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*There is a substantial risk of loss associated with trading Derivatives . Losses can and will occur. My methods will not ensure profits*

Saturday, July 6, 2013

## Emotions

Trading is all about [Decision Making](#). Decision making involves analyzing the possible outcome of various available decision options and taking the appropriate action. Decision making in an uncertain and probabilistic situation faces many challenges. Most of them are [discipline](#) related and psychological.

If you search the web, there is no shortage of articles on trading psychology. But I feel most of the trading psychology writings revolves around Expected Utility Theory. This theory assumes decision making takes place by calculating the expected utilities of all the possible options and choosing the option with the highest expected utility.

Trading psychologists advise us to be disciplined and advocate controlling and ignoring the emotions. They ignore the role of emotions in decision making and advise us to aim for an idealized rational approach. In my humble opinion this is not at all practical in an uncertain environment like trading. Further the probabilistic nature of the market makes it much more difficult to practice.

I find [Antonio Damasio's Somatic Marker Hypothesis](#) (SMH) much more relevant to trading than the conventional stuff. SMH gives a central role to emotions in decision making. Somatic Markers trigger automatic reactions to situations in human beings. Whenever a decision is to be made each option induces a somatic response which is experienced as a feeling or emotion and these responses will depend on the past experience. These somatic responses will almost always over ride. The more you resist, the more it will dominate.

The theory consists of two ideas. 1. Somatic Markers affect decisions and 2. Somatic Markers depends on past experience. If we want to get rid of emotions emotion related issues from our trading decisions we must have enough experience to develop right Somatic Markers to support the ideal action.

I think ultimately our edge will determine our trading success. If we are trading a method with an edge and doing well, slowly we will develop ideal Somatic Markers. Instead of contradicting and over riding the ideal decision, these SM will start producing what we call "Intuition" or "Gut feeling". This will help the decision process in an automatic manner and our discipline and psychological issues will disappear for ever.

Posted by [SMART Trader](#) at 8:32 PM



## 5 comments:



[K\\_Vir](#) July 6, 2013 at 8:59 PM

Excellent post. Thanks.

Reply

[Inditech](#) July 7, 2013 at 2:05 PM

If interested, you may also refer to "Prospect Theory" by Daniel Kahneman on how humans decide in situations involving probabilistic outcomes. It also debunks the standard assumption of Economic Utility Theory that humans behave in a "rational" manner - love his book "Thinking, Fast and Slow"!

Reply



[SMART Trader](#) July 8, 2013 at 12:06 AM

@K\_Vir

Thanks

@Inditech

I feel the Prospect Theory is just an extension of EUT. Respective probabilities are also taken into consideration while arriving at the utility of an option.

The real problem traders face is not in comparing expected utilities and choosing a rational decision but in their inability to execute this plan due to emotional reasons

ST  
Reply



**augubhai** July 9, 2013 at 12:30 PM

This is exactly reason that I have reverted to rule based mechanical trading. I unsuccessfully tried to trade on gut feel for about an year. Now, I try to define rules ahead of the trading day.

IMO, if we are following a discretionary approach in a consistent manner, then we can define the hard rules for that approach. Let's consider the 100 scenarios that we may come across and define rules for dealing with each of them. If then we come across scenario no. 101, we just need to update the rules to deal with that.

Just my thoughts at the moment...

Reply



**SMART Trader** July 9, 2013 at 8:43 PM

Augu Bhai

I agree 95% with you.

Discretionary trading is 95% rule based.

IMHO, this rule based 95% will make you a "Good Trader". But you need "Intuition" to become a "Great Trader".

Elite performance is not possible without Intuition. It plays a vital role in determining position size. Scratching the trades, part booking etc.

To develop the right kind of intuition we need to focus on the right thing.

ST

Reply

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