry points, and keep profit targets tight. That has me taking profits more aggressively and opportunistically in low volatility environments, reducing my frustration when moves reverse.

- When I see that volatility over the past 20 days is expanding, I can widen my stops, raise my profit targets, adjust my size, and let trades breathe a little more. Not infrequently, the higher volatility environment will be one in which I can set multiple price targets, taking partial profits when the first objective is hit and letting the rest of the position ride for the wider, second target.

Note that what's happening in the above situations is that I am taking control over my trading based on market volatility. *Instead of letting market movement (or lack of movement) control me, I am actively adjusting my trading to the day's environment.* That taking of control is a powerful antidote to trading distress, turning volatility shifts into potential opportunity.

The Excel skills outlined in Chapter 10 will be helpful in your tracking average volume and volatility over past market periods.

As your own trading coach, you want to monitor your mood over time. When you see your mood turn dark and frustrated, you want to examine whether there have been changes in the markets that might account for your emotional shifts. Many times, these will be changes in the volatility of the markets and instruments you're trading. Establish rules to adapt to different volatility environments as a best practice that aids both trading and mood.



#### COACHING CUE

If you know the average trading volume for your stock or futures contract at each point of the trading day, you can quickly gauge if days are unfolding as slow, low-volatility days or as busy, higher-volatility days. If you know how current volumes compare to their average levels you can identify when markets are truly breaking out of a range, with large participants jumping aboard the repricing of value. If you can identify markets slowing down as that process unfolds, you can be prepared and pull your trading back accordingly.

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## RESOURCES

The *Become Your Own Trading Coach* blog is the primary supplemental resource for this book. You can find links and additional posts on the topic of stress and distress at the home page on the blog for Chapter 2:

<http://becomeyourowntradingcoach.blogspot.com/2008/08/daily-trading-coach-chapter-two-links.html>

Make sure that you structure your learning process as a trader in a way that will build success and confidence. This process will help greatly with the management of stress and distress. That topic—and especially the topic of how to find your trading niche—is covered in depth in the *Enhancing Trader Performance* book, including a section on psychological trauma. A detailed discussion of how emotional states affect trading can be found in *The Psychology of Trading*. Links to both books can be found on the Trading Coach blog ([www.becomeyourowntradingcoach.blogspot.com](http://www.becomeyourowntradingcoach.blogspot.com)).

If you're looking for a book specific to stress and trading, you might look into *Mastering Trading Stress* by Ari Kiev, MD ([www.arikiev.com](http://www.arikiev.com)), which is written by an experienced trading coach.

How do emotions affect financial decisions? Two good books are Richard L. Peterson's *Inside the Investor's Brain*, published by Wiley (2007) and *Your Money and Your Brain*, written by Jason Zweig (Simon & Schuster, 2007).

Information on the research of James Pennebaker regarding writing as a way of coping with stress and distress can be found on his page: <http://pennebaker.socialpsychology.org/>



## CHAPTER 3

# Psychological Well-Being

### *Enhancing Trading Experience*

*Happiness is the meaning and the purpose of life,  
the whole aim and end of human existence.*

—Aristotle

Recent research into what has been called *positive psychology* has yielded insights into the importance of well-being: positive emotional experience. It is not enough to cope with stress and minimize distress. If we're going to maximize performance, it means that we need to make the most of our concentration, motivation, and energy. How many times have I seen traders miss trades or fail to prepare adequately for the day, simply because they were worn down, not operating at their peak? An Olympic athlete would never think of coming to his event in less than the best shape. Too often, however, traders will risk their capital after being sleep-deprived, burned out, or distracted. How you manage your trading will depend, in part, on how you manage the rest of your life.

But what is well-being and how can we maximize it? A wealth of research, much of it conducted in the past decade and unknown to traders and even trading coaches, helps us answer these questions. Let's take a look at how you can coach yourself toward more positive experience—and performance.

## **LESSON 21: THE IMPORTANCE OF FEELING GOOD**

One of the most overrated variables in trading psychology is passion for trading or passion for the markets. Self-reported passion means a great

deal of things to different people; my experience is that it is only weakly correlated with how hard traders actually work at their craft. Traders who are desperate for profits, traders who approach markets addictively like gamblers, traders who live and breathe markets 24/7: all may claim a special passion for what they do. These passions may or may not support good trading and a positive learning curve. Desire and motivation are necessary, but not sufficient, for trading success.

*Rather than focus on passion, traders would do well to reflect upon the overall emotional tone of their market experience.* In researching and trading markets, as well as working on trading skills, do you experience meaningful happiness, contentment, and motivation? Are you truly enjoying what you're doing?

This positive side of emotional experience is what psychologists refer to as psychological well-being. A person with high well-being experiences the following on a frequent basis:

- A positive mood (happiness).
- Favorable expectations (optimism).
- A positive physical state (energy).
- A positive appraisal of self and life (fulfillment).
- Favorable relations with others (affection).

None of us feel all of these things all of the time; indeed, many of these five factors may wax and wane depending upon life circumstances. Still, psychological research suggests that some of us experience significantly more well-being than others. A portion of this variation can be attributed to inborn personality traits that are present across a range of life circumstances. Other variations can be attributed to our environment, especially the degree to which our settings satisfy or frustrate our needs and affirm or contradict our values.

Much of psychological well-being is a function of the fit between a person and her social and work environments.

When people are chronically unable to experience positive emotions, we might suspect the presence of an emotional disorder, such as the form of depression known as dysthymia. Other emotional problems, including anxiety disorders, can be sufficiently pervasive as to prevent people from experiencing joy and life satisfaction. In such circumstances, it is important for people to seek the assistance of an experienced, licensed mental health professional. Many times, very hands-on approaches to therapy—sometimes in concert with medication—can make a huge difference when chronic problems interfere with positive life experience. You don't need to be actively depressed—crying, unable to get out of bed,



suicidal—to benefit from psychological help when positive emotions are chronically absent.

The Resources for Chapter 1 include a source for brief therapy referrals through the Beck Institute for Cognitive Therapy and Research.

The majority of people, however, experience varying balances of positive and negative emotions as a function of life circumstances. When their lives affirm their values and needs, they enjoy the emotions listed above. When life fails to meet their needs, they respond with unhappiness, frustration, and diminished energy. *In this sense, positive emotions serve as life barometers, informing us of the degree to which we're doing the right things for us.*

You can see, then, why positive emotions are so important to trading. If you're trading well, learning and developing, and succeeding in your efforts, your positive emotions should outweigh the negative ones over time. The dominant emotional experience of your work should be the kind of pride, satisfaction, and sense of accomplishment that gives you energy and optimism. If you're not trading well, if you're not growing and developing as a trader, and if your efforts are not yielding success, your experience of trading is apt to be more negative. You'll spend less time feeling satisfaction, energy, and optimism than frustration, overload, and discouragement.

*This is important because the energy and optimism generated by happiness and personal fulfillment are what sustain the trader's learning curve.* They fuel concentration, and they help traders make the extra efforts that result in superior internalization of patterns. The trader who sustains high well-being is more apt to have the confidence to aggressively pursue good trades and lay off marginal ones. The trader with a positive emotional experience is less apt to make impulsive trades out of frustration and more likely to have the resilience needed to weather losing periods. In short, feeling good is a huge part of performing well, because we function best cognitively under conditions of emotional wellness.

Emotional well-being fuels cognitive efficiency. We think best when we feel good.

As your own trading coach, a constructive step you can take is to track your emotional experience over time. A simple adjective checklist filled out at the end of each trading day can provide you with a sense for whether you are in the emotional zone or swimming against emotional currents. One such simple checklist is shown in Figure 3.1.

Check the Adjective That Best Corresponds to How You're Feeling Now

- Happy, Neutral, Unhappy
- Satisfied, Neutral, Dissatisfied
- Energetic, Neutral, Run Down
- Optimistic, Neutral, Pessimistic
- Focused, Neutral, Scattered
- Calm, Neutral, Stressed Out
- Competent, Neutral, Incompetent
- Growing, Neutral, Stagnant

**Scoring:** For each of the first adjectives in the series that you check, give yourself a +1 score. For each “neutral” answer, count this as 0. For each of the third adjectives that you check, give yourself a –1 score. Add the total. If your total score is +4 or higher, you want to identify what you're doing right to keep your mood positive—and maybe even do more of it. If your score is –4 or lower, you want to identify what you might be doing wrong to keep your mood negative. If your score is relatively neutral, you want to take both of these steps, identifying what you're doing that gives you more positive experience and what you're doing that takes away from positive experience. By tailoring your daily activities, you can tip the balance between positive and negative emotions in a favorable direction.

**FIGURE 3.1** Brief Emotional Checklist

*It is not necessary that you feel great after every single trading day.* That is unrealistic. Rather, what's important is the balance, over time, of positive and negative emotional experience. If you're feeling badly at the end of trading days more often than you're feeling good, that's a clear indication that either you're not trading well—that markets have shifted in ways that you have not adapted to— and/or that you're not doing a sufficiently good job of advancing your learning curve with clear, achievable goals.

When you take your emotional temperature at the end of each trading day, you also can become a better observer of the specific trading behaviors that aid and damage your mood. I learned to limit my losses on trades when I realized fully—in my own experience—that outsized losses were not only reducing my annual returns, but also ruining my love for and interest in trading. I also learned to focus on trading strengths when I realized that these brought me a deep sense of accomplishment over time. The idea of trading without emotion is hogwash: as long as we *care* about our performance, our feelings *will* be engaged when we put our capital at risk and pursue our goals. That emotional engagement can work to our favor if, through our self-coaching, we sustain a positive emotional state, bringing out the best in us.

**COACHING CUE**

Be particularly careful to track your well-being around times of great life transition: giving birth to a child, buying a new home, moving, undergoing a separation in a relationship, experiencing a death in the family, going through a major illness, etc. Many, many times these times of transition are also times of stress and diminished well-being. Even seemingly happy events, such as giving birth, can lead to enhanced performance pressures and diminished sleep! Adverse changes in financial status are particularly challenging in this regard. Consider reducing trading risk until these situations are placed into perspective and adequately addressed.

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**LESSON 22: BUILD YOUR HAPPINESS**

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Two of the essential components of psychological well-being are joy and contentment. It is important to have positive feelings about what we're doing, but it's also important to enjoy a degree of contentment with our lives. Together, joy and contentment yield an ongoing sense of happiness.

As the Aristotle quote at the beginning of this chapter indicates, happiness lies at the center of life. When the Greek philosophers referred to happiness, they did not simply mean a positive, sunny mood. Instead, happiness was intimately tied to fulfillment: the sense of actualizing one's potentials and being the person you are capable of becoming. A happy person in this sense can go through periods of sadness and loss, anxiety and frustration. Indeed, it is difficult to imagine a goal-directed life that does not encounter such obstacles. What contributes to the happiness, however, is the deep sense of being on the right path in life: the sense that you are doing what you're meant to be doing.

*In that context, the opposite of Aristotle's happiness is not sadness, but rather a certain kind of emotional dis-ease: a vague but pervasive existential guilt that you're letting life's opportunities slip by; that you're settling for less than you rightfully should.* Much is written about the negative emotional experiences of anger, anxiety, and depression, but little about this kind of gnawing guilt. It is not so dramatic as a panic reaction or an anger outburst, but it can be equally damaging in its haunting corrosiveness. Day after day, week after week, month after month, to feel like you're selling yourself short in your career, your romantic relationships, and your personal development: it's difficult to imagine a durable confidence and self-esteem built on such a foundation.

Conversely, there is a special glow of satisfaction when you're immersed in a truly fulfilling activity. As a psychologist, those moments when

everything comes together and I'm able to make a meaningful difference in someone's life—those are affirmations that carry me through many sessions of slow, gradual, difficult work. Similarly, to prepare a challenging trade idea, execute it with a plan, and then see it make money yields a kind of happiness that cannot be achieved by the same profits from a dumb luck trade. Pride, not as in overweening arrogance, but as an inner sense of conviction about the rightness of one's choices, is an important manifestation of Aristotle's happiness.

Sadly, participation in the markets does not bring this fulfillment to many traders. Yes, they feel pleasure when they make money and pain when they lose it. But they lack the deep, inner sense of satisfaction and joy possible only to those who are pursuing a calling. *The reason for this is that they are hoping that profits will bring happiness, when in fact the relationship works in exactly the reverse order.* We profit from our life's endeavors when we pursue our happiness. Just as sexual conquests cannot provide the happiness of a fulfilling emotional relationship and winning a lottery cannot yield the depth of experience possible to one who builds a business, profits on trades do not provide the primary emotional fuel for a trading career. They are the happy results, not the causes of happiness.

Unfortunately, many traders pursue markets in ways that *cannot* lead to fulfillment. They pursue profits like a pick-up artist goes after sex. Sometimes they score, sometimes they don't. There is nothing cumulative in their efforts, however: they no more build a career than the barfly builds meaningful relationships. Many times, traders recognize that gnawing existential guilt: they realize that hours upon hours in front of a screen are contributing little or no economic value, but also yielding no ongoing sense of meaning and satisfaction. It's not that they're necessarily anxious, depressed, or frustrated. *They are just empty.*

We can recognize the happy trader because he is immersed in the process of trading and finds fulfillment from this process even when markets are not open. I track the traffic to the *TraderFeed* blog daily and have long noted that the visitor count drops precipitously when markets close on a Friday and through the weekend. After all, what fun are markets if they're not open and active? This is the mindset of the trading barfly. The happy trader finds joy in researching and understanding markets, in preparing for the next day and week, in reviewing trading results and tweaking performance, and in generating new ideas and methods. The distinction between week and weekend is as immaterial for such a trader as it would be for a dedicated artist or laboratory scientist. Indeed, it's not uncommon for these traders to increase their reading during evenings and weekends: they are immersed in the entire process of trading, not just the process of making money from trades.

*You will know you're pursuing your happiness when you are so involved in what you're doing that you don't want it to be limited to business hours.* When you're in love with the right person, that love pervades all your activities, not just those in the nightclub or bedroom. When you find deep fulfillment in markets, you live and breathe markets, not just when they can pay you out. A useful self-assessment exercise to carry out during the coming week is to log your hours spent on trading outside of formal market hours and how you feel during those times. Do you get bursts of joy when you find new patterns and ideas? Do you generate a deep sense of mastery and pride when you work on yourself and improve your craft? Do your ongoing efforts at figuring out markets and enhancing your performance bring a sense of pride and satisfaction?

If you're not spending as much time on trading outside formal market hours as during them, trading is probably not your calling. Can you imagine a priest who spent time on his religion only from nine to five? An artist who only painted when art shows were active? When trading is truly a part of you, contributing to your happiness, you're most likely to be immersed in the activities that build skills and yield pattern recognition. So much of trading success is finding the niche that sustains such immersion. Trading can be a great job and a potentially lucrative career, but only if it's also a calling.



#### COACHING CUE

Many traders confuse contentment and fulfillment with laziness and smug self-satisfaction. Out of a fear of becoming complacent, they resist the experience of contentment. As a result, traders are often not content with their progress and fall prey to frustration—and the effects of frustration on trading. You can be content with your progress to date and still be motivated to move forward. The key is setting shorter *and* longer-term goals, so that you can bask in satisfaction when you reach an immediate objective, but still stay hungry for the larger objectives.

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## LESSON 23: GET INTO THE ZONE

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Most experienced traders know the feeling of being *in the zone*: seeing markets so clearly that the right decisions seem to be effortless. The psychologist Abraham Maslow referred to these occasions as peak experiences; researcher Mihalyi Csikszentmihalyi refers to them as periods of flow. The hallmark of being in the zone is that the performer feels at

one with the performance, executing skills in a highly competent manner, seemingly without conscious effort.

The zone is not an emotional state, though it brings feelings of emotional well-being and certainly can be disrupted by negative emotional states. Entering the zone requires *immersion*: a total focus on what one is doing. In that sense, the zone is a state of heightened attention: it is the result of being fully focused and involved in an activity.

Note that we can behave automatically—and even in skilled ways—without being immersed in our activity and without experiencing the zone. Repetitive, routine tasks, such as driving a car on an empty road or walking a city street, don't require particular attention and also don't usually bring any experience of well-being. To enter the zone, one must expend mental effort at a task that absorbs all of one's attention. Though performance in the zone may seem effortless, it is far from robotic.

Earlier—and in *Enhancing Trader Performance*—I emphasized the importance of *niche*: performing in an area that captures one's talents, skills, and interests. A good barometer of whether you are operating within your niche is the relative proportion of time you spend in the zone while engaged in performance. For me, those flow experiences are relatively common when I'm writing. Rarely do I operate from a detailed outline. Rather, I think about a topic and let the thoughts and words flow as I type. Similarly, when I'm working with a person in counseling, I'm completely focused on what they're saying, what it means, and how to use the information to be of assistance. It's not at all unusual for time to fly by quickly while I'm in a meeting with someone; I'm so immersed in the interaction that I lose track of the passage of time.

I most often find a zone state in trading when I'm actively figuring out markets—absorbing myself in research—and applying those insights to short-term trades. In an important sense, it's the puzzle-solving aspect of trading and not the placing of trades themselves that captures my attention. If I try to trade in a mechanical fashion without engaging in the problem solving, I find trading psychologically noxious. It's like talking with people in a superficial social context. There's no meat on the bones cognitively; my attention remains unengaged, and I stay out of the zone.

*One of the most damaging psychological patterns I see among traders is that they attempt to create a counterfeit zone by trading with too much risk.* In other words, traders are not intrinsically interested in markets and the process of trading, so they attempt to create interest and attention by making large wagers on trade ideas. This is problematic for obvious reasons: it exposes traders to outsized losses and potential risk of ruin. Psychologically, however, it is also ruinous. Once the trader habituates to one level of risk, a higher level is needed to grab attention and interest—much as addicts require greater doses of a drug to achieve a high. Eventually the

trader who needs the excitement of risk to sustain interest in trading has to blow up. This, truly, is addiction, not passion for markets.

More on trading addictions can be found in *Enhancing Trader Performance* and here: <http://traderfeed.blogspot.com/2006/11/dr-bretts-heartfelt-plea-when-trading.html>

One of the most effective ways to exit a flow state—or prevent one from emerging in the first place—is to focus attention on oneself rather than on one's performing. You can't be immersed in a sexual encounter if you're worried about your sexual performance. You can't find the zone in an athletic performance if you're pressuring yourself to set a record. The trader who focuses on P/L during the trade is, to that degree, no longer market focused. The dynamics of performance anxiety—thinking about the performance while you are performing—is a recipe for disaster if your goal is to operate within the zone.

When I wrote my first trading book, I decided to complete the entire manuscript before I ever had a signed contract from my publisher. I certainly wanted to see the text published, but I wasn't writing it for royalties or recognition. The book was written for me, to clarify my thoughts and contribute to the body of knowledge within the field. When I wrote in this fashion I didn't have to worry about how the readership would react to the ideas, whether editors would like my work, etc. I could just focus on the writing. It is very, very difficult to *need* to perform well and to stay absorbed in the performance. The surest way I could have ruined my writing experience (and my books) would have been to split my attention between generating/writing ideas and speculating about how those ideas would be received. Once performance becomes an acute *need*, not just a genuine desire, it is nearly impossible to place the outcome of performance in the back of your mind and solely focus on performing.

So it is for the trader. If a trader *needs* to make money, it is difficult to weather market ups and downs and stay focused on the execution of trade ideas and plans. If today's trade is needed to provide tomorrow's food and shelter, there can be no zone: anxiety naturally takes over whenever profits are threatened. Similarly, if I become psychologically attached to profitability, basing my self-esteem and identity upon my trading results, I no longer control my trading experience: market movements are likely to control how I feel. *The experience of flow requires a basic level of control over what we are doing.*

Perhaps a different analogy will illuminate the issue. My wife Margie and I recently invested a good amount of money in tax-free bonds, taking advantage of a situation in which their yields had skyrocketed above the

corresponding yields on (taxable) Treasury instruments and certificates of deposit. Our plan was to lock in these positions as investments, not as short-term trades. Over time, we felt, we would benefit from attractive yields and possible capital appreciation as tax-free yields fell into line with those of taxable instruments. We could make this investment comfortably because it represented less than 10 percent of our savings. Our remaining capital was diversified in other investments, working for us even as our bonds might move against us in the short run. We could stay focused on our overall investment plan because we were so diversified that we didn't *need* any one position to perform wonderfully.

Diversification, in life and markets, reduces performance pressure and allows us to become immersed in what we are doing.

Similarly, a trader who risks a small portion of her account on a trade can stay focused on executing an overall trading plan, because there is no acute need for that position to work out—and no acute threat if it fails to work.

*This is a psychological paradox: To best focus on any single performance, it helps to be diversified among performances.* If I have a successful experience as a father, husband, and psychologist, I don't *need* my books to sell well or my trades to make money. It is precisely that emotional diversification that enables me to stay focused on my writing and trading and achieve satisfying returns from them.

As your own trading coach you don't need to spend more and more time, effort, and emotion on markets. Indeed, if you place all your psychological eggs in the trading basket, it is a sure way to burn yourself out and stay out of a performance zone. Rather, you can best coach yourself by ensuring that trading is one among many fulfilling activities within your life. Other eggs might go into the baskets of spiritual interests, artistic activities, athletic pursuits, social life, intellectual life, family, community, and hobbies. If your life is full in those ways, you are best able to weather ups and downs in trading performance. You no longer need trading to work at any particular point in time, so you become more able to focus on the process of trading and generate and execute good trades.

So this is your assignment: Give yourself a grade for how much interest and satisfaction you've been achieving from the areas of life mentioned above. How diversified are you in your sources of well-being? Then select one area for cultivation to improve your emotional diversification. Not only will you find a new source of enjoyment and accomplishment, you will also lay the psychological groundwork—the inner sense of security and fulfillment—to find and stay in your performance zone.



**COACHING CUE**

Take short breaks from the trading screen. These breaks can be a great way to renew concentration and step back from difficult markets. Some of the best breaks are ones that are wholly absorbing, that get you into a different zone than trading. Physical exercise is one example, talking with people you enjoy can be another. I find myself wholly absorbed when I play with my cat Gina or when I swim in our pool. The activity completely takes my mind away from what I had been doing and lets me return with a new perspective. Switch gears—absorb yourself physically and/or emotionally—after you’ve been cognitively immersed in markets. These breaks can provide some of the most effective trades.

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**LESSON 24: TRADE WITH ENERGY**

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One of the important dimensions of psychological well-being is energy. Happiness, enthusiasm, motivation, and general contentment are difficult to sustain when you feel mentally and physically run down. Fatigue is the enemy of concentration; physical vibrancy fuels a positive, energetic mood.

*We are like laptop computers running on batteries: after sustained operation, we run down.* Concentration and attention require effort; eventually we drain our mental reserves and lose focus. This leads to trading mistakes: missing opportunities, overlooking important pieces of data, forgetting key aspects of trading plans. When we are run down, we’re also most likely to fall back into old—and often negative—habit patterns. When we’re drained, we might find ourselves eating out of boredom, becoming unusually irritated when things don’t go our way, or getting caught up in negative ways of thinking.

Think of it this way: it requires sustained focus to remain goal-oriented. To actively direct ourselves, we need an alert, active mind. When we become fatigued, we lose this active direction. We become passive, responding to events rather than making them happen.

This distinction between active and passive trading is all-important. The active trader is one who researches markets, identifies distinct areas of opportunity, and consciously executes and manages trades to maximize that opportunity. For the active trader, nothing is left to chance: where to pursue opportunity, where to sit back, where to take profits, where to limit losses—all are preplanned. This takes time, energy, and a sustained focus. Good trading, in this sense, is pure intentionality: it is a directed act of will.

When we are physically drained, we lose the ability to sustain this intentional focus. We neglect our research; we fail to calibrate risk and reward. We fall back on simple heuristics and enter trades based on

simple reasoning—chart patterns or price levels—that may well lack any true risk/reward edge. Worse still, when we're run down, we become emotionally reactive and find ourselves chasing price highs or lows or robotically enacting rules (fade weak stocks in a strong market) without taking the time and effort to assess the broader context our decisions (an trending day to the upside).

Managing your energy during the trading day may take little more than ensuring that you:

- **Get proper sleep and proper quality of sleep.** Interrupted sleep can deprive you of important stages of sleep and leave you feeling unrested, even though you've spent a full number of hours in bed.
- **Eat properly.** Highs and lows in blood sugar can make it difficult to sustain concentration; an excess of caffeine and sugar may provide temporary jolts, but can also lead to distracting rebound effects.
- **Maintain your mind properly.** I've seen alcohol and drugs take a fearsome toll on traders over time, as partying the night before leads to diminished performance the next day. Conversely, those who are focused and intentional in their personal lives tend to see this carry over into their trading.
- **Maintain your body properly.** Physical exercise is one of the most neglected facets of a trading plan. Hours upon hours sitting in front of a screen do not promote aerobic fitness. Over time, we lose conditioning—and our energy batteries lose their charge.
- **Take the breaks.** Not many people can stare at a screen and follow market action continuously through the day without losing focus. Breaks during slower market action can replenish the energy and concentration needed when markets become busier.

A trading career is a marathon, not a sprint: the winners pace themselves.

None of the above considerations is earth shattering, but it's amazing how poorly many traders score if they incorporate the five factors above into a daily checklist. *We prepare our trades, but we often fail to prepare ourselves for trading.* How can we stick to disciplined trading decisions if we're inconsistent in our personal discipline?

When you are your own trading coach, you cannot afford to run yourself into the ground by working so hard that you can no longer work. Nor can you so neglect your physical state to such a degree that, like that laptop battery, your memory effects lead you to lower and lower energy states with each recharging. Your assignment is to track your daily profits and losses simply as a function of two factors: your energy level (high or low)

and your trading mode (active/planned or passive/unplanned). Add a simple checklist to your trading journal to help you see the correlations among your physical state, your concentration level, your intentionality, and your trading results.

If you lack energy, you will lack focus; if you lack focus, you'll lack intentionality; if you lack intentionality, you'll lack the ability to follow trading plans.

Unless you calculate and appreciate these correlations for yourself, you're unlikely to sustain the motivation to address—with consistency—the five areas above. Once you *see* that your energy level is directly correlated with the quality of your trading (and with your trading results), you will prod yourself to build a daily routine that addresses sleep, eating, exercise, and a healthy lifestyle. You'll also be able to overcome guilt or fear over leaving the screen and realize that *opportunity is not just a function of moving markets: it's also a function of your ability to capitalize upon those markets.*



#### COACHING CUE

Many traders neglect their family lives (spouse, children) in their absorption into their work. The resulting guilt and distraction from those unmet needs wind up interfering more with performance than the time it would have taken to spend the quality hours together. The mental rejuvenation from vacations—even weekend holidays—can renew family relationships and energize work. If you're too worn down for your personal life, you're probably not operating with good efficiency in your trading. It's not necessary to have a totally balanced life—few of us do—but if your life *feels* unbalanced, that will undermine energy, concentration, optimism, and effort.

### LESSON 25: INTENTION AND GREATNESS: EXERCISE THE BRAIN THROUGH PLAY

One of the core concepts underlying *The Psychology of Trading* book is intentionality. We can define intentionality as the ability to sustain purposeful activity over time. The ability to sustain attention and concentration, coordinate a sequence of activities toward a chosen end, and persistently try different approaches toward solving a problem until a solution is reached: all of these are manifestations of intentionality.

As noted earlier, there is an intriguing connection between intentionality and psychological well-being. In studies of flow, Mihalyi Csikszentmihalyi found that these moments of being “in the zone” result from a complete absorption in one’s activities. It is when we are completely focused on what we’re doing that we reach a state in which performance seems almost effortless and completely natural. This is a highly pleasurable state and, among creative individuals, becomes a psychological reward in its own right. *In a real sense, the creator’s passion for her work represents a passion for the flow state.* Exemplary performance thus provides its own rewards: a psychological feedback system that lies at the heart of greatness.

This helps to explain researcher Dean Keith Simonton’s findings that great individuals across a variety of disciplines are unusually productive. They have mastered the art of working within their performance zones, so that sustained effort becomes a desired end in itself. Their productivity is a byproduct of a kind of positive addiction: a pursuit of the high of the performance zone for its own sake.

As Elkonon Goldberg notes in his excellent text *The Executive Brain*, the various facets of intentionality—attention, planning, reasoning—are functions of the brain’s frontal cortex. His research also suggests a surprising degree of plasticity to the brain: *utilize brain functions and you exercise those brain regions and strengthen their functions, much as going to a gym builds our muscles and endurance.* At any given point in time, we may possess a relatively fixed quantity of intentionality: we can only exercise the brain so much before we become fatigued with the effort and need to rest. Over time, however, we can build our brain’s capacity for intention by exercising those frontal cortex functions. Just as lifting weights is the best way to build our strength, engaging in sustained, directed effort is the best way to cultivate our intentional capacities.

When we pursue goals in an effortful manner, we build intentionality and free will.

One would think that trading should be an excellent form of mind exercise for this very reason. That is not necessarily the case, however. We can click a mouse and place trades without engaging in effortful, directed thought. This is the passive trading described in the previous lesson. When we trade without focused intent, we fail to use our mental muscles. At a broader level, when we live our lives on autopilot, those muscles atrophy. All of us know individuals who seem to drift from activity to activity, seemingly heedless of the longer-term consequences of their actions. They spend money and become mired in debt; they jump into relationships and reenact past conflicts. Gurdjieff described this as a tendency to live mechanically, as if we are stimulus-response machines. We see this

among retirees: after functioning passively over time, even small efforts become taxing. Life becomes mechanical; the capacity for intentionality has atrophied.

Just as exercising one muscle group will not develop other ones (or building aerobic capacity will not confer muscular strength), cultivating one form of intentionality does not necessarily raise our self-directed capacities in others. Good examples of this are high-frequency day traders who develop an amazing capacity to sustain attention in front of a screen, as they track bids and offers, upticks and downticks, through the day. These same traders are often unable to sustain the kind of mental effort needed to observe themselves over time or systematically review markets to identify trends and themes. Clearly, we're most able to sustain concentration and effort during activities that interest us and that fit with our skill sets. The creative talent who stays in the flow is partly able to achieve this state because he sticks to the performance niche we discussed in the last chapter: a sphere of talent, skill, and interest. Outside of those niches, the sheer effort needed to produce results, the frustrations of not getting those results, and the boredom from operating outside our values and interests all conspire to interrupt flow and disrupt intention.

This is the dynamic described in *Enhancing Trader Performance*: talents lead to interests lead to immersion in skill building leads to competence leads to further flow and the eventual development of elite performance. *It is the interplay between the flow state and the development of intentionality that creates accelerated learning curves: without flow, talents have no place to go; they never evolve into elite skills.*

Many traders fail to succeed because they are operating outside of the niches defined by the intersection of talents, interests, and skills. Because they attempt something that doesn't intrinsically interest them and that doesn't play to their distinctive abilities, they rarely encounter flow states: their trading brings little well-being. Without the flow, these traders lack the motivational impetus to sustain efforts, and that prevents them from cultivating intentionality. Then they wonder why they can't stick to trading plans or why they sabotage themselves with impulsive trades.

The learning curves of elite performers cultivate intentionality as they build skills, which means that—over time—elite performers can *do* more with their skills than others.

What is the first step in performance development? The most common response is *practice*, and that is important, of course. *But before practice, there should be play.* Play tells us which activities are fun and which are not. When we play with something, we discover its joys and frustrations: its intrinsic interest for us. Most traders who have not found their niche

have never *played* with markets. They haven't tried to trade different styles, different instruments, and different time frames. They don't know what it is like to hold positions for weeks—or for only a few minutes. These traders can't appreciate the difference between trades made from rapid pattern recognition and those made from rigorous analysis. They try to imitate other traders, or they take the path of least resistance and trade from superficial chart or indicator patterns. Elite skills can never develop in such a learning environment; intentionality is stunted.

*Elite performers never stop playing.* Artists sketch; athletes play in scrimmages; actors improvise. Play is a means of self-discovery, and sometimes we discover passions and talents we didn't know we had. Your assignment for this lesson is to pick a market, trading style, or time frame different from your usual one and conduct paper trading in parallel to your usual trading. Your paper trading should document real trade ideas and real-time tracking of P/L. The simulated trades should be managed as real ones, with profit targets, stop-losses, and decisions about adding to or reducing positions.

For example, I maintain a separate, small trading account where I play with longer-term trading ideas. It's a way to test out my research and discover possible edges with very small amounts of money at risk. A majority of ideas in this sketchbook account may fail to bear fruit, but it only takes one promising effort to open new doors to opportunity. This keeps my mind and trading fresh; it also helps me stay in touch with the market's larger picture when placing bread-and-butter shorter-term trades. Most of all, it tells me which trading ideas and strategies truly capture my interest and imagination: which may form the promising basis of a new niche. When you play with trading, you avoid stagnation; you also discover niches that will sustain intentionality and performance. That's how you build a trading career—and that's how you build the mental muscles that propel performance to ever-higher levels.



#### COACHING CUE

If you structure your trading preparation like you would structure physical workout routines, then every day you are adding a bit to your capacity to sustain intention. I recently observed a trader enter a trade with a strong idea. He was stopped out, but reentered the same trade on a fresh signal. That was stopped out also. He entered a third time and then rode a trend for a very large winner. His resilience was a function of his persistence: his ability to sustain purpose over time, even through fatigue and discouragement. His diligent preparation each day conditioned him to make extra efforts when it counted, at a time when most others would have given up on the idea. *When you put effort into trading development, you not only prepare the mind, you condition the will.*

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## LESSON 26: CULTIVATE THE QUIET MIND

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When we think of psychological well-being, we naturally think of joy, pleasure, and vigor. A different facet of well-being is serenity: a mind free of distracting thoughts and feelings. In many ways, serenity is vital to elite performance: *a mind at peace is one that can be fully focused on market patterns.*

Most of us spend too much of our time assaulted by stimuli to achieve a high degree of serenity. Social interaction, television, radio, music players, cell phones, billboards, and computers: much of our day is spent in a mélange of sights and sounds. Each calls to our attention, entertaining us from without, but leaving us ever more challenged to stimulate ourselves from within.

In the absence of the ability to generate our own stimulation, many of us equate the absence of stimulation with boredom. Boredom is an empty state, a frustrated state in which there is no-thing of interest. Upon reflection, however, we can see that boredom betrays a kind of inner emptiness, an inability to find objects of interest in our inner and outer worlds.

*The aversion to boredom is the source of many trading problems.* To erase boredom, traders will manufacture trades, overtrading—and sustaining losses—in the process. Traders will take unusual risks and size positions too daringly to sustain their excitement and interest. It is ironic that many traders consider emotion to be their enemy, when in fact it is the boredom of quiet markets that they particularly dread.

But the aversion to boredom damages trading in a much more subtle way. As I stressed in the *Enhancing Trader Performance* book, trading expertise hinges on the ability to detect and act on patterns that occur within noisy data. Experiments with implicit learning suggest that we can detect complex patterns in situations without being able to verbalize the specific nature of those patterns. This occurs routinely when we sense a market behaving differently from usual, or when we get an uneasy feeling about a conversation. Little children assemble grammatical phrases without knowing the rules of grammar: they've encountered so many examples of proper speech that they know what sounds right—and what sounds wrong. They, like traders and conversationalists, develop a feel for patterns and deviations from those.

This gut feeling, the basis of all valid intuition, is not mere hunch. It's the result of countless repetitions of complex patterns. When I first drove a car, I could barely stay in my lane. With experience, I now anticipate potential accidents several cars ahead of me. Many times I tap my brake or raise my alertness before I'm consciously aware of the troubling situation. If we needed to rely on explicit reasoning for all life's activities, we would never be able to respond quickly to danger. Evolutionarily, it

makes sense for us to be able to develop a feel for reality, as well as a conceptual grasp.

Access to intuition requires a still mind; highly intuitive people are not bored by stillness and, indeed, thrive on it.

*When our attention is divided and we are distracted, we lose our feel.* This is because the implicit pattern recognition manifests itself as a felt sense, a subtle kind of awareness. If I am not attending to those subtle cues of mind and body, I will miss signals altogether. In such a state, we cannot pick up on nuances of conversations or small, but significant shifts in traffic patterns. We lose valuable information, and we lose much of our ability to react quickly based upon internalized patterns.

Worse still, in a chronically distracted state, we never sustain the attention in the first place to internalize complex market patterns.

This is why serenity—the quiet mind—is so important. With a quiet mind, we can attend to the subtle cues of pattern recognition. Undistracted, our antennae are extended, able to pick up signals of situations that feel right and those that don't. The experienced trader has seen so many markets and perceived so many relationships among market variables that she learns to trust these gut signals. It is neither mystical nor irrational. Just as a horse whisperer can become one with the horse, understanding the most subtle communications, an experienced trader can hear the whispers of markets.

But if the mind is noisy, the whispers are drowned out.

Those who fear boredom never achieve the still mind.

*The two essential steps in achieving a quiet mind are a still body and focused thought.* This is where biofeedback can be extremely helpful for the trader: it provides a structured method for learning to quiet the mind. The biofeedback that I use currently is the *emWave* unit from Heart Math ([www.heartmath.com](http://www.heartmath.com)). It provides measures of both heart rate and heart rate variability (HRV). The user's finger goes into a small sensor, which is connected to a computer with the biofeedback software. The HRV readings are displayed in a chart; as readings rise, the chart readings become like sine waves. Lower readings create jagged, nonrhythmical patterns. The goal is to keep the patterns as sine wave-like as possible. There is also a feature that displays the proportion of high, medium, and low HRV readings over time, accompanied by audio beeps. You can thus close your eyes (for instance, while engaging in guided imagery) and still track your HRV. Even



children can use the unit by clicking on video game features that play the game by keeping HRV readings high.

After a while using the biofeedback, you learn that keeping yourself still, focusing your attention, and keeping your breathing deep and rhythmic is the best way of generating high HRV scores. (Users can set the software for various levels of difficulty to build skills.) The emWave is thus a training tool—teaching users to control mind and body—and a way of tracking focused attention over time. There are other, similar units available (for example, *Journey to the Wild Divine*); ease of use and the appeal of the graphical interface will dictate most traders' preferences. If I had to invest in a single psychological tool to aid trading, this kind of biofeedback unit would be my choice. It is highly portable and can even be used in real time during trading, with the feedback screen minimized but sound enabled.

Biofeedback is a tool for training yourself to control the arousal level of mind and body.

*When you are your own trading coach, it's important to keep your mind in shape much as an athlete stays in proper conditioning.* I find that 5 to 10 minutes each morning prior to the start of trading is useful in bringing a quiet mind to trading. During that time, you stay completely still in a comfortable seated position and breathe deeply, slowly, and very rhythmically. Your eyes can be closed throughout and you can focus your attention on your breathing, on soothing imagery, or on quiet music through headphones. The key is staying in that Yoda state described in *The Psychology of Trading*: very relaxed, yet very alert and focused. As you practice this each day, you build skills, so that you can eventually quiet your mind on demand, with only a few deep, rhythmic breaths. This is enormously helpful during hectic times during the trading day, keeping you out of situations in which you become impulsive and reactive in the face of moving markets.

*Just as you prepare for the day's trading by studying recent market action, reviewing charts, and identifying areas of opportunity, it makes sense to engage in mental preparation to build the mind-set needed to capitalize on your ideas.* Your assignment is to devote a portion of each morning to mental preparation and the generation of a quiet mind. If you have difficulty sustaining the effort or reaching that Yoda state, consider incorporating biofeedback into your morning routine, much as athletes work out daily on treadmills and weight machines. Mastering your mind state is a key component of mastering performance: if you can sustain serenity during the most boring market occasions, you'll be well prepared to catch moves when trading picks up.

**COACHING CUE**

If placing trades is your major source of stimulation in financial markets, you're bound to overtrade. By cultivating collaborative relationships with peer traders and developing routines for generating trade ideas and themes, you need not face boredom during slow markets. Other markets, other time frames: for the dedicated trader, there is always something of interest.

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**LESSON 27: BUILD EMOTIONAL RESILIENCE**

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Three traders place the exact same trades; all of them lose money. The first trader becomes discouraged, curses the market, and gives up for the day. The second trader reacts with frustration, vows to get his money back, trades more aggressively, and loses a bundle on the day. The third trader pulls back, reassesses her strategy, waits for a clear area of opportunity, and places a good trade that brings her even on the day.

What is the difference among these traders? The research literature in psychology refers to it as *resilience*: the ability to maintain high levels of functioning even in the face of significant stresses. A resilient person, for example, can lose his job, but still function well at home and implement an effective strategy for finding new work. The individual who lacks resilience is thrown for a loop by the lost job. This interferes with other areas of life and makes it difficult to find new opportunity.

*A key reason why many people lack resilience is that they take negative events personally.* Some portion of their self-worth is connected to their individual life outcomes. When events go well, they feel good. When they encounter roadblocks, they become discouraged, doubtful, and frustrated. Instead of dealing directly and constructively with the blocks, they react to the emotions triggered by their personalizing of events. An inspiring example of resilience is author Viktor Frankl's survival in a Nazi concentration camp. He set about writing a book (first on scraps of paper, then in his mind) during his internment, giving him a purpose: a reason to keep going. Others who experienced the same horrific conditions lacked such purpose and ultimately perished. The larger part of persistence is nurturing a reason to persist, a greater purpose and vision.

The survivors are those who have a vision and purpose greater than themselves.

I recently researched a new pattern that I wanted to trade and saw an opportunity in early-morning trading. I vacillated between placing a small-sized trade and one more normal in size. I thought about the trade going against me and realized that I didn't really want to lose money on a relatively untested idea. With the smaller trade, I didn't care about the implications of the profitability of the trade for my portfolio. A larger trade could dent my week's performance, and that would have been frustrating to me. So I placed the small trade, observed the pattern in real time, made a small profit, and started the process of integrating the pattern in my usual trading.

In selecting trade size, I was letting my psychological resilience dictate my risk taking. When I traded to my resilience level, I kept myself in a favorable state regardless of the trade's outcome. "How will I feel if I'm stopped out?" dictated my trading size. To be sure, this can be taken to an unhealthy, risk-averse extreme. We can take so little risk on trades that we severely diminish potential returns. The key is to know yourself and especially the limits of your resilience. Occasionally I'll fantasize about placing an über trade on a promising idea and taking a mammoth profit. I realize, however, that such a trade can overwhelm my resilience. As soon as the position went against me—even in a normal, expectable adverse excursion—I would be stressing about the dollars lost. Undoubtedly this would prevent me from managing the trade effectively.

*Successful traders learn to build their resilience over time and adapt to stresses that at one time might have been overwhelming.* That small trade I recently placed would have qualified as a large trade back in the late 1970s when I placed my first trades. Now it is emotionally inconsequential. Experience builds adaptation: we can generally handle familiar situations with a high degree of resilience.

When we master one level of challenge, we build resilience for the next level.

*The most effective way of to build emotional resilience is to undergo repeated, normal drawdowns and see—in your own experience—that you can overcome those.* Our losses provide us with the deep emotional conviction that we can weather losses and ultimately prosper. Someone who has undergone many life setbacks and bounced back acquires the confidence that he can land on his feet in almost any situation. The trader who experiences repeated drawdown, only to later hit fresh equity highs, knows that she has nothing to fear during normal performance pullbacks.

When you are your own trading coach, your challenge is not only to sustain a high level of resilience, but also to build that resilience over time.

A worthwhile exercise is to expand on the routine from my recent trade and vividly visualize the worst-case scenarios for trades that you place. In other words, once you set your stop level, visualize how you would feel and how you would respond in that worst-case scenario. Most importantly, figure out what your next course of action might be, including your possible next trade. In other words, mentally rehearse the resilient behavior that you want to cultivate. You can think of this as play-acting the role of a highly resilient person. As you rehearse resilience and act on the rehearsal, that role becomes more a part of you. To paraphrase Nietzsche, you're finding your greatness by play-acting your ideal.

In trading, we develop ourselves. Every gain is an opportunity to overcome greed and overconfidence. Every loss is an opportunity to build resilience.

*Beware: resiliency does not mean that you jump into subsequent trades after you sustain losing ones.* Rather, the resilient trader is one who can sustain well-being even after normal, expectable losing trades. When you lack resilience, you become backward-looking and respond to the last trade rather than the next market development. The resilient trader remains proactive, even in the face of loss. A resilient trader might thus stop trading or resume trading following a loss; it's the following of basic, time-tested plans and strategies—and not impulsively running toward or away from risk—that defines authentic resilience.



#### COACHING CUE

If I ask a trader how well he is doing and I receive a dollar figure as a reply, I usually know there's a problem afoot. Experienced traders think of their returns in percentage terms, not absolute dollars. Thus, for example, they might think of cutting their risk if they're down 5 percent on the year or limit their risk on a trade to 25 basis points (0.25 percent of their portfolio value). If you calibrate yourself in dollar terms, you will find it difficult to increase your trading size or to get larger as you grow your portfolio. Standardize your view in percentage terms and you make yourself more resilient; a \$20,000 loss on a \$2,000,000 portfolio won't feel significantly different from a \$500 loss on a \$50,000 portfolio. Similarly, when you cut your trading size, you'll standardize your risk management if you're calibrated by percentages, rather than let losses run because they seem small in absolute dollar terms.

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## LESSON 28: INTEGRITY AND DOING THE RIGHT THING

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Many of the lessons in this book begin with a discussion of a trading issue and then proceed to suggestions about what you can do about the issue. This lesson will actually start with the recommendation and then work backward from there. Your assignment is to read Ayn Rand's novel *The Fountainhead*. If you've read it previously, the assignment is to reread and review it.

For those not familiar with the book, *The Fountainhead* is the story of architect Howard Roark, who is an unorthodox creative genius. He faces stiff opposition to his ideas, including the ambivalence of the woman he loves. Throughout, he must decide whether to abandon or compromise his ideals, especially as he sees lesser talents succeed commercially by pandering to public fashion. In many ways, *The Fountainhead* is a study in integrity and the difficulty and importance of doing the right thing.

*There can be no self-esteem without a self: a well-defined sense of who one is and what one stands for.* There are many false substitutes for self-esteem, including the approval of others and the size of one's trading account. Ultimately, however, self-esteem is a function of knowing yourself and remaining true to your values: possessing a vision of what can be and remaining faithful to that vision.

Many traders have no more vision than a desire to make money. There's nothing wrong with making money, of course, and for those who do so through the independent efforts of mind, such earnings are a rightful source of pride. Traders who attempt to latch onto holy grails instead of independently relying on their planning and judgment, however, substitute the desire for a quick, easy score for the more difficult challenge of developing competency in reading and acting on market patterns. Someone who consummates a long-term courtship and someone who hooks up for a one-night stand engage in the same physical act, but the meaning is completely different. One is an expression of esteem; the other is often a flight from self.

In so many fields, we never see the fruits of our labors; we're part of a larger team and process. Trading is unique in that we alone are responsible for what we earn, and we see each day the outcomes of our efforts.

When you read *The Fountainhead*, it's instructive to reflect on how Howard Roark would approach the field of trading. Would he join a

proprietary trading firm that frantically searches for stocks in play, robotically fading moves or chasing strength or weakness? The mere thought is ludicrous. Would he attend a few seminars or read a couple of books and trade the same untested chart patterns as other beginners? It's unthinkable.

*No, Howard Roark the trader would be a keen student of markets, just as Roark the architect was a devoted student of building materials and methods.* He wouldn't trade a single method in all markets, just as he didn't repeat the same design to fit all housing sites. Rather, he would carefully consider each unique situation and tailor the strategy to fit the present context. Roark the trader would work from carefully considered plans, just as he worked from blueprints that he had developed from scratch. In short, Roark would approach trading the same way he approached architecture: as an expression of his creative vision and the sheer joy of giving birth to something new and valuable.

Most of all, Roark the trader, like the architect Roark, would stand for something. He would have a view of markets and how and why markets move, just as he had a view of design and building. It would be *his* view, not something borrowed slavishly from tradition or current fads. The odds are good that this view would be unconventional and meet with more than a little skepticism by the self-appointed gurus of trading. That wouldn't matter. Roark the trader would remain faithful to his framework. When confronted with the choice of following the crowd versus act on his convictions, he wouldn't hesitate to do the right thing.

Every great trader I have known has an outlook and a set of methods that are distinctively his own.

For that reason, economic success for trader Roark would be a tangible indicator of his efficacy and the rightness of his efforts. It is effect, not cause. He doesn't trade to simply make money any more than he builds to sell homes and office buildings. Roark the architect built because that was what he was meant to do. Even when he didn't have clients, he was designing buildings in his mind and in his sketches. Similarly, trader Roark would be tracking and investigating markets even if he wasn't placing orders. His work is an extension of who he is; his profits are the result of years of effort and integrity.

One's work could entail raising a child, building a business, designing a high-rise structure, or developing a unique framework for analyzing and trading financial markets. Each, to be accomplished well, requires sustained, dedicated effort; a vision of what can be; and a willingness to pursue that vision even when it's more comfortable to slide by. *This is the true source of emotional resilience: a pride and esteem so deep*



*that one is unwilling to compromise oneself in the face of setbacks and disappointments.*

What about your trading is uniquely yours? What have you developed that most distinctly distinguishes you as a trader? What is the vision behind your trading? That is your core, your essence as a trader. When you're trading well, you're remaining true to that essence, and that will serve you well during the most challenging times. If you can't provide detailed answers to these questions, are you truly ready to be risking your capital? Will you really have the confidence to weather adversity, with only borrowed ideas and methods to draw upon? Read Chapter 9 of this book carefully; you'll see that experienced traders build a career from their work from figuring markets out for themselves and then remaining true to their ideas and to the evidence of their senses.



#### COACHING CUE

This lesson shows why it is so important to follow one's trading plans. The plans may not be perfect, and they may not work well at times. If, however, you are to build confidence in your judgment and train yourself to act with integrity, there's no alternative to following the ideas you believe to be correct. You cannot build confidence by abandoning your convictions and contradicting your perceptions. The clearer you are about your market views, mapping out your actions under various scenarios and your rationales for trades, the easier it will be to act on your judgment and see, in your own experience, your own progress and growth.

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### LESSON 29: MAXIMIZE CONFIDENCE AND STAY WITH YOUR TRADES

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A great deal has been written about risk management and the importance of stop-losses. A stop-loss, ideally, is that point that tells you that your initial trade idea is wrong. Traders establish firm stops that are closer to the point of entry than the price targets and help ensure a favorable risk/reward profile to each trade. You can generally tell a professional trader by the way she closes out a losing trade. The exit is automatic, not a cause for consternation. Loss is an accepted part of the game. The good traders learn from those losses and use them to revise market views. A losing trade, as a result, can set up the next winning trade.

*Much harder for many traders and far less remarked upon is something we might call stop-profits. Traders who religiously adhere*



to stop-losses can find it difficult to let profits run on winning trades. They stop those profits out prematurely, reducing the reward portion of the risk/reward profile. Over time, these traders have trouble succeeding, because their winning trades end up being not much larger than their losers—and sometimes smaller.

There are a few reasons that traders tend to cut profits short. One reason is that they fail to identify profit targets as clearly as stop-loss points. Such targets may be based on a number of factors, such as the market's overall volatility, the presence of distinct support and resistance levels, and the time frame of the pattern being traded. Many of my trades, for example, are based on historical analyses of the probability of hitting particular price levels (previous day's high or low; pivot point levels based on the prior day's high-low-close); those levels then serve as targets for setups. *It is much easier to stick with a trade when there is a firm target in mind, just as it's easier to get work done when you have a clear goal in mind.* Without a predefined target, it's easy to get caught up in the tick-by-tick ups and downs of the market, acting on fear and greed unrelated to the initial trade idea.

Another culprit in those stop-profit scenarios is a lack of confidence in one's trade ideas. One of the important advantages of testing one's trading setups is that you can estimate the historical odds of a market acting in your favor. That knowledge can provide the security necessary to see the trade through to its ultimate target. When trade setups and patterns are borrowed from others without prior testing (either through one's own paper trading or through historical analysis), it is difficult to have a deep, inner sense of confidence in the ideas. As markets experience normal retracements on the way to a profit target, those adverse excursions become difficult to weather. Instead of seeing them as potential opportunities to add to the trade at good prices, it's easy to perceive them as threats to paper profits.

Finally, a trader's risk aversion may play a role in prematurely stopping out profits. Suppose you have a choice between taking a sure \$1,000 profit versus a 75 percent chance at \$1,500 and a 25 percent chance at \$500. Over time, taking the 75 percent chance will make you more money. Nonetheless, at any given point in time, a person may feel that it's foolish to walk away from a sure \$1,000. In such a situation, the decision is made as much for the trader's peace of mind as for overall profitability. Similarly, traders may set stop-profit levels to achieve a sense of certainty, not to maximize returns.

Seeing a trade through to its target requires an unusual degree of security and ability to tolerate uncertainty. As the trade moves further in your favor, you have more money in paper profits that you're exposing to future risk, even if the risk/reward picture remains favorable. This ability

to sit through a trade's uncertainty as profits accumulate requires particular confidence in the initial trade plan. Ironically, it takes more confidence to stay in the trade as it goes in your favor than if it remains in a narrow range, simply because more paper profits are at stake.

It usually takes more confidence to sit in a winning trade than to enter it.

So how does one achieve the level of confidence needed to sit through good trades? Often it's not the loss of the paper profits per se that are the real threat for traders. After all, if a trade moves your way and you prudently raise your stop-loss level to breakeven, you'll never get hurt by a sudden, unusual adverse excursion. As disappointing as it may be to lose a paper profit, it's hardly, in itself, a threat to one's account.

Rather, the threat to traders lies in how they would *process* such a retracement. In many cases, their attitude would become quite negative in the face of lost profits. They might criticize themselves for the missed opportunity or lapse into an uncomfortable state of frustration. Instead of viewing the reversal of a gain as nothing lost—simply a scratched trade—they treat it as a situation calling for blame. It's the self-blame and the discomfort of second-guessing that traders are avoiding, not the (paper) dollar loss itself. "You're never wrong taking a profit," is an attitude that speaks more to this psychological reality than to the logical necessity of taking larger winners than losers.

Traders often think they're managing a trade when they exit prematurely, when in fact they're managing their thoughts and feelings about that trade.

*A large part of confidence is trust.* You have confidence in your marriage because you trust your spouse. You have confidence in your driving because you trust your ability to maneuver the car under changing road conditions. If you don't act on your trade ideas—that is, by not seeing them through to their planned conclusion—you actually undercut your confidence by never allowing yourself to develop trust in those ideas. Just as mistrust of a spouse cannot lead to security in a marriage, a failure to trust your time-tested ideas cannot bring confidence to your trading. You can only endure the uncertainty of the trade that moves in your favor by seeing—in your own experience—that the discomfort is indeed endurable, and that you gain far more than you lose by sticking with your planned trades.

As your own trading coach, it's important that you instill both trust and confidence in your trading. This can be accomplished in two ways:

- **Instill the confident mindset.** Before trading starts, you want to mentally rehearse how you would talk to yourself in the event that you have to scratch a trade after having a paper profit. Specifically, you would rehearse a mindset of “nothing ventured, nothing gained”—it's okay to scratch a smaller percentage of trades if that allows you to let a larger percentage run—rather than a self-blaming, frustrated mindset. Prepare yourself in advance for adverse excursions so you remove much of their threat value.
- **Build on small change.** A useful brief therapy principle is to start making large changes by just starting with small changes. If you do just a little of the right thing, you will provide the feedback and encouragement necessary to expand those efforts. In the case of trading, this is easy: even if you take much of your position off ahead of a planned target, leave a small piece of the position on to either hit the target or scratch out. This preserves profits and assuages risk-aversion while it enables you to have the firsthand experience of seeing your ideas through to their conclusion. Over time, you can leave on larger pieces and build performance that way.

*Confidence is not just a function of how you think, but also how you act.* If you act in a way to trust your judgment, you'll have the opportunity to see your judgment work out—and that will build confidence. The stop-profit scenario, unfortunately, is a stop-confidence one as well. If you act with confidence—even in small measure—you coach yourself to self-trust and a deeper internalization of that confidence.



#### COACHING CUE

The flip side of the impulsive trader is the perfectionist. I've seen many traders come up with great trade ideas, only to never participate in them because the market never came to their desired entry levels. Coming up with a big, winning idea and then seeing it work out without you on board can be supremely frustrating. Don't let the perfect become the enemy of the good. If you have a fantastic idea—for instance, you see a market break out and enter a trending mode—get on board with at least a small piece of your maximum position size. If it's a good trend, you can always add to the position later on countertrend moves; if it's not a good trend, you can exit with a modest loss. *But always try to let your trading positions express your convictions:* you always benefit psychologically when you act on your confidence.

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## LESSON 30: COPING—TURN STRESS INTO WELL-BEING

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We have seen that stress does not need to become distress if it is balanced with generous amounts of well-being. People can endure high levels of challenge, pressure, and uncertainty if their work is meaningful to them and they experience rewards tied to their efforts.

We can think of coping as a set of strategies for handling stressful situations so that they don't become distressful. By coping effectively with the risks and uncertainties of markets and the demands of the learning curve, traders can go a long way toward maintaining a favorable emotional balance.

*Psychological research tells us that there is no single most effective coping strategy.* Rather, people with different personalities and needs employ different coping patterns to best handle situations. When you are your own trading coach, it is important to know how you cope best with trading stresses, so that you can activate these strategies on demand.

This knowledge is especially crucial because, at times of greatest stress, we often lapse into old, well-worn coping patterns that may have worked at one time, but may not be appropriate to the current situation. An avoidant coping pattern may have worked in past work situations involving interpersonal conflict, but would be disastrous if employed in the middle of a losing trade in a fast-moving market. Doing what comes naturally is not necessarily the best strategy for handling stress. As we will see in Chapter 5, those past, overlearned modes of coping are often what keep us locked into cyclical problem patterns.

One example that I commonly encounter involves traders who utilize highly confrontive coping strategies. Many traders have aggressive personalities and succeed by facing challenges head on. This can work quite well in situations where one must negotiate a business deal or handle a piece of bad news. In the markets, however, the aggressive response is not always the best one. When facing a series of losing trades—something that happens to all of us—traders can become more aggressive and confront the situation by trading more and larger. This way of handling frustration leads a trader to take maximum risk when he is seeing the market least clearly—a virtual formula for catastrophic drawdowns.

You can often recognize failed coping strategies when you look back on your actions and wonder what could possibly have led you to behave that way.

So how can you know which coping strategies work best for you in particular situations? Below is a checklist that will help you sort out your

different ways of handling trading problems. For this lesson's exercise, I'd like you to think back to several situations in which you've handled trading problems effectively and several situations in which you've handled them poorly. Next to each coping strategy, place a checkmark if it's a mode of coping that you utilized when trading well. Then, next to each item on the list, place a circle if it's a mode of coping that you utilized when trading poorly. Here we go:

1. I reached out to others for ideas or feedback \_\_\_\_.
2. I took steps to make sure I didn't overreact \_\_\_\_.
3. I stepped back from the situation and figured out what to do next \_\_\_\_.
4. I tried to not make a big deal out of the problem \_\_\_\_.
5. I looked for what I could take away from the situation that would help me in the future \_\_\_\_.
6. I made a concerted effort to tackle the problem there and then \_\_\_\_.
7. I recognized my mistake and took action \_\_\_\_.
8. I decided to stop trading for a while and regain perspective \_\_\_\_.

Once again, the key is not to figure out the right and wrong coping strategies, but rather the ones that have worked best for you—and the ones that have been associated with problem patterns in your trading.

One important dimension of coping is action/reflection. Some people benefit most by taking prompt action to own and address challenges; others step back, get themselves under control, put things in perspective, think through plans, and/or consult with others. Another key dimension is problem-focused versus emotion-focused coping. Some traders respond best to situations by first venting and getting things off their chest, reaching out to others for input and support, and working actively to dampen negative emotions. Other traders fare best by putting feelings aside, analyzing situations, and engaging in active problem solving to address problems.

*Often traders run into problems when they fail to enact their best coping strategies.* The analytical trader can get hurt when he finds himself venting emotion and confronting problems without prior reflection and planning. The trader who thrives on social support and feedback from others is unlikely to cope effectively if she becomes discouraged and isolates herself from valued peers.

If you contrast your best and worst coping—the times when you've handled trading problems most and least effectively—you identify what you need to do to sustain a favorable balance between well-being and distress.

When you track how you cope when you are trading well, you create a mental model of your best ways of handling trading challenges. This model can then become a script that you can draw on during times of difficulty. Make a coping checklist a part of your daily journal; it will alert you to behavior patterns that you can build on for the next market challenge.



### COACHING CUE

Think of your best and worst coping patterns as being *sequences of actions*, not just isolated strategies. Thus, for instance, when I'm coping well, I first take steps to calm myself and get focused; then I engage in concrete problem solving. I best cope with losses by analyzing them to death—figuring out what went wrong—and then drawing positive learning lessons from those. When I'm coping poorly, I don't calm myself, and blame myself instead, adding a second bad trade to the first as a way of making up for the loss. In my poor coping mode, I don't analyze my losers, instead turning my attention to more promising markets, instruments, or setups. That ensures that I'll learn nothing from my loss—and that my error will repeat itself at some juncture. Think of coping as sequences of behaviors, so we can develop mental blueprints for the actions we need to take in the most challenging market conditions. This helps ensure that trading stress does not generate performance-robbing distress.

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### RESOURCES

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The *Become Your Own Trading Coach* blog is the primary supplemental resource for this book. You can find links and additional posts on the topic of stress and distress at the home page on the blog for Chapter 3: <http://becomeyourowntradingcoach.blogspot.com/2008/08/daily-trading-coach-chapter-three-links.html>

One of the early texts summarizing research into positive psychology is *Well-Being: The Foundations of Hedonic Psychology*, edited by Daniel Kahneman, Ed Diener, and Norbert Schwarz and published by the Russell Sage Foundation (1999). Another worthwhile reference work is the *Handbook of Positive Psychology*, edited by C.R. Snyder and Shane J. Lopez and published by Oxford University Press (2003) and, by those same authors, *Positive Psychology: The Scientific and Practical Explorations of Human Strengths* (Sage Publications, 2006).

How our emotions affect our health and well-being is the topic of James W. Pennebaker's edited text *Emotions, Disclosure, and Health*, published by the American Psychological Association (1995).

A number of free articles covering topics of stress, coping, and emotions in trading can be found in the section "Articles on Trading Psychology" at [www.brettsteenbarger.com/articles.htm](http://www.brettsteenbarger.com/articles.htm).



## CHAPTER 4

# Steps toward Self- Improvement

### *The Coaching Process*

*Success does not consist in never making mistakes  
but in never making the same one a second time.*

—George Bernard Shaw

**W**hat are the core processes of self-coaching? What concrete steps can we take to make changes in our trading to improve performance? These are some of the topics we'll tackle in this chapter.

Much of this chapter comes from research over the past several decades that has illuminated common effective ingredients across all counseling and therapy approaches. An interesting finding from that research is that all of the major approaches to counseling appear to be more effective than no counseling at all, but no single approach consistently shows better results across a range of people and problems. Not only do the major modes of helping seem to work equivalently, they also seem to work for many of the same reasons. Those reasons capture the essence of what creates change—and what can fuel our efforts to become our own trading coaches.

### **LESSON 31: SELF-MONITOR BY KEEPING A TRADING JOURNAL**

Self-monitoring refers to methods that you use to track your own patterns of thought, feeling, and behavior over time. Self-monitoring is the foundation for many of the other self-coaching techniques described in this chapter, because it tells us what we need to change. We can't alter a pattern

if we're not aware of its existence. Very often in brief therapy, the first homework exercises involve self-monitoring. Just as observing market patterns precede our ability to trade them, becoming aware of our own patterns is the first step in changing them.

One of the most common ways to monitor oneself is through the use of trading journals. Active intraday traders might make entries during a mid-day break and at the end of the trading day; others might simply write in the journal at the end of each day in which they are making trading decisions. The key is to catch your patterns as soon after they occur as possible, rather than rely upon fallible memory.

*Note that self-monitoring is not a change technique in itself, but it often leads to changes.* Once you see your patterns with crystal clarity—including their costly consequences—it becomes much easier to interrupt them and prevent their future occurrence. At other times, self-monitoring may alert you to patterns that you didn't know were present. This is exceedingly valuable, as it lays the groundwork for change that otherwise would have been impossible.

Any time you systematically review your performance over time—and the factors associated with successful and unsuccessful performance—you're engaging in self-monitoring. For example, I reviewed my recent trading results trade by trade and found that I was taking larger point losers on small trades than on my larger ones. This review led to the realization that, when trades were quite small, I was not as vigilant in setting and sticking to stop-loss levels. Although the total dollar loss for each small trade was not huge, over time the small losses added up. This led me to establish a new routine for setting and sticking to stop-losses with small trades by explicitly writing out my risk/reward ratio for each trade before I placed the order. The self-monitoring made me more conscious of what I was doing, which in turn kept me trading well.

Self-monitoring is the foundation on which all coaching efforts are built.

My experience is that the best predictor of failure in the trading profession is the inability to sustain self-monitoring. This inability leaves traders unable to clearly identify their problem patterns, and it prevents them from reflecting and learning from their efforts at change. Goals without self-monitoring are but mere good intentions; they never translate into concrete actions to initiate and sustain change.

Why would a trader, seemingly desirous of success, not sustain efforts to monitor her own thoughts, emotions, and/or trading performance?

I believe it's because many traders are motivated by trading and making money, not by a desire to understand themselves and markets. This is an important distinction. To paraphrase coach Bob Knight, they are motivated to win, but not motivated to do the work it takes to become a winner. *In the best traders, self-mastery is a core motivation.* It's why they continue trading long after they could have comfortably retired.

The most common format for beginning a regimen of self-monitoring is keeping a journal. The basic components of a self-monitoring journal might look as follows:

Divide your journal page into three columns. The first column describes the trade that was placed, including the trade size and the time of day. If you scale into a single position, you would treat that as a single entry in the journal. Similarly, if you enter several positions to capitalize on a single trade idea (e.g., you want to be long precious metals, so you buy three different mining stocks), those would also be incorporated within a single journal entry. The first column might thus summarize what you did for each trade idea, how much you risked on the idea, when you placed the trades, the prices that you paid, and how you placed the trades (e.g., all at once or by scaling in; executed at the market or with limit orders). If you are a high-frequency trader, consider the possibility of automating your trade monitoring with tools such as StockTickr ([www.stocktickr.com](http://www.stocktickr.com)) or Trader DNA ([www.traderdna.com](http://www.traderdna.com)).

The second column would summarize the outcomes of the trades, including the prices and times of your exits, your P/L for that trade (or trade idea), and how you exited the trades (e.g., all at once or scaling out, at the market or by working orders).

The third column would include all of your behavioral observations for that particular trade or trade idea: what you were thinking, how you were feeling, your preparation for that trade, your degree of confidence in the trade, etc. In other words, the third column takes a look at you and your state of mind, thought patterns, and physical state during the trades. The third column could also include observations about how well you entered, managed, and exited the trades. Whatever stands out for you—good or bad—about the trade would be included in that third column.

Keep your trading journal doable; many efforts at self-monitoring fail because they become onerous.

For a trader such as myself who only place, at most, a few trades per day, such a journal is relatively easy to keep. Prop traders who make dozens of trades per day or more, however, are likely to find such a journal

to be onerous. One of the best ways to sabotage self-monitoring efforts is to make them so burdensome that you won't sustain the effort. If you're an active trader and cannot automate your monitoring of trades, you can streamline the journal in one of several ways:

- You can create a single entry for the morning trading and a second entry for the afternoon's trading, with the columns simply summarizing your positions, your P/L for the A.M. or P.M., and your associated observations of your trading at those times.
- You can create entries for selected positions only that stand out in your mind either because they were quite successful or quite unsuccessful. If you sample from your trades in this manner, make sure that you include best and worst trades, so that you can observe positive and negative patterns. These are the trades from which we learn the most.
- If your trading is complex, with many positions, hedges, and a flowing in and out of risk exposure over time (like a market maker or a very active portfolio manager), you can simply summarize your day with a single journal entry. The first column would review your major trading ideas, the second column would note P/L, and the third column would include your self-observations.

*There is no single self-monitoring format perfect for all traders; the key is to adapt the format to your needs and trading style.* The real work comes when you've accumulated enough entries to notice patterns in your trading: the factors that distinguish your best trades and days and those that accompany your worst trading. How to analyze your self-monitoring journal will be the focus of the next lesson. For now, however, your task is simply to sustain self-awareness: to be an active observer of your own trading process.

When you are your own trading coach, there is always a part of you that stands apart from your decision-making and execution, observing yourself and exercising control over what you do and how you do it. The real value of the trading journal is that it structures the process of self-awareness and helps make it more regular and automatic. If you were walking on a familiar street, you would hardly think about how you walk, everything would be on autopilot. If, however, you were taking the same walk in a minefield, you would be exquisitely self-aware, conscious of every step that you took. Trading is neither a walk in the park nor a minefield . . . perhaps it's more like a walk in a beautiful, but somewhat dangerous park. You want to be absorbed in the walk, but alert and aware at the same time. That is the function of the trading journal: it enables you to monitor yourself, even as you are immersed in what you're doing.

**COACHING CUE**

A great insight into journal keeping is offered by Charles Kirk ([www.thekirkreport.com](http://www.thekirkreport.com)) in Chapter 9, who enters his observations into a database program so that he can readily retrieve journal entries on various topics. This is an effective way of monitoring specific trading challenges over time.

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**LESSON 32: RECOGNIZE YOUR PATTERNS**

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One of the keys to brief therapy is the creation of a concrete focus for change. One of the reasons that older forms of therapy took so long to implement—including years of psychoanalysis—was that they attempted broad personality changes. Our understanding of personality traits and their biological, hereditary components helps us to be a bit more modest in our aims. No form of coaching or counseling will restructure a person's personality; nor should it. *The goal of coaching is to help people work around their weaknesses and build their strengths, so that they can express their basic personalities and skills as constructively and successfully as possible.*

You cannot change your personality, but you can change how it is expressed.

Many self-described coaches lack formal training in psychology and especially lack the experience and grounding of licensed helping professionals. They acquire a cluster of self-help methods and try to fit all problems to those. The result is a canned set of solutions for any given problem. This can be disastrous. The patterns that interfere with trading often lie well outside canned, self-help nostrums. One successful trader I recently met at a conference presentation was having a poor trading year and was even considering retiring. She complained of a loss of enthusiasm and excitement about her trading, as well as weight gain and more negative feelings about herself. She had seen three prior coaches and therapists, all to no avail. After a short discussion, I obtained enough information to suggest that she obtain a blood workup from her primary care physician. She did so, and the results suggested a low level of thyroid activity. Once she received proper hormonal supplementation, her mood and energy level returned, her concentration improved, and she resumed her successful career.

How many traders lose their careers because they never understand the patterns that underlie their problems?

You might ask the question, “How can I, as a trader relatively uneducated in applied psychology, ever hope to identify obscure patterns such as low hormone levels? If experienced coaches and counselors miss the pattern, how can I detect it?”

Ironically, I think that you’re in better shape than most commercial coaches to identify and act upon unusual patterns that interfere with good trading. I could readily make the recommendation for the trader because I was not seeking her business. She was not paying me for my services and I did not stand to gain by making one recommendation versus another. (Note: my coaching is limited to a limited group of proprietary trading firms, hedge funds, and investment banks; I don’t take on individual traders as clients.) Most coaches who focus on retail traders, on the other hand, need to constantly drum up business. It is not in their self-interest to raise a possible course of action (such as blood tests and thyroid medication) that doesn’t lead to further services and additional fees. As a result, they focus on solutions that they can provide (i.e., that will bring them additional business). When all you have is a hammer, Maslow once remarked, you tend to treat everything as nails.

As your own trading coach, you have no such conflicts of interest. You can learn pattern recognition for yourself and diagnose your own concerns. If the problem still eludes you, even after you’ve reviewed your journal extensively, send an e-mail to the special address reserved for this book (coachingself@aol.com; see the Conclusion) and I will do my best to point you in a promising direction. But I think you’ll be pleasantly surprised to find how readily you can tackle your own challenges once you learn a few basic techniques.

Once you learn to coach yourself, you have the skills to guide your development across a lifetime.

So let’s see how you can become expert in recognizing your own patterns, building on the trading journal described in the previous lesson. Reviewing your journal entries, you want to divide them into two clusters: those describing your most successful trading and those that capture when you were trading at your worst. The first cluster will reveal what we call *solution patterns*; the second cluster alerts you to *problem patterns*. Many times, the difference between the solution and problem patterns will themselves point you to practical actions you can take to improve your performance. For instance, you might notice that during your successful trading you’re more patient entering trades and take fewer trades, each with smaller size. When you’re less successful, you trade more often and with maximum size.

The comparison between best and worst trading will also alert you to differences in your coping with market challenges. You may find, for

example, that when you're trading well, you tend to be very problem-focused. When you are less successful, you trade while you are confused or frustrated, without waiting for clearly defined opportunity.

The key is to look for patterns, not just isolated instances of good or poor trading. For each good day of trading, you might jot down several things you did right and then see which entries appear day after day. Similarly, in reviewing the poor trading days, you would write down the key mistakes you made and observe which ones appear over time.

Your trading strengths can be found in the patterns that repeat across successful trades.

If you cannot find patterns that stand out, you may need to monitor your trading over a longer period, so that you have a rich sample of good and poor trading days. You're looking for common elements that jump out at you; don't be too quick to read subtleties into the patterns. The best things to work on are the ones that are most salient—that hit you between the eyes. For instance, when I have done the pattern-recognition work and compared my best and worst trading, I found stark differences in the sizing of my trades (initial positions neither too large nor too small performed best); the timing of the trades (positions too early in the morning or later in the afternoon underperformed those made after the market sorted itself out in the first minutes of trade); and the duration of my trades (better performance when held shorter, with clear targets and stops). I also found that I traded best when I had a clear longer-term picture of the market to guide shorter-term entries and trades. My absolute worst trading occurred when I held a strong view at the start of the market day and did not modify the view as the day progressed, continuing to trade against a market trend.

Notice how each of these patterns focuses a trader on *what* to change, which is the first step in deciding *how* to make changes. Many times, traders fail to make changes because they aren't clear on what to change. They rely on vague generalizations ("I need to be more disciplined") rather than identify specific behaviors to work on. By conducting detailed comparisons between your best and worst trading, you can find a focus for your self-coaching efforts and channel your energies in the most constructive directions. If you know your patterns—those that bring you success and failure—you're generally halfway home in making lasting changes. Below are some patterns to be especially aware of as you review your journal:

- **Emotional Patterns**—Distinct differences in how you feel when you're trading well and when you're trading poorly, particularly before and during trades.
- **Behavioral Patterns**—Notable differences in how you prepare for trades and manage them during your best and worst trading episodes.



- **Cognitive Patterns**—Meaningful differences in your thought process and concentration level during and after your best and worst trades.
- **Physical Patterns**—Differences in how you are feeling—your energy level, physical tension and relaxation, and posture—when you're trading at your best and worst.
- **Trading Patterns**—Differences in the sizing of trades, times of day when you're trading, mode of entering and exiting trades, and instruments being traded as a function of good versus poor trading.



### COACHING CUE

Many times you'll observe more than one kind of pattern, and many times those patterns will be linked. For example, your cognitive patterns may lead to particular emotional patterns, which are then linked to specific trading patterns. Think of patterns in sequence—as a kind of positive or negative cascade—not as either/or phenomena. Excellent coaches see not only patterns, but also patterns of patterns. Here are some of the most common patterns among traders to watch out for:

- Placing impulsive, frustrated trades after losing ones.
- Becoming risk-averse and failing to take good trades after a losing period.
- Becoming overconfident during a winning period and taking more marginal and/or unplanned trades.
- Becoming anxious about performance and cutting winning trades short.
- Oversizing trades to make up for prior losses.
- Ignoring stop-loss levels to avoid taking losses.
- Working on your trading when you're losing money, but not when you're making money.
- Becoming caught up in the market action from moment to moment rather than actively managing a trade, preparing for a next trade, or managing a portfolio.
- Beating yourself up after losing trades and losing your motivation for trading.
- Trading for excitement and activity rather than to make money.
- Taking trades because you're afraid of missing a market move, rather than because of a favorable risk/reward profile for your idea.

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## LESSON 33: ESTABLISH COSTS AND BENEFITS TO PATTERNS

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A huge step forward for traders who seek to mentor themselves is to know the patterns of behavior, thought, and emotion associated with successful and unsuccessful trading. Still, it is necessary, but not sufficient to produce lasting change. *This is because knowing a pattern is different*

*from having—and sustaining—the motivation to alter that pattern.* It is in the motivational arena that many of our change efforts, personal and professional, fall short. We need only to look at the dismal record of people's attempts to diet, eat in healthy ways, or exercise regularly to see that knowing what you need to do and actually doing it are two different things.

When you are your own trading coach, your challenge is to *motivate* change, just as a sports coach motivates a team to keep them working hard and sustaining practice efforts. If keeping a journal and tracking your patterns of good and bad trading is nothing more than a routine exercise—another item on a to-do list—it will not inspire motivation, and you will not sustain the efforts. Stoking the desire to make changes is difficult, especially when trading is going reasonably well. “If it ain’t broke, don’t fix it,” is a formula for eventually lacking fixes when things do break.

But there’s a more important reason for sustaining self-coaching efforts. *When you’re trading well is precisely the time you want to be the most self-aware of your strengths, so that you can maximize your earnings at those times.* The true competitors and most successful participants in sport, warfare, and games of skill such as chess are the ones who possess the killer instinct: they have a sense for when they have the advantage, and they press that advantage to the hilt. Making modest money when you are trading well is a great way to ensure poor returns when you’re not seeing markets as well. For many traders, it’s the relatively few, large gains from the best trading periods that contribute most to overall profitability.

The measure of self-coaching is how hard you work on trading when you’re making money.

It’s as important to work on yourself when you’re trading well as when you’re trading poorly. It’s not that you want to fix what isn’t broken; rather, you want to crystallize what you’re doing right so that you can do more of it and capitalize fully on it. Conversely, when you’re trading poorly, you don’t want to lapse into discouragement and defeat. Maintain the journal and the pattern recognition efforts to keep you in a constructive mode, even when all you may be able to do for the moment is to cut your risk when your negative patterns surface. That is still progress.

So how do excellent traders (and competitors in any field) sustain the motivation to operate at elite levels of performance? An important driver of that motivation is an intense competitive drive and a ferocious desire to win. The traders I’ve worked with personally who have been consistent, high earners have traded quite differently and viewed markets in radically different ways. Some traders have been loud and outgoing; others have been cerebral. Some have been uncannily intuitive; others have been analytically insightful. The common feature among all of them, however, has been their intense competitive nature. They compete against peers,

they compete against markets: most of all they compete against themselves. They derive pride and validation, not just from making money, but also from getting better, which is what keeps successful traders in the game long after they could have retired comfortably.

The lesser traders? They trade to not lose; they trade to keep their jobs. They don't hunger to become more than they are; they want to do well, not to be their best.

The drive for self-improvement is different from the desire to make money and is far more rare.

These successful traders can sustain their drive by staying mindful of the costs of their negative patterns and the benefits of their positive ones. When a successful trader decides to avoid a particular trade or market, it's often because of a specific recollection that this idea has caused past losses. By staying emotionally connected to the pain created by their worst trading, traders stoke their motivation to avoid trading mistakes. Similarly, knowing their strengths is not just an abstract awareness for successful traders, but an emotional connection to the pride and sense of accomplishment over doing well.

*A best practice in self-coaching—and a great assignment for this lesson—is to not only summarize the patterns of your best and worst trading, but to actually write down and visualize the costs associated with the most negative trading patterns and the benefits that accompany the best patterns.* In other words, you don't finish your journaling until you achieve a state in which you are emotionally connected to the things you are writing about. You will want to change your negative patterns when you get to the point of hating those patterns and becoming disgusted with the ways in which they've set you back. You'll want to build on your positive patterns when you see and feel their benefits. When you're coaching yourself well, journaling is an emotional exercise, not merely a cognitive one.

There is little to be gained from abstract positive thinking. Reciting such affirmations as, "I will be a successful trader" is empty at best, self-delusional at worst. The reason such positive thinking doesn't work is that it is not connected to the day-to-day conduct of your trading. It's not enough to simply make yourself feel good, and, indeed, there can be real value in feeling so bad that you'll never repeat a mistake again. What is helpful is to associate the best emotional experiences of trading—your greatest moments of joy and achievement—with the specific practices that brought you such happiness. It is also tremendously helpful to re-create the pain of your worst trading with concrete vows to never go there again.

Think of football, basketball, and tennis coaches. Every practice session teaches skills, offers feedback, and supplies motivation. It's not a bad formula for self-coaching as well. You are most likely to change a negative thought or behavior pattern when you associate it with concrete costs and consequences; you're most likely to motivate a positive behavior by attaching to it specific, felt benefits.



### COACHING CUE

Efforts at self-change break down when people start to make exceptions and allow themselves to revert to old ways. To accept exceptions, you have to accept the old, negative patterns. It's when our old patterns become thoroughly unacceptable that we are most likely to sustain change. When you keep a journal, you want to cultivate an attitude, not just jot down bloodless summaries of what you do. If you don't see plenty of emotion words in your journal—constructively expressed—the odds are that your journal will summarize your changes but not motivate them.

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## LESSON 34: SET EFFECTIVE GOALS

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Successful coaching requires a focus for change. *Many self-help efforts among traders fail because they are unfocused.* One day the trader writes in a journal about position sizing and works on that; the next day he emphasizes emotional control; and the following day he stresses taking losses quicker. By jumping from one focus to another, no single direction is sustained.

This is problematic because most learning does not occur all at once. We know from research that learning typically requires many trials and considerable feedback. If we think about important skills that we've learned—from using a computer to driving a car—we can see that trial and error has been the norm. I can study a map of a new city for a long time and learn quite a bit, but I ultimately only learn to find my way around by driving on various roads, following signs, getting lost, and recognizing landmarks. If we pursue this learning intentionally—organizing our trials over a concentrated period of time with immediate feedback throughout—we can greatly shorten our learning curves. It's easier to learn to play a piano by practicing every day and taking lessons every week than by engaging in occasional efforts spread over years.

The training of an Olympic athlete is a study in proper skill development: intensive work on specific aspects of performance,

accompanied by plenty of coaching feedback and corrective efforts.

When we lack a specific focus for change and jump from one trading goal to another from day to day, we don't really enter a learning curve: there is nothing cumulative in our efforts. As your own coach, you need to establish—and also sustain—a specific direction to guide your growth and development. This is the key to effective goal setting. If motivation provides the energy for self-improvement, goals supply the aim, the channeling of that energy.

When you recognize a problem pattern, it is not the same as establishing a goal for self-work, though the former usually will guide the latter. A problem pattern alerts you to what you're doing wrong. Goal setting requires an awareness of new patterns of thought, feeling, and/or action that will replace the problem pattern. A goal states what you are going to do or not do in specific situations. If you have constructed your trading journal and pattern-identification exercises in the ways suggested in recent lessons, many of your goals will naturally follow from the patterns associated with your best trading. Your overarching goal will be to trade in the way that you typically trade when you're trading well.

*Notice that I am defining goals in a process sense, rather than as absolute outcomes.* This is very important. Many traders think of such goals as making a million dollars or being able to trade for a living. These outcome goals may be motivating, and definitely have their place, but they do not focus a trader on what she needs to do today and tomorrow to become better. Traders on a short time frame do not have full control over their outcomes: a trader can make good decisions, placing all odds in their favor, only to lose money when markets behave in an anomalous fashion. What traders *can* control is the process of trading: how they make and implement decisions. The most effective daily goals emphasize trading well, not making oodles of money.

The same logic guides athletic coaches. A coach may stress the goal of victory over the next opponent, but the day-to-day practices will emphasize such fundamentals as swinging at good pitches (baseball), making the extra pass (basketball), and blocking effectively on running plays (football). These process goals provide the ongoing focus for practice over time and ensure that coaching leads to effective learning. Every coach is, at root, a teacher. When you're your own coach, you guide your own learning efforts.

Effective goals target effective trading practices that break trading down to component skills and then set targets for these, one at a time.

As you examine your journal entries for the patterns that distinguish your best and worst trading, the question you want to ask is, “What is the difference that will make the greatest difference in my trading?” Stated otherwise, your question is, “What are the one or two ways I can trade more like my best trading and less like my worst trading?” The answer to these questions will form the basis for your best process goals—and will guide your self-development efforts from day to day and week to week. Goals should not be so specific that they only apply to a limited set of circumstances (“I want to be a market buyer when put/call ratios hit 100-day highs”), and they should not be so broad or vague that they don’t guide concrete actions (“I want to trade less often”). *The best goals are ones you can work on every day for a number of weeks.* If you do not work on a goal day after day for at least several weeks, it’s unlikely that you will turn your new patterns into positive habits.

As mentioned earlier, you don’t want to focus on too many goals at once. I’ve generally found three to be as many as I can work on with consistent intensity—and many times I will focus on fewer objectives. This means that a good self-coach will prioritize needed changes, emphasizing those differences that will most make a difference. A great exercise to try is to close your eyes and imagine yourself as a great trader. Visualize yourself as the best trader you can possibly be—or maybe visualize an absolutely perfect trading day. What are you doing differently from your usual trading when you’re the great trader? How is your trading different on the perfect day than on poor one? In your visualizations, try seeing yourself doing all the right things when you’re trading well. What are you doing? How are you doing it? Those visions, made highly specific, will form the backbones of your goals.



#### COACHING CUE

Make it a point to get to know successful traders who have had plenty of market experience. Many times you can form effective goals by simply trying to emulate their best trading qualities.

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### LESSON 35: BUILD ON YOUR BEST: MAINTAIN A SOLUTION FOCUS

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To this point, the lessons in this chapter have emphasized the importance of tracking the patterns associated with both your trading shortcomings and your trading successes. It is common to focus on the



former only. When we use coaching to build strengths rather than simply shoring up weaknesses, that solution focus produces surprising—and surprisingly rapid—results.

For more on the solution-focused approach to change, check out *The Psychology of Trading*

There are several reasons why a solution focus is helpful for traders who seek to coach themselves:

- **Motivation**—It is easier to stay motivated and optimistic when we emphasize what we're doing right, not just where we fall short. Imagine a sports coach who only harped on players' weaknesses. Over time, that would be demoralizing. When the focus is strengths, coaching can be empowering and inspiring without ignoring changes that need to be made or the urgency of making those changes.
- **Goal Setting**—Knowing what you've done wrong, in and of itself, does not tell you what you need to do right. When you focus on your best trading, you can identify specific patterns that are associated with your success and turn these into concrete goals for future work.
- **Bang for the Buck**—Working solely on improving weak areas is unlikely to create strengths; at best, you'll take a deficient area and bring it to average. It's making the most of strengths and learning how to work around shortcomings that produces optimal performance results.

One of the reasons I emphasize the importance of paper (simulation) trading and playing with different trading styles and markets is that this experience enables you to observe your own strengths firsthand. Many, many times, traders stumble across their performance niches when they discover something they're good at. If you don't know your strengths, it's unlikely that you'll be able to systematically build on them and turn them into drivers of elite performance.

But you might wonder, "How do I stay solution focused if, day after day, I'm in a slump and losing money?" It is difficult to stay connected to our strengths when our failings are written all over our P/L summaries!

We've seen that this question is a particular challenge when we identify winning days as good trading and losing days as bad trading. This thinking makes it difficult to observe and appreciate good trading when we're not making money. But traders can trade well—they can take setups with demonstrated edges, size positions well, and manage the risk of their trades—even if trades happen to go against them. After all, even a 60 to 40 edge per trade ensures that a trader, over time, will have sequences of consecutive losing trades and/or days. If you define good and bad trading in terms of process, not just outcome, you can observe strengths during



performance slumps and also you can detect flaws even when you're making money.

To keep yourself solution-focused, you want to ask yourself, "What did I do well today? What about this trade did I do right?" You'll find that, over time, your performance is varied. Not all trades are poorly conceived, poorly executed losers. If you lost less today than the past several days, what did you do better? If you had a number of winning trades during several losing days, what distinguished those winners? Focus on the improvements in your trading and then isolate the specific actions you took to generate those improvements. These actions can be meaningful additions to a daily to-do list.

"What did I do better this week than last week?" is a great starting point for guiding next week's efforts. Do more of what works—it's the essence of the solution focus.

Another technique for sustaining the solution focus referenced at the end of the last lesson is to identify a mentor or trader you respect and ask yourself how he would be trading a particular idea. Sometimes it is very helpful to try out solution patterns that you borrow from others. Over time, you adapt these patterns to your own ways of thinking and trading, so that they become distinctly yours. For example, I've worked with quite a few hedge fund portfolio managers and have learned from them the importance of thinking thematically about markets: observing various sectors and asset classes and creating narratives that guide a longer-term perspective. The specific themes I track and the time frames I monitor are completely different from theirs, but there is a similarity of process. When I'm not trading well, I can model their processes and place myself more in line with market's trends.

Still another way to keep the solution focus is to make special note of mistakes that you *don't* make in your trading. These notes represent exceptions to problem patterns. If there's a mistake you've made lately, it helps to hone in on occasions when you haven't made the mistake. What are you doing differently at those times to avoid the mistake? Perhaps you're anticipating the problem and consciously doing something different. Maybe you're avoiding the mistake by following a particular rule or practice. Whatever helps you do less of the wrong things can also form the basis for solutions.

Look to situations in which you don't make your worst mistakes. Many times those situations hold the key to avoiding problem patterns more consistently.

The real power of the solution focus is that, when you discover what you do during your best trading, those positive patterns are uniquely yours. Instead of ceding the role of expert and guru to others, you're turning yourself into your own guru by finding the best practices that are unique to you. *You become your own role model.* This is one of the most promising facets of self-coaching: by discovering who you are at your best, you can create goals that are specific, unique, and relevant to you. The learning, as a result, will be more relevant and empowering, reinforcing strengths as you build them.

A great assignment is to review your trading journal and assess the ratio of problem entries (writings about your bad trading) to solution entries (writings about what you're doing best). If the ratio is lopsided in favor of the problem focus, consider structuring your writing to force yourself to address a few basic questions:

- What, specifically, am I doing best in my recent trading?
- How, specifically, am I avoiding old trading mistakes when I'm trading well?
- How, specifically, am I trading like my idea of the ideal trader during my best trading?

A good sports coach never loses sight of a player's potential, even when correcting weaknesses. The challenge of self-coaching is never losing sight of your strengths, and then working daily on how you can maximize them.



#### COACHING CUE

We have solution markets as well as solution patterns of behavior: specific markets and market conditions that facilitate our most successful trading. Knowing these intimately is very helpful in allocating risk to your trade ideas. It can also be helpful in staying out of certain kinds of trades and emphasizing others.

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### LESSON 36: DISRUPT OLD PROBLEM PATTERNS

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As you continue your journaling over a period of weeks or longer, you will become attuned to your problem patterns. Usually, a trader does not have 10 different problems. Rather, he may have one or two problems that manifest themselves in 10 different ways. For instance, a trader may grapple with missing good trades, occasionally ignoring stop-loss levels, sizing positions too conservatively, and cutting winning trades too quickly. These examples may seem like different problems, each requiring a different coaching plan and process. As the trader examines his or her

journals, however, they're likely to find that a single problem pattern—anxiety related to negative self-talk—is responsible for all of these. *It's not that the trader has many problems (though it may certainly feel that way); it's that there is a single, core problem that affects many aspects of the trading process.*

As you can see from the above example, self-coaching requires that you not only detect patterns but patterns among the patterns. It's these patterns of patterns that usually form the core focus of coaching efforts. This means that if you can accurately identify the core pattern, many different trading difficulties can fall into place in a reasonable period of time. Once the trader in our example learns to master anxiety and not channel it through self-defeating self-talk, he will miss far fewer opportunities, become more consistent in sticking to stop-loss levels, take appropriate risk, and let trades progress toward their designated targets.

Asking yourself, "What is the common denominator behind my different trading mistakes?" begins the process of finding patterns of patterns.

Often the core pattern will involve a feeling state that recurs for the trader and that disrupts good decision-making. For example, the trader may lapse into periods of anxiety, frustration, or self-defeat. How this feeling state impacts trading may vary from day to day, which is what produces the multiple manifestations that lead traders to think that they have dozens of problems. By tracing each trading problem back to a particular cognitive (thinking) or emotional (feeling) state, we can then identify the events that typically trigger that state and design effective coaching interventions to tackle those situations and triggers.

*Often, a trader will know what he is doing wrong, but won't know the right thing to do.* This issue occurs when traders have not been sufficiently solution-focused. They know, for instance, that they should not double down on losing trades to make money back, but they don't know how to reenter a trade and exploit good research after having been stopped out of an initial position. This situation requires two important coaching steps: 1) interrupt the problem pattern so that it does not disrupt trading; and 2) develop rules and procedures for a possible solution pattern (which will form the theme of the next lesson).

Because traders don't always have solutions readily at hand and need to stop bleeding losses, interrupting problem patterns is often a first coaching objective. "Above all else, do no harm"—the Socratic oath in medicine—is relevant here. The ability to stop doing wrong things won't, by itself, generate good things, but it can keep you solvent long enough to find solutions!

Change starts when you stop yourself from doing what doesn't work.

A major point from *The Psychology of Trading* is that *the key to disrupting problem patterns is to alter the state that you're in when those problems first appear*. This means that it's important to become vigilant to the emergence of patterns, recognizing the characteristic ways that they appear. For example, some of my worst trading occurs when I focus on my P/L as the trade is unfolding. This focus may lead me to tolerate larger than normal losses in a small position, because it's not hurting me, or it may lead me to take profits too quickly on a large position to book a sure gain. I've learned that if I start counting profits during the trade, I need to refocus my attention. I accomplish this by turning briefly from the screen, fixing my gaze on something nearby, and taking a few deep breaths. Once I'm in a new state—more calm and focused—I find it easier to be detached from the P/L and let the trade unfold in its planned manner.

Another quick way of shifting state is simply to walk away from the screen temporarily and engage in a quick activity unrelated to trading. Some activities might be a few stretches or exercises; talking with a fellow trader; or getting something to eat or drink. Often, *doing* something different enables you to approach situations differently: the new activity helps you shift your frame of thinking and feeling. I find this activity particularly useful after taking losses: a quick walk outdoors, getting away from markets, allows me to return to the screen with a fresh perspective.

When you change your physical state, you alter how you experience the world and process information.

Still another mode of state shifting is to write in a journal or talk aloud during a particular situation. The latter is especially useful if you're trading alone and won't be a distraction to others if you process information aloud. If you write or talk about what is happening and give voice to what you think and feel at the time you're thinking and feeling it, you shift from being a person immersed in experience to being a person observing his own experience. If you're an active trader, in and out of markets quickly, you may not have time to write out journal entries and observe yourself in that manner. Talking aloud, however, can be accomplished while still watching the screen; in fact, that's how many traders in Chicago work with me during the trading day: they talk aloud about what is happening while they are engaged in trading.

To use my example from above, if I talk aloud my thoughts about my P/L while I'm in a trade, that alerts me to the fact that I'm no longer focused

on the trade itself. If I hear myself talk about something other than the management of the present trade, it kicks me into a different mode and pushes me to make an effort to get back to the market itself. This shift becomes easier and easier as traders learn to make self-observation a habit.

When you talk aloud your thoughts and feelings, you no longer identify with them; you listen to them as an observer.

A good self-coaching question to ask yourself is: How different would your P/L be if you could eliminate the 5 percent of your largest losing trades? Often, this percent by itself would make a huge difference to a trader's profitability. By interrupting the patterns that accompany those large losers that result from bad trading (not just being wrong on an idea), you can "above all else, do no harm." *It's usually a particular emotional state or pathway of thinking that triggers the bad trading.* If you recognize the state and thoughts as they're occurring, you can stop yourself and, at the very least, avoid disaster.

This recognition would make a wonderful goal to work on in your trading. Choose just one negative pattern that has accounted for many of your largest losing trades and then identify the common triggers for that pattern. Then select one method for interrupting the pattern when you notice one of the triggers occurring—even if that method is doing nothing more than placing no more trades until you regain emotional equilibrium. A good coach knows when to take his player out of the game for rest and a lesson. When you are your own trading coach, sometimes you need to do something similar. Remember: the goal is not to trade; the goal is to make money. Sometimes the best way to make money over the long haul is to ensure that you keep your money when all the wrong patterns are firing.



#### COACHING CUE

If I say something in a frustrated tone or make a frustrated gesture while I'm trying to get into a trade, while I'm managing a trade that's already on, or while I'm trying to exit, that is my signal that I need to interrupt an emerging pattern. I typically will slow my breathing considerably and focus on my breathing as I'm continuing with my business. As soon as is practical thereafter, I take a short break from the screen and don't enter any new positions until I have figured out why I'm frustrated, what that tells me (about me and/or the market), and how I want to factor that into my trading. If you use frustration as a cue to interrupt patterns you are prevented from acting mindlessly on the frustration, but also you are set up to become mindful of the reasons for the frustration.

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## LESSON 37: BUILD YOUR CONSISTENCY BY BECOMING RULE-GOVERNED

One of the major goals of coaching yourself is to turn positive trading behaviors into habit patterns. This is crucially important. You don't want to have to think and make yourself do the right things each time opportunity occurs. Rather, you want to do the right things automatically. Effort and energy you spend thinking about what to do—and trying to make yourself do it—is taken away from markets themselves. When you can do the right things automatically, your concentration can be wholly focused on what you are doing. That is essential if you're going to be sensitive to subtle market shifts in supply and demand.

*Rules are the bridge between new behavior patterns and acquired habits.* Children are not born with a developed sense of ethics and responsibility. They are taught rules by parents and teachers that are eventually internalized. Some of that internalization occurs by observing role models over time; much of it results from turning the desired behaviors into explicit rules that can be rehearsed. Such mental rehearsal allows people to keep old behavior patterns in check and make conscious efforts to engage in new ones.

We see such dynamics at work when traders are learning to control losses. Instead of exiting trades when the pain of loss is too great—a pattern that comes all too naturally—a trader will create a rule-based stop-loss level. The rule may be accompanied by other thoughts that emphasize the importance of the rule, the losses that will follow from not following the rule, and the benefits of adhering to the rule. In such an instance, traders choose to refuse to do what they feel like doing at the moment. Rather, they seek to be rule-governed. That is what keeps us driving on the proper side of the road, even when we're in a rush. Rules are checks on our impulses; they keep us doing the right things even when we're not inclined to act in our own best interests or the interests of others.

We follow social rules without even thinking about the rules of proper social behavior because we've repeated the right behaviors so often and have internalized the rules so thoroughly over time. That's the goal with trading rules.

Trading is especially challenging, because the normal human response is rarely the one that makes money. One exercise from the *TraderFeed* blog examined periods of time that were up on a one-month, one-week, and one-day basis and compared those with periods that were down over those three time frames. In the first situation, almost anyone would identify



the trend as rising; in the second situation, it's a clear downtrend. Had you bought the market after the up periods, however, you would have severely underperformed the market averages. Had you sold after the down periods, you would have lost considerable money. The obvious strategy fails precisely because it is so obvious. By the time a trend is readily apparent; all the momentum and trend followers are aboard. They're the ones scrambling to get out when the tide turns, leaving traders who acted on the obvious with losses.

When we create rules, we put a brake on those normal human tendencies. A rule might be as simple as "only buy if the market is down over X period." Surprisingly, in the broad stock market, such a simple rule works pretty well on average. Another rule might be, "Never enter a trade unless you first measure risk (stop-loss level) and reward (profit target) and have a reward-to-risk ratio of 2:1 or better." Such a rule would restrain a trader who is tempted to jump aboard late in a market move.

What traders call *setup* criteria often are simply rules for getting them into trades. When the criteria are not established as firm rules—and mentally rehearsed as such—there is a tendency to violate the setups. This violation often occurs because of the fear of missing a profit opportunity or because of risk aversion after a prior loss or series of losses. When the setups are structured as rules, trading may not be mechanical, but it can be much more consistent. Most frequently, the inconsistent trader is the one with the loosest rules.

Rules aid trading consistency.

When you are your own trading coach, you not only formulate your rules, but also must do so in a way as to maximize the odds that you will actually follow them. The key to successful rule-creation is the recognition that rules are more than thoughts that go into your head. *A good rule also comes with feelings attached:* an awareness of both the consequences of violating the rule and the benefits of following it. What keeps a diabetic person faithful to a diet or an eager child patiently waiting her turn to answer a question in class? It's not just the thought of the rule, but also the immediate sense of what would happen if the rule were violated. When people think, "I can get away with it," the rule loses its force: it's merely a set of empty words and good intentions.

This, then, is the secret to formulating trading rules, whether they relate to entries, exit, position sizing, stop-losses, diversification, or idea generation: *whenever you write down the rule or mentally rehearse it, make sure that you are emotionally connected to that rule.* Make yourself re-live situations in which you've violated the rule. Focus your attention on



successful episodes of trading in which you followed the rule. Make the rule more than a guideline; it should represent a belief and conviction. The best rules feel like *must*, not just *should*.

Your assignment is to take a thorough trading inventory of your trading rules. How many do you really have, and how explicit are they? Do you just remind yourself of them passively, or do you rehearse them with belief and conviction? If you're like most traders, you'll find that you have many loose guidelines, but few firm rules. That means that you haven't really drilled down to identify the patterns behind your best and worst trading, which really form the backbone of all good rules.

Rules should reflect best practices in trading.

Remember: *you can't follow a discipline that you never formulated in the first place*. The clearer the rules and the more you feel them, the stronger they will serve as brakes to your impulses and guides to your best behavior. Rules are not straightjackets; they free you up to be your best. Think of professions in which consistency is a virtue: airline pilots landing an aircraft, surgeons making incisions, racecar drivers maneuvering in a pack. The best performers are rule governed: they are keenly aware of the dangers of ignoring the rules of their profession. It is in the internalization of their rules that they achieve flawless execution. That is your goal in coaching yourself: to make rules so routine that they make extraordinary performance the norm.



#### COACHING CUE

Rule-following is a great basis for self-evaluation. Creating checklist report cards to track your rule governance helps ground you day to day in best practices. Among the rules you should consider formulating and tracking for self-assessment are:

- Rules for position sizing.
- Rules for limiting losses, per trade, per day, per week, etc.
- Rules for adding to existing positions.
- Rules for when you stop trading or limit your size/risk.
- Rules for increasing your size/risk, per trade, per day, etc.
- Rules for entering and exiting positions.
- Rules for preparing for the trading day/week.
- Rules for diversification among positions.

Not all these rules will apply to all traders; the key is to focus on the rules that capture your best trading and turn those into report cards for daily/weekly self-assessment and goal setting.

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## LESSON 38: RELAPSE AND REPETITION

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The greatest enemy of coaching is relapse. It is relatively easy to initiate change, but quite difficult to sustain it. Our old patterns are what come naturally: they're what we've been doing day after day, year after year. Those patterns are overlearned; they have been repeated so often that they have become automatic. If change efforts are not sustained, the automatic patterns naturally fill the void.

What this means in practice is that there is a certain series of stages to any change process:

**Phase One**—We repeat old patterns automatically, experience consequences, and try to avoid the consequences as much as possible.

**Phase Two**—Consequences of old patterns accumulate and we develop an awareness of the need to change, though we may not know how to change and may have ambivalent feelings about change.

**Phase Three**—We can no longer accept the negative consequences of our old ways and commit ourselves to making changes by trying to think and act differently.

**Phase Four**—We slide back into old patterns periodically when our change efforts lose momentum, creating oscillating periods of change and relapse.

**Phase Five**—We engage in new patterns sufficiently often that they become automatic, greatly reducing the relapse into old ways.

So let's take a practical example: In phase one, we are in an unfulfilling romantic relationship, but minimize the problems and try to go on from day to day. In phase two, we recognize that the problems are there, but wrestle with the question of whether we really want to rock the boat and raise concerns with our partner. Phase three brings clear awareness of the need for change and discussions at home to work out problems. Phase four sees periods of good times, interrupted by resumptions of the problematic interactions, perhaps aided by couples counseling. In phase five, we keep working on the counseling exercises, changing patterns of communication, until there are new and more constructive ways of engaging each other that have become routine.

*This step-wise scheme suggests that relapse is not merely a problem, it is a step on the road to change.* Few people change patterns all at once and for all time. More often, there is a tug-of-war between the old, overlearned patterns and the new, constructive ones we're working on. This tug-of-war occurs precisely because the new patterns have not yet been overlearned: it takes conscious effort to enact them. Early in the change process, we don't think about change; in the middle phases, we have to

think about change in a very conscious manner. Only late in the process do the new behaviors come more naturally and automatically.

In every change process, there is an intermediate phase in which old problem patterns coexist with new, positive ones. Relapse at this stage is the norm—not necessarily a sign of failure.

So what enables us to make the transition from effortful change to an internalization of new patterns so thorough that those patterns become second nature? If you think back to when you learned to drive a car, there was a period when you had to consciously focus on every aspect of driving, from signaling and making turns to changing lanes. Only with repeated experience did these activities become automatic, freeing you up to focus on road conditions when necessary, converse with passengers, and locate unfamiliar destinations. Similarly, repeated experience with new cognitive, emotional, and behavioral patterns in trading is what cements these patterns and frees you up to focus on markets. Relapse is overcome through repetition.

Only when new behaviors have been repeated many times, in many contexts, do they begin to become automatic, overcoming the tendency to relapse.

We saw in the lesson dealing with goal setting that, as your own trading coach, you don't want to set a goal one day, another goal the next day, and still a different one later that week. This is a common flaw with many trading journals. Traders take steps to initiate change—phases three and four above—but fail to cement the changes through repeated experience. It is far better to focus on one or two changes and institute those with regularity over a period of weeks and months than to try to make many changes in a short period of time.

Your assignment, following the discussion of rules from the previous chapter, is to review your current trading goals and assess *how well you sustain work on them day after day*. Ideally your goals—and the changes you attempt to make—should be expressed in such a manner that you will necessarily have to work on them each and every trading day. One way to foster this consistency is to generate a daily report card, in which you grade yourself on your enactment of the behaviors you try to cultivate. The goal is to achieve good grades each day, not just hit your targets on a particular occasion.

Similarly, if you are writing about your goal performance each day, the mere act of thinking about your new behaviors and evaluating them will serve as a kind of repetition. You're much more likely to stick with new behaviors if they command top-of-the mind awareness. Talk about the changes you're making, write about them, grade yourself daily on them and—most of all—enact them during each day's trade. As with the driving, before too long you'll find yourself doing the right things automatically. At that point, you don't need motivation; you've turned goals into habits.



#### COACHING CUE

Engage in an important goal-oriented pattern as your first activity of the day to build momentum for a purposeful day. I've worked with traders who stuck with their trading goals much better after they began programs of physical fitness. Their fitness work forced them to be goal-oriented to start their day, which carried over into their trading. You're not just training yourself to trade better; you're training yourself to sustain change efforts across all facets of life.

### LESSON 39: CREATE A SAFE ENVIRONMENT FOR CHANGE

In the last lesson, we took a look at the importance of repetition in cementing new patterns of thinking, feeling, and behaving. The single most common reason why skilled traders fail to coach themselves to higher levels of performance is that they *initiate* changes, but fail to *sustain* them. As soon as they make improvements, they relax their efforts and fall back into old ways. A successful coach knows when the opponent is on the ropes and doesn't let up. When you have a positive experience, you want it to be a motivation for further positive experiences, not a cue for complacency. The best coaching efforts develop a kind of momentum in that way, adding success to success and sustaining a sense of mastery and accomplishment.

The problem with experience is that it takes time. Particularly if you're a longer-time-frame trader, many weeks or months of trading may pass before you have the opportunity to build a large base of new experience. If only you could multiply your experience, you could accelerate your learning curve. Changes that would otherwise take months could be accomplished in a few weeks.

*The way that coaches in sports and the performing arts multiply experience is through repeated practice.* A team might only play opponents on the weekend, but will practice every day to prepare for the games. Similarly, actors and actresses will rehearse their lines every day before

opening the curtains for the actual production. During those practice sessions, performers condense the coaching process: they learn what they're doing right and wrong, make conscious efforts to repeat their positive performances and correct their faulty ones, and eventually reach the point where their efforts become natural and automatic. Practice is valuable, because it creates a safe environment for making mistakes. The game won't be on the line or the play won't be ruined if a performer tries something new and it falls flat in practice.

Rehearsal speeds the learning curve.

Practice can be very helpful to your efforts to coach yourself. If you identify a specific change to make, the place to begin is in simulated trading where no capital is at risk. This can occur in several different ways:

- **Simple Chart Review**—Sometimes the changes you make to your trading involve decisions regarding how you would enter, exit, or manage risk. When those are your goals, you can review charts and simply talk aloud the decisions you'd be making at each juncture. This lacks the realism of real-time trading (and cannot substitute for real-life experience), but it does slow the decision-making process down to the point where you can try new things in a very conscious, reflective manner. My favorite way of engaging in the chart review is to advance the chart on my screen one bar at a time and then talk aloud my perceptions and decisions. This is like first learning to drive a car by driving very slowly in a large, empty parking lot. It gives the learner plenty of time to crawl before walking and running.
- **Simulated Trading**—My charting software comes with a simulation feature in which I can place orders and track my profits and losses over time. This is helpful because you're making decisions with real market data in real time, but placing no capital at risk. By trading in simulation mode, you can gain many days' worth of experience in a single day. You can also focus your attention on the most problematic and challenging market occasions, concentrating your skill rehearsal in contexts that most call for your new patterns.
- **Trading with Reduced Size**—Not all of the changes I seek in my own trading are revolutionary. Some are evolutionary tweaks. Recently I altered the criteria by which I set profit targets, allowing me to hold certain trades for a bit longer. I reduced my trading size in half when I traded with the new criteria, knowing that the extended holding times would, by themselves, be uncomfortable for me. Once I developed a comfort level with the lowered size—and made my mistakes with the

smaller risk exposure—I then gradually returned to my prior level of risk.

Learning is best started in very safe environments and only later tackled in riskier situations. If you violate safety and security, you create distractions that interfere with learning.

Note that if I were to make radical changes in my trading—say, switch from trading equity indexes to trading agricultural commodities—I would need an extensive period of time with chart review and simulation prior to putting any capital at risk. Those more substantial changes take longer to internalize; there is a more extensive learning curve. On average, we'll make more mistakes when we attempt large changes rather than small tweaks. When you are your own coach, you provide more security and safety for big change efforts; the smaller pattern shifts can proceed with live trading and reduced risk exposure.

*One of the greatest mistakes traders make is to make a change once or twice and then jump immediately into larger risk-taking, giddy with the prospects of new returns from new habits.* It is not unusual in my coaching and trading experience for trading results to get worse before they get better when tackling meaningful changes in trading practice. Just as you wouldn't learn how to use the car's brakes and gearshift in a couple lessons and then jump into highway driving, you don't want to greatly alter your decision-making process while running full risk. As the *Enhancing Trader Performance* book stresses, the worst psychological mistake you can make is to traumatize yourself. If you create large drawdowns in your account because you weren't prepared for your changes, the result will be damaging to both your trading performance and to your self-coaching. You want to structure the change process as much as possible to provide frequent successes and no emotionally damaging losses. This is how you sustain confidence and self-efficacy, even as you make your mistakes.

*Many traders are too eager to trade.* They crave excitement and profits and find it difficult to trade in observation, simulation, and reduced risk modes. This short-circuits the process of generating repetitions that cement new patterns. Once traders undergo losses while making changes, they become self-doubting and pull back from their change efforts. Instead of generating success and confidence, traders learn to fear change. An important key to coaching yourself is to turn yourself into a generator of concentrated experience by making maximum use of practice and feedback. We often seek change after periods of loss; it's human nature to want to jump back into markets and regain the lost capital. But the goal is to instill the right trading behaviors, not to make money back all at once. If you internalize the right patterns, the results will naturally follow.



Your assignment is to embed concentrated learning into your schedule by allocating time for daily rehearsal of new skills and patterns. *An excellent goal is to generate two day's worth of learning experience into every day by rehearsing new patterns outside of trading hours as well as during them.* Replay market days, either in video mode or through a simulation platform that has a replay feature, to accomplish this goal.

I know from the traffic statistics on my blog and others that traders spend less time gathering market information after the close of trading and especially during weekends and holidays. Traders use the hours outside of trading to get away from markets. No one argues with the need for and desirability of life balance, but a nine-to-five approach will work no better in trading than it would in running a business or building a career as an artist, scientist, or athlete. When you read about elite performers in any field, one fact stands out: they are not the clock punchers. They are absorbed in their interests and, as a result, learn far more than others. They develop new skills and competencies far more readily than their peers simply because they multiply experience.

Many traders back away from the screen when they have trading problems, thereby reducing their experience. During the worst drawdowns, you want to minimize your trading and risk exposure, but maximize your work on markets.

When you create safe environments for changing yourself and your trading, you mimic the learning behaviors of the greats, from concert pianists to chess champions to Olympic athletes. When you start with practice that encourages errors and learning from them, development becomes a joy, not a burden. This is self-coaching at its finest.



#### COACHING CUE

The video recording of markets for later review is an excellent way to multiply experience. Replaying the market day allows you to watch patterns unfold again and again under different market conditions. Reviewing market moves that you missed sensitizes you to future occasions of opportunity.

### LESSON 40: USE IMAGERY TO ADVANCE THE CHANGE PROCESS

The previous two lessons have emphasized the importance of repetition in cementing new ways of behaving and unlearning old patterns. By creating new opportunities to rehearse fresh skills, insights, and behavior patterns



we accelerate their internalization, freeing our minds for the basic tasks of trading.

*A huge advantage of the human brain in this context is the ability to generate experience virtually, through the use of imagination.* If we vividly imagine a specific trading situation and visualize ourselves, step-by-step, enacting a new way of handling that situation, the mental rehearsal approaches the power of actual experience. You do not have to trade to rehearse many trading-related behaviors. By creating realistic situations in our minds and using imagination to summon our desired patterns, we can also cement these patterns.

A technique that makes use of this kind of visualization is the stress inoculation approach first described by Donald Meichenbaum. *By mentally summoning stressful market scenarios and imagining in detail how we want to respond to these, we inoculate ourselves against those stresses by priming our coping mechanisms.* This mental preparation can be applied to a range of situations, from ones that are psychologically challenging to those that require new trading methods.

Our coping is mobilized when we imagine anticipated stressful situations, preparing us for when those situations actually occur in trading.

The key to making effective use of imagery is ensuring that the imagery is vivid and evokes real feeling. Unlike a simple verbal repetition of a trading goal, imagery has the power to evoke the emotions associated with situations. This imagery turns the verbal recitation into a much closer approximation of trading experience. When we vividly imagine a trade going through our mental stop-loss level before we can execute an exit, we summon some of the fearful or frustrated feelings normally associated with unexpected loss. While we experience a mild version of the trading emotions (imagery can rarely fully duplicate actual experience), we can rehearse our best practices, keeping ourselves planful and disciplined in the face of stress. This mild exposure to the trading stress is like the body's exposure to a weak form of a virus: it inoculates because it is strong enough to arouse adaptive responses, but not so strong as to pose a major threat.

Few psychological techniques are as recognized and recommended as imagery, and few are executed as poorly. There are several facets of effective imagery exercises:

- **Specificity**—It's not good enough to imagine a stressful situation, such as losing money or missing an opportunity, in the abstract. The imagery should be very specific and guided, visualizing a specific market and market situation, specific price levels, and specific market

action. It is the realism of the imagery that enables the exercises to serve as substitutes for actual experience.

- **Dynamism**—The imagery should be more like a detailed, realistic movie rather than a broad, static snapshot. If you read a newspaper description of a situation, your reaction isn't as strong as it would be if you were to see the same situation dramatized in a movie. The dynamic nature of imagery is essential to its realism, which in turn is essential to the inoculation process. Flat, unconvincing images won't arouse our coping, and they surely won't be effective approximations of real trading experience.
- **Elaboration**—If I had to identify the most common shortcoming in people's use of imagery as a change technique, it would be their tendency to cut the imagery work short. Longer, more elaborated exposures to imagined challenges are more effective than very brief exposures. Indeed, if the exposures are too brief, you may unwittingly reinforce the pattern of fleeing from stresses! The best practice is to imagine a situation from beginning to end in elaborate detail—and *then repeat the scenario until it no longer evokes emotion*. This practice not only reinforces coping, but mastery and success.

An interesting technique from the behavioral literature is *flooding*: prolonged exposure to imagined situations that are highly stressful. Traders learn to stay in control even during a flood of stressful imagery, so they prepare themselves for most anything the markets throw at them.

- **Variation**—Traders commonly imagine a challenge scenario, evoke the imagery, and then quickly move on to something else. As we've already seen, repetition cements learning. By failing to use the principle of repetition in the area of imagery, traders open themselves to the risks of relapse. Once you evoke a detailed, realistic trading scenario and how you would handle it and once you repeat the scene to the point of mastery, you then want to create variations on the scenario. For instance, you might begin by imagining a frustration associated with a fast-moving market. If your goal were to learn new coping patterns during periods of frustration, you would master this first scenario and then create variations, such as frustrations associated with slow markets or not getting filled on orders. Vary the scenarios and you can generalize your learning and make it increasingly applicable to actual trading conditions.
- **Consistency**—Any single imagery session will not affect behavior over days and weeks. *It is the daily repetition of the sessions that*

*yield enduring results.* Many traders derive some benefit from initial imagery work and then promptly return to business as usual. Consistency in the use of the exercises ensures that the new patterns you're rehearsing will remain top of the mind over time. Frequent use of imagery work is a great way to sustain mindfulness about change and the need for change.

When you are your own trading coach, you want to *see* and *feel* yourself to be successful, not just engage in occasional thoughts of success. In your internal world, you can practice skills, engage in new thought patterns, and achieve goals with consistency long before you actually accomplish all of those in live trading. Your assignment is to generate powerful, elaborate imagery scenarios of stressful, challenging market situations; the thoughts, feelings, and behavior patterns associated with those; and the specific steps you want to take to master those situations. When you construct your guided imagery, you want to feel the emotions of fear, greed, frustration, and boredom and imagine yourself tempted to engage in your usual, negative patterns in response to those states. In your imagined scenario, you will vividly envision yourself keeping those negative patterns in check and purposefully enacting your best practices. Thus, for instance, you might imagine yourself tempted to add to a position when it goes through your stop-loss level, but checking that temptation and instead acting on the stop.

Imagination for the trader is the equivalent of a practice field for an athlete: a place to prepare for performance by creating simulated performance situations.

*You will be the trader you are capable of being in your imagery work and practice long before you consistently enact those ideals in your daily trading.* There is no reason to take months or years to change behavior patterns when you can make every day an experience of concentrated learning. Much of successful self-coaching is the result of a creative and tenacious use of imagery and practice.



#### COACHING CUE

Use your imagery to imagine yourself as the kind of trader you aspire to be: the risk taker, the disciplined decision maker, the patient executioner of ideas, the canny trader who learns from losing trades. If you create a role and an image of yourself in that role, you enact scenarios that, over time, become part of you.

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## RESOURCES

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The *Become Your Own Trading Coach* blog is the primary supplemental resource for this book. You can find links and additional posts on the topic of coaching processes at the home page on the blog for Chapter 4: <http://becomeyourowntradingcoach.blogspot.com/2008/08/daily-trading-coach-chapter-four-links.html>

Much of the framework discussed in this chapter comes from research into helping processes in brief therapy. Standard reference works in this area include the chapter on “Brief Therapy” written by Dewan, Steenbarger, and Greenberg for the volume *Textbook of Psychiatry (Fifth Edition, Volume 1)*, edited by Robert E. Hales, Stuart C. Yudofsky, and Glen O. Gabbard (American Psychiatric Publishing, 2008) and the chapter on “Brief Psychotherapies” by the same authors for the reference work *Psychiatry (Third Edition)*, edited by Allan Tasman, Jerald Kay, Jeffrey A. Lieberman, Michael B. First, and Mario Maj (Wiley, 2008).

An excellent framework for thinking about making the most of strengths is the Gallup research described in *Now, Discover Your Strengths*, written by Marcus Buckingham and Donald O. Clifton (The Free Press, 2001). See also the popular management text *Good to Great*, written by Jim Collins (Harper Business, 2001).

A full description of solution-focused work can be found in my chapter “Solution-Focused Brief Therapy: Doing What Works” in *The Art and Science of Brief Psychotherapies*, edited by Mantosh J. Dewan, Brett N. Steenbarger, and Roger P. Greenberg (American Psychiatric Publishing, 2004).

## CHAPTER 5

# Breaking Old Patterns

### *Psychodynamic Frameworks for Self-Coaching*

*The strangest and most fantastic fact about negative emotions is that people actually worship them.*

—P.D. Ouspensky

**T**o this point, we've been exploring processes that are common to all change efforts and all performance coaching. Now we begin a look at individual frameworks for coaching, beginning with psychodynamic modalities. These frameworks are approaches that emphasize the continuity of past and present—how old patterns replay themselves in the present—and the ways in which current relationships can remake patterns born of prior, negative relationship experiences.

The psychodynamic framework is more commonly connected to long-term psychoanalysis than to coaching, but I've found tremendous value in utilizing the medium of relationship experiences to help traders with their performance. This chapter will explain how psychodynamics are related to trading and how the dynamic framework can inform your own efforts at self-coaching.

I personally draw most upon dynamic modalities when I'm working on trading problems that are part of larger life challenges—particularly when those challenges have been part of our life histories prior to trading. Many issues that impact trading—concerns over success/failure, self-confidence/self-doubt, security/insecurity—predate our trading efforts, but play themselves out in how we make financial decisions.

The best way to describe psychodynamics is as a way of thinking, as well as a set of tools, to help ensure that people's pasts don't become their futures. And, in the context of this book, it all starts with a single insight:

we have relationships with our markets, and those relationships repeat patterns that we've enacted in other relationships. Let's take a look at how we break free of those patterns . . .

## **LESSON 41: PSYCHODYNAMICS: ESCAPE THE GRAVITY OF PAST RELATIONSHIPS**

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The psychodynamic approaches to change have evolved significantly from the psychoanalytic work of Sigmund Freud and the subsequent contributions of “neo-Freudians.” In the process of this evolution, psychodynamic thought has turned away from viewing instincts and sexuality as the primary basis for behavior and toward an interpersonal understanding of recurring conflicts and patterns. At the same time, psychodynamic psychology has also departed from the analytic couch and the presumption of therapy as a long-term process, emphasizing more active, shorter-term methods of change. Surprisingly, this evolution has largely taken place outside the public eye, contributing to a perception that analytic methods are outmoded and outdated. Nothing could be further from the truth.

*The core perspective of the psychodynamic model is that current problems are reenactments of conflicts and patterns from past relationships.* The self is viewed as the result of years of internalization of relationship experiences. When we enjoy positive, affirming relationships, we internalize a positive self-image and concept. Negative, conflicted relationships are internalized as a negative and conflicted sense of self. This perspective touches on one of the themes from earlier in this book: relationships serve as mirrors by which we experience ourselves. We are the sum of our significant relationship experiences.

Over the lifespan, we learn coping strategies (defenses) for dealing with the anxieties brought by relationship conflicts and their consequences. These defenses may be successful in warding off discomfort, but they tend to become outmoded in future relationships and life situations. When current situations trigger the feelings evoked by past relationship problems, our outmoded defenses lead us to behave in ways that bring unwanted outcomes. These patterns of feelings evoked from the past along with the defensive reactions and negative consequences constitute what Lester Luborsky calls core conflictual relationship themes. These themes repeat themselves in various ways, across various situations, causing us to behave in unwanted ways. The purpose of counseling and therapy, from this vantage point, is to free us from these cyclical maladaptive patterns.

When we “overreact” to situations, the odds are good that we're reacting to themes from our past as well as the current situations that trigger those themes.

To use an example from *The Psychology of Trading*, I grew up in a very close family. My parents were both estranged from their parents and vowed to create a very different family environment for their children. They were so successful in that regard that I sometimes felt that the environment was *too close*. I sought privacy, taking long bicycle rides, walks, and even showers. Later, when I met my wife Margie and became part of a household with her three children, I found myself taking long showers and withdrawing from family life. This disrupted morning routines and led to a bit of tension in the household.

For years I had lived alone and had never experienced the feeling of being too close to others. When I entered a new family situation, the old feelings from my formative experiences came back to me and I coped rigidly in my old way: by withdrawing and seeking privacy. What worked in childhood, however, failed dismally in the new family. By reenacting old defenses in new situations, I created a fresh set of problems.

*All of these defenses tend to happen automatically, outside of conscious awareness.* Without some way of making these repetitive patterns conscious, we cannot change them. One goal of psychodynamic work is to make the unconscious conscious: to make us self-aware, so that we can find new endings to old conflicts. I was able to change my patterns within the family once I recognized that I no longer needed to cope in ways from my past: my present family wasn't my former one, and I was no longer a child.

The first goal of psychodynamic work is insight: recognition and understanding of one's patterns and awareness of their limitations. The key insight is simply: You had a reason for doing this in the past; you don't have to do it any more.

So how does this relate to trading? *The risk and uncertainty of trading—the gains and losses, victories and defeats—have an uncanny way of triggering feelings from our past.* A classic example is the trader who felt as though he never measured up to his parents' standards and expectations. He brings his sense of inferiority to the markets, taking imprudent risks to prove that he truly is a success. Of course, no amount of winning in markets can fill the emotional void, leading him to take ever-greater risks, until he finally blows up—and confirms his worst fears. In such a situation, no tweaking of trading methods will solve the trader's problem. Until he resolves the conflict at the heart of his dilemma, he will continually find himself acting out his personal dramas in his trading.

Many trading problems are the result of acting out personal dramas in markets.



The best way to identify situations in which past conflicts intrude into current trading is to consult the feelings evoked by your trading problems. If they are similar to feelings you've experienced in past career and relationship situations, there's a good chance that they represent the leading edge of cyclical maladaptive patterns. For instance, if your frustration gets you into trouble in your trading and has also gotten you into trouble with friends and romantic partners, there's a clear pattern that transcends markets. If trading leaves you with the same conflicted, hurt feelings that you've experienced in your past, that's a sign that the past is refusing to stay in the past.

As your own trading coach, you sometimes need to dig beneath the surface of problems to discover their origins. This discovery must be accomplished by reviewing your personal history and mapping that history against recent experience. *In other words, you want to look not only at your current patterns, but past ones as well.* It's in the overlap that we can make greatest use of psychodynamic change methods.

Your assignment is to take a sheet of paper and draw two sets of sine waves, each with at least four peaks and four troughs. For the first set of sine waves, you'll mark the peaks with the "peak experiences" from your life: your most positive and fulfilling experiences. These experiences can be taken from any life sphere, from relationships to career. You'll label the troughs with the most negative experiences of your life, again from any sphere. These experiences will be those filled with the most emotional pain and distress. By the time you're finished, the first sine wave chart should be filled with the highlights and lowlights of your life.

When you're finished with the first set of sine waves, you'll fill out the second set similarly, *only you'll limit your entries to trading-related incidents.* Thus, you'll mark the peaks of the sine waves with your most positive and fulfilling trading experiences and the valleys of the sine waves with your most painful and upsetting market-related experiences. Make sure that all of your entries from both sets of sine waves are described in sufficient detail that you can readily appreciate *why* each incident was a peak or valley experience.

The real work comes in when you compare the peaks across the two sets of waves and the valleys. *You're looking for common themes that link your life experience with your trading experience.* Many of these commonalities will be at an emotional level. Here are some common ones to look out for:

- Themes of adequacy and inadequacy.
- Themes of rebellion against rules and discipline.
- Themes of boredom and risk taking.

- Themes of achievement/hopefulness and failure/discouragement.
- Themes of recognition and rejection.
- Themes of contentment/acceptance and anger/frustration.
- Themes of safety and danger.

*If the markets are making you feel the way you've felt during some of your life's valley experiences, consider the possibility that you've been caught in a web of repetitive conflict and coping.* Recognizing that web and keeping it firmly in mind is half the battle of changing it. As your own trading coach, you want to be mindful in your trading, not unconsciously repeating your past. It is much more difficult to fall into old, destructive patterns when you're clear on what those patterns are.



#### COACHING CUE

So often, we're fighting the last psychological battle. Identify the most recent conflicted relationship experience in your life and the thoughts, feelings, and behaviors evoked by that relationship. Then take a look at your most recent trading difficulties to see if similar thoughts, feelings, and behaviors are involved. Many times, it's not just early childhood relationships that color our current behavior, but the most recent sets of conflicts. Identifying how you resolved those problems in the relationship (or are taking steps to resolve them if they are current) can be very helpful in minimizing their spillover into trading.

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## LESSON 42: CRYSTALLIZE OUR REPETITIVE PATTERNS

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In the previous lesson, we used sine wave charts to identify peak and valley experiences from our life histories and from our trading. Once we have the sense that there are, indeed, commonalities, the next step is to crystallize these patterns so that we clearly understand why they exist and how they repeat themselves.

First, however, let's address the question of what it means if you cannot find common themes across the peaks and valleys of your charted experience. One possibility is that you need to draw more peaks and valleys on each chart before the themes will become salient. Another is that you are looking at the events logically, not psychologically. Examine the peaks and valleys for similarities of motivation and emotion, not surface detail. Many times the common elements will jump out when we think of the patterns as *emotional recurrences*.

Sometimes, though, there truly *aren't* links between our trading problems and our prior life's challenges. The trading problems may simply reflect shifting markets, a lack of skills and experience, or situational factors related to present-day distractions. If these are the most important sources of current trading difficulties, the psychodynamic approach will be less relevant to your change efforts. Rather, you may need to structure your learning process, as described in the *Enhancing Trader Performance* book, or you might need to adopt a framework that is more present-centered, such as the self-coaching approaches described in chapters 6 and 7.

Not all trading problems have an emotional genesis. Sometimes we just need to hone our trading skills.

In my experience, the most fertile area to seek for similarities between trading problems and prior life conflicts is in significant relationships: those with parents and romantic partners. *Conflicts with parents and lovers are usually among the most emotionally powerful, and are the ones we are most likely to defend against—and thus reenact—in our trading.* Once we crystallize those patterns, we can become quite adept at recognizing their reappearance. That is the first step toward short-circuiting them and providing them with a new ending.

One trader I worked with had numerous relationships with girlfriends over the years, but he never committed to any of them. Indeed, he often kept one relationship on the side in case his primary one ever fell through. He had lost a sibling when he was young; his parents, devastated by the loss, tried to forge on by not dwelling on the tragedy. Our trader learned to defend against loss by never getting too involved with another person. This defense kept him from reexperiencing the pain of the childhood event, but it also kept him from having a fulfilling emotional life.

So what do you think his trading problem was? Although he described himself as being passionately interested in trading, he in fact spent surprisingly little time at it. He undertraded markets—in other words ignored trading signals, traded with almost ludicrously small size—and he was easily distracted by communications in chat rooms and reading web sites. While he justified the latter as “preparation” for his trading, he never actually got around to trading seriously. Just as he avoided commitment and loss in relationships, he dabbled at the edges of markets, never achieving anything close to his potential.

To crystallize this pattern, a good place to begin is with *our underlying need*. The trader in the example above has an overwhelming need for safety and consequently takes the path in relationships and trading that seems safest. The feeling that he is guarding against is the pain of loss: the vulnerability of investing oneself and losing that emotional investment. The

trader was close to his sibling; he never truly recovered from the fallout of the loss. The way that he defends against that feeling is by keeping commitments at bay. He avoids becoming too involved with his relationships and trading so that he can never experience a loss as painful as that from his childhood. This leaves him with a host of negative consequences. Most of all, he feels empty, not truly fulfilled in love or career.

Most repetitive patterns can be broken down into this schematic of:

- **Need**—What we are missing, what we crave.
- **Feeling State**—Distress associated with not having that need met.
- **Defense**—What we do to cope and avoid the painful feeling state.
- **Repetitions**—How we replay defenses in current situations.
- **Consequences**—The negative outcomes from our current defensive efforts.

One trader I met with had an intense need for emotional support. His parents had divorced at an early age and his mother quickly remarried, forcing him to cope with joining a blended family. He frequently felt abandoned by his mother, and he felt not good enough to merit his (distant) father's involvement. His defense against these feelings was to take the role of overachiever, pushing himself to get the best grades at school, excel at athletics, and star in extracurricular activities. By doing more, he hoped to feel more worthy. As a result, however, he frequently drove himself to exhaustion and periods of hopelessness, as no amount of achievement could substitute for the parental love he missed. Unlike the trader from the prior example, he worked himself to the bone in trading, at times breaking down when his overachieving tendencies failed to bring results.

So this, as your own trading coach, is your psychodynamic challenge: *figure out your core need*. Most often, this will be something that you wanted in past relationships and could not consistently obtain. It might be autonomy, love, respect, or support. Once you identify that need, you want to review your valley experiences from your sine wave charts and clearly identify the feeling states that have been associated with the frustration of your core need. Maybe that feeling is depression and sadness, maybe it's anxiety, and maybe it's anger and frustration. This feeling, quite likely, will be the one that is repeated in your most difficult trading experiences.

The needs that are most unmet in our personal lives are the ones most likely to sabotage our trading.

Now reflect on how you try to make that feeling go away. That is your defensive pattern, your way of coping with the pain of needs going unmet. Most likely, this coping is what most immediately brings you difficulties in

your trading, causing you to overtrade, stand aside during times of opportunity, etc. *At these times, you're making trading decisions, not to manage your capital, but to manage the distress from those core conflicts.* Our worst trading occurs when we're managing our feelings rather than our positions.

Your assignment is to draw upon your sine wave charts from the previous lesson to map your trading problems as sequences of needs, feelings, coping/defenses, and consequences. You should be able to draw an accurate flow chart that shows how feelings associated with frustrated needs lead you to take actions that bring present-day problems. This chart will capture the focus of your psychodynamic self-coaching efforts. By breaking this pattern and inserting new elements, we can become more intentional in our trading, more self-determined in our results.



#### COACHING CUE

Most traders, I find, don't require long-term therapy. If traders are significantly troubled, they cannot sustain a trading career. Rather, they cope and function well, but periodically lapse into old patterns that interfere with their effectiveness. Many times, traders can identify their patterns by identifying their most frequent and costly departures from their trading plans and then noting the feelings and situations that accompanied these departures. By noting feelings from recent trading problems and then observing when you've felt those feelings in other areas of life, you can crystallize patterns that are most likely to impact future trading.

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### LESSON 43: CHALLENGE OUR DEFENSES

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A cardinal idea within psychodynamic work is that the problems that motivate people to make change efforts are rarely the core conflicts that they are repeating across situations. Rather, it's their *defending* against the pain of those conflicts that brings the unfortunate consequences and the recognition of the need for change. Our problems, from this vantage point, are the result of our rigid, outmoded coping. What worked for us at one time of life now works against us.

A good example from the markets is "revenge trading." This occurs when we trade more aggressively following losses in an attempt to get our money back all at once. Pain and frustration from a loss lead to an angry defensive response, an effort to get rid of the hurt. At that point, the trading

is not about opportunity; it's a defense to keep the feelings of disappointment and loss at bay. Of course, this often leads to further losses and a fresh set of consequences.

The defense is there because, deep down, the trader doesn't believe that she can tolerate the hurt or sadness of loss. Perhaps at one time of life such pain was indeed intolerable. Now, as a mature adult, the trader can handle normal losses, whether in business, markets, or love. It doesn't *feel* that way, however, and the trader continues to handle losses in the old, childhood ways. By crystallizing the pattern, the trader builds a self-observing capacity and a clearer awareness of the consequences of perpetuating old cycles. It is this heightened awareness that eventually enables the trader to challenge defenses and respond to old threats in new ways.

Change in the psychodynamic mode means doing what doesn't come naturally: refrain from the old ways of coping that keep unpleasant feelings at bay.

In your role as your own trading coach, you interrupt cyclical problems by becoming their observer, not the one caught inside the patterns. *By observing, you stand outside the cycles; they no longer consume you.* The sine wave and flow charts described earlier are useful tools in sustaining this self-awareness. Your goal is to recognize repetitive patterns *before* they have an opportunity to play themselves out to their unhappy conclusions.

One way of accomplishing this will form the basis for your next coaching task. You'll typically observe a pattern beginning to emerge when an associated feeling state interrupts your trading. In the revenge-trading example above, that characteristic feeling might be frustration and tension. In other situations, the feeling may be one of loss or emptiness. As soon as you notice the characteristic feeling, you want to acknowledge it out loud, almost as if you are a play-by-play sports announcer. For instance, you might say aloud, "I just took a loss and now I'm feeling really frustrated. I'm feeling mad, and I want to get my money back. I want to find another trade, but that's what's hurt me in the past. I jump back into the market and it makes things worse."

If you cannot invoke this self-observation aloud—perhaps because you're trading in a room with others—a psychological journal can accomplish the same function. The key is to describe in detail what you are thinking and feeling, what you are tempted to do to make the thoughts and feelings go away, and how this course of action has hurt you in the past. "I'm disgusted with myself and I want to just quit trading for the day," would be one self-observation from a trader who rides a cycle of aggressive trading,

losing money, guilt, withdrawal from markets, and renewed attempts at aggressive trading to make up for lost time and opportunity. You're taking the role of psychologist, identifying what is going on instead of identifying with it.

When you describe a pattern of behavior, you're no longer identified with it.

At this point, we're not concerned with changing the pattern. Rather, we're becoming more alert to its appearance and more aware of its manifestations and consequences. This can take days and even weeks of consistent effort as you sustain the stance of the self-observer. With this effort, it's inevitable that, at times, you'll interrupt the pattern entirely: you'll avoid the revenge trade or the overaggressive trade. Before you do the right things, you'll stop doing the wrong ones. This builds a sense of mastery and self-control: *you're starting to control the patterns instead of having them control you.*

Talking aloud and writing in journals, by themselves, will not rid you of overlearned behavior patterns, but they do provide you with options. Just by doing something different—even in small degree, such as placing much smaller revenge trades—you achieve a measure of control.

One type of talking aloud to gain self-awareness is to actively remind yourself that what is going on in the present is not really the problem. The problem is what happened and hurt you in the past, not what you are reacting (overreacting) to in the present. For instance, you might be losing money on a position prior to hitting your stop-out level. You catch yourself feeling fear and you're tempted to bail out of the trade prematurely. In addition to talking this fear and temptation aloud, you would remind yourself, "The loss on this particular position is not the real issue. I'm reacting to my losses from last year (or the loss of my relationship). Abandoning my trade idea isn't going to take away those old losses."

(Notice, of course, how this example presumes that you've allocated a responsible size to your position and a reasonable stop-loss level. If not, it could be your poor trading and not any problems from your past that would be triggering—quite reasonably!—your fear and desire to exit.)

What you're really emphasizing in this talking aloud is the message of, "The problem isn't my trading; it's something else." That frees you up to deal with the "something else" and not act out the past in the present. *It also frees you to simply deal with your trade as a trade and not as something more emotionally laden.* You'll know that you've made significant progress when you consistently catch your patterns as they unfold, maintaining the role of observer rather than passive participant.





## COACHING CUE

I've mentioned in this book and in *Enhancing Trader Performance* how video-taping markets can sensitize traders to patterns of supply and demand, aiding them in trading decisions. I've had traders turn the tables and turn the video-recorder on themselves, so that they're recording themselves as they trade. It's a great tool for self-observation and recognizing your emotional and behavioral patterns. After you've seen a few of your recurring cycles on tape, you become more sensitive to their appearance during real-time trading.

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## LESSON 44: ONCE AGAIN, WITH FEELING: GET DISTANCE FROM YOUR PROBLEM PATTERNS

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Two crucial transitions that occur in psychodynamic work are viewing your past patterns as alien to you and experiencing them as your own, personal obstacles. *Once you've become skilled at recognizing your old ways and their disruption of your trading, your next step is to distance yourself from them.* You will not gravitate toward ways of thinking, feeling, and acting if these patterns feel alien to you and if you view them as sources of pain.

A term commonly used in psychodynamic writing is *ego alien*. What that means is that some way of viewing the world, experiencing it, or acting within it has become foreign to one's sense of self. When a person starts to repeat a pattern that has become ego alien, the resulting thoughts are:

"This is not the real me."

"This is what I used to do; not what I want to be doing."

"I'm reacting to the past, not to what's happening now."

Of course, no one consciously owns destructive behavior patterns. It is easy, however, to repeat them unthinkingly. When we make those patterns ego-alien, we're not just thinking about them, *we're actively rejecting them.*

It's helpful in this regard to start thinking about the old me and the new me. The old me was afraid of failure and equated falling short with losing the love and approval of others. The new me realizes that the outcome of any single trade will not make me a better or worse human being. The old me became angry and frustrated when I couldn't get my way, because I hated feeling out of control. The new me controls my trading through my

planning and lets the market do what it will do. Notice how keeping a clear distinction between the old and new helps traders identify with positive, constructive patterns and maintain distance from old, automatic ones.

“Am I reacting to markets or to my feelings from the past?”—This is the question that follows from self-observation.

Another way to frame this distinction is to focus on “here’s what I do to make money; here’s what I do to lose money.” Whenever you entertain a certain thought or course of action, ask yourself, “Is this how I think/act when I make money, or is it how I think/act when I lose money?” Once again, by focusing on the likely outcomes of what you’re doing, you become the observer of your patterns and interrupt the automatic replaying of those patterns.

As we saw earlier in discussing the costs of patterns, focusing on the consequences of destructive patterns from the past not only keeps those patterns alien, but also heightens your motivation to not repeat them. If you recall a recent incident of losing money or opportunity as the result of falling into old habits, it is a great way to avoid making the same mistake again, particularly if that recollection highlights the monetary cost and emotional pain of the incident. In *The Psychology of Trading*, I emphasize the importance of treating old, negative patterns as an enemy. If you view something as an enemy, it’s difficult to embrace it and it becomes easier to sustain efforts at changing it.

Most people are uncomfortable with the emotion of hate. We’ve been taught that it’s not right to hate; that we should be nice to others. Hate, however, has its uses. Hate implies total rejection—a complete pushing away from the self. When we hate our past patterns, we are so attuned to their destructive consequences that we will move heaven and earth to not repeat them. The addict who has seen the destructive consequences of substance abuse learns to hate drugs; the person who has gone through a painful marriage and divorce to a narcissistic partner is so disgusted with the experience that she’ll never make that same mistake again. There is no question in my mind that I would not have found my life partner had I not had prior, unsatisfying relationships. I so hated the way I felt in bad relationships that I was absolutely determined to find something better.

When we hate how our old patterns have hurt us, we find a source of positive motivation: the drive for a better life.

There’s an old saw in Alcoholics Anonymous that alcohol abusers have to hit bottom before they sustain efforts at sobriety. Before serious

consequences have accumulated, it's all too easy to deny and minimize problems, putting them out of mind. When you hit bottom the consequences have gotten to the point where they cannot be ignored; they have inflicted too much pain and damage. At that point, people give up entirely, or they reach the point of hating what their habit has done to their lives. "I can't go back there again," is the feeling of many people who have reached that point of hate and disgust. At that point, the old ways are held at arm's length; there is no identification with them.

A great application of this idea (and worthwhile homework exercise) is to focus on one enemy that you want to conquer over the next month of trading. Your choice should be a pattern of thinking, feeling, and acting that has noticeably hurt your trading in the past several months, and it should be a pattern that you've observed in others areas of your life. This is especially powerful if, with your sine wave charts, you've observed damaging consequences of the pattern not only in trading but also in those other life areas. You can then call to mind all the pain that this pattern has caused you over the years and the prices you've paid for repeating the pattern. You declare that pattern your enemy and then you purposefully look for opportunities to confront this enemy in each day's trading.

Notice that this is different from simply observing a pattern as it's happening. Instead, you're actively *anticipating* the pattern and even looking forward to its appearance so that you have the opportunity to reject it. The trader's frame of mind becomes, "I'm not the problem; it's this old pattern that's the problem." Once you frame outmoded ways of thinking and acting as leftovers from the past that no longer work for you, you've taken a giant step toward freeing yourself from those patterns.

It will take sustained effort to tackle your enemy, but it can be tremendously fun and empowering as well. Each time you notice your old ways of losing money and refuse to engage in them, you've won a victory against your enemy—and struck a blow for your own sense of confidence and



#### COACHING CUE

One of the first enemies to tackle in self-coaching is procrastination. We procrastinate when we know we need to change, but cannot summon and sustain a sense of urgency. In that situation, procrastination itself becomes the pattern we must battle, as it robs us of the power to change our lives. Often, procrastination is itself a defense—a way of avoiding anxieties associated with anticipated changes. By starting with small, nonthreatening changes that we undertake every single day, we do battle with procrastination and build a sense of control and mastery over change processes. Big goals and radical changes often meet with procrastination. If you focus on intermediate goals that can be pursued regularly, you rob change of its threat value.

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mastery. *If you are highly competitive and achievement-oriented, ask yourself if you want to win your freedom of will or lose it to the repetition of your past.* The competitive soul does not want to lose and will fight an enemy to the death. A powerful aid to change is to use your competitive drive to defeat the enemies of your happiness: your internal demons.

## **LESSON 45: MAKE THE MOST OUT OF YOUR COACHING RELATIONSHIP**

One of the cardinal principles of psychodynamic work is that change often occurs in the context of relationships. When you are your own trading coach, one of your challenges is to surround yourself with the right kind of relationships: ones that support your goals and mirror to you the person and trader you're capable of being.

Consider two coaching scenarios in which I'm working with a trader at a trading firm. In both situations, the trader has lost more money than planned by exceeding position and loss limits. An entire week's profit is wiped out by the single day's loss. In the first scenario, I chide the trader:

*"How could you be so careless? You just ruined your week. Do you realize what will happen if you continue to do this? This is not a good time to be on the street looking for a firm hiring new traders."*

In the second scenario, I adopt a different tone:

*"C'mon, you're a better trader than that! Remember last month when you put together a string of winning days? You never needed to put on big size to do that. Let's see if we can get back to that great trading."*

The first interaction mirrors a sense of failure; "I'm so disappointed in you!" is the tone of the message. The approach also focuses on the negative, emphasizing the worst-case scenario.

The second scenario doesn't avoid the problem, but starts from the premise of good trading. It mirrors encouragement and a reminder of the trader's strengths.

Imagine that these interactions occur day after day, week after week. It's not difficult to see how the first approach would undercut a trader's security and confidence, leading to further bad trading. The second interaction would likely help a trader get back to trading well. It would coach success, not just the avoidance of failure.

*All traders inevitably coach themselves:* they always talk to themselves about performance, take action to improve performance, and keep

track of results. The only question is the degree to which this self-coaching is purposeful, guided, and constructive. From a psychodynamic perspective, your self-coaching is no different from a relationship with a professional coach: the dynamics of that relationship will serve as a mirror, and you'll tend to internalize what is reflected.

Our self-talk *is* our self-coaching.

What this means is that *how* you focus on your problem patterns from the past is crucial to the success of your self-coaching. You *are* going to fall back into old patterns sometimes; you *are* going to miss opportunities to enact new, positive patterns. There will be occasions in which you work hard to avoid one pattern, only to fall into another one. All of these situations can be discouraging and frustrating. Yet, as your own coach, you are tasked with the responsibility of maintaining a constructive relationship with you, your student.

"Comfort the afflicted and afflict the comfortable," is the way I described my approach to working with people in *The Psychology of Trading*. It's not a bad formulation for coaching oneself. When you're afflicted—suffering, hurting, losing—you want to be your own best support. When you're winning, you want to be afflicting yourself by doubling down on your discipline, alert to any overconfidence that might allow old habits to reenter your trade.

*A great exercise is to cull through your trading journal and examine the emotional tone of your writings.* Do they sound like positive coaching communications, or are they negative, frustrated, and blaming? Do they place equal emphasis on your progress and achievements, or do they harp on what you didn't do right?

The worst thing you can do as a trading coach is reenact old personal patterns by adopting the voice of a past figure who was part of the destructive cyclical conflicts that you're trying to move beyond. If you had a parent who was hostile and critical, one who couldn't be pleased; if you had a spouse who could not acknowledge your achievements or a resentful sibling, you don't want to replay their voices in your own self-coaching. How you treat yourself may well be part of the very pattern you're trying to change: working on your coaching voice is a great way to move that work forward.

Perfectionism is often a hostile, rejecting set of self-communications that masquerades as a drive for achievement.

One trader I work with actually talks to himself in the third person when he is in his self-coaching mode, reviewing his goals and performance in tape recordings that he then replays during breaks in the day. He might say, “Bill, today you need to be alert for your temptation to overtrade this market. That got you into trouble last week. We’re coming up to a Fed announcement and it’s unlikely that the market is going to move much until that’s out of the way. Let’s make sure you do it right this week!”

Day after day, listening to messages such as this, turns intentional coaching talk into internalized self-talk. After a long period of saying the right things, you’ll start to feel them and repeat them to yourself automatically. The coaching role, at that point, has truly become part of you. Conversely, if your self-coaching voice is one of frustration, you are cultivating a relationship with yourself that can only rob you of motivation and confidence over time. Many traders think they are pushing themselves to succeed when, in fact, all they are doing is replaying critical, hostile voices from past relationships.

One trader I worked with would make significant money with many more winning trades than losing ones, but you would never know it from the way he talked. He always focused on the losing trades, the trades that he could have left on longer for greater profits, and the trades he could have exited sooner. The basic message of his talk was that anything he did was not good enough. When it came time for him to increase his risk and pursue larger profits, he hit the wall and could not make the change. Days, weeks, and months of telling himself that his trading was not good enough undercut his ability to be confident trading large size. He thought he was coaching himself for success by refusing to be content with his gains, but in reality he was wounding his self-esteem.

A far different approach to self-coaching was exemplified by the trader who set challenging, but reachable, performance goals and then promised himself (and his wife) a long-awaited vacation abroad if he reached those goals. When he recruited his spouse into his efforts to improve his trading and chose an incentive that meant a great deal to both of them, he was able to sustain a positive motivation. This made their trip especially rewarding, as it was a tangible reminder of his success. In this situation, he cultivated a relationship with himself that fed self-esteem and mastery.

The central message of the psychodynamic approach is that we are the sum of our significant relationships. None of our relationships is quite so central as the one that we have with ourselves. *In coaching ourselves, we take control over our relationship to our self*; the voice that we use as coach will be the voice that enters our head when we tackle the risk and uncertainty of markets.

**COACHING CUE**

Coaches typically address their teams before a game to emphasize important lessons and build motivation. Consider addressing yourself before the start of market days, stressing your plans and goals for the session. Tape record your address and then review it midday. Pay particular attention to how you speak to yourself: it's much harder to lapse into negativity when you take the time to make your self-talk explicit and then approach that self-talk from the perspective of a listener.

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**LESSON 46: FIND POSITIVE TRADING RELATIONSHIPS**

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Why do people hire a personal trainer to help them get into shape when they already know which exercises they should be doing? Why does a hedge fund hire a coach to work with experienced portfolio managers, when those managers know far more about the business than the coach? Why do elite athletes who have more skills than anyone they could possibly hire still rely on performance coaches?

An understanding of the psychodynamics of personal change makes the answers to these questions perfectly clear. In each case, hiring a coach or trainer takes an individual development process and turns it into an interpersonal process. This is one of the most powerful steps anyone can take toward accelerating their learning curves, but it is poorly understood.

*When you pursue a goal with other people, you add a new source of motivation to your efforts.* We know from the research in psychology that the most important ingredient in counseling and therapy outcomes is the quality of the relationship between the client and the helper. This makes sense: when the helper is valued, the client wants to not only make changes for himself, but also for the counselor. You don't want to let down someone you value and who's working for you. If you decide to go to the gym every other day to work out and get into shape, it's easy to skip a day here or there. But if you make that commitment with a close friend, you won't want to disappoint that person. You're more likely to stick to your plans.

Making a commitment to change to others adds a layer of motivation and helps the other person motivate you.

Bring another person into change efforts and you will introduce a new source of mirroring. A good athletic trainer will provide you with feedback



about how you're doing and will keep your motivation up, even as you seem to plateau in your efforts. One of the helpers at a diet center will help you track your weight loss, providing you with positive feedback when you're working the plan. Day after day, exposure to this encouragement makes it easier for you to generate your own encouraging self-talk. You become your own coach, in part, by internalizing the role of an actual helper.

To achieve this benefit, it is not necessary that your mentor be professionally trained or that your relationship with them be a commercial one. Alcoholics Anonymous is a great example of a peer organization in which experienced members aid newcomers. The group meetings provide a supportive environment for change; the slogans and readings provide a shared set of beliefs and commitments; and the relationship with a sponsor provides the motivation of working with someone who cares about your life. *The net effect is to mirror a new identity for the participant*: an identity as a recovering person, not simply that of a failed addict.

As a trading coach, I work hard to take money out of the equation with the traders and portfolio managers I work with. I routinely receive phone calls and e-mail from traders who update me on their progress. I wouldn't think of billing for that. That's not because I'm an altruist; it's because I want to emphasize that this isn't simply about the money. I want no impediments to a trader calling me, and I want the trader calling me because I care about what happens to them, not because I want to generate a billing. For me, it's about the relationship and doing everything I can to aid the trader's happiness and success, and my hope is that it becomes that way for the traders as well. Frequently, my motivation to see the trader succeed carries him through the rocky periods of self-doubt. It's easier for me to see his strengths than it is for him at such times.

A good coach is one who never loses sight of the best within you.

As your own trading coach, you don't need to hire someone like me in order to make meaningful change or to extend your change efforts to an interpersonal context. Rather, you can maximize your efforts at self-development *by creating your own performance team*—a group of like-minded, mutually concerned peers who help each other. If I were going into full-time trading, one of my first steps would be to scour blog comments, forum postings, conference attendees, and similar gatherings of traders to find people who trade my markets and take trading seriously. I wouldn't need clones, just traders who are compatible with me in their trading instruments and time frames. I would then reach out to form what I call *virtual trading groups*: a group of peers who trade their own capital, but freely share ideas and help one another. The group would have to be chosen carefully, and all participants would have to share their

trade ideas and trading results completely freely. In such an environment, the group members could cross-fertilize each other's views, support one another during difficult periods, and learn from one another. A particularly valuable function within such a group would be peer mentoring, similar to the mutual assistance within Alcoholics Anonymous.

StockTickr ([www.stocktickr.com](http://www.stocktickr.com)) has been active in facilitating trading groups and communities, with an eye toward improving performance.

Even if you just find one or two supportive peers to share ideas and results with, you've taken an important step to create a fresh, interpersonal context for the changes you're trying to make. If you choose your peers wisely, they will challenge you, support you, learn from you, and teach you. Because you value them and don't want to let them down, you'll be more likely to stick to your preparation, discipline, and goals.

*A little-appreciated piece of psychological wisdom is to find social contexts to be the person (trader) you want to be.* Over time, the feedback and responses from others will mirror the best of you to you and that ideal self will become an increasing part of you. When you're your own trading coach, you don't need to do everything yourself. A cardinal principle underlying the psychodynamic framework is that the best changes are the result of powerful, emotional relationship experiences.

Your assignment is to find just one person to be part of your team: someone whose developmental efforts you can support, and someone who will support your own. Out of that relationship may spring many more—a network of dedicated professionals mentoring and motivating each other. When you turn trading into a relationship experience, you gain role models, become a role model, learn from others, and benefit from teaching others. You add fresh ways to experience your strengths, even as you build on them.



#### COACHING CUE

Online trading rooms are excellent venues for meeting like-minded traders, and they can be powerful learning tools. Several long-standing ones are Linda Bradford Raschke's trading room, which emphasizes technical trading across multiple markets ([www.lbrgroup.com](http://www.lbrgroup.com)); the Market Profile-oriented Institute of Auction Market Theory room run by Bill Duryea ([www.instituteofauctionmarkettheory.com](http://www.instituteofauctionmarkettheory.com)); and the trading room run by John Carter and Hubert Senters ([www.tradethemarkets.com](http://www.tradethemarkets.com)). Also take a look at the Market Profile-related educational programs run by Jim Dalton and Terry Liberman ([www.marketsinrprofile.com](http://www.marketsinrprofile.com)) as possible venues for connecting with like-minded traders. Two well-known

trading forums are Elite Trader ([www.elitetrader.com](http://www.elitetrader.com)) and Trade2Win ([www.trade2win.com](http://www.trade2win.com)). Both can be ways of sharing information with other traders and connecting with peers. For those developing trading systems, the community that has developed around the TradeStation platform ([www.tradestation.com](http://www.tradestation.com)) is worth checking out. Indeed, if you have a favorite trading platform or application, connecting with others who are using the same tools can be quite valuable. Market Delta ([www.marketdelta.com](http://www.marketdelta.com)) runs educational programs for users and maintains a Web presence for users, as does Trade Ideas ([www.tradeideas.com](http://www.tradeideas.com)); these are two trading applications I've found useful.

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## LESSON 47: TOLERATE DISCOMFORT

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An important insight from psychodynamic psychology is that our defenses—the ways we cope with the pain from past patterns of conflict—can take a physical manifestation. Consider a trader who is caught in a losing position. He watches, tick after tick, as the trade grinds against him. Gradually, he becomes tenser: he hunches over the screen, tightens his neck and forehead muscles, and grips his mouse tightly. *This physical tension can be seen as a defensive strategy.* This strategy cuts off other, threatening physical and emotional experiences. Perhaps the trader would love to yell and curse, but is afraid to lose control. Perhaps the trader just wants to cry, saddened by a series of needless losses. Not wanting to seem weak, he holds back the tears with his tension.

There are many other physical manifestations of defense. Consider the trader who is conflicted about acting on a well-researched trading signal. As his anxiety mounts, he tells himself that the market is too uncertain and he walks away from the screen, only to find that his signal was valid after all. His avoidant defense—leaving the situation—temporarily defuses his nervousness, but it also keeps him from figuring markets out and acting on opportunity.

Still another physical defense occurs when traders act out of frustration, pounding a table, throwing their mouse, or cursing loudly and blaming unseen others for their losses. By venting their feelings, they avoid introspection and self-responsibility. Their defense is against the guilt and the awareness that they have been hurting their portfolios.

Often we use our bodies to keep our feelings out of sight, out of mind.

One of my subtle defenses is that, when I sense a position isn't going my way, I'll begin a frantic scan of information to validate my idea. Of

course, I'm defending against the feeling of being wrong and I'm looking desperately for reasons to stay in the trade and undo the loss. This reaction generally makes the situation much worse. I've learned that if I'm behaving frantically in a trade, there's usually good reason for my feelings and I need to listen to them.

Recall that in psychodynamic theory defenses are coping strategies that protect us from the emotional pain of past conflicts. One of the most basic defenses is repression: keeping thoughts, feelings, and memories out of conscious awareness so that they cannot trouble us. *The problem with repression, of course, is that a conflict repressed is a conflict that remains unresolved.* We can't overcome something if we remain unaware of its presence. Many traders use their bodies to repress their minds: their physical tension binds them, restricting the physical and emotional expression of feelings. I've met traders who were quite tight physically and yet who had no insight into the degree and nature of their emotional stresses. In an odd way, getting tense was their way of coping: they were always mobilized for danger, tightly keeping themselves in control. *It is difficult to stay in touch with the subtle cues of trading hunches—the implicit knowledge we derive from years of pattern recognition—when our bodies are screaming with tension and even pain.*

In your self-coaching, it takes more than a willingness to interrupt these defensive patterns to make the most of them. What is also needed is the ability to focus on the feelings being defended against. The questions you want to ask yourself are: "What feelings am I holding off when I'm tensing my muscles?" and "What am I trying to avoid by blaming others or by walking away from the screen?" The idea is to hold off on that defense—purposely relax the muscles, turn the focus inward, stay in front of the screen—and *simply experience the feelings that are threatening.*

In psychodynamic work this is known as facing or confronting one's defenses. In counseling, for example, a client might begin talking about her painful relationship experiences and then suddenly change the topic and begin talking about her children and how they are doing in school. I might gently point out the change of topic to the client, explaining that it's perhaps easier for her to talk about her children than about herself. She then resumes discussing her relationship, and new information—and a flood of feelings—comes forth, followed by memories of her bad relationship with her father. *Breaking through the defenses leads to an emotional breakthrough:* she becomes aware of suppressed and repressed feelings and their depth.

Psychodynamic therapists are quite familiar with this phenomenon: when you get in touch with repressed thoughts, feelings, and impulses, the result is a fresh emotional awareness of your situation. *Your perspective changes when your emotional state and awareness change.*

This shift often leads to new insights and new inspirations for dealing with difficult conflicts.

When you feel in new ways, you often see in new ways as well.

This emotional work can be conducted effectively through guided imagery. If you vividly imagine a market situation that leads you to tense up or lash out in frustration, you can reenter your frame of mind at that time and see what it feels like to not engage in those defenses. Very often a different set of feelings will emerge in the situation: ones that you hadn't been aware of. For example, when you refuse to shout and blame others, you may find that you feel saddened for yourself, pained at your losses. This frees you to address the pain and support yourself, rather than bury the feelings beneath a show of anger.

Enhanced emotional awareness can lead to a feeling of empowerment, not greater distress. A good psychodynamic counselor or therapist will *challenge* our defenses, not letting us get away with the various strategies we use to keep difficult feelings at bay. *What results is awareness that the feelings we've been avoiding are not so devastating after all.* Perhaps at one time in life, when we were young and more vulnerable, we couldn't cope with those feelings and had to do our best to erase them. Now, as mature adults, we don't have to run. Feeling our most threatening emotions and seeing, at the end of it all, that we had nothing so terrible to fear after all is a tremendously powerful and empowering experience.

So what are you running from? *Think of your worst trading patterns as defensive maneuvers: actions you're taking to ward off emotional pain.* Then, when you refuse to act on those patterns, just sit with the experience and see what you feel. See if you can find a different way to handle that feeling. Very, very often, beneath our impulsive trading, our anxious avoidance of risk, our outbursts, and our mismanagement of risk are efforts to protect us from a painful emotional experience. Once you find that experience and contact those feelings, you find there's nothing to run from. You can handle loss, fears of failure, and disappointment. As your coach, you only need to prove that to you.



#### COACHING CUE

Massage can be an excellent tool for reducing physical tension, but also for learning about your body's pattern of tension. When you become more aware of your body, you can catch yourself tensing muscles and restricting your breathing and then make conscious efforts to relax. When you relax in this manner by loosening muscles and deepening breathing, you are opening yourself to emotional experience—and new ways of handling your feelings.

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**LESSON 48: MASTER TRANSFERENCE**

When I was in graduate school, I entered psychoanalytic therapy during my internship year in New York. The therapist's office was in his home in a typical Manhattan high rise. Many of the issues I wanted to work on pertained to rebellion against authority, a pattern that appeared in various work and school settings. I generally tried to please those who supervised me. If I couldn't win their approval, I became quite rebellious. I particularly did not like the feeling of being controlled by others. If there was a hint of coercion in a working relationship, I pushed back—sometimes quite hard.

When I arrived at my therapist's office, I noticed that the keys had been left in the door. I pocketed the keys, knocked on the door, met my therapist, and began the session. A few minutes into the session, the therapist's wife—mortified to interrupt our session—entered the office to ask her husband if he had the house keys. I reached into my pocket, smiled at her, and handed them over with a wink. Not a bad start for a first session.

Well, you don't have to be a Freudian to have a field day with my therapy session, even apart from the sexual symbolism of the keys. I had the keys and I had control. When the wife needed something, I was the one to give it to her.

To my therapist's everlasting credit, he responded very well to the situation, didn't get defensive, but also didn't ignore the matter. He encouraged me to join him in reflecting on what had happened and why it happened. That's the psychodynamic way: you use your relationship as a medium for dealing with repeated conflicts from the past.

What the therapist recognized, of course, was *transference*. Transference, in psychodynamic jargon, refers to the transferring of conflicts from the past to the present day. In other words, I was reacting to my therapist the way I might have reacted to my father or boss.

Had the therapist become hostile and defensive (reactions he would have been entitled to, given that I had pocketed his keys!), I would have stayed in my rebellious stance. Indeed, such a reaction by the therapist would likely have fallen into the trap of confirming my worst fears about authority figures. By refusing to budge from his professionalism, he disconfirmed my expectations and took himself out of the authority role. That gave me the space to take a look at what I was doing in this and other relationships and why I was doing it. Eventually I came to recognize that my need to take control in relationships stemmed from weakness and fear, not from strength. I learned that I could achieve far better control by using my relationship skills to engage people constructively.

The curative force in psychodynamic work is the use of the relationship to create new, positive, powerful emotional experiences.



It is not unusual for traders to personalize markets. Sometimes we view markets as dangerous, as out to get us, as rigged games, as treasure chests, as playgrounds, or as complex puzzles. When we attribute human characteristics to markets, we have to ask ourselves why we choose some qualities over others. *Just as I projected authority onto my therapist, we project the qualities we most struggle with onto markets.* This is a kind of transference. If we've lived for years with the sense that no one listened to us, we now feel that markets are irrational and capricious. If we've felt that others have taken advantage of us, we may just focus our frustration on the market makers who manipulate markets to our detriment.

*The idea of transference suggests that what most frustrates us about markets is most likely to be something that has frustrated us in our past—and probably in relationships.* In a very important sense, we have relationships to the markets we trade, and it's not unusual for us to imbue those relationships with the same qualities that bedevil our personal relationships. When we act out past patterns with current markets, we're no longer responding to objective demand and supply; lost in our own patterns, we become blind to those of our markets.

We can see examples of transference in our dealings with trading partners as well. Very often, how a trader interacts with me reflects how she is dealing with markets. Some traders will avoid interaction with me out of embarrassment due to recent losses. These same traders enact avoidant patterns in their trading, neglecting to limit losses, neglecting their preparation. Other traders take a helpless stance with me during coaching, almost begging to be spoon-fed answers rather than trying methods out for themselves. These same traders become passive in difficult markets, giving up readily, displaying little resilience after normal losses. One advantage of sharing your trading with a peer mentor or a group of like-minded traders is that you can monitor how you engage them and how they deal with you. Not infrequently, the patterns that show up in your dealings with traders will reflect the patterns you need to work on in your trading. Patterns of overconfidence, avoidance, rationalization—all come out in our social interactions.

Your greatest shortcomings in dealing with relationships will find expression in markets.

How do you view the markets you trade? What do you say about markets when you're most upset about trading? If you were to draw a picture of your markets or describe them to a nontrader, how would you depict them? A worthwhile assignment is to review your journal and track your self-talk for anything you might say to personalize markets and trading.



As your own trading coach, you have the ability to create your own trading experiences. By controlling your risk exposure, executing trades only when there is a favorable reward-to-risk ratio, and limiting your setups to clear, tested patterns, you have the opportunity to create trading experiences that don't follow the transference script—much as my therapist refused to accept the role I had cast for him. If your problem is handling frustration, your challenge is to create manageable frustrations in how you approach markets. If your pattern is escapism, your task is to find safe ways of staying in trades, in accordance with plans.

Create trading experiences in which you can safely face your fears and constructively give voice to frustrations. That experience provides new endings to old scripts.

When we project hated qualities onto markets, we divide ourselves. Part of us fights the trading process and part of us tries to stay absorbed in it. Thus distracted and divided, we are less able to pick up on market patterns and shifts among those.

There's a saying traders use: "Let the market come to you." What that implies is that you should approach markets with an open mind, processing patterns as they unfold. This means being free of projections, free of conflicts that we transfer to our trading. By tracking how you talk to markets—and about them—you can step back from those repetitive themes and truly let markets come to you.



#### COACHING CUE

You can see from the foregoing discussion why it is so important psychologically to reduce your trading size/risk when you are experiencing trading difficulties. This provides a safe context for trying out new ideas and tweaking your methods, so that you can face market problems directly and constructively rather than respond with defensiveness. When we make our trading more planned and rule-governed, we create experiences of control. When we reduce risk, we create experiences of safety. The essence of self-coaching in the psychodynamic mode is to generate new and powerful experiences that change how we deal with self, others, and world. Fashioning new trading experiences enables you to experience your trading and your markets in fresh ways that open the door to opportunity.

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## LESSON 49: THE POWER OF DISCREPANCY

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A cornerstone of the psychodynamic framework is that talk alone does not generate lasting change. Rather, as we saw in the last lesson, we change through new, powerful emotional experiences. These experiences are powerful precisely because they undercut our worst fears and expectations and show us that we can, indeed, master the past conflicts and feelings that were once overwhelming.

*We can think of this change process as generating new endings to old stories.* Perhaps my old story is that I am fearful of loss, having been through traumatizing losses in my past, either as a trader or predating my trading career. Out of this fear of loss, I find it impossible to hold trades until their logical stop-loss or profit targets have been hit. Invariably I become so concerned with protecting a gain or minimizing a loss that I front-run my trading plan and exit early.

Note that this pattern is a defensive one: I am trying to ward off the discomfort of loss by getting out of the market prematurely. The cost of that pattern is that I never fully participate in the upside of my ideas, leaving me to chop around in my P/L. As long as I continue to act on that pattern, I never stay in touch with that fear of loss and thus can never master that fear. Repeating the pattern simply reinforces it.

So what we need in psychodynamic work is a new ending to the scenario. We need to refuse to indulge in the defense and purposefully sit in the trade, while allowing the feeling of fear to remain. The idea is that, at one point of time in our lives, this fear was too threatening to sit with. Now, however, at a new life period when you have more resources, you can handle the fear. You don't *need* to continue to defend against it. Getting in touch with your basic conflict and its emotions—the things you have been most defending against—is crucial to the psychodynamic change process.

The psychodynamic change process can be schematized as a sequence:

- Identify your recurring problem patterns.
- Connect yourself to the costs and consequences of those patterns.
- Identify what those patterns are defending against (what you are avoiding).
- Create experiences, particularly in relationships, for facing what you've been avoiding.
- Repeat these experiences across different relationships to internalize new, constructive ways of coping.

Your problems, this view emphasizes, are simply ways of protecting you from fearful memories, feelings, or desires. Once you experience

those fears and acknowledge them, the challenge is to channel the fear in a way that does not derail your trading plan. You could talk with a trading colleague to gain some perspective, perform some exercises to calm yourself down and reassure yourself, or use the opportunity to write in your journal and remain an observer to the anxiety rather than the one immersed in it.

*By refusing to act on the old defensive pattern, you guarantee yourself a psychologically helpful outcome.* This is very important. As long as your position is sized properly with appropriate risk/reward in the placement of stops and targets, one of two things will happen: you'll either hit your target and make your money or you'll get stopped out at your predetermined level.

While the latter scenario is less desirable than the first, neither scenario is catastrophic. By acting in a manner that is discrepant from your old pattern, you have created a win-win: either you make money, or you find out—in your own experience—that the loss was not so bad after all and nothing to fear. In some ways, it's this latter experience that is the most helpful. By facing your worst-case scenario and seeing that it's something you can, indeed, cope with, you generate a tremendous sense of confidence and mastery.

Trading well is a powerful source of new, positive emotional experiences.

There are many ways of constructing discrepant experiences. One is to surround yourself with people who respond differently to you than those from your past and let them be a part of the changes you're working on. They can then support you in not repeating old patterns, but also in providing positive feedback when you enact new, positive ones. Another way to generate discrepancy is to face uncomfortable situations directly, refusing to engage in old defensive maneuvers. Once you get in touch with the feelings you've been holding at bay, you'll be surprised at how readily you can arrive at ways of coping with them that provide you with the new, constructive endings.

A term used by psychodynamic therapists Alexander and French captures the essence of this approach: *corrective emotional experience*. What enables people to overcome their problem patterns is a set of emotional experiences that correct the learning that occurred during times of past conflict. *It's not enough to perceive a problem and think about it; as your own trading coach, you need to create experiences that enable you to move past that problem.* Invariably this means refusing to keep difficult feelings buried and, instead, experience them fully and face them

directly. When you see that you can live through your emotional worst-case scenarios and emerge with no lasting damage, *that* is the corrective emotional experience.

Your assignment, then, is to conduct a personal experiment and seek just one corrective emotional experience during the trading day. Identify the repetitive trading behaviors that most disrupt your trading and then figure out what you would be thinking and feeling if you *didn't* engage in those behaviors. When a situation arises in which you would normally repeat your pattern, make the effort to hold off and experience those feelings you identified. See what those feelings are like, see how you cope with them, and see how the new coping affects your trading. You may be surprised to find that facing your fears is the best way of moving past them.



#### COACHING CUE

If you have a trading mentor, someone you respect and admire, try trading like that person just for one day. Do everything as you think they would do it. See how you feel with the discrepant experience, as the enactment forces you to forego your own negative patterns. In enacting an ideal pattern, you create new experiences with markets that undercut old, repetitive patterns.

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### LESSON 50: WORKING THROUGH

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The term “working through” has a specific meaning in psychodynamic work. Once you have made initial changes—breaking old patterns of defense, facing challenging emotional conflicts, and finding new ways of dealing with those—the working-through process involves extending these gains by repeating the process across a variety of situations. As we’ve seen, *repetition combats relapse*: working a problem through a number of relationship situations cements new, mature ways of handling core conflicts.

A classic example is the trader who avoids closeness in relationships out of fear of rejection. Sure enough, in his relationship with his counselor, he transfers his past fears to the present relationship and avoids intimate topics. While this provides a superficial sense of safety, it prevents the trader from talking about what is truly important—and moving beyond it. Once the trader makes a conscious effort to open up in the sessions, the counselor provides the discrepant response by not being rejecting. This makes it easier over time to break the pattern with the counselor in future sessions and remain open.

In the working-through process, the trader in our example would take the progress with the counselor and now apply it to other relationships, as

appropriate: friendships, close work relationships, and romantic relationships. By working through the conflict in multiple situations, new, positive patterns are cemented. The positive mirroring of many relationships enables the trader to internalize a sense of safety and security, which can be carried forward to a variety of life situations. In other words, it's not a single corrective emotional experience but multiple such experiences that enable us to internalize a new sense of self.

Successful self-coaching builds multiple corrective emotional experiences, so that new, constructive patterns can be internalized.

After all, this really is the essence of psychodynamic work: redefining the self by creating and absorbing so many impactful, constructive experiences that it becomes impossible to remain stuck in the past. I internalized the identity of an author not just by writing articles and books, but also by interacting with editors and readers over time. There was a time when I sat in front of a blank screen in writer's block mode, concerned that what I wrote would not find a receptive audience. Following multiple positive experiences with writings and readers, that is no longer a concern. The writing flows as naturally as conversation.

Similarly, there may have been a time when you thought of yourself as a small, beginning trader. Over months and years of trading experience, making money and building your account, you no longer see yourself as a newbie. Through the positive experiences, you absorb the identity of an experienced, skilled trader. Think back to the process of expertise development from *Enhancing Trader Performance*: the steps that build skills are also the steps that construct identity. Working the learning curve, moving from novice trader to competent trader to expert trader is more than building knowledge and skills. It is a transformation of self as the result of repeated, positive experience.

Your training as a trader should provide ongoing corrective emotional experiences: training itself becomes a means of working through our shortcomings.

When you're at the point of working through, you want to be an active experience generator and tackle your patterns in as many situations as possible, giving yourself the opportunity to enact new ones. As prior lessons have emphasized, and as you'll detect from the advice of experienced traders in Chapter 9, this is particularly powerful if you're working problems through with the support of trading peers. Their mirroring of

your success, like the feedback that solidified my identity as an author, will enable you to literally take your changes to heart.

Your efforts at self-coaching in the psychodynamic mode will find their greatest success if you can disrupt old patterns and enact new ones *on a daily basis*, with the active feedback of those you're working with. Many traders I've known have sought to keep their specific trading performance secret, obviously embarrassed that they're not making more money. They freely talk about winning days, but remain strangely vague or silent following bad ones. This is exactly the opposite approach to the one that will work for you. *You want to be visible, warts and all, because that will help you—emotionally—put those warts into perspective.* If your flaws (or your concerns about others' reactions to those flaws) are so threatening that you must hide them, then your defenses control you. When you can make yourself completely visible to others, you have nothing to hide. Their acceptance of you is complete and genuine, not a false reflection of a false self.

A while ago, when I was posting my trades live to the Web via the *TraderFeed* blog, I invited readers to join me and post their trades as well. The daily count of unique visitors at that time was around 2,000; I figured that, even if just one-half of 1 percent took me up on the offer, we could get 10 different models of trading to learn from. Well, out of 2,000 people, only one showed tentative interest. No one was willing to go public with his trading.

*That, dear reader, is how losers react.* If readers were taking a psychodynamic approach to change, they would freely share their trades in real time and make no effort whatsoever to maintain false selves. Over time, their progress would be evident and the massive positive feedback they would generate would cement a new identity, a deep sense of security, and an emotional fearlessness.

Accountability provides powerful opportunities to work through our greatest insecurities.

Your challenge for this lesson is to open the kimono and conduct your working-through socially, with the feedback of people you respect. This would be part of a daily trading plan, ensuring that you're generating corrective emotional experiences every single day. Several traders I know have taken precisely that approach by starting their own blogs, posting their trades, and developing relationships with the traders who responded constructively to their ideas. *Relationships are a powerful medium for change, perhaps the most powerful.* If you harness the right relationships you will give your self-coaching a reality that transcends simple entries in a trading journal.



**COACHING CUE**

Find at least one person to whom you are accountable for your development as a trader. This should be someone you can trust in sharing your P/L, your trading journals, and your tracking of personal goals. A major advantage enjoyed by traders at professional trading firms is that they are automatically accountable for performance and can thus openly discuss success and failure with mentors and risk managers. Accountability leaves no place to hide; it's an excellent strategy for combating defensiveness and removing the threat behind setbacks.

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**RESOURCES**

The *Become Your Own Trading Coach* blog is the primary supplemental resource for this book. You can find links and additional posts on the topic of coaching processes at the home page on the blog for Chapter 5: <http://becomeyourowntradingcoach.blogspot.com/2008/08/daily-trading-coach-chapter-five-links.html>

An excellent overview of psychodynamic approaches to brief therapy can be found in Hanna Levenson's chapter "Time-Limited Dynamic Psychotherapy: Formulation and Intervention" in *The Art and Science of Brief Psychotherapies*, edited by Mantosh J. Dewan, Brett N. Steenbarger, and Roger P. Greenberg (American Psychiatric Publishing, 2004).

A worthwhile resource for building emotional self-awareness is Leslie S. Greenberg's *Emotion-Focused Therapy: Coaching Clients to Work Through Their Feelings* (American Psychological Association, 2002). See also the classic text by Leslie S. Greenberg, Laura N. Rice, and Robert Elliott, *Facilitating Emotional Change: The Moment-by-Moment Process* (Guilford, 1993).

Articles relevant to psychodynamics and self-coaching can be found in the "Articles on Trading Psychology" section of my personal site: [www.brettsteenbarger.com/articles.htm](http://www.brettsteenbarger.com/articles.htm). These articles include "Behavioral Patterns That Sabotage Traders" and "Brief Therapy for Traders."

It is rare to find trading coaches who know anything about psychodynamics; a notable exception is Denise Shull, who wrote the chapter, "What Would Freud Say: Stroll Down Freud's Mental Path to Profits" in the book edited by Laura Sether, *The Psychology of Trading* (W&A Publishing, 2007).





# Remapping the Mind

## *Cognitive Approaches to Self-Coaching*

*The greater danger for most of us lies not in setting our aim too high and falling short, but in setting our aim too low, and achieving our mark.*

—Michaelangelo

In Chapter 5, we explored psychodynamic frameworks for self-coaching. These frameworks are especially relevant when we repeat unproductive patterns across a variety of situations over time. Fundamentally, the psychodynamic view is a historical one: it emphasizes linkages between how we coped in the past and how we now find ourselves responding to situations.

The cognitive framework, like the behavioral one that we'll visit in Chapter 7, is less historical: it emphasizes how we process the world in the here and now. Change the viewing and you change the doing is the essential message of cognitive approaches. While the past is not irrelevant to this task, cognitive self-coaching stresses what we can do in the here and now to alter how we process the world around us.

Cognitive coaching is most relevant if you find yourself battling negative thought patterns that interfere with your motivation, concentration, and decision-making. Some of the most common cognitive patterns that traders target for change include:

- Perfectionism
- Beating Up on Oneself After Losses
- Worry
- Taking Adverse Market Events Personally
- Overconfidence

Cognitive methods help us think about our thinking and restructure our perceptions of self and world . Let's take a look how. . .

## LESSON 51: SCHEMAS OF THE MIND

Chapter 5 outlined psychodynamic approaches to the change process. That framework makes use of powerful emotional relationship experiences to break patterns of behavior left over from prior life conflicts. When applied to self-coaching, the psychodynamic perspective requires a dual look at past and present, with an eye toward recognizing occasions when we repeat the past in our current responses to trading challenges. The cognitive framework, on the other hand, is more present-oriented. Its focus is on how we think and the relationship between our thinking and the ways in which we feel and behave.

The cognitive approach to change, like the behavioral methods described in Chapter 7, is grounded in learning theory. Instead of emphasizing the creation of relationship experiences, the focus is on *skills building*. For that reason, homework exercises play a prominent role in cognitive work, which makes the cognitive modality particularly useful for self-coaching. In cognitive coaching, you learn skills for processing information more constructively.

Many cognitive psychologists draw on the analogy of the scientist when describing our thought processes. Scientists observe nature and look for patterns and regularities. Once scientists observed these relationships, they develop theories to explain their observations. Experiments test these theories and provide new observations that enable scientists to modify their theories. Over time, science arrives at ever more refined understandings of the world through the process of testing, observing, modifying, and testing further.

Cognitive researchers call the theories in our head *schemas*. These schemas are like mental maps, orienting us to the world around us. We interpret events and interactions with others through these schemas, assimilating new events to them when possible and accommodating our understandings to fit new events when needed. As developmental psychologist Jean Piaget explained, this process of assimilation and accommodation provides us with deeper and richer understandings of our world. We are always elaborating our maps of reality.

We never experience the world directly; all perception is filtered through our mental maps. If our maps distort the world, our perceptions will be distorted.

Schemas are not just collections of thoughts, but are complexes of thoughts, feelings, and action tendencies. Let's say, for example, that I was beaten severely as a child and now perceive the world as a dangerous place. One of my schemas might be that, "You can't trust people; they'll hurt you." When others try to get to know me, that schema becomes a lens through which I view their behavior. Instead of responding with friendliness, I raise my guard and distance myself. Because of the schema, I've interpreted their behavior as dangerous.

Sometimes schemas, as the lenses through which we view events, are distorted. They lead us to view and respond to events in exaggerated ways, as in the example above. Take the example of the trader who views his worth through his profit/loss statements. He becomes overconfident and expansive when he's making money, and he turns risk-averse and self-doubting when he's in a slump. As long as his trading results are filtered through this schema, he's likely to think about and respond to his profitability in distorted ways.

Problem patterns develop when our distorted responses to the world become self-reinforcing. In the example above, because others hurt me, I now perceive people as dangerous and untrustworthy—even when they approach me in a friendly way. My guardedness makes me seem hostile or suspicious to others, and they naturally stop their friendly overtures. That, in turn, convinces me that my views of them were right all along, reinforcing my distorted schema. *When we are caught in such self-reinforcing patterns, we stop revising our mental maps:* we become locked into negative ways of perceiving—and responding to—the world.

Automatic thoughts are the habitual ways of thinking that result from our schemas. Once a schema is triggered, it usually sets off a series of thoughts and feelings that guide our action. A schema of vulnerable self-worth might, for instance, lead us to respond to a market loss with dejection and depression and a host of thoughts amounting to, "I'll never succeed." These thoughts and feelings are not objective assessments of the markets or our trading. Rather, they are automatic, learned reactions that have become habit patterns.

We never directly observe our schemas; rather, we experience their manifestations through our automatic thoughts.

The goal of cognitive work is to unlearn these negative thought patterns and replace them with more realistic ways of viewing the world. This restructuring of our thinking means that we, like scientists, must revise our theories. The cognitive approach provides methods for accomplishing this revision.

There are many automatic thoughts that affect traders as they struggle with risk and uncertainty. Some of these thoughts are:

- “I need to make more money.”
- “I’m so stupid; how could I have done that?”
- “I’ve got this market licked.”
- “I can’t afford to lose money.”
- “The market is out to get me.”
- “I’ve got to get my money back.”
- “Nothing I do is right.”

*The first step toward becoming your own trading coach in a cognitive vein is to identify the thoughts that automatically appear during your trading.* Several traders I’ve worked with have taken the unusual step of audio recording or videotaping themselves throughout the trading day and then reviewing the recording after the close of trading. It’s a great way to identify the recurring thoughts and feelings associated with trading challenges. Many times, there are just one or two core automatic thoughts that dominate our experience. These are the thoughts that will form the initial focus of your coaching efforts.

Your assignment is to observe yourself in trading with either video or audio recording, making notes of recurring thoughts and feelings. At first, don’t worry about changing these thoughts: simply observe how your mind is occasionally hijacked when events trigger particular schemas. It is crucial that you understand, from your own first-person experience, that you do not have complete freedom of will or mind. At times, all of us can be quite robotic, replaying thoughts that have become mere habits. By observing these habitual thought patterns, you begin the process of separating yourself from them.



#### COACHING CUE

Our most problematic automatic thoughts often come out when we’re fatigued and/or overwhelmed. Think back to times when you’ve felt overloaded with work, responsibilities, and market challenges. What are the thoughts that go through your mind? How do those thoughts affect your feelings and behavior? Observing yourself when you’re most psychologically vulnerable is a great way of clearly seeing the negative thought patterns and schemas that affect us.

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## LESSON 52: USE FEELING TO UNDERSTAND YOUR THINKING

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One of the best ways to identify the automatic thinking that could most jeopardize your trading is to track your strongest feelings. In the cognitive framework, how we feel is a function of our perception: how we see things and how we interpret what we see shape our emotional responses. When our interpretations of events are extreme, we're most likely to respond with extreme feelings. Those occasions in which we look back at our behavior with embarrassment, wondering how we could have blown things so out of proportion, are most likely reflections of times in which we were controlled by the automatic thoughts from distorted mental maps.

If, say, I think about the times in which I most completely lose my temper, they would be occasions in which I want to accomplish something but find my path blocked for no apparent good reason. Perhaps I'm trying to get to an appointment on time and find myself behind a slow driver who is absorbed in a cell phone call. Or it could be a situation in which I'm trying to accomplish something with a trader at a firm, but find myself stymied by a bureaucratic response. The thought behind my temper outburst is, "I have to get this done, *now!*"

Often these are situations that aren't life or death: they don't truly *need* to be accomplished there and then. My schema says, however, that if something doesn't get done now, that would be *awful*; it would be a *catastrophe*. I am responding to my own internal should and must, not to the objective demands of the situation. The exaggerated emotional response is a tip-off to an entrenched thought pattern that distorts my perception.

When we turn a desire into a demand, we mobilize the body and respond with stress.

In psychodynamic work, the focus would be historical: figuring out past relationship patterns that might have initiated my particular way of thinking and feeling. The cognitive framework, however, is less concerned with the origins of the thinking patterns than on what we do in the present to recognize and modify those. *By tracking our extreme emotional responses as they are occurring, we can learn to recognize the thought patterns that affect us in the present and eventually challenge these.* In the cognitive approach, this is accomplished literally by teaching yourself to think differently and filter the world through a different set of lenses.

For example, when I pressure myself about time and tasks that I want to accomplish, I recognize the mounting frustration and tell myself that

this is going to get me nowhere. A different perspective on the situation is, “What’s the worst that could happen? Will this really be a catastrophe?” By pushing myself to entertain the worst-case scenario, I see how foolish it is to get worked up. Rarely is the likely consequence commensurate with the extent of the pressure I’m placing on myself. That, after all, is what makes the schema distorted!

When we change the lenses through which we view events, we change our responses to those events.

What are your most exaggerated emotional responses to markets? Do you feel angry when ideas don’t work out; devastated after losses; stricken by fear during volatile periods? Or perhaps you swing from overconfident, cocky feelings to feelings of despair and worthlessness? Your strongest feelings are reflections of your most entrenched thought patterns, and those feelings reflect your core schemas:

- **Schemas of justice**—“I put in my work; I *should* make money.”
- **Schemas of catastrophe**—“It would be terrible if my trade didn’t work out.”
- **Schemas of safety**—“I can’t act; the market is too dangerous.”
- **Schemas of self-worth**—“I’m a total failure; I can’t make money.”
- **Schemas of rejection**—“I’ll look like such a fool if I can’t succeed at this.”

It’s easy to see how these schemas naturally lead to exaggerated emotions of anger, frustration, fear, and depression. As your own trading coach, you want to use your most extreme feelings to figure out your most distorted ways of viewing yourself and your trading. *If you’re managing risk properly, there should be nothing overly threatening about any single trade or any single day’s trading.* If you find yourself responding to markets with a high degree of threat, then you know that the problem is not the markets themselves or even your trading, but the interpretations you’ve placed on your trading results.

Please read those last two sentences again, slowly. If you are trading well—with plans built on demonstrated edges, with proper risk control—trading will have its stresses, but should not be filled with distress. Markets cannot *make* us feel anxious, depressed, or angry; the threat lies in how we view our market outcomes.

One exercise I like to conduct when I find myself responding to trading with strong emotion is to simply ask, *Am I reacting to the situation as it really is, or am I reacting to what I’m telling myself about the situation?* That question forces me to confront my thinking and ask whether the



magnitude of my emotional reaction is truly warranted. If it is not the objective situation that creates your feelings, then your emotion has to be internally generated, a function of how you are processing events. If the emotion is out of proportion to the situation, your thinking about the situation must be distorted.

The greater the distortion in our thinking, the greater the distortion in our emotions.

Make yourself write down what you would have to say to another person—another trader—to make them react the way you’ve just reacted. What could you say to them that would lead them to respond so extremely? The odds are good that what you would tell another person to generate the emotion is what you are telling yourself:

- “You’re no good!”
- “It’s all your fault!”
- “You’re going to lose your money!”
- “You can’t win!”

If you write down these messages every time you catch yourself in the throes of an extreme emotional response, you’ll come close to duplicating the output from your cognitive schemas. It’s much easier to redraw mental maps when they’re lying open in front of you.



#### COACHING CUE

A common thought pattern that distorts traders’ reactions to markets is what we might call a “justice schema”: the idea that markets *should* be fair, *should* offer opportunity, or *should* behave as they’ve behaved in the past. Once we lock ourselves into notions of how markets should behave, we open ourselves to frustration and disappointment when they take their own course. Many times, I’ve seen traders grow restive, fuming at markets that just aren’t moving. Traders become impatient and jump all over any move to new highs or lows, hoping that this will be the breakout move—only to find the market return to its slow range. By challenging yourself when you catch yourself thinking or talking about how the market *should* behave (but isn’t behaving), you can use the frustration to channel your energies elsewhere: toward longer time frames in the same market, toward fresh research, or toward other instruments or markets. When we react to our own sense of justice and injustice, we no longer objectively process actual market activity.

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## LESSON 53: LEARN FROM YOUR WORST TRADES

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Alcoholics Anonymous teaches people to become aware of their stinkin' thinkin'. But we don't have to be alcoholics to process the world in distorted ways. We develop repetitive patterns of behavior, and we follow daily routines. Most of us are creatures of habit: we tend to go through consistent morning routines, eat at the same times of day, and go to sleep around the same hour. We take the same routes to and from work, and we listen to the same music, watch the same television shows. There's not much in our lives that isn't patterned.

So it is with our thinking. *We learn ways of processing information, and these become part of our routines.* We blame ourselves to help avoid conflict with others; we anticipate negative outcomes to help us not become surprised when things go wrong. In individual situations, such modes of thinking may suit us well. As engrained habit patterns, however, they impose distortions upon the world. After all, not everything really is our fault. Not every event does go poorly.

Our negative thought patterns are learned habits; the key to cognitive work is unlearning them and replacing them with more constructive ways of processing events.

Once these modes of thinking become automatic, their accompanying feelings follow along. When we blame ourselves, we feel discouraged, diminished, and depressed. When we anticipate the worst, we feel anxious and uncertain. To the extent that we bring these schemas to trading, we no longer respond to markets objectively. We are like robots, responding with automatic thoughts and unwanted feelings.

As Gurdjieff noted, it is important to become emotionally aware of this reality: At some point you're deeply absorbed in trading, observing market patterns, and acting upon those. Then a shift occurs, and you are no longer in control of your thinking. It has become hijacked. An activated schema now sets off an avalanche of thoughts and feelings that may very well have nothing to do with the situation at hand. Suppose someone hijacked your computer as you were trading and suddenly switched the screen from your markets to some other, random ones? Suppose your mouse was taken out of your control and clicked on trades that you didn't want?

I guarantee, if that happened to you, you'd become very upset. You would not tolerate someone controlling your computer or your mouse. You would do everything in your power to regain control of your equipment. That has to become your attitude toward the hijacking of your mind. It's not enough to simply observe automatic thoughts taking control; you need to

feel the horror of literally losing control of your mind and behavior. Much of the motivation to change faulty schemas will come from the awareness of the pain they inflict in all aspects of your life.

Automatic thoughts don't just enter our mind; they take over. We change when we sustain the motivation to stay in control of our minds.

We've seen that reviewing your self-talk via audio or video recording and tracking your most extreme emotions during trading can alert you to your stinkin' thinkin'. Another powerful tool to help identify problematic schemas and thought patterns is to review your absolute worst trading decisions. Your worst trading decisions may or may not be your largest losing trades; they could be occasions in which you simply missed a golden opportunity. You'll know your worst trading decisions by your reaction to them, "How could I have done that?" That reaction is a fantastic tell, indicating that you truly were not in your proper mindset when you made the poor decision. At some level, when you're mystified how you could have been so mistaken or boneheaded, you are recognizing that your mind had been hijacked.

Once you identify these worst trades—and this will require a review of your journal, as well as a look back on your recent trading experience—you then want to re-create the thoughts and feelings that led to the faulty decision-making. Normally we like to put such episodes behind us, with a simple reassurance that next time we'll trade with better discipline and preparation. But in this exercise, you want to perform a psychological autopsy and exhume your faulty decision-making process in all its gory detail. What were you thinking at the time? What were you feeling? What were you trying to avoid or accomplish with your trading decision?

*The common thoughts and feelings during these poor trading episodes will be your clue as to the schemas that were being activated at the time.* Perhaps it was a safety schema: you were telling yourself that you could not afford to lose paper profits or to take a particular risk. Alternatively, it could have been a self-worth schema, as you told yourself how great it would be if this trade hit a home run. Your feelings during these trades—the fear, the overconfidence—will provide valuable clues as to the automatic thoughts that were generated.

Our worst trades come from reacting to our automatic thoughts instead of markets themselves.

In my own trading, a common schema that is activated is a variation of the safety theme: avoid danger. To be sure, this can be a useful mode at

certain market junctures, helping a trader size positions appropriately and limit losses on trades. Where the schema introduces distorted perception, however, is in defining danger as any drop from an equity peak, not as an outright loss of capital. This makes it particularly difficult to stay in winning trades, because relatively small retracements will stimulate desires for profit taking. A more realistic perspective would define danger not only in terms of lost paper profits, but also in terms of lost opportunity. Some of my worst trades have been ones in which I acted on a short-term perspective and subsequently missed the longer-term market move. The need to avoid danger exposed me to the equal danger of cutting profits short.

Notice that these worst trading episodes cut across patterns of thinking, feeling, and behaving. *Once we start from the (faulty) premise, "You must avoid risk," and once we define risk as any market movement against our positions, we shape our feelings and actions accordingly.* Reviewing your worst trades may be painful, but it is also liberating. It tells you where your mind has gone astray, and that can lead you to corrective action.



#### COACHING CUE

Many of our worst trades come from the demands we place on ourselves. Keep tabs of the times you tell yourself that you need to, must, and have to participate in market moves or make money. When these demands become rigid absolutes, we end up chasing market moves, refusing to take small losses, and otherwise violating principles of good trading. When we are more focused on those internal demands than on our trading rules, that's when we're most likely to lose money. You'll be able to identify those demands by the internal feeling of pressure that they generate. There's a different feeling when you trade from opportunity versus trade from pressure. Track your worst trades and the feelings associated with them to alert you to the ways in which your automatic thoughts can sabotage your best trading.

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## LESSON 54: USE A JOURNAL TO RESTRUCTURE OUR THINKING

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Review your past emotional episodes and trading mistakes as a helpful way to identify your mental maps and the ways in which they can distort your perception. The goal of cognitive work, however, is to be able to catch your automatic thoughts—those bouts of stinkin' thinkin'—as they are occurring so that they cannot hijack your mind and your trading.

In *Enhancing Trader Performance*, I outlined how a cognitive journal can be used to help traders restructure their thought processes. The journal format I suggested took the form of a single page for each trading day or week (depending on the frequency of your trading), with each page taking the form of a table. The left-hand column of the table describes the events that occurred at the time you experienced a trading problem. This column would include what was happening in the market, what you were planning, and how you entered—or didn't enter—the market.

The second column is an account of how you are talking to yourself about the problem. In the book, I took the traditional approach of using the second column to describe your beliefs about the events. *What may be most helpful to your self-coaching, however, is to actually transcribe your thoughts about the events and capture what you're thinking and feeling.* This column should capture the ideas going through your head at the time as faithfully as possible, as in, "Why didn't I take the trade when I had it? I should have been up money today and instead I've lost more than I should. I am so disgusted with myself. I don't know if I even want to keep trading."

Many times, key phrases from your transcribed self-talk will alert you to the nature of the schemas being activated. For instance, in the example above, the word *should* is often a good sign that a perfectionist self-worth schema is playing itself out, leading to angry self-talk and a discouraged frame of mind. Once the musts and shoulds are triggered, they turn the trader's attention away from markets and toward the issue of self-worth. Note that this is not happening in a constructive context; rather, the self-talk is critical and punitive. It is difficult to see how such thinking could move a trader forward.

I like to think of these automatic thoughts from the second column as a kind of tape recorder in the brain that clicks on during particular situations (first column). Many times, the very same phrases and messages recur from situation to situation. This process becomes easy to observe when reviewing your cognitive journal: you see not only how negative the self-talk can be, but also how automatic and robotic it is.

Pay particular attention to emotional words and phrases that recur in your self-talk: These words and phrases are shaped by our core schemas.

The third column describes what happens as a result of the self-talk: the feelings you have and the actions you take. For instance, in the example above, those angry, perfectionist thoughts might lead you to quit for the day and sulk, missing opportunity and a chance to learn about current

markets. Alternatively, the angry self-talk might lead to subsequent revenge trades that lose even more money. The third column chronicles *all* the consequences of the automatic thinking, both personal and monetary.

Over time, a review of this third column will cement for you the absolute toll taken by the distortions in your thinking. When you are your own trading coach, it's necessary to sustain your motivation for change. Seeing that your thinking is both tape recorder-like in its mechanicalness and sabotaging in its consequences will sear into your mind that *change is not optional*. Reading entries from day after day after day that highlight the same thoughts, the same behaviors, and the same losses and lost opportunities focuses not only the mind, but also the motivation for change.

*The most common mistake traders make in keeping such a journal is that they are not sufficiently specific in their entries and thus miss crucial details and understanding.* Below is a sample of a journal that lacks detail and fails to help the trader understand the specific thought patterns and consequences that appear across various trading situations:

Situations	Self-Talk	Consequences
Didn't go over my charts in the morning	I need to get my rest	Missed a good move
Sized my trade too large	This could be a great trade	Took a large loss
Market moved through my stop	I'm losing too much money	Took a break
Didn't take profit on a trade	I think we're going lower	Market reversed
News came out	Stock is really moving	Stock failed to rally; I quit for the day

Now let's take a look at the same cognitive journal, but with detailed entries.

Situations	Self-Talk	Consequences
I was tired because I had been partying late at night and didn't go over my charts before the open.	"I have to get my rest, but I'll be able to figure things out after the open. I've got a good feel for the market"	I couldn't see the market well. I missed an opportunity that I had researched last week, but forgot about once the market opened. I could have made several thousand dollars on that trade.

Situations	Self-Talk	Consequences
I thought I had a good idea after I missed the morning trade. I doubled the position size to make up for the lost trade.	"This could be a great trade. If it goes for me, it would make my day. Maybe it was a good thing I missed that trade."	An economic report came out and the market moved against me. I didn't remember that the report was coming out. I panicked and sold out for a several thousand-dollar loss. This put me in the red after a good start to the month.
Right after the big loss, I saw that gold was moving. I went with it, but it reversed and blew through my stop.	"I'm losing my shirt today. If this keeps up, I'll be so far down for the month that I won't be able to come back. There's no way I can explain this to my wife."	I decided to take a break from trading, but I couldn't relax. I was worried about coming home and telling her about my day.
I had a winning trade in the solar stocks, but decided to hold the position past my profit target to make my day back.	"I can't afford another losing day. This trade can make me even on the day; then I'm going home. I have to stop doing this to myself."	The solar stocks reversed, and I only took a small profit on the position. I feel totally stupid for ignoring my exit.
One of the stocks on my list was favorably mentioned by an analyst and popped on the news. I decided to not take the trade, because I didn't want to lose more money.	"This is going to break out of its range; it could go much higher. I want to be on board, but I can't afford to lose any more."	The stock stalled near the top of its range and then broke through on high volume. I watched the stock move without being on board. I feel totally disgusted with myself, like I don't deserve to trade any more.

Note how the added detail makes it clear what is going on in the trader's mind. The elaboration of the trader's self-talk also clarifies the links among the events, as one trading mistake led to another, with one schema (self-worth) first triggering overconfident thoughts and feelings, then frustrated ones, then ones of defeat and failure. We can also see how the trader's home life is connected to the thoughts and feelings affecting trading decisions, as the trader is feeling a need to prove himself to his spouse as well as to himself.

When you are your own trading coach, you want to look *between* the journal entries as well as within each of them. That will often illustrate



the links among your thoughts, as events trigger distortions in processing, which bring further events, and still additional distortions. Your assignment is to capture the flow of your thoughts and the connections of these to your feelings and actions. Only once you clearly see how the mental dominoes fall can you interrupt the process by turning your mind in a different direction.



#### COACHING CUE

What are the schemas and thoughts that accompany your *best* trades? Extending your journal to include how you think when you're trading very well helps you take a solution-focused approach to cognitive work. The last lesson in this chapter may provide some ideas along this line. Also keep an eye out for the hope schema, in which trades that are losing money trigger automatic thoughts of hope for a return to breakeven. Those thoughts often lead to violation of stop-loss rules and trigger subsequent schemas of regret and self-blame. There's a role for intuition in trading, but beware situations in which you are into wishin'. Those are usually excellent points to get flat and regain perspective. When you are your own observer, your negative thoughts can themselves become reliable trading indicators.

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### LESSON 55: DISRUPT NEGATIVE THOUGHT PATTERNS

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How do you break a habit pattern? When we have a smoking habit, or when we find ourselves eating out of habit, one of the first steps toward change is simply catching ourselves in the act of repeating our unwanted actions. *By disrupting a habit pattern, we gradually make it less automatic, less capable of controlling us.*

So it is with our habitual thought patterns. When we interrupt and disrupt these patterns, they become less automatic. We gain a measure of control over them; they no longer take control from us.

The most basic technique to disrupt negative thought patterns is thought-stopping. Thought-stopping is exactly what it suggests: a conscious effort to stop a train of thinking while it is occurring. When you have used cognitive journals and reviews of your trading to clearly identify your pattern of automatic thoughts, you become increasingly sensitive to their recurrence. This enables you to recognize their appearance in real time. By giving yourself the command to Stop!, you disrupt the automatic nature of the thinking. This gives you time to calm down, change the focus of your attention, and engage in other useful cognitive exercises.

A good example from the previous lesson is situations in which you find yourself losing money on a trade and hoping or praying for a turnaround. I've even encountered traders who engage in a kind of bargaining (not unlike the dynamics of someone facing death in the Kubler-Ross work), promising to never violate their discipline again if they could just break even on this trade. The fact that hope is dominating the cognitive picture for the trader suggests that there is more than a little desperation. At some level, the trader is aware that this is not a good position to be holding. The underlying schema, however, says that it is not okay to lose money; that losing money equals failure. This makes even normal market losses unduly distressful, triggering maladaptive coping (holding positions beyond stop-loss points out of hope; doubling down on losing trades). If, however, the trader recognizes this pattern as it is occurring, he can use the appearance of hope to *stop* himself and disrupt the automatic thoughts and actions.

The more vigorous your efforts at *stopping*, the more successful you'll be in disrupting unwanted patterns of thought and behavior.

Thought-stopping is useful because it separates you from your ways of thinking. Instead of identifying with automatic thoughts and the feelings they engender, you separate yourself from them and remind yourself that this is what has gotten you into trouble in the past. In the beginning, as you coach yourself, you will find that you have to engage in thought-stopping numerous times during a trading day. As you become more expert at recognizing your negative thoughts and disrupting them, however, you find it easier and easier to stop yourself. A simple reminder of, "There I go again!" is sufficient to turn your mind to a different track. The interruption of habitual thoughts itself becomes a positive habit pattern.

I have found it helpful in my own trading to make the stop efforts particularly impactful, almost as if I'm shaking myself awake and mobilizing other ways of dealing with situations. One time I caught myself holding a winning trade beyond the point at which it had reversed and returned to breakeven. A cardinal rule I've learned to follow is to not allow trades that have moved a threshold amount in my favor to become losing trades. As I watched the winning trade hit breakeven and then turn red, I caught myself hoping that it would return to breakeven. The order flow was clearly suggesting, however, that large traders were hitting bids and driving the market lower. I gave myself a swift slap across the cheek and told myself to get out. That spontaneous act—admittedly not a coaching technique I use with other traders—woke me up and enabled me to take a small loss rather than a much larger one. However, I have remembered that slap over the years, and its impact has kept me out of trouble on multiple occasions.

(Now I take a break from the screen and douse my face in cold water when I need to shift how I'm thinking about markets. The physical jolt seems to facilitate a cognitive shift.)

When the thought-stopping is dramatic, the mind-shift can be equally radical.

Some traders I've worked with have found it useful to post signs on their computer monitors to remind themselves of the thoughts they most want to stop. *Stay Humble* is one sign a trader wrote after identifying a pattern of overconfident, arrogant thinking. Such signs help traders to think about their thinking, standing apart from the patterns that would normally trigger negative emotions and poor trading decisions. They also remind traders to periodically stop, interrupt automatic thought patterns, and reengage markets constructively. You can't be absorbed in a pattern of thinking if you're making yourself its observer.

Here is a simple thought-stopping exercise that I have found useful in my own trading. The idea is to be on the lookout for any thoughts during trading that include the words *I* or *me*. The goal is to interrupt and disrupt those thoughts. *The reason for this is that you don't want to be self-focused when you're concentrating on markets.* You neither want to be thinking overly positively about yourself and your performance or overly negatively. When your automatic thinking turns attention inward, that's the cue to immediately disrupt the pattern and become more market focused.

There are many examples of self-directed attention that divide your focus from markets. These include:

- "I'm doing great; this is the time to be aggressive."
- "I can't believe how badly I'm trading."
- "Why did I just do that?"
- "The market is killing me."
- "I'm going to make my money back."
- "Everything I do is wrong."
- "I hate this market."

Once the words *I* or *me* appear, you want to quickly close your eyes, take a deep breath, relax your muscles, and turn your attention to the markets. If you're already worked up to that point, a quick break from the screen—clearing your head and turning your attention elsewhere—can be useful.

I find it helpful, during trading, to periodically remind myself, "It's not about me."

With practice, you can become quite good at proactively steering your mind from self-focused thoughts. During one recent trading episode, I caught myself looking up my P/L in the middle of a trade, wondering how well I was doing and how much I was willing to give up of my week's gains. Of course, that had nothing whatsoever to do with the merits of the trade I was in. Because of prior practice, I was able to stop myself from clicking on the P/L summary before the numbers could get into my head. Reminding yourself that "it's not about me"—it's about the markets—is an excellent start to maintaining control over your decisions in the heat of market action. If you stop yourself from doing the wrong things, you clear the decks for implementing sound trading practices.



### COACHING CUE

When I work with traders, one of my roles is to help them *stop* the flow of negative, automatic thoughts. Even when you're coaching yourself, however, you can derive the same benefit by keeping in touch with one or more trusted and valued trading peers during market hours. This can be in a single trading office or via Skype, Hotcomm, or even instant messaging. Many times your mates will pick up on your negative thinking before you're aware of their appearance. This can be very helpful in checking yourself and refocusing your attention.

## LESSON 56: REFRAME NEGATIVE THOUGHT PATTERNS

Reframing is a psychological technique that takes a problem pattern and places it in a different context so that it can be viewed in fresh ways, opening the door to new responses. Suppose I'm meeting with a trader who is experiencing occasional bouts of performance anxiety that leave him unable to act on clear trading signals. He views himself as a weak person who can never succeed at trading. I take a different perspective, emphasizing his prudence about taking risk and his success at avoiding large losses. "Perhaps we can use that same good judgment to identify and act upon opportunity in a way that keeps you secure," I suggest. What the trader frames as weakness, I reframe as a potential strength. Instead of fighting against his own tendencies, the trader can use the reframing to help him figure out how to use those tendencies to produce acceptable risk-adjusted returns.

Often we can find a strength underlying one of our weaknesses, enabling us to approach problem patterns in novel ways.

Reframing can often take a negative motivation and turn it positive. For a while, it seemed to me that my daughter was lazy in getting her school-work completed. I then hit on the idea that her primary motivations are social in nature: she's a real people-person. I proposed that we do homework together, and she readily rose to the occasion. This became a father-daughter tradition during the school year and a valued bonding experience. Similarly, when my son angrily confronted a teacher at school who "got in my face" about getting work done quickly, I started my conversation with him by congratulating him for using words only and not storming out of the class or laying hands on the teacher. Instead of framing the discipline problem as a failure experience, I reinforced the important lessons of self-control. He was much more able to hear my later advice, and he left the incident feeling better about himself, having learned from the confrontation. *The most negative thought patterns are there for a reason; identifying that positive reason and finding new ways to accomplish it makes self-coaching empowering.*

Consider, for example, the example of the trader who becomes lost in hope during a losing trade. Instead of flaying him for a lack of discipline, I will emphasize that he has found a valuable market indicator: the Hope-Meter. When hope enters the picture during a trade, it's a sign that deep down we know the trade is ill fated. By following the Hope-Meter, we can use the automatic thinking pattern to aid good trading, rather than interfere with it.

When you see problems in new ways, you gain the ability to respond in new ways. Novelty is a central element in all change efforts.

Many problems have a cyclical nature: I am afraid of losing money, so I set my stops too tight, lose more money on choppy action, and generate even more fear of losing money. When we reframe a problem, the new perspective can help us break the cycle. If I reframe the problem as one of position sizing, I can take the same monetary risk with wider stops, breaking the cycle of loss in choppy markets. *How we view our patterns very much determines how we respond to them.*

A useful exercise that I described in *The Psychology of Trading* is to reframe our inner dialogues by viewing them as actual dialogues. What we say to ourselves sounds very different when we imagine the same words spoken by someone else. This is particularly true when we are hard on ourselves after losses. What feels like worry when we are absorbed in our own thoughts sounds more like hostility when we reframe the same messages as part of an interpersonal dialogue.

Let's say a trader misses a good trade and then tells herself, "I can't believe I missed that trade. What is wrong with me? I wait all week for the right setup and get it handed to me on a silver platter and I don't take advantage of it. I'm never going to make it if I keep making mistakes like this."

Many traders actually consider such self-talk to be constructive. Traders think that being hard on themselves will help them avoid similar mistakes in the future. Suppose, however, we reframe the very same conversation as a dialogue from a friend to the trader:

"I can't believe you missed that trade. What is wrong with you? You wait all week for the right setup and get it handed to you on a silver platter and you don't take advantage of it. You're never going to make it if you keep making mistakes like this."

Clearly, when the dialogue is framed in such a manner we can appreciate that the tone is not at all constructive. Indeed, no true friend would ever talk to us in such a manner. The message is blaming and hostile, with no empathy or suggestions for improvement. Reframing the self-talk as an actual dialogue reveals the true emotion behind the automatic thoughts.

Reframing thoughts as dialogues helps us view our thinking in a new light.

Such reframing is particularly effective if we imagine ourselves speaking to a good friend in such a manner. For instance, suppose a good friend of yours went through a series of losing trades and you were to say to that friend, "I can't believe you missed that trade. What's wrong with you?" We can be hard on ourselves and buy into all sorts of hostile ways of talking to ourselves, but if we imagine delivering those same messages to a friend, we don't buy into the scripts at all. When we reframe our thoughts as interactions with a friend, we draw upon personal strengths such as our ability to be supportive of others. Such strengths make it impossible to maintain a stance of angry blaming.

*As your own trading coach, you want to maintain a consistent and constructive tone of voice with yourself, so that you don't damage your concentration or your motivation.* An excellent exercise for working on this process is to close your eyes and imagine yourself as another trader that you are responsible for: perhaps an assistant or a student trader. Imagine that this valued assistant of yours has just made the same mistakes in the market that you've made. How would you talk with this person? What would you say? What would be your tone of voice? What emotions would you convey? Imagine these in as vivid detail as possible. Then note how your approach to this other trader differs from your own self-talk. If you wouldn't talk to a valued colleague in the way that you're addressing



yourself, then you know that your automatic thinking is distorted in a negative way. Surely you deserve to talk to yourself the way you would talk with others in a similar situation!

Many times it's the tone of our self-talk, not just its content, that disrupts our trading.

When you conduct this guided imagery exercise day after day, particularly after you've interrupted some of your negative thoughts, you gradually learn to talk with yourself in more positive ways. In one variation of the exercise, I have traders imagine that *they* are the other trader they are talking to, so that they literally are practicing talking to themselves in ways that they would support someone else they cared about. During these exercises, traders who have been the most volatile and angry can access a wealth of caring, supportive messages as they view themselves as people they truly care about.

You are your own trading coach. Do you want your coach to berate you, to focus on your every mistake, to threaten you with dire consequences? Or do you want your coach to bring out the best in you? When you cast your thoughts as dialogues, you have a chance to reframe the mental maps that guide your thinking, feeling, and acting. Inevitably, we do talk to ourselves. We *are* coaching ourselves. The only question is whether we do so consciously and constructively or automatically and destructively.



#### COACHING CUE

If you have a mentor or peer trader who you are working with, pay particular attention to how they talk to you when you are having problems. Many times we can internalize the voices of others in reframing our automatic thought patterns. "What would my mentor say to me?" or "What would a good coach say to me?" is an excellent start toward constructive reframing.

### LESSON 57: USE INTENSIVE GUIDED IMAGERY TO CHANGE THOUGHT PATTERNS

The value of imagery is that it stands in for actual experience, with an unusual power to access emotional responses. Here is an effective cognitive exercise that makes active use of the emotional power of imagery.

The first step in the exercise, as emphasized in recent lessons, is to identify the repetitive, automatic thoughts that are disrupting your trading.



As noted earlier, these thoughts will generally form the self-talk that accompanies your most emotional trading episodes. The clearer you are in your capturing this self-talk, the more realistic and vivid your imagery work will be.

Let's take a specific example. A trader I recently worked with uncovered a pattern that was greatly holding him back in his success. He was a profitable trader over many years, but always had the nagging feeling that he was not fulfilling his potential. When we examined his trading and thinking patterns, it became clear that he became more risk-averse as he hit new peaks in his trading account and new P/L highs for the day. He was upset to finish off his highs (for the day, for the week), so he became unusually risk-averse as he hit these highs. He cut his size, traded less often, and behaved like a person who had just undergone a drastic drawdown.

His self-talk at these times was revealing. "You've had a good day," he'd tell himself. "Let's hang onto the gains. There will be more opportunity tomorrow." When it became clear that he missed opportunity because of this unusual caution, he felt vaguely guilty, but he reassured himself that his equity curve was positive and "you never go broke taking a profit."

This was a difficult pattern to break because, while the trader realized the pattern's limitations, he also bought into it at an emotional level. The trader who beats himself up truly suffers as a result of his self-talk and will want to change that, simply to feel better. The risk-averse thinking, however, kept our trader feeling safe. He *liked* the consequences of over-caution: it helped keep his emotions in check.

We are less likely to change a pattern if we buy into it, if we're not in at least a moderate amount of distress over the consequences of that pattern.

*A key step in changing his self-talk was to reframe the "let's not lose money" talk as "I don't think I can make money" talk.* The trader thought of his self-talk as messages of safety; I reframed them as messages of low self-confidence. He doesn't want to finish off his highs, because at some level he's not sure that he can get past those peaks. He doubts his ability to bounce back from drawdowns, so he desperately tries to avoid drawing down. He settles for a steady, but modest equity curve because he doesn't have confidence that he can generate and sustain more robust returns. Perhaps he even feels, deep down, that he does not deserve large rewards.

Note how, in this situation, my reframing was not a way of helping a trader view a negative pattern more constructively; rather, I was framing the pattern in a way to accentuate the trader's discomfort. It's back to that notion that coaching is all about comforting the afflicted and afflicting the comfortable. Our trader was far too comfortable in his risk-averse ways;

my goal was to move him forward in his readiness for change by helping him highlight the costs of his ways of coping. In your own cognitive self-coaching, you are not simply reframing negative thought patterns positively; you also will frame them in ways that summon your motivation for change. Earlier, I mentioned the value of viewing negative patterns as personal enemies: this is an example of a reframing that afflicts our comfort.

When I reframed his self-talk as a lack of confidence, the trader's immediate response was to describe his mother. He loved her and felt close to her as a child, but said that she was overprotective. When other boys went out to play, she held him back, afraid he would into fights. She tried to dissuade him from dating later in life, because she thought that girls might "take advantage" of him. The trader explained, with some sadness, how he never had the opportunity to excel in sports despite early promise, because his mother worried about injuries.

This response provided me with the opening to use the guided imagery method. I asked the trader to close his eyes and vividly imagine a situation in which he has made money early in the day and now is considering packing it in for the day and sitting on his profits. I told him to imagine that the markets were moving and opportunity was present, *but to visualize his mother saying to him everything he has been saying to himself during his risk-averse self-talk*. He thus had to imagine his mother, with a worried, overprotective look on her face, warning him to not trade, to not lose the money he made, to not get hurt in the markets.

Personalizing a pattern you want to change can heighten your motivation to change that pattern—and help you sustain that motivation.

Before we had finished the exercise, the trader opened his eyes and exclaimed, "Yuck!" The idea of being a little boy controlled by his mother disgusted him. "But isn't that your mother talking," I asked, "when you're telling yourself to not lose your money, to not get hurt in trades? Isn't that your Mom's voice within you?"

That reframing was what the trader needed to separate himself from his pattern. The last thing he wanted to do was repeat his overprotective childhood. Whenever he felt uneasy about participating in a market with opportunity, he simply closed his eyes and visualized what his mother would say in that situation. That visualization gave him the motivation to push the negative thinking aside and act on his trading instincts.

As I noted in *The Psychology of Trading*, most of us have someone in our past who we don't like or who we associate with negative thoughts and influences. If you imagine your least favorite person—someone who was mean to you, who hated you, who was abusive to you—saying to you what

you have been saying to yourself in your worst self-talk, it will become much easier to push back. If that hated person were actually standing in front of you while you were trading, voicing negativity, you'd have no trouble telling him to shut up. When you use imagery to associate your worst thinking with the worst people from your past, you learn to shut yourself up. And that is a major triumph of self-coaching!



### COACHING CUE

There are many other powerful applications of imagery in combating negative, automatic thought patterns. One trader I worked with took up martial arts and used the workouts to imagine striking out against the patterns that had held him back. After he rehearsed that mind frame in practice after practice, he only needed to adopt certain postures during the trading day to regain his fighting form. Another trader found that he was sharpest in his trading when he felt physically fit. He used his exercise routines to rehearse ways of thinking about himself and trading that reinforced his strengths. During the midday, he took a short exercise break, which helped clear his mind, but also placed him in greater touch with the mindset that he was cultivating. Not all effective imagery is visual; sometimes associating a way of thinking with a physical state can help us use body to affect mind.

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## LESSON 58: CHALLENGE NEGATIVE THOUGHT PATTERNS WITH THE COGNITIVE JOURNAL

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One way to use a cognitive journal, we have seen, is to track automatic thought patterns, so that you can become highly aware of negative self-talk and how it is connected to your emotions and behavior. A simple extension of the journal, however, is useful in restructuring our mind maps.

In the journal described earlier, we divided pages into three columns, with the first column representing a description of situations in which automatic thoughts occur; the second column captures the self-talk; and the third column highlights the consequences (in mood, behavior, trading) of that self-talk. The added fourth column represents your systematic efforts to change the internal dialogue and replace the automatic, negative thoughts with more realistic, constructive alternatives.

Let's start with an example. Suppose a trader is dealing with a perfectionist pattern in which she frequently criticizes her performance as not good enough. Even when she makes money, she focuses on how much she left on the table by not catching highs and lows. The result leaves her

feeling discouraged, and it also leads her to take bad trades in order to try to catch exact highs and lows.

In the fourth column of her journal she engages in a Socratic debate with those negative thoughts, challenging them and coming up with different ways of viewing the situation. This is truly self-coaching, because, just as the second column is the voice of the negative self-talk, the fourth column becomes the voice of the inner coach.

The cognitive journal can become a forum in which we vigorously and emotionally challenge our most negative thought patterns.

Here are sample entries and what they might look like:

Situation	Self-Talk	Consequences	Coaching Talk
I lost money when markets reversed on the surprise rate hike and my stop was hit.	"I don't know what I was thinking. I'm so stupid to be trading when there's a chance of news coming out and hurting me."	I felt down all morning and took too little risk in my next trades, even though they were good ideas that I had conviction in.	"This rate hike was not expected; c'mon, I can't anticipate everything. I had a high probability idea and kept the losses well within planned limits. That's a trade I should always take."
I got out of a winning trade too early, and the market ended up moving five points further in my direction.	"Why can't I stay in good trades? The only way I'll make money is by holding winners. I could have made so much more money."	I finished the day feeling rotten instead of feeling good about the money I made. I was in a bad mood all evening.	"This is just my frustration talking. The market had been choppy all day; it's part of my plan to take profits more quickly in choppy markets. Give me a break; I got a good price and made a nice profit. Beating myself up is just going to ruin my next trades."

*Notice how the fourth column, the trading voice, is close to what you might say to someone else who might be going through your situation. It is an attempt to provide a perspective that is not so blaming and self-critical. As with other parts of the journal, it's important that this fourth*

column be detailed, so that you have an opportunity to really think about and absorb the alternative view. Writing, “I shouldn’t be so hard on myself,” is less effective than writing, “This is the same kind of talk I heard from the boss at my old job who couldn’t stand me. I hated him, and I hate how he treated me. I don’t deserve this and I’m not going to do it to myself.” It is also effective to elaborate the negative consequences of the automatic thinking in that fourth column: “This kind of thinking has interfered with my trading all year long. I’m not going to let it cost me any more money!”

You want to counter your automatic thoughts with emotional force; it is the emotional experience of challenging your ways of thinking that will cement the new patterns.

The reason the journal is effective is that it provides a regular, structured opportunity for you to take the self-coaching role: it’s a great way to practice mentoring yourself. The use of the journal may feel artificial at first, but—with repeated entries—you’ll begin to internalize that coach’s voice and start challenging your negative thinking as soon as it pops up.

The cognitive journal also offers an excellent tool for reviewing your trading, particularly if you add a simple fifth column and track your profitability each day and/or grade the quality of your trading for that day. That column enables you to see how your progress in changing your self-talk is related to your trading progress, adding to motivation. Another alteration to the framework is to create an audio journal, so that all of your entries are spoken out loud in real time. This not only helps you restructure your thinking during breaks in the trading day, it also provides a useful day’s end review and cements your lessons.



#### COACHING CUE

Where traders often fall short with the cognitive journal is in making it more of a logical exercise than a psychological one. Traders challenge their negative thoughts in a calm, rational manner, but that doesn’t carry emotional force. The research literature in psychology suggests that we process emotional material more deeply than ordinary thoughts. You want to make your challenging of negative thought patterns into an emotional exercise where you vigorously reject the thinking that is holding you back. It helps to keep in mind that these are the thoughts and behaviors that have sabotaged your trading, cost you money, and threatened your success. If there was a person posing such a threat to you, you would surely confront him and reject his influence. When you personalize your automatic thoughts, you can create more powerful emotional experiences that aid the restructuring of your perception.

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As your own trading coach, you want to use tools such as the journal in a way that helps your trading, not that becomes burdensome. It takes a bit of experimentation to see how the journal best fits into your workflow and routine. An excellent rule is that you won't make significant progress until the time you spend in the self-coaching mode exceeds the time you spend in the throes of negative, automatic thinking. The journal is a useful way to ensure that you get that coaching time.

## **LESSON 59: CONDUCT COGNITIVE EXPERIMENTS TO CREATE CHANGE**

If people are like scientists, who construct their theories of the world based on their observations and experience, then it should be possible to treat their expectations as hypotheses that could either be confirmed or contradicted. *When you generate new observations and experiences that disconfirm negative thought patterns, you gradually modify those patterns and eliminate their distortions.*

Sometimes just a review of recent experience in a Socratic dialogue can be enough to challenge and modify negative views. "Whatever I do in the market is wrong!" might be one negative thought that automatically kicks in when the trader is losing money. A simple review of recent results, however, may bring the trader back to reality: "Wait a minute. I've had some excellent trades this week. I need to step back and figure out what's working for me."

When you're in the midst of negative thoughts, we've seen that it helps to take the role of the observer and ask, "Is this really true? Is this what I would be saying to someone else in my shoes? Is this what I would want someone else to be saying to me right now?" By disconfirming those negative thoughts, you make them less automatic—less able to take control of your decisions.

Sometimes, however, constructing specific experiments to challenge your negative thoughts and expectations can provide the right experience to jar and reshape your beliefs. One trader I worked with insisted that diversification didn't matter to him; he just wanted to be right on his trades. When he saw a good idea in a sector, he bought every name in the group, piling into the trade. Of course, the stocks moved in a correlated way; he probably would have been just as well off if he had bought the sector ETF and had saved some commissions. His thought pattern, "This is a great idea; I have to go all in," led him to risk a large amount of his capital on a single idea, even as he tried to convince himself that he was diversified because he held many names in his book.



For this trader, good enough wasn't good enough. He couldn't view his trade as a success unless it was a home run. For every home run he hit, however, he took a harrowing loss, leaving him discouraged and worried about his future. His pattern of needing to be "all in" to make his money back was taking an emotional as well as financial toll.

I suggested that we try an experiment. The gist of the experiment was that he had to divide his capital into four equal segments. No more than one segment, at his normal leverage, could go into any single trade idea. Thus, if he thought gold was going up, he could use up to a quarter of his normal buying power to buy the gold ETF and/or to buy gold miners. If he bought five names among the mining stocks, that quarter of his buying power would be divided among the five. To utilize the other quarters of his buying power, he needed to have different ideas. For instance, while he was long gold, he might have a short position on an individual stock or sector because of unfavorable news that had just been released.

An experiment, properly constructed, can provide a powerful, firsthand disconfirmation of our schemas.

What this meant, of course, was that our trader wouldn't be using all his buying power all the time, because he wouldn't always have four truly independent (noncorrelated) ideas. When he did deploy a good amount of his capital, it would be evenly distributed among setups and ideas. Some would be devoted to short-term scalps; other money would be used for longer-time-frame ideas. Some would be long; some might be short. This process would even out his returns, enabling him to benefit from the fact that he tended to have more winning trades than losers. By eliminating the large losers through diversification, the trader could actually take less risk (experience lower volatility of daily returns) and make more money.

The trader agreed to the experiment for a week. "What do I have to lose?" was his attitude. During the week, however, he actually saw that he made more money than he had during any week of the past several months. This result convinced him to continue the experiment. "I don't need to be banging my head against the wall," he explained after a few weeks. He was making more money—and he was happier doing it. Had he not actually conducted the experiment, however, he wouldn't have truly known—in his own experience—how wrong his thinking had been. Pointing out the destructiveness of a negative thought pattern (and the benefits of a more positive one) is one thing; actually seeing it for yourself and *experiencing the difference* is far more powerful.

The successful self-coach creates powerful and vivid experiences that undercut old habit patterns.



A common myth held by traders is that they need to be hard on themselves to maintain their motivation. This is another situation where a week's experiment can be helpful: make a conscious effort to stay constructive and positive every day for a week, and let's see how you feel and how you trade. When a trader sees that when he gives up the negative pattern he actually improves his concentration and the process of his trading, he gains considerable incentive to extend the experiment.

Your assignment, as your own trading coach, is to create a simple experiment—even if it's just for the span of a single day—in which you disrupt the negative thought patterns you've identified and just see what happens to your mood and your trading. If you don't like the results of the experiment, you can always go back to old ways and retool. If, however, you find that you can focus on trading better, that you stick to your plans better, and feel better about your work as a result, then you can decide to extend the experiment in time and perhaps also to other facets of your life. Our negative thought patterns have been the result of learning; surely we are capable of acquiring new ways of viewing our trading and ourselves. Well-constructed experiments provide us with the catalyst for changing that viewing—and that can change our doing.



#### **COACHING CUE**

Every trading rule can be turned into a cognitive experiment: See what happens when you follow the rule religiously—your trading results, your mood, and your decision-making. Many times, traders harbor fears in the backs of their minds as to negative consequences of sticking by their rules. By constructing experiments around the rules, we can see, firsthand, that these consequences are manageable and nothing to be feared.

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### **LESSON 60: BUILD POSITIVE THINKING**

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The lessons for cognitive coaching thus far have emphasized ways to identify and restructure negative, automatic thoughts. What, however, of positive thought patterns? How can we become more intentional in building these? Fortunately, many of the cognitive techniques that work well to unlearn negative thought patterns can also be used effectively to cement positive ways to view self and world.

Note that the positive thinking we're looking to build is not necessarily positive in the superficial sense. Look into a mirror and tell yourself how you're the best trader, how you're going to make so much money, etc. This

process is not positive thinking; it is delusional. It also reinforces unrealistic expectations, setting traders up for disappointment.

Rather, positive thinking is thinking that leads to constructive responses to challenging situations. For instance, a trader may make a rookie error and might chide himself for the mistake, using the incident to firm up his execution and attention to detail. This is very positive. A trader might also simply tell himself, "You're really not trading well; you can do better than this." That might be an accurate assessment and a prod toward greater motivation.

Positive thinking is not necessarily optimistic thinking; it is *constructive* thought.

How do you know the schemas and thinking patterns that are best for you and your trading? Fortunately, we can create a customized cognitive journal precisely for this purpose. Recall that in the traditional journal, the first column describes specific incidents of problematic trading; the second column summarizes the self-talk associated with the incidents; and the third column lays out the consequences of the self-talk. To create a format to track positive thinking, we use the journal to highlight episodes of positive trading. The first column describes what was happening in the markets at the time of the exemplary trading. The second column features the self-talk that occurred before and during these incidents; the third column identifies how the self-talk contributed to good trading practice. *In other words, you use the journal to highlight what you're doing when you're trading at your best.*

Observe that this doesn't mean that you only focus on your profitable trades, though many of your positive journal entries will be profitable occasions. Rather, you want to focus on *all* occasions when you traded well, even if you took normal losses. For instance, if you took a trade with very favorable risk/reward but were stopped out at your preset level and later reentered the idea for a gain, which would be a very positive episode of trading. The role of the journal is to isolate the thought processes that enabled you to keep your losses small and your trading flexible.

The cognitive journal can be used to identify the best practices in our thinking and trading.

One example of such a positive-oriented journal appears below. Once again, we are keeping the journal entries detailed so that we can crystallize in our minds the kinds of self-talk that are associated with our best

trading. Some of the most useful entries will come from occasions when we *don't* make our usual mistakes and manage to break free of old, unhelpful patterns.

Situation	Self-Talk	Trading Outcome
The market gapped up at the open and continued to rise before I could get into the trade.	"I'm afraid I'm going to miss this move, but I've seen what happens when I chase a runaway market. I'm going to wait for the first pullback toward zero in the NYSE TICK and then see if that price level holds when I enter on the next bounce. It's more important to get a good price on my trades than to be involved in every move."	The market pulled back more sharply than I expected and made a feeble bounce. I saw that the buying was not continuing and actually sold the bounce for a nice scalp. Staying out of the market, being okay with the possibility of missing a trade, and sticking to my execution rules kept me flexible and made me some money.
I was stopped out of a trade within a few minutes of entry, as large selling pressure entered the market	"We just broke important levels in all the indexes. I just paid for useful information. The market is going to test its overnight lows if we see continued selling pressure."	I waited for the first bounce and sold the market, riding the trade down to the overnight lows. I looked at the losing trade as a useful piece of market data instead of as a failure. That led to a good trade.

*Notice how the journal highlights the specific thoughts that led to the good trading decisions.* By rehearsing this thinking, you can turn it into a positive set of habit patterns. Some of the best ways of thinking, I've found, have come from my interactions with successful traders. Talking with them has provided a model for how I can talk to myself during challenging trading occasions. For instance, one trader set his entry price at a level that would ensure a favorable risk/reward for the trade and said, "The market has to come to me." Instead of telling himself that he had to chase after opportunity, he insisted that he would only play when the market action fit his parameters. This kept him out of bad trades, but it also gave him an ongoing sense of control over his trading. It is difficult to feel stressed out by markets if you feel in control of your risk. I eventually adapted this way of thinking to my own entries, simply by never entering long trades on a high NYSE TICK reading and never selling the market on low readings. By

making the market come to me, I found that I greatly reduced the heat I took on trades, maximizing profits. “The market has to come to me,” became one of my cognitive best practices.

Your assignment is to identify the ways of thinking that put you into your best trades and that enable you to manage risk most effectively. Once you identify how you think at your best, you have a model that you can replicate day after day in your trading, turning virtues into positive habits. You don’t have to be mired in cognitive distortions to benefit from a cognitive journal. Use the journal as a discovery tool for your best practices. It’s an exercise even the most experienced, successful traders can benefit from.



### COACHING CUE

A trader I worked with used the phrase *make them pay* (and other, choice colorful phrases) when he saw that the longs or shorts were overextended in a market. He would not exit until he saw evidence of high-volume puking from the traders running from cover. The idea of *make them pay* engaged his competitive instinct and kept him in winning trades. Frequently, he would add to his position on retracements, eager to make them pay even more. You may find that you use similar phrases during your best trades. Cement those phrases into cognitive patterns that you can rehearse. The phrases keep you grounded in best practices.

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### RESOURCES

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The *Become Your Own Trading Coach* blog is the primary supplemental resource for this book. You can find links and additional posts on the topic of coaching processes at the home page on the blog for Chapter 6: <http://becomeyourowntradingcoach.blogspot.com/2008/08/daily-trading-coach-chapter-six-links.html>

More material on cognitive approaches to change can be found in my chapter on “Cognitive Techniques for Enhancing Performance” in *Enhancing Trader Performance*. See also the chapter on “Cognitive Therapy: Introduction to Theory and Practice” by Judith S. Beck and Peter J. Bieling in *The Art and Science of Brief Psychotherapies* (American Psychiatric Press, 2004). Of additional interest might be the article “Remapping the Mind” from the articles section of my personal site: [www.brettsteenbarger.com/articles.htm](http://www.brettsteenbarger.com/articles.htm)

I like books that interview successful traders and portfolio managers; these books provide positive models for how to view markets and trading decisions. Among the most popular are the *Market Wizards* books by Jack Schwager; *Inside the House of Money* by Steven Drobny (Wiley, 2006), and *Hedge Hunters* by Katherine Burton (Bloomberg, 2007). Other models can be found in the writings of the contributors to Chapter 9: <http://becomeyourowntradingcoach.blogspot.com/2008/08/contributors-to-daily-trading-coach.html>. See also the Daily Speculations site ([www.daily-speculations.com](http://www.daily-speculations.com)) for interesting ways to think about markets and trading.

## CHAPTER 7

# Learning New Action Patterns

### *Behavioral Approaches to Self-Coaching*

*Without self-knowledge, without understanding the working and functions of his machine, man cannot be free, he cannot govern himself and he will always remain a slave.*

—G.I. Gurdjieff

**B**ehavioral methods in psychology are the outgrowth of early research into animal learning, emphasizing the roles of conditioning and reinforcement in the unlearning and learning of action tendencies. Modern cognitive-behavioral approaches to change treat thinking as a kind of behavior, making use of such methods as imagery and self-statements to modify our reactions to situations. Like the cognitive restructuring framework from Chapter 6, behavioral methods make extensive use of homework assignments in fostering change. The focus is on here-and-now skills-building, not explorations of past conflicts and their repetition in present-day relationships. Behavioral methods have been especially powerful in addressing anxiety problems, as well as issues of anger and frustration. In this chapter, we'll explore behavioral techniques that you can master as part of your own self-coaching. You'll find these techniques particularly relevant to help you deal with performance pressures and impulsive behavior.

Because the essence of the behavioral approach is skills-building, you will benefit from these methods to the degree that you are a diligent student. Frequent practice of the techniques and application of skills to new situations is crucial in making the behavioral efforts stick. Pay particular attention to the exposure methods discussed later in the chapter and also

summarized in *Enhancing Trader Performance*. Pound for pound, so to speak, I find these the most useful methods in the coaching arsenal. Let's take a look at how you can master these methods for yourself . . .

## **LESSON 61: UNDERSTAND YOUR CONTINGENCIES**

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The essence of behavioral psychology is that we share many of the learning mechanisms found in the animal world. My cats Gina and Ginger, for instance, have learned that, when I get up at 5 A.M., I will give them some moist food for their breakfast. As soon as they hear me walking about, they come from wherever they've been sleeping and hustle into the kitchen, looking up at me with expectation. Because of repetition, they have learned to associate my walking around after a period of quiet with being fed. This is the essence of stimulus-response learning: animals learn to associate response patterns to stimulus situations. The contingencies between situation and response are reinforced over time, strengthening the learned pattern.

Much of our behavior consists of simple responses to particular situations.

In traditional behaviorism, it is not necessary to explain these learned connections with reference to the mental states of the learners. The cats don't explicitly reason that it must be morning and I am rising for the day, so they should go to the kitchen. Nor does reason enter their decision to come to the portion of the house where we keep the moist food rather than the dry. Rather, the stimulus of hearing me awaken triggers their anticipation, much as hearing a particular old song may trigger associated memories. In the cognitive restructuring approach to coaching, we look to remap the mind and shift the explicit thinking of traders. In the behavioral mode, the goal is to unlearn associative connections that bring negative outcomes and acquire new connections that will be more adaptive.

In behavioral psychology, unlearning is the flip side of learning: if we don't reinforce a particular contingency over time, the associative links are weakened, and the response patterns eventually die out. If I were to ring a bell each evening and feed the cats but then not feed them in the morning, eventually they would stop coming to the kitchen in the morning. Instead, they would learn to come running at the sound of the bell. You build a behavior pattern by reinforcing it; you divest yourself of the pattern by removing reinforcement.

*Many negative behavior patterns in trading, from this perspective, occur because they are either positively reinforced or negatively*



*reinforced*. This distinction is important and not well appreciated. Positive reinforcement is like the feeding of the cats: people come to associate something favorable with a particular stimulus situation. Thus, for example, I may associate my early-morning market preparation with a particular emotional state of readiness and mastery. That linkage has me looking forward to the preparation time and sticking with my routines. The contingencies between being prepared and feeling good (or being prepared and making good trades) are reinforced over time until they become ingrained habits.

Negative reinforcement is a bit subtler, and it lies at the heart of why traders seem to cling to patterns that bring them losses. In negative reinforcement, it is the removal of a negative set of consequences, not the appearance of something positive, that strengthens the bond between stimulus situation and response. Let's say I am in a trade that is going against me and I bail out of the trade at the worst possible time, when everyone else is selling. Intellectually I may know that, on average, this is an inopportune time to join the crowd, but the trade is so painful at that point that the exit feels, for the moment, like a relief. Drug addicts commonly begin their habits first by seeking a high (positive reinforcement), then by seeking to avoid withdrawal (negative reinforcement). The avoidance of pain is a powerful human reinforcement, and it shapes learned action patterns just as effectively as the introduction of pleasure.

Many destructive trading behaviors are the result of pain-avoidance.

One of the most devastating examples of learned behavior patterns in trading is the association of thrills and excitement with the assumption of risk. When traders take too much risk, they experience profits and losses that are very large relative to their portfolio size. Some traders may find these swings stimulating, to the point where they become their own reinforcements. These traders find themselves trading, not for profits, but for thrills. Inevitably, the law of averages catches up to such traders. When these traders go through a series of losing trades, days, or weeks, their high leverage works against them and they blow up. This is not because thrill-seeking traders are inherently self-destructive. Rather, it is because they have learned, through repeated emotional experience, the linkage between risk-taking and excitement.

Research suggests that contingencies between situations and responses are more quickly and deeply learned if they are accompanied by strong emotion. This process is how people can become addicted to powerful drugs after only a few uses. It is also how we can become fearful and paralyzed by a single traumatic incident. An animal that would take weeks

to learn a new trick can learn to avoid tainted food after getting sick on it just once. *Emotion accelerates behavioral learning*. This is the source of many trading problems, and it also opens the door to powerful behavioral coaching methods.

As your own trading coach, it is important that you understand your own contingencies: the linkages between your expectations and your behaviors. Instead of thinking of your trading problems as irrational, think of them as learned patterns that are supported by something positive that you gain or something negative that you avoid. Something is reinforcing your worst trading behaviors: once you understand that contingency, you are well-positioned to remove the reinforcement and introduce new reinforcers of desired trading patterns.

Behavioral coaching is about reinforcing the right behaviors and removing reinforcement from the wrong ones.

To get started, think back to your most recent episode of truly bad trading. I can recall, for instance, a recent incident in which I so convinced myself of a turnaround in a falling market that I held a position well beyond the original stop-loss point. What is the reinforcement in that situation? In my case, I had been on a nice winning streak and I didn't want that to end. I associated getting out of the trade with breaking my streak; as long as I was in the trade, I could retain hope that my streak would be intact.

That reasoning makes no sense of course and, if pursued to its logical conclusion, I could have given back every ounce of profit I made during the streak just by holding the one bad trade. But the emotional connection was strong: I was attached to the winning—so much so that its pull was greater than the pull of simply trading well.

So take a look at your most recent episode of horrific trading. What gain were you associating with the bad trading? What negatives were you looking to avoid? What was the contingency at work? As previous lessons



#### COACHING CUE

Identify the emotions that are most painful for you and then track their occurrence during your trading. For some traders, this will be the pain of losing. Other traders respond negatively to boredom or to the helplessness of uncertainty. Many times your worst trading decisions will be the result of trying to rid yourself of those emotions. This negative reinforcement leads to hasty, unplanned trading behaviors that seem to make no sense in retrospect. If you can identify the negative reinforcement at work, you can more consciously and constructively deal with the difficult feelings.

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have emphasized, the first step in the change process is to become our own observers and recognize the patterns that hold us back. Your behaviors, as irrational and destructive as they seem, are there for a reason. A careful behavioral analysis will reveal the reasons—and will position you well for changing those.

## **LESSON 62: IDENTIFY SUBTLE CONTINGENCIES**

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The linkages between situations and our behavioral responses to those linkages are sometimes quite clear. When traders experience fear in a volatile market and prematurely exit a position, we can readily appreciate that they are managing their emotions, not their capital. The relief at being out of a fast market outweighs objective considerations of risk and reward.

Other times, the contingencies that govern our behavior are far more subtle and difficult to identify. For that reason, such patterns can be extremely challenging to change. If we don't know what we're responding to, it's difficult to shape a different response pattern.

Subtle shifts of mood are one example of stimulus situations that could affect decision-making without our awareness. For instance, some individuals are emotionally reactive to the amount of sunlight they receive and can experience winter blues or even seasonal affective problems during periods of low sunlight. This disruption can affect a trader's concentration and motivation, interfering with his research and preparation. Similarly, family conflicts can affect mood, which in turn affects trading. One trader I worked with found himself less patient with his ideas, entering and exiting before his signals unfolded. When we looked into the problem, it was clearly episodic—not something that occurred every day. During periods of conflict at home, he was more irritated, and that manifested itself as impatience in his trading.

The problem patterns in our trading are often triggered by subtle shifts in mood and energy level.

Many physical cues can also affect mood and cognitive functioning. These cues include fatigue, hunger, muscle tension, and fitness. I know that I process market data much more effectively and efficiently when I am alert. Anything that affects my energy level adversely will also impair my ability to synthesize large amounts of market information. This is not only because I am less cognitively efficient, but because lack of alertness also

affects my mood. In a more fatigued state, I tend to feel less emotionally energetic and optimistic. I won't look for that creative market idea; I'll become more discouraged and risk-averse after losses. If I'm not clued into my physical state and its relationship to my mood, I'll simply think that these periods of lesser performance are random. In fact, most mind and body shifts are as stimulus-response bound as any animal behavior in a learning experiment.

As I emphasized in *The Psychology of Trading*, a great deal of our learning is state-based: *what we know in one state of mind and body can be quite different from what we process in another state*. When I am listening to favorite music, my mind is expansive, I can see broad market relationships, and formulate big picture ideas to guide the week's trade. In a state when I'm pressured for time or distracted by an irritating situation, I suffer from tunnel vision, losing the large perspective. On those occasions, I'm much more likely to make impulsive trades, responding to recent price action rather than broad market dynamics. Often those trades lack good risk/reward qualities; they are much more likely to be losers than winners.

I refer to these subtle environmental cues as triggers, because they can set off behaviors that are unplanned and unwanted. When I'm irritated, for instance, I've learned to rid myself of the feeling by simply pushing aside whatever is bothering me. This reaction is a classic example of negative reinforcement. If the thought of doing errands irritates me because I have other things I want to be doing, I quickly push the errands away and focus on what I want to do. The errands don't get done, of course, and loom as a chronic irritant. My pattern of procrastination is clearly negative reinforcement-based, but it is not helpful: it leaves me with a lingering negative mood and a backlog of unfinished business. Worse still, continually reinforced, the negative mood can become a pattern in my trading. It's not too great a leap from procrastinating over errands to procrastinating about acting on a losing position.

Many of the behavioral patterns that interfere with our day-to-day lives also find expression in our trading.

Sometimes, when coaching yourself, you won't know what is triggering your most troubling trading behaviors. They seem to come out of nowhere. That's when it's most important to use a trading journal to catalog all the possible factors—physical, situational, emotional, relationship-based, trading-based—that might be associated with your problematic trading. When you engage in this cataloging, you want as open a mind as possible; often, the patterns will be different from ones that you've been considering. One trader I worked with experienced trading problems for no apparent

reason; only after considerable review did we figure out that these problems occurred when he experienced problems with the firm's management. The frustration led him to seek gratification from his trading, impelling him to overtrade. He didn't make a conscious connection between the two; rather, he was trading to manage an emotional state in a simple stimulus/response manner.

The cataloging you undertake in your journal may need to cover a considerable period of time before you notice patterns. What you're likely to find, however, is that how you trade is affected by your physical and emotional state—which is affected by situational factors at home and work. Understanding these contingencies enables you to build some firewalls into your trading practice, as we will see in the next several lessons. Without such understanding, however, you're likely to blindly repeat history, losing a measure of self-determination. It's when we create our own contingencies that we truly possess free will and the ability to pursue our chosen goals.



#### COACHING CUE

Track your daily physical well-being—your state of alertness, your energy level, your overall feeling of health—against your daily trading results. Many times fatigue, physical tension, and ill health contribute to lapses in concentration and a relapse into old, unhelpful behavior patterns. It is difficult to make and sustain mental efforts when you lack proper sleep or feel run down from a lack of exercise. Very often, our moods are influenced by our physical states, even by factors as subtle as what and how much we eat. When you keep a record of your daily performance as a function of your physical condition, you can see these relationships for yourself and begin preventive maintenance by keeping body—and thus mind—in peak operating condition.

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### LESSON 63: HARNESS THE POWER OF SOCIAL LEARNING

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One of the greatest mistakes traders can make in coaching themselves is to work on their craft in isolation. It is easy to become isolated as a trader, particularly given that all it takes is a computer and Internet connection in one's home to access the most liquid markets. During my work with trading firms, however, I have consistently seen how access to other professionals aids the learning process. From peer professionals you obtain role modeling, encouragement, and valuable feedback on ideas. A social network of

traders also offers powerful behavioral advantages that can aid your self-coaching. Thanks to Web 2.0 and the many online resources available, such social networking can occur virtually, not just within a trading firm.

Psychologist Albert Bandura was one of the first behaviorists to observe how reinforcement in a social context can aid the acquisition of new behaviors. *When we observe others rewarded for positive behaviors, the vicarious experience becomes part of our learning.* Similarly, when we see others making mistakes and paying the price for these, we learn to avoid a similar fate. In this way, your learning becomes a model for others and theirs provides models for you. Experience is multiplied many times over, accelerating the learning process.

Social learning multiplies experience and shortens learning curves.

Since I first began full-time work as a coach for trading firms in 2004, my own trading has changed radically. I have learned to factor intermarket relationships into my trading, and I have learned to think in terms of risk-adjusted returns, with each trade carefully calibrated for both risk and reward. I am keenly aware of the effect of position sizing on my returns, and I carefully track my trading results to identify periods of shifting performance that might be attributable to market changes. These changes all resulted from observing successful professionals across a variety of trading settings, from proprietary trading shops to investment banks. Since instituting these changes, I've enjoyed greater profitability with smaller draw-downs. Seeing how the best traders managed their capital provided me with powerful lessons that I could apply to my own trading.

Perhaps my most effective learning, however, came from observing failed traders. I have seen many traders lose their jobs (and careers) as the result of faulty risk management and an inability to adapt to market shifts. Those failure experiences were painful for the traders, but also for me, as I developed close relationships with many of them. Their pain and the crushing of their dreams was powerful learning for me. I vowed to never make those mistakes myself.

We learn most from emotional experience, including the experiences of others.

When you share ideas in a social network, including self-coaching efforts, you obtain many learning experiences that become your own. Vicarious learning is still learning, whether it's learning concrete trading skills or learning ways of handling performance pressures. One of the real values of



published interviews with successful traders, such as found in the *Market Wizards* series, is that you can learn from the experience of others. When you actually observe this experience in real time, however, the contingencies are much more immediate and powerful. How a trader in the hole pulls himself out, or how a trader adapts to a changing market, or how a trader successfully prepares for a market day—all provide models for your own behavior. You learn, not just from their actions, but also from observing the results of their actions.

Once you enter a social network of capable and motivated peers, the praise and encouragement of the group become powerful reinforcers. Most of us want to be respected by our fellow professionals, and the support of valued peers can be a meaningful reward. This reinforcer occurs among children, who find that they are praised by teachers, parents, and peers for good behavior and not praised when they behave badly. Over time, this differential reinforcement creates associative links for the child, so that he will do the right things even if no immediate praise is available. Similarly, young, developing traders will absorb the praise of mentors like a sponge; this helps them associate the right trading behaviors with favorable outcomes. When you share successes with fellow professionals, you turn social interaction into social learning.

Find experienced traders who will not be shy in telling you when you are making mistakes. In their lessons, you will learn to teach yourself.

For this lesson, I encourage you to locate online networks of traders (or assemble one of your own) in which there is openness about trading successes and failures. Online forums are a possible venue; you can also connect with readers of trading-oriented blogs who participate in discussions. Or perhaps you will choose to write your own blog, openly sharing your trading experiences and attracting like-minded peers. When you network with traders who have similar levels of motivation, commitment, and ability (as well as compatible trading styles and markets), you can establish a framework in which learning follows from shared ideas and experiences. We've seen in Chapter 5 how relationships can be powerful agents of change. In the behavioral sense, you want to be part of the learning curves of other traders, so that you can absorb their lessons. A great start is to establish such a mutual learning framework with just one other compatible trader. Their emotional learning experiences become yours; yours become theirs. Their victories spur your ability to do the right things; your accomplishments show them the path to success. This effectively doubles your behavioral learning, supercharging your self-coaching efforts.



**COACHING CUE**

An increasing number of professional trading firms—particularly proprietary trading shops—are creating online access to their traders, trading, and resources. Several of these firms are mentioned in Chapter 9. Read the blogs from these firms and participate in their learning activities as an excellent way to connect with other traders and model their best practices.

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**LESSON 64: SHAPE YOUR TRADING BEHAVIORS**

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Two children, two different homes: both improve their test grades in math; both fail in English. In the first home, the parents praise the improvement in math and encourage similar progress in English. In the second home, the parents call attention to the English grade and demand to know why the child couldn't pick up that grade as well. Which child will be most likely to show further school progress?

Behavioral psychologists who utilize behavior modification as a means for altering action patterns would support the first set of parents. Positive reinforcement, as a whole, works better than punishment. If we reinforce the right behaviors, the child will learn to do the right thing. If we punish the wrong behaviors, the child will learn to fear us. Nothing positive is necessarily learned.

Punishment fails because it does not model and reinforce the right behaviors.

Many traders seek to motivate themselves more through punishment than praise. These traders focus more on their losing trades than on their winners. They spend more time on weak areas of trading than building and extending their strengths. Such traders learn to associate unpleasant things with trading. These traders anticipate criticism and punishment and find it difficult to stay wholeheartedly engaged with the learning process.

We can see such dynamics at work in the journals many traders keep. One page after another details what the trader did wrong and what he needs to do to improve. Self-evaluations emphasize the bad trading, everything that could have been better. It's little wonder that these traders find it difficult to sustain the process of maintaining a journal. After all, who wants to face negativity and psychological punishment every working day?

Many traders fail to sustain work on their trading because they find little positive reinforcement in their work.

Trainers use frequent rewards to teach animals tricks. The trainers don't expect the dog to, say, jump through the hoops all at once. Rather, they will first give a reward each time the dog approaches the hoop. Then the trainer will wait for the dog to go through the hoop before they dole out the reward. Then they'll lift the hoop just a couple of inches and reward the dog when it jumps through the hoop. Then they'll add a second hoop and a third . . . they'll raise the hoops a little at a time . . . all the while requiring new behaviors that are closer to the desired endpoint before giving the reward.

This process is known as *shaping*. Trainers shape animal behaviors by rewarding successive approximations to desired ends. In a classroom, a teacher might first reward a disruptive student for five minutes of quiet attention. Later, it will take 10 minutes for the student to earn the reward; eventually the reward will require an entire class period of good behavior. Frequent-flyer programs at airlines aren't so different. At first, you earn bonuses for simply joining the programs. Only after you ride the airline regularly, however, do you earn later rewards. If you want the greatest perks, you have to shape your riding habits to fit the program.

Shaping is a testament to the power of positive reinforcement. Imagine punishing the dog for not going through the hoops. The chances are good that the dog would simply cower in the presence of the trainer; it certainly wouldn't figure out the right behaviors from the punishment of the wrong.

*When you are your own trading coach, you are the trainer as well as trainee.* You are teaching yourself to jump through the hoops of good trading. For this reason, you need an approach to coaching that is grounded in positive reinforcement. Your coaching must stay relentlessly positive, building desired trading behaviors—not punishing the wrong ones.

You can keep a positive tone to the learning process by shaping your trading behaviors: rewarding small, incremental progress toward the desired ends.

The first place to implement the shaping approach is in a journal. As an experiment and a worthwhile exercise, try keeping a *positive trading journal* for a few weeks. Divide your trading into several categories, such as:

- Research and preparation.
- Quality of trade ideas (ideas that carry conviction).

- Number of diversified (uncorrelated) trade ideas.
- Quality of entries (favorable risk/reward for trades; low amount of heat taken per trade).
- Sizing/management of trades (scaling in/out by planned criteria).
- Execution of exits (following profit targets/stop losses).

Each journal entry then focuses on *what you did right* in each of those categories each week. You write down, in specific detail, your best performance in each of these areas and then you review your entries before trading the next week, with the aim of continuing the positives.

As the previous lesson noted, this use of positive reinforcement and shaping is even more powerful if you conduct your assessment in a social framework, where you exchange your weekly positive report cards with one or more valued peers. This framework allows you to support the progress of others, even as they reward yours.

One of the better pieces of self-coaching from early in my trading career occurred when I set a goal of reaching a certain size in my trading account. I normally don't emphasize P/L goals, but in this case I wanted a tangible focus on steady profitability. Once I reached the goal, my commitment was to withdraw a portion of money from the trading account and use it for something enjoyable for the family. This emphasis rewarded my longer-term progress, but also brought my family into the positive reinforcement. When I finish this book, one of my personal goals will be to lose some weight—long hours in airplanes and hotels between working with traders have taken their toll. I've promised myself a new wardrobe from a Chicago tailor if I reach my weight goals. Each week I'll be weighing myself and tracking my progress. With every opportunity to snack, I'll be thinking about that new wardrobe and how I would feel if I didn't make weight that week. There's little doubt in my mind that I'll reach my goal.

Tangible rewards for your success are among the strongest positive reinforcers.

The key to making a positive journal work is shaping. At first, you jot down entries for even very small things that you did right. Later, you only make notations of larger examples of virtuous trading. *If you conduct the shaping process properly, you'll always have good things to write about—even on losing days.* This process ensures that you're always learning, always building on strengths, always keeping your motivation up. The difficult part about self-coaching isn't just making progress, it's sustaining the progress. Progress is much easier to accomplish when your focus is building yourself up, not tearing yourself down.

**COACHING CUE**

What is meaningful for you as a tangible reward for your self-coaching progress? A vacation with loved ones? A new car? One trader I work with donates a portion of his profits to a charity he deeply believes in; helping them out inspires his own efforts. It helps to reinforce the small steps of progress via shaping, but it also helps to have a larger goal that you're working toward; a goal that is meaningful for you. Remind yourself periodically of the goal; track your progress toward the goal. The psychologist Abraham Maslow recognized clearly: we perform at our best when we are impelled toward positive goals, not driven by deficits and unmet needs.

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**LESSON 65: THE CONDITIONING OF MARKETS**

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A large part of money management follows from a deep appreciation of fat tails. Market returns are not normally distributed; they show a higher proportion of extreme occurrences than you would expect from a simple flipping of coins. This is true across all time frames. The odds of a multiple standard deviation move against you (or for you) are sufficiently high that, if you're in the market frequently over a long period of time, you will surely encounter those periods in which markets stay irrational longer than you can stay solvent.

The distribution of market returns is also leptokurtic: it is far more peaked around the median than a normal distribution. This implies that market moves revert to a mean more often than we would normally expect by chance. Just as a market seems to be moving in one direction—trending—it reverses course and finishes little changed.

*It is difficult to imagine a situation better designed to create frustration.* Markets produce large moves more often than would be expected if returns were distributed normally, which leads traders to seek large, trending moves. But markets also revert to mean returns more often than we would expect in normal distributions, creating many false trends. If you trade a countertrend strategy, you run the risk of being blown out by a multiple standard deviation move. If you try to jump aboard trends, you'll find yourself chopped to pieces during false breakouts.

The very structure of market returns ensures a high degree of psychological challenge for traders.

The tendency of markets to make extreme moves amid frequent mean reversion creates interesting and important psychological challenges that affect self-coaching. To fully appreciate this, we need to understand the dynamics of behavioral conditioning.

Let's say that, each time I ring a bell, I hit you over the head. Soon, you'll learn to duck as soon as you hear the bell. That is a *conditioned response*. Days later, you might be in a different location and will still duck if the bell sounds. It's automatic; not a behavior guided by explicit reasoning. You've learned to associate bell and pain, just as Pavlov's dogs associated a ringing bell with the appearance of meat. Bell rings, dogs salivate. Bell rings, you protect yourself.

Now let's take our experiment a step further. I ring a similar but different bell and once again hit you over the head. Before long, you learn to duck whenever you hear any bell. This is called *generalization*. Your conditioned responses (the ducking) have now extended to a class of stimuli similar to the original one.

Much of what we call traumatic stress is the result of such conditioning. In the *Psychology of Trading* book, I mentioned my car accident in which I was thrown from a vehicle while riding as a passenger. Just as a result of that single, powerful event, I developed an anxiety response anytime I subsequently sat in the passenger seat of a car—even when the vehicle wasn't moving! I had learned an associative connection between being a passenger and extreme danger; the conditioning stuck with me even though I intellectually knew it made no sense.

Many of our extreme reactions to market events are the result of prior conditioning.

Powerful positive emotional events can yield the same kind of conditioning. The high obtained from certain drugs can be so strong that some people will develop addictive patterns after a single use. Underlying the addiction is the learned connection between the high and the use of the substance. That, too, overrides reason and reorganizes behavior.

One of my greatest failures as a trading coach occurred with a young trader who experienced early market success. He took the time to observe markets, learn short-term patterns, and track his own trading. He started trading small and learned the important lessons about waiting for good entry points, cutting losing trades, and letting his winning trades run to their target points. The trading firm was happy with his progress and gave him significantly greater size to trade. That was where I went wrong. I should have stepped in and demanded that the trader's increase in risk be more graduated. Instead, armed with his new size, the young trader decided he would try to compete with the more experienced traders at the firm. He

traded full size in his positions and his profits and losses swung wildly. Unprepared emotionally for those swings, he became impulsive and, one day, abandoned all discipline, blowing himself up on a single trade he allowed to get away from him. He never recovered from that loss and eventually had to start over at another firm.

It is impossible to remain emotionally stable if you greatly amplify your P/L swings.

When traders are undercapitalized and still hope to trade for a living, they too are impelled to take high levels of risk to achieve their desired returns. The result is that their portfolio swings wildly, with gains and losses that represent a large portion of total account value. These financial swings bring emotional swings, both positive and negative. The larger the financial swings, on average, the larger the emotional swings. The larger the emotional swings, the greater the potential for the development of learned, conditioned responses that disrupt future trading.

*When a trader undergoes an emotionally harrowing loss, many of the situational factors associated with that trade may become associated with the emotional pain.* Some of these situational factors, from the trader's physical state to the particular type of movement in the market, may be quite random. Nonetheless, they can trigger the emotional pain, much like sitting in a passenger seat triggered my anxiety following the automobile accident. A trader who consulted me about problems pulling the trigger on good trade setups experienced precisely that problem. He had lost significant money shorting the market during an uptrend, incurring several large losses. Subsequently, even when his trades were small in size, he felt fear whenever he tried to short the market. The feelings associated with his loss came back as a conditioned response, inhibiting his trading. This is the dynamic behind the flashbacks that occur during post-traumatic stress: stimuli associated with the initial trauma trigger memories and feelings from that painful incident.

The problem may have been just as severe had this trader made large money on the initial trade instead of losing. The emotional impact of a windfall profit, like the impact of a crack cocaine high, would bring its own conditioning, leading him to pursue similar gains (and highs) in future trades. It is poorly understood by traders that, psychologically, outsized gains are just as problematic as outsized losses. The fat tails of returns threaten fat tails of psychological response, interfering with sound perception and decision-making.

For this reason, when you're your own trading coach, you don't want patterns of extreme returns. Steady, consistent profits are far better for psychological performance than wild swings up and down, even though



they may lead to the same ultimate returns. Stated otherwise, good risk-adjusted returns are better for the psyche than extreme patterns of returns. *It's not how much you make, but how much you make per unit of risk taken that will keep you in or out of the performance zone.*

Your assignment for this lesson is to track the variability of your returns as intensively as your overall profitability. By variability of returns, I mean the absolute value of daily/weekly changes in your portfolio value: how much your account swings up or down on average each day. As markets change in their volatility and as you shift in your level of conviction about trades, you'll see changes in this variability. This tracking will tell you when you run more and less risk. On the whole, you'll want greater variability when you trade well and have many solid ideas; you'll want to cut your risk (lower the variability of returns) when you don't see markets well and when good trading ideas and moves are scarce.

Track the volatility of your returns, not just their direction. Volatility affects trading psychology every bit as much as winning and losing.

When you track the variability of returns, you'll also be able to see when your swings in profit/loss are outliers from your historical norms. This will be an excellent alert that your levels of risk may be sufficient to generate those large emotional swings that will produce unwanted conditioned responses. Traders tend to love volatility when they're making money and hate volatility when they're losing. Psychologically, it makes sense to keep the volatility of your returns within bounds: markets may possess fat tails, but with prudent position sizing, your returns can remain stable. You don't want markets conditioning your learning: you want to be your own coach, directing your own learning.



#### COACHING CUE

The psychological research on trauma suggests that processing a very stressful event verbally—out loud or in writing—can be extremely helpful in making sense of that event and divesting it of enduring emotional impact. When we repeat something again and again, it becomes familiar to us and no longer evokes powerful emotion. If you encounter outsized gains or losses in your portfolio, double down in your use of the trading journal or in your conversations with peer traders to thoroughly process what happened and why. As noted above, this process is just as important following large gains as following large losses. When highly emotional events bypass explicit processing, that is when we are most vulnerable to the effects of conditioning.

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## LESSON 66: THE POWER OF INCOMPATIBILITY

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Earlier we saw how much of what we learn is state-dependent. We associate particular outcomes with specific physical and emotional states. These associative links trigger unwanted behavior patterns when we enter those states. The classical conditioning mentioned in the previous lesson is an excellent example: if we experience overwhelming anxiety due to large losses, exiting the market may provide immediate relief. Subsequent experiences of anxiety in the market may trigger the same exiting behavior even when it would be in our financial interest to hold the position. The association between the anxiety and perceptions of danger may be so strong that it overwhelms our prior planning.

Boredom, for many active traders, can be as noxious as strong anxiety. It may be associated with failure to make money, or it may have much earlier negative associations: being lonely or feeling abandoned as a child. If you get into a trade—particularly a risky one—you immediately relieve the boredom, but you create a new trading problem. In such cases, the trading behaviors triggered by the state are more psychological in their origins than logical.

If trading is associated with an aversive state, we tend to do what is necessary to alleviate the state, even at the expense of our portfolios.

One of the simplest behavioral techniques for breaking these bonds of conditioning is to place yourself in a state that is incompatible with the one that triggers your problematic trading. Thus, for instance, if you find that anxiety triggers hasty and ill-timed market exits, you would work on placing yourself in a calm, relaxed physical condition that is incompatible with anxiety. If boredom were your nemesis, you would cultivate activities that hold your interest during slow markets. When I am fatigued, I find that a round of vigorous exercise not only makes me more alert, but also triggers positive action patterns, as I tackle work that had previously seemed overwhelming. *If you're not in a state that supports sound decision-making, your self-coaching focus turns from the markets to yourself and doing something different to shift your state.*

Two of the methods I have found particularly helpful in maintaining states incompatible with one's triggers are controlling breathing and muscle tension during trading. When I focus on the screen and breathe deeply and slowly while I follow the market, I minimize the physical manifestations of any form of overexcitement—from overconfidence to fear—and stay in a highly focused mode that I have learned to associate with good

trading. When we slow ourselves down through deep, rhythmical breathing, it is difficult to be simultaneously speeded up and excited. The careful breathing thus acts as a dampener on extreme emotion. It reinforces self-control and discipline at the most elemental level.

In my own trading, I've found that problematic trading tends to occur when I am physically tense, especially when I tense the muscles of my forehead. I rarely knit my eyebrows and wrinkle my forehead when I am comfortable in a situation. Conversely, I am prone to headaches and associate forehead muscle tension with tension headaches, which can pose a considerable distraction. By purposely keeping my forehead relaxed—widening my eyes slightly and going into a temporary stare—as I maintain the slow, deep breathing, I can sustain a state incompatible with the ones that occur when I'm on edge. Instead of waiting to become tense or nervous and then performing exercises to reduce these feelings, I proactively pursue and maintain an incompatible state *before* problematic trading occurs.

Control the arousal level of the body as a powerful means of controlling the arousal level of the mind.

I can often recognize my physical level of tension by my seating position. When I am comfortable, confident, and relaxed, I sit in the chair firmly, with my lower back and behind flush with the seat back. When market events trigger a stress response, however, I find myself leaning forward, with my seat near the end of the chair. Over time, this position gives me a backache in my lower back. I know that I'm not comfortable with my trading or with the markets when I feel that pain. Often, I'll readjust my seating, reorient my breathing, and find it easier to view the markets from a different—and more promising—angle.

The principle of incompatibility can also extend to thinking behaviors. Cognitive-behavioral work treats thinking as a discrete behavior that can be conditioned and modified just like any muscular behavior. If we tend to engage in negative thinking during trading, we can enter a mode of thinking that is incompatible with negativity before trading problems occur. I frequently have one of my cats sitting beside me as I'm trading, usually Gina. It's nearly impossible for me to become consumed with negative or angry thoughts when I am petting Gina. She alternates between licking me and rubbing her face against mine, all the while purring loudly and making kneading movements with her front paws. Stroking the cat helps me stay in touch with loving, caring feelings that are incompatible with the nastier emotions that can emerge during frustrating market periods.

One of the states that is most disruptive to my trading is what I would call a *chaotic* state, in which I feel as though I'm a step behind markets,

not really understanding what is going on. It's a confused state, but also a frustrated one, as I don't feel in control in the situation. I've learned that if I place myself in environments that are incompatible with chaos, I am in a much more balanced frame of mind. Such environments are ordered and well organized—my notes and materials are readily at hand—and they are designed to evoke positive feelings. Music is particularly effective for me in this regard. It is also harder for me to feel chaotic if I have gone through a routine of research and track markets prior to the New York stock market open. I organize my ideas in advance to help me feel more organized, settled, and in control.

You can structure your trading routines to make them incompatible with stress and distress.

When you are your own trading coach, you have wide latitude in modifying your environment—inner and outer—so that it does not trigger states that are associated with poor trading. One trader I worked with loved trading in a room with other traders (he joined a prop firm) because, in the social setting, he was too embarrassed to engage in behaviors he might lapse into on his own. He found that he was much more prudent about risk-taking and much less emotionally volatile when he was accountable to others. *The key is to find a state or situation that is incompatible with the triggers for your worst trading and then build that into your normal trading routine.*

A simple way to get started is to complete the following sentence:

I trade my worst when I \_\_\_\_\_.

Once you write your answer, your assignment is to create the incompatible situation. For example, I would complete the sentence with “don't do my homework.” I know that my day's preparation for the trade has a huge bearing on my odds for success that day. I also know that I'm least likely to do my homework diligently if I oversleep or am fatigued. When I build stretching and physical exercise into my early mornings, I enter an energized state that prepares me for the homework: I've learned to associate the vigorous, energetic state with being prepared and engaging in my preparation. After you observe the differences in your states when you trade your best and worst, you'll be able to construct similar activities that proactively keep you in an optimal trading mode.

**COACHING CUE**

I mentioned above how *chaotic* feelings are a trigger for my worst trading. If markets aren't making sense to me, my mind feels scrambled and trading seems rushed. I've learned through hard experience that a powerful way to create a state incompatible with that chaos is to temporarily lower my trading size until I regain a feel for markets. With much less at risk, I don't feel pressured and yet can stay actively engaged in markets. When we control our risk we can control our emotional reactions to markets: it's tough to panic when you have little on the line. Markets seem to move slower—and our feel for them returns—when we're not distracted by emotions triggered by risk and uncertainty.

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**LESSON 67: BUILD ON POSITIVE ASSOCIATIONS**

In the cognitive-behavioral framework, we can utilize imagery as a stimulus to evoke desired responses, triggering our own positive, learned patterns. Making use of imagery in this fashion can help us create *positive* associative links, triggering our best trading behaviors.

Let's say we have a trader who anticipates an early-morning entry into the market based upon a researched setup. Before the market opens, she visualizes the setup and her execution, noting the feelings of satisfaction from making a good decision. This positive mental rehearsal acts as a preparation for the actual trade, as she follows the behavioral pathway she has laid down in advance. I call this *anticipatory reinforcement*: by imagining the positive benefits of doing the right things, we strengthen positive associative links and make it easier to act on our learning in real time.

Many traders conduct anticipatory reinforcement in reverse: they dwell on negative outcomes and feared scenarios, undercutting their own sense of efficacy. This, in essence, is anticipatory punishment, and it leads traders to miss opportunities or to not act on them. I've found over the years that much of what separates the excellent traders from the average ones is not so much their ideas, but what they do with those ideas. Two traders will have positions go their way and then pull back a bit. The first trader, anticipating punishment, fears losing his gain and takes a quick, small profit. The second trader, anticipating reward, adds to the position on the pull back and reaps large gains. Same idea, different outcomes, all as the result of conditioned patterns of thinking.

Our ways of thinking can reflect conditioned responses; that's how markets can control our minds.

When we reinforce positive patterns, we not only strengthen these but also begin the process of extinguishing negative patterns. In behavioral theory, a stimulus-response connection is extinguished over time if it is not reinforced. The animal that was given food each time it performed a trick will eventually stop performing the trick if food is not forthcoming. *Behavioral patterns, in this way, not only have to be learned but also actively reinforced to find active expression in our trading.* We can unlearn negative behavior patterns simply by withdrawing their reinforcement and by introducing more powerful rewards elsewhere. This is a powerful principle.

One common learned pattern among traders is the connection between anger/frustration and aggression. When traders become frustrated by market conditions—say, a choppy, directionless trade—they react out of anger and lash out by placing trades to get even with the offending market. This pattern—relieving anger by lashing out—may make traders feel better for the moment (negative reinforcement), but it leads to poor decisions and losing trades.

How can we use positive associations to unlearn this pattern of revenge trading?

Suppose a trader engages in a thorough examination of his trading during the choppy markets of the past month. He investigates charts to identify the choppy periods and then reviews all his trades from these periods, pulling out the most successful ones. What he may find is that his successful trades in choppy conditions are more selective (fewer in number); that they are placed near the edges of trading ranges; and that they are held for shorter periods of time to capitalize either on breakouts/false breakouts or on moves back within the range. His losing trades, on the other hand, tend to be placed in the middle of the range and are held for longer periods, reversing before they can hit distant price targets.

Armed with this bit of self-coaching information, the trader now can view the choppy period as one of opportunity, not threat. When he notices a trading range going into the day's trade, he can use imagery to rehearse calm caution when the market is trading near the center of the range. He can also mentally rehearse entries near range extremes, including his placement of modest price targets. When he rehearses these trade ideas, it is with the feelings associated with his prior winning trades. Over time, with repetition, he learns a *positive* association with range-bound, choppy markets. His prior behavior pattern, built on frustration and its removal, is no longer reinforced. It faces gradual extinction, as he builds the more constructive associative patterns.

Find the market conditions that are most challenging for you and then identify how you trade them best. This process turns threat into opportunity.

Since the late 1970s, I have traded actively and gained a pretty good feel for many short-term market patterns, including patterns of volume and intraday sentiment. Many times I first become aware of these patterns with a gut feeling: something seems right or not right about the market action. I have learned through hard-won experience that I suffer in my performance if I ignore these intuitions. They are not based on hopes or fears; they are the result of implicit learning over a period of years. In my mental rehearsals, I include scenarios in which I act upon this feel for the market, recalling specific, recent trades in which I saved myself considerable grief by not overriding my judgment. This rehearsal of positive associations has created a kind of intrinsic reinforcement: I actively look forward to the emergence of those gut cues and am mentally prepared to act on them when they arise.

As I mentioned in the previous section, I have many positive associations to music. Indeed, as I'm writing this, I'm listening to music from a group called Edenbridge, a kind of music that I find both energetic and uplifting. My writing today began at 6:30 A.M., and it is now two hours later and I'm going strong. The association of the music with the writing keeps me in a positive state of mind. It keeps me looking forward to the writing, even when the editing process can become tedious. With these positive connections activated regularly, my more negative patterns of procrastination are not reinforced and gradually lose their strength. It is not necessary for me to fight my tendency to procrastinate; such internal conflict would likely create writer's block. Rather, I create a positive source of motivation that outweighs the negative reinforcement value of avoidance.

A good example of the power of anticipatory reinforcement is occurring right now as I am writing this. I'm on a 15-hour flight to Hong Kong on my way to working with traders in Asia. The cabin is dark, and I'm feeling tired. I've promised myself, however, that I can take a long-awaited rest after I finish this chapter. I find myself more motivated as I get closer to my goal; by the time I get to rest, I will have earned it. Ultimately, the positive reinforcement of living up to my deal and earning the rest outweighs any negative reinforcement value of avoiding the writing out of tiredness.

Find your strongest motivations and link those to your best behaviors.

Your coaching assignment for this lesson is to create what-if scenarios for the day's trading, rehearsing the good, planned trades you would make in each scenario. These rehearsals should be detailed and vivid, accompanied by a visualization of the pride and satisfaction you experience when you trade well. For every single what-if outcome, you should envision a



concrete response that embodies good trading. In this way, you plan your trading as well as your trades, but you also strengthen the bonds of positive learned patterns and extinguish the negative patterns. As your own trading coach, you have the power to be teacher as well as student: the shaper of behavior as well as the one whose behavior is shaped. If you take the active learning role that lies at the heart of the behavioral approach, you become the programmer of your own patterns.



#### COACHING CUE

I find it helpful to help traders identify the highlights of their trading from the past week: what they did especially well. From these highlights, we frame ideas about what the trader is really good at—what makes her successful. We then use this *what I'm good at* idea to frame positive goals for the coming week: how the trader is going to enact those strengths in the next few days. Because these are goals we track together, we create a situation of anticipatory reinforcement and a momentum for continuing best practices. This is a process you can carry forward with trading colleagues: share what you do best and how you put your best talents and skills into practice. Focus on your best trading and you begin the process of extinguishing your worst practices.

### LESSON 68: EXPOSURE: A POWERFUL AND FLEXIBLE BEHAVIORAL METHOD

If I had to name a single behavioral method that is of greatest value to traders, it would be exposure. As I described in my chapter on behavioral methods in the *Enhancing Trader Performance* book, exposure is a technique that enables you to reprogram those stimulus-response triggers that set off faulty trading.

A major idea underlying exposure is that the avoidance of negative experience itself becomes a reinforcer, preventing people from overcoming learned fears. Let's say, for instance, that I have taken large losses on a short position and now experience fear whenever a buy program hits the tape and moves the index higher by several ticks. I can avoid that fear by simply exiting the position. While that avoidance is a relief, it never addresses the learned connection impelling my behavior. Indeed, it reinforces my fear by acting on it. It is impossible to overcome a fear when you give into it.

We overcome fear by facing it successfully.



In exposure work, we intentionally expose ourselves to the situations that set us off. Generally, this process begins with imaginal exposure (facing situations in realistic imagery) and progresses to in vivo (real time) exposure. These exposures pair the trigger situation with learned skills that invoke a state incompatible with the bad trading. Thus, in the example above, we might rehearse a calm, focused state of mind while vividly imagining the market moving higher against us.

Think about what this accomplishes. On one hand, we immerse ourselves in thoughts and images of something we find threatening. We force ourselves to experience our worst fears. At the same time, however, we make special efforts to keep ourselves calm and controlled. We talk to ourselves in calming ways, slow our breathing, and keep our bodies relaxed. We do this again and again, repeating the imagined scenarios until we are able to stay completely calm and focused throughout. In that way, we extinguish the learned connection between the situation and the fear.

Exposure methods are ways to reprogram our emotional responses to situations.

Two steps are important to make exposure effective:

1. Before you try to expose yourself to imagery of your trigger situations, make sure you've thoroughly learned the coping skill that you'll be using as part of the pairing. For example, you want to practice a deep breathing, muscle relaxation routine every day for at least a week to ensure that you can focus and relax yourself on demand. At first, practicing the technique may take 20 minutes or so to get quite relaxed; later it will take only 15, then 10. Eventually, with enough practice, you'll be able to relax and focus yourself quite effectively with just a few deep breaths. You want to get to that point *before* undertaking the imagery work. The idea is to internalize the coping skill before you try to pair it with threatening situations.
2. Repetition is the key to effective exposure work. You don't just imagine a stressful situation, keep yourself calm, and then go on with your day. Rather, you imagine the situation in great detail, with multiple variations. You won't imagine very stressful situations until you've been able to keep yourself thoroughly relaxed with less stressful imagined scenarios. If that means you repeat a single scenario five times until it no longer elicits anxiety, that is fine. The goal is to unlearn the connection between the situation and the unwanted response and train yourself to a new connection: between the trigger situation and staying in the zone.

As a beginning exercise, here is a very basic exposure routine that you can apply to almost any trading patterns that you wish to change. I have found that this works very well for reprogramming anxiety responses to market situations and frustration/anger responses. Any time a situation evokes an exaggerated emotional and/or behavioral response from you, exposure methods can be used to alter your reactions:

- Step 1.** Seat yourself comfortably, listening to relaxing music through headphones. While listening, close your eyes and breathe deeply and slowly. Keep yourself still physically and keep your mind focused on the music.
- Step 2.** Start with lower part of your body and gradually tense and relax the muscles, performing several repetitions with each muscle group before moving higher along your body. Thus you tense and relax your toes several times, then you flex your foot, then your lower leg, etc. All the while you are tensing and relaxing, you are breathing deeply and slowly and staying focused on the music.
- Step 3.** Once you reach the top of your body, tensing and relaxing the muscles of your face, you then take a few more deep breaths and notice your body's relaxation.
- Step 4.** With the music still playing, imagine in detail a trading situation that you anticipate. Visualize the position you're in and the market movement. Imagine the market behaving in a way that normally would trigger your fear, frustration, etc. All the while, you are breathing deeply and slowly, keeping your muscles relaxed, and playing the music in the background.
- Step 5.** When you feel yourself tense up or experience fear or frustration, stop the visualization (freeze the frame) and simply go back to breathing deeply and slowly and listening to the music. Once you're relaxed again, continue the scenario from where you left off. Make sure you freeze things and keep yourself calm and focused when trigger responses start to affect your visualization.
- Step 6.** If you had to interrupt the visualization to keep yourself calm, repeat the exact same scenario the same way until you can get all the way through without having to freeze the scene. At that point, you've extinguished the response to the situation.
- Step 7.** After you master one scenario, construct variations of the scenario, perhaps making each one a bit more stressful. Once again, don't move on to another scene until you've been able to keep yourself fully relaxed and focused during the scene you've been rehearsing. If you can stay calm and focused during a

visualization of a moderate stress, make the next visualizations more threatening. Don't stop your exposure work until you have tackled your absolute worst fears.

This basic exercise enables you to extinguish emotional and behavioral responses to trading situations that can lose you money. If you rehearse staying calm and focused in stressful situations, you build a new learned connection and reprogram your behavioral responses. This process is effective for situations in which you've been through extreme losses, and it is also quite useful in reprogramming patterns of overtrading. When you coach yourself to face and overcome your worst fears, you build confidence, resilience, and a sense of efficacy, empowering yourself in situations where you had seemed powerless.



#### **COACHING CUE**

Imagery can be powerful in programming new responses, but consider extending your exposure work to live trading. Such in-vivo exposure, beginning with small trading size and gradually ramping up to full size with success, is the single most effective technique for reprogramming traumatic experiences in trading, such as large losses that overwhelm mood and confidence. By re-creating the market conditions that caused the trauma in imagery—and then facing those conditions in simulated and actual trading—all the while rehearsing self-control skills, we can regain a sense of mastery over trading. It takes repeated experiences of safety during exposure work to undo traumatic stresses. Eventually, the emotional learning that we can face our fears without terrible things happening sinks in and contributes to a newfound confidence.

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### **LESSON 69: EXTEND EXPOSURE WORK TO BUILD SKILLS**

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In the previous lesson, we saw how exposure methods can be used to de-program negative behavior patterns. Just a small adjustment in the technique is needed to create positive learning by rehearsing and reinforcing proper trading behaviors.

The fundamental difficulty of trading is that we know what to do (enter on pullbacks in a trend, size positions appropriately) when we are out of the heat of battle. When stressed, however, or when we face unusual opportunity, we find that other behavior patterns are triggered and it is much more difficult to do the right things. I work with a good number of experienced portfolio managers and proprietary traders, and even they make the occasional rookie errors, in which they are swayed by situational

influences. Techniques that reinforce the right actions can be useful for the pros as well as beginners.

One trader I worked with was bedeviled with the problem of regret. He would enter a longer-term position and, while it was going his way, he was fine. As soon as the position retraced some of the gains, however, he began to regret that he hadn't lightened up at the more favorable price levels. This regret was a very tangible psychological influence for him. At times, it became outright guilt as he convinced himself that he had done the wrong thing.

What happened as a result of this pattern is that he would inevitably assuage this guilt by waiting for the profits on the trade to move back to their high water mark so that he had an exit approximating the one he had missed. The problem was that this cut his original trade idea short. Many times he would take his profit on the first rebound from the retracement, only to see the position move toward his initial target without him on board. Then the trader experienced massive regret and guilt. This led him to seek additional home run trades (to relieve his newest guilt), only to make the same mistakes on these trades as well. By the time I met with this trader, all he could talk about was how much he could have made if he had just traded the way he planned.

Many traders are shaken out of good trades when they aim to not lose, rather than aim to maximize profits.

The exposure work for this trader was straightforward. As the previous lesson outlined, we first just worked on the skill of staying calm and focused. I used the heart-rate variability (HRV) biofeedback unit for this work ([www.heartmath.com](http://www.heartmath.com)). He had to concentrate and breathe rhythmically and deeply while keeping his HRV readings high. The trader was able to use the biofeedback unit for practice at home and he could track his skill-building by keeping the majority of his readings in the highest bin for a continuous period of five minutes or more. He found that he could keep his readings high by focusing his attention (counting in his head), keeping physically still and relaxed, and breathing from his diaphragm in a smooth, gradual fashion.

Once he had mastered the skill of keeping himself in the HRV zone, he used visualization to walk himself through his trade setup, including his profit target and stop. He vividly imagined the market moving in his favor, but instead of imagining himself being pleased with this outcome (which was what happened in his usual trading), he mentally reviewed his original trade plan and told himself that nothing had changed to alter the plan: it was working as anticipated. I asked the trader to simply repeat this part of the visualization over and over until he no longer reacted to the initial

gain with excitement (and with a mental accounting of his paper profits). Instead, he visualized staying calm by reaffirming his plan for the trade.

Getting excited by gains in a trade is the first step toward getting panicky when those gains are threatened.

Only after the trader had mastered this aspect of the trading situation did we proceed to imagining that the market retraced some of its initial move, eroding a portion of his gain. Again and again, he imagined this retracement while breathing deeply and slowly and staying focused on the computer screen (which displayed his biofeedback readings), until the imagery of the retracement no longer brought fear or concern. At that point we mentally rehearsed the pullbacks all over again, this time while not only staying calm and focused but also while mentally reviewing his trade idea and his exits. Our trader spontaneously began to focus his attention on how proud he would feel if he just stuck with his ideas and saw them through. This pride, for him, was the opposite of the guilt he had been feeling. When he invoked this sense of pride, he not only extinguished his old behavior, but also positively reinforced his discipline.

*The key to making this work is mentally rehearsing the right trading behaviors while you're in the state that normally triggers the wrong ones.* When you're your own trading coach, your challenge isn't simply to figure out the right things to do. Rather, your job is to be able to act in the right ways in situations that normally pull for all the wrong trading behaviors. If you practice good trading when you're not in realistic trading situations, it is much less powerful than overcoming learned connections as they're occurring.

Of course, we can extend the power of exposure by shifting from imagery-based work to actual trading. Typically I'll have a trader start trading small size at first while engaging in the deep breathing and concentration and implementing trading plans. While the trade is on, the trader keeps her biofeedback readings in the optimal range and rehearses the plan for that trade. During the troublesome retracements, the trader simply repeats what she had practiced in the imagery: staying focused on the trading plan and keeping physically calm through the regular, deep breathing. Once this process is successful with small trades, the trader can gradually increase size back to the normal level of risk, performing the biofeedback work at each new size level.

Utilize biofeedback during trading and you can often detect departures from the performance zone before you are consciously aware of them.

If there are challenging market situations, the best approach to master them is to face them directly while you stay grounded in your best trading practices. With the use of imagery, this conditioning work can be accomplished outside of market hours and without taking risks. With repetition, the mentally rehearsed patterns feel increasingly natural, as the old, learned connections fall away. It is not always comfortable doing exposure work—and the better you do it, the less comfortable it will be—but you cannot coach yourself through discomfort unless you're willing and able to tackle it directly. Rehearse your best trading practices while you're in your most stressful situations; it is one of the most effective training techniques you can employ.



### COACHING CUE

It is helpful to formulate your best trading practices as specific, concrete rules so that these rules can be rehearsed in detail during the exposure work. Among the rules I've found most helpful for this work are:

- Generating trading ideas by identifying themes that cut across sectors and/or asset classes.
- Waiting for pullbacks in a trend before entering a position.
- Establishing my target price at the outset of the trade, so that I can enter the trade with a profit potential that exceeds the loss I'm willing to take.
- Sizing my trade so that I'm risking a fixed, small percentage of my portfolio value on the idea.
- Adding to longer-term trades on pullbacks after they have gone my way and remain profitable.
- Exiting trades on my planned stop-loss points or at my designated profit target.

Trading rules will differ for each trader depending on their markets and trading style. The important thing is to know what you do when you are most successful, so that you can cement these positive patterns, even as you expose yourself to challenging trading conditions.

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## LESSON 70: A BEHAVIORAL FRAMEWORK FOR DEALING WITH WORRY

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We hear a great deal about fear and greed, and all of us have experienced bouts of overconfidence and frustration. On a day-in and day-out basis, however, few problems are as thorny for traders as worry.

Worry occurs when we anticipate an adverse outcome and its consequences. We can worry about missing an opportunity or about being wrong in a trade. We can worry about the future of our trading career or, sometimes, worries from personal life outside of trading can affect decision-making. It is common, for instance, for young traders to experience more stress after they have married, had children, or purchased a new home. With the added financial responsibilities come worries.

Worry is problematic for traders for several reasons:

- **It undercuts confidence.** It is difficult to maintain optimism and focus on progress while anticipating negative outcomes.
- **It interferes with concentration.** Thought and emotion directed toward worries are taken away from tracking market patterns.
- **It leads to impulsive decisions.** For most people, worry is so noxious that they will take action to reduce their concerns. Such action is not necessarily in the best interest of one's trading account.
- **It is not productive.** Rarely does worry lead to concrete, constructive problem solving. Worrying about negative outcomes does not generally help people achieve positive ones.

It is difficult to make sense of worry from a behavioral vantage point. No one truly enjoys worry, so it is unclear why the behavior persists. This is especially puzzling for chronic worriers. They do not enjoy focusing on negative things and typically are not happy people. So what keeps them worrying?

Visualizing worst-case scenarios and how you would handle them is constructive; worry reinforces a sense of hopelessness and helplessness in the face of those scenarios.

To make sense of worry, let's review the difference between thinking about a negative event and actually experiencing that event. I can think about losing money in my trading and the thought does not bring particular anxiety or concern. If, however, I vividly imagine a particular trade that I am planning and visualize myself taking a loss on a large position, I can generate palpable experiences of nervousness. Abstract thought rarely generates strong emotion. Imagery, on the other hand, acts as a surrogate for reality. Think about sexuality and nothing happens; imagine an erotically charged scene and the body responds.

*From a behavioral vantage point, worry is a form of thinking and, as such, it can function as a negative reinforcer.* Let's say that I anticipate a stressful meeting with the risk manager at my trading firm. My underlying fear is that he will reduce my capital and express a loss of confidence in



me. Rather than experience the hurt and resentment that such a meeting would engender, I worry about making the meeting on time, what I'll say in the meeting, what I might miss in the markets while the meeting is going on, etc. None of these worries has the power to evoke strong emotion. Rather, the worries serve as distractions from the difficult feelings I would experience if I actually visualized outcomes of the meeting. If I avoid experiencing these feelings, worry serves as a negative reinforcer. Strange as it might seem, worry is not so noxious when the alternative is facing scary outcomes.

Worry can possess reinforcement value in other ways, as well. If I were feeling out of control in my trading, that feeling would be unpleasant to dwell upon. If I worry about details in the work I'm going to have done on my house, I shift my focus to something more controllable. While it may seem that I worry about negative outcomes—and, in the example, I am—the psychological reality is that I substitute a lesser concern for a greater one when I worry. *What we worry about is usually not what is scariest to us.* Indeed, it is a diversion from the scariest scenario—and therein lies its reinforcement value.

Worries about small things usually mask larger concerns.

Exposure work can be a great antidote to worry. When we expose ourselves to our greatest concerns—our worst-case scenarios—we can plan for these possibilities and mentally rehearse positive coping. If, for instance, I'm threatened by an upcoming meeting with the risk manager at my firm, I'll look at the worst case outcome—a large cut in my capital—and figure out a trading plan that will focus on my most successful trading and bring me back to my prior portfolio size. Once I anticipate the worst and figure out how I'd deal with it, I take the catastrophe out of the situation. That eliminates the need for worry-based diversions. Worry thinking can't be a negative reinforcer if it is more noxious than the alternative of facing possible outcomes constructively.

A great way to coach yourself past worry is to make note whenever you catch yourself worrying and ask, "What am I *really* fearful of? What's the real issue here?" What you generally find is that there's an unresolved situation looming in the background. Until the situation is faced squarely, it intrudes in your work and affects your mood. Suppose you find yourself worrying about whether a specific trade will work out. When you stop and reflect, you realize that you've sized the trade and placed your stop-loss point in such a way as to make such worry unnecessary. So what is the real concern? Perhaps the fear is of one's future as a trader. Perhaps it's a conflict at home. Whatever the real problem is, you want to visualize the

situation vividly and walk yourself through your most constructive response. Then visualize the situation and solution again—and again. With repetition, the worst-case scenario will become routine. It will no longer evoke strong emotion. And that will leave you with little reason for worry.



### COACHING CUE

Worry can be a great signal that we are harboring larger concerns about our basic trade ideas. When I find myself glued to the screen, following the market tick by tick during a longer-term trade, I know that something is wrong. Beneath the worries about the market's moment-to-moment action, I have deeper concerns—perhaps that my basic idea is wrong all along. This can be a useful signal: when we're comfortable with trades, we don't need to worry over every tick in the market. And when we are worrying about those ticks, it's a good sign that we're not comfortable with our position—and that can lead to constructive reevaluation and planning.

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### RESOURCES

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The *Become Your Own Trading Coach* blog is the primary supplemental resource for this book. You can find links and additional posts on the topic of coaching processes at the home page on the blog for Chapter 7: <http://becomeyourowntradingcoach.blogspot.com/2008/08/daily-trading-coach-chapter-seven-links.html>

Chapter 9 of *Enhancing Trader Performance* details several strategies for changing behaviors that interfere with trading decisions, including a step-by-step description of exposure-based methods. See also Chapter 8 of that book for cognitive and cognitive-behavioral techniques.

A detailed account of behavioral approaches to change can be found in the chapter “Brief Behavior Therapy” by Hembree, Roth, Bux, and Foa in *The Art and Science of Brief Psychotherapies*, edited by Dewan, Steenbarger, and Greenberg (American Psychiatric Publishing, 2004).

Articles relevant to behavioral views of trading can be found among my collected articles, including the articles on “Behavioral Patterns That Sabotage Traders” and “Techniques for Overcoming Performance Anxiety in Trading”: [www.brettsteenbarger.com/articles.htm](http://www.brettsteenbarger.com/articles.htm)

Articles on emotional intelligence, staying in the zone, and balancing trading with the rest of life can be found in *Psychology of Trading*, edited by Laura Sether (W&A Publishing, 2007).

# Coaching Your Trading Business

*He is not great who is not greatly good.*

—William Shakespeare

**I**n the previous chapters, we have explored ways of coaching yourself by becoming your own trading psychologist. Now we will turn to another facet of self-coaching: guiding your trading business. You, as a trader, are a business person no less than someone who offers goods and services to the public. You have overhead to cover, and you have returns you need to make to stay in business. Like any business owner, you risk your time, effort, and capital to earn returns higher than you could obtain from other activities. But are you getting the best return for your efforts? Are you taking the right amount of risk at the right times? Are you devoting the majority of your efforts to the activities that will provide the best returns? When you are your own business coach, you focus both on doing the right things and upon doing things right. There's much you can do as your own psychologist. Now let's see how you can thrive as your own business consultant . . .

## **LESSON 71: THE IMPORTANCE OF STARTUP CAPITAL**

If you consistently break even in your trading, you will eventually lose all your capital. This is because there are costs embedded within trading, such as commissions and fees for data services, software, and computer

support. It is no different in any business: an entrepreneur has to at least make enough to cover the overhead to stay afloat.

Many businesses fail because they lack adequate startup capital and cannot keep their overhead under tight control. They don't realize how long it will take to build a large and loyal customer base. As a result, they burn through their cash before they can sustain breakeven operations. To preserve capital, they cut back on essentials such as marketing and advertising. This creates a death spiral of fewer customers, lower income, and further belt-tightening.

Adequate startup capital enables the entrepreneur to make a beginner's mistakes and address the holes in his business plan before going out of business. Business plans are like battle plans in times of war: they are indispensable, but also subject to frequent change. Without sufficient resources, businesses cannot weather those changes.

Much of the stress that new traders experience is the result of an inadequate capital base: they are trying to do too much with too little.

So it is with traders. When they begin their business with modest capital, they cannot survive their learning curves when markets change and inevitable slumps take hold. Like failing businesses, they then begin to cut back on essential overhead, such as needed data and redundant systems. With little more to trade with than the same charts that everyone else looks at, the undercapitalized trader in overhead reduction mode virtually ensures that she will never maintain a distinctive edge.

So how much startup capital is sufficient for a trader? If you are just learning about markets, very little capital is needed to advance your learning curve. I began trading in late 1977 with a \$2,500 stock market account at a regional brokerage in Kansas City. That enabled me to trade 100-share lots of individual stocks and test out my ideas without undue risk. Now, with the advent of simulation platforms, as discussed in the *Enhancing Trader Performance* book, it is possible to realistically test strategies and gain a feel for markets without placing money at risk.

Some commentators downplay the value of paper trading and simulation-based trading with live data because the psychological pressures of losing real money (and the overconfidence that comes with winning) are not present. This, however, is precisely why simulated trading is perfect for traders early in their development. Simulation enables the beginner to simply focus on the mechanics of trading and the recognition of trading patterns without having to worry about losing startup capital.

After all, if traders can't succeed in simulated trading, there's no way they'll succeed when those psychological pressures are added to the mix!

What makes sense, therefore, is to require yourself to earn consistent money in practice trading before you assume modest risk with 100 shares (or one lot of a futures contract). You thus need to sustain success with that small size before you trade larger. Just as a business should sustain success with one store before opening other outlets, a trader should have to earn his way toward trading size. If beginning traders stick to this one self-coaching rule, many could stay in the game long enough to become experienced traders.

A great business rule: Make yourself earn increases in trading size/risk by trading well and consistently with smaller size/risk.

When the aim is trading for a living, far more startup capital is required. At the money management firms I currently work with, for example, a portfolio manager is quite a star if she can sustain 30 percent returns year after year without taking undue risk. That portfolio manager will inevitably be given more capital to manage and, if success follows, may even strike out on her own with her own fund. In truth, a consistent 15 percent annual return, achieved with modest risk, will keep a portfolio manager well employed at most firms. True, any particular trader may achieve outsized returns in a given year, especially if taking large risk. The question, however, is: What kinds of average returns are sustainable over time?

*A developing trader who expects to outperform seasoned money managers year after year substitutes fantasies for business plans.* But if consistent 30 percent returns after expenses are stellar, how much trading capital would be required to sustain a living—and to keep the trading account growing at the same time? It's not difficult to see that an account well into the six figures would be a minimum startup for a trader that wanted a good living from his work.

Not many traders early in their careers have access to that kind of liquid capital. As a result, they start with much less capital and try to trade it aggressively to generate returns large enough to support a household. For a while, that might work out. Eventually, however, such traders sustain grievous losses that cannot be surmounted. After all, once you lose 50 percent of your capital, you have to double your remaining money just to get back to where you were. An undercapitalized trader, like an undercapitalized business, can't weather many adverse events—especially if taking large and frequent risks.

Long before you seek to trade for a living, you should work at trading competence: just breaking even after costs.

When you are your own trading coach, you're also the manager and entrepreneur of your own trading business. That means that you have to start with a viable plan for success. Among other things, that plan should address:

1. How you'll learn markets and obtain trading competencies.
2. How you'll capitalize your business so that you can make a good income from realistic, solid risk-adjusted returns.

If you cannot raise the capital needed to make a living from realistically good returns, then your challenge is to make yourself attractive to trading firms that can front you sufficient trading capital. Take the steps needed to become attractive to such a firm and make that part of your business plan; this will form the basis for the next lesson. For now, your assignment is simply to learn markets before you put significant capital at risk, establish success over a range of market conditions and cycles, and ensure adequate access to capital before you give up your day job. Stress test the startup plan for your trading business: calculate how you would get by if returns were modest for the first couple of years. Run your plan by seasoned traders who make their living from markets; find the weak spots and address them. As the old saying goes, failing to plan is tantamount to planning to fail.



#### COACHING CUE

One of the smartest business decisions I made in my trading was to begin with an account small enough that it would not impact my family's lifestyle if I lost every penny. Early in my development, I had no illusions of trading for a living; my goal was to simply get better. A major milestone in my development came when I could consistently keep losing trades smaller than winners. Early in my trading efforts, it was a few large losers that impaired my overall performance. Had I been trading with money needed for my family's well-being, the stress of making rookie mistakes would have been overwhelming. Margie referred to my trading account as play money; she never counted on it or the income from it in our financial planning. Without the pressure of profitability demands early in my development, I was free to make mistakes and learn from them. A sure way to maximize stress and lower your odds of success is to put your capital at risk before you have cultivated your skills.

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## LESSON 72: PLAN YOUR TRADING BUSINESS

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When you're your own trading coach, you are also the manager of your trading business. What is your business plan for success? How are you going to achieve your goals as a trader?

The first step toward good planning is to know *why* you are trading. That sounds silly: doesn't everyone trade to make money? Yes and no; I'm continually surprised at traders' fuzziness about their goals. If you're a beginner, your goal is simply to learn the ropes, internalize market patterns, and practice skills related to good execution and risk management. If so, as the previous lesson emphasized, you can accomplish those ends with little or no capital at risk. What you need is a learning plan and a platform from which you can observe markets and trade them in simulation mode. (The elements of learning plans are covered in *Enhancing Trader Performance* and will be addressed in later lessons in this chapter).

If you are like me and don't trade full time for a living, your goal is different. Your objective is to make more than the riskless rate of return (i.e., the amount you could earn, say, from a savings bond or bank certificate of deposit) after expenses. In that case, you allocate a portion of your savings to your trading account and use that portion of your money to improve returns from other investments and savings vehicles. This process means that you will be particularly sensitive to risk-adjusted returns, as you won't want to place your savings at undue risk. Trading, in that context, is part of diversification of your capital and is part of a larger financial plan.

Your business plan will look different if you're trading as an avocation rather than as your vocation.

If you're trading for a living, then you're truly in the mode in which your trading is your business. A retail business needs to know how it will make money: what products they will sell, how they will sell them, how much it will cost them to sell them, and how much they can charge for them in order to make an acceptable return on investment. In your trading business, the questions become:

- What will you trade and how will you trade it? What simulated and live trading experience tells you that this will be successful?
- What will your overhead be? This includes software, hardware, commissions, and other expenses related to full-time trading, from the cost of data to your electronic connections and educational materials.



- How much can you expect to make per trade? Per month? Per year? What is the likely variability of your income? Will this be manageable?

These questions require hard data based on experience, not guesses or hopes.

Before you attempt to trade for a living, you should have a sufficient base of experience to tell you four things:

- What is the average size of my winning trade?
- What is the average ratio of my winning trades to losing trades?
- What is my average percentage of winning versus losing trades?
- What is my average variability (volatility) of returns per day, week, and month?

The answers to these questions will determine the likely path of your returns: the income generated from your trading business. These questions lead you to ask other questions:

- What kind of trader am I: do I tend to make money by being right more often than wrong, by having larger winning trades than losers, or a combination of the two?
- How much variation in my winning percentage and in the ratio of the size of winners versus losers is normal for me?
- How large would my trading need to be to generate acceptable returns and how much capital would I need to support that trading without undergoing drastic swings?

*It is surprising—and dismaying—how few traders really look under the hood of their trading to understand how they make money. Because traders don't have a grasp on how they perform on average and how much variation from average can be expected, they are poorly equipped to distinguish normal drawdowns from troublesome slumps. They are also in a poor position to identify those occasions when the patterns of their returns shift due to changing markets.*

If your trading experience does not extend to a variety of market cycles and conditions, your trading business will be ill prepared to weather shifts in volatility and trend.

Your assignment for this lesson is to go to Henry Carstens' Vertical Solutions site ([www.verticalsolutions.com/tools.html](http://www.verticalsolutions.com/tools.html)) and check out his two forecaster tools, using your own trading data as inputs. His first tool will show you how the path of your returns will vary as a function of changes in volatility. These volatility shifts could be attributable to

market changes or to your taking more risk in each of your trades. You'll see clearly how much drawdown is associated with a given level of volatility, which will help you gauge your own tolerance.

The second forecaster tool asks you to input the average size of your winning trade, your average ratio of winning to losing trades, and the ratio of the size of your average winners to losers. Run the forecaster many times with your data and you'll see a variety of plausible sets of returns. This will give you a good sense for the expectable runs (to the upside and downside) in your trading, as well as the expectable returns over a 100-trade sequence.

Finally, tweak the parameters from the second forecaster to simulate the paths of possible returns if your average winning trade shrinks (maybe due to slow markets) or if your ratio of winning to losing trades declines (perhaps because of misreading markets). Tweak the ratio of the size of your average winners and losers to see what happens to your returns if you lose discipline and hold losers too long or cut losers short, creating poor risk/reward per trade.

All of these what-if scenarios will give you a good sense for what you can expect from your trading. It is much easier to deal with business adversity if you've planned for it in advance. When you're coaching yourself, the more you know about your trading business, the better you'll be able to make it grow.



#### COACHING CUE

An important element of success in building a trading career is being able to identify periods of underperformance as quickly as possible, before they create large drawdowns. The more you know about your trading—the average sizes and durations of drawdowns and the variability around those averages—the better prepared you'll be to identify departures from those norms. Keep statistics on your trading so you can also highlight periods in which you're trading particularly well and learn from these episodes. The single most important step you can take to further your trading performance is to keep detailed metrics on your trading. These steps will highlight what you're doing right and wrong, informing your self-coaching efforts.

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### LESSON 73: DIVERSIFY YOUR TRADING BUSINESS

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Suppose you have a passion for coffee and decide to start your own coffee-house as a business. You develop reliable sources for high quality beans,

purchase a roaster, and rent space in a well-trafficked area. You furnish the café attractively and purchase all the cups, saucers, and utensils you will need. Altogether you sink \$100,000 into your new enterprise, which is loaned from a bank with your home as collateral. Your average cost to serve a cup of coffee, just based on materials and labor expenses alone, is 50 cents. At \$1.50 per cup, you're making a dollar for each cup you sell. At 300 customers per day, that's \$300 per day or about \$90,000 per year. That doesn't leave you with much to take as a salary once you pay off your overhead.

In this scenario, you can only make a go of the business by increasing the number of customers coming to the café, by increasing the average expenditure per customer, or both. So let's say you try to increase the average check size per customer by adding something additional to the menu. In addition to coffee, you now also serve tea.

Unfortunately, this doesn't help your business greatly. A few more customers enter the café who are tea drinkers, but few customers order both coffee and tea. As a result, you've increased your overhead (for tea equipment and supplies), but haven't greatly added to the bottom line. Tea overlaps coffee too much to add much to the menu; it doesn't really diversify the offerings of your café.

Suppose, however, you add pastries to the menu, sourcing them from a local bakery. Now you find that many people interested in your coffee also like a pastry to go with their drinks; this increases the size of their checks and enables you to make profits from two sources instead of one: the beverage and the pastry. You also now attract people who are interested in a snack or who just want a bite to eat after a concert or theater. The increased traffic also adds to the bottom line.

*What has happened is that you've made your business more diversified.* You have multiple profit centers, not just one. If you offered evening entertainment, sandwiches, and breakfast items, you would be even more diversified. Instead of attracting 300 patrons per day at one dollar each, you might attract 800 a day at \$2.50 each. With \$2,000 a day of gross income after labor and materials costs, you now have the basis for a thriving business. Moreover, should a café open elsewhere in the neighborhood, your business will be protected because of its other unique offerings.

Diversification leverages talent.

The same business principles that impact the viability of the café apply to trading. When you trade different markets, time frames, and patterns, you generate multiple potential profit sources. This protects you when markets shift and place any single idea or pattern into drawdown mode. It also

leverages your trading productivity, as you now can generate profits from many centers instead of a very few.

There are many ways of diversifying your trading business. If you are an intraday trader, you'll be diversified by trading long and short and by allocating your trades to different stock names and/or sectors. You may also hold some positions overnight, creating a degree of diversification by time frame as well. If you are trading over a longer time frame, you may trade different markets or strategies, each with different holding periods.

*The key, for the trader as well as the café, is to make sure that diversification truly adds diversity.* Adding tea to a coffee menu did not achieve adequate diversification for the café. Adding a Dow trade to an S&P 500 trade similarly fails to add unique value. Your diversification should provide a truly independent and reliable income stream. When the coffee business is slow, for example, customers may come to the café for a bite to eat. This keeps the flow of customers strong through the day. Similarly, when one of your trading strategies is drawing down, other ones that are not correlated can sustain the flow of profits to your account.

Of course, when you diversify, you need to make sure you stay within your range of expertise. Adding fresh entrées to a menu would make little sense for a café owner who lacked cooking skills. Similarly, it doesn't help your profitability as a trader to add strategies that are not well tested and known to be successful. Diversification only makes sense when it adds unique value to what you're already doing.

Many beginning traders think they'll find a way of trading that is profitable and then trade that for a career. Rarely are markets so accommodating. If a café brings in a huge number of customers, you can be sure competitors will soon follow. If a trading strategy is successful, it will find wide interest. Successful businesses must always innovate, staying ahead of the competitive curve. Adding new sources of revenue to exploit changing markets is essential to long-term survival.

I cannot emphasize this strongly enough: *markets change*. Edges in markets disappear. Trends change. The participants in markets change. The themes that drive markets change. The levels of volatility and risk in markets change. I have heard many promoters hype trading methods that they claim are successful in all markets, but I have yet to see documentation of such success. Every trader I have known who has sustained a long, successful career has evolved over time, just as successful businesses evolve with changing consumer tastes and economic conditions. Quite a few traders I've known who have been successful with a single method have failed to sustain that success when that strategy no longer fit market conditions (momentum trading of tech stocks in the late 1990s) or when it became so overcrowded that the edge disappeared (scalping ticks on the S&P 500 index by reading and gaming order flow). It's difficult to learn how to trade; even harder to unlearn old ways and cultivate new ones.

The successful trading business, like elite technology, pharmaceutical, consumer, and manufacturing firms, devote significant resources to research and development: staying ahead of their markets.

When you are your own trading coach, it's not enough to learn markets. You're an entrepreneur; you're always developing new strategies, new ways of building upon your strengths. What products do you have in your pipeline? What markets, strategies, or time frames are you looking to expand to? You can adapt your current trading approaches to new markets or cultivate new strategies for familiar markets. *Your challenge is to develop a pipeline: to always be innovating, always searching for new sources of profit that capitalize on what you do best.*

Many traders sit down at their stations a little before markets open, trade through the day, and then go home, repeating the process day after day. That schedule is like coming to work at your café, putting in your hours, and then going home until the next workday. That is what you do if you're the employee of the business, not the owner. Your challenge, as your own coach, is to actively own and manage your trading business, not just put in hours in front of a screen. You need an edge to succeed at trading, but you need to develop fresh sources of edge to sustain your trading business.



#### COACHING CUE

I find there is value in learning trading skills at time frames different from your own. Short-term, intraday traders can benefit from looking at larger market themes that move the markets day to day, including intermarket relationships and correlations among stock sectors. If you identify those themes and relationships you can catch market trends as they emerge. Conversely, I find it helpful for longer-term traders, portfolio managers, and investors to learn the market timing perspectives of the short-term trader. This process aids execution, helping traders enter—and add to positions—at good prices. The views from different time frames can fertilize the search for new sources of edge: the perspectives of big-picture macro investors and laser-focused market makers can add value to one another.

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## LESSON 74: TRACK YOUR TRADING RESULTS

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You cannot coach your trading to success if you do not keep score. Keeping score is more than tracking your profits and losses for the day, week, or

year. It means knowing how you're performing and how this compares with your normal performance.

Score keeping makes sense if you once again think of your trading as a business. A sophisticated retail clothing firm tracks sales closely every week. Retailers know not only how much they've sold in total, but how much of each product. Perhaps the economy is slow, so women's accessories—which are lower-priced—are hot, but high-priced clothing is not. The company that tracks these trends regularly will be in the best position to shift their product mix and maximize profits. Similarly, if one store is dramatically underperforming its peers despite a favorable location, managers can use that information to see what might be going wrong at the store and make corrections.

Score keeping in the business world can be extremely detailed. There are good reasons for the investments in information systems that we observe among the world's most successful corporations. Firms may track sales by hour of the day to help them determine when to open and close. Purchasing patterns based on gender and age are factored into advertising messages and promotional campaigns. Score keeping provides the business with knowledge; in the business world, knowledge utilized properly is power.

You can't properly manage your business if you don't understand what it is doing right and wrong.

Nowhere do we see this power more dramatically than in quality control. Firms such as Toyota collect reams of data on their manufacturing processes to help them identify lapses in quality, but also to make continuous improvements in manufacturing processes. If you don't collect the data, you can't establish the benchmarks that enable you to track progress. *It's not just about ensuring that you do well; the best businesses are driven to do better.*

When you keep score in your trading business, a few metrics are absolutely essential. These include:

- Your equity curve, tracking changes in portfolio value over time.
- Your number of winning versus losing trades.
- The average size of your winning trades and the average size of your losers.
- Your average win/loss per trade.
- The variability of your daily returns.

Let's take a look at each metric in a bit of detail.

## Equity Curve

Here you're interested in the slope of your returns and changes in the slope. As we saw with Henry Carstens' tools that simulate trading returns, a great deal of directional change in your portfolio can be attributed to chance. For that reason, you don't want to overreact to every squiggle in your equity curve, abandoning hard-won experience. Too many traders jump from one promised Holy Grail to another, shifting whenever they draw down. *A far more promising framework for your self-coaching is to know the equity curve variation that is typical of your past trading, so that you can compare yourself against your own norms.* If you have learned trading properly, you will have a historical curve of your returns from simulation trading and small-size trading before you begin trading as an income-generating business. When your current equity curve varies meaningfully from your historical performance, that's when you know you may need to make adjustments. If the variation is in a positive, profitable direction, you'll want to isolate what is working for you so that you can take full advantage. If the variation is creating outsized losses, you may need to cut your risk (reduce the size of your trades) and diagnose the problems.

Knowing your normal performance is invaluable in identifying those periods when returns are significantly subnormal.

## Winning Versus Losing Trades

This is a basic metric of how well you're reading markets. Again, the emphasis is not on hitting a particular number, but on comparing your current performance to your historical norms. Let's say, for instance, you're a trend follower. You tend to make money on only 40 percent of your trades, but you ride those winners for relatively large gains compared to your losers. If your win percentage suddenly drops to 25 percent, you'll want to diagnose possible problems. Has your market turned choppy and directionless? Have you altered the way in which you're entering trades or managing them? The more the drop to 25 percent is atypical of your historical trading, the more you'll want to enter a diagnostic mode. If, however, you've had past periods of 25 percent winners just as a function of slow, directionless markets, you may choose to ride things out without making major changes in your trading simply by focusing on markets or times of day with greater opportunity.

## Average Sizes of Winning and Losing Trades

It doesn't help to have 60 percent winning trades if the average size of your losers is twice that of your winners. Keeping score of the average sizes of



winners and losers will tell you a great deal about your execution of trade ideas—whether you’re entering at points that provide you with favorable returns relative to the heat that you’re taking. The data will also tell you how well you’re sticking to your risk management discipline, particularly stop-losses. If your average win size *and* loss size are expanding or contracting at the same time, you may simply be dealing with greater or lesser market volatility (or you may be sizing your positions larger or smaller). It is the relative shifts in size of average wins and losses that are most important for managing your business. If your winners are increasing in average size and your losers are decreasing, you’re obviously trading quite well. It will be important to identify what you’re doing right so that you can be consistent with it. Conversely, when losers are increasing in average size and winners are not, you want to figure out where the problem lies. Are you reading markets wrong, executing and managing trades poorly, or both?

### **Average Win/Loss Per Trade**

Suppose you make a particular amount of money in January and the same amount in February. You might be tempted to conclude that you traded equally well in the two months. That would be a mistake, however. If you had placed 50 trades in the first month and 100 in the second month, then you can see that more trading did not produce more profit. Your average profit per trade actually declined. This suggests that at least some of your trading is not providing good returns, and that bears investigation. The situation is similar to that of a business that opens five new stores in a year, but reports the same sales volume year over year. The average sales per store have actually declined, an important factor masked by the increase in overall activity. Average win/loss per trade will vary with your position sizing and with overall market volatility. Be alert for occasions in which market volatility may increase, but your average win per trade goes down: you may not be trading as well in shifting market conditions. Many times, traders make as much or more money if they simply focus on their best ideas and reduce their total number of trades. This selectivity shows up as a soaring average win per trade. It’s a great measure of the efficiency of your trading efforts.

When you trade more often, make sure that the incremental trades are adding economic value.

### **Variability of Daily Returns**

If you take your wins and losses for each day and convert those to absolute values, you’ll then have a distribution of your returns. You’ll see how much your equity curve moves per day on average. You’ll also observe the

variation around this average: the range of daily swings that is typical for your trading. The variation in your daily returns will ultimately shape the size of drawdowns you experience in your portfolio. Given that you're going to experience runs of losing days over your career, you'll have larger drawdowns when those runs are 2 percent each than if they're  $\frac{1}{2}$  percent. *Indeed, if you investigate the losing periods that are historically typical of your trading, you can use these to calibrate the daily variability you want to tolerate in your trading.* This is central to risk management. If you want to keep total drawdowns in your portfolio to less than 10 percent, for example, you cannot risk average daily swings of 2 percent. Of course, if you're keeping drawdowns to less than 10 percent, you also cannot expect to be making 50 percent or more per year: risk and reward will be proportional. By calibrating the average swing in your portfolio per day, you target both overall risk and reward. If you're trading very well (i.e., very profitably) with a relatively low variation in your portfolio size from day to day, you can probably afford to gradually pick up your risk (increase trade size to generate larger returns). If you're trading poorly and losing money beyond your norms, you may want to reduce your daily variation and cut your risk.

What all of this means is that, when you're your own trading coach, you are also your own scorekeeper. The metrics above are, in my estimation, an essential part of the journals of any serious trader. The more you know about how you're doing, the more prepared you'll be to expand on your strengths and address your vulnerabilities.



#### COACHING CUE

See David Adler's lesson in Chapter 9 for additional perspectives on trader metrics. A particular focus that is helpful is to examine what happens to your trades after your entry and what happens to them following your exit. Knowing the average heat that you take on winning trades helps you gauge your execution skill; knowing the average move in your favor following your exit enables you to track the value of your exit criteria. Sometimes the most important data don't show up on a P/L summary: how much money you left on the table by not patiently waiting for a good entry price or by exiting a move precipitously.

### LESSON 75: ADVANCED SCOREKEEPING FOR YOUR TRADING BUSINESS

After the last lesson, you may be feeling overwhelmed by the data you need to keep to truly track and understand your trading business. I'm

sorry to inform you that such items as equity curve, average numbers of winning/losing trades, and average size of winning/losing trades are just a start to serious scorekeeping. Professional traders at many firms obtain much more information than that about their performance. Access to dedicated risk-management resources is one of the great advantages of working in such firms. Although it is unlikely that you could duplicate the output of a dedicated risk manager, it is possible to drill down further into your trading to uncover patterns that will aid your self-coaching.

In this lesson, we'll focus on one specific advanced application of metrics that can greatly enhance your efforts at performance improvement: tracking results across your markets and/or types of trades. This tracking will tell you, not only how well you're doing, but also which trading is most contributing to and limiting your results.

Of the different types of trades that you place, which most contribute to your profits? These are the drivers of your trading business success.

We've already seen how important it is for your trading to be diversified. Among the forms of diversification commonly found are:

- Trading different instruments, such as individual stocks versus index ETFs.
- Trading different markets, such as crude oil futures and stock indexes.
- Trading different setups, such as event trades and breakout trades.
- Trading different times of day and/or different time frames.

To truly understand your trading business, you want to tag each of your trades by the type of trade it represents. You will thus segregate trades based on the criteria above. All your overnight trades, for instance, will go in one bin; all your day trades in another. All our stock index trades will fall into one category; all our fixed income trades in another. If you're a day trader, you may want to segregate trades by time of day, by sector traded, or even by stock name.

Each of these categories is a product in your trading business. Each category is a potential profit center. When you think of your trading as a diversified business, you want to know how each of your products is contributing to your bottom line. Simply looking at your bottom line will mask important differences in results among your trades.

In practice this means that the metrics discussed in the last section—equity curve; proportion of winning/losing trades; average size of winning/losing trades; win/loss per trade; and variability of returns—*should be broken down for each portion of your trading business*. My own trading,

for example, consists of three kinds of trades: intraday trades with planned holding times of less than an hour; intraday swing trades with planned holding times of greater than an hour; and overnight trades. The short intraday trades are based on short-term patterns of price, volume, and sentiment. The swing trades are trend following and are based on historical research that gauges the odds of taking out price levels derived from the prior day's pivot points. The overnight trades are also trend following and are based on longer-term historical research that shows a directional edge to markets. These trades comprise different kinds of trades, because they are based on different rationales and involve different positioning in the markets. For instance, I can take a short-term intraday trade to the long side, but short the market for an overnight trade that same day.

You can identify the inventory of your trading business by segregating trades based on what you're trading and how you're trading it.

For other traders, the division of the trading business will be by asset class (rates trading versus currency trades versus equity trades) or by trading strategy/setup (trades based on news items; trades based on opening gaps; trades based on relative sector strength). Relatively early in my trading career, I broke my trades down by time of day and found very different metrics associated with morning, midday, and afternoon trades. That finding was instrumental in focusing my trading on the morning hours. In other words, the divisions of your trades should reflect anticipated differences in your income streams. If the returns from the trading strategies or approaches are likely to be independent of one another, they will deserve their own bin for analysis by metrics.

One of the breakdowns I've found most helpful in my trading is based on tagging the market conditions at the time of entry. To accomplish this, you would tag each trade based on whether it was placed in an upward trending market, a downward trending market, or a nontrending market. You will want to be consistent in how you identify market conditions; my own breakdowns (because I trade short-term) were simply based on how the current market session was trading relative to the previous one. It is common that traders will perform better in some market environments than others. For instance, based on a different breakdown, I learned that I was most profitable in moderate volatility markets, as tagged by the VIX index at the time of entry. When markets were relatively nonvolatile or highly volatile, my returns were significantly reduced. This was useful to me in knowing when and where to take risk.

Your trading business is most likely to succeed if you play to your strengths and work around your weaknesses.

What you'll find by breaking your trading down in this fashion is areas of relative strength and weakness in your performance. You will have a historical database of the normal trading in each area of your trading business, and you will have a way to see how your current trading compares with those norms. Thus, for example, you might make money overall, but your event-based trades (those based on fast entries after news items and economic reports) perform much better than your trend-following trades. This may say something about the market you're in and how you want to be trading that market by focusing more on what's working than what is not. Similarly, you may find that your average numbers of winners versus losers is fine overall, but lagging in one particular market. This could lead you to fine tune what you're doing in that market.

The goal of keeping score is to identify your own patterns and use those patterns to your advantage.

*When you are coaching yourself, I encourage you to think of yourself as a collection of different trading systems.* Each system—each market or strategy that you trade—contributes to the overall performance of your portfolio. Your job is to track the results of each system, see when each is performing well, and determine when each is underperforming. Armed with that information, you can thus allocate your capital most effectively to the systems that are working rather than those that are not. Diversification can't work for you if you are not diversified in how you view and work on your trading performance. Just as a football coach breaks down his team's performance into segments—running, kicking, defense against the run, defense against the pass, throwing—and works on each, you want to analyze and refine your team of strategies. Many a drawdown can be avoided if you stay on top of each segment of your trading business.



#### COACHING CUE

When you add to positions or scale out of them, how much value does your management of the trade provide? What is the performance specific to the pieces that you add to positions? How much money do you save or leave on the table by removing pieces from your positions? If you hedge your positions, how much do you gain or save through those strategies? Are you better trading from the long or short side? Do you perform better when trades are entered at certain times of day or held for particular time frames? If you drill down with metrics you can become specific when you work on various facets of your trading performance.

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## LESSON 76: TRACK THE CORRELATIONS OF YOUR RETURNS

A department store is an example of a diversified business. The store sells a variety of goods, so it attracts a wide range of customers. If consumers aren't buying seasonal items, they may come in to shop for clothes or housewares. The departments that offer products for children, teens, men, and women ensure that there will be a mix among customers, evening out peaks and valleys in traffic patterns for any of these individual groups.

In your trading business, diversification provides you with multiple profit centers. You can make money from intraday stock index trades and longer-term moves in the bond market, for example. If you divide your capital among different ideas and strategies, you smooth out your equity curve, much as the presence of many departments keeps traffic flowing to the department store. When any one or two strategies fail to produce good returns, others contribute to the bottom line.

Diversification in your trading enables you to stay afloat when any one of your strategies stops working for a while or becomes obsolete.

But how do you know your trading business is truly diversified? *Just because you are trading different setups or markets doesn't mean that you necessarily possess a diversified portfolio.* The only way you can ensure true diversification is by tracking the correlations among the returns of your different strategies.

Suppose you are a day trader who trades two basic patterns: moves on earnings news and breakouts from trading ranges. The idea is that your returns would be diversified because you would be long some names (earnings surprises and breakouts to the upside) and short others (earnings surprises and breakouts to the downside). You would also be diversified across market sectors and perhaps even by the time frame of your holdings. If you follow the logic of the previous lesson, you can track performance metrics for your earnings-related trades and your breakout trades. You can also track performance across your long trades and your shorts.

When you track the correlation of your returns, you take the analysis a step further. You calculate the daily P/L for each of your strategies over a period of time. You then evaluate the correlation between the two number series. If the strategies are truly independent, they should not be highly correlated. A slow market, for example, may yield little in the way of breakout trades, but you could still make money on selected stocks with earnings surprises. Similarly, you may get little earnings news on a particular day,



but the market may provide a number of breakout moves due to economic reports.

Many traders think they are diversified, when in reality they are trading the same strategy or idea across multiple, related instruments. This means they're taking much more risk than they realize.

One stock market trader I worked with had a phenomenal track record and then stopped making money all of a sudden. On the surface, he was well diversified, trading many issues and utilizing options effectively for hedging and directional trade. When we reviewed his strategies in detail, however, it was clear that all of them relied on bull market trending to one degree or another. When the market first went into range-bound mode and then into a protracted bear move, he no longer made money. He was trading many things without much in the way of diversification. His trading business was like a car dealership that sells many kinds of trucks, vans, and SUVs. Once large vehicles go out of favor, perhaps due to high fuel costs, the business becomes vulnerable. It's not as diversified as it looks.

Suppose you track your performance historically and find that your strategies correlate at a level of 0.20. The outcome variance shared by the strategies would be the square of the correlation—0.04, or 4 percent. That means that results from one strategy only account for 4 percent of the variation in the other strategy—not a high level. Imagine, however, that during the last month, the correlation soars to 0.70. Now the overlap between strategies is close to 50 percent. They are hardly independent.

What could cause such a jump in correlation? In a strongly trending market, the breakouts might all be in one direction—the same direction as earnings surprises. Alternatively, you might get caught with an overall market opinion and select your trades to fit that opinion. In either case, your diversified business is no longer so diversified, just like the car dealership.

Correlations among your strategies and trades vary over time because of how markets trade and because of your own hidden biases.

That lack of diversification matters, because it means that your capital is concentrated on fewer ideas. Your risk is higher, because instead of dividing your capital among two or more independent strategies, it is now concentrated in what is effectively a single strategy. The same problem occurs when different markets or asset classes begin trading in a more correlated fashion, perhaps due to panicky conditions among investors. During



those periods of high risk-aversion, traders will often shun stocks and seek the perceived safety of bonds and gold. The three asset classes (equities, fixed income, and gold) will thus trade in a highly correlated manner. Instead of being diversified across three markets, your capital is effectively concentrated in one.

*When your trading results are becoming more correlated, your self-coaching will lead you to ask whether the correlations are due to biases in your trade selection or due to shifts among the markets.* In the first instance, you can make special efforts to seek out uncorrelated ideas; in the second, you may want to reduce the size of each of your trades so that you have less concentrated risk. What you want to avoid are situations in which all your trading and investment eggs are in a single package. That can produce fine returns for a while, but leaves a trading business vulnerable when market conditions change.

My coaching experience with traders suggests that they most often achieve sound diversification in one or more ways:

- Blending intraday trading with swing trading or blending longer-term trading/investing with shorter-term swing trading.
- Blending directional trading (being long or short a particular instrument) with relative value trading (being long one instrument and short another, related one).
- Blending one strategy (such as trading around earnings events) with another (trading opening range breakouts).
- Blending the trading of one market or asset class (such as a currency pair) with another (U.S. small cap stocks).

For example, a trader might be long high-yielding stocks as one idea. A second idea would have the trader selling the front end of the yield curve and buying the long end, perhaps in anticipation of yield curve flattening ahead of Fed tightening. A third idea would have the trader short value stocks and long growth issues, anticipating that a historically wide spread in performance between the two will revert to its norm. A fourth idea might be a short-term long trade on small cap stocks. The good thing about spread/pairs trades, such as ideas two and three, is that they can work regardless of the direction of the underlying market, providing a measure of diversification. Trading horizons widen considerably when you don't just ask if a market is going up or down, but start to think about what will go up or down *versus other things*.

High frequency day traders will tend to achieve diversification and low correlation in other ways. They will demonstrate a relatively even mix of long and short trades over time. They may also manage positions over different time frames or place different trades in different stocks and

sectors. The risk for the day trader is getting caught up in fixed opinions about the market, biasing trades in a single direction. If the day trader is diversified, the correlations among returns from his different setups and the serial correlations of returns among trades (and among returns across times of day) should be relatively modest over time. Each trade or type of trade for the day trader should, in a sense, be a separate product in the business mix.

You don't have to diversify by trading many markets. You can diversify by time frame (longer-term, shorter-term), directionality (long, short), and setup pattern (trending, reversal).

Is your trading business adequately diversified? Is its diversification expanding or narrowing? If you're like most traders, you don't know the answers to these questions. The data, however, can be at your fingertips. All you need is to divide your trades by strategy, track the results of each strategy daily, and enter the information into Excel. From there, it's simple to calculate correlations over varying time periods. And if you don't trade every day and hold most positions for days? No problem: simply calculate the returns of each strategy as if you had sold all positions at the end of each trading day. That will tell you if your trades are moving in unison or independently. And *that* will tell you if you have many profit centers supporting your business or only a very limited few.



#### COACHING CUE

It is not too difficult to turn good directional ideas into good pairs trades. Once you determine that an index, sector, commodity, or stock is going to go up or down, ask yourself what related indexes, sectors, commodities, or stocks are most likely to maximize this move. You would then buy the instrument most likely to maximize the move and sell the related one that is likely to lag. For instance, you might think the S&P 500 Index is headed higher. You note strength in the NYSE TICK (\$TICK) relative to the Dow TICK (\$TICKI) and so buy the Russell 2000 small caps and sell the Dow Jones Industrials in equal dollar amounts. This gives you an idea that can be profitable even if your original idea about directionality in the S&P Index doesn't work out. As long as there's more buying in the broad market than among the large caps in relative terms, you'll make money. Learn to think and trade in terms of relationships so you increase your arsenal of ideas.

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## LESSON 77: CALIBRATE YOUR RISK AND REWARD

I recently used Henry Carstens' P/L Forecaster ([www.verticalsolutions.com/tools.html](http://www.verticalsolutions.com/tools.html)) to simulate possible equity curves under scenarios for two small traders:

1. Trader A has a small negative edge – The trader wins on 48 percent of trades and the ratio of the size of winners to losers is 0.90.
2. Trader B has a small positive edge – The trader wins on 52 percent of trades and the ratio of the size of winners to losers is 1.10.

I viewed the simulation as tracking returns over a 100-day period. The average size of winning days was \$100 in both scenarios. That means that, if we assume that the traders began with a portfolio size of \$20,000, that the daily variability of their returns was somewhere around 50 basis points ( $\frac{1}{2}$  percent, or \$100/\$20,000). If the traders averaged just one trade per day, then it's plausible that they were risking roughly 2 S&P 500 emini points per trade and making about that much per trade.

By running the scenarios 10 times each, I was able to generate an array of returns for the two traders:

Forecast Number	Trader A	Trader B
1	-\$904.2	\$769.9
2	-727.4	667.5
3	-718.5	614.7
4	-763.5	783.8
5	-786.1	528.7
6	-551.0	830.4
7	-518.9	933.0
8	-610.5	500.7
9	-760.5	791.5
10	-812.6	884.2

*What we see is that small edges over time add up.* When the small edge is negative, as in the case of Trader A, the average portfolio loss over 100 days is around 3 percent. When the edge is positive, we see that Trader B averages a 100-day gain of about 3 percent.

Clearly, it doesn't take much to turn a modest positive edge into a modest negative one: the distance between 52 percent and 48 percent winners and the difference between a win size that is 10 percent smaller versus larger than the average loss size are not so great. Just a relatively small change in how markets move, how we execute our trades, or how well we concentrate and follow our ideas can turn a modest winning edge into a consistent loser.

You don't need to have a large edge to run a successful trading business; you do need to have a consistent edge.

Had we tracked results every single day, we would have found that Trader A had some winning days and Trader B had some losers. Over a series of 100 days, however, the edge manifests itself boldly. There are no scenarios in which Trader A is profitable and none where Trader B loses money. Just as the edge per bet in a casino leads to reliable earnings for the house over time, the edge per trade can create a reliable profit stream when sustained over the long run. Once you have your edge, your greatest challenge as your own trading coach is to ensure your consistency in exploiting that edge, every day, every trade.

But let's take the analysis a step further and explore risk and reward. Our Traders A and B are not great risk takers: they are only trading one ES contract for their \$20,000 account. This provides them with average daily volatility of returns approximating 50 basis points, which is not so unusual in the money management world. We can see, however, that the 3 percent return for Trader B over 100 days would amount to about 7.5 percent per year (250 trading days). While that's not a terrible return, it is before commissions and other expenses are deducted. The consistent small edge does not produce a large return when risk-taking is modest.

So how could our Trader B juice his returns? A simple way would be to trade 3 contracts instead of 1. Assuming that this does not change how Trader B trades, the average daily variability of returns would now be 1.5 percent, with an average win size of \$300. The return of over 20 percent per year would now look superior. If you take more risk when you have a consistent edge, this certainly makes sense, just as betting more makes sense at a casino makes sense if the odds are in your favor. You simply need to have deep enough pockets to weather series of losses that are expectable even when you do have the edge. When I ran the scenarios for Trader B, peak to trough drawdowns of \$700 to \$800 were evident. Multiply that by the factor of 3 and now Trader B incurs drawdowns of 12 percent.

But what if Trader B took pedal to the metal and traded 10 contracts with a small edge? The potential annual return of 75 percent looks fantastic. The potential drawdowns of more than 40 percent now seem onerous. That small, consistent edge suddenly generates large losses when risk is ramped to an extreme.

The variability of your returns will tend to be correlated with the variability of your emotions.

In that aggressive scenario, Trader B would ramp the variability of daily returns to 5 percent. Average daily swings of that magnitude, particularly during a slump, are bound to affect the trader's psyche. Once the trader becomes rattled, that small positive edge can turn into a small negative one. Amplified by leverage, the trader could easily blow up and lose everything, all the while possessing sound trading methods.

The size of your edge and the variability of your daily returns (which is a function of position sizing) will determine the path of your P/L curve. Management of that path is crucial to emotional self-management. Your assignment is to utilize Henry's forecaster in the manner illustrated above, using your historical information regarding your edge and average win size to generate likely paths of your returns. Then play with the average win size to find the level of risk, reward, and drawdown that makes trading worth your while financially, but that doesn't overwhelm you with swings in your portfolio.

Few traders truly understand the implications of their trading size, given their degree of edge. If you know what you're likely to make and lose in your trading business, you'll be best able to cope with the lean times and not become overconfident when things are good. Match your level of portfolio risk to your level of personal risk tolerance for a huge step toward trading success.



#### COACHING CUE

Doubling your position sizing will have the same effect on the path of your returns as keeping a constant trading size when market volatility doubles. This process is a dilemma for traders who hold positions over many days and weeks, but is also a challenge for day traders, who experience different patterns of volatility at different parts of the trading day. It is common for traders to identify volatility with opportunity and even raise their trading size/risk as markets become more volatile. This greatly amplifies the swings of a trading account, and it plays havoc with traders' emotions. Adjusting your risk for the volatility of the market is a good way to control your bet size so that a few losses won't wipe out the profits from many days and weeks.

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### LESSON 78: THE IMPORTANCE OF EXECUTION IN TRADING

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You can have the greatest ideas in the business world, but if they're not executed properly, they won't be worth much. A great product marketed

poorly won't sell. A phenomenal game plan by a top coach won't work on the basketball court if the players don't pass well and can't establish position underneath the basket for rebounds. The quarterback can call a great play, but if the line doesn't block, the pass will never get off.

So it is with trading: execution is a much larger part of success than most traders realize. The average trader spends a great deal of attention on getting into a market, but it's the management of that trade idea that often determines its fate. When you are the manager of your trading business, you want to focus on day-in and day-out execution, just as you would if you were running your own store.

A trade idea begins with the perception that an index, commodity, or stock is likely to be repriced. For example, we may perceive that a stock index is trading at one level of value, but is likely to be trading at a different level. Our rationale for believing this may be grounded in fundamentals: at our forecasted levels of interest rates and earnings growth, the index should be trading at X price rather than Y. Our rationale might be purely statistical: the spread between March and January options contracts on the index is historically high and we anticipate a return to normal levels. Too, we may use technical criteria for our inference: the market could not break above its long-term range, so we expect it to probe value levels at the lower end of the range. In each case, the trade idea takes the form: "We're trading here at this price, but I hypothesize we'll be trading there at that price."

What this suggests is that a fully formed trade idea includes not just an entry setup, but also a profit target. Too often that target is not made clear and explicit, but still it lies at the heart of any trade idea. A trade only makes sense if we expect prices to move in an anticipated way to an extent that is meaningful relative to the risk we are taking.

Just as businesses set target returns on their investments, traders target returns on their trade ideas.

*It is in this context that every trade is a hypothesis:* our belief regarding the proper pricing of the asset represents our hypothesis, and our trade can be thought of as a test of that hypothesis. As markets move, they provide incremental support for or disconfirmation of the hypothesis. That means that, as trades unfold, we either gain or lose confidence in our hypothesis.

Any good scientist not only knows when a hypothesis is supported, but also when it is not finding support. A hypothesis is only meaningful if it can be objectively tested and falsified. The outcome that would falsify our trade hypothesis is what we set as a stop-loss level. It is the counterpart to the target; if the target defines the possible movement in our favor, the

stop-loss point captures the amount of adverse movement we're willing to incur prior to exiting the trade and declaring our hypothesis wrong.

*The trader who lacks clearly defined targets and stop-losses is like the scientist who lacks a clear hypothesis.* You can trade to see what happens, and scientists can play around in the laboratory, but neither is science and neither is likely to prove profitable over the long run. A firm hypothesis and objective criteria for accepting or rejecting the hypothesis advances knowledge. Similarly, a clear trading idea and explicit criteria for validating or rejecting the idea can guide our market understanding. Frequently, if you get stopped out of a seemingly good trade idea you can reframe your understanding of what is going on in the market. After all, scientists learn from hypotheses that are not confirmed as well as those that are.

With the target and stop-loss firmly in mind, we now have the basis for executing our idea. Good execution mandates that we enter the trade at a price in which the amount of money we would lose if we were wrong (if we're stopped out) is less than the amount of money that we would make if we were right (if we reach our target). When traders talk about getting a good price, this is what they mean: they are entering an idea with relatively little risk and a good deal more potential reward. A good way to think about this is to think of each trade as a hand of poker: where we place our stop-loss level reflects how much we're willing to bet on a particular idea.

Many traders make the mistake of placing stops at a particular dollar loss level. Rather, you want to place stops at levels that clearly tell you that your trade idea is wrong.

Let's say my research tells me that we have an excellent chance of breaking above the prior day's high price of \$51 per share. We are currently trading a bit below \$49 after two bouts of morning selling took the stock down to \$48, which is above the prior day's low of \$47.50. A news item favorable to the sector hits the tape and I immediately buy the stock at \$49, with \$51 as my immediate target. My hypothesis is that this news will be a catalyst for propelling the stock higher, given that earlier selling could not take out yesterday's low. I'm willing to lose a point on the trade (stop myself out at \$48) to make two points on the idea (target of \$51).

Suppose, however, that the stock was trading at \$50, rather than \$49 when the news came out. Now my risk/reward is not weighted in my favor. If I'm willing to accept a move back to \$48 before concluding I'm wrong, I now have two points of potential loss for a single point of targeted profit. While the idea is the same, the execution is quite different. It is difficult to make money over the long haul if you're consistently risking two dollars



to make one. If, however, you're risking a dollar to make two or more, you can be right less than half the time and still wind up in the plus column.

Good execution means that you calibrate risk as a function of anticipated reward.

Execution provides proactive risk management. If you control how much you can win and lose based on your price of entry, you keep your risk known and lower than your potential reward. You can track the quality of your execution if you calculate the amount of heat you take on your average trades. Heat is the amount of adverse price movement that occurs while you're in the trade. If you're taking a great deal of heat to make a small amount of money, you're obviously courting disaster. When your execution is good, you should take relatively little heat compared to the size of your gains. Your assignment for this lesson is to calculate heat for each of your recent trades and track that over time. This assignment will tell you how successful you are at executing your ideas, and it will provide a sensitive measure of changing risk/reward in your trading.

Good execution, psychologically, is all about patience. To get a good price, you will have to lay off some trade ideas that end up being profitable. Like the poker player, you want to bet when the odds are clearly in your favor. That means mucking a lot of hands. Similarly, a business doesn't try to be all things to all people. A business owner passes up certain opportunities to sell products in order to focus on what she does best. When you're running your trading business well, you don't take every conceivable opportunity to make money; you wait for *your* highest probability opportunities. The clearer you are about risk and reward, the easier it will be to stick to trades that offer favorable expected returns.



#### COACHING CUE

A simple rule that has greatly aided my executions has been to wait for buyers to take their turn if I'm selling the market and wait for sellers to take their turn before I'm buying the market. Thus, I can only buy if the NYSE TICK has gone negative and if the last X price bars are down. Similarly, I can only sell if the NYSE TICK has gone positive and the most recent X price bars have been up. This reduces the heat I take on trades by entering after short squeezes and program trades juke the market up or down. Once in a while you'll miss a trade if you wait patiently for the other side to take their turn, but the extra ticks you make on the trades you do get into more than make up for that.

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## LESSON 79: THINK IN THEMES— GENERATING GOOD TRADING IDEAS

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Notice how successful businesses are always coming up with new products and services to meet the changing needs and demands of consumers. A great way to become obsolescent in the business world is to remain static. If a current product is a hit, competitors and imitators are sure to follow. What was hot at one time—large vehicles during periods of cheap gasoline, compact disc players for music—can go cold quite suddenly when economic conditions or technologies change.

It is the same way in the trading world. For a while, buying technology stocks was a sure road to success. Thousands of day traders gave up their jobs to seek their fortunes. After 2000, that trade vanished with a severe bear market. Now, selected technology firms are doing relatively well, while others languish. Markets, like consumer tastes, are never static.

As we saw in the lesson on diversification, if you base your trading business on a single type of trading—a limited set of ideas or patterns—it is a vulnerable place to be. I recall when breakouts of opening ranges were profitable trades; in recent years, those breakouts have tended to reverse. We all hear that the trend is your friend, but in recent years buying after losing days, weeks, and months has—on average—been more profitable than selling. Market patterns, as Niederhoffer emphasized, are ever-changing. That means that successful traders, like successful business people, must continually scout for fresh opportunity.

The best system developers don't just develop and trade a single system. Rather, they continually test and trade new systems as part of a diversified mix.

One of the skills I see in the best traders is the ability to synthesize data across markets, asset classes, and time frames to generate trading themes. These themes are narratives that the trader constructs to make sense of what is going on in markets. These themes are the trader's *theories* of the financial marketplace. Their trades are tests of these theories. The successful trader is one who generates and acts on good theories: themes that truly capture what is happening and why.

This thematic thinking is common in the portfolio management world, but I see it also among successful short-term traders. The scope of the theories—and the data used to generate them—may differ, but the process is remarkably similar. A portfolio manager might note high gasoline prices and weakening housing values and conclude that a lack of discretionary income among consumers should hurt consumer discretionary stocks. That might lead to a trade in which the manager shorts the consumer

discretionary sector and buys consumer staples stocks that are more recession-proof.

The short-term trader may look at a Market Profile graphic covering the past week and observe a broad trading range, with the majority of volume transacted in the middle of that range. As the market moves to the top of that range, the trader sees that many sectors are nowhere near breaking out. Moreover, overall market volume is light during the move, with as much volume transacted at the market bid as at the offer. From this configuration, the short-term trader theorizes that there is not sufficient demand to push the market's value area higher. She then places a trade to sell the market, in anticipation of a move back into the middle of the range.

Thematic thinking turns market data into market hypotheses.

The key to thematic thinking is the synthesizing of a range of data into a coherent picture. Many traders, particularly beginners, only look at their market in their time frame. Their view is myopic; all they see are shapes on a chart. The factors that actually catalyze the movement of capital—news, economic conditions, tests of value areas, intraday and longer-term sentiment—remain invisible to them. Without the ability to read the market's themes, they trade the same way under all market conditions. They'll trade breakout moves in trending markets and in slow, choppy ones. They'll fade gaps whether currencies and interest rates are impelling a repricing of markets or not. Little wonder that they are mystified when their trading suddenly turns from green to red: they don't understand why markets are behaving as they are.

There is much to be said for keeping trading logic simple. The synthesis of market data into coherent themes is a great way to distill a large amount of information into actionable patterns. In the quest for simplicity, however, traders can gravitate to the simplistic. A setup—a particular configuration of prices or oscillators—may aid execution of a trade idea, but it is not an *explanation* of why you think a market is going to do what you anticipate. The clearer you are about the logic of your trade, the clearer you'll be about when the trade is going in your favor and when it is going against you.

Intermarket relationships are particularly fertile ground for the development of themes. You'll notice in the *TraderFeed* blog that I regularly update how sectors of the stock market are trading relative to one another. This alerts us to themes of economic growth and weakness, as well as to lead-lag relationships in the market. These sector themes change periodically—financial issues that had been market leaders recently became severe laggards—but they tend to be durable over the intermediate-term, setting up worthwhile trade ideas for active traders.

Other intermarket themes capture the relative movements of asset classes. When the economy weakens and the Federal Reserve has to lower interest rates, this has implications not only for how bonds trade, but also the U.S. dollar. Lower rates and a weaker dollar might also support the prospects of companies that do business overseas, as their goods will be cheaper for consumers in other countries. That situation might set up some promising stock market ideas.

Track rises and falls in correlations among sectors and markets as a great way to detect emerging themes—and ones that are shifting.

Short-term traders can detect themes from how markets trade in Europe and Asia before the U.S. markets open. Are interest rates rising or falling? Commodities? The U.S. dollar? Are overnight traders behaving in a risk-averse way or are they buying riskier assets and selling safer ones? Are Asian or European markets breaking out to new value levels on their economic news or on decisions from their central banks? Often, these overnight events affect the morning trade in the United States and set up trade ideas about whether a market is likely to move to new highs or lows relative to the prior day.

The short-term trader can also develop themes from breaking news and the behavior of sectors that are leading or lagging the market. If you keep track of stocks and sectors making new highs and lows often, you will highlight particular themes that are active in the market. If oil prices are strong, you may notice that the shares of alternative energy companies are making new highs. That can be an excellent theme to track. Similarly, in the wake of a credit crunch, you might find that banking stocks are making new lows. *Catching these themes early is the very essence of riding trends; after all, a theme may persist even as the broad market remains range bound.*

As your own trading coach and the manager of your trading business, you need to keep abreast of the marketplace. That means that considerable reading and observation must accompany trading time in front of the screen. On my blog, I try to highlight sources of information that are particularly relevant to market themes. I update those themes daily with tweets from the Twitter messaging application ([www.twitter.com/steenbab](http://www.twitter.com/steenbab)). Ultimately, however, you need to figure out the themes that most make sense to you and the sources of information for generating and tracking those themes. The more you understand about markets, the more you'll understand what is happening in *your* market. Like a quarterback, you need to see the entire playing field to make the right calls; it's too easy to be blindsided by a blitzing linebacker when your gaze is fixed!

**COACHING CUE**

It is particularly promising to find themes that result from a particular news catalyst. For instance, if a report on the economy is stronger than expected and you see sustained buying, track the sectors and stocks leading the move early on and consider trading them for a trending move, especially if they hold up well on market pullbacks. Many of those themes can run for several days, setting up great swing moves.

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**LESSON 80: MANAGE THE TRADE**

Business success isn't just about the products and services a firm offers to the public. Much of success can be traced to the management of the business. If you don't hire the right people, supervise them properly, track inventories, and stick to a budget, you'll fail to make money with even the best products and services.

So it is with trading. The best traders I've known are quite skilled at *managing trades*. By trade management, I mean something different from generating the trade idea and executing it. Rather, I'm referring to what you do with the position *after* you've entered it and *before* you've exited.

Your first reaction might be: You don't do anything! It's certainly possible to enter a position and sit in it, waiting for it to hit your profit target or your stoploss level. That reaction, however, is inefficient. It's like selling the same mix of products at all stores even though some products sell better and some sell worse at particular locations.

To appreciate why this is the case, consider the moment you enter a trade. At that point you have a minimum of information regarding the soundness of your idea. As the market trades following your entry, you accumulate fresh data about your idea: the action is either supporting or not supporting your reasons for being in the market. For instance, if your idea is predicated on falling interest rates and you see bonds break out of a price range, that would be supportive of your trade. If you anticipate an upside breakout in stocks and you see volume expand and the NYSE TICK move to new highs for the day on an upward move, that is similarly supportive. *If you track market action and themes while the trade is on, you can update the odds of your trade being successful.*

Trade management is the set of decisions you make based on the fresh information that accumulates during the trade.

One way that I see traders utilizing this information is in the way that they scale into trades. Their initial position size might be relatively small, but traders will add to the position as fresh information validates their idea. My trading capital per trade idea is divided into six units. I typically will enter a position with one or two units. Only if the idea is finding support will a third or fourth unit enter the picture. I have found that, if my trades are going to be wrong, they're generally wrong early in their lifespan. By entering with minimal size, I incur small drawdowns when I'm wrong. If I add to a position as it is finding support, I maximize the gains from good trades. *This trade management, I find, is just as important to many traders' performance as the quality of their initial ideas.* Indeed, I've seen traders throw lots of trade ideas at the wall and only add capital to the ones that stick: the management of their trades makes all the difference to their returns.

*Such trade management means that you have to be actively engaged in processing information while the trade is on, not just passively watching your position.* Good trade management is quite different from chasing markets that happen to be going in your favor. It is a separate execution process unto itself, in which you can wait for normal pullbacks against your position to add to the position at favorable levels. If you are long, for example, and the market is in an uptrend, the retracements should occur at successively higher price levels. By adding after the retracement, you gain the profit potential when the market returns to its prior peak, but you also ensure that risk/reward will be favorable for the piece of the trade that you're adding.

Each piece added to a trade needs a separate assessment of risk and reward to guide its execution.

While I'm in a short-term trade, I'm closely watching intraday sentiment for clues as to whether buyers or sellers are more aggressive in the market. I will watch the NYSE TICK (the number of stocks trading on upticks minus those trading on downticks), and I will track the Market Delta ([www.marketdelta.com](http://www.marketdelta.com); the volume of ES futures transacted at the market offer minus the volume transacted at the market bid). These trackings tell me if the balance of sentiment is in my direction. If the sentiment turns against me, I may decide to discretionarily exit the position prior to hitting my stop-loss level. That, too, is part of trade management. To be sure, it is risky to front-run stop-levels: it invites impulsive behavior whenever markets tick against you. I've found, however, that if I'm long the ES futures and we see a breakdown in the Russell 2000 (ER2) futures or a move to new lows in a couple of key market sectors, the odds are good



that we will not trend higher. By proactively exiting the position, I save myself money and can position myself for the next trade.

What this suggests is that it is important to be right in the markets, but it is even more valuable to *know when you're right*. Very successful traders, I find, press their advantage when they know they're right, and they're good at knowing when they're right. This means that they are keen observers of markets in real time, able to assess when their trade ideas—their hypotheses—are working out and when they're not. They are good traders because they're good managers of their trades.

Your assignment for this lesson is to assess your trade management as a separate profit center. Do you scale into trade ideas? Do you act aggressively on your best ideas when you are right? If you're like many traders, this is an underdeveloped part of your trading business. It may take a return to simulation mode and practice with small additions to trades to cultivate your trade management skills. It may also mean that you structure your time while you're in trades, highlighting the information most relevant for the management of your particular idea. Most of all it means cultivating an aggressive mindset for those occasions when you *know* you have the market nailed.

As your own trading coach, you want to make the most of your assets. It's easy to identify traders who exit the business because they lose money. It's harder to appreciate the equally large number of traders who never meet their potential because they don't make the most of their winning ideas. A great exercise is to add to every position at least once on paper after you've made your real-money entry. Then track the execution of your added piece, its profitability, the heat you take on it, etc. In short, treat trade management the way you would treat trading a totally new market, with its own learning curve and need for practice and feedback. You don't have to be right all the time; the key is to know when you're right and make the most of those opportunities.



#### COACHING CUE

Track your trades in which you exit the market prior to your stops being hit. Does that discretionary trade management save you money or cost you money? It's important to understand your management practices and whether they add value to your business.

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## RESOURCES

The *Become Your Own Trading Coach* blog is the primary supplemental resource for this book. You can find links and additional posts on the



topic of coaching processes at the home page on the blog for Chapter 8: <http://becomeyourowntradingcoach.blogspot.com/2008/08/daily-trading-coach-chapter-eight-links.html>

Jim Dalton's books are excellent resources when it comes to developing a conceptual framework for trading. I recommend *Mind Over Markets* as a first read, then *Markets in Profile*. Both books are available on the site where Jim and Terry Liberman offer training for developing traders: [www.marketsinprofile.com](http://www.marketsinprofile.com)

An excellent book on risk and risk management is Kenneth L. Grant's text *Trading Risk* (Wiley, 2004).

Exchange Traded Funds (ETFs) are an excellent tool for achieving diversification. Two good introductions to ETFs are David H. Fry's book *Create Your Own ETF Hedge Fund* (Wiley, 2008) and Richard A. Ferri's text *The ETF Book* (Wiley, 2008).

I receive a number of questions regarding seminars, courses, and other resources that are offered for sale under the general rubric of trading education. My impression, and the feedback I get from blog readers, is that these offerings are often expensive and of limited relevance to the particular strengths and interests of individual traders. Similarly, I receive many inquiries into proprietary trading firms, which allow traders to trade the firm's capital in exchange for a share of profits. Some of these firms are quite professional and ethical; others are not. I strongly encourage due diligence: talk to a number of people who have taken these courses or who are trading at these firms. If you cannot get direct feedback from actual users (not just one or two stooges), move on. Don't pay thousands of dollars for something unless you know *exactly* what you're getting.

## CHAPTER 9

# Lessons from Trading Professionals

*Resources and Perspectives  
on Self-Coaching*

*Anyone who fights for the future lives in it today.*

—Ayn Rand

**I**n this chapter, I sought the perspectives of experienced traders who share their views on the Web. The question I asked them was simple:

“What are the three things you have found most helpful in mentoring/coaching yourself as a trader?”

I think you’ll find their outlooks worthwhile, and I know you’ll benefit from checking into the resources these traders provide. To coach yourself, you don’t need to reinvent wheels. The guidance of those who have come before you can be invaluable. Think of this chapter as lessons in the best practices of self-coaching. Look for the themes emphasized by a majority of the contributors; these themes include the best of the best practices.

### **LESSON 81: LEVERAGE CORE COMPETENCIES AND CULTIVATE CREATIVITY**

We encountered Henry Carstens when we took a look at profits and losses as a function of one’s trading metrics. Henry’s web site ([www.verticalsolutions.com](http://www.verticalsolutions.com)) is filled with valuable information for discretionary traders,

but his distinct specialty is the design of trading systems. Henry eats his own cooking: he builds and trades his own systems, manages money for clients with his systems, and develops trading systems for other traders and trading firms. When I posed the question to him of what he has found most helpful in coaching himself, he quickly offered three responses:

1. Leveraging core competencies and interests
2. Learning about learning
3. Collaboration and work ethic

Let's take a look at each.

From childhood, Henry learned about building and the use of machinery from his grandfather, Floyd Grahm. "I am, and have always been, a heavy equipment operator," Henry observes. Out of his fascination with machines and moving things around, Henry tried his hand at a different kind of building: *he built a machine that traded*. After building several such machines, he figured out a way to quantify rates of change in market behavior. When he tossed aside all but one of his machines, Henry developed others, so that his machines would never rust and become obsolete. His core competence and interest is building: markets just happen to be the earth he is currently moving. Henry leveraged what he knows and loves and found success and fulfillment.

Success is found by leveraging distinctive interests, talents, and skills: doing what you love, and doing what you do well.

Note, however, that the flip side of building is destroying. Sometimes you have to take down a structure to erect a new one; you have to remove a mound of earth to lay a foundation for something new. It was Henry's willingness to put aside his old machines and develop new ones that provided him with his edge. It's not about finding a perfect system and taking cash from it like an ATM. It's about having the integrity to acknowledge when ideas are no longer working and having the desire to be the best machine operator possible.

With respect to learning about learning, Henry credits his chess lessons with grandmaster Nigel Davies for helping him become sensitive to patterns and their nuances. "What I learned from those lessons was the power of nuance—the cascading insights brought by experience and the continuous pursuit of a single objective," he explains. Henry has learned to scan markets like he scans a chessboard for moves. "I continually search for the next insight now, the nuance that means just a bit of an edge for just a little while longer."

I've observed this interdisciplinary cross-fertilization among many successful traders. Those traders with mathematical backgrounds learn to quantify value and divergences from value. Those with athletic training use their experience to guide their training and direct their competitive drive. My own work in psychology has sensitized me to the ways in which human behavior is patterned. This work has been a tremendous aid in recognizing similar patterns in markets. Coaching yourself begins with knowing yourself, and especially knowing your distinctive strengths: how you best process information, how you think, what you love. It is difficult to imagine being successful at trading if your market activity does not tap into these core competencies and values.

Finally, Henry identifies collaboration and a strong work ethic as key to his self-development. "A diverse network of people with broad and similar interests in trading both pushed and supported me," Henry explains. "The very strong work ethic I got from my grandfather always makes me do just a little bit more." The keys here are that the network is diverse—providing input from many angles to aid creativity—and the network is both challenging and supportive. I've often been asked why I don't charge money for my blog content. The answer is that, in developing a community of readers, I also cultivate the diverse network described by Henry. Readers push me to think more deeply about markets, and they support my efforts at learning more. All of us tend to fall into the trap of operating within our comfort zones. We benefit when those who care about us also push us to move beyond those self-imposed boundaries.

Like many successful creative individuals, Henry exemplifies what I call an *open source* approach to networking. When others share ideas and research with him, he freely passes his work on to them. This approach is very common among professional portfolio managers, particularly the successful ones. A surprising number of traders, however, are convinced that they must keep their work secret. The result is that they become isolated and stagnant. "When a colleague sends me something that I build upon or that sets me off on a new and interesting direction, I always try to reciprocate with a relevant finding or study as way of thanks," Henry points out. "What I give up in secrecy comes back many-fold in strong relationships and flow of ideas that are the lifeblood of the creator."

The trader must be a creator if his business is to avoid stagnation.

I cannot emphasize this latter point strongly enough: as a trader, you are only as strong as your flow of ideas. Those ideas are your lifeblood: the novel mutations that will enable you to evolve and adapt to changing market conditions. Success in trading *is* a kind of evolution; without creativity

and the ongoing flow of ideas, extinction is a real threat—as it is for any business that fails to keep up with the marketplace.

Your assignment for this lesson is to set a goal and plan for becoming just a bit more creative in your approach to markets. You don't have to be a system developer to learn about learning, build upon your distinctive strengths, and fertilize your creativity within a network of colleagues. For your assignment, I encourage you to add just one source of new ideas that will add to and challenge your own. This source can be a web site, a newsletter, or a peer trader—but it should be a source that you can consult as a regular part of your generation of trading ideas. Henry freely shares his experience on his site, including a framework for testing trading ideas; making use of the fruits of his self-coaching will be invaluable for your own.



#### COACHING CUE

When we're successful, our work expresses who we are. Henry emphasizes that he is a builder and creator. How does your trading express who you are: your greatest talents and interests? Identify the recent times in the markets when you have been your happiest and most fulfilled. What made those times special? How can you bring those special elements into your trading more regularly?

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### LESSON 82: I ALONE AM RESPONSIBLE

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Chris Czirnich, author of the Globetrader blog ([www.globetrader.blogspot.com](http://www.globetrader.blogspot.com)), was one of the first contributors I considered for this chapter. Uniquely among market writers, Chris is sensitive to the psychology of trading. His blog consistently combines market insights and psychological ones; it's a useful resource.

I posed the three-pronged question to Chris, asking him what has been most helpful for his self-coaching as a trader. The floodgates opened and Chris came up with 10 ideas, not three. His response was so well considered that I decided to summarize all 10 of his insights and their implications for self-coaching:

1. Being able to observe myself.
2. Discipline.
3. Having an edge.

4. Accepting that I alone am responsible.
5. There is no holy grail.
6. Having trust in myself.
7. Being able to stand up again, after being beaten down.
8. Being lucky from time to time.
9. Keeping a trading journal and writing a blog.
10. Don't panic.

### **Building the External Observer**

"The external observer is a concept I came across after reading your first book," Chris explains. "It allows me to see myself trading, to observe and interact in case I'm in a position from a teacher's perspective. It allows me to argue about my trade, to see the pros and cons, to notice price behavior I might miss otherwise. It's an invaluable resource in a trade because it is not affected by emotions and will guide me, even in a fast-moving market. I rely on it to always know what I should do. I might override it, but it is the clear voice in a turbulent market, where I can always turn to find the safe way out."

### **Maintaining Discipline**

"Discipline is so elusive, so difficult to maintain, and yet it is something without which you won't succeed at trading," Chris explains. "Am I a disciplined trader? Alas no, unfortunately not, but after all these years I have learned that I have to follow certain rules or I will do a lot of damage to my account. Let's look at a concept that every trading book tells you is wrong and will lead to disaster: adding to a losing position. Admit it, you have done it at times, because you were certain that you were right and the market was wrong. My biggest loss came from adding to a losing position; still on a range day, adding to a losing position is the way to trade, because otherwise, you will die the death of a thousand stops. Yes I add to losing positions, but now I have the discipline to stick to the twice wrong and I'm out rule. Meaning, if the add-on does not work, I'm out. Of course you can be wrong and a trade signal might go against you, but if you have two signals in a row that go against you, then you have to take a step back and see why your signals aren't working properly."

Rules promote discipline.

### **Having an Edge**

“Without an edge you are doomed,” Chris asserts. “Very simple. Of course you might throw a coin and trade a 50:50 chance system. But only a professional will have the discipline to stick to the necessary money management rules to trade a 50:50 system successfully. Having an edge means you can statistically prove that your trading system works, that it would have paid your commissions and costs of doing business and made you profits in the long run. You might be a mechanical trader, you might trade fundamentals, you might trade price action or some arcane indicator or a combination of all of them. It all comes down to one thing only: You must be able to prove to yourself that your trading system works and will make you profits in the long run. If you can’t prove that to yourself, if you don’t understand the mechanics behind your trading system, then you won’t trust your trading system and you will not be able to trade it. The best trading system will produce losses in the hands of a trader who does not believe that that trading system works.”

### **I Alone Am Responsible**

“I came to trading because I came into real financial difficulties after some clients of mine went bankrupt and did not pay their bills” Chris recounts. “Trading seemed the solution to me, because only trading gave me the promise of instant payment, of knowing that when I did it right I would get paid. But that promise came with a responsibility I did not fully understand: I alone am responsible for any action taken. There is no one but me to blame, if I have a red day, a red week, a red month or year. Each and every day I can look back and tell you where I was wrong, what trade I should have taken, where I missed the opportunity to make it back. It’s only me who is responsible. And if I alone am responsible, then there can’t be any guru to whom I can turn to tell me what to do. I trade my system. I can tell you what I do, but whether you will be able to use that knowledge depends on you alone.”

The need for a guru confesses an absence of self-guidance.

### **There Is No Holy Grail**

“The charts of the best traders have price bars only or they trade without charts at all, like many forex traders,” Chris explains. “They are not



magicians, but they follow the price of the instruments they trade for such a long time, they no longer need indicators or charts. But if you ask them, they will tell you that there is divergence on price and that a bottom or top might be near, that right now will be a great buying or selling opportunity. All these traders have looked at charts, they have used all the common and not so common indicators or oscillators or volume analysis and after a while they removed them from their charts until they were back at the beginning looking at a bare chart, but now knowing that there is no holy grail among these indicators. Nothing will give you 100 percent winning trades, so it's futile to search for it. You need to focus your efforts somewhere else to succeed."

### **Having Trust in Yourself**

"I'm a discretionary trader," Chris points out. "This means that I have certain trade rules, which provide me with a trade setup, but I decide on a, let's call it *gut feeling* whether I take the trade or not. I have tried a few times already to build a successful mechanical trading system, but I was never able to boil my trade rules down to a mechanical system that I could trust enough to trade. On the other hand I have accepted that my subconscious mind is a better computer than my mechanical skills will ever be. Maybe if I tried my hands at neural nets, I could come up with a working mechanical trade system, but then I would not understand the rules any longer and that means I would not trust it enough to trade it. The subconscious mind will not give clear instructions; it communicates through feelings. You need to learn to listen to them, if you want to use its power. But if you do, it can be a nearly unlimited resource you shouldn't ignore. To teach or program your subconscious mind to do its job, you need to invest a lot of screen time. You need to expose it to as many situations as possible . . . to develop that trust in yourself, the trust that you will always do what's right for you."

If you don't trust yourself or your methods, you will not find the emotional resilience to weather periods of loss.

### **Standing Up after Being Beaten Down**

"Being bankrupt, having a real bad day: yes it happens," Chris explains. "Many traders trading for their own account will have gone through such a slump not once but multiple times before they manage to develop their account. When I started trading, I had lost a huge amount

of money in funds. I had trusted the fund managers to do a good job; instead they did a lousy job and I decided I could do better! It wasn't easy. Somewhere I read that if you can't trade 1 futures contract successfully, why do you think you can trade 10 contracts successfully? That was a statement I could accept and actually still follow to this day. So I gave myself a \$3,000 account and started trading futures. (I never encountered the problems I had in my trading when trading in demo mode, so I traded real most of the time). I went bankrupt (actually below \$2,000, which was the limit I had to maintain to continue trading) at least five times. I funded my account with about \$20,000 over the last seven years and made it all back within three months, when I finally got it right. I'm not out of the woods today, but I have started taking out money for my living from my account. I still have days where I screw up big time and need to build myself up again; where I need to question my plan, myself, and my approach to the markets. But I know today that I can trade and that I have an edge. I trust myself to do what is necessary to do, even when I screw up. I know I will stand up again and make it back."

Mastering great challenges yields great confidence.

### **Luck**

"There is no room for luck in trading? Don't believe that for one second," Chris asserts. "How many trades did you do and looking back you know you were just lucky to get out breakeven or make a huge windfall profit? I always think I'm entitled to two or three lucky trades per month. But make sure you know you got away lucky. Don't bask in the glory of that wonderful trade, when all you did was violate your rules, add to that lousy entry, and then have the luck to ride a spike against the prevailing trend right to the tip."

### **Keep a Detailed Trade Journal and Write a Blog**

"You need to be totally honest with yourself," Chris advises. "There is no rock to hide under if you screw up. It shows in your account and you need to document it. Otherwise you will do the same mistakes over and over. Believe me, you will still do the same mistakes over and over again, even when you write a journal, but at least now you know you made the same mistake again. A trading journal can provide you with the statistics necessary to develop trust in yourself. It will tell you if you have an edge. It can tell you which approach to the markets works

and which was a big failure. The trading journal I use today goes back more than four years now, and I made about 5,500 trades in that time. It is an invaluable source of information about myself and the ways I handle certain types of markets. If I encounter a rough patch in the markets I can look back and see if I had a similar experience in the past. I can see how I handled the situation then, whether my solution was successful, or whether I should better try a different approach today. Usually before I screw up big time, I have a few days with smaller and smaller profits. Looking back I see that I felt insecure in the markets: something was changing and I was not changing with the market. So I struggled to keep the green until something snapped and suddenly I was totally and absolutely wrong. The next day or two, I often make it back before I have a second deep red down day. After that I usually get back on track with smaller profits. The account starts to consolidate before I manage the next trend move.

“Writing the *Globetrader* blog I maintain to this day has made me accountable. I started the blog because I hoped that by sharing my approach to the markets, older, wiser traders would read it and question me or point me in a different direction by commenting on my ideas. Fortunately for me some of the comments I received proved invaluable and are now an integral part of my trading system. You don’t need to write a public blog, but writing about your thoughts in a trade, how you see the markets, or what constitutes a trade setup structures your approach to the markets. Right now I’m at a point in my development as a trader where I try to dissect that gut feeling I wrote about earlier, so I can consciously see why my subconscious mind just gave me a clear *Go ahead and take that trade* signal. Or why it just questioned an otherwise wonderful looking signal and is proven right a minute later. By writing about these trade setups, I can relive the feelings I had when the trade opportunity presented itself in real time. Eventually I can see why the trade setup actually was not an opportunity. The blog is also the place to deal with all the demons and obstructions you will encounter in your trading. Writing about the problems is the first step to solving them. As long as you have no mechanical automated trade system, you have to accept that you are human and will make mistakes. You need to deal with them and you will have to find ways to avoid or integrate them or you will not make it in trading. But the first step is always to bring them in the open, so they can no longer hide.”

Start a blog as a great way to journal your ideas and interact with others about them.

### Don't Panic

"These are the famous words found on the cover of the *Hitchhikers Guide to the Galaxy* by Douglas Adams," Chris explains. "They are so true in trading. If you panic, your instincts take over, and these instincts will surely cause the maximum possible damage to your account. If the market suddenly starts to drop big time and you are long, don't be frozen; believe what you see and act. Or decide not to act and execute your contingency plan. You need to have a plan for every situation. Usually you will pay for every lesson the market gives you. How much you pay is totally up to you . . . So if I'm suddenly in an unwanted position, I look at the chart and see if I like the position or not. If not, I'm out. Simple as that. Otherwise I manage the trade. But never ever allow panic to take over."

Chris's lessons are the result of hard-won experience. His attitude of taking full responsibility for all aspects of trading lies at the heart of self-coaching: you are the author of the story of your trading career. Your actions will determine the plot and ending of that story. One of Chris's lessons that I like best is the notion of standing up after being beaten down. His success came as a result of resilience: he lost small amounts of money many times before he started to trade well and trade larger. Your assignment for this lesson is to create a disaster plan for your trading that explains how and when you will cut your trading size/risk when you are not trading well, but also how you will stand up and persevere with your best trading ideas to bring yourself out of drawdown. The best traders are quick to pull in their horns when they're not trading well, but they are not quick to give up on their trading. If you develop and follow your disaster plans, you take responsibility for your trading and place yourself in control of your market participation. As Chris notes, we cannot repeal uncertainty, but we can avoid the poor decisions that come from panic and lack of preparation.



#### COACHING CUE

Make sure your trading journal highlights important lessons learned, so that it becomes a constructive tool for review months and years later. The value of a journal is in its review, not just its initial writing. If you ensure that every journal entry has a lesson for the future, you also ensure that today's learning can enrich tomorrow.

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## LESSON 83: CULTIVATE SELF-AWARENESS

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Trevor Harnett enjoys an interesting perspective on the trading world. He is a seasoned trader, and he is someone who runs a software firm that provides tools for traders. As a result, he has observed his learning curve, but also the curves of traders who utilize his Market Delta software ([www.marketdelta.com](http://www.marketdelta.com)). While Market Delta incorporates a number of charting features, the heart of the program is its ability to separate volume traded at the market's offer price and volume transacted at the bid. This distinction enables traders to obtain instantaneous readings of short-term sentiment. This is very valuable for intraday traders, and it provides a useful execution tool for longer timeframe traders.

Michael Seneadza is a full-time trader and author of the *Trader Mike* blog ([www.tradermike.net](http://www.tradermike.net)). When I first entered the world of blogging, Michael's was one of the very first blogs I read regularly. It seemed to me that he had a fine grasp for short-term trading, including the news items that move markets. His blog posts the stocks he's following for the day, as well as market and news updates. Michael keeps it real—his site is devoid of hype and self-promotion—which helps account for its popularity. I grouped Trevor and Michael together for this lesson because they both touched on an important facet of self-coaching: being self-aware and acting as one's own psychologist.

When I asked Trevor for the three things that have most contributed to his self-coaching, he replied, "Upon looking back at my trading career, the three factors that have influenced my trading the most are 1) the environment I put myself into, 2) the discipline I exercised as a trader and else where in my life, and 3) self-awareness in terms of personality and how I viewed the markets." Let's take a look at those.

### Environment

When Trevor started trading, he made sure that he was close to the action and rented an office in the Chicago Mercantile Exchange building. "I had plenty of desire but little knowledge and few friends or mentors to show me the way," Trevor explains. "Being in an environment with lots of seasoned traders was important to me." Trevor learned most from these traders' mistakes. "A majority of what I learned by being around other traders was what *not* to do," Trevor pointed out. "I learned valuable lessons from other traders, but the lessons that have kept me trading over the years are the lessons I learned from other traders on not what to do. For me, being in an environment that

consisted of more than just my own experiences increased my rate of learning tremendously. I was able to share in others successes and defeats and learn from what they did right and wrong. To me this was invaluable because some of the experiences they had to endure were ones that I hoped to never find myself in. I could see what happened and try and learn from the situation.”

I find this theme again and again with successful professionals: much of their success comes from the accelerated learning curve afforded by being in the right settings. Trevor’s experience suggests that it’s not necessary to be employed by a trading firm to find that environment. Just being around experienced peer professionals can multiply learning experience.

If you want to experience yourself as successful, place yourself in settings and situations where you can interact with successful people.

### Self-Awareness

Trevor emphasizes the importance of knowing yourself as a trader. “For me,” he explains, “when I entered into trading in 1998 after graduating from college everyone was telling me pit trading was what I needed to do. I had always been much more of an introvert and very proficient on the computer.” He quickly found pit trading not to his liking and became involved in the emerging electronic Globex trading platform. He also recognized that his trading style was naturally risk-averse and stayed within his comfort zone. “My personality was much more oriented to taking frequent trades and keeping my losses under control,” Trevor recalls. “This worked very well for me because very rarely would I have a day that would get away from me.” We hear many generalizations about the best or right way to trade. *Trevor’s insight was that his trading had to fit who he was.* His success came from sticking to his basic strengths and interests.

### Discipline

“This makes or breaks traders from what I saw,” Trevor points out. “When you are trading your own money with no risk manager breathing down your neck, you better have discipline. Without it, it will be just a matter of time before you blow up and are unable to recover.” Indeed, this discipline is what makes the learning curve possible. “I was often early on many trades because I lacked the patience to let



the trade play out,” Trevor explains. “Fortunately I had the discipline to work my way out of the trade and try over.” This is an excellent point: *discipline doesn’t mean not making mistakes; it means making mistakes the right way*. Particularly when you’re building your competence and confidence, it’s important to learn how to “work your way out of the trade.” Positive experience can build optimism, but it’s the ability to work out of difficult situations that yields the confidence that you can handle most anything the market can throw your way.

First and foremost, good traders are good risk managers.

Michael described his three most valuable steps in self-coaching as: 1) keeping a detailed trading journal; 2) becoming an amateur trading psychologist; and 3) listening to trading affirmations. This reflects a balance that I see among many experienced, successful traders: always working on their trading, and always working on themselves.

### **Keeping a Journal**

“The thing that’s helped my development the most,” Michael explains, “is keeping a proper, detailed trading journal. I’ve always prided myself on my ability to remember and learn things solely by memory. Writing things down just seemed like unnecessary work . . . That all changed a few years ago when I hit a rough spot and decided to reassess things. I went back to basics and did things according to the advice of what I’d read in all those books over the years—mainly create a detailed business plan and keep a journal. In just a few weeks of keeping a detailed journal, a few self-defeating behaviors jumped out at me. I was amazed at how those behaviors never registered with me previously. For example, I discovered that I had a bad habit of adjusting my initial stop-losses too soon. That often resulted in stopping myself out of winning trades at breakeven. Fixing that one thing has added considerably to my bottom line.”

I have experienced the same thing: in keeping records of my trading, I learn things about my performance that I had never recognized earlier. Often, it’s just a few tweaks to what you’re doing that makes the difference between breakeven and profit.

The advice you see repeated in one trading book after another is often the best advice, because it’s the result of years of experience.



### Becoming an Amateur Trading Psychologist

“I had picked up bits and pieces about trading psychology over time,” Michael notes, “but it wasn’t until I read a book dedicated to the topic that things really jelled for me. The book I read was *Trading in the Zone* by Mark Douglas. The book crystallized all those bits and pieces I’d picked up, as well as forced me to take a look at my own beliefs and behaviors. It’s one of those books in which I get something different each time I read it. Long before I read *Trading in the Zone*, I knew logically that trading was nothing but a game of probabilities. I knew all about expectancy and that I could still make money, even if I had more losing trades than winning trades. Yet there was a disconnect between my knowledge and my actions while actually trading. The book made it very clear to me that I needed to accept that I won’t know, nor do I need to know, how any given trade is going to turn out. It made me realize that, as long as I stuck to my business/trading plan and kept taking good setups, I would make money over time.”

When we become our own psychologists, we bridge the gap between what we know and what we feel.

### Listening to Trading Affirmations

“A few years ago, I purchased a CD called *Trader Affirmation* from the Day Trading Course site ([www.DayTradingCourse.com/cd/](http://www.DayTradingCourse.com/cd/)),” Michael recalls. “The CD has about 30 minutes of someone reading a list of affirmations to help the trader’s state of mind. I try to listen to the affirmations at least twice a week, usually while I’m showering in the morning. The affirmations help me to remember all the things I’ve read in the aforementioned book on trading psychology. Listening to them has been a great help in keeping my head on straight.” To be honest, I’ve never been a big fan of the whole idea of positive thinking and affirmations (I haven’t heard the CD that Michael uses), but I have to say that what Michael says makes a great deal of sense. It’s not enough to read a book on trading psychology and file away the lessons. Rather, you need to repeat those lessons in order for them to sink in. That has become a part of Michael’s weekly routine, helping him cement his efforts at becoming his own psychologist.

Your assignment for this lesson is to identify and implement one weekly routine to help you internalize sound trading practices. This routine could be listening to a CD (or even your own self-recorded messages), or it could be a structured review of your trading journal with a colleague.

The idea is to make right thinking and right action a regular part of your experience, so that you become your ideals.



#### COACHING CUE

Check out Michael's insights into trading journals at [http://tradermike.net/2005/08/on\\_trading\\_journals/](http://tradermike.net/2005/08/on_trading_journals/) and [http://tradermike.net/2005/08/thoughts\\_on\\_day\\_trading/#moving\\_stops](http://tradermike.net/2005/08/thoughts_on_day_trading/#moving_stops). See also Charles Kirk's insights in this chapter.

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### LESSON 84: MENTOR YOURSELF FOR SUCCESS

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Brian Shannon is a trader and an educator of traders. His *AlphaTrends* blog ([www.alphatrends.blogspot.com](http://www.alphatrends.blogspot.com)) utilizes video to illustrate trading patterns each day, a unique resource for developing traders. He has captured many of the principles from these videos in his book *Technical Analysis Using Multiple Timeframes*. Brian's work is a great illustration of what I call contextual thinking: placing observed patterns into larger contexts to gauge their meaning and significance. I find that many short-term traders run into problems when they become so focused on the patterns over the past few minutes that they miss the larger picture of what the market is doing from hour to hour, day to day. By gauging patterns within larger contexts, we stand a greater chance of aligning ourselves with longer timeframe trends.

Corey Rosenbloom is a full-time trader who chronicles his work in his *Afraid to Trade* blog ([www.afraidtotrade.com](http://www.afraidtotrade.com)). What I like most about Corey's work is that he blends an awareness of trading psychology with an understanding of the psychology of markets. His site provides a number of trading insights, as well as insights into the minds of traders. I grouped Brian and Corey for this lesson because both described the ways in which they mentor themselves—guide their own learning processes—as part of coaching themselves for success.

Brian's response to my query about the three things that have been most valuable to his self-coaching reflects his trading as well as his teaching. Let's take a look.

#### Tuning Out Opinions

Brian stresses that he doesn't completely ignore what he hears from others, but he's learned to emphasize his own views from what he's learned over the years. "The edge in trading is so small and quite often

elusive that it is imperative to understand market dynamics/structure and where my personal edge lies,” he points out. This is very important: As Brian’s videos illustrate, he is extremely open to information from the markets, but he filters out opinions. He has learned to rely on his own judgment and experience to maintain his advantage in the marketplace. This reliance is essential in building and maintaining confidence. It’s difficult to imagine sustaining the resilience to weather drawdowns if you don’t have a basic trust in how you process information and make decisions. It is better to make a mistake with your own judgment—and learn from that—than to make a lucky trade based on the tips of others.

### **Review**

When you view markets and review them day after day, week after week, you develop an intimacy with market relationships and trading patterns. An internalization of this intimacy is what traders refer to as a feel for markets. It is not mystical inspiration; it’s the result of repeated exposure to information under proper learning conditions. Brian explains, “I review hundreds of stocks using multiple timeframes in an attempt to find what I believe to be the lowest risk/highest potential trades according to my entry and exit parameters.” This review provides him with good trade ideas, but it also feeds a learning curve. After so much review across multiple timeframes, he has learned what a good stock looks like. This internalized expertise helps him deploy his capital in the most efficient manner possible.

We learn our patterns—and the patterns of markets—through intensive review. It is the intensity of the review that enables us to internalize those patterns and become sensitive to their occurrence.

### **Mental Checklist**

Here I’ll let Brian speak for himself: “This one is somewhat new and came about as a result of letting my guard down on a few occasions earlier in the year, which resulted in losses which were larger than what I would normally take. Each day before the market opens I go through a mental checklist of: how do I feel (tired, anxious, excited, etc.) to identify any possible weakness before I commit money. I also try to visualize how I will react to what I view as either normal or abnormal trading conditions. I am trying to spend more time on the mental preparation than I have in the past and it seems to be working well

for me.” *Time and again, I find that this is what winners do: they learn from their losses and adapt.* Trading requires an active mindset; it’s a bit like patrolling enemy territory, where you have to be on the alert for surprises at all times. If you’re not prepared—and haven’t rehearsed that preparation—you won’t be able to act on instinct when those surprises hit. Brian let down his guard, and he was surprised. He created a mental checklist and incorporated visualizations of what-if scenarios and sharpened his active focus, anticipated what could go wrong, and enhanced his results.

Corey’s three best practices for self-coaching were: 1) find a trading partner/group; 2) think in terms of concepts; and 3) keep an idealized trade notebook. All three practices reflect the progression of his learning as a trader.

### **Find a Trading Partner/Group**

“The first thing I learned when I began trading full-time,” Corey recounts, “was that trading could be an extremely lonely, isolating experience. It can be difficult to sustain motivation when you’re the only one who knows what you’re doing, and friends and family may not understand what trading is all about. Trading can be quite difficult, and it is immensely helpful to have at least a handful of solid friends or colleagues who understand your strengths and weaknesses while supporting one another for mutual benefit, such that the whole is greater than its parts. I began writing the blog initially as a way to reach out to others who had similar experiences . . . That has made an ultimate difference in my trading, mostly from the interactions and idea-sharing with others, which has broadened my awareness . . . I also have one experienced trader locally with whom I meet almost every evening to discuss the day’s events and share ideas and study markets. This interaction has challenged us both, and we bring a combination of skills that benefit us academically (combined research), emotionally (motivation), and financially (improved trading tactics).”

Form a team to make trading personally rewarding and stimulate ongoing learning.

### **Think in Terms of Concepts**

“I think the largest shift in my performance came when I began to view markets and price behavior conceptually, rather than being

driven by indicators or news reports,” Corey explains. “This was a process that took time and was difficult for me. Previously, I viewed multiple indicators and believed those were the secret to trading success. However, too much conflicting information was not only frustrating, but unprofitable. Even when I decreased the number of indicators, I still struggled to find profitability. My results were often no better than random entries, which was endlessly disappointing. The shift came when I was able to view markets and price behavior conceptually . . . The shift happened slowly and was attributable in part to studying Market Profile information, such as the concepts of trend day, bracketing markets, auction dynamics, timeframe participation, etc. Other concepts were based in the teachings of the early founders of technical analysis, including momentum, price range (expansion/contraction), broader trend structure, dynamics of price behavior, and price patterns (with their underlying reasons: accumulation or distribution, reversal or continuation). Essentially the shift was one towards greater understanding of price behavior and participation by all sorts of market participants . . . To further the conceptualization switch, I also began researching the broader concepts of intermarket analysis, which compares markets to each other, and sector rotation, which details performance of equity sectors and expectations . . . I began to see markets as a grand chess game, which opened up a new method of perception. Markets clearly do not trade in isolation.”

When you think in concepts, you understand why markets move, and that helps you formulate promising trade ideas.

### **Keeping an Idealized Trade Notebook**

Corey explains, “In addition to keeping a simple spreadsheet that tracks trading performance (which is essential in knowing when you’re making mistakes and correcting them), I use a different kind of trading journal that I call my idealized trade notebook. In this notebook, I print off the intraday chart (I use the five-minute chart most frequently) of the stock or index I traded for the day. Also, if there are particular charts I find interesting, I annotate by hand what I deem to be ideal (or best) trades based on my understanding of price behavior and opportunity. Through looking at the charts at the end of the day without the pressure of real-time trading, I am able to see new patterns that I had missed . . . I then overlay my fills to see how close I came to achieving the total potential move . . . This serves a dual purpose of deeper visualization of my performance, but more importantly, helps clarify the

distinct patterns and trade setups I use for trade entry, management, and exit.”

By tracking ideal trades, we internalize best practices.

Following Brian and Corey, your task for this lesson is to structure your process of review. One task should include a review of the market day, comparing your trades to the actual moves in the market, so that you are learning both about you and about the patterns you want to be trading. Mentoring yourself is not an occasional activity to be performed during losing periods. Rather, among the best traders, it is a regular process embedded into each trading day. Compare what you did with what you could have done as a great way to track your progress and bring yourself closer to your ideals.



#### COACHING CUE

When you coordinate your learning with a trading partner, compare your ideas of the best setups for the markets you are trading. If you see markets through the eyes of others, you can enrich your own pattern recognition.

### LESSON 85: KEEP DETAILED RECORDS

Two of the respondents to my question—two whose work I’ve followed for years now—independently arrived at similar answers. This is not because they trade similarly. Instead, it’s a reflection of the wisdom they’ve accumulated over years of tackling markets and honing their own performance.

Charles Kirk is a trader, portfolio manager, and author of *The Kirk Report* blog site ([www.thekirkreport.com](http://www.thekirkreport.com)). He also maintains a portion of his site for members, who are treated to his stock picking tools and selections. Much writing focuses on when to trade; Charles’s forte is selecting *what* to trade. His blog is among the few on the Web that comprehensively links to articles on key themes that deal with markets and the economy. This is a particularly valuable resource for those who want to stay on top of the market’s larger picture. If you want to see how institutional money might move markets, it makes sense to focus on the themes tracked by institutional money managers. Charles seems to have a knack for identifying those themes.



Jason Goepfert is the editor of the Sentimentrader site ([www.sentimentrader.com](http://www.sentimentrader.com)), which—as its name suggests—focuses on measures of market sentiment. Jason freely offers his perspectives on markets and also shares the results of his tests of historical market patterns. He collects a large amount of data on markets and assembles the data in unique ways to uncover possible edges. These data provide information to guide traders' thinking, as well as food for specific trade ideas. A particularly interesting facet of his service is the tracking of relative smart and dumb money, including unique ways of reading options sentiment.

In response to my question of what has most helped his self-mentoring, Charles Kirk provided a single, detailed response: his BOO book. BOO stands for Book of Observations, and it is a collection of his trading experience. "In this book," he explains, "I keep a detailed track record for every trade I've made, along with observations about the market and things I've learned from others and from monitoring my own success and failures ... My BOO book contains specific and detailed information on every strategy and screen(s) I use, along with detailed performance information over different periods of time. In essence, everything I've learned up until now can be found in this book." Significantly, the contents of the book are organized in a database called do-Organizer ([www.gemx.com](http://www.gemx.com)), which enables him to readily access any idea that he's written about.

A database turns a trading journal into an active research tool.

Charles indicates that the database keeps his thoughts organized, as a scientist might systematically record data and observations from laboratory investigations. "Treating the market, and a strategy, from a scientific, evidence-based approach in this manner was helpful to me to keep me focused, disciplined, and on the right track," he explains. "This also helped me to test new strategies and to recognize early when certain strategies stopped working in specific market conditions, so I could adjust and transition my trading as needed." He also uses the BOO book to track new strategy ideas that he wants to integrate into his own trading. "I consider myself a perpetual student of the market and maintaining and using my BOO book has been incredibly helpful in this regard," he notes.

Indeed, Charles explains, "Looking back, the biggest mistake of my trading career was not starting my BOO book sooner. It took me several years to understand the importance of keeping notes in an organized manner while using a scientific, evidence-based approach to test and improve my skills and strategies."

The BOO book is a great example of the creative strategies that successful traders utilize to identify and hone their strengths. I believe



Charles's key insight is that the ideas in his book must be organized to be maximally useful. By placing his journal in a database format, he is able, with a few keystrokes, to access relevant experience from a broad time period. Journals can become unwieldy over time, and it is difficult to pull material from past entries. Increasing his access to his experience has enabled Charles to keep the past relevant to the present as a source of learning.

When I asked Jason Goepfert to share his three greatest sources of self-coaching, he started with an idea similar to Charles Kirk's.

### **Write Down Every Idea**

"I've written close to 5,000 comments publicly over the past six years," Jason explains, "and also keep a personal journal that tracks more soft subjects such as how I'm feeling, anecdotal evidence, clips of headlines on news sites, etc. I review all of these periodically and find that they are exceptional tools in several respects. They keep me honest (not getting too ahead of myself when trading well and not too down when not), and they also serve as a check for when I'm anxious about a trade. I've looked at how I felt right before putting on past winning trades and saw that I was anxious then, too, so what I'm feeling now isn't necessarily some sixth sense subconsciously hinting that I not put on a trade."

### **Talking to More Accomplished and Experienced Traders**

Jason notes that he meets many successful traders through his market service. "I am always struck that most of them suffer through the same travails as the rest of us," he points out. "They all get emotional at times, but they never let that seep into their risk control discipline. And that discipline is constant—there is no deviation from the strict principle that no one trade will sink them or their career. That is something I have written down in front of me. Risk control is paramount, and it is something I use as a mantra.

It's okay to be emotional; it's not okay to let emotions change your management of risk.

### **Always Learning New Things**

"It's a cliché," Jason acknowledges, "but I've found that the more I learn, the more I discover how little I know. That helps tremendously in trading, as it has helped me to find new ways to approach old problems. Market dynamics are always changing, so we need to find ways

to adjust as conditions change. Learning new trading strategies or new ways to test old ones can be very fruitful. It's a lot of work, but anyone afraid of hard work shouldn't be risking his or her capital. It isn't just trading-related stuff, either. I try to push myself into uncomfortable situations and experience new places, new people. That helps broaden my perspectives so I don't get closed-minded to new approaches."

What most struck me about Jason's insights was that *writing thoughts down led to self-discovery*. When he tracked his trades and emotions, he found that he was often nervous prior to winning trades. This tracking helped him not succumb to nerves when putting on a trade. It is this constant desire to learn new things—about self and market—that keeps trading challenging and interesting as a career. Tracking also helps the trader adapt to shifting market conditions. Jason Goepfert and Charles Kirk are not afraid of the hard work: they spend a great deal of time developing, reviewing, and testing their strategies. There is nothing *get rich quick* about their approaches to markets. Their record keeping is their way of sustaining a learning curve.

Your assignment for this lesson is to create an indexing system for your own trading journal, so that you can track themes associated with what you're doing and how well you're doing it. Tracking means categorizing your trades by strategy/setup, by markets, by results, and by your specific market and personal observations. Keep a journal in electronic form, such as through the StockTickr service ([www.stocktickr.com](http://www.stocktickr.com)), as one way of indexing your ideas. Another method is to turn your journal into a trading blog, with tags for various topics. Still another approach is to maintain your journal in a formal database, like Charles Kirk. *Your records need to be living, breathing entities that you can frequently review for insight and perspective*. Imagine your trades organized by market, market condition, trade setup, time of day, and size, so that you can pull up your results for any given market situation. Organized in this manner, your experience may just become your greatest trading coach—as it has been for Charles and Jason.



#### COACHING CUE

Consider a portion of your journal devoted solely to research: developing and tracking new trade ideas. Charles and Jason continuously search and research for trade ideas as market conditions change. What is working in the current market environment? Which stocks are moving? Which patterns are showing up? Journal about the markets as well as about your trading to help you anticipate opportunity.

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**LESSON 86: LEARN TO BE FALLIBLE**

Dave Mabe is a trader, system developer, and founder of the StockTickr service and site ([www.stocktickr.com](http://www.stocktickr.com)). StockTickr is a unique resource because it enables traders to track their ideas and performance in an on-line format that can be shared with selected groups of traders. This Web 2.0 approach to developing ideas and tracking progress enables traders to build their own community of like-minded peers. The StockTickr site also includes an informative blog featuring interviews with traders who share their work online. I particularly like how StockTickr has created a true online trading journal, making journaling a social activity. It gives traders control over what they share and with whom. Indeed, there is huge potential simply in the idea of sharing a real-time journal with a trading coach.

Chris Perruna is a full-time trader and blogger whose work can be found on the site that bears his name ([www.chrisperruna.com](http://www.chrisperruna.com)). His site is devoted to “successful investing through education” and covers topics ranging from screening for fundamentals among stocks to position sizing and charting. He shares his stock screens with readers, along with specific trade ideas. I like how the site enables traders to learn from his example.

Let’s take a look at how these two pros responded to my question about what has been most helpful to their self-coaching, starting with Dave.

**Trading Journal**

Dave asserts, “A trading journal is by far more powerful than any indicator or platform. It provides the foundation for everything I do as a trader. Your mind can play tricks on you, but your execution data don’t lie. Being able to reflect upon my trading results allows me to step back and view results in aggregate to see how I’m measuring up to my goals.” I’ve seen this with many successful traders: the journal offers a layer of accountability and focus that would otherwise be missing. Dave also stresses the importance of flexibility in goal setting via journals. “Instead of setting a single goal (for example, a certain dollar amount over a time period), I find it much better to set a range of goals from conservative to radical. A lot of traders will set high goals, which set them up for devastation when they aren’t achieved.”

We often focus on what we want to see. Statistics on our trading patterns don’t lie; they focus us on what we need to see.

### **Learning to Be Wrong**

“Most beginning traders have a tremendous need to be right and are resistant to admitting they might be wrong,” Dave observes. “I learned quickly that being right (that is, having a high win rate) doesn’t correlate well with making money. Win rate is overrated—in fact, one of the most profitable strategies I’ve traded had a winning percentage below 30 percent.” Dave is right: most good traders I’ve worked with are not far from a win rate of 50 percent. Their success comes from knowing when they’re right—and taking full advantage—and knowing when they’re wrong—and minimizing losses. Overcoming the psychological need to be right is essential to success; without that, it’s too easy to take profits early and remain stubborn in losing trades.

### **Automate**

Dave recounts, “I’ve spent my trading career trying to remove as much of my discretion as possible from my trading. Many aspects of manual trading systems can be automated. The benefits of automation are numerous: more consistency, less time spent doing trading grunt work, and fewer mistakes. I’ve found that the more automation I have in my systems, the better my results. This includes my manual trading systems all the way to 100 percent completely automated trading systems that I trade.” His point is well taken: even with discretionary trading, execution can be automated so that decisions can remain strictly rule-governed. The simple step of trading with limit orders rather than at the market can make a meaningful difference in performance over time, as traders enter and exit trades at favorable levels, rather than chase markets and get themselves in and out at the worst possible times.

Chris Perruna’s responses will ring true to traders who have traversed their initial learning curves; he focuses on some of the universals of successful trading:

### **Understand Me**

“The most powerful tool I have found in life and in this specific case, the market,” Chris explains, “is what I, as a person, am capable of doing. I finally understand that personal characteristics that are ingrained in my DNA will only allow me to trade successfully under specific circumstances. For example, I am much more consistent and profitable as a medium-term and longer-term trend trader than as a day trader (even more so on the long side). I don’t need to be everything all the time as long as I continue to focus on the areas that bring me the greatest

success. Understanding *me* has been my holy grail of understanding how to trade the market with consistency and profitability.” Chris’s insight is critically important: *you don’t make yourself fit a market or trading style; you find the markets and styles that best fit you*. Successful traders trade within themselves: they stick to what they do best and ignore the rest.

Find what you do best and fashion trading strategies around that.

### Learning to Cut Losses

“It’s almost cliché,” Chris points out, “but not many people can do it in any aspect of life. I have learned to cut losses in my trading, my career, my hobby of competitive poker, and everywhere else in life where the rule applies. Without this rule, there wouldn’t be a third rule.” Chris makes a valuable point: *you can’t live one way and trade another*. It’s hard to imagine being totally disciplined in trading and lax in other areas of life. Good trading practice is a philosophy of living: pursuing opportunity, managing risk, limiting losses, and diversifying positions. Chris trades the way he lives.

### Study and Work Hard

It is difficult to find a successful trader who does not place hard work at the center of what she does. “It is extremely important to my success for me to continuously study the markets on a fundamental and technical level and learn from my successes and mistakes,” Chris points out. “Applying the knowledge gained from past experience allows me to properly analyze similar situations in the future with slightly greater odds of success. Never stop learning is a phrase I will never stop saying, as it proves to be truer as I get older.”

Notice how both Dave and Chris emphasize the importance of *knowing when they’re wrong*. This is an important difference between beginning traders and experienced ones. The beginners focus on being right, as Chris pointed out. Beginners try to avoid being wrong. The experienced traders know they’ll be wrong on a significant proportion of their trades and fully accept that. *Their self-coaching is designed to help them anticipate and manage losses, not avoid them*. They have a plan for each trade to deal with loss, and they have an overall trading plan to deal with periods of drawdown. Your assignment for this lesson is to use your trading journal to flag your fallibility, identifying the five largest losing days in the past

year. What did you do wrong on those days; what could you have done differently? What were the problems that occurred on more than one of these losing occasions? The idea is to embrace your fallibility by turning it into an engine of learning. If you clearly identify the mistakes from your worst trading days, you'll be better prepared to avoid them in the future. Your worst trades can be your best tool for self-understanding—and your best guide for self-coaching.



### COACHING CUE

As you review your trading, make a special study of how you exit trades. Do you tend to exit too early, so that you leave potential profits on the table? Do you tend to overstay your welcome, so that potential profits are retraced? Take it a step further: what could you have looked at to stay in the trade longer or to exit sooner? How can you best adjust your exits to the market's level of volatility? If you refine your exits, you can break your trading down into components and turn observations into goals for improvement.

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## LESSON 87: THE POWER OF RESEARCH

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Rob Hanna is a trader and the writer of the Quantifiable Edges blog ([www.quantifiableedges.blogspot.com](http://www.quantifiableedges.blogspot.com)), a unique site that tracks historical patterns in the stock market. His electronic newsletter goes out daily, detailing the trades he places from his research. For traders, the blog and newsletter are unique tools that can extend their market edge. I particularly find historical patterns relevant to discretionary trading, as we'll see in Chapter 10. With a sound understanding of historical performance, we are in a great position to identify markets that are following their usual patterns and those that are not. Both scenarios can generate excellent trade ideas.

Jeff Miller is a money manager in Naperville, Illinois, who also shares his ideas about markets and trading through his blog, *A Dash of Insight* (<http://oldprof.typepad.com>). He frequently challenges accepted trading wisdom and offers perspectives on markets that reflect his disciplined analysis and understanding of economics. He has researched trading systems and uses those systems in his portfolio management. Like Rob, Jeff's edge is that he tests ideas before he trades them, giving him confidence in risking his capital.

Rob's answer to my question of what he's found most helpful to his self-mentoring as a trader was quite simple: "Research, research, and

research.” He explains, “I know that sounds like one answer repeated three times, but it’s not. It’s the top three answers . . . I’ve been through several stages in my career and traded using different methodologies. The one constant I’ve found with any method of trading I’ve employed is that it takes a substantial amount of research outside of market hours to successfully implement them.”

Rob Hanna started his career day trading, focusing on short-term setups, such as those described in Jeff Cooper’s *Hit and Run* books. What Rob found most useful was not the setup patterns, but the screening for volatile, trending stocks to implement the strategies. He began creating his own scans based on trading patterns, focusing on trades with the best risk/reward. “I wrote down each potential trade in a notebook along with the trigger price for the next trading day,” Rob described. “When the trade was done, I would log the results in my accounting software. I kept a field in the accounting database called *reason*. It was there I entered the name of the setup I used to initiate the trade.” This is a theme we see time and again with successful traders: they track their results meticulously to aid their learning curves.

Keeping records of trades that work cements success patterns in your mind.

Rob Hanna points out that keeping his trades in a database accomplished two goals: it forced him to have a reason for every trade, and it enabled him to track his results as a function of the trade setups employed. “It made it extremely easy for me to determine which setups worked best and which ones struggled,” he explains. “By doing this, I knew which setups I should continue to focus on and which ones I should scrap altogether.” When Rob didn’t have a solid reason for a trade, he simply entered the word *Hunch* as the reason for the trade. “It didn’t take long for me to figure out how much the Hunch trades were costing,” he recounts. He quickly scrapped trading from hunch alone.

The second phase of Rob’s research occurred when he switched to longer-term trading that utilized patterns inspired by William O’Neil’s CANSLIM approach. Rob began to utilize technical screens with the TC2000 software from Worden Bros., with his final lists filtered through fundamental criteria. “With TC2000,” he describes, “I am able to easily place notes on the chart. This is incredibly useful. If a stock pops up with an interesting pattern, I may have already researched that stock in recent weeks. With the note feature, I can see if I already checked the fundamentals and rejected it for some reason. No need to waste time looking up the same symbol over and over.” As with the day-trading patterns, the



setups were less important than the work that went into implementing them. “Once again,” he notes, “I found it was the research and not the trading that made me the money.”

In Rob’s third phase of research, he has formally back-tested his trading ideas, using Excel and TradeStation as primary tools. This back-testing has enabled him to generate actionable trade ideas. As he puts it, “I love taking these trades because I have a good idea of my success rate and profitability expectation going in.” Reviewing a variety of price, breadth, volume, sentiment, and other indicator data helps him develop a view on markets, but it also “helps me to unveil what is truth and what is lore with regards to conventional market wisdom. There is so much information out there. It’s difficult to know what’s valuable and what information is simply hype . . . There is great value in being able to test ideas and understand what indicators and setups actually provide a quantifiable edge, and what ones don’t.”

Much conventional trading wisdom does not stand the scrutiny of objective analysis.

For Rob, research has been his source of edge. “Whether my focus has been day trading, intermediate-term momentum trading, or quantitative swing trading,” he explains, “I have consistently found that it’s been the nightly research that has facilitated my growth as a trader more than anything . . . The ideas are all constructed at night. Market hours are simply used for executing those ideas. Research (stock screening and charting), research (quantitative analysis), and research (results analysis) are the three things I’ve found most helpful in coaching myself as a trader.”

What I most like about Rob’s perspective is that it highlights the relevance of research for every kind of trader, not just those that trade mechanical systems. Rob has tested and traded setups, *but he also has treated himself—and his trading—as a subject for study*. When Rob identified the ideas that work best for him, he has been able to maximize opportunity and eliminate the hunches and market lore that cost him money.

Jeff Miller approaches markets differently from Rob, but his perspectives on self-mentoring are surprisingly similar. “The most important thing—by far—in my trading is having a system and/or method,” he stresses. “Without a system in which you have confidence, you are adrift. You second-guess yourself on every occasion. This leads to selling winners too soon, holding on to losers too long, and many other errors. You need to know that your basic method works. If you really understand and believe this, you can focus on making the correct decisions, which may not always be the winning decisions.”

The key word Jeff uses is *know*. Many traders don't know their edge; they don't know how well their methods work in different market conditions. They have beliefs, but not deeply held convictions about the ways in which they make decisions. As a result, traders lose discipline. This loss is not because they cannot follow rules. It's because they don't deeply believe in the rules to begin with.

Many times, poor discipline is the result of shallow conviction. If we don't truly know our edge, how can we believe in it?

A second important element for Jeff Miller's self-coaching is analysis and review. "Having a system means testing it properly," he explains. "This is not back-fitting for a short time period. It is developing the method in one era and testing over out-of-sample data covering different markets. Only then can you be confident. Even with this method, you must do regular performance reviews to make sure that something in the world has not changed. There may be a tough decision about whether you are in a predictable slack period or circumstances that are really different." In other words, trading is fraught with uncertainty; even the best ideas have a limited shelf life. *The purpose of analysis and review is to generate an edge, but also to monitor changes in that edge over time.* It's not as simple as finding systems that make money for all time and all markets.

Jeff's third area of self-coaching is learning to recognize exceptions. "Understanding your method means knowing when something truly exceptional is happening," he points out. "We all know the danger in saying that, 'This time is different.' Keeping this in mind, there are exceptional trading opportunities lasting a day or a week, even for those of us with longer time horizons." This thought gets us back to the excellent point raised by Henry Carstens: knowing when to turn your trading off. When markets are behaving in historically abnormal ways, the usual methods may not produce their usual results. Exceptional markets yield exceptional risks as well as rewards.

The takeaway from Rob and Jeff is the value of self-knowledge. *The more you know about your trading methods, the more you can play to their strengths and avoid their weaknesses.* Note that for both Rob and Jeff, this has meant considerable time and effort outside of trading hours to hone their edges and stay on top of how they change. I consistently find that a major predictor of trading success is the amount of time devoted to markets outside of trading hours proper. The time spent in defining and refining trading methods is a major part of this commitment. When you are your own trading coach, you are no different from a basketball or football

coach: much of your success will come from the hours you put into recruiting new talent, practicing, and planning.

Your assignment for this lesson is to treat yourself as a trading system, so that you can research, research, research your performance over various markets and market conditions. For this assignment, pay particular attention to the kinds of trades that make you most of your money. Do they occur at particular times of day, or in particular market conditions? Do they occur primarily in a few markets or stock names? Are they primarily short-term trades or longer-term ones? Are they mostly reversal trade, or are they trend following? Your goal is to clearly identify your bread and butter as a trader, so that you can allocate most of your risk to what you do best and reduce the risk associated with trades that are outside your wheelhouse. Understand what you do—especially what you do best—as it is the most effective means for developing and sustaining confidence in your work. Weekly and monthly reviews of each of your trades by categories are a great start in this direction.



#### COACHING CUE

Track the number of trades you place that break even or that make or lose only a small amount of money. Many times, this is a sign of good discipline in cutting losers (although it can also reveal problems with exiting winning trades far too early). Recognize quickly when a trade is wrong to help keep the average size of losing trades below that of winners, an essential ingredient of trading success.

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### LESSON 88: ATTITUDES AND GOALS, THE BUILDING BLOCKS OF SUCCESS

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Ray Barros wears many hats as a money manager, trader, blog writer, book author, and trading coach. He is one of the very few coaches that I know who incorporates a keen awareness of psychology with a sound understanding of markets. His *Trading Success* blog ([www.tradingsuccess.com/blog](http://www.tradingsuccess.com/blog)) is notable for trading and psychological insights, and his book *The Nature of Trends* is an excellent tool for mentorship. It explains his ways of analyzing markets, his risk/money management ideas, and his trading psychology tools.

John Forman similarly combines a wealth of roles. An athletic coach, he also mentors traders and offers his insights in *The Essentials of Trading* blog ([www.theessentialsoftrading.com/Blog](http://www.theessentialsoftrading.com/Blog)). His book by that same name is an excellent introduction and orientation to markets, with

valuable views on analyzing markets, executing trades, and developing trading systems. He is keenly aware of the importance of skill development and psychology to the evolution of traders.

When I asked Ray for the three things that have most contributed to his self-coaching, his number one factor was attitudes. Among the attitudes he views as essential to trading success are:

### **Honesty**

Ray defines this as “the value of never consciously faking reality. If there is one trait that has proven critical to my success and to the success of my students, it has been this one. Successful students are brutally honest with themselves. Failed students tend to provide excuses and rationalizations for their failures.”

### **Responsibility**

“I learned to take full responsibility for my successes and failures,” Ray explains. “With successes, my question is: How can I repeat this? With failures, my question is: What can I learn from this?”

### **Tenacity**

“I’ll do whatever is necessary to achieve my goals,” Ray emphasizes. “This includes constant learning by first learning the material, then adapting it to suit my needs. I notice that failed students tend to resist the material whenever that leads outside their comfort zones.”

Learning requires a willingness to venture outside one’s comfort zone to see and do things in new ways.

### **Discipline**

Ray stresses, “I am disciplined enough to write out my trading rules and execute the rules consistently. I am disciplined enough to keep my psychological and equity journals so that I can learn from my trades. And I am disciplined enough to celebrate my successes and take time from the markets to recharge.”

Citing Linda Bradford Raschke, who has mentored many traders over the years through her online trading room, seminars, and books, Ray Barros stresses that coaching is only valuable if its insights are implemented by traders in their *3-Rs*: routines, research, and reviews.

Among the routines that Ray finds essential to his lifestyle as a trader are:

- Updating data and journals.
- Reviewing trades.
- Preparing for the coming day, “including visualization of entries and exits.”
- Balancing other duties and responsibilities with trading regimes.
- Staying on top of personal and business finances.
- Completing commitments, including writing articles, preparing for talks, and so on.

He notes that his self-mentoring blends review and research. “I may notice a pattern in my journals that needs attention,” he explains. “It may be that I am suffering losses or experiencing profits beyond the norm. In the former case, I would need to research the context that is leading to the loss. I’d need to determine whether it is incompatibility between my plan and current market conditions, or whether I am breaching discipline. In either case, I have to decide what to do. If current market conditions do not suit my plan, I’ll cut down size or take a break. If I am breaching discipline, I identify the context/contexts within which the breach/breaches occur and take remedial actions. I then review the actions to see if they have had the desired results. If not, I change the actions.”

Ray also carefully reviews and researches periods of unusually positive trading performance. “If I am making above normal profits, I determine if current market conditions happen to suit my plan or if there has been a fundamental shift that is leading to greater profitability. In the former case, I increase my size and ensure that I maintain my discipline before I take a trade. I have learned that, in my case, I need to be more vigilant when I am having a great run than when I am suffering a drawdown. If there has been a fundamental shift, I seek to identify what I have done to cause the shift, and I seek consciously to continue the new behavior.”

Vigilance during a run of profitability is an effective way to prevent overconfidence and lapses of discipline.

“I also constantly research new ideas,” Ray Barros notes. He is an avid reader and seeks insights that will impact his life and trading. When he encounters a new trading idea, he outsources the testing of the idea to determine whether or not it truly possesses an edge. “My review provides a solid foundation for my activities,” he explains. “I set goals, take action, and then see if the action is leading toward or away from the desired outcome.”

*One of Ray's best practices is the separation of his daily journals into trading and personal components.* In his trading journal, he grades his entry and exit discipline, giving himself three points if he entered and exited according to plan; one point if either the entry or exit broke discipline; and zero points if he broke discipline on both. "I look to maintain a 90 percent threshold," he explains. "I must garner 90 percent of the total possible points. If I drop below 90 percent but above 85 percent, I start looking for causes, and I start remedial actions. If I drop below 85 percent, I take time off from trading." In the trading journal, he also tracks the excursion of each of his trades, expressing how much he took out of the trade as a proportion of what he possibly could have made. "I seek to capture around 65 percent of a possible move," he elaborates. "If I find that I am consistently capturing significantly less than 65 percent, I take this as a warning I am entering an ebb state."

Like successful manufacturing businesses, traders can engage in continuous quality improvement by evaluating their processes and correcting shortcomings.

In the personal portion of the journal, Ray notes event, feelings, and behaviors that accompany each of his trades. "The aim here," he points out, "is to have enough details so that I can spot the patterns that warn of fundamental shifts, breaches of discipline, and ebb-and-flow conditions." In other words, he is tracking his performance much as he tracks a market, looking for signs of trends emerging from the data. When he is flowing, he wants to be more aggressive in his trading; when his execution is ebbing, he wants to cut his risk. Toward this end, he also tracks his trading metrics, including his average win and loss sizes; his win and loss rate; the standard deviations of profits and losses; consecutive wins and losses; average holding periods for winners and losers; his expectancy ratio; his drawdowns; and his recovery periods from drawdowns. The key to Ray's self-coaching is to study himself as intensively as he studies markets.

John Forman echoes Ray's point about making sure that one's trading life fits into her personal life. "The first thing a trader needs to do," he emphasizes, "is step back and take a big picture view of things. This is extremely important for new traders, as they need to figure out how trading is going to fit into their lives. Even folks who have been doing it for a while need to do this from time to time as well. Trading is part of one's life, not separate from it. What part it plays must necessarily define how it is approached, and that can change over time. Periodically taking the 30,000-foot view allows one to maintain perspective." I wholeheartedly agree with John's insight. Even successful professional traders can become



overloaded by work responsibilities, tracking markets and themes day and night. If traders allow trading to consume them, they lose concentration and efficiency—and eventually that takes a toll on performance. *Successful trading means knowing when to not trade and when to conserve and renew personal energy.* Often, the best trading decision is the decision to take risk off and go on a holiday from markets. This reprieve can spark good thinking about markets and performance from the 30,000-foot view, aiding performance once trading commences.

“A second important thing,” John Forman notes of his self-coaching, “is the commitment to performance improvement. That may seem to be an obvious thing, but it’s something easy to stray from at times. It’s often hard to not become complacent with one’s trading, especially when a level of success has been achieved. In order for the self-coaching to have any value, though, the realization that one can keep getting better, and the desire to do so, must be at the fore all the time.” I have noticed this time and again among the firms where I work. The best traders and portfolio managers seek out coaching when they’re doing well, not just when they’re losing. They have a continual drive for self-improvement; not just a temporary desire to remedy deficiencies.

The measure of a trader is how hard he works on trading during winning periods.

“Finally,” John concludes, “setting good goals and assessing how one is progressing toward them is critical. These are things coaches in other activities like athletics do as external observers. The advantage there, however, is that they don’t have the direct link to the individual’s psyche, which complicates self-assessment. The most challenging aspect of this process for the individual is not allowing it to adversely impact one’s confidence level. That means the process needs to be as objective as possible, and the trader needs to be able to disconnect their ego from it.” Forman raises an excellent point here: *goal setting and review must be pursued in a manner that does not damage confidence or motivation.* Vague or distant goals offer insufficient feedback and learning; difficult goals can yield frustration. Tracking goals with a negative mindset—emphasizing shortfalls—makes self-coaching a punitive activity. The good self-coach, like the good athletic coach, uses goals to facilitate learning and build confidence. No one will sustain a process if, over time, it leads them to feel worse about themselves.

Your assignment for this lesson is to conduct a self-assessment from 30,000 feet. We’ve talked about tracking your trading, *but now the goal is to track your self-coaching.* Is trading fitting into your life, or do you find yourself fitting your life into the markets? Is most your time consumed



with trading, or are you spending at least equal time in performance improvement—the reviews and research of markets and trades—and the routines that help you develop new ideas and hone skills? How much of your efforts are goal-focused, and how much are you drifting from day to day? Do you get down to the hard business of grading your performance and tracking your ebbs and flows, and do you use this information to guide your risk-taking? In short, if you're going to be a good self-coach, you have to be as aware of your own coaching performance as your trading results. The value of such meta-coaching—training yourself to be a better mentor of yourself—is a key lesson we can take away from Ray and John.



### COACHING CUE

Just as you can develop a report card on your trading to track your progress, you can grade your self-coaching efforts by assessing how much time you spend in self-coaching mode; how clearly you set goals for yourself; and how well you sustain work toward those goals. You can't develop as a trader without working on trading skills, and you can't develop as your own coach without working on your coaching skills.

## LESSON 89: A VIEW FROM THE TRADING FIRMS

Mike Bellafiore is a partner at SMB Capital, a proprietary trading firm in New York City that specializes in the short-term trading of individual equities. He is also a successful trader and a mentor of traders within the firm. Most recently, SMB has extended its training to the trading public via a blog ([www.smbtraining.com/blog](http://www.smbtraining.com/blog)) and a formal trading curriculum. I had the pleasure of visiting SMB Capital and was impressed by Mike, Steve Spencer, and the others in the firm. There was a good buzz on the trading floor throughout the day as traders shared ideas and breaking developments.

Larry Fisher is a co-owner of Trading RM, a proprietary trading firm in Chicago that specializes in trading individual stocks and options on those stocks (<http://tradingrm.com>). Larry and his partner Reid Valfer started the firm with the desire of providing a mentoring and teaching environment for traders. An unusual feature of the firm is that Larry and Reid call out all their trades, illustrating to their traders what they're doing throughout the day. Teaching and mentorship are thus woven into the fabric of daily trading. In visiting Trading RM, I was impressed by the learning

environment. Larry and Reid have developed a web site and blog so that they can share their insights with the trading public (<http://blog.tradingrm.com>).

It is typical of Mike that, when I asked him for the three things that most help his self-coaching, he emailed me a 14-page document. He is attuned to the mentoring process and practices it in his own trading. Number one on his list is keeping trading statistics. “Statistics are very important for my trading,” Mike explains. “I must know what trading plays are working best for me, what stocks I am trading profitably, my win rate, my liquidity stats, etc.”

The head trader at SMB, Gilbert Mendez (GMan) created a tool for the desk called the SMB Chop Tracker. It summarizes trading statistics each day for each trader, so that they can see how well they’re doing and where their profits and losses are coming from. “Most often I struggle with my trading because I am in the wrong stocks,” Mike Bellafiore notes. He tells the story of how he traded one particular stock, MBI, quite well in the fall and then consistently lost money in it. “I felt like someone else was inhabiting my trading body,” he jokes. “So I looked at my stats. They were screaming, ‘Hey, Mike, maybe another stock for you?’ I figured out some adjustments I could make, concluded there were better stocks for me to trade, and decided to move on. I went right back to making money.”

Statistics on our trading alerts us to hidden patterns, both problems and solutions.

Mike also tells about a particularly vicious loss he took in trading SNDK. “I will always remember 11/21/05,” he recalls. “What a bloodbath. For weeks I walked around cussing SNDK underneath my breath and swore to never trade it again. But one day I checked my statistics and surprisingly learned that I actually traded SNDK well, save that one day. I was overvaluing that last rip. While trading, you develop a perception of how well you are trading a stock. That perception can be incorrect. When you study your trading statistics, you may discover that the stocks you thought you were killing, you weren’t. And you may discover that the stocks you thought were a disaster weren’t.”

Mike Bellafiore’s second coaching practice is something we all do, but not with intention: breathe. “While trading, it is essential to quiet your mind so that you accurately process the data that the market offers,” he observes. “Some traders think they just need to focus better and shut out unneeded stimuli. These traders believe they can will themselves to focus better. But quieting your mind is an acquired skill. Mariano Rivera [a fast-ball pitcher] can’t just start throwing a changeup because he really wants

to. He would have to spend hundreds of hours working on his grip, motion, and control. It takes 15 to 30 minutes of deep breathing a day to develop and maintain this skill. My partner and co-founder of SMB Capital, Steve Spencer, taught me how to properly breathe. Steve teaches this to our new traders on our prop desk. I used to think I accurately processed the data that the market offered. But after I learned how to properly breathe, I recognized that this was not accurate . . . You must develop the skill of quieting your mind so that you accurately process your market data and, as a result, fulfill your trading potential.”

Mike tells the story of a young trader next to him who cheered whenever his stocks moved in his favor. The veteran traders merely smirked; that trader soon blew up. “For old-school traders like us,” he points out, “there is no celebrating intraday. You are now rooting for your stocks and not just interpreting the data that the market is offering.” By controlling his breathing, he is better able to let the market data come to him, improving his decision-making.

If you’re celebrating or bemoaning a trade while you’re in it, you’re not focused on the market itself.

Mike Bellafiore’s third self-coaching best practice is watching his trading tapes. “Watching my trading tapes has improved my trading more than any other self-improvement technique,” he asserts. “Many great athletes such as Alex Rodriguez use video to improve their performance. I record all my trades and watch back the important plays. Doing so has helped me particularly with my two biggest weaknesses: closing out a winning position prematurely, and adding size.” By watching tapes of his trading, Mike developed rules for recognizing when he should hold positions, when he should get back into a position he has exited, and when he should get out of positions. These rules were compiled into lists that became his system. “It gave me the confidence to add size when I see a great risk/reward opportunity that is on my list,” he explains. “I learned from my trading tapes that adding size in certain spots offered favorable risk/reward trading opportunities, and that perhaps it was even irresponsible to not add size with certain trades. So when I spot a trade from my list of When to Add Size, I just execute.”

Once again, self-coaching boils down to directed, hard work. “In my trading space,” Mike insists, “if you are not willing to come into the office on the weekends and/or find some time after the close to watch your trading tapes, then you are not competing as a trader. Trading is a sport. It’s a competition. And the results of your trading are often determined by the effort you put in before the open.”

Larry Fisher's responses to the question of the three self-coaching practices that have most aided his trading reflect his teaching practices at his firm, which in turn reflect his years of trading experience. Here's what he has to say:

### **Writing a Trading Journal**

"Over the years, I have used a journal as a medium to make sure that I am in tune with my emotions," Larry explains. "The journaling process has become a very important part of my trading routine. I have realized that writing in my journal pays huge dividends, especially when I am trading well and I am trading poorly. The process keeps me grounded, while often limiting the duration of trading slumps and extending periods of trading successes." Notice that Larry employs the journal effectively both when he's trading well and when he's not. This keeps him attuned to emotions in a positive way—it grounds him in confident trading when he's seeing markets well—and it enables him to take corrective action quickly when he's not in tune with the stocks he's trading. So often the difference between the successful trader and the unsuccessful one is how they handle being very right and very wrong. The journal, properly constructed, can be a tool for adjusting to these extremes, enabling you to add risk when you're trading well and pull back when you're not.

The trading journal is a means for sustaining self-observation.

### **Communicating with Peers**

Larry Fisher notes, "I have a network of friends and colleagues with whom I make an effort to communicate on a regular basis. This allows me to learn from others while sharing real-time market experiences. These conversations aid me in dealing with the ebb and flow associated with being a professional trader." This theme arises again and again with the best traders: they have a rich network of contacts that help them personally and professionally. Larry's observation echoes what we heard from Ray Barros: there is always an ebb and flow to trading; profitable times and lean times. Being able to connect with traders who have been through the cycles and know how to move beyond them can be a tremendous support. We also underestimate the power of social interaction as a means of cognition: *some of us simply think more effectively when we think aloud*. Sounding boards for our ideas helps us hone our market views and make better decisions.

### Trading in a Good Environment

“In order for me to be able to coach myself,” Larry explains, “I need to trade in an environment that is conducive for success. We built our firm with that in mind. All the traders at my firm are on the same page. Willingness to be a part of a team combined with the desire to learn are characteristics each trader possesses.” I have visited many firms in which traders operate in almost total isolation of one another. One person’s learning experiences become just that: opportunities to learn for that individual alone. *When a firm is founded upon a team concept, everyone’s learning becomes learning for the group.* This is Larry Fisher’s central insight, and it is the greatest strength of his firm. When everyone calls out her trades, there’s no place to hide. That is tremendously freeing. You can learn from the successes of your peers and also from their mistakes. Their ideas spark yours, and your heads-up on news or breakouts aids everyone else. In an environment in which all traders are their own coaches, all traders inevitably contribute to each other’s coaching.

Learning cannot occur without accountability.

These are the real words of real traders who really trade for a living and really run successful trading firms. Their best practices can become your own, even if you don’t work for SMB Capital or Trading RM. How do your trading practices compare with those at these firms? How does your trading atmosphere compare with theirs? When you’re coaching yourself, you are—in a sense—creating your own trading firm. You are coach, risk manager, researcher, and trader rolled into one. How well you fulfill these roles depends on the time and effort you devote to each. A world-class basketball player works on offense and defense; on passing, dribbling, shooting, rebounding, and physical conditioning. There are many facets to one’s game—in sports and in trading. The successful firms pay attention to all of them.

Mike and his partner Steve are correct to emphasize breathing in their training of traders. This exercise makes a worthwhile assignment for your development. *The first step toward controlling emotional and cognitive arousal is controlling the level of arousal in the body.* When we are filled with stresses and worries, we bring those to markets. When we sustain a quiet mind, we let markets come to us and free our minds to respond to the patterns we perceive. Write in journals, communicate with peers, and consult your trading statistics. These actions are all ways to make sense of your market experience so that you can then sit in front of the screen with

a quiet, confident mind. It does take dedicated time each day to sustain the quiet mind, but it comes more easily with experience. Find a room with no distractions—no noise—and keep yourself totally still as you fix your attention on something in the room: an object on the wall, music in headphones, etc. Then breathe very deeply and slowly, keeping your attention as fixed as possible. You'll find yourself able to tune out fear and greed, anxiety and overconfidence as you sustain a high level of concentration and fix your attention on an emotionally neutral stimulus. The best trading practices and environments cannot benefit you if you are not in a state to make good use of them. Quite literally, with each breath, you can be coaching yourself.



#### COACHING CUE

I have found that if I start my day with physical exercise and biofeedback, I can sustain calm concentration as an effective strategy for maximizing my energy and focus. If you start your day run down and distracted, you're likely to become even more fatigued and scattered during the trading day. Part of preparation is to study the market; part is also to keep yourself in a physical and cognitive mode that maximizes performance.

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### LESSON 90: USE DATA TO IMPROVE TRADING PERFORMANCE

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Rainsford “Rennie” Yang is the author of the Market Tells web site and newsletter ([www.markettells.com](http://www.markettells.com)), which generates trade ideas through historical analyses of stock market behavior. His service is unusually helpful in finding trading edges, particularly with respect to generating trend-catcher alerts during the day. The ideas can either be traded outright or can be used to inform discretionary decisions from favored setups. For traders who don't have the time, skills, or inclination to conduct their own historical research (see Chapter 10), a service such as Market Tells is invaluable.

David Adler is the Director of Trader DNA ([www.traderdna.com](http://www.traderdna.com)), which markets a program for tracking trading performance over time. The software captures information about futures trades and generates a series of metrics that reveal areas of trading strength and weakness. This information is especially helpful for high-frequency traders, who would find it impossible to manually enter trades into a log for analysis. Results are charted as well as summarized in print, providing easy-to-understand reports.

When I asked Rennie to summarize his most useful self-coaching practices, he most generously shared some of the patterns from his historical research. He included daily/weekly analysis and intraday analysis in his response, which I quote extensively in the following pages.



## Daily/Weekly Analysis

“When advancers recently outnumbered decliners by more than a 3:1 margin on the NYSE and the market continued to push higher over the next few sessions,” Rennie recounts, “I brought up the Master Spreadsheet where I conduct all of my testing and research. It contains the daily data back to 1980 and weekly data back to 1950 on all of the major averages and all of the market internals (breadth, volume, new highs/lows, etc.) to make testing quick and easy. In this case, I searched for instances when the S&P was higher three days after a 3:1 positive breadth session and examined the market’s performance over the next two weeks. Such lopsided breadth days can mark *buying climaxes*, in which buying power is exhausted and the market trades lower short-term. But when the market remains on firm ground in the days following such a lopsided positive breadth session, I would expect the S&P to continue moving higher over the next two weeks.”

Rennie Yang explains how to conduct this analysis: “To keep things simple, let’s assume I have a spreadsheet containing daily S&P 500 and NYSE advance/decline data. Column A has the date, while columns B and C contain the daily S&P 500 closing price and NYSE advance/decline ratio, respectively. Starting at the fifth row in column D, enter the following formula:

$$= \text{if}(\text{and}(\text{c2} > 3, \text{b5} > \text{b2}), (\text{b15} - \text{b5}) / \text{b5}, "")$$

“This states: *if the advance/decline ratio from three days ago was over 3.0 and the S&P closed above its three-day ago close, show the percentage gain for the S&P over the next ten trading days*. Fill this column down to the point where the data ends and quickly scan the results. You can immediately see that the hypothesis seems correct. Over the last 30 examples, the S&P has been higher 10 trading days later in 25 out of 30 cases, or 83 percent of the time.”

To get a sense for whether an edge is present, it is important to compare a historical pattern over X days with the market’s general tendency over X days.

“That may look like a bullish edge,” Rennie points out, “but first you need to check the S&Ps at-any-time odds of posting a higher close 10 trading days later. Here’s a quick and easy method. Go back to the fifth row in Column D of the sample spreadsheet above and change the formula to read “=if(b15>b5,1,”)”. This means that *if the S&Ps close two weeks later is greater than today’s closing S&P, print a one, otherwise print nothing*. Then fill this column down to the point where the data ends. In most



spreadsheet applications, such as Excel, you'll see in the lower right corner the summation of all those 1s. Dividing that result by the number of days in the sample reveals the at-any-time odds—57 percent. In other words, on any given day, the chances that the S&P will be higher two weeks later have been 57 percent. That is far less than the 83 percent odds when the S&P is higher three days after a 3:1 breadth session. This confirms the original hypothesis that the chances for a market rally over the intermediate-term are far better than average, meaning there's a clearly bullish edge.

"Instead of relying on traditional indicators, most of which merely manipulate and regurgitate price action, look beneath the surface of the major averages at the market internals such as breadth, up/down volume, new highs/lows, NYSE TICK action, etc," Rennie advises. "This is the area in which I've found the majority of trading setups that stand up to historical testing. Does a surge in new 52-week lows portend an intermediate-term bottom? Is a 90 percent up volume day bullish? How about a cluster of 80 percent up volume days in a short time frame? Just about any concept you can imagine can be quickly researched and tested with the proper preparation. By maintaining your own version of a master spreadsheet and conducting your own testing and research, you'll know when a concept truly provides a bullish or bearish edge. Consistently exploit that edge, and you'll have a leg up on the competition."

It is powerful when you find a pattern with an edge, but even more powerful when your edge is the ability to find and trade many such patterns.

## Intraday Analysis

"The NYSE TICK is probably the single most helpful intraday indicator," Rennie Yang asserts. "It tells you, at a glance, how many issues last traded on an uptick versus a downtick. A reading of +500, for instance, means that, at that moment, 500 more issues last traded on an uptick. When you first view a chart of the NYSE TICK, it will look as if it's too noisy to be of any use . . . But change your viewpoint and you'll see an entirely different picture . . . You can actually hide the NYSE TICK itself and just plot the 20-period moving average of the TICK to gain considerable insight into the supply/demand equation. Is the average holding above zero, meaning generally more buying power, or is the average holding below zero, reflecting better selling pressure? That's something every day trader should know.

"Here's another technique for utilizing intraday TICK readings," Rennie offers. "Many data feeds such as e-Signal allow you to export data in real time to a spreadsheet. Through a technology known as DDE (dynamic

data exchange), it's a relatively simple process to have one-minute NYSE TICK data updating constantly in your spreadsheet. Once this has been accomplished, you can easily create your own cumulative TICK. Here's how: Set up a spreadsheet with columns A, B, and C containing the date, time, and close of the NYSE TICK (\$TICK in e-Signal). It should start at row 2 and contain the last 390 one-minute bars, the equivalent of one full trading day. In the first row of column D, enter a zero. In the first row of column E, enter a space, followed by today's date (the space is due to a quirk on e-Signal's part). Then jump down to the second row of column D and enter the following formula:

$$= \text{if}(a2 = \$E\$1, c2 + d1, d1)$$

“and fill it down through all 390 rows. This states that, *if the date matches today, then take the most recent closing one-minute TICK and add it to the running total for the session.* As the data comes in, this will automatically build a cumulative TICK in column D, which can then be charted to provide a real-time intraday chart of the cumulative TICK. Draw a line at the zero mark and watch the cumulative TICK reveal the underlying buying and selling pressure that is hidden in the noise of the NYSE TICK.”

The cumulative TICK reveals the trend of daily sentiment.

David Adler approaches the use of data for self-coaching in a different manner, focusing on the assessment of trading performance itself. “The philosophy behind TraderDNA, which I firmly believe,” he explains, “is the idea of being cognizant of what happened (in terms of your performance) within a given session, week, month, etc. of your trading, so that, going forward, the negative aspects can be minimized and the positive can be maximized. The fundamental idea is that, if the trader is able to look back on a certain time period of his trading and understand more about the overall result, then he can be proactive . . . in preventing the same mistakes going forward. Likewise, he can identify strengths and focus on situations that are likely to result in a profit based upon what his past trading has shown.

“Our users extract their order data from their front-end software,” David Adler notes, “and import the data into TraderDNA. This affords them the opportunity to thoroughly analyze their data in order to understand more about the strengths and weaknesses of their trading: specifically, their performance trends, where their losses came from, characteristics of their trades, the differences in their winners and losers, amongst other things.” Here are some of the analytics provided by the software, along with David's commentary:

1. **Hour of day analysis.** “Because markets trade differently throughout the day,” David explains, “many of our users measure their performance (in terms of average P/L, risk taken, profit opportunity, number of winners/losers, size of winners/losers) by the time of day the trade occurred. This helps them to use their past performance to determine the most ideal times for them to trade a given market.”
2. **Winning trades versus losing trades.** “In looking for differences in winning and losing trades, it’s helpful—and necessary—to group all winners together and group all losers together and then apply metrics to each category,” David points out. “The value in doing so is the opportunity for you to discover the differences in your winning trades and your losing trades.” Among the metrics applied to both the winning and losing trades are the number of winners and losers; the average win and average loss size; the number of times a trader added to winning and losing positions; the average amount of heat taken in a trade before it was covered for a profit or loss; and the average time it has taken to hit the point of maximum heat. The latter is an especially interesting metric in that, by comparing winning and losing trades, it can help guide traders to formulate rules for the proper amount of time to be holding positions.

If you know how much heat you take on winners versus losers and how long it takes you to reach that point of maximum heat, you can set guidelines for when and where it might be prudent to cut your losers.

3. **Comparing results among market/product traded.** “Traders that trade more than one market/product sometimes have difficulty interpreting how their performance compares in their trading of each market,” David Adler observes. “Oftentimes the trader will be very profitable in one market but have consistently less profit or even losses in other markets. If you trade more than one market, it’s important to split up any analysis or performance reporting that you do by the markets you trade.” Among the metrics he applies to different markets are: the total amount earned/lost per market; the average win and average loss for each market; the number of consecutive winning and losing trades for each market; the average risk incurred among trades for each market; the average lost profit opportunity for each market; the number of times you added to losing and winning positions per market; the average amount of time spent in losing trades per market; the maximum losing and winning trades per market; and breakdowns by hour of the day for each market. My experience with metrics is that these

breakdowns by market will often shift over time, as certain markets yield greater opportunities and others go dry. *Tracking results over time can be a great way of seeing, in real time, when and how markets are changing.*

“I’ve seen numerous traders increase their P/L by minimizing trading losses and increasing the frequency and/or size of their winners after applying one or more of the techniques above,” David concludes. “From what I’ve seen, it’s most effective to conduct your analysis or review of your trading no more than once a week, and ideally once every two weeks or even once a month.”

Intuition—the result of implicit learning that occurs after long periods of observing market patterns—may play an important role in getting traders into and out of positions. Even the most intuitive and discretionary trading, however, can benefit from analytics: knowing which markets and time frames offer opportunity and measuring how well you’re taking advantage of that opportunity. *Ultimately, you are your own trading system.* Your task, as your own performance coach, is to know how your system operates, avoid its shortcomings, and maximize its strengths. The insights and tools provided by Rennie and Dave are excellent guides in the quest to become more scientific in the management of our trading business.



### COACHING CUE

The contributors to this chapter have provided a wealth of insights, derived from firsthand experience, as to the principles and practices that can improve your trading. A worthwhile exercise is to review each of the contributor’s ideas and identify the overlap: the points emphasized by more than one contributor. These points of overlap represent important best practices that can guide your efforts going forward.

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## RESOURCES

The *Become Your Own Trading Coach* blog is the primary supplemental resource for this book. You can find links and additional posts on the topic of coaching processes at the home page on the blog for Chapter 9: <http://becomeyourowntradingcoach.blogspot.com/2008/08/daily-trading-coach-chapter-nine-links.html>

The contributors to this chapter maintain their own web sites, which offer a wealth of resources to developing traders. Here are links to the contributors to this chapter and their web sites:

<http://becomeyourowntradingcoach.blogspot.com/2008/08/contributors-to-daily-trading-coach.html>

For background on technical analysis, Brian Shannon's book is a useful resource for mentorship:

[www.technicalanalysisbook.com/](http://www.technicalanalysisbook.com/)

Ray Barros's book *The Nature of Trends* details his approach to trading and trading psychology; see also the seminars he offers on these topics: [www.tradingsuccess.com/](http://www.tradingsuccess.com/)

John Forman's book *The Essentials of Trading* is an excellent introduction to the practice and business of trading: [www.theessentialsoftrading.com/Blog/index.php/the-essentials-of-trading/](http://www.theessentialsoftrading.com/Blog/index.php/the-essentials-of-trading/)

The NewsFlashr site is a great way of staying on top of many popular trading-related blogs, as well as news: [www.newsflashr.com/feeds/business\\_blogs.html](http://www.newsflashr.com/feeds/business_blogs.html)

# Looking for the Edge

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## *Finding Historical Patterns in Markets*

*Science is the great antidote to the poison of enthusiasm and superstition.*

—Adam Smith

**T**raders commonly refer to having an *edge* in markets. What this means is that they have a positive expectancy regarding the returns from their trades. Card counting can provide an edge to a poker player, but how can traders count the cards of their markets and put probabilities on their side? One way of accomplishing this is historical investigation. While history may not repeat exactly in markets, we can identify patterns that have been associated with a directional edge in the past and hypothesize that these will yield similar tendencies in the immediate future. By knowing market history, we identify patterns to guide trade ideas.

So how can we investigate market history to uncover such patterns? This has been a recurring topic of reader interest on the *TraderFeed* blog. If you're going to mentor yourself as a trader, your efforts will be greatly aided by your ability to test the patterns you trade. After all, if you know the edge associated with what you're trading, you're most likely to sustain the confidence needed to see those trades through.

A thorough presentation of testing market ideas would take a book in itself, but this chapter should get you started. Armed with a historical database and Excel, you can greatly improve your ability to find worthy market hypotheses to guide your trading. Let's get started . . .

## LESSON 91: USE HISTORICAL PATTERNS IN TRADING

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A trading guru declares that he has turned bearish because the S&P 500 Index has fallen below its 200-day average. Is this a reasonable basis for setting your trading or investing strategy? Is there truly an edge to selling the market when it moves below its moving averages?

*The only way we can determine the answer is through investigation.* Otherwise, investing and trading become little more than exercises in faith and superstition. Because markets have behaved in a particular way in the past does not guarantee that they will act that way now. Still, history provides the best guide we have. Markets, like people, will never be perfectly predictable. But if we've observed people over time in different conditions, we can arrive at some generalizations about their tendencies. Similarly, a careful exploration of markets under different historical conditions can help us find regularities worth exploiting.

As it turns out, moving average strategies—so often touted in the popular trading press—are not so robust. As of my writing this, since 1980, the average 200-day gain in the S&P 500 Index following occasions when we've traded above the 200-day moving average has been 8.68 percent. When we've been below the 200-day moving average, the next 200 days in the S&P 500 Index have returned 7.32 percent. That's not a huge difference, and it's hardly grounds to turn bearish on a market. When David Aronson tested more than 6,000 technical indicators for his excellent book, *Evidence-Based Technical Analysis*, he found a similar lack of robustness: not a single indicator emerged as a significant predictor of future market returns.

Investigate before you invest: Common trading wisdom is uncommonly wrong.

One way that historical patterns aid our self-coaching is by helping us distinguish myth from fact. "The trend is your friend" we commonly hear. My research on the blog, however, has consistently documented worse returns following winning days, weeks, and months than following losing ones. It is not enough to accept market wisdom at face value: just as you would research the reliability of a vehicle before making a purchase, it makes sense to research the reliability and validity of trading strategies.

There are traders who make the opposite mistake and trade mechanically from historical market patterns. I have seen an unusual proportion of these traders blow up. Market patterns are relative to the historical period that we study. If I examine the past few years of returns in a bull market, I will find significant patterns that will completely vanish in a bear



market. If I include many bull and bear markets in my database, I will go back so far in time that I will be studying periods that are radically different from the current one in terms of who and what are moving markets. Automated, algorithmic strategies have completely reshaped market patterns, particularly over short time periods. If you study precomputer-era markets you would miss this influence altogether. Select a look-back period for historical analysis that is long enough to cover different markets but not so lengthy as to leave us with irrelevant data is as much art as science.

*My approach to trading treats historical market patterns as qualitative research data.* In a nutshell, qualitative research is *hypothesis-generating research*, not hypothesis-testing research. I view the patterns of markets as sources of trading hypotheses, not as fixed conclusions. The basic hypothesis is that the next trading period will not differ significantly from the recent past ones. If a pattern has existed over the past X periods, we can hypothesize that it will persist over the next period. Like any hypothesis, this is a testable proposition. It is an idea backed by support, not just faith or superstition, but it is not accepted as a fixed truth to be traded blindly.

Historical testing yields hypotheses for trading, not conclusions.

For this reason, I do not emphasize the use of inferential statistics in the investigation of historical patterns. I am looking for qualitative differences much as a psychologist might look for various behavior patterns in a person seeking therapy. In short, I'm looking to generate a hypothesis, not test one. The testing, in the trading context, is reflected in my trading results: if my returns significantly exceed those expected by chance, we can conclude that I am trading knowledge, not randomness.

When we adopt a qualitative perspective, the issue of look-back period becomes less thorny. As long as we consider the results of historical investigations to be nothing more than hypotheses, we can draw our ideas from the past few weeks, months, years, or decades of trading. The basic hypothesis remains the same: that the next time period will not differ significantly from the most recent ones. With that in mind, we can frame multiple hypotheses derived from different patterns over different time frames. One hypothesis, for example, might predicate buying the market based on strong action at the close of the prior day, with the anticipation of taking out the previous day's R1 pivot level. A second hypothesis might also entail buying the market based on a pattern of weakness during the previous week's trading. When multiple independent patterns point in the same direction, we still don't have a certain conclusion, but we do have a firm hypothesis.

When independent patterns point to similar directional edges, we have especially promising hypotheses for trading.

Of course, if we generate enough hypotheses, some are going to look promising simply as a matter of chance. We could look at all combinations of Dow stocks, day of week, and week of year and the odds are good that we'd find some pattern for some stock that looks enticing, such as (to invent one possibility) IBM tends to rise on the first Wednesday of months during the summer season. Good hypotheses need to make sense; you should have some idea of *why* they might be valid. It makes sense, for instance, to buy after a period of weakness because you would benefit from short covering and an influx of money from the sidelines. It doesn't make sense to buy a stock on alternate Thursdays during months that begin with M—no matter what the historical data tell you.

When you're first learning to generate good hypotheses, your best bet is to keep it simple and get your feel for the kinds of patterns that are most promising. Many of your initial candidates will emerge from investigations of charts. Perhaps you'll notice that it has been worth selling a stock when it rises on unusually high volume, or that markets have tended to bounce following a down open that follows a down day. Such ideas are worth checking out historically. What patterns have you noticed in your trading and observation? Write down these patterns and keep them simple: these patterns will get you started in our qualitative research.



#### COACHING CUE

Several newsletters do an excellent job of testing historical patterns and can provide you with inspiration for ideas of your own. Check out the contributions of Jason Goepfert, Rob Hanna, and Rennie Yang in Chapter 9, along with their links. All three are experienced traders and investigators of market patterns.

## LESSON 92: FRAME GOOD HYPOTHESES WITH THE RIGHT DATA

In the previous lesson, I encouraged you to keep hypotheses simple. This is not just for your learning; in general, we will generate the most robust hypotheses if we don't try to get too fancy and add many conditions to our ideas. Ask a question that is simple and straightforward, such as, "What

typically happens the week following a very strong down week?” This question is better than asking, “What typically happens the week following a very strong down week during the month of March when gold has been up and bonds have been down?” The latter question will yield a small sample of matching occasions—perhaps only three over many years—so that it would be difficult to generalize from these. While I will occasionally look at patterns with a small N simply as a way to determine if the current market is behaving in historically unusual ways, it is the patterns that have at least 20 occurrences during a look-back period that will merit the greatest attention. The more conditions we add to a search, the more we limit the sample and make generalization difficult.

The simplest patterns will tend to be the most robust.

Of course, the number of occurrences in a look-back period will partly depend on the frequency of data that you investigate. With 415 minutes in a trading day for stock index futures, you would have 8,300 observations of one-minute patterns in a 20-day period. If you were investigating daily data, the same number of observations would have to cover a period exceeding 30 years. Databases with high frequency data can become unwieldy in a hurry and require dedicated database applications. The simple historical investigations that I conduct utilize database functions in a flat Excel file. When I investigate a limited number of variables over a manageable time frame, I find this to be adequate to my needs. Clearly, a system developer who is going to test many variables over many time frames would need a relational database or a dedicated system-testing platform, such as TradeStation. The kind of hypothesis-generating activities covered in this chapter are most appropriate for discretionary traders who would like to be a bit more systematic and selective in their selection of market patterns to trade—not formal system developers.

Before you frame hypotheses worthy of historical exploration, you need to create your data set. This data set would include a range of variables over a defined time period. The variables that you select would reflect the markets and indicators that you typically consult when making discretionary trading decisions. For instance, if you trade off lead-lag relationships among stock market sectors, you'll need to include sector indexes/ETFs in your database. If you trade gap patterns in individual stocks, you'll need daily open-high-low-close prices for each issue that you trade at the very least. Some of the patterns I track in my own trading involve the number of stocks making new highs or lows; this is included in my database with separate columns on a sheet dedicated to each.

As you might suspect, a database can get large quickly. With a column in a spreadsheet for each of the following: date, open price, high price, low price, closing price, volume, rate of change, and several variables (indicators) that you track, you can have a large sheet for each stock or futures contract that you trade—particularly if you are archiving intraday data. *I strongly recommend that beginners at this kind of historical investigation get their feet wet with daily data.* This process will keep the data sets manageable and will be helpful in framing longer timeframe hypotheses that can supplement intraday observation and judgment. Many good swing patterns can be found with daily data and clean, affordable data are readily available.

Some of the most promising historical patterns occur over a period of several days to several weeks.

There are several possible sources for your historical database. Many real-time platforms archive considerable historical data on their servers. You can download these data from programs such as e-Signal and Real Tick (two vendors I've personally used) and update your databases manually at the end of the trading day. The advantage of this solution is that it keeps you from the expense of purchasing historical data from vendors. It also enables you to capture just the data you want in the way you want to store them. This is how I collect most of my intraday data for stock index futures and such variables as NYSE TICK. My spreadsheet is laid out in columns in ways that I find intuitive. The entire process of updating a sheet, including built in charts, takes a few minutes at most.

A second way you can go, which I also use, is to purchase historical data from a vendor. I obtain daily data from Pinnacle Data ([www.pinnacledata.com](http://www.pinnacledata.com)), which includes an online program for updating that is idiot-proof. Many of their data fields go back far in market history, and many of them cover markets and indicators that I would not be able to easily archive on my own. The data are automatically saved in Excel sheets, with a separate sheet for each data element. That means that you have to enter the different sheets and pull out all the data relevant to a particular hypothesis and time frame. The various fields can be copied onto a single worksheet that you can use for your historical investigations (more on this later). Among the data that I find useful from Pinnacle Data are advance-decline information; new highs/lows; volume (including up/down volume); interest rates; commodity and currency prices; and weekly data. These data are general market data, not data for individual equities. When I collect individual equity data, I generally find the historical data from the real-time quotation platforms to be adequate to my needs.

For the collection of clean intraday data, I've found TickData ([www.tickdata.com](http://www.tickdata.com)) to be a particularly valuable vendor. The data management software that accompanies the historical data enables you to place the data in any time frame and store them as files within Excel. This is a great way to build a historical database of intraday information quickly, including price data for stocks and futures and a surprising array of indicator data.

If you go with a historical data vendor, you'll have plenty of data for exploration and the updating process will be easy. Manual updating of data from charting platforms is more cumbersome and time-consuming, but obviously cheaper if you're already subscribing to the data service. *It is important thing that you obtain the data you most want from reliable sources in user-friendly ways.* If the process becomes too cumbersome, you'll quickly abandon it.

As your own trading coach, you want to make the learning process stimulating and enjoyable; that is how you'll sustain positive motivation. Focus on what you already look at in your trading and limit your initial data collection to those elements. Price, volume, and a few basic variables for each stock, sector, index, or futures contract that you typically look at will be plenty at first. Adding data is never a problem. The key is to organize the information in a way that will make it easy for you to pull out what you want, when you want it. As you become proficient at observing historical patterns, you'll be pleasantly surprised at how this process prepares you for recognizing the patterns as they emerge in real time.



#### COACHING CUE

Consider setting up separate data archives for daily and weekly data, so that you can investigate patterns covering periods from a single day to several weeks. You'd be surprised how many hypotheses can be generated from simple open-high-low-close price data alone. How do returns differ after an up day versus a down day? What happens after a down day in which the day's range is the highest of the past 20 days? What happens after three consecutive up or down days? How do the returns differ following a down day during a down week versus a down day during an up week? You can learn quite a bit simply by investigating price data.

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### LESSON 93: EXCEL BASICS

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In this lesson, I'll go over just a few essentials of Excel that I employ in examining historical market data. If you do not already have a basic

understanding of spreadsheets (how cells are named, how to copy information and paste it into cells, how to copy data from one cell to another, how to create a chart of the data in a sheet, how to write simple formulas into cells), you'll need a beginning text for Excel users. All of the things we'll be reviewing here are true basics; we won't be using workbooks linking multiple sheets, and we won't be writing complex macros. Everything you need to formulate straightforward hypotheses from market data can be accomplished with these basics.

So let's get started. Your first step in searching for market patterns and themes is to download your historical data into Excel. Your data vendors will have instructions for downloading data; generally this will involve copying the data from the charting application or from the data vendors' servers and pasting them into Excel. If, for instance, you were using e-Signal ([www.esignal.com](http://www.esignal.com)) as a real-time data/charting application, you would activate the chart of the data you're interested in by clicking on that chart. You then click on the menu item Tools and then click on the option for Data Export. A spreadsheet-like screen will pop up with the chart data included. Along the very top row, you can check the boxes for the data elements you want in your spreadsheet. If there are data in the chart that you don't need for your pattern search, you simply uncheck the boxes for those columns.

On that spreadsheet screen in e-Signal, if you click on the button for Copy to Clipboard, you will place all of the selected data on the Windows clipboard, where the data elements are stored as alphanumeric text. You then open a blank sheet in Excel, click on the Excel menu item for Edit, and select the option for Paste. That will place the selected data into your Excel spreadsheet.

If you had wanted more historical data than popped up in the e-Signal spreadsheet-like screen, you would have to click your chart and drag your mouse to the right, moving view of the data into the past. Move it back as far as you need and then go through the process of clicking on Tools, selecting Data Export, etc. If you need more historical data than e-Signal (or your current charting/data vendor) carries on their servers, that's when you'll need to subscribe to a dedicated historical data source such as Pinnacle Data ([www.pinnacledata.com](http://www.pinnacledata.com)).

If you need data going back many years for multiple indicators or instruments, you'll want to download data from a historical data vendor who has checked the data for completeness and accuracy.

If you're using Pinnacle Data, you can automatically update your entire database daily with its Goweb application. The program places all the updated data into Excel sheets that are stored on the C drive in a folder



labeled Data. The IDXDATA folder within Data contains spreadsheets with each instrument or piece of data (S&P 500 Index open-high-low-close; number of NYSE stocks making 52-week highs) in its own spreadsheet. Once you open these sheets, you can highlight the data from the historical period you're interested in, click on the Edit menu item in Excel, click on the Copy option, open a fresh, blank spreadsheet, click on Edit, and then click on the Paste option. By copying from the Pinnacle sheets and pasting into your own worksheets, you don't modify your historical data files when you manipulate the data for your analyses.

*Personally, I would not subscribe to a data/charting service that did not facilitate an easy downloading of data into spreadsheets for analysis.* It's also helpful to have data services that carry a large amount of intraday and daily data on their servers, so that you can easily retrieve all the data you need from a single source. In general, I've found e-Signal and Pinnacle to be reliable clean sources of data. There are others out there, however, and I encourage you to shop around.

When you download data for analysis, save your sheets in folders that will help you organize your findings and give the sheets names that you'll recognize. Over time, you'll perform many analyses; saving and organizing your work will prevent you from having to reinvent wheels later.

Once you have the data in your sheet, you'll need to use formulas in Excel to get the data into the form you need to examine patterns of interest. Formulas in Excel will begin with an = sign. If, for example, you wanted to calculate an average value for the first 10 periods of price data (where the earliest data are in row 2 and later data below), you might enter into the cell labeled D11: "=`average(C2:C11)`," without typing the quotation marks. That will give you the simple average (mean) of the price data in cells C1 through C10. If you want to create a moving average, you could simply click on the D10 cell, click the Excel menu item for copy, left-click your mouse and drag from cell D11 down, and release. Your column D cells will update the average for each new cell in column C, creating a 10-period moving average.

*As a rule, each column in Excel (labeled with the letters) will represent a variable of interest.* Usually, my column A is date, column B is time (if I'm exploring intraday data), column C is open price, column D is high price, column E is low price, and column F is closing price. Column G might be devoted to volume data for each of those periods (if that's part of what I'm investigating); columns H and above will be devoted to other variables of interest, such as the data series for another index or stock or the readings of a market indicator for that period. *Each row of data is a time period, such as a day.* Generally, my data are organized so that the



earliest data are in row 2 and the later data fall underneath. I save row 1 for data labels, so that each column is labeled clearly: DATE, OPEN, HIGH, LOW, CLOSE, etc. You'll see why this labeling is helpful when we get to the process of sorting the data.

Here are some simple statistical functions that I use frequently to examine data in a qualitative way. Each example assumes that we're investigating the data in column C, from cells 1 through 10:

- =median(C2:C11) – The median value for the data in the formula.
- =max(C2:C11) – The largest value for the data in the formula.
- =min(C2:C11) – The smallest value for the data in the formula.
- =stdev(C2:C11) – The standard deviation for the data in the formula.
- =correl(C2:C11,D2:D11) – The correlation between the data in columns C and D, cells 1–10.

Much of the time, our analyses won't be of the raw data, but will be of the changes in the data from period to period. The formula =(C3-C2) gives the difference from cell C2 to cell C3. If we want to express this difference as a percentage (so that we're analyzing percent price changes from period to period), the formula would read = ((C3-C2)/C2)\*100. This takes the difference of cells C3 and C2 as a proportion of the initial value (C2), multiplied by 100 to give a percentage.

When we want to update later cells with the percentage difference information, we don't need to rewrite the formulas. Instead, as noted above, we click on the cell with the formula, click on the Excel menu item Edit, click on copy, then left click the cell below the one with the formula and drag down as far as we want the data. The spreadsheet will calculate price changes for each of the time periods that you selected by dragging. This means that if you save your formulas into worksheets, updating your data is as simple as downloading the fresh data from your vendor, pasting into the appropriate cells in your sheets, and copying the data from formulas for the cells representing the new data period. Once you've organized your sheets in this manner, it thus only takes a few minutes a day to completely update.

Once you create a spreadsheet with the appropriate formulas, updating your analyses is mostly a matter of pasting and copying. As a result, you can update many analyses in just a few minutes.

Once again, the basic formulas, arrangement of rows and columns, and copying of data will take some practice before you move on to actual analyses. I strongly encourage you to become proficient with downloading your data from your vendor/application and manipulating the data in Excel with copying, pasting, and formula writing before moving on. Once you have

these skills, you'll have them for life, and they will greatly aid your ability to generate promising trading hypotheses.



### COACHING CUE

Trading platforms that support Dynamic Data Exchange (DDE) enable you to link spreadsheets to the platform's data servers, so that the spreadsheets will populate in real time. This is helpful for tracking indicators as you trade, and it can also be a time-efficient way to archive data of interest. See Rennie Yang's segment in Chapter 9 for an illustration of the use of DDE.

## LESSON 94: VISUALIZE YOUR DATA

One of the best ways to explore data for possible relationships is to actually see the data for yourself. You can create simple charts in Excel that will enable you to see how two variables are related over time, identifying possible patterns that you might not have noticed from the spreadsheet rows and columns. For instance, when charting an indicator against a market average, you may notice divergence patterns that precede changes in market direction. Should you notice such patterns frequently, they might form the basis for worthwhile historical explorations.

Again, a basic introductory text for Excel users will cover the details of creating different kinds of charts, from column charts to line graphs to pie charts. You'll also learn about the nuances of changing the colors on a chart, altering the graphics, and labeling the various lines and axes. In this lesson, I'll walk you through a few basics that will get you started in your data exploration.

Many times, you can identify potential trading hypotheses by *seeing* relationships among data elements.

A simple chart to begin with will have dates in column A, price data in column B, and a second set of price data in column C (see Table 10.1). This chart is helpful when you want to visualize how movements in the first trading instrument are related to movements in the second. For basic practice, here are some hypothetical data to type into Excel, with the data labels in the first row. Column A has the dates, column B contains closing prices for a market index, and column C has the closing prices for a mining stock.

To create the chart, highlight the data with your mouse, including the data labels, and click on the Excel menu item for Insert. You'll select

**TABLE 10.1** Sample Market Data

Date	Market Index	Mining Stock
12/1/2008	1200.25	9.46
12/2/2008	1221.06	9.32
12/3/2008	1228.01	9.33
12/4/2008	1230.75	9.30
12/5/2008	1255.37	9.18
12/8/2008	1234.44	9.24
12/9/2008	1230.24	9.22
12/10/2008	1228.68	9.27
12/11/2008	1235.56	9.20
12/12/2008	1240.20	9.22
12/15/2008	1251.98	9.12
12/16/2008	1255.50	9.15
12/17/2008	1239.88	9.29
12/18/2008	1226.51	9.39

Chart and a menu of different kinds of charts will appear. You'll click on Line and select the chart option at the top left in the submenu. That is a simple line chart. Then click Next, and you will see a small picture of your chart, the range of your data, and whether the series are in rows or columns. Your selection should be columns, because that is how you have your variables separated. Click Next again and you will see Step 3 of 4 in the Chart Wizard, allowing you to type in a chart title and labels for the X and Y axes. Go ahead and type in Market Index and Mining Stock for the title, Date for the Category (X) axis label, and Price for the Value (Y) axis label. Then click Next.

The Step 4 of 4 screen will ask you if you want the chart as an object in your spreadsheet, or if you want the chart to be on a separate sheet. Go ahead and select the option for "As new sheet." Then click Finish.

What you'll see is that the Wizard has recognized the date information from column A and placed it on the X-axis. The Wizard has also given us a single Y-axis and scaled it according to the high and low values in the data. Unfortunately, this leaves us unable to see much of the ups and downs in the mining stock data, since the price of the stock is much smaller than the price of the index.

To correct this problem, point your cursor at the line on the chart for your Market Index and right click. A menu will pop up, and you will select the option for Format Data Series. Click the tab for Axes and then click on the button for "Plot Series on Secondary Axis." When you do that, the picture of the chart underneath the buttons will change, and you'll notice

now that you have two Y-axes: one for the Market Index price data and one for the Mining Stock data. You'll be able to see their relative ups and downs much more clearly. Click on OK and you will see your new chart. If you'd like the Y-axes to have new labels, you can place your cursor on the center of the chart (away from the lines for the data) and right click. A menu will pop up, and you'll select Chart Options. That will give you a screen enabling you to type in new labels for the Value (Y) axis (at left) and the Second value (Y) axis (at right).

If you right click on either of the two lines in the chart and, from the pop-up menu select Format Data Series, you'll see a tab for Patterns. You can click the arrow beside the option for Weight and make the line thicker. You can click the arrow beside the option for Color and change the color of the line.

If you right-click on the X- or Y-axes, you'll get a pop-up menu; click on Format Axis. If you select the tab for Font, you can choose the typeface, font style, and size of the print for the axis labels. If you select the tab for Scale, you can change the range of values for the axis. With a little practice, you can customize the look of your charts.

So what does your chart tell you? You can see that the Mining Stock is not moving in unison with the Market Index. When the index shows large rises or declines, the stock is tending to move in the opposite direction. By itself, over such a short period, that won't tell you anything you'd want to hang your hat on, but it does raise interesting questions:

- Why is the mining stock moving opposite to the market index? Might the mining stock be moving in unison with the gold market instead?
- If the mining stock is moving with gold, is gold also moving opposite to the market index? If so, why might that be? Might there be a common influence on both of them: the strength of the U.S. dollar?
- Does this relationship occur over intraday time frames? Might we be able to identify some buy or sell signals in the mining stock when we see selling or buying in the broad market?

Reviewing charts that you create helps you see intermarket and intramarket relationships.

Many times, investigating relationships through charts leads you to worthwhile questions, which may then lead you to interesting and profitable trading ideas. The key is asking "Why?" What might be responsible for the relationship I am observing? Remember, in your own self-coaching, you want to be generating hypotheses, and there is no better way than plain old brainstorming. When you can actually see how the data are related to

each other in graphical form, it is easier to accomplish that brainstorming. You won't arrive at hard and fast conclusions, but you'll be on your way toward generating promising trading ideas.



### COACHING CUE

Plot charts of the S&P 500 Index (SPY) against the major sector ETFs from the S&P 500 universe as a great way to observe leading and lagging sectors, as well as divergences at market highs and lows. The sectors I follow most closely are: XLB (Materials); XLI (Industrials); XLY (Consumer Discretionary); XLP (Consumer Staples); XLE (Energy); XLF (Financial); XLV (Health Care); and XLK (Technology). If you want to bypass such charting, you can view excellent sector-related indicators and charts at the Decision Point site ([www.decisionpoint.com](http://www.decisionpoint.com)). Another excellent site for stock and sector charts is Barchart ([www.barchart.com](http://www.barchart.com)).

## LESSON 95: CREATE YOUR INDEPENDENT AND DEPENDENT VARIABLES

When I organize my spreadsheets, I generally place my raw data furthest to the left (columns A, B, C, etc.); transformations of the raw data into independent variables in the middle; and dependent variables furthest to the right. Let's take a look at what this means.

Your independent variables are what we might call *candidate predictors*. They are variables that we think have an effect on the markets we're trading. For example, let's say that we're investigating the impact of price change over the previous day of trading (independent variable) on the next day's return for the S&P 500 Index (dependent variable). The raw data would consist of price data for the S&P 500 Index over the look-back period that we select. The independent variable would be a moving calculation of the prior day's return. The dependent variable would be a calculation of the return over the next day. The independent variable is what we think might give us a trading edge; the dependent variable is what we would be trading to exploit that edge.

If I keep my raw data to the left in the spreadsheet, followed by transformations of the raw data to form the independent variable, and then followed by the dependent variable, I keep analyses clear from spreadsheet to spreadsheet.

Let's set that up as an exercise. We'll download data for the S&P 500 Index (cash close) for the past 1,000 trading days. That information will give us roughly four years of daily data. If I obtain the data from Pinnacle Data, I'll open a blank sheet in Excel; click on the Excel menu item for File; click Open; go to the Data folder in the C drive; double-click on the IDXDATA folder; select All Files as the Files of type; and double-click the S&P 500 file. I'll highlight the cells for the past 1,000 sessions; click on the Edit menu item in Excel; click on Copy; open a new, blank spreadsheet; then click the Edit menu item again; and click Paste, with the cursor highlighting the A2 cell. The data from the Pinnacle sheet will appear in my worksheet, leaving row A for data labels (Date, Open, High, Low, Close).

If you download your data from another source, your menu items to access the data will differ, but the result will be the same: you'll copy the data from your source and paste them into the blank spreadsheet at cell A2, then create your data labels. As a result, your raw data will occupy columns A–E. (Column A will be Date; column B will be Open; column C will be High; column D will be Low; and column E will be Close.) Now, for the data label for column F (cell F1), you can type (without quotation marks): "SP(1)." This is your independent variable, the current day's rate of change in the index. Your first entry will go into cell F3 and will be (again without quotations marks): " $=((E3-E2)/E2)*100$ ." This is the percentage change in the index from the close of the session at A2 to the close of the session at A3.

Now let's create our dependent variable in cell G7, with column G labeled SP+1 at G1. Your formula for cell G3 will be " $=((E4-E3)/E3)*100$ ." This represents the next day's percentage return for the index.

To complete your sheet, you would click and highlight the formula cells at F3 and G3; click on the Excel menu item for Edit; and select the option for Copy. You'll see the F3 and G3 cells specially highlighted. Then, with your cursor highlighting cells F4 and G4, drag your mouse down the full length of the data set and release, highlighting all those cells. Click again on the Excel menu item for Edit, then select Paste. Your spreadsheet will calculate the formulas for each of the cells and the data portion of your spreadsheet will be finished. The raw data will be in columns A–E. The independent variable (our candidate predictor) will be in column F; and our variable of trading interest—the dependent variable—will reside in column G. Save this spreadsheet as Practice Sheet in an Excel folder. We'll be using it for future lessons.

Note that we downloaded 1,000 days worth of data, but the actual number of data points in our sample is 998. We could not compute SP(1) from the first data point because we didn't have the prior day's close; hence we had to begin our formula in the third data row. We also could not compute SP+1 from the last data point because we don't know tomorrow's closing

price. Thus our analyses can only use 998 of the data points of the 1,000 that we downloaded. If you want an even 1,000 data points, you'd have to download the last 1,002 values.

*With a bit of practice, all of this will become second nature.* It will take only a minute or two to open your data files, copy and paste the raw data, write your formulas, and copy the cells to complete your sheet. In this example, we are exploring how the prior day's return is related to the next day's return. We're setting the spreadsheet up to ask the question, "Does it make sense to buy after an up day/sell after a down day; does it make sense to sell after an up day/buy after a down day; or does it make no apparent difference?" I call the independent variable the *candidate* predictor, because we don't really know if it is related to our variable of interest. It's also only a candidate because we're not conducting the statistical significance tests that would tell us more conclusively that this is a significant predictor. Rather, we're using the analysis much as we used the charting in the prior lesson: as a way to generate hypotheses.

Remember, in the current examples, we're using historical relationship to describe patterns in markets, not to statistically analyze them. We're generating, not testing, hypotheses.

If I had been interested in examining the relationship between the prior week's price change with the next week's return, the spreadsheet would look very similar, except the raw data would consist of weekly index data, rather than daily. *In general, it's neatest for analysis if you are investigating the impact of the prior period's data on the next period.* This ensures that all observations are independent; there are no overlapping data.

To see what I mean, consider investigating the relationship of the prior week's (five-day) price change on the price change over the next five trading days utilizing daily market data. Your independent variable in column F would now look like " $=((E7-E2)/E2)*100$ "—price change over the past five days. The dependent variable in column G would be written as " $=((E12-E7)/E7)*100$ ": the next five-day's price change. *Note, however, that as you copy those cells down the spreadsheet per the above procedure, that each observation at cells F8, F9, F10, and so on and G8, G9, G10, and so on, is not completely independent.* The prior five-day return overlaps the values for F8, F9, and F10, and the prospective five-day return overlaps for cells G8, G9, and G10. This will always be the case when you're using a smaller time period for your raw data than the period that you're investigating for your independent and dependent variables.

Inferential statistical tests depend on each observation in the data set being independent, so it is not appropriate to include overlapping data



when calculating statistical significance. For my purpose of hypothesis generation, I am willing to tolerate a degree of overlap, and so will use daily data to investigate relationships of up to 20 days in duration—particularly if the amount of overlap relative to the size of the entire data set is small. I would not, say, investigate the next 200 days' return using daily data for a sample of 1,000 trading days. I wouldn't have a particular problem using the daily data to investigate, for instance, the prior five-day price change on the next five-day return with a four-year look-back period.

Your findings will be most robust if your look-back period (the period that you are drawing data from) includes a variety of market conditions: rising, falling, range bound, high volatility, low volatility, and so on.

In general, my dependent variable will consist of prospective price change, because that is what I'm interested in as a trader. The independent variable(s) will consist of whatever my observations tell me might be meaningfully related to prospective price change. Normally, I look at dependent variables with respect to the next day's return (to help with day trading ideas) and the next week's return (to help with formulating swing hypotheses). If I want a sense of the market's possible bigger picture, I'll investigate returns over the next 20 trading days. Traders with different time frames may use different periods, including intraday. Overall, I've found the 1 to 20 day framework to be most useful in my investigations.

Once again, practice makes perfect. I would encourage you to become proficient at downloading your data and assembling your spreadsheets into variables before you try your hand at the actual historical investigations. Your results, after all, will only be as valid as the data you enter and the transformations you impose upon the data.



#### COACHING CUE

Note how, with the Practice Sheet assembled as in the above example, you can easily look at the next day's average returns following opening gaps. Your independent variable would be the opening gap, which would be written as  $=((b3-e2)/e2)*100$  (the difference between today's open and yesterday's close as a percentage). The day's price change would be  $=((e3-b3)/b3)*100$  (the difference between today's close and today's open as a percentage). You would need to use stock index futures data or ETF data to get an accurate reflection of the market open; the cash index does not reflect accurate opening values, as not all stocks open for trading in the first minute of the session.

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## LESSON 96: CONDUCT YOUR HISTORICAL INVESTIGATIONS

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Once you have your data downloaded and your independent and dependent variables calculated, you're ready to take a look at the relationship between your two sets of variables. In the last lesson, you saved your spreadsheet of the S&P 500 Index data with the prior day's price change in column F and the next day's change in column G. Open that sheet, and we will get started with our investigation.

Your first step will be to copy the data from the sheet to a fresh worksheet. We will first copy the data to the Windows clipboard, then paste into the new sheet. This eliminates all formulas from the sheet, because the clipboard saves only alphanumeric text data. This process is necessary for the data manipulations that will be required for our investigation.

So, highlight all the cells in your sheet with the exception of the last row (the most recent day's data). We don't include that row in our analysis because there won't be any data for the next day's return. With the cells highlighted, click the Excel menu item for Edit, then select Copy. You'll then exit out of the spreadsheet and instruct Windows to save the data to the clipboard. Open a fresh, blank sheet; click on cell A1; click the Excel menu item for Edit; and select Paste. Your data will be transferred to the new sheet, with no formulas included.

Once you've done this, you'll delete the first row of data below the data labels, because there will be no data for the change from the prior day. When you delete the row by highlighting the entire row and clicking Edit and selecting Delete, the rows below will move up, so that there are no empty rows between the data labels and the data themselves.

You'll now highlight all the data (including the first row of data labels), select the Excel menu item for Data; then select Sort; and select the option SP(1) in the Sort By drop down menu. You can click the button on the drop down menu for Descending: this will place your largest daily gain in the S&P 500 Index in the first row, the next largest in the second row, etc. The last row of data will be the day of the largest daily drop in the S&P 500 Index.

The Sort function separates your independent variables into high and low values, so that you can see how the dependent variables are affected.

Now we're ready to explore the data. For the purpose of the illustration, I'll assume that your data labels are in row 1 and that you have 999 rows of data (998 days of S&P data plus the row of labels). Below

your bottom row in column G (say cell G1002), type in “=average(g2:g500)” (without the quotation marks) and hit Enter. In the cell below that (G1003), type in “=average(g501:g999)” and hit Enter. This gives you a general sense for whether next day returns have been better or worse following the half of the days in the sample that were strongest versus the half of days that were weakest. Note that you could analyze the next day returns roughly by quartiles simply by entering “=average(g2:g250)”; “=average(g251:g500)”; “=average(g501:g750)”; and “=average(g751:g999)”.

What your data will show is that next day returns tend to be most positive following weak days in the S&P 500 Index and most restrained following strong days in the Index. How much of a difference makes a difference for your trading? As I emphasized earlier in the chapter, I am not using this information to establish a statistically significant mechanical trading system. Rather, I’m looking qualitatively for differences that hit me between the eyes. These will be the most promising relationships for developing trading hypotheses. If the difference between average next day returns following an up day and a down day is the difference between a gain of 0.01 percent and 0.03 percent, I’m not going to get excited. If the average returns following the strong days are negative and those following the weak days are positive, that’s more interesting.

As you conduct many sortings, you’ll gain a good feel for differences that may form the basis for worthwhile hypotheses.

So how might I use the information? Perhaps I’ll drill down further, examine those quartiles, and find that returns are particularly muted following strong up days. If that’s the case, I will entertain the hypothesis of range-bound trading the morning following a strong daily rise in the S&P 500 Index. If I see that particularly weak days in the S&P 500 Index tend to close higher the next day, I may entertain the notion of an intraday reversal the day following a large drop. *The data provide me with a heads up, a hypothesis—not a firm, fixed conclusion.*

The data might also help sharpen some of my trading practices. If I’m holding positions for intermediate-term swing positions, I might be more likely to add to a long position after a daily market dip than after a strong daily rise. I might be more likely to take partial profits on a short position following toward the end of a weak market day than toward the end of an up day.

And suppose we find no apparent differences whatsoever? This, too, is a finding. It would tell us that—at this time frame, for this time period—there is no evidence of trend or countertrend effects. This would help us temper our expectations following strong and weak market days.

We would not assume that trends are our friends; nor would we be tempted to fade moves automatically. We would also know to look for potential edges elsewhere.

Keep a record of the relationships that you examine and what you find; this will guide future inquiries and prevent you from duplicating efforts later on.

If your analysis does not identify a promising relationship within the data, you're limited only by your own creativity in exploring alternate hypotheses. For instance, you might look at how prior returns affect next returns for weekly or monthly data, rather than daily data. You might explore next day returns for a different instrument or market. Perhaps you'll see greater evidence of trendiness in commodities or small stocks than in the S&P 500 Index.

*Where your creativity can really kick in is in your selection of independent variables.* The same basic spreadsheet format outlined above could be used to examine the relationship between the current day's put-call ratio and the next day's S&P 500 returns; the current day's volume and next day returns; the current day's financial sector performance and next day S&P 500 returns; the current day's bond yield performance and next day returns. Once you have the spreadsheet analysis process mastered, it's simply a matter of switching one set of variables for another. This way, you can investigate a host of candidate hypotheses in a relatively short period of time.

The key to making this work is the Sort command in Excel. This sorts your independent variable from high to low or low to high so that you can see what happens in your dependent variable as a result. Along with visualizing data in charts, sorting is a great way to get a feel for how variables may be related, highlighting important market themes. But save your original spreadsheet with the formulas—the one you had titled Practice Sheet in the previous lesson. We're not finished with Excel tricks!



#### COACHING CUE

Here is one fruitful line of investigation: Take a look at next day returns as a function of weak up days versus strong up days. You can define weak versus strong with indicators such as the daily advance/decline ratio or the ratio of up volume to down volume. Limit your sort to the rising days in the sample and sort those based on market strength. What you'll find for some markets is that very strong markets tend to continue their strength in the near term; weaker rising

markets are more likely to reverse direction. Later, you can limit your sorting to the declining days and sort them by very weak and less weak markets. Many times, the patterns you see among the rising days are different from those that show up among the falling days.

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## LESSON 97: CODE THE DATA

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Sometimes the independent variable you're interested in is a categorical variable, not a set of continuous values. If I wanted to investigate the relationship between a person's weight (independent variable) and their lung capacity (dependent variable), all of my data would be continuous. If, however, I wanted to investigate the relationship between gender (male/female) and lung capacity, I would now be looking at a categorical variable in relationship to a continuous one. Conversely, if I wanted to simply identify whether a person had normal versus subnormal lung capacity, I would wind up with a categorical breakdown for my dependent variable.

There are times in market analysis when we want to look at the data categorically, rather than in a continuous fashion. In my own investigations, I routinely combine categorical views with continuous ones. Here's why:

If you reopen the spreadsheet we created, Practice Sheet, that examined current day returns in the S&P 500 Index as a function of the previous day's performance, you'll see that we had Date data in column A; open-high-low-close data in columns B–E; the present day's price change in column F; and the next day's price change in column G. For the analysis in the last lesson, we sorted the data based upon the present day's price change and then examined the average price change for the next day as a function of strong versus weak days. Our dependent measure, next day's price change, was continuous, and we compared average values to get a sense for the relationship between the independent and dependent variables.

Averages, however, can be misleading: a few extreme values can skew the result. These outliers can make the differences between two sets of averages look much larger than they really are. We can eliminate this possible source of bias by changing our dependent variable. We'll keep the next day's price change in column G, but now will add a dummy-coded variable in column H. This code will simply tell us whether the price change in column G is up or down. Thus, in cell H2, I would type in (without quotation marks): `=if(G2>0,1,0)` and hit Enter. This instructs the cell at H2 to return a "1" if the price change in cell G2 is positive; anything else—a zero or negative return—will return a "0." I will then click on H2; click the Excel menu item for Edit; click Copy; click cell H3 and drag all the way down the

length of the data; and then click Enter. The 0,1 dummy code will populate each of the column H cells.

We want to know whether the independent variable is associated with greater frequency of up/down days, as well as the magnitudes of change across those days.

Now we go through the same sorting procedure described in the previous lesson. We highlight all the cells in the worksheet—including the new column H—and click Edit and Copy. We exit the spreadsheet, instructing Excel to save changes and to save the highlighted data. We open a new sheet; click Edit; click Paste; and all the spreadsheet data—again minus the formulas—will appear on the sheet. Once again we sort the data by column F (current day's price change) in descending order, as described in the previous lesson. Again we divide the data in half and, below the last entry in column G, we type in “=average(g2:g500)” and, below that, “=average(g501:g999).”

This, as noted in the previous lesson, shows us the magnitude of the average differences in next day's returns when the current day is relatively strong (top half of price change) versus relatively weak (bottom half of the price change distribution).

In column H, next to the cells for the two averages in column G, we enter the formula “=sum(H2:H500)” and, below that, “=sum(H501:H999).” *This tells us how many up days occurred following relatively strong days in the market and how many up days occurred following relatively weak days.* Because we're splitting the data in half, we should see roughly equal numbers of up days in the two sums if the current day's performance is not strongly related to the next day's price change. On the other hand, if we see considerably fewer up days following the strong market days than following the weak ones, we might begin to entertain a hypothesis.

If the average next day changes in column G look quite discrepant, but the number of winning days in the two conditions in column G are similar, that means that the odds of a winning day may not be significantly affected by the prior day's return, but the *size* of that day might be affected. In general, I like to see clear differences in both criteria. Thus, if the average size of the next day's return are higher following a falling day than a rising one *and* the odds of a rising day are higher, I'll be most likely to use the observation to frame a possible market hypothesis.

Note that we can dummy code independent variables as well. If, for example, I wanted to see whether an up or down day (independent variable) tended to be followed by an up or down day (dependent variable), I could code column F (current day's price change) with a code as above in column H and also code column G (next day's price change) identically in



column I. I would then copy the spreadsheet to a fresh sheet and sort the data based on column H, so that we'd separate the 1s from the 0s. We'd then examine the column I sum for the cells in column H that were 1s and compare with the column I sum for the cells in column H that were 0s.

Dummy coding is especially helpful if we want to examine the impact of events on prospective returns. For instance, we could code all Mondays with a 1; all Tuesdays with a 2, etc., and then sort the next day's return based on the codings to tell us whether returns were more or less favorable following particular days of the week. Coding is also useful when we want to set up complex conditions among two or more independent variables and examine their relationship to future returns. This kind of coding gets a bit more complex and will form the basis for the next lesson.



### COACHING CUE

If you include volume in your spreadsheet, you can code days with rising volume with a 1 and days with falling volume with a 0. This would then allow you to compare next day returns as a function of whether today's rise or decline were on rising or falling volume. All you'd need to do is sort the data once based on the current day's price change and then a second time separately for the rising and falling occasions as a function of the rising and declining volume.

## LESSON 98: EXAMINE CONTEXT

Philosopher Stephen Pepper coined the term *contextualism* to describe a worldview in which truth is a function of the context in which knowledge is embedded. A short-term price pattern might have one set of expectations in a larger bull market; quite another under bear conditions. A short-term reversal in the first hour of trading has different implications than one that occurs midday. To use an example from *The Psychology of Trading*, you understand *Bear right!* one way on the highway, quite another way in the Alaskan wilderness.

We can code market data for contexts and then investigate patterns specific to those contexts. What we're really asking is, "Under the set of conditions that we find at present, what is the distribution of future expectations?" We're not pretending that these will be universal expectations. Rather, they are contextual—applicable to our current situation.

Many of the most fruitful trading hypotheses pertain to certain kinds of markets—not to all markets, all the time.



Let's retrieve the Practice Sheet historical daily data for the S&P 500 Index that we used in our previous lessons. To refresh memory: Column A in our spreadsheet consists of the Date; columns B through E are open-high-low-close data. Column F is the independent variable, the current day's price change; entered into cell F22, it would be: `"=((F22-F21)/F21)*100."` Column G will serve as our contextual variable. In G22, we enter the following:

$$= \text{if}(E22 > \text{average}(E3:E21), 1, 0)$$

This will return to cell G23 a "1" if the current price is above the prior day's simple 20-day moving average for the S&P 500 Index; a "0" if it is not above the average. The data label for cell G1 might be MA. Our dependent measure will be the next day's price change. In cell H22, this would be `"=((E23-E22)/E22)*100"` and H1 would have the label SP+1.

To complete the sheet, we would highlight cell G22 and H22; click the Excel menu item for Edit; click Copy; highlight the cells below G23 for the full length of the data set; and hit Enter. We highlight and copy all the data in the sheet as before; save the sheet as Practice Sheet2; and instruct Windows to save the data to the clipboard for another application. We open a fresh spreadsheet; click on cell A1; click the Excel menu item for Edit; select Paste; and our sheet now fills with text data. Note that, in this case, we'll have to eliminate rows 2 to 21, since they don't have a value for the 20-day moving average. We'll also eliminate the last row of data, because there are no data for the next day. You eliminate a row simply by highlighting the letter(s) for the row(s) at left; clicking the Excel menu item for Edit; selecting Delete. The row will disappear and the remaining data below will move into place.

Note that using a moving average as a variable of interest reduces the size of your data set, since the initial values will not have a moving average calculated. You need to take this into account when determining your desired sample size.

We now double sort the data to perform the contextual investigation. Let's say that we're interested in the expectations following a rising day in a market that is trading above versus below its 20-day moving average. We sort the data based on column F "SP(1)" as we did in our previous lesson, performing the sort on a Descending basis, so that the largest and positive price changes appear at the top of the sheet. Now we select only the data for the cells that show positive price change and copy those to another sheet. Our second sort will be based on column G (MA), again on a Descending Basis. This will separate the up days in markets trading above their 20-day moving average (those coded "1") from all other days.

As before, we'll examine the average next day's return by calculating the average for the cells in column H that are coded in column G as "1" and comparing that to the average for the cells in column H that are coded in column G as "0."

Thus, let's say that there are 538 cells for up days; 383 of these are coded "1" in column G and 155 are coded "0." You would compare `"=average(H2:H384)"` and `"=average(H385:H539)"`. You could also code the cells in column H as either "1" or "0" in column I based on whether they are up or down `"=if(H2>0,1,0)"` and then compare `"=sum(I2:I384)"` and `"=sum(I385:I539)"` to see if there are notable differences in the number of up days following up days in markets that are above and below their moving averages.

Just for your curiosity, using cash S&P 500 data as the raw data, I found that the average next day change following an up day when we're above the 20-day moving average to be  $-0.04$  percent; the average next day change following an up day when we're below the 20-day moving average was  $-0.18$  percent. This is a good example of a finding that doesn't knock my socks off, but is suggestive. I would want to conduct other investigations of what happens after rising days in falling markets before generating trading hypotheses that would have me shorting strength in a broader downtrend.

Many times you'll see differences in the sorted data that are strong enough to warrant further investigation, but not strong enough to justify a trading hypothesis by itself.

This combination of coding and sorting can create a variety of contextual views of markets. For example, if we type in, `"=if(E21=max(E2:E21),1,0)"` we can examine the context in which the current day is the highest price in the past 20 and see how that influences returns. If we include a second independent variable, such as the number of stocks making new 52-week highs and lows, we can examine how markets behave when new highs exceed new lows versus when new lows exceed new highs. For instance, if new highs go into column F and new lows into column G, we can code for `"=if(F21>G21,1,0)"` in column H, place our dependent measure (perhaps the next day's price change) in column I and sort based on the new high/low coding.

As mentioned earlier, it is wise to not create too many contextual conditions, because you will wind up with a very small sample of occasions that fit your query, and generalization will be difficult. If you obtain fewer than 20 occasions that meet your criteria, you may need to relax those criteria or include fewer of them.

As your own trading coach, you can utilize these contextual queries to see how markets behave under a variety of conditions. The movement of

sectors, related asset classes—anything can be a context that affects recent market behavior. In exploring these patterns, you become more sensitive to them in real-time, aiding your selection and execution of trades.



### COACHING CUE

If you're interested in longer-term trading or investing, you can create spreadsheets with weekly or monthly data and investigate independent variables such as monthly returns on the next month's returns; VIX levels on the next month's volatility; sentiment data on the next month's returns; price changes in oil on the next month's returns, etc. You can also code data for months of the year (or beginning/end of the month) to investigate calendar effects on returns.

## LESSON 99: FILTER DATA

Let's say you want to analyze intraday information for the S&P 500 Index futures. Now your spreadsheet will look different as you download data from sources such as your real-time charting application. Your first column will be date, your second column will be time of day, and your next columns will be open, high, low, and closing prices. If you so select, the next column can be trading volume for that time period (one-minute, five-minute, hourly, and so on).

Suppose you want to see how the S&P 500 market has behaved at a certain time of day. What we will need to do is filter out that time of day from the mass of downloaded data and only examine that subset. Instead of sorting data, which has been a mainstay of our investigations to this point, we will use Excel's filter function.

To illustrate how we might do this, we'll start with a simple question. Suppose we want to know how trading volume for the current first half-hour of trading compares with the average trading volume for that corresponding half-hour over the prior 20 days of trading. This will give us a rough sense of market activity, which correlates positively with price volatility. The volume also gives a relative sense for the participation of large, institutional traders. If, say, we observe a break out of a range during the first 30 minutes of trading, it is helpful to know whether or not these large market-moving participants are on board.

Volume analyses can help you identify who is in the market.

For this investigation, we'll examine half-hourly data for the S&P 500 emini contract. I obtain my intraday data from my quote platforms; in the current example, I'll use e-Signal. To do this, we create a 30-minute chart of the ES futures contract; click on the chart and scroll to the right to move the chart backward in time. When we've covered the last 20 days or so, we click on the menu item Tools; select Data Export; then uncheck the boxes for the data that we won't need. In this case, all we'll need is Date, Time, and Volume. We click the button for Copy to Clipboard and open a fresh sheet in Excel. Once we click on the Excel menu item for Edit and select Paste, with the cursor at cell A2, we'll populate the sheet with the intraday data. We can then enter names for the columns in row 1: Date; Time; and Volume. (If you're downloading from e-Signal, those names will accompany the data and you can download the data with the cursor at A1).

Our next step is to highlight the entire data set that we want to cover. We click on the Excel menu item for Data; select Filter; and select AutoFilter. A set of small arrows will appear beside the column names. Click the arrow next to Time and, from the drop down menu, select the time that represents the start of the trading day. In my case, living in the Chicago area in Central Time, that would be 8:30 A.M. You'll then see all the volume figures for the half-hour 8:30 A.M. to 9:00 A.M. Click on Edit; select Copy; open a blank sheet; click on Edit; and select Paste. This will put the 8:30 A.M. data on a separate sheet. If you have 20 values (the past 20 days), you can enter the formula "`=average(c2:c21)`" and you'll see the average trading volume for the first half-hour of trading. Of course, you can filter for any time of day and see that half-hour's average volume as well.

When you know the average trading volume for a particular time period, you can assess institutional participation in real time—particularly with respect to whether this volume picks up or slows down as a function of market direction.

The filter function is helpful when you want to pull out data selectively from a data set. Let's say, for instance, that you had a column in which you coded Mondays as 1; Tuesday's as 2; etc. You could then filter out the 1s in the historical data set and see how the market behaved specifically on Mondays. Similarly, you could code the first or last days of the month and filter the data to observe the returns associated with those.

In general, I find filtering most helpful for intraday analyses, when I want to see how markets behave at a particular time of day under particular conditions. *Frankly, however, this is not where I find the greatest edges typically, and it's not where I'd recommend that a beginner start with historical investigations.* Should you become serious about investigating

such intraday patterns, I strongly recommend obtaining a clean database from a vendor such as Tick Data. You can use their data management software to create data points at any periodicity and download these easily to Excel. Serious, longer-term investigations of historical intraday data need tools far stronger than Excel. Limits to the size of spreadsheets and the ease of maneuvering them make it impossible to use Excel for long-term investigations of high frequency data.

Still, when you want to see how markets behave in the short run—say, in the first hour of trading after a large gap open—investigations with intraday data and filtering can be quite useful. You'll find interesting patterns of continuation and reversal to set up day-trading ideas or to help with the execution of longer timeframe trades.



### COACHING CUE

Filtering can be useful for examining patterns of returns as a function of time of day. For instance, say the market is down over the past two hours: how do returns compare if those two hours are the first versus the last two hours of the day? How are returns over the next few hours impacted if the day prior to those two hours was down? Such analyses can be very helpful for intraday traders, particularly when you combine price change independent variables with such intraday predictors as NYSE TICK.

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## LESSON 100: MAKE USE OF YOUR FINDINGS

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This chapter has provided only a sampling of the kinds of ways that you can use simple spreadsheets and formulas to investigate possible patterns in historical data. Remember: these are qualitative looks at the data; they are designed to generate hypotheses, not prove them. Manipulating data and looking at them from various angles is a skill just like executing trades. With practice and experience, you can get to the point where you investigate quite a few patterns all in the hour or two after market close or before they open.

*The key is to identify what makes the current market unique or distinctive.* Are we well below or above a moving average? Have there been many more new lows than highs or the reverse? Has one sector been unusually strong or weak? Have the previous days been strong or weak? It is often at the extremes—when indicators or patterns are at their most unusual—that we find the greatest potential edges. But sometimes those

unique elements are hard to find. Very high or low volume; strong or weak put/call ratios; large opening gaps—all are good areas for investigations.

We find the greatest directional edges following extreme market events.

Once you have identified a pattern that stands out, this becomes a hypothesis that you entertain to start a trading day or week. If, say, I find that 40 of the last 50 occasions in which the market has been very weak with a high put/call ratio have shown higher prices 20 days later, this will have me looking for a near-term bottoming process. If, after that analysis, I notice that we're making lower price lows but with fewer stocks and sectors participating in the weakness, this may add a measure of weight to my hypothesis. Eventually, I might get to the point where I think we've put in a price bottom and I'll buy the market, giving myself a favorable risk/reward should the historical pattern play out.

But equally important, consider the scenario in which we see good historical odds of bouncing over a 20-day period, leading us to search for a near-term bottoming process. My fresh data, however, suggest that the market is weakening further: more stocks and sectors are making lows, not fewer. *The historical pattern does not appear to be playing itself out.* This, too, is very useful data. When markets buck their historical tendencies, something special may be at work. Some very good trades can proceed from the recognition that markets are not behaving normally.

This is the value of considering patterns as hypotheses and keeping your mind open to those hypotheses being supported or not. A historical pattern in markets is a kind of script for the market to follow; your job is to determine whether or not it's following that script.

Our analyses only inform us of historical tendencies. If a market is not behaving in a manner that is consistent with its history, this alerts us to unique, situational forces at work.

All of this suggests that historical investigations are useful logical aids, but my experience is that their greatest value may be psychological. Day after day, week after week, and year after year of investigating patterns and running market results through Excel have given me a unique feel for patterns. It also has given me a keen sense for when patterns are changing: when historical precedents may no longer hold.

One routine that has been very helpful has been to isolate the last five or so instances of a potential pattern. *If the market has behaved quite*



*differently in the last several instances than it has historically, I entertain the possibility that we're seeing a shift in market patterns.* If I see the last few instances behaving abnormally across many different variables and time frames, those anomalies strengthen my sense of a market shift.

When I see how results have played out over the years, I become a less naïve trend follower. I don't automatically assume that rising markets will continue to skyrocket or that falling markets will continue to plunge. I've developed tools for determining when trending markets are gaining and losing steam; these have been helpful in anticipating reversals. Seeing how these indicators behave under various market conditions over time—and actually quantifying their track record—has provided me with a measure of confidence in the ideas that I would not have in the absence of intimacy with the data.

Much of the edge in trading comes from seeing markets in unique ways, catching moves before they occur or early in their appearance. It is easy to become fixed in our views, with vision narrowed by looking at too few markets and patterns. As your own trading coach, you need to keep your mind open and fresh. Read, talk with experienced traders, follow a range of markets closely, test patterns historically, and know what's happening globally: you'll see things that never register on the radar of the average trader. You'll be at your most creative when you have the broadest vision.



#### COACHING CUE

When you examine historical patterns, go into your data set and specifically examine the returns from the occasions that didn't fit into the pattern. This will give you an idea of the kind of drawdowns you could expect *if* you were to trade the pattern mechanically. Many times, the exceptions to patterns end up being large moves; for instance, most occasions may show a countertrend tendency with a relative handful of very large trending moves. If you know this, you can look for those possible exceptions, study them, and maybe even identify and profit from them.

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#### RESOURCES

The *Become Your Own Trading Coach* blog is the primary supplemental resource for this book. You can find links and additional posts on the topic of coaching processes at the home page on the blog for Chapter 10: <http://becomeyourowntradingcoach.blogspot.com/2008/08/daily-trading-coach-chapter-ten-links.html>



My own interest in historical patterns owes a great deal to the work of Victor Niederhoffer. His Daily Speculations web site is a source of many testable ideas regarding market movements:

[www.dailyspeculations.com](http://www.dailyspeculations.com)

Henry Carstens' online resource, *An Introduction to Testing Trading Ideas*, is a worthwhile and popular resource:

[www.verticalsolutions.com/books.html](http://www.verticalsolutions.com/books.html)

Mike Bryant's trading systems work is quite good; here's a collection of free downloads from his site:

[www.breakoutfutures.com/PreDownload.htm](http://www.breakoutfutures.com/PreDownload.htm)

Rob Hanna's blog tests a number of historical trading patterns and is a great stimulus for your own research:

[www.quantifiableedges.blogspot.com](http://www.quantifiableedges.blogspot.com)

Two subscription services that do a fine job of testing trading ideas are the SentimenTrader site from Jason Goepfert ([www.sentimentrader.com](http://www.sentimentrader.com)) and the Market Tells letter from Rennie Yang ([www.markettells.com](http://www.markettells.com)).

Henry, Rob, Jason, and Rennie all contributed segments to Chapter 9 of this book, offering insights into the relevance of testing ideas for self-coaching.



# Conclusion

*Science strives to achieve unity of fact. Art strives to achieve unity of feeling.*

—Stephen Pepper

This is our final lesson; let's see if we can achieve a bit of unity of feeling as well as fact.

## LESSON 101: FIND YOUR PATH

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My mother, Constance Steenbarger, passed away last year. She was an artist and an art teacher. Her greatest work of art, however, was her family. She provided her children—and her husband—with the one, irreplaceable psychological gift: the knowledge and the feeling that they were special. It's amazing how much you can achieve when you know that you're not ordinary. Out of that awareness, you're unwilling to settle for average in your work, your relationships, or your returns from markets. When you create a work of art out of your family, you empower human beings to want to make works of art of their lives. What greater accomplishment could there be? If I can achieve, as a psychologist and parent, a bit of what Connie Steenbarger accomplished with her family, it will count more than any degree after my name, any great trade I might place.

But isn't that what becoming your own coach is all about? It doesn't matter if the focus is trading, sales, parenting, or athletics: *the goal is to make a work of art of your life by becoming the best you can possibly be.*

The great disease that afflicts most people is their inability to think greatly of themselves. It's not about narcissism (which reflects an absence of self, not authentic greatness), and it's not about new-age self-esteem palliatives. Rather, thinking greatly of oneself is charting a path in life that makes a difference. It's living a goal-oriented life, not a life of drifting from day to day. It's remaining true to values and purposes, so that life has worth

and meaning. It's about making such a profound impact that someone, somewhere will want to conclude their book with a dedication to you.

Your life is a partially finished work of art.

There's an old saw that we tend to marry people like our parents. In my younger days, I would have been horrified at the prospect. Looking back on my mother's impact on her family and my wife Margie's impact on hers, I know that the rule holds true for me. Margie's greatest talent is that she is secure enough within herself to help others feel special about themselves. When one of our children went through a difficult marriage, I never once worried. I knew that she would eventually find happiness, because she had the experience of being special to her mother. *When you have that deep feeling of not being ordinary, you ultimately gravitate toward the best within you, the best for you.*

If you are going to be successful as your own coach, you will need to be like Connie and Margie; you'll need to sustain a relationship with yourself in which you are always special, no matter how daunting immediate obstacles may seem. You'll need to focus on your successes every bit as much—if not more—than your failures. You'll need to structure specific goals and concrete activities designed to achieve those, so that every day is an affirmation of drive and competence. Self-coaching is not about keeping journals or tracking your profits and losses. It's about forging a relationship with yourself that is as empowering as a mother's with a family.

At the end of all of this, you may decide that trading is not your path in life. Have the courage to embrace that and find the work that truly captures who you are and what you do best. I love trading—the intellectual challenge, the endless opportunities for improvement, and the immediacy of the feedback. You know when you've done well; you know when you've let yourself down. While trading has made me money, it's not truly what I do best. I once tried to be a full-time trader and quickly felt a large hole in my life where psychology—and working with people—had vanished. So now I trade markets on the side, work as a coach to professional traders, apply my greatest interests and talents in the most challenging settings, and write books that maybe, just maybe, will help others find what is special within them.

Let your strengths define your path.

Know what you do best. Build on strengths. Never stop working on yourself. Never stop improving. Every so often, upset the apple cart and

pursue wholly new challenges. The enemy of greatness is not evil; it's mediocrity. Don't settle for the mediocre. You don't have to be an artist and art teacher to make a work of art out of your life. And if trading is your path, learn from those who have blazed the trail ahead of you. Your final assignment is to absorb the resources from the various chapters of this book and select the few that will best support your self-coaching. They will provide the brushes and paint with which you'll create your life's artwork.

### **FOR MORE ON SELF-COACHING**

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The contributors to Chapter 9 have assembled their own mentoring resources, all linked on the Trading Coach site: <http://becomeyourowntradingcoach.blogspot.com/2008/08/contributors-to-daily-trading-coach.html>

My latest project is a free electronic book on trading theory and technique entitled Introduction to Trading that I am writing one blog post at a time: <http://becomeyourowntradingcoach.blogspot.com/2008/09/introduction-to-trading.html>

The TraderFeed blog covers a range of topics, from the psychology of traders to the psychology of markets: [www.traderfeed.blogspot.com](http://www.traderfeed.blogspot.com)

I'll be adding coaching resources to the Trading Coach site over time; if you have questions or particular interests, by all means feel free to leave a question or comment on one of the blog posts: <http://becomeyourowntradingcoach.blogspot.com>. Also feel free to contact me at the e-mail address specific to this book: [coachingself@aol.com](mailto:coachingself@aol.com)

For my books on trading psychology and trader performance, as well as related materials, check out the Amazon site: [www.amazon.com/s/ref=nb\\_ss\\_b?url=search-alias%3Dstripbooks&field-keywords=Brett+Steenbarger&x=8&y=18](http://www.amazon.com/s/ref=nb_ss_b?url=search-alias%3Dstripbooks&field-keywords=Brett+Steenbarger&x=8&y=18)



## About the Author

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**THE DAILY TRADING COACH**

“A great book! Simply written, motivational with unique content that leads any trader, novice or experienced, along the path of self-coaching. This is by far Dr. Steenbarger’s best book and a must-have addition to any trader’s bookshelf. I’ll certainly be recommending it to all my friends.”

—Ray Barros  
CEO, Ray Barros Trading Group

“Dr. Steenbarger has been helping traders help themselves for many years. Simply put, this book is a must-read for anyone who desires to achieve great success in the market.”

—Charles E. Kirk  
The Kirk Report

“‘Dr. Brett’, as he is affectionately known by his blog readers, has assembled a practical guide to self coaching in this excellent book. The strategies he outlines are further enhanced with numerous resources and exercises for the reader to refer to and keep the principles fresh. I enthusiastically encourage anyone interested in bettering their trading and investing to read this book and keep it on their desk as a constant source of learning.”

—Brian Shannon, [www.alphatrends.net](http://www.alphatrends.net)  
author of *Technical Analysis Using Multiple Timeframes*

“Dr. Brett has distilled his years of experience, as both a trader and a psychologist/coach, into the 101 practical lessons found in *The Daily Trading Coach*. Those lessons provide effective strategies for coping with the stumbling blocks that traders often face. This book should be a cornerstone of any serious trader’s library.”

—Michael Seneadza  
equities trader and blogger at [TraderMike.net](http://TraderMike.net)

