HOW TO USE RISK TO BECOME A MORE SUCCESSFUL INVESTOR

Van K. Tharp, Ph.D.

Illustrations by Tom Ellery

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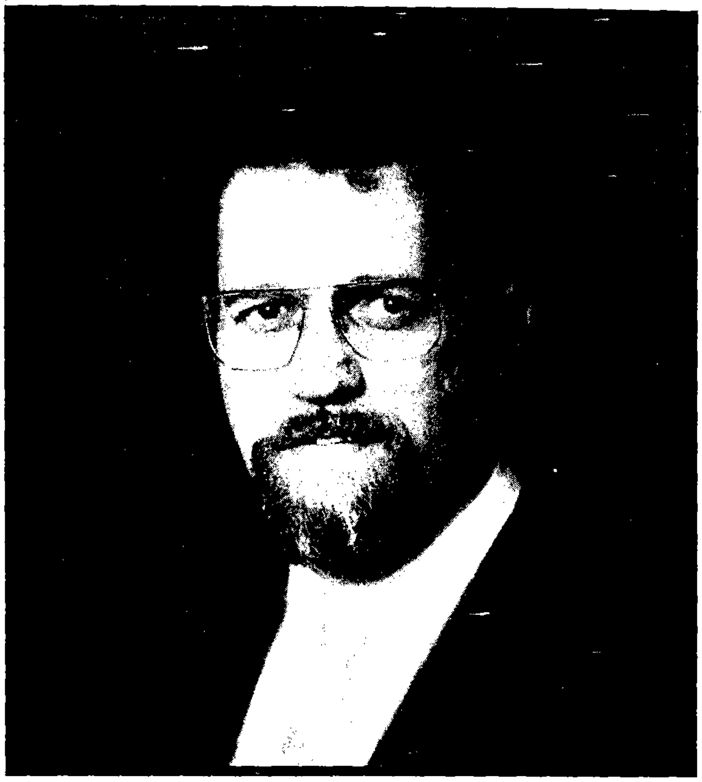

Dr. Van K. Tharp

Dr. Van K. Tharp is known internationally for his ability to help people become more successful. He has helped thousands of investors and traders to make more money in the markets. Dr. Tharp has helped big winners perform even better; he has assisted those who could not trade to execute their trades easily; and he's taught people who consistently lost money to become winners. Traders frequently double or triple their profits within a few months of consulting with him.

Van K. Tharp, Ph.D. is a research psychologist and an efficiency expert for professional traders. He received his Ph.D. from the University of Oklahoma Health Sciences Center in 1975.

He has spent over 20 years studying how stress affects human performance. His strongest interest is in the Psychology of Winning—especially as winning applies to the various investment markets. In 1982, Dr. Tharp developed the *Investment Psychology Inventory*, a test that measures winning and losing traits. Thousands of people have taken the test and learned how to improve their performance. In 1983, he founded **Investment Psychology Consulting**, a company dedicated to helping people increase their success as investors or traders. Some of his clients are now earning several hundred percent on their trading capital each year.

Dr. Tharp best describes his duties as that of a **coach for traders**. He says that a coach attracts top players, and then makes sure that they remember and follow the fundamentals of the game. Dr. Tharp also is a **modeler**—which means that he finds the top players and determines how they achieve their "market wizard" status. Thus, he has spent a great deal of research effort in determining what is <u>involved in</u> peak performance trading.

Dr. Tharp has completed a five volume, four cassette tape course on the psychology of investing and numerous articles for publications such as *Futures*, *Technical Analysis of Stocks and Commodities, Commodity Insider, Futures at Option World*, and *Wealth*. He also has been featured in *The Reaper*, *The Commodity Traders Consumer Reports*, Investor's Hotline, the Financial News Network, and various other media around the country. Dr. Tharp's workshops have been very popular at financial conventions such as The International Futures Symposium, Technical Securities Analysts Association, The American Association of Individual Investors, The N.C.M.R. Convention, Advanced Trading Seminars, CompuTrac, The Managed Account Reports Conference, Commodities Educational Institute, etc. He now has his own three-day seminars and has achieved world-wide recognition with coaching and research on peak performance trading.

PREFACE TO SERIES

I am affected only by my thoughts. Anonymous[1]

My goal in developing this course is to teach you how to make money in the markets the easiest and most painless way possible—by developing a sound game plan and the discipline and self-control to carry it out. In the process of doing so you will learn how the best traders and the most seasoned investors think. You will not be able to duplicate their success unless you can duplicate their thinking.

Investing is far behind most fields in acknowledging the contributions that psychology has for it. Psychologists have been reluctant to study trading or investing, and traders have been reluctant to acknowledge that psychology can help them.

Investing is one endeavor in which the majority lose. It is an area in which the salesman (i.e., the broker) is often asked for advice on what to buy. Misinformation abounds in the area. As a result, an intensive course on the psychology of successful investing is greatly needed, and that is the purpose of these **Investment Psychology Guides**.

Investors often go through three stages of growth before they become successful:

STAGE ONE INVOLVES THINKING THAT ONE CAN MAKE "EASY MONEY" FROM INVESTING. The novice investor thinks, "It's how rich people get richer, so it's how I'll become rich." Most novices approach the market quite naively, asking for advice on what to buy or sell. A few investors make money with this approach, but most lose money and leave the market quickly. Just look at some of the facts:

- Most funds (money market, mutual, commodity, etc.) fail to outperform the market averages and many of them carry heavy sales commissions, which make them even less attractive.

- Most investment advisors fail to outperform the market in up years and lose money in poor years.

- Investors are usually attracted by strong sales pitches or good public relations. These qualities often mean excellent commissions to the advisor or broker using them and losses or poor performance to the investor attracted to them.

- Investors flock to the best performing fund or advisor. The time when most people turn in this direction is usually the point at which the fund or advisor begins a trend of very poor performance.

- Most investors, even when given a profitable recommendation, often manage to lose money because they fail to follow the recommendations exactly or they fail to exercise proper money management.

STAGE TWO TYPICALLY INVOLVES A SUBSTANTIAL CHANGE IN STRATEGY IN WHICH THE INVESTOR NOW BEGINS TO ASK, "HOW SHOULD I TRADE TO MAKE MONEY?" Some investors begin at stage two, but for most people this stage involves a switch from asking the question, "What should I buy to make money?" Stage two might be called the search for the Holy Grail—or the search for the trading system that will make the investor financially secure. Most investors fail in this endeavor. Systems do not make money for the investor, the investor makes the money! Look at the evidence:

- Most trading systems are presented to the buyer with data showing outstanding performances. Quite often, the performance record reflects the system developer's misuse of statistics. As a result, the buyer cannot come close to matching the advertised performance.

- The error rate of a system (i.e., how well the system does paper trading) is the best possible performance an investor can hope to achieve with that system. When psychological factors are considered, as the investor enters the market place, the investor's performance is usually much worse.

- Investors who buy trading systems often do not use the system at all or do not use the system as it was intended to be used.

- Investors can be given a money-making system, use it properly, and still fail to make money. I know of several examples of well known traders who have tried to train others to use their proven systems only to find that they were unable to do so. By the time you finish this course you should understand why this occurs.

- Some of the best traders I know of claim to have no system at all. They say they are just "intuitive" traders.

The introduction of the personal computer has added an intermediate stage. **STAGE TWO-A IS A REGRESSION BACK TO STAGE ONE, BECAUSE THE INVESTOR TYPICALLY BUYS A TRADING METHOD ALONG WITH A COMPUTER AND THEN ASKS THE COMPUTER THE "WHAT SHOULD I BUY?" QUESTION.**

STAGE THREE COMES WHEN THE INVESTOR REALIZES THAT INVESTMENT SUCCESS DOES NOT COME FROM EXTERNAL CONTROL, BUT FROM INTERNAL CONTROL. It involves a radical change for most investors. Internal control, however, is not that difficult to achieve, but realizing that it is important is difficult. Most investors believe that the markets are living entities which create many victims. If you believe that statement, then it is true for you. But markets do not create victims, investors turn themselves into victims. Each investor controls his own destiny. No investor will find success without understanding this important principle at least subconsciously!

Again, let us look at the facts:

- Most successful investors achieve success by controlling risk (Volume 1). Controlling risk goes against our "natural" tendencies. Risk control requires tremendous internal control.

- Most successful speculators have success rates of 35-50%. They are not successful because they predict prices well, but because the size of their profitable trades far exceeds the size of their losses. This requires internal control.

- Most successful conservative investors are contrarians. They do what everyone else is afraid to do, and they have the patience to wait. This also requires internal control.

Investment success requires internal control more than any other factor. I dedicate this **Investment Psychology Guides** course to those investors who understand the importance of internal control. This is the first step toward success, and you are the investors who will ultimately succeed.

This course contains a complete psychological model for successful trading. We call it the **Successful Attitude Model for Trading™**, or SAM for short. In learning about SAM, you will learn how these investors structure information internally and how you can do the same. In the five volumes, you will learn (1) risk control, (2) stress control, (3) attitude control, (4) state of mind control, and (5) the decision-making skills of winners.

A number of you would profit greatly from a private consultation, be it a phone consultation or an in-person, private consultation. A 10-minute phone consultation comes with the *Investment Psychology Inventory* or a 30-minute phone consultation comes with our full Annual Update Program (see course postscript after last chapter of Volume 5). You may sign up for a one-hour private consultation when you purchase the course. However, most of you will benefit most from my four-day private consultation, with guaranteed results, or my super-trader program.

If you allow someone to help you with these techniques, you will find them easy and quick to learn. **People who adopt the Successful Attitude Model™ can easily triple their current profits each year.** We provide one-on-one consultation in the development of investment excellence, specifically designed to solve your problems. My clients are amazed and delighted with the results. Many of them are electing to have yearly follow-ups. If you are interested, I would be happy to talk with you about it.

I hope you develop as much self-insight and personal success studying this course as I have developed writing it.

PART ONE

INTRODUCTION

CHAPTER I

COMMITMENT

"The quality of a person's life is in direct proportion to their commitment to excellence, regardless of their chosen field of endeavor"—Vince Lombardi

Jack had a successful business, but he wanted to be a trader. Nevertheless, he wasn't willing to give up his annual $75,000 salary until he was certain that he could be successful as a trader. As a result, he just dabbled in the markets waiting to find the *magic secret.* He tried different brokers, different advisors, different software programs, and different systems. Everything he tried, however, had the same results—he never made enough money.

One day, Jack discovered the name of a trader who had made consistent and large profits in the markets for over 30 years. Furthermore, he learned that this trader would teach anyone who was willing to learn how to trade effectively. As a result, Jack packed his bags and went to visit the old man[1].

"I want to be a trader," Jack said. "I understand that you are willing to teach people how to do what you've been doing over the past 30 years."

"Well," said the trader, "I'm willing to teach people, but most people don't seem to be willing to learn. I've had this offer to teach people all these years. All I ask is that they do what I tell them to do. Many people say, "Yes, that's the life for me." But most of them don't even carry out the first assignment. I imagine you will probably be the same. But maybe not. Tell me about yourself! What makes you think you are a trader?"

"Well," said Jack, "I've been at it for over ten years. I keep losing money, but I still stick with it. I'll do whatever it takes to find the secret of successful trading. I followed Guru X's advice. He was successful, but I wasn't able to make money following his recommendations. I then bought the XYZ, the RKS, and the PRT systems. I know people make money following those systems, but somehow I don't. So I came here to learn how you trade. What's your secret?"

"I'm a trader," said the old man.

"I know that," said Jack, "but what's your secret."

"I just told you. I'm a trader. You're not. You're just playing a game. When you decide to become a trader, to become fully committed, then you will understand. Are you willing to fully commit yourself to trading?"

WHAT IS COMMITMENT?

Commitment means congruency. It means that the whole person is working together for a common purpose. In order to illustrate the difference between commitment and lack of commitment, imagine yourself in each of the following situations:

• You just made a small paper profit in the market, but you did not follow your tested system.

• You have followed your trading system, but you expect the market to move in the opposite direction of your position.

• You are following the investment advice of an advisor with an excellent track record, but somehow you just don't trust this person.

In contrast, now imagine yourself in the following situations:

• You just made a small paper profit in the market and you were following your system.

• You followed your trading system, and you know you will make money each month if you stick to your system.

• Your are following the investment advice of an advisor with an excellent track record, and you feel really good about this advisor.

You should easily sense the difference between the first set of conditions and the second set. In the first set, you felt unsure and at conflict with yourself. You experienced lack of commitment. In the second set of situations, you felt confident and congruent. No conflict existed.

Conflict exists because the average person is fragmented. He or she is driven in many different directions by different internal parts[2]. Each part is trying to carry out some positive intention for you by adopting certain behaviors that it selects. But the behaviors that support each of those intentions are not necessarily congruent. For example, behaviors that support fun and excitement might contrast strongly with those that support security. Think about your own behaviors!

HOW DO YOU KNOW IF YOU'RE COMMITTED?

The ultimate test of whether or not you're committed is consistency of profits. If you consistently made profits year after year, then you know you were committed. Yet even if you pass this ultimate test, how do you know you are still committed? Successful, consistent traders know that there is a potential trade with their number on it, a trade that will put them out of business. They know that their job is to avoid that one trade! For example, this course provides numerous suggestions for avoiding that trade. Are you going to make this material part of you? Or are you just going to skim it? Are you trading to become a trader or just to play some sort of game with yourself?

The possibility always remains that you might suddenly fragment yourself. As a result, I suggest that you become aware of the symptoms of lack of commitment, which are 1) obstacles to trading successfully and 2) factors that distract you from your trading.

"I want to make a living as a trader," said Jack. "When I'm sure I can do that, then I'll do it full time. But every time I

> think I'm on my way, I suffer a major setback. Somehow I need a system that avoids those losses."

Obstacles to Trading Successfully. Most people get into the market with the idea that trading is somewhat like going from point A to point B. The problem is that many obstacles, like Jack's losses, exist between A and B. What happens is that they keep bumping into the obstacles. Quite often those obstacles are either the profits the person wants or the losses the person is trying to avoid. Yet both of those obstacles are dangerous to the potential trader. If a person is trying to avoid losses, then he tends not to take small losses and those small losses turn into big ones. This is the **Loss Trap** described in Part II of this volume. Similarly, if the person is concentrating on big profits, then those profits become a stressor and the person loses touch with what is happening in the market. For example, in 1988 many traders had huge profits in grains during the summer drought. However, many of them got lost in those profits and ended up losing large sums of money.

The real issue for most traders is what is going on inside their heads. Most people tend to avoid working on themselves. It's too painful. Instead, the issue they have with themselves (e.g., security, self-worth, etc.) becomes an issue they have with the market (e.g., profits, losses, etc.). For example, suppose a trader has a problem with being organized. He does not keep on top of the market and does not update his charts. As a result, he decides, "Well, if I just have the right advice it will take care of the problem." He subscribes to several hotline services and doesn't keep up with them. Then, he decides, "If I just get the right system, it will take care of the problem." Once again, he simply transfers his problem, transmutes it, and then has the same problem following his system. He can't trade because he is disorganized. And being organized might mean dealing with a personal issue which he is not willing to confront, e.g., acting like his father whom he hates. As a result, he continues to search for better advice or the magic system, while avoiding the real issue.

When a trader is looking for a system to solve his personal crisis, reflected by his trading crisis, then he will find that the same crisis transfers to his system. When the trader keeps bumping into obstacles and then decides that he needs a system to handle all these obstacles, he's just going to find the same obstacles following the system that he had following the market in the first place. Instead, the trader needs to come to

terms with himself. Once he does that, then any workable system will do.

> "You have to come to terms with the obstacles you are facing," said the old trader. In your case that obstacle seems to be your losses. What if I told you that to be a trader, the best way is to take your losses and not worry about them. Just enjoy the game of trading which involves both winning and losing. You might feel bad about losses, but notice that it's just you feeling bad about losses. It has nothing to do with the game of trading which involves taking losses."

> "That's fine for you to say with all your money," said Jack, "but I don't want to lose money, I want to be a successful trader."

> "Then I think you need to make it okay to be unsuccessful," said the old man. It's very difficult to trade if you're not willing to lose. Almost impossible. It's like wanting to be alive, always willing to breathe in, but not willing to breathe out."

Distractions that Keep You from Trading. Most traders approach trading as a hobby, something they do part time. For example, if you have a full time job, like Jack, then trading is a hobby for you. To be successful, you need to totally throw yourself into knowing everything about trading, learning more and more about it. People who are not willing to do that are just playing some sort of psychological game with the market. Some people need to justify an emotion which is always possible through the market. Others use trading to meet some sort of need for drama in their life. For people who want a hobby, trading is a fairly accessible hobby.

> "You still haven't answered my question about whether or not you are fully committed to trading," said the old man.

> "I'm fully committed now," said Jack, "but I'll make more of a commitment as soon as I know that I can be successful. Tell me your secret of success. I need to know your secret first. That's why I came here."

"I told you," the old man said, "I'm a trader. What I do is an art form. You can't be something else and be a trader at the same time. The trader who knows what he's doing, trades. No one else could possibly understand. There are as many ways to trade as there are people. If you want to become a trader, then you should commit your life to doing it. Trading for you, as far as I can tell from our discussion, is just a dream and a struggle with something that doesn't work. You really need to go one way or the other. To go into trading, saying, "I'm basically a lawyer or doctor or something else and I'll just trade on the side," is not adequate. Can you imagine this society tolerating someone who says, "I'm going to practice brain surgery as a hobby?". When it's a hobby, there's something missing.

"But what about Mr. X," he's running a forecasting business, writing a newsletter, doing seminars, and he's now got $5 million under management. Last year he was up 200%. If he can do it, why can't I?"

"Mr. X will probably go snap and breakdown. Maybe not for a couple of years, but when he does he'll lose most of those profits. You'll probably think he was unlucky, but it will have nothing to do with luck. Mr. X doesn't seem to be committed to being a trader. You and Mr. X both have an idea that you want to be traders. I don't think that's enough. You have to look inside and determine whether it's true. Maybe you have some voice in your head from your youth or a friend that says, "Boy, I should really be a trader." And you're convinced you should be a trader. But are you? Do you have what it takes to be a real trader?"

HOW TO DEVELOP COMMITMENT

Perhaps you are like Jack. You trade part time and you keep running into obstacles. You show both symptoms of being uncommitted. Yet, at some level you really want to become a successful, full-time trader. How do you develop the commitment that is required? It is a three step process.

First, you need to determine what your obstacles are. List them on a sheet of paper. If you are not sure, then keep some sort of diary of your trades as we recommend in this course.[3] After about ten trades, review that diary. What happened? What do your obstacles seem to be?

The second step is more difficult. You need to determine *how those obstacles reflect what is going on within you.* What is the common element? Can you not take losses easily? Do you bail out of profitable positions too quickly? Are you disorganized? Is some emotion usually present when you trade? Do some soul searching. Go deep within yourself for the answers.

The last step is to deal with whatever is going on within you. Make peace with the obstacles by making them unimportant. Do it mentally, because once you've done it in your mind it is much easier to deal with when it actually happens. For example, if you have a problem with losses, then imagine taking a string of horrendous losses. Pretty soon, you will notice that taking those losses becomes less and less significant. When they become insignificant, then you will find that taking them early when they are small becomes easy.

Your obstacle may reflect some sort of conflict. If conflict is a problem, then follow the suggestions presented later in this course. That is, find the conflicting parts in your mind, determine their positive intention for you, and then negotiate between the parts until you find some behaviors that satisfy the intentions of both parts. When you do that, your parts will begin to work together congruently. You will be committed. YOU WILL BE A TRADER. Or will you discover that you really want to be something else.

> Do you really have a love for the art?" asked the trader.
>
> "I think so," said Jack.
>
> "Then I'll help you trade," said the old trader skeptically, "but you must follow my instructions. First, here is a list of books I'd like you to read. Read those books and make plans to fully commit yourself to living with the markets. When you've done that, come back and we'll talk some more about trading."

> Jack took the list and thanked the trader. He left the house, shaking his head. "I don't want a list of books to read," he said. "What I want is to know how he trades. What's his secret? I guess he just doesn't want to share it with me."

Jack's story represents what happens to most people who want to be a good trader. They want to be successful, but they are never willing to fully commit themselves to do what it takes. This doesn't mean jumping right in without any preparation. But it does mean taking the first steps. Most people are never willing to BECOME a trader. Instead, they simply trade while trying to deal with some personal issue. The result is that the issue overwhelms them, they lose their shirt, and have to find a different avenue in which to deal with that personal issue.

Until one is committed
there is hesitancy, the chance to draw back,
always ineffectiveness.
Concerning all acts of initiative (and creation)
there is one elementary truth,
the ignorance of which kills countless ideas
and splendid plans:
that the moment one definitely commits oneself,
then Providence moves too.
All sorts of things occur to help one
that would otherwise have never occurred.
A whole stream of events issue from the decision,
raising in one's favor all manner
of unforseen assistance,
which no man could have dreamt
would have come his way.
I have learned a deep respect
for one of Goethe's couplets:

Whatever you can do, or dream you can...begin it.
Boldness has genius, power and magic in it.
W.N. Murray[4]

This course and my journey into this business have resulted from the occurrence of a series of very low probability events. For example,

- I designed the *Investment Psychology Inventory* as a creative project with no specific commercial purpose in mind, but two months after completing the preliminary version of it almost a thousand traders took the test. This data base helped me complete the essential research on the test. It also gave me the encouragement to pursue a career in trading psychology—even though a number of people had tried to develop a business in the area and failed.

- As I became more interested in specializing in trading psychology as a business, I noticed an advertisement in the *Los Angeles Times* indicating that Richard Dennis (reportedly one of the world's top traders) was looking for people to train in his proprietary trading methods. I knew I could help him screen traders, so I responded to the ad on that basis. Instead, I ended up being one of the 40 people (from well over a thousand applications) that he interviewed for a trading position. Although I was not selected (I sabotaged myself because I had a lot of conflict over whether or not I wanted to work for him), that interview added to my knowledge on the psychology of trading and further stimulated my interest in this field.

- When I wrote the first book of this series, Bruce Babcock, Editor of the *Commodity Traders Consumer Reports*, was impressed enough to purchase 150 copies of it. His interest and backing helped give me the encouragement to complete the course—a five year project.

- Some of my early clients were above average traders in that they were making a living at trading. Most of them already knew what their basic weaknesses were and just needed help overcoming them. They were very honest with me, so as I helped them, I also learned from them. Insights gained from them formed the foundation for the **Successful Attitude Model for trading™**.

- My clients suggested several top traders that I should study. As a result, I made a commitment to work with those traders. When I commit to doing something, it usually happens and it usually occurs in a way that I would not have imagined had I tried. In fact, I had the opportunity to interview each of them within a year of making a commitment to do so. For example, when Jack Schwager interviewed me for his book, *The Market Wizards: Interviews with Top Traders*, I suddenly had access to some of the best traders in the world.

- I spoke on a panel at the Market Technician's Association Meeting in 1989 with two of the world's best traders. One of my goals at that meeting was to get an opportunity to interview both traders in detail. I got more. One of them told me, "Van, with my abilities and what you can do, I'll be the best in the world. I'm willing to do whatever it takes."

Each of those occurrences was very unlikely to occur by chance. I would guess that the probability of them all occurring together is about a billion to one or less. Yet I am in this business and your are reading this course. As a result, I strongly identify with what Murray says because I've experienced it for myself. I meet the right people at the right time.

In addition, many of my clients and course subscribers have experienced miraculous turn-abouts in their personal lives. Why? I think the answer is their commitment to what they are doing.

Do you have the commitment to do what it takes to be a successful trader? For example, some traders buy this course and let it sit on the shelf. Others skim it and if you are reading this you are probably at least in that category. Other traders read it thoroughly and do all the exercises. Finally, some traders make the material part of themselves by continuing to review it and think about it. Which of these traders do you think is committed enough to become successful?

If you are committed, then you have taken a giant step toward becoming more successful. You understand the basic elements of what you need to accomplish. Enjoy the exciting journey ahead of you.

CHAPTER II

HOW TO USE THE COURSE

I believe that each person produces the results he or she gets in life. This occurs in all aspects of life, but it is especially evident in trading. The results you get in the market are exactly what you program yourself to get. Most traders battle the market for many years before they begin to come to this conclusion. More conservative investors seldom reach this conclusion. In a sense, you are lucky because *what happens to you in the market is a terrific mirror to what is going on inside your head.* People in other walks of life also have such mirrors, but they are not always so obvious.

My goal in developing this course is to teach you how to make money in the markets the easiest and most painless way possible—by developing a sound game plan and the discipline and self-control to carry it out. In the process of doing so you will learn how the best traders and the most seasoned investors think. You will not be able to duplicate their success unless you can duplicate their thinking.

I am most interested in the qualities of successful people that produce lasting results. Those qualities, it turns out, are also the qualities that generally produce successful lives. As a result, if you develop the kind of self-control and self-understanding that is necessary for market success, you probably will also have a more successful and happier life. I think that's a wonderful by-product of this material.

IS THE COURSE MATERIAL FOR YOU?

You might ask the same question about physical exercise. If you do it, you'll have more energy. You'll feel better, and you'll perform better. You can probably get along without it, but not without a significant sacrifice in the quality of your life. Exercise is physical conditioning. This course is a form of mental conditioning. You can make money without it, but doing so will require more effort and you will probably sacrifice much of your personal life.

When you first read through the course, you might think that the material only applies to speculative trading. I sometimes get calls from people who purchase the course saying that they only invest in mutual funds so the course material does not apply to them. Others claim that the course material doesn't apply to them no matter what kind of trading they do. About 90% of those who purchase the course are commodity and option traders, so the specific language in the course is geared toward them. However, the exercises, the self-insight and the game plan development are appropriate for all investors and traders. The material is equally applicable to day traders in futures and to conservative long-term mutual fund investors.

For example, people think that successful speculators and conservative investors have differences in terms of the risk they are willing to take. That difference may apply when losing speculators are contrasted with conservative investors. But the top traders abhor risk and take very little. That's one reason why they last and make consistent profits.

Others may think that speculators differ in terms of decision-making needs. Again, this is a misconception. The development of a game plan and the discipline needed to carry that plan out are equally applicable to the floor trader and the investor who doesn't want to touch his investment for 10 years. In fact, sometimes the latter individual will use his long term orientation as an excuse for not needing a game plan. Yet if he puts his money into an investment that does not perform well and keeps it there under the guise of having a long term orientation, then he is making just as big a mistake as the day trader who decides to hang on to a loss overnight. Unfortunately, the long term trader takes ten years to make a mistake and may not even realize that it is his mistake at the end of ten years. If a mistake lasts ten years, you may only get a few chances to repeat it. Since people tend to repeat mistakes several times, he may run out of time before he can correct it. The day trader who hangs on to a loss may get forced out of the market and lose all his money, but sooner or later he realizes that he has made a mistake. Since he still has time on his side, he can rebuild his capital and correct those mistakes.

Every other important aspect of this course—stress management, internal conflict mastery, developing useful beliefs, goal setting, decision making biases, etc.—applies to all facets of investing and trading. If you understand and apply these concepts, then you can make a lot of money consistently. If you neglect these areas, then you probably will join the crowd and lose money. Thus, **whatever kind of trading or investing**

you do, this course is applicable to you. It is a form of mental conditioning. You can probably do without it, but consistent application of the principles can dramatically improve your life and your finances.

If you call yourself an investor, rather than a trader, then I would suggest that you switch. A trader is someone who is concerned about market direction, market timing, and obtaining the best possible position. He might be buying a stock market index or IBM, while shorting the Swiss Franc, and buying a gold position. In contrast, the investor is always on the long side of the market. He concentrates on the investment that has the best possible chance of outperforming the market and he tends to hold on to positions. When he makes a major change in position, it usually amounts to how fully invested he should be under current market conditions. In my opinion, therefore, the trader has a lot more choices (profit opportunities) than the investor. Since successful people tend to be successful because they give themselves more choices, I strongly suggest that investors give themselves more choices by playing both sides of the market—in other words, become traders.

Throughout the remainder of this course I will primarily use the word "trader." However, I am generally referring to both traders and investors when I use it. In addition, since males constitute about 90% of the readership of this course, I will generally refer to traders with masculine terms such as he, him, his, etc.. This in no way reflects on the ability of women to be successful traders.

HOW YOUR COURSE IS ORGANIZED

SAM, the Trading Tiger, will assist you on your journey through this volume and through future editions of subsequent volumes of this course. SAM is now one of the world's top

Figure 2-1
SAM, The Trading Tiger

Finally, the fourth tape is designed to give you confidence in yourself. Play it regularly and you will be able to access confidence whenever you need it. However, only certain traders need confidence. If you tend to be compulsive, then you should avoid Tape 4. As a result, I recommend that you avoid using Tape 4 until you have completely finished the course.

THE INVESTMENT PSYCHOLOGY INVENTORY©

If you elected not to purchase the *Investment Psychology Inventory©* with your course, then skip to the section on page 26 entitled, HOW TO USE THE COURSE. If you did not purchase the test with the course, then the course discount price applies for 30 days after you purchased the course.

The *Investment Psychology Inventory©* is a 176-item questionnaire that allows me to evaluate your strengths and weaknesses as a trader. Each question only has two possible answers (generally, true or false), so you should be able to complete it in about 30 minutes. If you have purchased the test and have some trading experience, then take it now before going any further with the course.

Although all the workbook exercises are self-evaluations, most people are not totally objective when taking a self-evaluation. The person you are most likely not to be honest with is yourself. The *Investment Psychology Inventory©* provides you with a way to get a complete evaluation prior to taking the course. Furthermore, if you have a tendency to be defensive, it shows up in the test. Most importantly, the profile results give me a way to provide you with immediate suggestions for improvement via the phone consultation that comes with the profile.

If you have been trading or investing for at least a year prior to purchasing the course, then I recommend that you take the *Investment Psychology Inventory©* prior to beginning the course. Approximately half of the value of the test is based upon your previous trading or investing experience. If you have little trading experience, then I recommend that you wait to take the *Investment Psychology Inventory©*. Instead, go through the course, gain some trading experience, and then take the evaluation about a year later. A later section in this chapter— **Special Instructions for Novice Traders**—provides more specific details.

I recommend that you use the phone consultation that comes with the profile to ask specific questions about your profile or how you should most effectively use the course to improve your trading. Some of you may want to wait for your phone consultation until you have completed the course. If you do wait, then I can give you specific suggestions on how to overcome any difficulties that you may not have been able to deal with yourself by going through the course.

HOW TO USE YOUR TEST SCORES

If you've taken the *Investment Psychology Inventory*©, copy your scores into the space below. If you have the test but have not taken it, then do so now. When you receive your profile back, copy your scores in the space below. All scores above 30 (except for your intuition—IN—score) will be circled. Pay particular attention to those scores.

_____ WR Score. WR stands for Well-Rounded. It indicates to what extent your personal life may interfere with your financial well-being. Your score is composed of both stressors in your life and your stress protection. If you have a score over 30, then you should immediately proceed to the stress test to determine areas in which you specifically need to work. Volume 2 is a complete stress management course, so a high WR score indicates that you need to direct your attention to that portion of the course.

_____ PA Score. PA stands for Positive Attitude. It indicates the degree to which your expectations may interfere with your trading. If your score is 30 or more, I would suggest that you review the belief sections given in Volume 3 of the course and work on adopting those beliefs. They will change your trading and your life.

_____ MT Score. MT stands for Motivation. Your MT score indicates the extent to which you are motivated to invest or trade for reasons other than to make money. Most top traders will have high MT scores, so we only consider an MT score to be significant if it is combined with either a high PC score or a high SF score.

_____ PC Score. PC stands for Prosperity Conflict. A high PC score indicates that you have a lot of conflicts that may detract from your ability to make money in the market. Conflict is discussed extensively in Volume 3 of the course.

_____ SF Score. SF stands for Speculative Fever. A high SF score indicates that you have a tendency to be a gambler. If your SF score is high, then you should immediately take the compulsive gambler test in Volume 4.

Copy your score from that space here:_______ If you miss 12 or more questions in that test, then it's time to stop trading. Do not trade until you've developed a complete game plan in which you resolve to only take low risk trades. In addition, prior to resuming activity in the market, deal with the part of you that needs "action". That part of you, unless you follow this advice, will probably cost you thousands of dollars.

_____ RS Score. RS stands for Respondability. Respondability is discussed throughout the course. If your score is above 30, then you may be playing the victim role. However, we have found that people who are interested in working on themselves (i.e., who take the course) seldom have RS scores above 40.

_____ TK Score. TK stands for Technical Knowledge. A high TK score indicates that you probably need to work on developing a better trading system, although it may also mean that your system is a little unusual. If you have a high TK score, be certain that you complete Volume 5 of the course.

_____ OZ Score. OZ stands for Organization. A high OZ score suggests that you need to work on becoming better organized in your approach to the markets. If you have a high OZ score, a high TK score, and a low IN score, then emphasis on system development and organization should be a high priority for you. A high OZ score also may suggest that money management is a problem for you. Money management is covered in this volume and Volume 5 of the course.

_____ JH Score. JH stands for Judgmental Heuristics. A high JH score indicates that you have many of the biases in your decision making that are discussed in Volume 5. Review that material in detail.

_____ CF Score. CF stands for Conformity. A high CF score suggests that you tend to be a crowd follower. This occurs in certain personality types such as those people with a high need to be liked. It also tends to occur under high stress conditions. If you have a high CF score, then you should work on Volume 5 and possibly Volume 2.

_____ IN Score. IN stands for Intuition. The scale is a little different from any of the others. If your IN score is below 75, then you are more intuitive than the average person taking the inventory. If it is 50 or below, then you are very intuitive. Your game plan, see the last chapter of Volume 5, should take into account your intuitive abilities. However, you should be certain that your intuition is not just an excuse ("into wishing") for laziness and that you really do make good intuitive decisions.

____ Composite Percentage. The percentage score, given in the middle of the last paragraph on your profile sheet, compares you with the other investors and speculators who have taken the *Investment Psychology Inventory*. Our data indicate that 50% of the people who have taken the test are successful and that 90% are speculators. Since most speculators are not successful, you are comparing yourself with above average traders. A score of 13.2% means that 13.2% of the people who have taken this test scored better than you. Thus, any score below 50% is above average. But, of course, that does not prevent you from aiming higher.

HOW TO USE THE COURSE

You are about to begin a journey of self-evaluation and self-discovery. Although you may have some initial shocks about where you are now, proceed with enthusiasm and commitment and you will find the journey very rewarding. Your objectives in going through the course are to develop insight about how you produce your trading results; to devise a complete game plan for making money; and then to use the course and your game plan to continue to improve.

People frequently ask me how long it takes to go through the course. If you are overweight, how long does it take to get yourself in shape through diet and exercise? Only a few months if you begin a daily conditioning program and stick to it! This course is a daily conditioning program for your mind. You can probably make a dramatic improvement in your trading in a few months of work, but you must continue to apply the principles. Would you expect your body to stay in shape if you stopped exercising? No! Similarly, you cannot expect your mind to perform well in trading if you stop the regular program we recommend in this course. **This course provides you with a form of coaching to help you achieve peak performance.** It is a lifelong process of conditioning.

The first step in the journey, unless you are a novice to the markets, is to take the *Investment Psychology Inventory*©. Take the test and return the answer sheet to us. It will provide you with your first insights. Instructions for taking the test are included on the test form. Your scores, once you enter them into the spaces provided earlier in this chapter, will also guide you to the most essential elements of this course for you.

You can start the course once you have sent the test to us for scoring. Begin by going through Volume 1 in detail. Whenever you encounter an exercise, do it immediately. If you proceed in the manner suggested, most of you should have your profile back by the time you complete this volume.

If you have not made money consistently in the market, then I recommend that you immediately suspend trading (or at least avoid opening new positions in the market) until you have completed the course and developed a written game plan for trading. **YOU WILL PROBABLY SAVE YOURSELF THOUSANDS OF DOLLARS BY FOLLOWING THIS ADVICE.** On the other hand, if you consistently make money and you just plan to use the course for improvement, then continue trading.

Once you have your profile, you can proceed with the course in two ways. The best method is simply to go through each volume in order and complete each exercise when you get to it. When you have completed the five workbooks, then devise a complete game plan for your trading. Once you have that game plan, ask yourself if you could convince me (or someone else who might have an astute eye for low-risk plans) to invest in you. If you think the answer is "yes", then resume trading. Otherwise, continue to work on it.

The next best way to complete the course is to concentrate on your weak areas based on my recommendations from your profile. Do all of the exercises in those areas and then read the remainder of the course. Once you finish the reading and exercises, develop your complete game plan that would satisfy the above criteria. When you have it, then resume trading.

You are not finished with the course when you complete your game plan. In fact, **the course will have the most value for you once you have your game plan.** At that point, you can begin to apply the principles in the course most effectively. Start using a trading diary and use the results of your trading as a means to improve yourself. As you trade, you will discover new insights about yourself. You can use the course material to avoid repeating mistakes and to develop more self-control. Traders who get the most out of the course continue to review the books regularly.

Your game plan must involve feedback so that you can evaluate mistakes and continue to work on becoming a more effective trader. As a result, the course is something you should be using for the rest of your life. I recommend that you retake the course exercises at least once a year, and we provide an *Annual Update Program* for that purpose. The *Annual Update Program* provides you with a workbook for redoing the exercises and updating your game plan. In addition, it provides you with new material, since we plan to continue to revise and update the course. More detailed information about the *Annual Update Program* is contained at the end of the last volume.

The course will be of little value to you if you just skim the books or just put it on the shelf as reference material in case you need it some day. Even if you read the books thoroughly, but avoid doing the exercises, you will be cheating yourself. **TAKE THE TIME TO DO EVERY EXERCISE.** In fact, once you've gone through the course the first time, notice the parts of it that you tended to neglect or put off. *Those portions of the course are probably the ones that you need to work on the most.*

SPECIAL INSTRUCTIONS FOR NOVICE TRADERS

If you are a novice to the investment world and you have chosen to go through the course prior to entering the market, then you are exceptional. You will probably do very well in the trading business. Most people choose to make many mistakes, and lose a lot of money before they develop sufficient insight to realize that they are the cause of those mistakes.

My first recommendation for the novice trader is that you do not trade until you go through the course step by step and develop a complete game plan. DO NOT ENTER THE MARKET UNTIL YOU HAVE DONE SO. Some exercises, such as the compulsive trader exercises, will not apply to you at first. Just skip those and concentrate on getting as many insights about yourself as you can so that you can develop an effective game plan. That game plan will help you shortcut many mistakes, save you a lot of money by minimizing losses, and help you earn consistent profits.

Your initial game plan will probably have some weak areas, because there is no substitute for real market experience. Nevertheless, you probably can circumvent many problem areas and your initial game plan will provide a solid foundation for personal growth.

Once you have a game plan, make about 20 to 40 (even fewer if you only plan to make a few trades each year) low-risk trades. These should involve a very small percentage of your overall capital (e.g., 0.5% per trade). If you trade futures, use the Mid-America Exchange mini-contracts. If you invest in stocks, then consider buying 10 shares. You may lose money even after you've completed a game plan. That is part of your education as a trader. Why lose large amounts of money when you are just beginning? Even if you have a large trading account, only risk small amounts while you are learning. Learn by making mistakes that do not cost you much money. **Undertrade until you have a proven game plan!**

After you have completed your 20 to 40 low risk trades, then stop and re-evaluate. If you have lost money, consider those trades to be part of your education. If you have made money, then re-evaluating yourself is probably even more important. A big ego is the worst thing you can bring to a trading business.

Consider taking the *Investment Psychology Inventory©* as the first part of your re-evaluation. Also go through the course again. At this point, you will have the foundation and experience to build a solid game plan. If you follow this method of growth and education, instead of the School of Hard Knocks, then you will probably save thousands of dollars in your tuition.

CHAPTER III

HOW TO DUPLICATE SUCCESS

The purpose of this course is to teach you about, and to help you adopt, the **Successful Attitude Model for Trading™**. A model is a duplication of something—in this case top trading. The **Successful Attitude Model for Trading™** has taken over five years to develop, and we are continuing to refine it. As a result, you need to understand a little about the process and the potential of modeling.

Modeling is both a science and an art that developed within the last decade out of NeuroLinguistic Programming (NLP). NLP is the name given to the material presented in a series of seminars and books developed by John Grinder and Richard Bandler. But NLP really is the science of duplicating success. If anyone can do something well, then an expert modeler can learn how they do it and teach those skills to others. However, most NLP books and courses concentrate of the techniques that have been learned through modeling, rather than the modeling process itself. For example, this course primarily focuses on the techniques we have developed for duplicating trading success. However, I would like to devote this chapter to the science of modeling itself, so that you can understand how I developed the model.

One of the first major modeling projects was conducted by the Army and the CIA. It involved duplicating the expertise of two of the top rifle shooters in the world. These skills were then taught during the basic Army course in rifle shooting[1]. The modelers were able to reduce the training time from four days to two days and to increase the percentage of recruits qualifying from 80% to 100%. In doing so, they only used a third of the ammunition normally needed for training. In addition, they were also able to improve the performance of the two top shooters from whom the model was developed simply by making them more aware of the elements that were important to their success.

I've been able to model board breaking as it is taught by karate experts. Those experts claim that it takes years of study before anyone can develop the skill and mental discipline necessary to break a board. If you put yourself in the right mental state, concentrate on a spot about a foot beyond the board, and duplicate the motions and thinking required for each phase of the task, then board breaking is easy. For example, I watched people break boards for about 15 minutes to determine each subtask and the necessary mental requirements. I then asked a few questions for clarification, and then was able to break two 1/2 inch pine boards held up together with my bare hand. I was even able to teach my son, who was ten years old at the time, to do it. In addition, I can now do a contact break, which means putting one's hand on the board and breaking it while touching the board.

Although board breaking and rifle shooting are simple tasks, a modeler can duplicate much more complex tasks. As a result, the potential applications of this technology to business and education are staggering. Modelers, working at Polaroid Corporation are streamlining the process of becoming competent at Computer Aided Design (CAD). Currently, developing competence takes about nine months of classroom training followed by two years of on-the-job training. Through the process of modeling, trainees will reach competency in 12 months. CAD is the most complex skill being modeled to date. It involves many different subtasks and levels of training.

We are in the process of modeling every type of trading (day trading, floor trading, position trading, fund management). We already have most of the essential elements of all of these types of trading. We are simply refining our models and developing training programs to teach top-level trading performance to others.

To model a skill, you need several people at the top of their field to serve as models. Finding those people in the trading world is not easy. The best traders tend to value their anonymity. In addition, people who gain a lot of notoriety for their skills at trading either tend to be good at getting publicity (i.e., rather than good at trading) or their fame eventually leads to their downfall. As a result, finding appropriate models tends to be a major part of the task of modeling.

WHAT DOES IT TAKE TO DUPLICATE SUCCESS?

There are three primary factors involved in duplicating success—**beliefs, mental states, and mental strategies.** If you duplicate the way the best traders use these three factors in every aspect of trading, then you can duplicate their results exactly.

Some people argue that duplicating top trading skills is impossible because you cannot duplicate their *experience*. I believe that notion is ridiculous. Two traders can have the same experiences and produce entirely different results. Why? **Because it is not the experience, per se, that is important, but how people represent that experience internally.** How experts code their experience in their brain is the key to duplicating their success. You can duplicate the internal representations of top traders by duplicating their beliefs, mental states, and mental strategies.

Most experts are unconsciously competent at what they do. Your conscious mind, which is everything you are aware of at any given moment, is primarily concerned with those things that you cannot do well. Your unconscious mind, which is everything else in your mind, is in control of the things you generally do well. For example, most people are unconsciously competent at driving a car. You don't even think about driving, you just do it. When someone who is unconsciously competent tries to consciously explain what he or she is doing, much of what is important is left out. For example, most people are unaware of the fact that they steer a car by means of kinesthetic feedback and that they would have to totally relearn steering if only given visual feedback. My focus as a modeler is to discover the missing (unconscious) pieces and help people install those pieces in themselves.

Beliefs. Beliefs, the first factor, are a primary way that you filter information from the world. Beliefs are judgments, categorizations, meanings, or comparisons. They determine how we perceive reality and relationships in reality. What you expect (i.e., your reality) depends upon your beliefs which are largely unconscious.

Earlier I talked about the modeling project with rifle shooting. The information gathered about shooting beliefs was particularly revealing in terms of producing success. The two top shooters who were modeled, for example, believed that:

- Shooting well is important for survival.
- Hunting is fun.
- Mental rehearsal is important to successful performance.

- If I miss a shot, it has something to do with my performance.

When the two top shooters were in competition together, one of them always won. You could distinguish the one who usually won by his beliefs. For example, the best shooter believed that it was important to rehearse an entire 1,000 round match the prior evening, whereas the second best shooter only believed that mental rehearsal was important. In addition, the best shooter believed that it was important to hit the center of the bull's-eye on each shot (even though you didn't get extra points for that), whereas the second best shooter only believed that it was important to hit the bull's-eye. Can you understand why one was better than the other just from their beliefs?

Contrast the beliefs of the top shooters with the typical beliefs of new recruits coming into the Army. They might believe that:

- Guns are evil; they kill people.

- If I shoot this weapon very often, I might go deaf.

- If I miss the target, the gun is misaligned.

Perhaps you can begin to understand, just on beliefs alone, why the top shooters were so much better than the raw recruits.

Now think about seminars you may have attended in which you learned how to trade. Did the guru conducting the seminar teach you his beliefs? Some of the techniques he taught may have been part of his belief system (and they may not have been). He probably didn't teach some of his most important beliefs. In addition, you probably rejected other important beliefs—those that clashed with your beliefs. Yet without sharing that guru's beliefs, you could never duplicate his performance.

Mental States. The second aspect of duplicating top success is mental state duplication. This is what most of you call discipline or emotional control. If you ask people to list their trading or investment problems, they are of two types—problems they don't own and mental state control problems.

Problems that traders don't own consist of blaming the markets, blaming floor traders or locals, blaming insider trading, blaming brokers, or blaming systems for what goes wrong. We have a natural tendency to blame something other than ourselves for what happens. Society promotes it. Yet when you blame something other than yourself, you can continue to repeat the mistake because it was the result of something beyond your control. The best thing an investor can do, when things go wrong, is to determine how he or she produced those results. Now I don't mean blame yourself for your mistakes either. At some point in time, for any situation, you made a choice that produced those results. Determine what that choice point was and give yourself other options to take when you encounter a similar choice point in the future.

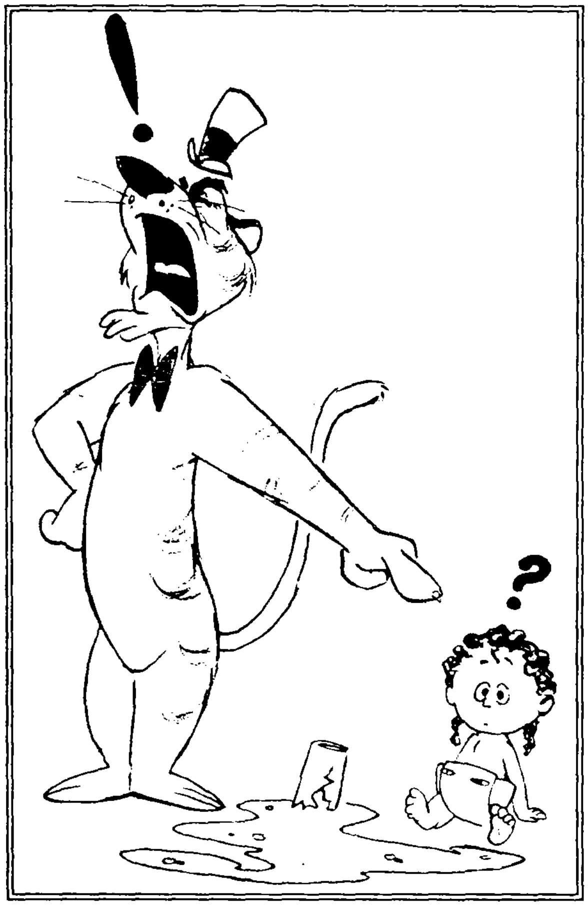


Figure 3-1 "We tend to blame others."

When people **own their problems**, they discover that their results usually stem from some sort of mental state. Common examples are:

- I'm too *impatient* with the markets.
- I get *angry* at the markets.
- I'm *afraid* at the wrong time.
- I'm too *optimistic* about what will happen.

These are just a few examples of mental state problems. Once you have a mental state problem, you can do something about it because this sort of problem is within your control. For example, go into a shopping mall and notice how other people walk. Duplicate a dozen or so walks for yourself and notice how your mental state changes with each one. The reason is because what you do with your body has a great impact on your mental state.

Controlling your mental state is not necessarily the magic solution to trading success. It's just part of the answer. But when you admit that the answer is within yourself, you've come a long way.

Mental Strategies. To understand strategies, you have to understand how people think. People think in their five sensory modalities, that is, in terms of visual images, sounds, feelings, and for some people, tastes and smells. These modalities of thinking are demonstrated for you throughout this course. Listen to Tape 1 for specific examples.

The five modalities of thinking are to mental strategies, like the alphabet is to a great novel or like musical notes are to a great symphony. It's not the elements, but the way in which the elements are put together that produces the work of art. A mental strategy is really the sequence in which you think. Many strategies produce garbage, but the right mental strategy will produce the skill of a top artist.

Let me give you two examples to try on for yourself as a way of introducing yourself to the concept of mental strategies. First, imagine that you have a trading system that gives you specific signals. Since most signals are visual, such as a particular chart pattern or certain signals on your computer, imagine that your system gives you visual signals. Now, try on the following strategy.

SEE THE SIGNAL

⇓

RECOGNIZE THAT IT IS FAMILIAR

⇓

TELL YOURSELF WHAT MIGHT GO WRONG IF YOU TAKE IT

⇓

FEEL BAD ABOUT IT

Could you trade effectively using that strategy? Would you even take the signal if you used it? Probably not! What would happen if you used this next strategy?

SEE THE SIGNAL
⇓
RECOGNIZE THAT IT IS FAMILIAR
⇓
FEEL GOOD ABOUT IT

Could you trade from the signal using this strategy? Probably so. So even though the two strategies are quite similar, they lead to quite different results in terms of trading. If you are following a trading system, you need a simple strategy like the last one in order to use it effectively.

UNDERSTANDING THE TASKS INVOLVED

Another critical aspect of modeling is to determine the different tasks involved in the behavior you want to model. You then need to know the beliefs, mental states, and mental strategies for **each** of the important tasks involved in the skill you are modeling. Unfortunately, most traders, even the best ones, don't know what those tasks are. When you ask them, you get responses like:

- "I don't really know. I trade when it feels right. It's mostly gut feel."

- "Well, I get up in the morning, and I do other things until the markets close, and then I turn on my computer and the data comes in via the modem, the computer cranks out an analysis, the orders go out to the brokerage network, and then I do other things. That's effectively what I do, what I do broken down into tasks."

- "The formula for what I do is to look for X, Y, and Z. When I see that pattern and the market hits my entry point, I get in."

As a result of such responses, I became very frustrated. What do these people have in common? What tasks are involved in trading?

In an interview in *Technical Analysis of Stocks and Commodities* (April, 1987) I mentioned the importance of knowing the different tasks involved in trading. That interview stimulated one of the people in my Super-

Trader Program to start thinking about them. He came up with a model which included seven different tasks. I've subsequently added three more for trading, two preparation tasks, plus what you do with your life when you are out of the market. This model is the starting block for understanding successful trading, and the complete model is included in the next chapter of this volume.

CHAPTER IV

THE TASKS OF TOP TRADING

In order to duplicate successful trading you need to adequately perform all of the tasks that are part of that success. To date, I have determined that top trading involves 13 different tasks. There are two preparation tasks, ten trading tasks, plus the all-important task of being out of the market.

PREPARATION TASKS

To become a successful trader you must develop a plan for generating low-risk ideas and you must attain the necessary self-insight to carry out that plan. Most successful traders learn these preparatory tasks informally through trial and error. This course is designed to take you through this preparation in the most painless, cost-effective method possible.

Developing Self-Insight. Self-insight is important because it allows one to capitalize on strengths and overcome weaknesses. For example, if you develop and refine certain market related skills (i.e., tape reading), then you probably ought to make use of those skills in your trading. Similarly, if you have difficulty making decisions because you are thorough, then you probably should use that thoroughness to develop and refine a mechanical system that you will be satisfied with and that will make decisions for you easily.

Most people are unaware of what they are trying to accomplish as traders. Our minds have a tremendous ability to produce what we want by focusing energy in the appropriate direction. However, when someone is uncertain of what he or she wants or has a conflict between several desires, then the result is usually "zero." Thus, every trader needs to develop congruent goals about what he wants from the market. Goal setting is a very important part of self-insight that is covered throughout the course.

People have a natural tendency to externalize issues. Rather than deal with the issue, we prefer to blame external factors and assume that we have no control over the issue. As a result, the issue will continue to resurface, often through market experiences, until we deal with it. Self-insight involves coming to grips with the real issues and taking charge of them. When you do so, then you can deal with the market rather than your personal issues. What I said in the first chapter is worth repeating:

> Most people tend to avoid working on themselves. It's too painful. Instead, the issue they have with themselves (e.g., security, self-worth, etc.) becomes an issue they have with the market (e.g., profits, losses, etc.)....[the trader] simply transfers his problem, transmutes it, and then has the same problem [but with a different external manifestation].

If you have trouble dealing with self-esteem, then you will probably transfer that issue to being unable to take market losses. If you decide you want a system to help you deal with the losses, then the system will just become the new problem. You will probably jump from system to system until you learn to deal with the primary issue—self-esteem.

Most traders, in my opinion, have some basic psychological issue(s) that they bring to the market. That issue generally stems from something that happened in the first five years of life. For example, the issue might involve self-esteem, dealing with early childhood fears, getting even with a parent, etc. Once a person deals with that particular issue(s), then following a low-risk game plan (if one is available) becomes easy. But as long as that issue remains, then the market is simply a place to play out some game and its real purpose is to teach the trader how to deal with his issue.

Developing A Low-Risk Game Plan. The other key to making money as a trader is to capitalize on low-risk ideas. Many traders have no idea how to make low-risk trades. Others know how, but they get caught up in the process of analyzing the market and forget that their purpose is to make low-risk trades. As a result, I recommend that all traders develop a **written** low-risk game plan. Both this volume and the last volume of the course will teach you how to develop such a plan.

Your game plan should be written, because it allows you to be precise. And when your plan is precise, you can determine whether or not you have any biases in your thinking and you actually can test the plan. You must do this sort of testing to determine whether or not your plan is "low-risk."

Most traders object to the idea of developing a written game plan. The most common objections being:

- I'm intuitive. How can I write that down?

- I hate following rules—that's something you impose upon kids. I'm an adult now.

- It's probably a good idea. I'll do it someday.

Lets explore these three objections:

(1) Intuitive trading occurs for several reasons. Many traders claim to be intuitive because they really don't know what they do. As a result, they are just inconsistent and haphazard. A **written** plan can do wonders for this sort of trader. Other traders, in contrast, must do a lot of visual interpretation (i.e., pattern recognition) which is an art form. This artistry is the intuitive aspect of their trading. If this description fits you, then the checklist form of game plan described in Volume 5 is perfect for you. Develop such a plan.

(2) A low-risk plan should have a set a rules that is developed during the planning process. Making money requires consistency which you get by following the rules you generate. Top traders play the game of trading by understanding that a mistake has nothing to do with making or losing money. A mistake is not following your rules! You need written rules.

(3) Businesses that thrive have a business plan. Trading is a form of business. Traders, in order to survive and thrive, need a low-risk, written trading plan. Develop it as you go through this course. Do not put it off!

THE TEN TRADING TASKS

The ten trading tasks are illustrated in Figure 4-1. These tasks may be somewhat different for traders with different time frames in the market. For example, "stalking" through "taking profits" will be circular for the floor trader or for the day trader who is in and out of the market many times each day. He may be "stalking several low-risk ideas", while

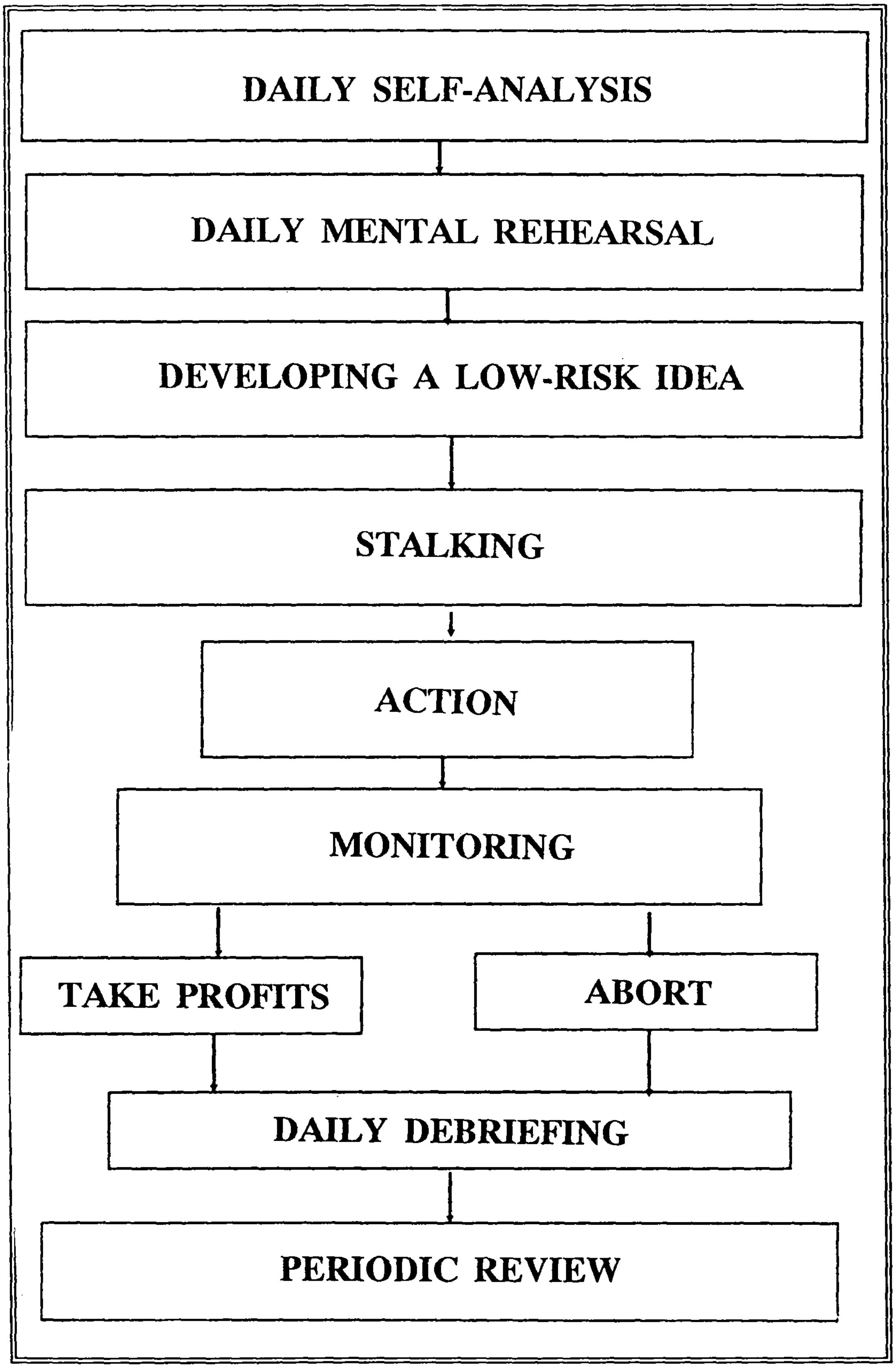


Figure 4-1 The Ten Tasks of Top Trading©

"monitoring" several others, and "aborting" a third trade. However, he still should ideally begin each day with certain daily tasks such as "mental rehearsal" and "self-analysis." On the other hand, the longer term trader is more likely to spend several months allowing a low-risk idea to develop and to "stalk" the idea for a week or more before acting. However, each day he is likely to do self-analysis and mental rehearsal.

These ten tasks fit the metaphor of a hunter, a predator, or a warrior. For example, in his book, *The Art of War*, Sun Tzu points out that **battles are won before they start**[1]. Think about the implications of that statement. In the case of trading, it means that your mental state and preparation virtually determine whether you will win or lose in a given trade before you even open the position. Perhaps that statement is a little strong, but I believe that your mental state and preparation determine whether you will win on the average. The statement also points out the importance of the first stage of successful trading, a task called **self-analysis.**

1. Daily Self-Analysis. Successful trading is 40% risk control and 60% self-control. In turn, the risk control portion is one half money management and one half market analysis.[2] Thus, market analysis is only about 20% of successful trading. Yet most traders emphasize market analysis while avoiding self-control and de-emphasizing risk control. To become successful, traders need to invert their priorities.

Trading involves human performance, and that performance can be objectively measured in terms of profits and losses. You can't hide from your performance record. Your performance is either profitable, breakeven, or losing. Since <u>you</u> are the most important factor in *your* performance, doesn't it make sense to spend time analyzing yourself? The best traders do it subconsciously. You will probably be one step ahead of them if you make a conscious effort to begin each day with self-analysis.

Stressors, or anything that detracts from your performance such as a cold or illness, are going to impact upon your trading. What if your normal performance is breakeven and you have a cold which reduces your performance by 10%? Suddenly, you're going to start losing money. Even if your typical performance is profitable, if some stressor reduces it by 10%, then you might find yourself at breakeven or losing money. As a result, you are better off staying away from trading until you eliminate the stress from your life. Yet if you don't spend some time analyzing yourself prior to trading, then you are likely to trade out of habit. And if you

Figure 4-2 Self-Analysis

do trade under these circumstances, then you'll wonder why you suddenly start losing.

Numerous people find that their best trades are the hardest trades to take. You generally go against the crowd in the best trades. As a result, when most people believe you are wrong with enough conviction to be in the market, and you're around a lot of them, it's very hard to go against them. As a result, people who trade in a crowd perceive their good trades to be "hard trades."[3] Let's assume that for you the hard trades are the big winners. How do you know if a trade is hard, or whether you are simply not in the mood to trade? You don't. Self-analysis allows you to distinguish between the "hard" trade and those times when you make the trade seem hard.

You might do self-analysis in several ways. The easiest method is to develop a rating scale going from 1 to 8, with 1 being poor and 8 being great. A sample rating scale is illustrated below:

HOW I FEEL TODAY

1 2 3 4 5 6 7 8

POOR GREAT

At the beginning of each day, spend about 30 seconds meditating. Go inside yourself and determine how you are feeling that particular day. Rate yourself on the scale, with 1 being your worst, 8 being your best, and 4 to 5 being average. For a month or so, compare your trading performance with your morning ratings. You will find that trading may not be worthwhile unless your rating is above a particular level. When you discover what that rating level is, make a rule not to trade unless your self-rating is above it.

An even more effective way to conduct self-analysis is by means of a parts analysis. The concept of parts is described in some detail in Volume 3 of the course. In essence, I find the belief that we are composed of parts, most of which are in your unconscious mind, to be useful. You might think of your parts as your various roles in life, although they are probably more extensive than that. Each part is formed to carry out some positive intention. For example, you might establish a part to protect you or to increase your security, to help you make money, to have fun, to bring love into your life, to bring excitement into your life, etc. Since most of these parts are unconscious, you are not aware of them. In fact, you probably don't pay attention to any of them. As a result, each part simply finds behaviors to fulfill its intention. Those behaviors are not necessarily in your overall best interest, since the behaviors of one part often will conflict with the behaviors of another. For example, if a part wants your attention, it will produce some signal to get that attention. If you ignore the signal that it gives you, it will produce a more dramatic signal. This process continues until it finally gets your attention. Unfortunately, many traders do not respond to these signals until they become very dramatic such as extreme anxiety or a major loss.

People can learn to determine what parts are active and how to communicate with those parts easily. What happens is that once parts know that you are willing to pay attention to them, then they do not have to produce dramatic signals to get your attention. Self-analysis, using the parts model, amounts to a short dialogue with your parts in the morning. It might simply amount to asking yourself, "Does anybody (i.e., any of your parts) need anything?" while you pay attention to any signals you get. Be sensitive to a range of internal cues. Your parts might communicate by means of a voice, a visual image, or a feeling of some type. Be open to such signals throughout the day.

When you do this process every morning, it only takes 15 seconds to a minute to complete. Furthermore, the parts dialogue method of self-analysis has an advantage over the self-rating method in that if you have a problem, you can deal with it immediately by finding an appropriate way to meet the needs of the part in distress. In contrast, if you just give yourself a poor rating without knowing the source of the problem, then all you can do is not trade.

Most people begin to understand their parts after they repeatedly listen to the first tape in this course and follow the directions. Give yourself some time. Your parts might not trust you, because you've ignored them for years. Developing trust may take time. If this procedure does not work, then I can usually help people learn how to do a parts analysis through several telephone consultations.

Self-analysis, when practiced regularly, can make an immense difference in your trading. If you do it, we think you will be amazed at the improvement in your trading results.

2. Daily Mental Rehearsal. One of the most important activities to improving almost any form of human performance is mental rehearsal. Trading is no exception. Remember how important mental rehearsal is for top shooters. The top shooter in the world rehearsed every single shot that might be necessary in a shooting match. The second best shooter believed that rehearsal was important, but he did not rehearse the entire match. Most shooters, in contrast, do not even practice mental rehearsal. Similarly, most traders fail to practice mental rehearsal. How about you?

Top Athletes—from professionals to Olympians—mentally rehearse their performance prior to acting. For example, Billy Casper, one of the best golfers on the PGA Senior Tour, almost never three-putts a green. Casper claims that he learned to putt in almost total darkness and that experience taught him to really concentrate on the internal image of the putt he is attempting to make. Extreme concentration on his internal mental image is what makes him one of the world's best putters.

The rehearsal task allows you to pre-plan how you will carry out any of the trading tasks so that the actual task is automatic. It allows you to anticipate problems and develop appropriate solutions to them. And most importantly, mental rehearsal helps you avoid mistakes. Nevertheless, there are appropriate and non-appropriate ways to do the rehearsal.

One of my clients uses a planning log for his next trading day. One entry he showed me went something like this:

> Tomorrow will be *hell.* I will be tempted to trade—probably from both sides of the market and probably several times. In addition, the market is due for a big swing tomorrow and they will try to grab my stops. It'll be a real test of my mental state control.....

His plan anticipates problems, but from the wrong framework. He is actually programming himself for a day of "Hell." Typically, you get what you program yourself to get. Instead, he could have said the following:

> Tomorrow will have some interesting challenges. The market may come close to my stops. That is part of the game of trading. I will stick to my rules and practice mental state control throughout the day.

In this second form of mental rehearsal, he is anticipating the same events. However, the events are **challenges**, not "hell." More importantly, he is rehearsing carrying out his plan and following his rules, despite potential challenges. As a result, his rehearsal will be very effective.

A client in my Super-Trader Program performs his mental rehearsal by listening to a 60 minute tape each day. He has made tapes covering most of the important tasks in this model. Each tape includes a description of the task and the appropriate mental state, as well as music and poetry to help him achieve the correct mental framework for the task.

3. Developing A Low-Risk Idea. The predator must know the location of his prey, the water holes used by his prey, and the habits of his prey. Once he knows that information, the predator can relax until the prey appear. The next stage in the model, as a result, involves **developing a low-risk idea**.

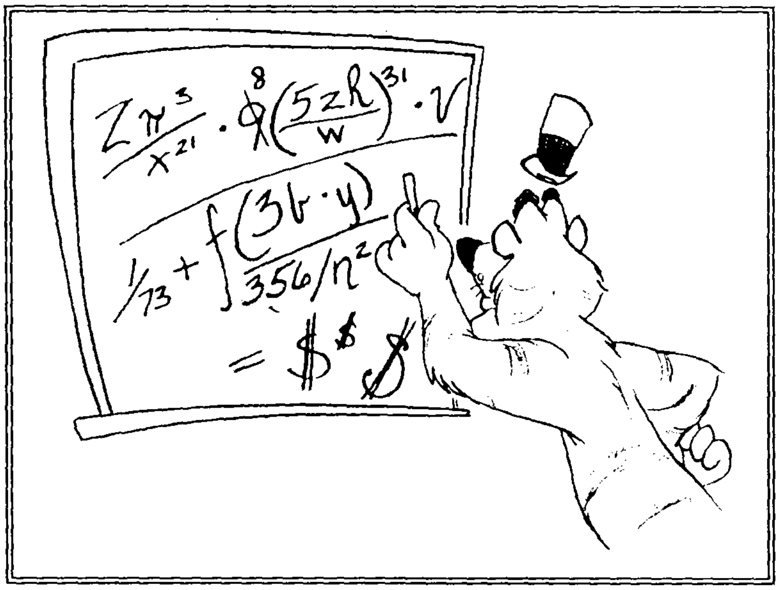


Figure 4-3 Develop a Low-Risk Idea

I initially called this task "market analysis." However, one of the best traders in the world told me that market analysis for most traders amounts to building a straw house. They collect data about the markets; they look at different patterns of charts and specific market indicators; and they even make predictions about the future direction of the market and then focus on trying to help those predictions come true. However, they don't consider the probabilities of winning and losing or the amount that might be won or lost. In other words, what most traders do in terms of market analysis has nothing to do with making low-risk trades. Hunters like to build straw houses, but that activity has nothing to do with catching prey. It amounts to spending time and energy on what you think is important, while you avoid the really important issues. Building a straw house has more to do with giving you a false sense of security. Your straw house might indicate where you live and dictate the boundaries of your territory. In that sense, having a straw house is important.

A fundamental principle of modeling is that those elements which are important to a skill will be present in everyone who performs that skill at a top level. In contrast, elements which are present in one person at the top of a skilled area, but not in another, are probably idiosyncracies. Since successful traders analyze the market in different ways, the type of analysis one does is not that important as long as it helps to minimize the risk taken. In addition, since there are countless examples of successful traders training other people in their methodology yet not being able to transfer their success, the methodology per se must not be a critical aspect of that success. What top traders **all** do, on the other hand, is develop a low-risk idea. If your market analysis focuses on developing a low-risk idea, then you are performing a useful task in terms of making money as a trader.

Most traders analyze the market in order to predict prices. Predicting prices has little to do with successful trading. What is important is determining when the risk is overwhelmingly in your favor and then controlling that risk (i.e., through the next five tasks in the model). You have already learned that the development of a written game plan for generating low-risk ideas is a critical task in preparing to become a top trader. The last chapter of Volume 5 of the course gives suggestions on how to design such a plan based upon your own temperament. Risk control is the topic of the second part of this volume.

There are several subtasks to **developing a low-risk idea**. The first subtask involves **gathering data** (i.e., recording the high, low, opening and closing prices; the volume; the advance decline ratio in the stock market; sentiment indicators; etc.). It involves transferring information into your charts, your computer, or your tables. Other subtasks involve **creative brainstorming** and **determining the risk behind those ideas**. We are exploring these subtasks in more detail, and we will provide a further update when more information is available.

Most traders gather data and jump to a conclusion at the same time. For example, if you have a bearish bias, then most of your trades will tend to be on the short side—even in a major bull market. When you interpret data you begin to form an opinion which will strongly influence any subsequent operations that you do. Be objective and dispassionate while you are doing the analysis. Complete the entire data gathering phase of market analysis before you brainstorm. Once you have generated a number of ideas, determine the risk behind each idea. Don't jump to conclusions until the entire sequence is complete.

Avoid the opinions of others while you are developing your low-risk idea. The thoughts of others can easily result in you jumping to a conclusion prior to completing your own analysis. In addition, other people are usually wrong, so you do not want to accept the crowd sentiment. The only exception to this rule is if you know someone who accurately signals market turns by his euphoria about the market continuing a move. If you know such a person, then consider using that person's reaction as one of your sentiment indicators.

Document the development of your ideas. This documentation will provide you with valuable information in some of the later tasks that you will need to do, such as your daily debriefing and your periodic review.

Once you have a low-risk idea about how to trade, you must take that idea to the market. Thus, the next task in the model is "stalking" your idea in the market.

4. Stalking. Imagine the following scenario: You have developed an idea that you think has little risk and you want to open a position. You have two choices. You could just jump into the market or you could attempt to find the best possible price by becoming a day-trader. The essence of "stalking" is to find the best possible price for entry. Thus, stalking is another form of risk control.

Think about the predator after its prey. Have you ever watched a young cat chase a bird? It sees the bird and then runs after it. The young cat gives the bird a lot of warning, so it has little chance of catching the bird unless the bird flies right into it. Contrast the young cat with the mature cat. The mature animal stalks the bird. It waits until the bird gets close enough so that the kill is almost certain. At that moment it pounces. The mature cat will expend little energy unless it knows that there is a good chance of success.

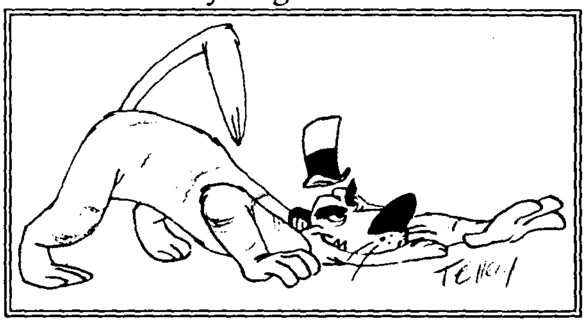


Figure 4-4 Stalking

Top traders love the hunting metaphor to describe what they do. One of them, for example, claims he is like a cheetah. The cheetah can outrun any animal, but it still stalks its prey. It won't attack until it is right on top of its prey. In addition, the cheetah usually waits for a weak or lame animal to get close. Another top trader told me that he trades like a lion. He watches the herd for weeks until something <u>other</u> than his presence causes the herd to panic. When the herd panics, he then chases a weak or lame animal that appears most confused. The difference between an average hunter and a really skilled animal like the swift cheetah or the cunning lion is that the skilled hunter waits until the odds are overwhelmingly in his favor.

Stalking means making sure the odds are even more in your favor by paying attention to the smallest time frame possible for you. This means that you must narrow your focus to find the best possible entry price in the day (e.g., by selling an intraday rally or buying on an intraday decline). Steidlmayer's Market Profile® was designed for this purpose, but other technical signals[4] will give you the same information.

Stalking is difficult for most people because it requires a mental state that is totally different from the mental state required in the next task, the action phase of trading. The mental state for stalking your idea involves a broad focus, a slowly moving time frame, and a strong intensity.[5] These qualities are a distinct contrast to the mental characteristics that most people have when they have developed a low-risk idea about the market. Most traders, after analyzing the market, are energized and ready to act. By doing so, they don't miss an opportunity, but they also increase their risk because they are rehearsing action rather than responding to actual market conditions.

When you are "stalking," you need to get into the flow of the market. Become sensitive to a range of cues! The market is sending you numerous signals if you pay attention to them. Learn how to read and interpret those cues. One of my clients, a long time frame trader who only puts on occasional trades begins the stalking task by paper trading a position in the opposite direction of the one he is planning. This helps him develop "finger-tip" feeling for the market. At the same time, he knows that the best time to get out of his paper trade is also the best time to open his planned position.

5. Action. The action stage only takes an instant. But to perform it correctly, you must be aggressive, bold, and courageous. You just do it. The trader must have quickness, accuracy, and a narrow focus of attention—concentrating on getting the trade off accurately and quickly. He must be quick or he will miss the opportunity. And he must be accurate, or he might find himself with something other than his prey.

The action phase of trading must be strong and intense. A weak response will not get the job done, because it lacks the necessary commitment. Imagine what would happen if a lion or tiger fails to go all-out when it attacks its prey. The answer is obvious. It would go hungry.

Action involves commitment to entering a market position. If the trader has completed the first three tasks, then he knows the consequences of this commitment. He knows he is ready. He knows the maximum loss he is willing to tolerate and the potential profit. He knows that the risk is overwhelmingly in his favor, and as a result, the commitment is easy to make.

When action is appropriate, reflection, second guessing, and delays are inappropriate. You should have reflected on the consequences of your trade in the tasks prior to the action stage. When a trader thinks about consequences at the time of action, he cannot act with abandonment. The action stage is a time for prompt, courageous action.

Figure 4-5 Action

Similarly, the action stage needs to be very accurate. Both you and your prey are moving rapidly. If you are not extremely accurate, then you are likely to miss. You may even get hurt. Accuracy should not be problem, however, if it is carefully practiced and rehearsed in advance. For example, write down your order ahead of time. Read it to your broker in a clear firm voice. Have your broker read it back to you after you finish and at the time of confirmation.

The contrast between the requirements for the "stalking" task and the "action" task is so dramatic that many traders cannot make the abrupt shift. They are either energized and prepared to act or they are cautious and wary of any action. As a result, they either take the trade immediately and increase the risk of the situation, or they concentrate on getting the best possible trade and end up getting nothing.

6. Monitoring. Once a trader has a position in the market, he must monitor that position. In a sense, the hunting metaphor breaks down for monitoring. Imagine a tiger attacking a buffalo. Monitoring would occur at the split second the tiger lands on the back of the buffalo. He must instantaneously decide to either make the kill or to abort because the buffalo is bigger and stronger than he is. Fortunately, traders have a longer time frame to make the same decision about the market.

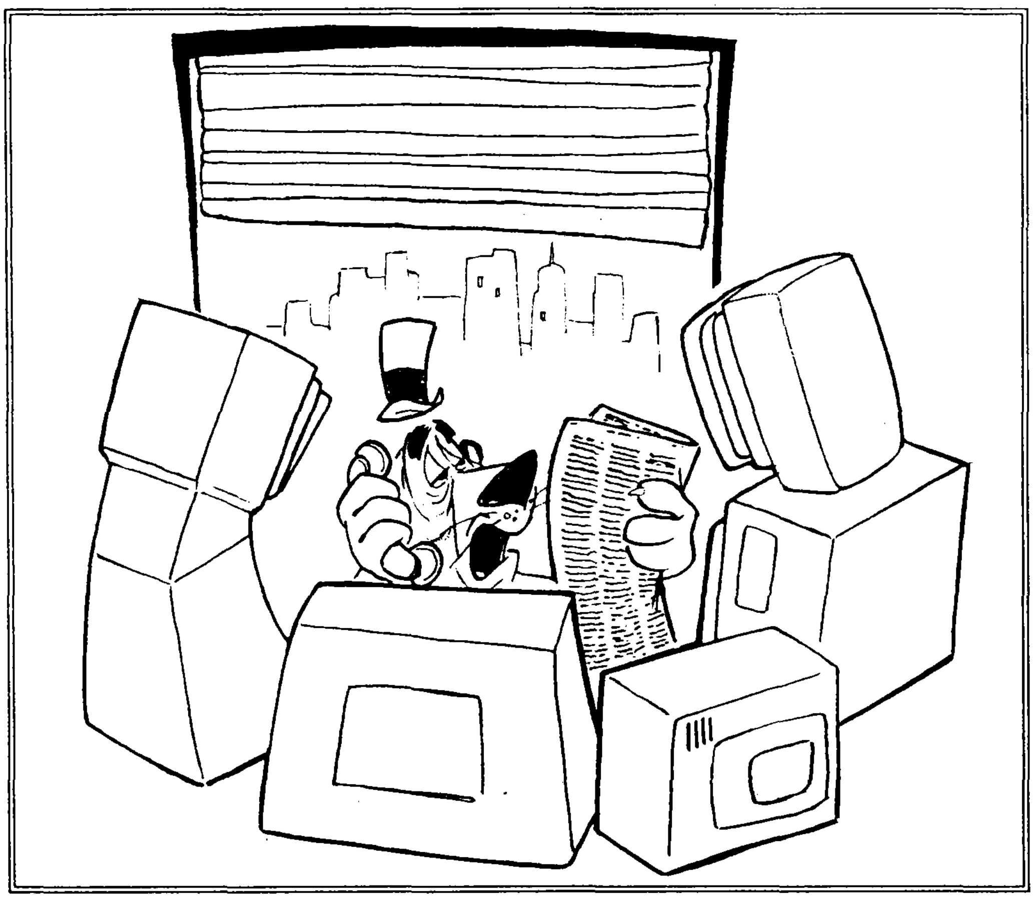


Figure 4-6 Monitoring

The nature of the monitoring task depends upon the trader's time frame for keeping his position. For a top day-trader, the stages of stalking, monitoring, taking profits,· and aborting are somewhat circular. Day-traders may take several positions each day and may do all these tasks together. The constant need to shift mental states between tasks is one reason that so many people lose money day-trading.

A top position trader, in contrast, will wait for exceptional opportunities and then allow them to unfold. As a result, the monitoring process is more relaxed for the position trader. Nevertheless, complacency can destroy even the longest term trader.

Monitoring may consist of two subtasks, especially for the longer-time-frame trader. The first subtask, **detailed monitoring**, is similar to stalking. It involves paying detailed attention to the pulse of the market while getting ready to take action by adding to your position, by aborting, or by taking profits. On the other hand, when the market is moving comfortably in your favor on a long-term time frame, the trader can step back from the market into more of an "overview" position. Thus, the second subtask might be called **overview monitoring.**

Detailed Monitoring. Detailed monitoring begins as soon as one opens a position. If you correctly stalked your position, then the market should move in your favor soon after you open it. If it does not, then you probably do not belong in that position. As a result, a trader needs to pay close attention to the fine details of the market. He should be alert, vigilant, and suspicious.

I frequently recommend that my longer-time-frame clients rate their position three times a day for the first three days according to "how easy it feels". A typical scale might look like the one illustrated below:

Easy   Neutral   Hard

↑______↑______↑______↑______↑______↑______↑

"How Easy Does It Feel" Scale

Use a scale similar to this one at the beginning, middle, and end of each of the first three trading days. If the position does not feel "easy" by the end of the three day period, then it probably is a bad trade for you to be holding. On the other hand, if it is easy to hold, then you can probably switch to "overview monitoring." If you trade around other traders and are influenced by their opinions, then a good trade might feel "hard" because you are holding it against the crowd. If this is the case, then reverse the rules given above.

Switch back to detailed monitoring only when action of some sort might soon be necessary or for a periodic check of your position. You might, depending on your time frame for the trade, switch back to detailed monitoring once each day or once every three days.

Overview Monitoring. During overview monitoring, the trader broadens his focus and steps back from the market. He is looking at the forest instead of the detail of the trees. When a trader is in the overview phase of monitoring, he is more detached and objective. He is more patient and calm. He focus is much broader and his time frame is slower.

The worst mistake that one can make during the monitoring phase is to rationalize and distort data according to expectations. The purpose of monitoring the market is to pay attention to market signals. The trader who interprets signals according to his expectations is not performing this task adequately.

During overview monitoring, the trader is simply surveying the conditions. He is comparing market events as they unfold with his plan and his knowledge of what various market events mean. If everything is going according to his plan, then monitoring can remain a detached and relaxed process. Some traders give away big profits simply because they are unable to relax when the markets move in their favor. You don't get rich, as a rule, taking a dollar profit. On the other hand, if events do not unfold according to plan, then the trader needs to focus on the details of the trade (i.e. switch to detailed monitoring).

The monitoring stage is a form of risk control. If a trade is good, then it should be easy to hold because it is moving in one's favor. When the market moves in support of your position, the trader can change his stop level to decrease his risk or even lock in a profit. On the other hand, if nothing happens, if the market behaves unexpectedly, or if the trader is uncertain, then he should get out or, at minimum, reduce his exposure to a loss by reducing the size of his position.

7. Abort. The two stages which occur after monitoring are action-like stages much like the task of opening the position. These stages are "abort" or "take profits." One could argue that these stages involve "searching for the right opportunity to act" and "acting." On the other hand, since many traders search for the right opportunity during the detailed monitoring phase, we simply call these "action" stages.

Developing a low-risk idea and marketing your idea allows you to plan risk control. **Planning your risk is not nearly as important as execut-**

ing your trades in a manner in which you can **actually control your risk**. In executing trades, the golden rule of trading, "*Cut your losses short and let your profits run,*" comes into play. Controlling risk involves aborting and taking profits under the appropriate conditions.

Figure 4-7 Abort

Most successful traders have one or more of the following three beliefs about aborting a position:

1) If the market is going against you, then that is the most critical time to get out. You can't afford to lose big. Some traders enter a position with a stop and get out when the stop is hit. However, other traders expect the market to go in their favor as soon as they open the position. If it does not, then they get out. **The issue of when to get out depends upon the maximum amount of loss you are willing to tolerate.** However, if your best trades immediately go in your direction, then when you open a position and the market starts going against you, don't wait for your stop to be hit. If it's going against you, then it's not the trade for you. Get out! Limit your risk.

(2) When the original reason for a trade no longer exists, get out of the market. And when you are uncertain, get out.

> One of my clients, for example, had a problem with uncertainty. He said "I don't know what to do when uncertainty comes up. You haven't described uncertainty in your books and I don't know how to handle it."
>
> I responded, "What percentage of your trades make money?"
>
> "About 40%", he said.

> Then I asked, "When you're uncertain, what percentage of those trades make money?" He couldn't remember ever making money when he was uncertain, so I said, "If you're uncertain, just get out." Rather than trying to control your uncertainty, treat it as a valuable signal about what you should do.

(3) When time is against you, you probably should be in a better position, so get out. Many of the people reading this course are speculators, as opposed to floor traders or commercial traders. **Your primary advantage to trading is that at any particular time you don't have to be in the market.** Use that advantage! Enter and stay in a position only when it is fully advantageous for you to do so.

Aborting involves a quick, accurate, and very focused mental state. Once you determine, through the monitoring process that it is appropriate to get out of the market, then you must immediately shift mental states to abort properly. If the predator decides that the prey he's selected is inappropriate (i.e., it's too big and strong for him), then he retreats quickly. A quick retreat allows him to survive to hunt again another day.

A quarterback can sense if the play is going to work out as soon as he gets the ball. If he senses that he is in a "busted" play, then he needs to do whatever is necessary to keep from losing ground. He may just throw the ball out of bounds just to make sure that he doesn't lose yardage. What's important for him is to have the best possible position when the next opportunity comes. He doesn't want to lose ground.

If you have trouble aborting a position, then look at "pro" and "con" scenarios together. Allow the evidence against your position to unfold and then allow the evidence for your position to unfold and compare the two pictures together in your mind. If the evidence is against your position, then simply call it a **bad trade** and get out.

8. Take Profits. Many traders claim that their game plan emphasizes trade entry but not trade exit. As a result, they argue that they do not make enough profit on each trade. If you have not thought about trade exit prior to opening a position, then you have a problem with your game plan because you have not adequately calculated the risk involved in the position. If you've calculated risk properly, then you should know two elements ahead of time: 1) your chances of being right on that trade and;

2) the size of your potential profit versus your potential loss. See the expected value formula on page 80. If you don't have that information (at least generally), then you still need to work on your game plan.

Figure 4-8 Take Profits

A properly-designed low-risk game plan will give you optimum profits within your comfort level for trading. Thus, the task of maximizing your profits should simply be one of following your plan. For example, if you have a plan that gives you a 50% return each year and you maintain that record year after year, compounding your profits, then you will be one of the best traders in the world. Some of my clients have designed plans that give them three digit rates of returns each year. As a result, all it takes for any of them to become one of the best is to avoid self-sabotage by becoming too greedy or too fearful. If you concentrate on anything other than maintaining consistency, then I believe your concentration is misplaced.

Top traders have four primary beliefs about taking profits. Taking profits is equivalent to the predator's kill. When the predator acts, he must be quick and decisive. Thus, the first belief is that if market conditions change so that your reason for your trade no longer applies, then take your profits. Avoid being greedy. Just react to the signals provided by the market.

A second belief about taking profits is to do so when the market reaches your objective. Be patient and allow the market to move toward the target. If you set your targets at extreme levels, then you probably don't give up much by taking your profits at those levels. In most cases, market conditions will probably change before your target is reached, so you can get out simply by acting when those occur. If the market hits your target, however, I recommend that you take profits by continuing to move your stop[6] closer to the market price as the target is reached. Wait for the market to take you out. If the market keeps moving rapidly in favor of your position, then you have no reason to take profits.

A third belief about taking profits is that one should do so if market volatility changes dramatically, thus altering the risk parameters of the trade. Volatility typically increases when a market becomes popular and mass hysteria exists. Although a lot of profit potential may exist in that market, the risk is much greater compared to the potential profit. As a result, increasing volatility after you're in the market might be a good reason to take profits.

Bear market moves are often climatic, and that climatic portion of the move may go past your target area. However, if you wait for the climatic portion of the move to end, you might get whipsawed in the opposite direction as soon as the move ends. As a result, the fourth belief is that when such a move occurs, you should take profits immediately.

9. Daily Debriefing. The ninth task in the model is a **daily debriefing**. Most good traders do it, either formally or informally. I think a daily debriefing is essential for consistent, top performance. It provides an important transition period between trading and being out of the market.

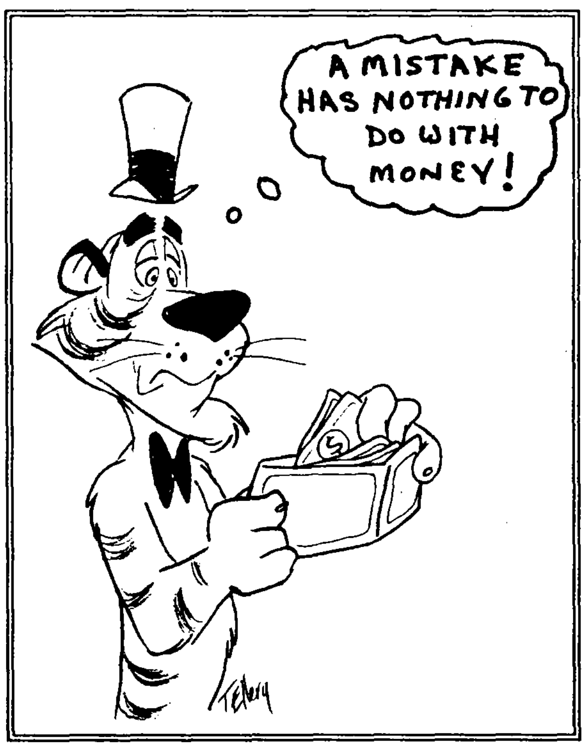


Figure 4-9 Daily Debriefing

The idea behind the daily debriefing is to determine whether or not you made a mistake during the day. A mistake, however, has nothing to do with losses. **A trading mistake means not following one's trading rules and one's plan of action.** In fact, traders should pay special attention to mistakes made while making money. Just because a predator chases its prey though an area filled with quicksand or tar without getting stuck, doesn't mean that it is safe to do so again. The LaBrea Tar Pits in Los Angeles contain the bones of many more predators than prey, because numerous predators made the mistake of going after the other animals caught in the tar.

Look at your written trading rules and the written notes you made when you were developing your low-risk idea. What can you do if you made a mistake by not following your rules?

- First, avoid self-recrimination—telling yourself that you "should have" done this or you "could have" done that. Instead, resolve not to repeat that mistake again.

- Second, replay the trade in your mind. Prior to making that mistake, you reached a choice point. At that choice point, you had a number of options available to you.

- Third, mentally go back in time to that choice point and review your options.

- Fourth, for each possible option, determine what the outcome would be if you had taken it. Be sure that you give yourself at least three good choices and mentally rehearse them. Some generals are known for fighting the strategies of the last war. Those who do usually lose the battle. Always give yourself as many choices as possible, so that you don't get stuck with limited options or a forced choice.

- Fifth, once you've found at least three options with favorable outcomes, mentally rehearse carrying them out in the future when you encounter similar situations. Once you've practiced them in your mind, you will find that selecting one of them is easy when you encounter a similar situation in the future.

Tape 3 of the course contains an exercise that is specifically designed to take you through the mistake correcting process. Whenever you decide during your debriefing that you have made a mistake use Tape 3 to help you develop other choices for similar situations in the future.

When you do follow your rules, pat yourself on the back at the end of your debriefing. If you followed your rules and lost money, then pat yourself on the back twice. You may have lost money this time, but in the long run following your rules will make you money. Mistakes, on the other hand, will not result in long term, consistent profits.

Once you have analyzed your day's trading, summarize it in writing. Write down your mistakes and your new choices for that situation. This written information will be very important when you begin the next task of doing a periodic review of yourself and your game plan for trading.

The daily debriefing shouldn't take more than 5 or 10 minutes, so do it every day. It is one of the most important tasks of the ten part model. Get through it. Then put the trading day behind you, because tomorrow is a new trading day.

10. Periodic Review. The tenth task in the model is a periodic review of what you're doing. Markets change and you change. As a result, you

Figure 4-10 Periodic Review

need to be sure that your rules are still appropriate for both you and the markets. In addition, once you develop a sound business plan, I don't recommend that you change your rules on the spur of the moment or without a thorough review. The day you do your periodic review is the time for rule changes. It's also a time to be away from the market. You cannot objectively review yourself and your rules while you are actively involved in the markets.

How often you need a periodic review depends upon your time frame for trading. If you make several trades (or more) each day, then you need to review your rules every three to four weeks. If you trade three or four times each week, then a periodic review is necessary every three to four months. If you trade several times each month, then a semiannual review is appropriate. Finally, if you trade less than once a month, then an annual review is probably sufficient.

When you do your periodic review, first go through your written debriefing statements. Once that information is fresh in your mind, go through your entire business plan step by step. The workbook which you receive with the **Annual Update Program** is designed for this purpose. You need to review your trading diary and determine your strengths and weaknesses. You need to review your system using the criteria given in Volume 5 of the course. You also need to review your trading rules and your daily procedure. Give yourself a whole day to do a periodic review. It is an important part of maintaining consistency.

THE TASK OF BEING OUT OF THE MARKET

I have saved the most important part of the model until last—taking care of yourself when you are out of the market.

Top traders who last lead
well balanced lives.

To understand the importance of how you live your life when you are "out of the market," consider the parts model discussed earlier in the self-analysis section. You've created a number of parts with various needs. All of your parts have good intentions. ***If you do not take care of your needs when you are away from the market, then your parts will act to fulfill those needs while you are in the market.*** If you don't play or add excitement to your out-of-the-market life, for example, and part of you desires those aspects of life, then you're going to get those needs met while you're in the market. Getting those needs met while you are in the market will not make you money in the long run. I guarantee it. As a result, you must deal with the needs of your parts while you're out of the market.

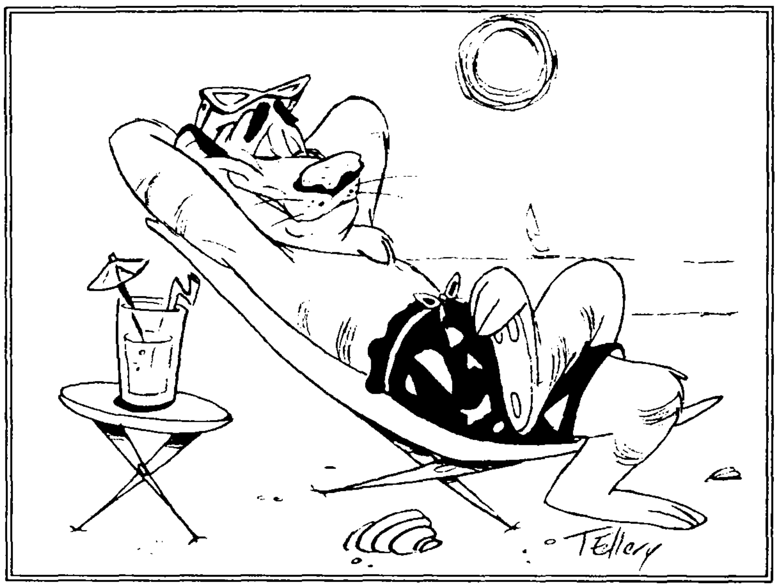


Figure 4-11 Out of the Market

You might argue that "out of the market" is not a trading task. Yet it is the most important task for trading success. If you ignore important aspects of your life when you are out of the market, you will have trouble ignoring those aspects while you are in the market.

Many people want to be in the market to avoid personal issues. You cannot escape personal problems by trading in the market. What happens, unfortunately, is that the market magnifies those problems. A compulsive gambler is probably the best example of how failure to deal with personal issues can result in market disasters.[7]

One of the course subscribers called me, saying that he couldn't follow my suggestions in the course. He couldn't bring himself to trade most of the time. When he did trade, he did the opposite of what he really wanted to do. He also told me that the material in the course didn't seem to help him in solving his personal problems. In addition, during our conversation he also told me that he only had $5,000 with which to trade commodities and he had been trading for over nine years with no nest egg and never more than $5,000 in his trading account. I recommended that he immediately suspend trading and seek help in solving his personal problems which I believed to be serious. *Traders with serious personal problems cannot trade successfully because they will bring those personal problems to the market.* I also recommended that once he had solved those problems that he continue to stay away from the market until he had enough capital to trade with—in his case, about $50,000. Once he had solved his personal problems and raised enough money to trade effectively, he had a chance to become a good trader. Although my advice would have saved him thousands of dollars and would have given him the opportunity to become a successful trader, I doubt if he took me seriously.

Consistent, top traders keep their lives in balance and that makes trading fun. In addition, they also seem to realize their overall purpose in life. Predators are helpful to the whole system. They weed out the weak members of their prey and in doing so strengthen the herd. As a result, they serve a very useful purpose. Similarly, strong traders serve as predators for weaker traders and weed them out of the market. As a result, they strengthen the markets by their presence. As long as you keep that perspective in mind, then you can continue to have success. Traders who have a lot of initial success tend to lose that perspective. They suddenly believe they are bigger than the markets. As a result, the market teaches them humility by wiping out most, if not all, of their capital.

Many traders will make a lot of money at some time in their trading lives and then give it back. Why? Because they don't keep the overall ecology of the system in mind. They use the markets to prove something to themselves that has nothing to do with trading. What happens to them? They ignore their overall purpose. They increase their trading dramatically or, if they are big enough, they try to corner the market (as the Hunts tried to do with silver) and fail miserably. As a result, they lose everything and are forced out of the market.

Being out of the market means BEING OUT of the market. It's important to exercise, take a vacation, and even take a break during the day. And when you do those things, do not take the market with you. When you start worrying about trades that you might have missed and a thousand other possibilities, you are like a puppet on a string and the market is pulling your strings. If you take the market with you, then those parts of you that wanted the vacation or the break will disrupt your performance during those times in which you need to give your full attention to the market. Remember:

You don't have to catch every move!
There is always another opportunity!

Serious traders when they are out of the market also participate in gatherings. The tribal hunters do their war dance together to prepare for the hunt. I've also noticed that traders tend to gather with traders of an equal calibre to tell their war stories. Average traders gather with other average traders. Good traders gather with good traders. And the few top traders in the world also tend to know each other, and they meet together. The result of these gatherings is that traders tend to remain at their current level, because they reinforce each others beliefs about trading. Beliefs are critical in determining one's level of performance in the market.

I have emphasized low-risk trading repeatedly in this chapter. The remainder of this volume is devoted to helping you understand and incorporate the psychology of risk-taking into your trading game plan and into the execution of that plan. In addition, I suggest that you review the information in this chapter frequently.

PART TWO

UNDERSTANDING AND USING RISK

CHAPTER V

A BRIEF LOOK AT RISK

Not risking is the surest way of losing. If you do not risk, risk eventually comes to you. There is simply no way to avoid taking a risk. David Vicott, M.D., Risking, p. 20-1.[1]

People take risks every day. Driving to work constitutes a risk, since more than 50,000 people are killed in automobile crashes each year. Staying at home in bed, with one's head underneath the covers, is just as big a risk, since by doing so a person will miss out on life. No matter what we do, we risk. The secret of taking a risk successfully is to do so prepared.

Being prepared to risk requires a person to know thoroughly the risk involved. Understanding risk is difficult, because the topic has so many dimensions. Consider the risk of trading. Trading risk is defined objectively as the variability of performance of invested funds that go up and down in value.[2] In addition, each trader has a subjective concept of risk which may have little relation to performance variability.[3] Instead, subjective risk has more to do with the fear that a person attaches to a particular activity.

RISK IS SUBJECTIVE

My wife and I went on a helicopter ride over the big island of Hawaii and flew over a bubbling lava lake. My wife was **terrified** and asked the pilot why he risked his life every day. What if he crashed? What if lava suddenly spurted up and hit the helicopter? The pilot said he felt that what he did was safer than driving a car and then commented, "You have to take some risks in your life!" My wife could not understand that. Meanwhile my wife teaches in an inner city school in Los Angeles in an area replete with gang shootings (e.g., a 16-year old boy was killed on the school playground where she works in 1989) and a high crime rate! She goes to school every day and she enjoys it. She also commutes 25 miles each way during rush hour on Los Angeles freeways. She doesn't enjoy that, but she still does it.

People consider commodity trading to be a high risk activity because most commodity traders lose and, as a result, they fear it. This is a common, subjective assessment of commodity trading, which equates risk with the probability of losing. Yet is Joe, the commodity trader described below, a risky trader?

> Joe has investment capital of $400,000. Most of his money is invested in T-bills, stocks, and real estate. However, he reserves about $50,000 for commodities. In the eyes of many people, Joe's involvement with futures makes him a big risk taker. Joe loves the excitement of investing and might even agree that he is a risk taker, but Joe mostly considers himself to be a competent professional. Joe devotes much time to futures investing and has developed a disciplined plan. He manages his money well. He always uses stop loss orders, which he adjusts when he makes a profit. He never invests more than 15% of the money in his futures account, yet he tries to invest in several commodities at a time.
>
> Joe controls himself. The market does not control him. His futures portfolio is usually profitable over any 12-month period and his total portfolio usually shows a gain of 0.8% to 1.4% per month.

Joe might be a "risk taker" by many subjective criteria. He trades commodities. He trades in ways that most people would never consider. He is willing to take chances when the outcome appears to be in his favor. Remember that the second task of successful trading is to develop a low-risk idea. Joe is willing to change and give up the status quo. Most people would be terrified to "risk" their money the way Joe does.

In contrast, if we define risk objectively as the variability of his investment performance, Joe assumes little risk. Joe's portfolio generally increases in value with only a small amount of variability. Joe does everything in his power to reduce his objective risk.

He develops low-risk ideas, then successfully "stalks" those ideas, and he controls risk by his actions. Joe is very disciplined and he constantly works on himself. Since some futures contracts are quite independent of more traditional investments, they make excellent vehicles for diversification. Thus, even investing a portion of his money in the futures market helps Joe reduce the variability of his portfolio and his exposure to risk. Objectively, Joe assumes very little risk.

Now let us look at Jim, another commodity trader.

> Jim only trades in futures. He has lost a lot of money speculating over the last few years, and he is not willing to admit that he is a loser. He feels a sense of desperation, and believes that highly leveraged contracts provide the only way for him to make a big killing. He knows he is afraid to keep more than $3000 in his account. As a result, Jim figures that he has little to lose. Jim only trades in one commodity at a time, putting up the minimum margin. His broker tries to put stop losses on orders, but Jim often resists strongly. Jim is afraid his stops will be "picked" off on the floor. Jim loses big every year, but the more Jim loses, the more determined he becomes to make up those losses.

Jim is afraid of himself and of life. Changes terrify him, which is part of the reason that he consistently loses. He is afraid to put much money in his account for fear of losing it. He is also afraid to really study the markets for fear of investing too much at a time in a losing cause. Most of all, Jim is afraid to stop trading in commodities because that would mean he would never get his money back. Although Jim is a little uneasy about his trades, he does not feel that he is a risk taker. Jim thinks he is afraid of high-risk situations. In reality, he does not understand the concept of risk.

When Jim's risk taking is viewed objectively, he has a high probability of losing all the money he has. He seldom has a winning month in the market. Jim's portfolio is highly variable and he has a 100% probability of ruin. Jim might be described as someone who is afraid of change and is **unprepared** for the risk that will come to him.

Most people are like Jim. They simply follow their natural inclinations as traders, and, in doing so, feel that they are avoiding risk. These natural inclinations lead them toward heavy losses. They prevent people from getting out of a losing activity before it becomes a disaster.

One time I appeared on MoneyTalk, a popular call-in television show on the Financial News Network at the time. One viewer asked me to comment on the differences between short term speculators and long term investors. I had seen no differences between speculators and long term investors in my studies of winning and losing investor characteristics, so that is what I said. There are losing speculators and long term investors who continually create disaster for themselves. Similarly, there are winning speculators and long term investors who continually win. The primary difference between speculators and long-term investors seems to be the time in which it takes to win or lose.

I was amazed at the reaction to my answer. Neither the host not the hostess seemed willing to accept my response. "But, Van, you know what he means. Speculators are much more "go-go" people—there must be a difference in terms of risk seeking?" I searched for an answer, but, in my opinion, most of the successful speculators I had worked with were not big risk takers. For example, you have already learned that one of the ten tasks of successful trading is to develop a low-risk idea and that many of the tasks aim to reduce risk. At the same time, I know of many unsuccessful stock investors who, in my opinion, take horrendous risks. They have no idea that trading involves developing and stalking low-risk ideas. "No," I said, "even in terms of risk taking there is very little difference between speculators and long term investors. Most short-term traders who continually win, take very little risk, while long-term investors who win also assume little risk. In contrast, losers—whether speculators or long term investors—assume a lot of risk."

Later, as I watched a videotape of the show, I could see that some of the controversy came from different definitions of risk. People assume, for example, that commodity trading is risky because most people lose; whereas investing in stock is less risky because fewer people lose. The second part of that statement is debatable—stock investors may just take longer to lose. The probability of losing in an investment medium is just a subjective definition of risk. That is, it seems as if most people lose so the medium must be risky. The objective definition of risk, in contrast, is performance variability. For example, a top trader might consistently take low-risk ideas and regularly make 10% per month. If a top trader's performance is *consistently* good, then he takes little risk from the objective viewpoint. In contrast, poor traders will not search for low-risk ideas. Their performance will be erratic at best, and, as a result, their account variability (i.e., risk) will be high.

I was a little confused at this point, even by my own thinking, and I needed to study the psychological literature on risk taking in depth. At the time, I did not know about the ten tasks of trading or how to develop a low-risk trading game plan. I just knew that top traders are not heavy risk takers. The remainder of this volume is the result of my initial study into the psychology of risk.

THE LOSS TRAP

A very powerful, hidden trap lurks within the risk process, which I call the **loss trap**. The rest of this volume gives specific exercises to illustrate how vulnerable we all are to the loss trap. It presents four objective procedures to help the reader decide when his risk level is too great. And it provides specific guidelines for sound money management.

Its basic message is that:

YOU MUST MAKE IT OKAY TO LOSE, IF YOU WANT TO WIN!

Most of us are taught that winning is everything or the "only thing." We can imagine the top football coaches telling their players that they must win. Yet when a team becomes defensive and concentrates on avoiding a loss, the team typically loses. How about the business executive who tells employees that they must win if they want to survive. In those situations, when winning is everything, people are likely to lose. When my son was eight, he was able to understand this lesson with respect to his soccer games. When his team was behind at halftime, and it was not okay to lose, then the team becomes fearful of losing and is even more likely to lose. But when it is okay to lose, the team can perform at peak level and still have a chance to win.

Taking losses goes against all of our cultural training. The loser is not respected. The loser feels as if he or she is somehow inferior. Yet if there is one secret to becoming a winning speculator, it is "TO MAKE IT OKAY TO LOSE." You are playing a game and losing is part of that game.

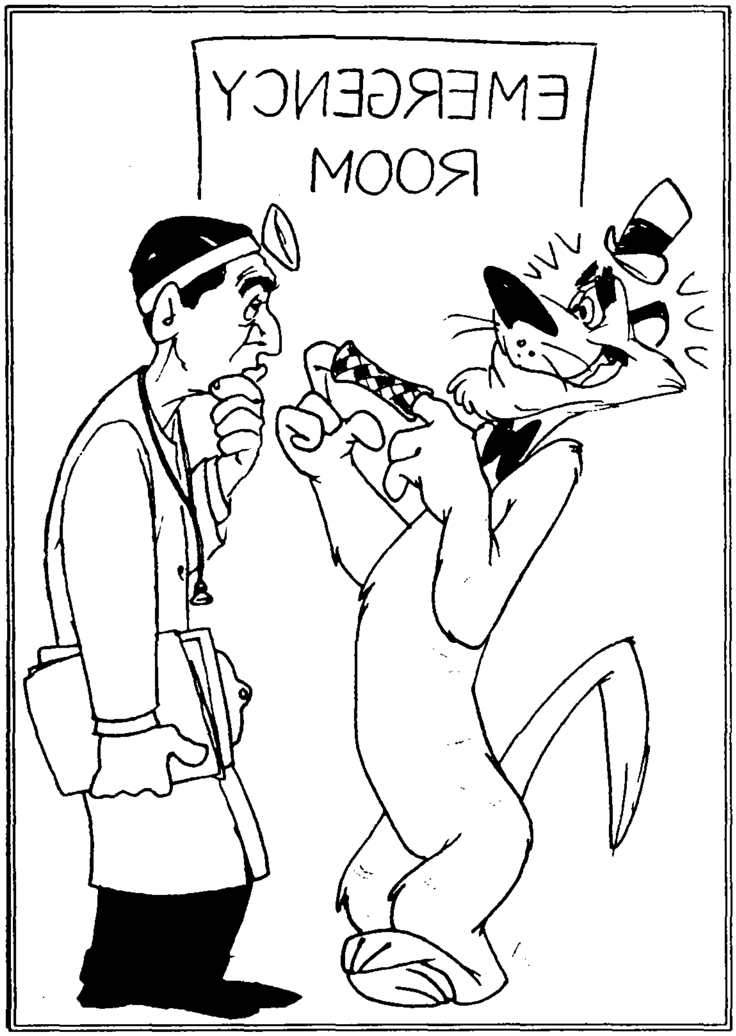


Figure 5-1 "Getting Out of the Trap"

The loss trap is similar to a toy that many of us played with as children—the Chinese Finger Trap. This toy is a four-inch woven straw cylinder, with an opening at each end just large enough for a finger. Once you insert a finger in each end, you are in the trap. The harder you try to pull to get out, the tighter the cylinder compresses around your fingers. Only when you let go and relax does the trap let go of you.

Similarly, the more a trader resists a loss, the tighter the loss trap becomes. Hidden factors keep him deep in the jaws of the trap as he struggles with the loss. The more the trader resists the losses, the more difficult it is to get away from them.

Consider someone who wants to make a killing in a speculative stock. First, he pays $5000 for some stock, including nearly $200 in expenses. Because these transaction costs start the investment off at a loss, the trader is already in the trap. He has passed a critical point in time, the point of no return, where thinking often becomes irrational and "risk" takes on its real meaning.

Soon, the stock goes down in value to $4300. The trader thinks to himself, "I have a loss, but it will turn around." These are normal thoughts, resulting from his natural inclination to justify his stock purchase. As a result, he reasons, "I can afford to lose a few hundred dollars more to make a nice profit." When people are in the loss trap, they avoid the sure loss and take an unwise gamble which often leads to greater losses.

The stock goes down further, so that our friend only has $3800. Now he has a considerable loss.

Somehow, he reasons, the stock has gone down so far that it cannot possibly go down any more. Therefore, he can afford to risk a few hundred dollars more to make back his stake. The trader has now lost sight of his original profit goal, if he had one, and now wants to just break even on this trade.

What happens? The stock goes down to $2500. Our trader cannot give up now. He has "spent" $2500 on this investment. His stock must have bottomed now, so the risk of holding on to the stock is minimal—so he thinks. He holds on to his trade, and soon only has $500 left.

Each possible loss that our trader envisions is compared against what has already been lost. Each time he imagines that his stock has reached rock bottom, he can envision no further risk. It can only go up. He already has so much at stake that he might as well just continue to hold it. And with each loss the trap gets tighter. Unfortunately, **the only way to get out of such a trap is *to let go*.** Often, the trader is financially dead before he gets out of the trap.

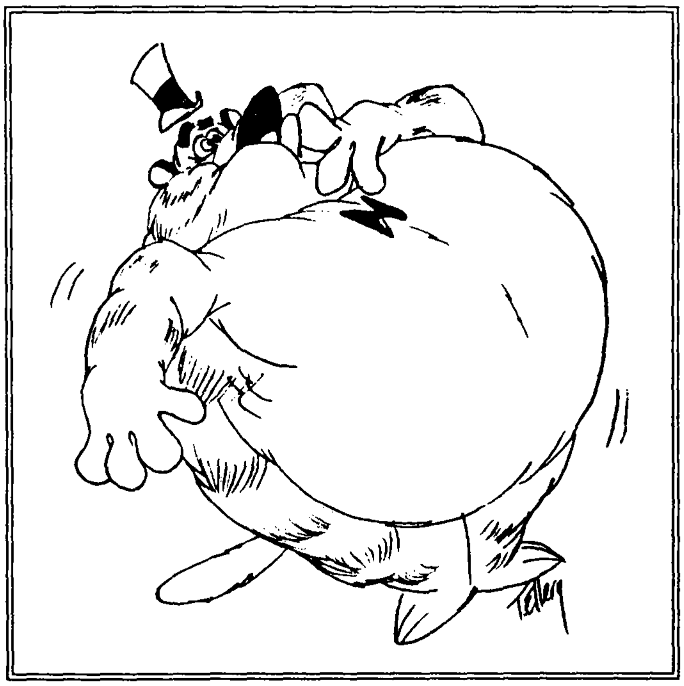


Figure 5-2 "Willing to breathe in, but not breathe out."

Remember what the old trader said in the chapter on commitment.

> "It's very difficult to trade if you're not willing to lose. Almost impossible. It's like wanting to be alive, always willing to breathe in, but not willing to breathe out."

The trader who can take little losses, because it is okay to lose, can compensate for them with big wins. But the trader who finds losing unacceptable will not take losses when they should be taken. As a result, the small loss becomes a big loss and the big loss becomes a disaster. Few people can survive this kind of activity for long. Yet if they could just make it okay to take losses when they come, winning would become much easier.

In the next chapter you will learn how the loss trap forms. In Chapter VII you will learn how to objectively measure risk and in Chapter VIII you learn how to control risk by properly managing your money.

CHAPTER VI

PSYCHOLOGICAL ELEMENTS OF RISKING

"Each of us has a psychological map of the real world. All of our maps differ, each corresponding to the real world in some ways but not in others. Whenever our maps differ from the real world and we act as if they did not, we get into trouble....Ironically, the less seriously a trader takes this problem, the more serious the problem is for him." Fred Gehm[1]

If you want to be a losing trader, then follow a simple rule:

HANG ON TO YOUR LOSSES AND WATCH THEM GROW

This rule is so simple that most traders manage to follow it every year. They are lured by the promise of fantastic profits for little work, and step right into the loss trap.

At least five factors are involved in the loss trap. These factors are:

(1) **Framing** guards the loss trap and keeps us from seeing it for what it really is. Traders have three primary "frames" of reference which either lead them to the loss trap or keep them in it: a) the "loss is not a loss" frame; b) the percentage frame; and c) the criterion frame. A trader, for example, might perceive the price of a trade which has gone down a lot to be at "rock bottom". This is an example of the percentage frame.

(2) **The need to explain** what is happening sometimes keeps people in the loss trap. Traders develop superstitions which they cling to despite numerous losses. Superstition may relieve anxiety, but superstitious behavior is too rigid to produce market success. In addition, traders look for social confirmation of their beliefs—either from experts or by confor-

ming to what most people believe. Consensus opinion is seldom correct, and the validity of financial expert opinion is questionable.

(3) **We are overconfident about our market activities.** Our need to believe we are correct and to justify what we are doing often leads to self-deception and keeps us in a losing situation. Most traders would rather be right than make money. Thus, a trader holds on to a losing position rather than admit the purchase was a mistake.

(4) **We place more value on probability changes near certainty (100%) or impossibility (0%) than we do on similar magnitude changes in the middle of the probability scale.** In other words, we abhor the sure loss, preferring the unwise gamble of holding on to a losing investment which usually leads to even bigger losses.

(5) When traders commit themselves to a position, wise plans may become "fuzzy-headed" logic at the **moment of commitment.** Irrational behavior that develops at this point in time often leads to big losses.

These five factors are discussed in detail in the remainder of this chapter.

THE FRAMING OF LOSSES

Each situation in life may be viewed from a number of perspectives, each producing a different way of "perceiving" the situation. This phenomenon is called *framing*[2], since each situation is viewed with a different frame or viewpoint. Framing is illustrated by the story of a farmer who could not accept the "frames" that his neighbors held about events in his life:

> An old world farmer was consider to be well off by his neighbors because he had a horse, a plough, and a strong son. But one day the horse ran off. All the neighbors came to visit and exclaim how unlucky the farmer was. The farmer just said, "Maybe." Three days later the horse returned, bringing with him two wild horses. The neighbors rejoiced at how lucky the farmer was, but he just said, "Maybe." During the next week, when the farmer's son was trying to tame one of the wild horses, he fell off and broke his leg. The neighbors all exclaimed how unlucky the farmer was, but the farmer just said, "Maybe." That week-end soldiers came to the village to recruit young men for

> military duty. When they saw the farmer's son with his broken leg, they rejected him. The neighbors now knew that the farmer was lucky, but he just said, "Maybe..."

The story of the farmer is important because it illustrates that the most widely held frame, the one usually held by the neighbors, is not necessarily the correct frame.[3] Some common frames can be disastrous for traders. These are the frames that support the loss trap, including: (1) the "loss is not a loss" frame; (2) the percentage frame; and (3) the criterion frame.

The "Loss is Not a Loss" Frame. Many money decisions involve a loss that is framed as something else, making it seem less painful or even acceptable. A $600 insurance premium is a *sure loss*, but most of us do not consider it as such. One might argue that it is not a sure loss compared with a $10,000 accident bill, but that argument just supports the frame. The insurance company might pay off your $10,000 bill, but they will not give you back your premium. You have just limited your loss to $600, but you still have a *sure loss* of $600 whether the accident occurs or not. I am not suggesting that you avoid insurance. I am just using insurance as a prime example of the "loss is not a loss" frame.

Picture the retailer who features his "cash discounts" in the newspaper and radio commercials. Would you be as attracted to the same retailer if the company stated that "If you pay cash, you avoid our 4% credit card surcharge." The two are equivalent, but the cash discount is an attractive way of framing the credit card surcharge (i.e., the sure loss) so that it seems to be part of the regular price.

How does this "loss is not a loss" frame apply to trading? Consider the following decisions and check the item that best describes your feelings:

> (1) Would you find a $200 expense acceptable if it gave you a 60% chance to win $350 and a 40% chance of no gain?
>
> ____Yes, it is an acceptable risk.
> ____No, it is not an acceptable risk.
>
> (2) Would you take a risk that gave you a 60% chance to win $150 and a 40% chance to lose $200?

____Yes ____No

(3) Do you find decision one to be more or less acceptable than decision two?

____More Acceptable ____Less Acceptable

You may have decided that decision one was an acceptable risk. After all, you could win $350 and you would not lose anything except your expenses.[4] Decision one is commonly made by traders whenever a moderate gain is sought on a trade involving $200 in transaction costs.

How did you feel about decision two? Perhaps it did not seem as good. You only had a chance to win $150, and you could lose even more. Losing more than you can win is not that acceptable. Thus, if you are like most people, you find decision one much more acceptable than decision two.

Look at the two decisions again. Mathematically they are equivalent. The apparent difference is that a loss is framed as an expense in decision one, while it is framed as a loss in decision two. When the $200 in expenses is considered as a loss—**and it is a loss**—the $350 gain becomes a $150 gain and the no gain becomes a $200 loss. If you realized that decision one and two were equivalent, congratulations. Hopefully, you are just as perceptive when real money is at stake.

Some people may have calculated the expected value of the two investments. The expected value is the amount one can win (W) times the probability of winning (PW) less the amount you can lose (L) times the probability of losing (PL).

$$\textbf{Expected Value} = (W \times PW) - (L \times PL)$$

For both decisions:

$$\begin{aligned}\text{Expected Value} &= (\$150 \times 0.6) - (\$200 \times 0.4)\\ &= \$90 - \$80\\ &= \$10\end{aligned}$$

Thus, both decisions are acceptable risks over many trials, since you will make $10 on the average each time you decide to take the risk.

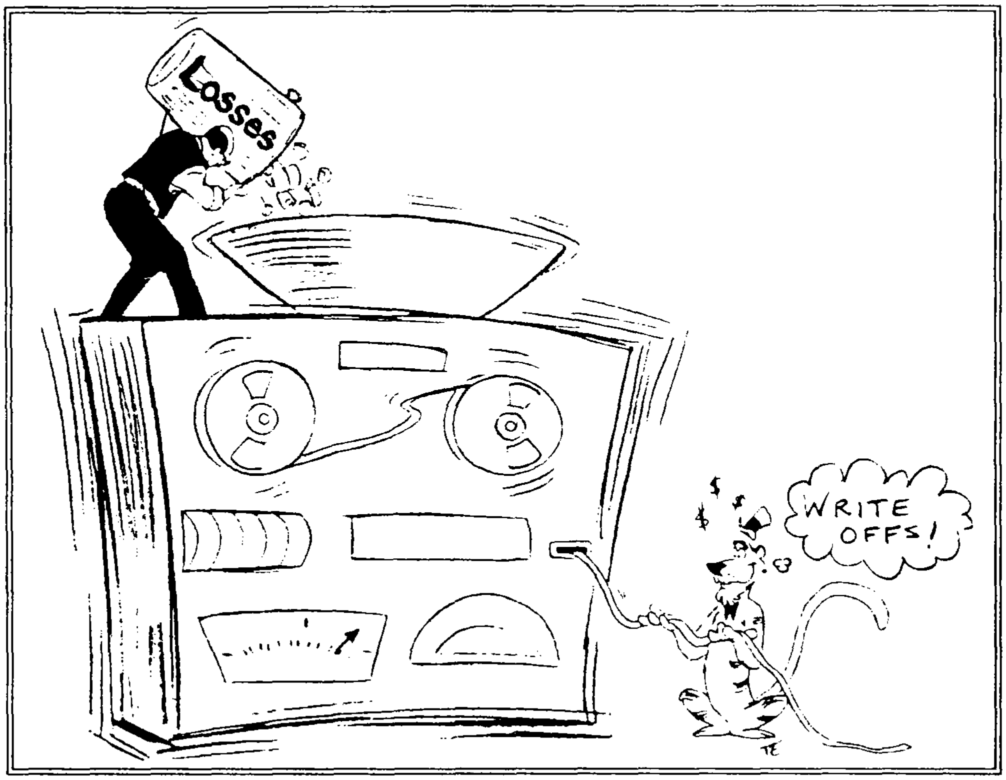


Figure 6-1 "Tax Write-Offs"

Traders also frame losses as tax write-offs. Many traders do not keep a running total of their gains and losses during the year. Those who do keep their records up-to-date may not include commissions in those records. Investment expenses such as trips and newsletters certainly are not considered to be part of those losses. Around April 15th the expenses and losses are given to the family accountant. The accountant promptly feeds them into a computer and cranks out "Tax Write-Offs." Those cannot be bad, can they? They might put you into a lower tax bracket and allow you to get some money back from the government. (Notice how I frame paying less taxes as "getting money back from the government.")

Tax write-offs of this nature are losses framed as something else. They help keep you in the loss trap. You stay with a losing situation, because tax write-offs help you perceive your losses as desirable. You stay with a losing situation (i.e., in this case, a very poor investment strategy) because you do not totally recognize the loss for what it is.

If these exercises have shown you that you frame losses as something else, you will find the exercises in Chapter VII useful. The worksheets are designed to help you frame losses as losses.

The Percentage Frame. Framing is also important with respect to the cost of an item. Many people will drive across town to save $5.00 on the purchase of a $20 article of clothing. They would not dream about driving across town, however, to save $5.00 on the cost of a $500 appliance. Yet the saving is exactly the same and the cost of driving across town (which might be more than the $5.00 saved) is exactly the same. Somehow the added miles and time seem worth a 25% savings, but not worth a 1% savings, even though both savings are $5.00. As a result, high ticket items have a lot more pricing variability between stores because people are much more concerned with the percent saved than with the actual dollar cost.[5] This is the percentage frame.

The percentage frame is important to traders. One is much more likely to tolerate a $500 loss on a $10,000 position (5%) than a $500 loss on a $2000 position (25%). Before transaction costs are figured into each $500 loss, the two losses are equivalent!

The loser with large losses can use the percentage frame to turn his losses into a catastrophe. For example, consider someone who has a $5000 loss which appears to have bottomed. He is quite willing to risk a few hundred dollars more (which he perceives to be the maximum risk) to recover his money. This "small risk" seems even more attractive and the "bottom" seems even closer, as the losses increase, because the percentage frame becomes more effective. The percentage frame, as a rule, just allows losses to grow.

Brokers effectively use the percentage frame in promoting options. Options are a means of having a highly leveraged investment with "limited" risk. Options are an excellent way of controlling risk if they are used as insurance or to add income to a portfolio. But many traders use all of their assets to buy options. Each option is considered only a "small risk" (the percentage frame again), and the risk appears to be limited—limited to 100% of everything invested. We have seen more people pile up losses from "limited risk" options than from highly leveraged commodity contracts.

Commodity traders are less likely to use the percentage frame in a single trade—at least after one or two disastrous results. The trader who keeps a losing contract with no protection could be ruined by the losses on a single contract. Yet commodity traders have three methods of using the percentage frame on a single position—by buying back a contract in which they are stopped out; by meeting margin calls; and by hedging or using a spread[6] to avoid taking a loss.

All types of traders/investors apply the percentage frame to their trading strategy. They do so by failing to see a losing strategy as a losing strategy. A trader may have lost $100,000 over three years, leaving only an emergency savings account of $5000. When the $5000 is framed against a $100,000 loss, it seems paltry. As a result, the trader is willing to "risk" his last $5000 in a desperate attempt to make back his losses. Even this act of desperation may not be the end of the loss trap. Some traders go heavily into debt before they finally let go.

The best way to recognize a losing strategy as one is to periodically calculate your success rate. Detailed procedures and guidelines for doing so are given in Chapter VII.

The Criterion Frame. You may have noticed several examples in this

Figure 6-2 "In the loss-trap, you forget your original goal."

chapter of traders who change their trading criteria as a result of losing. People get into the loss trap, only to forget their original goals. Suddenly, the trader's goal is just to recoup losses. He reasons that he is not asking "FATE" for much—just to make back what he gave away. The "paltry" goal, however, may amount to a return of 2000% on his remaining capital. The trader may become desperate and irrational, because the goal is unattainable. A trading criterion is a framework for behavior and as the criterion changes, so does the behavior.

What kind of criteria do you have for selecting a trade? Determine whether you use each of the following trade selection criteria regularly and consciously by checking "yes" or "no" on the lines beside each criterion.

Trading Selection Criteria

	YES	NO
1) Intrinsic value	____	____
2) A high probability of winning	____	____
3) A large payoff	____	____
4) Low probability of losing	____	____
5) Limited total loss	____	____

Do you apply one or more of these criteria on a planned and regular basis to your trades? Are you definite about which criteria you use? Perhaps you had not considered that the five items above were different criteria.[7]

Now consider the two gambles below and check which one you would prefer to make?

> BET A: A 90% chance to win $400 and a 10% chance to lose $200.______

BET B: A 30% chance to win $1600 and a 70% chance to lose $200.______

Most people, when given a choice between these two bets, pick A. People look for the highest probability of winning when they pick between alternatives. Since 90% is much higher than 30%, most people pick bet A.

Now assume that you owned two lottery tickets—one corresponding to bet A and the other corresponding to bet B. Someone offers you $250 for one of the tickets. You need the money and have to give up one ticket, so think about this decision carefully. Which one would you be more likely to sell?

A______ B______

The criterion frame has now shifted for the second question. Your criterion is now value. People look at the possible payoff when they consider value. $1600 is a much better payoff than $400, so most people would sell (i.e., check) bet A.

If you responded like most traders, you preferred bet A over bet B, but you were more likely to give up bet A for $250. Doesn't that seem a little strange? Value and preference apparently are not the same for you.

If you do not have definite trading selection criteria, you may pick different trades under similar conditions on different days. Your lack of decisiveness may lead you into the loss trap.

Some of you may have calculated the expected value of bets A and B, using the formula given on page 80. If you did, you probably discovered that both bets have the same expected value of $340. You may have thought that the two exercises were pointless, but in the real world of trading, you may not have an "expected value" to use as a frame. Thus, you may also pick different positions as your arbitrary selection criteria change. Think about it!

EXPLANATIONS INFLUENCE LOSSES

A friend of mine works for a large computer company. He told me that his company expects to be producing computers with massive memories in the near future. He explained that one reason such massive memories are necessary is because economists are demanding them. Economists, it seems, feel that they need information from every business and government in order to predict the economy accurately.

If economists have trouble predicting the economy now, they certainly have difficulty predicting market prices which often depend on the economy. Extensive research suggests that the future prices of stocks, bonds, and commodities are not predictable—at least from past prices.[8]

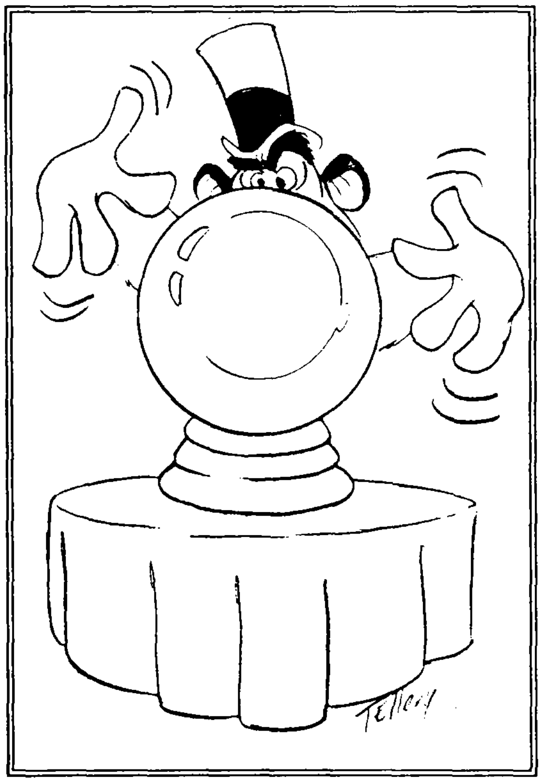


Figure 6-3
"Predicting the Market."

Although economists used to think that market price changes were random, and now they are not sure, traders continually hear about market success stories. Many theories exist to explain how these successes are achieved. Table 6-1 gives a short listing of some current theories, many of which are untested or, in some cases, even valueless.

Every trading strategy we can think of involves the application of one or more of these theories. There are many different trading tools and strategies. You should not accept a basic theory and then assume that a particular tool of that theory automatically will work. Each tool should be thoroughly tested using, at minimum, the procedures suggested in Chapter VII, and the guidelines given in Volume 5. In addition, remember that the second task of trading is to develop a low-risk idea. Thus, you must be able to measure risk (using the expected value formula) and to generate low-risk ideas. Most traders emphasize market analysis which for most of them is building a straw house.

1. FUNDAMENTAL ANALYSIS — believes that trades have an inherent, determinable value that is often incorrectly appraised by the marketplace. The trader wins by identifying discrepancies.
2. TECHNICAL ANALYSIS — believes that the market works perfectly and that "all that is known" is automatically reflected in its price. The trader wins by spotting patterns that indicate supply and demand changes.
3. CYCLIC ANALYSIS — believes that numerous cycles, caused by unknown forces, control market prices. The trader wins by correctly identifying where the market is with respect to the important cycles.
4. CONTRARIAN THEORY — believes that other market theorists create consensus information that is frequently mistaken. The trader wins by identifying what "everyone else" is doing and then trading in the opposite manner.
5. MISCELLANEOUS THEORIES — believe that there is some phenomenon in the cosmos that relates to market prices. The trader wins by thoroughly understanding the phenomenon and using its relationship to the market to predict prices.

TABLE 6-1 Some Common Trading Theories

for most of them is building a straw house.

Although the validity of many market systems is questionable, people generally open positions with *no overall system* to guide their behavior. More importantly, if they have a system, they have no idea what sort of risk they are taking. In other words, the system is not used to generate low-risk ideas. Instead, they develop odd behavior patterns with respect to their market activities or they look to others for advice.

Superstitious Behavior. Some traders develop consistent behavior patterns with respect to the market that might be described as superstition. One might, for example, believe that trades executed at 11:47 AM EST have a 20% greater chance of being successful than trades made at any other time. As a result, the trader attempts to open positions at 11:47 AM.

The more risk a person perceives in a situation and the greater the stake on the game, the more likely the person is to practice some superstitious behavior.[9] A high risk situation has a lot of uncertainty, and the superstition tends to function to reduce the anxiety associated with uncertainty. Since trading frequently involves high risk and high stakes, many traders practice superstitious behavior.

Psychologists, who first studied superstitious behavior in pigeons, found that birds who were given food randomly would develop strange and repetitive behaviors to "obtain" the food. One pigeon might make a complete circle and then bob his head once. Another might peck at a spot on the wall of his cage. A third bird might stretch his wings and flap them.[10] These superstitious behaviors were characterized by their *repetitive patterns* and by their *persistence*. If food delivery were stopped, for example, the pigeon might repeat the same behavior pattern 10,000 times before stopping.

Superstition may reduce trader anxiety, but it also produces losses. Trading success requires flexibility, because the trader must adapt to different market conditions. Superstitious behaviors are rigid. The same pattern persists over and over again, regardless of the consequences. The trader who buys at 11:47 AM is not very flexible, and as a result, enters the loss trap. The behavior is difficult to give up, since it does reduce the anxiety of the uncertain situation. Trading at 11:47 AM EST may have produced one big gain, perhaps followed by a string of successes. But the behavior has no real relationship to market prices so success does not continue. Since the behavior is a superstition, it continues. The trader is locked in the loss trap.

Social Reality. Leon Festinger[11], a well known social psychologist, has shown that people rely on other people to help them understand vague, uncertain situations. If many people believe the same thing, other people will follow. When a situation is uncertain, people look to other people for advice. The greater the uncertainty, risk, stake, and thus anxiety involved, the more people need these *social comparisons* to feel comfortable.

Traders often use social comparisons to help in their decisions. Rather than study market behavior to determine low-risk positions, they attempt to determine what their friends are doing or they flock to experts. And many willing experts are available for the average trader. The media financial commentator always has a reason why the market went up or down. A broker who sells investments must know what is a good buy and what is not. The neighbor who says he put all his money on investment X must know what he is doing. And most of all, the professional advisor is always willing to help. These experts[12] do not even have to promote their services, because traders will seek out their advice.

Whenever I give a talk before a group of traders, I carefully explain that I study how people win and lose in the markets, not the markets themselves. Two or three people, without fail, will approach me at the end of the talk and want to know what to do with their trade or what I think about a particular market. They often become quite upset to learn that I am not willing to give them an opinion on that topic. If a psychologist understands successful trading, people also expect him to make market predictions.

Social comparison processes do not help the trader with trading decisions. Advisors, as a whole, have such a dismal record of price prediction that their opinions as a group (i.e., sentiment indicators) are frequently used to suggest that prices will move in the direction opposite to the prediction.[13] I doubt that the opinions of brokers, neighbors, or psychologists on future prices would be any better.

Even if the experts were generally correct, the average trader would not make money following their predictions. For example, people tend to follow the advisor with the best recent record. Popular recommendations have many followers, which mean high transaction costs (i.e., it costs more to open or close a position when a number of traders try to do so at the same time). And, after a string of successes, the advisor might be ready for a few failures. The result is the loss trap.

Some traders gather information from different advisory sources as their method of trading. They twist the information to fit their own beliefs, add some ideas of their own, and then act on the resulting concoction—often they are too late or too inaccurate to make any money.

Social comparisons lead the trader right to the loss trap. The trader steps in unwittingly, and the trap closes. When the trader is actually in the trap, uncertainty, anxiety, and risk go up. Social comparison processes become even more important as anxiety levels rise, and the trader remains securely in the trap.

The exercises in Chapter VII are critical to the trader at this point. He must obtain objective information about whether he is following a winning or losing system. He must know that each trade he takes has little risk. In addition, the guidelines designed to develop self-control given in subsequent volumes of this course are critical. The trader must have sufficient knowledge and a strategic plan to be successful.

AN EXERCISE IN PREDICTION

Try some predictions before going on to the next section. The charts given in this section are of real market entities—stocks, commodities, etc. Each chart is a daily bar chart with volume. Look at each of them and estimate whether the price will be higher or lower in two months by checking the appropriate box. If you have no idea, just guess. Next rate your confidence in your prediction by putting a number between 0.50 (meaning you have no idea) to 1.00 (meaning you are certain) beside the box you checked. Do not use a number lower than 0.50, since this would indicate that you believe your guess is wrong. If that is what you think, check the opposite direction of movement so you believe you are correct. You may want to use the following guidelines to estimate confidence levels, but you do not have to limit yourself to these numbers.

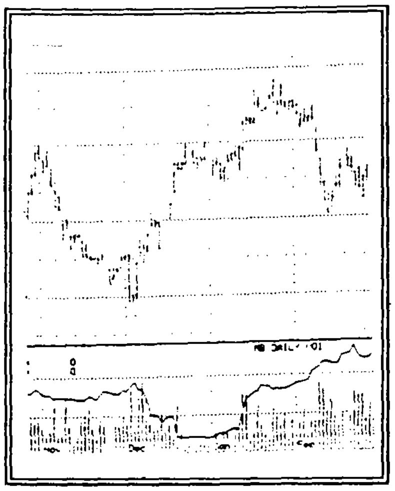
Guide to Confidence Estimates

.50 -- a guess, I have no idea.
.60 -- maybe, but I wouldn't bet on it.
.70 -- I might bet on it.
.80 -- I would bet on it.
.90 -- A good bet, I'd take it in a minute.
1.00 -- A sure thing.

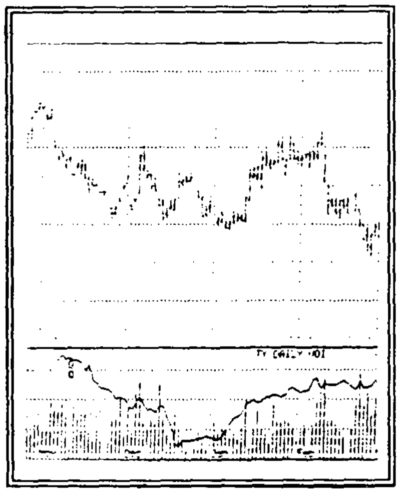
Figure 6-4

Once you have made your prediction and rated your confidence in those predictions (most important part of the exercise), look up the correct answers in Appendix I. Calculate your percentage correct and your average confidence. Rank your predictions in order of confidence using the form provided in the appendix. Then see how correct you are at each level of confidence.

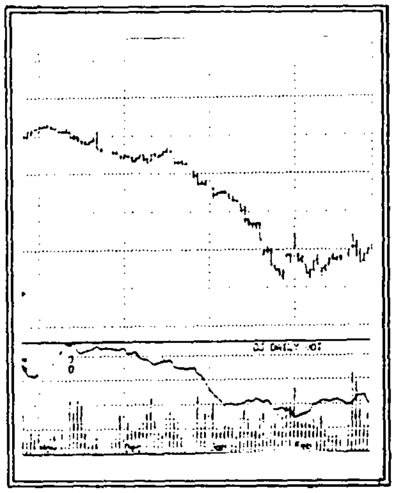
PREDICTION TEST (1) COMMODITIES CHARTS



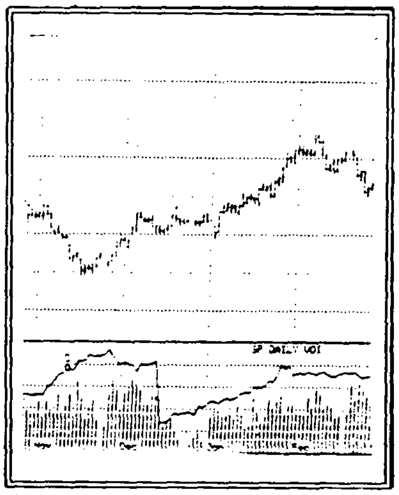
(1) Up_____ Down_____
Confidence________



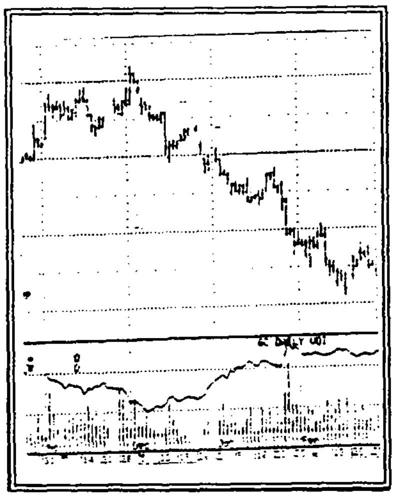
(2) Up_____ Down_____
Confidence________



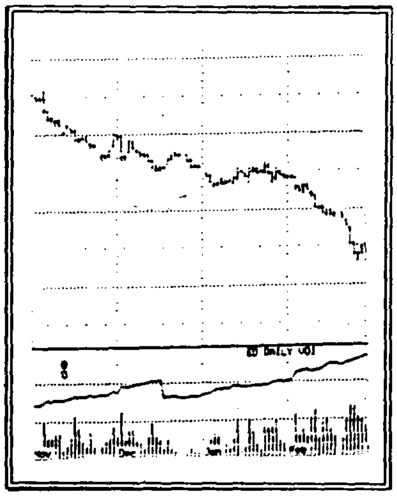
(3) Up_____ Down_____
Confidence________



(4) Up_____ Down_____
Confidence________

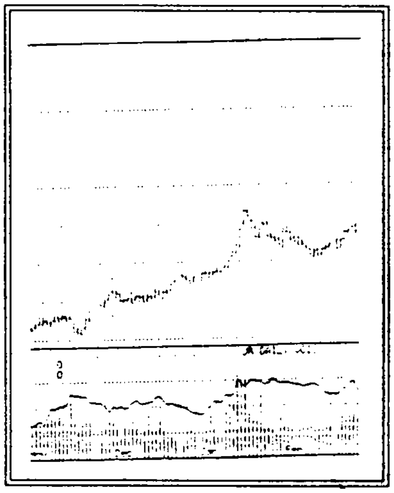


(5) Up_____ Down_____
Confidence________

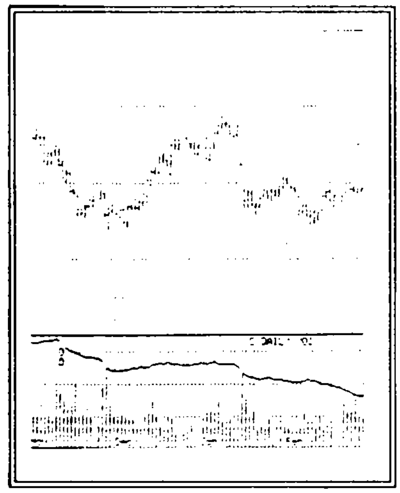


(6) Up_____ Down_____
Confidence________

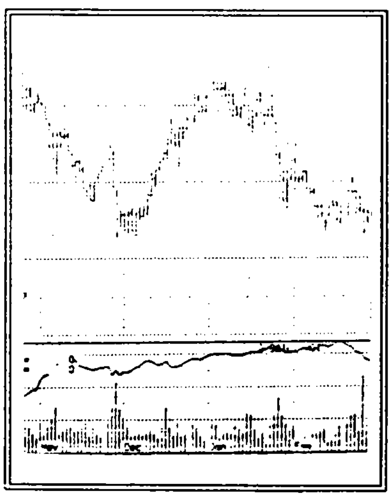
PREDICTION TEST (2) COMMODITIES CHARTS



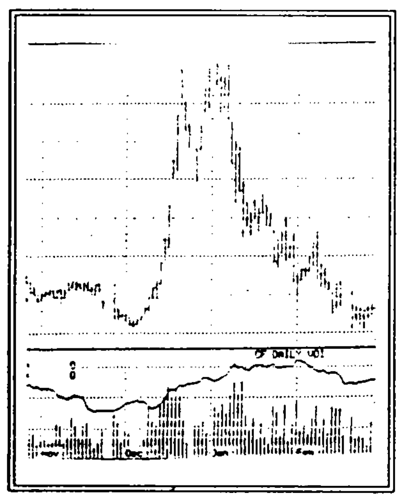
(7) Up_____ Down_____
Confidence________



(8) Up_____ Down_____
Confidence________

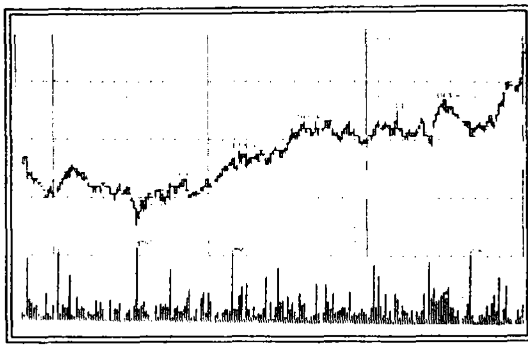


(9) Up_____ Down_____
Confidence________

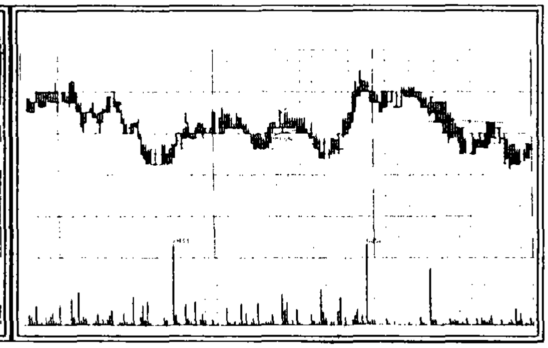


(10) Up_____ Down_____
Confidence________

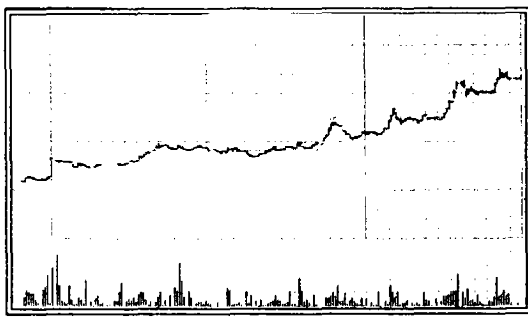
PREDICTION TEST (3)
STOCK CHARTS



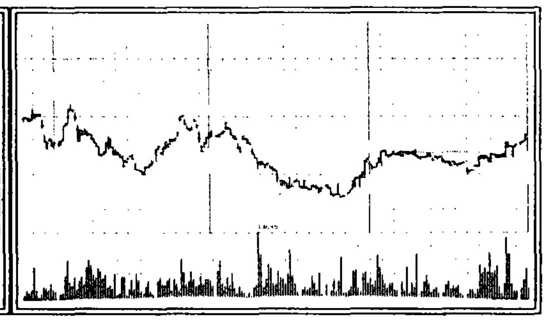
(11) Up_____ Down_____
Confidence_____________



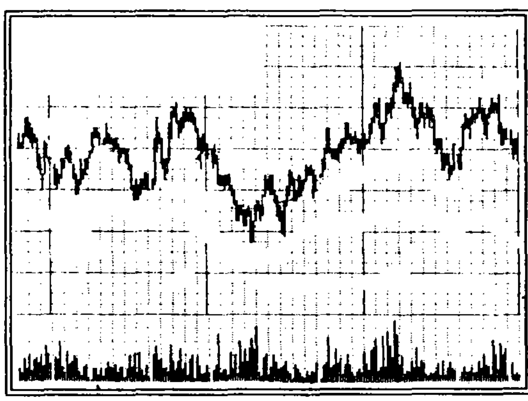
(12) Up_____ Down_____
Confidence_____________



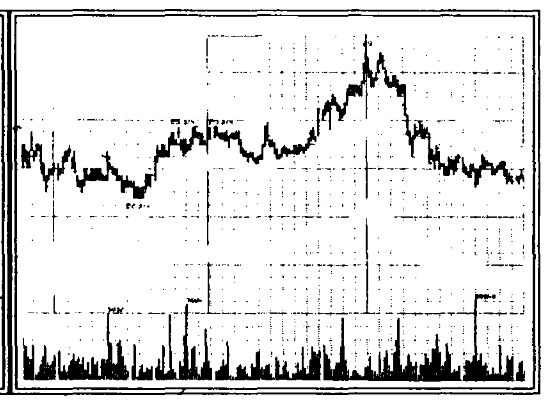
(13) Up_____ Down_____
Confidence_____________



(14) Up_____ Down_____
Confidence_____________

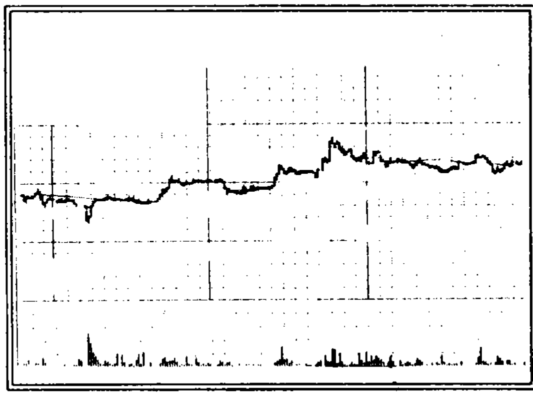


(15) Up_____ Down_____
Confidence_____________

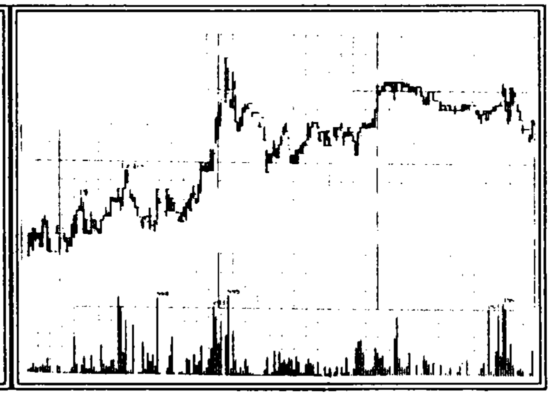


(16) Up_____ Down_____
Confidence_____________

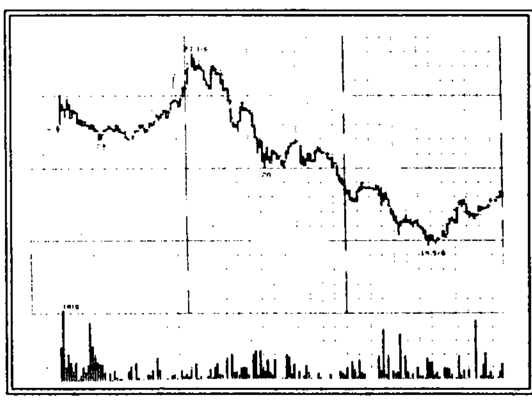
PREDICTION TEST (4)



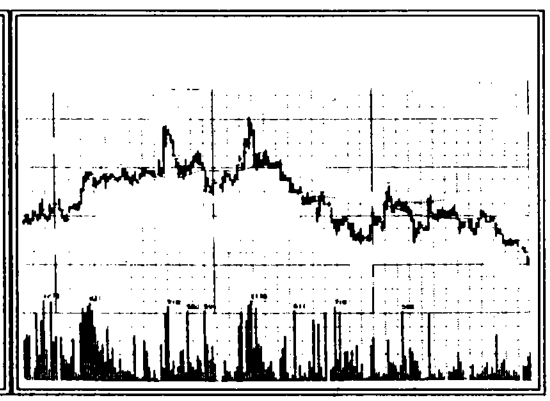
(17) Up_____ Down_____
Confidence_____________



(18) Up_____ Down_____
Confidence_____________



(19) Up_____ Down_____
Confidence_____________



(20) Up_____ Down_____
Confidence_____________

OVERCONFIDENCE AND LOSSES

Useless perceptual frames and poor market systems may bring the trader to the loss trap, but the trader's need to believe his position is right is what keeps him locked in the trap's jaws. Many people refuse to admit that they are wrong about a position—even if it means losing money.

Einstein was once told of an error in one of his calculations.[14] Rather than acknowledge the error, he chose to ignore the evidence for several years. When he did admit the error, he found that several of his postulates that had troubled him suddenly made sense. His reluctance to admit that his theory was wrong resulted in wasted effort and mental anguish.

People tend to deceive themselves the most. Self-deception occurs each time a person clings to a false belief, and everyone holds many false beliefs.[15] Remember that beliefs are one of the essential elements in duplicating success. As a result, such false beliefs greatly increase the risk of failure, since we really do not know what we are confronting. When we fail because of self-deception, we continually face the same problem over and over because it has not been resolved.

> Martin followed his broker's advice and bought a soybean contract. The contract went down, and hit the stop his broker had set. Martin promptly bought some more, and was again stopped out. Soon he had lost over $15,000.
>
> Martin was very persistent. People make big money trading, so he was going to get his share. He just needed better advice. Martin found another broker, and promptly lost $18,000 in silver and cotton.
>
> At this point, Martin decided to trade on his own. He was going to be successful, but not by trusting the recommendations of brokers. As a result, he subscribed to three of the more prominent advisory services and followed their respective hotline recommendations. Whenever he received a recommendation he liked, he traded. Martin lost over $29,000 during the next year, and over $31,000 the following year. At this point, he was over $20,000 in debt, so Martin finally stopped trading futures.

> Several years later, Martin decided to trade again, this time with "good" advisors. Martin took a few quick profits, and then again found himself in a losing situation. He chose to ignore his losses and began following his previous pattern of denying failure as a trader. Martin, by not admitting defeat, continually spent mental effort by ignoring his failure, wasting time and money trying to prove a point. He exerted much more effort than it would have taken to admit his failure, reorganize, and start a more profitable venture.

Review the chapter on commitment and note in the space below why Martin was not committed to being a trader.

____

____

____

When people believe something, they manage to find evidence to support their beliefs.[16] If a person is expecting the market to go up, every correction upward in a bear market will support the theory. And if the market does turn around, even if the timing was off by six months, the person often will believe he was correct all along. Martin can remain a loser for years by finding selective information to support his beliefs that he is not a bad trader, he is just getting bad advice. Martin is playing the role of a victim and he is probably using the market to work out his personal need for more drama in his life.

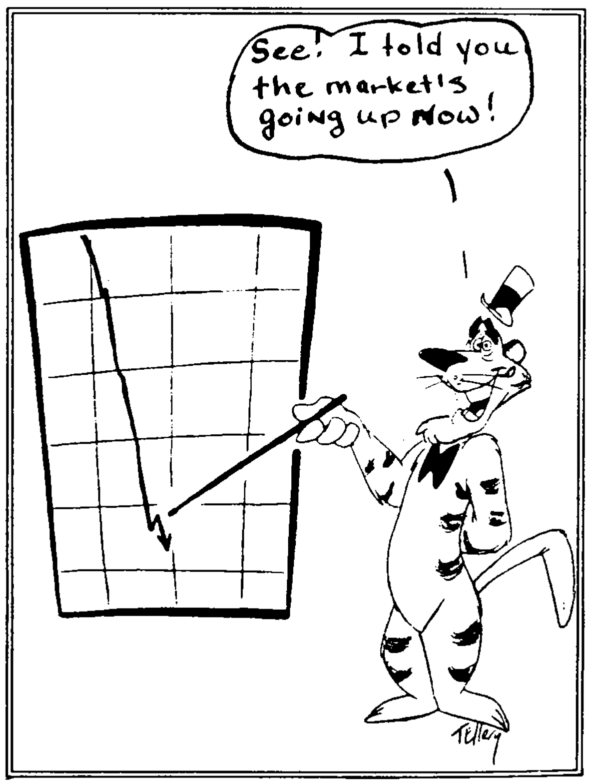


Figure 6-5 "Something will support your beliefs."

How did you do with the prediction exercise in the last section? Although the examples were ***not*** selected to trick you, most people fail to do much better than chance (50%). In addition, your confidence in your ability to predict was probably much better than your actual ability to predict. If you got 55% correct, your average confidence level on all items should be .55—but it was probably over 70%. How many predictions did you make with a confidence rating of .75 or better? How many of these predictions were correct? How many predictions did you make with a confidence rating of less than .75? How many of these were correct? Can you understand how overconfidence in your ability to predict could cost you a lot of money in the market? **The point of the exercise was not to see how well you could predict, but to determine how well you *recognize* your ability to predict.**

Sarah Lichtenstein and Baruch Fischoff[17] found that people who were taught to read stock charts and then asked to read a series of charts were only correct 47.2% of the time in predicting whether prices would be higher or lower one month later. Their confidence levels, however, averaged 0.654. These experimental subjects were no more correct when their confidence was high than when their confidence was low.

What about extreme confidence—those times when we are really sure? Fischhoff and his colleagues[18] had people rate their confidence in various answers in terms of odds, rather than as a percentage. For example, 75% confidence would be equivalent to 3 to 1 odds or 3 of 4 times. When people gave odds of 100 to 1 in the confidence of their answers, they were correct only 3 out of 4 times in one study and 4 out of 5 times in another. When people rated their confidence at a million to one, they were correct 9 out of 10 times in one experiment and 16 out of 17 times in another one. This occurred even though the researchers carefully explained the meaning of the odds to the people participating in the experiment. Moreover, *most people had enough faith in their confidence judgments that they were willing to stake money on their validity.*

Most of us overestimate how right we are. This tendency does not depend upon intelligence.[19] Einstein, as noted earlier, wasted several years of valuable research time because of his misplaced confidence in his equation. Overconfidence in our beliefs does not depend upon our expertise with the subject matter. Experts may know more about their subject matter, but they still are not very accurate in estimating how much they know.[20]

Overconfidence does relate to the amount of information available to the decision maker. Research has shown, for example, that clinicians develop more confidence in their clinical judgments when they have more information. Unfortunately, more information does not increase the accuracy of expert prediction, just the clinician's confidence in his/her predictions.[21] In addition, some evidence suggests that the same phenomenon exists in financial circles.[22]

Later, in Volume 3, you will learn that beliefs are filters for our experience. By recognizing your beliefs as having degrees of utility (as opposed to being overconfident in them) you will become much more flexible in your approach to living and trading. Flexibility is very important to success.

BIG LOSSES FROM SUBJECTIVE DECISION WEIGHTS

Suppose you have a lottery ticket for a $5000 prize. How much is the lottery ticket worth to you? It is not a linear function of the probability of winning the prize, because probability is weighted more at the extremes (i.e., the sure loss or the sure gain). In particular, an increase from 0% to 5% seems like a greater change to most people than an increase from 30% to 35%. That is, moving from no chance of winning (0%) to a possibility of winning (5%) has more impact than a similar percentage change in the middle of the probability scale. Similarly, an increase from 95% to 100% has a greater subjective impact than an increase from 30 to 35%.[23]

These unequal decision weights explain many phenomena we observe in the psychological study of risk. For example, consider the following two decisions:

(1) Which would you prefer? A) a sure profit of $900 or B) an 95% chance of a $1000 profit and a 5% chance of no profit.

Write down your preference:____

(2) Which would you prefer? A) A sure loss of $900 or B) a 95% chance of a $1000 loss and a 5% chance of no loss.

Write down your preference:____

Most people (i.e., over 75%) are **risk aversive** in the realm of profits and **risk seeking** in the domain of losses.[24] Risk aversion in the realm of profits means that they would prefer the sure gain of $900 to a wise gamble. Risk seeking in the realm of losses means that most people would prefer a gamble to a sure loss. When you considered the two decisions above, you probably picked A for decision 1 and B for decision 2.

The increased value associated with moving from the probable (the gamble) to the sure thing (the sure gain) reduces the attractiveness of the gamble in decision 1. We prefer the sure gain to the wise gamble that mathematically has a higher expected outcome (i.e., 95% of $1000 is a gain of $950, which is larger than the sure gain of $900).

The increased value associated with moving from the impossible (i.e., the sure loss that has no chance of winning) to the probable (the slim chance of no gain) increases the attractiveness of the gamble (Choice B) in decision two. The sure loss, even though it is a smaller loss, seems worse to us than an unwise gamble which will probably result in a bigger loss.

What is the result of making these two preferences for traders? First, each preference violates part of a fundamental law of trading—to cut losses short and let profits run. If you pick the sure profit over a wise gamble, you are not letting your profits run. If you pick the unwise gamble over the sure loss, you are not cutting losses short.

Second, our natural inclinations go against the mathematical probabilities of each situation. Assume that in your trading experience you were faced with each of these two decisions 100 times each. You always pick the sure gain and you always gamble against the sure loss. The result is that you will make $900 one hundred times for a total profit of $90,000. You will also lose $1000 an average of ninety five times for a total loss of $95,000. Thus, by following your natural inclination to take sure profits and gamble against losses you will have a net loss of $5000.

Assume, on the other hand, that you went against your natural inclination and were risk seeking in the realm of profits and risk aversive in the realm of losses. You always take the sure loss over the unwise gamble and you always gamble for the bigger profits when the odds are in your favor. The result would be a hundred losses of $900 (i.e., $90,000) and an average of 95 profits of $1000 (i.e, $95,000). Thus, by avoiding your natural inclination you would make a profit of $5000 over the 200 trades as opposed to a $5000 loss.

The sure loss, for someone in the loss trap, always exists. Taking a loss seems less attractive than the hope that one's fortune might turn around by holding onto the losses. Taking the sure loss frees the trader from the loss trap, but the more attractive option again is to stay deep within the jaws of the trap.

TIME INFLUENCES LOSSES

Traders consider time important because it is part of the rate of return equation. Rate of return is usually calculated on a yearly basis. In addition, option and futures traders face critical delivery dates, so time is important to them. Furthermore, if your position does nothing for a long period of time, it probably is no longer a low-risk position.

Time may be even more important to traders from a psychological perspective.[25] The risk, for example, has two critical time periods: (1) the point of commitment and (2) the point of no return. Many people do not truly understand the risk they have taken until these critical time points are reached.

The moment of commitment to a position is the moment at which you open a position and have money at stake. The cost of backing out at the moment of commitment is small from a monetary viewpoint (i.e., you would lose your transaction costs), but it may be high from a psychological viewpoint. This is why one of the primary tasks of top trading is to "stalk" your low-risk idea. This means that you enter the position when your risk is the least.

Sometimes our perceptions change at the *moment of commitment.* Time seems to go by faster. Our fears also seem much larger. If you have been dishonest with yourself about this risk, your past may take over as you revert to past behavior patterns. Your reactions at the moment of commitment are what make the process of risking so dangerous. It's when you must shift from the "action" task to the "monitoring" task. For many traders this is a difficult mental shift.

The "point of no return" is the critical time period beyond which you cannot back out of the decision without suffering the consequences. This time period requires rational thinking and inner calm to survive. Many people, however, become irrational at this point, and the risking process becomes even more dangerous.

Some people, upon making a decision to trade, may have devoted so much time and energy to the decision that they would never back out no matter what it costs monetarily. For these people, the point of no return is the point of commitment. The point of no return for other traders may be the point at which the position has a significant change in value.

The point of no return is the critical time period when the trader who is not honest with himself begins to have trouble. He may not be able to cut losses short because illusions about himself will not allow him to back away because he believes that would mean admitting defeat. A typical response to a loss might be:

> "This is not happening to me. It's just a momentary setback on paper which will soon change."

or

> "I can't afford this loss. To avoid it I can afford to risk a little more. I know the market will turn around if I wait a little longer."

Illusions at the point of no return can even hurt the trader with a small gain. The trader, for example, might panic. He sells out quickly, taking a $400 profit and missing out on a possible $4000 gain. What hurts is not taking the profit too soon, but the illusion of knowledge which evaporates into fear at the point of no return. For example, the $3600 the trader failed to make by selling too soon provides a motive to trade again. The trader is no more knowledgeable, so the results of further trades may be much worse.

The critical time periods often mark a time for action or at least rational thinking. One must gather all one's strength for what lies ahead. Part of this preparation consists of accepting goals and motives and coming to terms with one's need to move ahead. The act of opening a position may be motivated by money, but it generally requires that the trader honestly come to terms with himself, including any motivations which may interfere with success. Are you trading because you are a trader who has found a good, low-risk trade? Or do you have some other reason for the position? This process of gathering strength often rests upon a fragile ego. It is easily shattered by fear and defeat. At a critical time period, the trader may suddenly find himself doubting his original motives and be unable to find the answers to important questions about the risk being taken:

- Why am I doing this?
- What should I do?
- Should I act now or later?
- How do I do it?

This doubt drains all energy and leaves the trader paralyzed. The result may be that no action is taken at a critical time that requires action or that action is taken when the situation requires patience.

Yet if you follow the ten-task model, self-analysis is completed at the beginning of the day. As a result, the successful trader will have dealt with these issues prior to committing to a position.

CONCLUSION

Several psychological factors, collectively known as the loss trap, are presented in this chapter. These factors often come into play when we follow our natural inclinations. People tend to perceive the world through common, erroneous frames; trade on the basis of irrational or nonexistent systems that have nothing to do with opening low-risk positions; have a need to think they are right, no matter how wrong they are; prefer gambles, even unwise ones, to sure losses; and panic at the point of no return. As a result, we step into a small version of the loss trap every time we have a loss, allowing the loss to grow much bigger. Some traders also step into a much bigger loss trap by ignoring the results of a losing trading strategy until those results become catastrophic.

The only way to get out of the loss trap is to let go of losses. But letting go is not that simple. It requires knowledge of how the trap works, as presented in this chapter, and self-knowledge. The next two chapters present some ideas and guidelines for measuring risk, managing money and avoiding the loss trap.

CHAPTER VII

TECHNIQUES TO OBJECTIVELY MEASURE RISK

"There is nothing wrong with taking a risk. The danger occurs when you don't recognize that you're taking one." —Harry Browne, How I Found Freedom in an Unfree World, p. 155.[1]

The danger of risk-taking occurs not only when you don't recognize that you're taking one, as Harry Browne suggests, but also when you do not recognize the extent of the risk you are taking. Again and again, traders fall into the trap in which they feel that the only way they can make "big" money is to plunge. They plunge into stocks, bonds, futures, or options and lose most, if not all, of their funds. Yet other traders, the more successful ones, invest in the same vehicles and are successful. What is the difference?

Speculation means "making an investment involving risk, but with the hope of gain."[2] It sometimes refers to the investment vehicle and sometimes to the approach used by the individual. The two are not the same! An investment vehicle that is considered speculative because most people who use it lose does not have to be a risk if you follow the ten tasks of top trading with the correct beliefs, mental resources, and mental strategies. Traders who do so tend to be consistent winners. **A risk is only dangerous if you do not understand it—what it is and how big it is.**

Many traders fall into the loss trap. They understand that they are losing money, but not how much. That job is left to the tax accountant every April. He frames the losses as "tax deductions" (which makes them much more acceptable). Only when the loss becomes a debt does the trader truly realize how poorly he was doing. This sort of disaster can be avoided by developing low-risk ideas and acting so as to minimize risk. Measure your risk objectively—for your financial health.

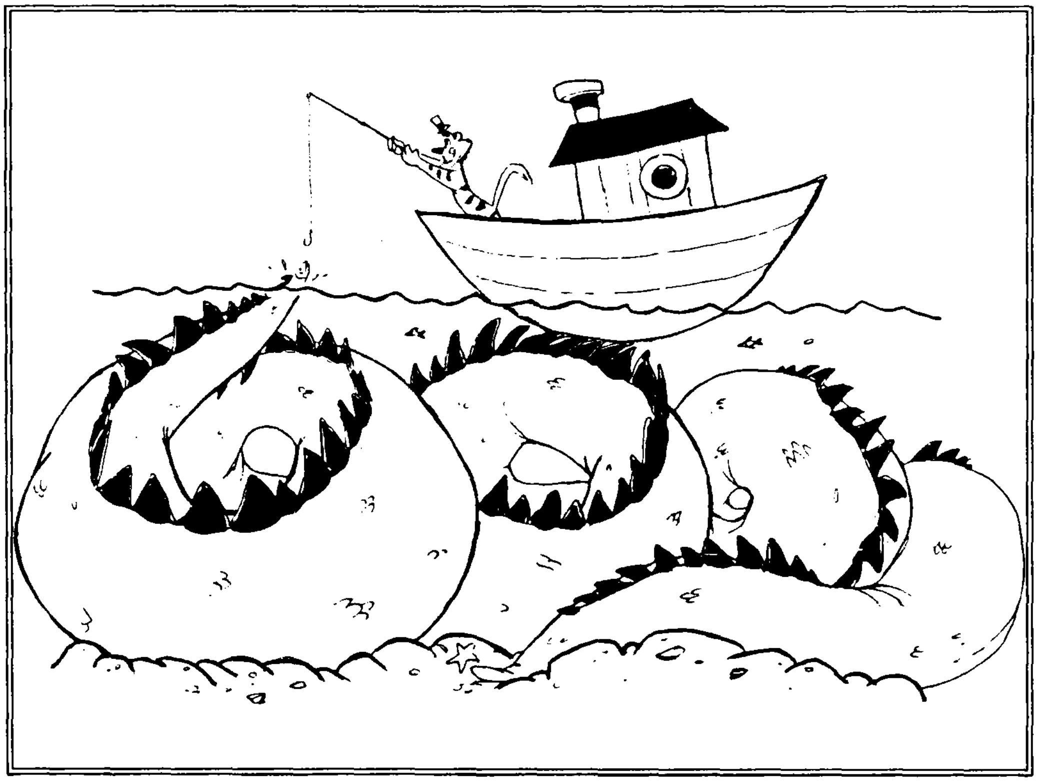


Figure 7-1 "How big is your risk?"

Risk can be objectively stated using several important methods that are not difficult to use. These procedures include:

1) The standard deviation of your return calculated over a 12 month period.

2) The probability of success with 95% confidence limits.

3) Calibrating *your ability* to predict with your game plan.

4) The trading salary and overhead.

If you will take the time to calculate these values for past trading activity, you will have a good idea of the amount of "real" risk you are taking. I'll show you how later in this chapter. Make these calculations regularly, and you will eliminate the danger of not knowing how much risk you are taking.

The best way a trader has of evaluating his future performance is from past performance. This evaluation is often inexact, because sampling assumptions are frequently violated.[3] Past success does not mean future success. But past mistakes are generally a good indication that you need to do something different.

Dr. Peter Griffen, an expert in gaming theory, has developed a formula for predicting one's risk of ruin.[4] One fact from the formula stands out:

IF YOU ARE A NET LOSER, YOUR RISK OF RUIN IS 100% IF YOU CONTINUE TO USE THE SAME STRATEGY (which might be no strategy).

Most traders would save a great deal of money by understanding this fact and getting out of the market after a string of losses or after losing 50% of their capital. In fact, two of the ten trading tasks are designed to help you in this area—the daily debriefing and the periodic review.

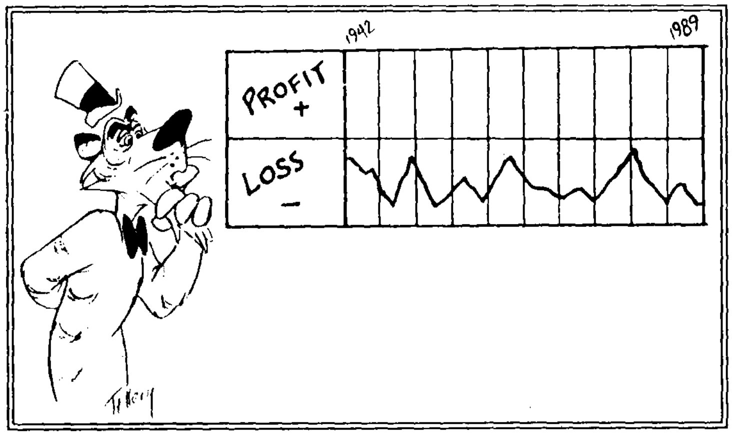


Figure 7-2 "What does it take to convince you?"

If your portfolio shows a net loss over the past six months, then you have a good chance of losing much more. You may be better off getting out of the market to develop a better approach to trading than you are staying in the market to make back losses.[5] How many consecutive years of losing do you need to convince yourself that there is a better way to trade? **If your portfolio has a loss over two straight years, the longer you stay in the market the more money you will probably lose.**

THE STANDARD DEVIATION AS A MEASURE OF RISK

If your trading activity is profitable, with some losing periods, then your risk can be objectively expressed as the standard deviation of the investment return. You don't need to know all the details, but the computations are given in Appendix II for those of you with a math background. The measure has some intrinsic beauty because, when calculated correctly, it can incorporate classic aspects of sound money management. When it is performed in a standard manner, it can be used to determine how much "risk" a person with a given psychological profile can take to achieve maximum profit.

Using the Standard Deviation. This volume contains several sheets for you to use to determine the "risk value" of your account. We define "risk" here as the standard deviation of the percentage change in your account value over 12 months.

1) Start with the first sheet (Figure 7-3) at column A and enter the closing value of your investment account for each of the last 13 months. This means the total value of your accounts, including the value of any open positions you may have.

2) Account for additions to and withdrawals from your account in column B. If you added new capital to your account during any particular month, put the amount added in column B beside the appropriate month. If you took funds out of your account during any of the 12 months, put the amount withdrawn (in parentheses) beside the appropriate month in column B. If you added and withdrew money from your account during a particular period, put the net amount added or withdrawn in column B.

3) Adjust each closing value (column A) by the amount added or withdrawn (column B). That is, subtract the additions from column A and add the withdrawals to column A. Put the adjusted value in column C.

4) Calculate the amount of profit or loss for each month by subtracting the value in column C from the value in column A for the prior month. Do this for each of the 12 months and put the resulting value in column D with a minus sign for losses and a plus sign for gains.

A		B	C	D	E
ACCOUNT VALUE		ADDITIONS/ WITHDRAWALS	NET AMOUNT	GAIN/LOSS	%CHANGE
________	13 MONTHS AGO				
________	12 MONTHS AGO	________	________	________	________
________	11 MONTHS AGO	________	________	________	________
________	10 MONTHS AGO	________	________	________	________
________	9 MONTHS AGO	________	________	________	________
________	8 MONTHS AGO	________	________	________	________
________	7 MONTHS AGO	________	________	________	________
________	6 MONTHS AGO	________	________	________	________
________	5 MONTHS AGO	________	________	________	________
________	4 MONTHS AGO	________	________	________	________
________	3 MONTHS AGO	________	________	________	________
________	2 MONTHS AGO	________	________	________	________
________	LAST MONTH	________	________	________	________
					$\bar{X}$ = ________
					SD= ________

NUMBER OF CLOSED TRADES DURING LAST 12 MONTHS ________

NUMBER OF WINNING TRADES (INCLUDING COMMISSIONS) ________

NUMBER OF LOSING TRADES (INCLUDING COMMISSIONS) ________

COMMENTS:

Figure 7-3 Risk Measurement Sheet

5) Calculate the percent change by dividing the value in column D by the closing value of the account for the previous month (i.e., column A for the previous month). Put this final number in column E. Figure 7-4 illustrates a risk analysis for a hypothetical account.

6) The final step is to determine the standard deviation of the 12 values in column E. We strongly suggest that you use a calculator with a standard deviation function. If you do not own one, you can probably buy one for under $20 (and the time saved over hand calculations is well worth the price). For those of you who prefer to do the calculation by hand, either out of intellectual curiosity or a sense of masochism, the formula is given in Appendix II.

In the sample sheet, Figure 7-4, the standard deviation is 10.74. Another example is illustrated in Figure 8-4. Here the calculated values are: standard deviation = 160.54, $\sum X=84.39$, and $\sum X^2= 284106.5815$.

Practice with the data in Figures 7-4 and 8-4 until you get these results.[6] Be sure to enter losing percentages, i.e., those in parentheses, as negative numbers.

Be sure that you apply this formula only to the percent changes over 12 months. If you have information for more than 12 months, you might want to calculate the formula as a moving average over each 12 month period. That is, for each new month of data that you add to the calculation, drop the first month on your list so that you are calculating only over a 12 month period.

How to Interpret This Risk Value. The value you obtain will be between 0 (if your portfolio never changes in value) to well over 100 (if you were wiped out several times during the year and also had several large gains). For example, between February 4, 1983 and January 27, 1984 the Commodities Magazine Index (CMI)[7] had a risk factor of 111.22 (assuming a trader put up only 4% and entered no stops). A trader would have been wiped out five times during the year, even though the overall index gained 4%, which translates to an overall gain of nearly 100% at the margin rate used. In contrast, a fully invested T-bill account in 1983 had a risk factor of 0.05, with a 9% return. The Wilshire 5000 stock index in 1983 had a risk factor of 3.18 with a return of 17.3%.

A		B	C	D	E
ACCOUNT VALUE		ADDITIONS/ WITHDRAWALS	NET AMOUNT	GAIN/LOSS	%CHANGE
$37438	13 MONTHS AGO				
$41912	12 MONTHS AGO		41912	4474	11.95
$35411	11 MONTHS AGO		35411	(6501)	(15.51)
$36811	10 MONTHS AGO	$3000	33811	(1600)	(4.52)
$36550	9 MONTHS AGO		36550	(261)	(0.71)
$38892	8 MONTHS AGO		38892	2342	6.41
$38892	7 MONTHS AGO		38892	0	0
$43542	6 MONTHS AGO	($5000)	48542	9650	24.80
$43344	5 MONTHS AGO		43344	(198)	(0.46)
$48711	4 MONTHS AGO		48711	5367	12.38
$46776	3 MONTHS AGO	$1000	45776	(2935)	(6.03)
$45100	2 MONTHS AGO		45100	(1676)	(3.58)
$42395	LAST MONTH		42395	(2705)	(6.00)
				$\bar{X}$ =	1.56
				SD=	10.74

NUMBER OF CLOSED TRADES DURING LAST 12 MONTHS 33

NUMBER OF WINNING TRADES (INCLUDING COMMISSIONS) 15

NUMBER OF LOSING TRADES (INCLUDING COMMISSIONS) 18

COMMENTS:

Figure 7-4 Risk Measurement Sheet

Forty commodity funds, for the 12 months between February 1983 and March 1984, had a median risk score of 7.0. That is, half of the funds had scores above 7 and half had scores below 7. The ten riskiest funds had risk levels ranging from 9.07 to 18.86. These included three of the five best performing funds and *all* five of the worst performing funds. The ten least risky funds included two of the five best performing funds and none of the worst performing funds.

You may use the following guidelines when you calculate risk in this manner:

1) High risk is sometimes associated with large gains, but more often it is associated with large losses.

2) The amount of risk a person can tolerate is directly related to his/her psychological profile. People with well rounded profiles can be successful with much higher risk levels than people with poor profiles.

3) We have found that people with better psychological profiles maintain low-risk levels. People with poorer profiles tend to have trading accounts with much higher risk levels.

4) People with poor psychological profiles can be successful, without changing themselves, if they maintain a low-risk portfolio. Numerous guidelines for reducing risk are given in Chapter VIII. Guidelines for controlling yourself are presented throughout this course.

Self-control is by far the best form of risk control.

5) Each individual must objectively measure the risk that he or she is taking. It is an important part of self-knowledge for the trader.

When you copied your scores from your *Investment Psychology Inventory* profile into Chapter II, what was your composite percentile rating? We offer the following guidelines based upon that percentile ranking:

IPI Percentile Ranking	Maximum Standard Deviation
Top 2%	30
Top 5%	25
Top 10%	20
Top 25%	15
25 -50%	10
50 -75%	5
Bottom 25%	3

Remember that these are maximum tolerable risk levels. I recommend that most people aim for an average value of about half of the maximum level. The beauty of the standard deviation calculation is that money management is built into the calculation. The procedures that will lower the standard deviation are all sound money management principles. (See Chapter VIII).

Limitations to the Standard Deviation Measure. The riskiest portfolio, regardless of how you trade, is the one that consistently loses. If a profile consistently loses 4% each month, the standard deviation measure would be low—suggesting little or no risk. This is an unlikely occurrence, but a possibility. As a result, I will suggest that you use <u>all</u> of the guidelines given in this chapter to better understand what you are doing.

A second limitation to the standard deviation is that it does not distinguish between losses and gains. Thus, a sharp gain will have as great an effect on the standard deviation as a sharp loss. A portfolio that shows several sharp gains during the year and only a few minor retracements would be considered as "risky" as one that might show sharp retracements.

The standard deviation is a function of N, which is equal to 12 months in the formula described above. Since we always use 12 months, we can compare risk factors of different people, different times, etc. If you ignore the 12 month period and substitute your own time period, then the guidelines developed through our research will be meaningless. On the other hand, one can always calculate a 12 month moving average, so this limitation is not serious.

THE PROBABILITY OF SUCCESS WITH 95% CONFIDENCE LIMITS

If you make one hundred trades in a given period of time and forty of them are profitable after deducting commissions and other costs associated with the trade, then your success rate is 40%. That is, forty profitable trades divided by one hundred total trades yields a 40% success rate. If certain assumptions are met, we can assume that 40% of the trades will be successful in the future plus or minus a certain error rate. This error rate is called the confidence interval and it indicates how reasonable your estimate of the success rate is. The 95% confidence interval indicates that 95% of the time your future success rate, using the same trading system, will fall within that interval.

Calculating the 95% Confidence Limits. To calculate your future success rate and its 95% confidence limits, do the steps outlined below:

1) Examine how well you have done in the past with the same trading methods you plan to use in the future. You should have a minimum of 30 trades on which to use this formula. A success is a trade that is profitable *after* costs. Using these data, divide the number of successes by the total number of trades. This is your success rate.

2) If you have not traded in the past with the methods you are investigating or if you do not have at least 30 trades, then paper trade to determine your maximum success rate. Be sure to estimate what your slippage[8] and transaction costs will be in your paper trading.[9] If you are not successful paper trading (or even very successful), you will not be successful trading in the real market. As a result, I recommend that you always paper trade a new game plan. Putting up real money before determining the maximum amount of success you can expect does not make sense.

3) Calculate your 95% confidence limits using the following formula:

$$\text{95\% CONFIDENCE LIMITS} = \quad S \pm 1.96\sqrt{\frac{S(1-S)}{(N-1)}}$$

Where S = success rate
N = total number of trades

Note that the value 1.96 represents the 95% confidence limits. If you prefer 99% confidence limits, then replace 1.96 with 2.58.

Our hypothetical trader made 100 trades (N=100) with a 40% success rate (S=0.40). Therefore,

$$\begin{aligned}
\text{95\% Confidence Limits} &= 0.4 \pm 1.96\sqrt{(.4)(.6)/99} \\
&= 0.4 \pm 1.96\sqrt{(.24)/99} \\
&= 0.4 \pm 1.96\sqrt{.00242} \\
&= 0.4 \pm 1.96(0.04924) \\
&= (0.4965,\ 0.30350)
\end{aligned}$$

Thus, the success rate of our hypothetical trader will lie between 0.30335 and 0.4965 with 95% confidence. In other words, there is a 95% chance that he will have a success rate between 30% and 50%.

Assumptions Made in Calculating the Success Rate. You are making several assumptions when you calculate the confidence interval of your success rate.

1) Your sample size (N) must be sufficiently large. The commonly used working rule is that (N)(S) *and* (N)(1-S) should both be greater than five. Otherwise, your confidence estimates will be inexact.[10] For our hypothetical trader, both (100 x 0.4 =40) and (100 x 0.6 = 60) are well over five. We recommend a minimum of 30 trades, because the accuracy of your confidence limits depend on the sample size. If your sample size is too small, the confidence intervals will be too large to be meaningful.

2) Your successes and failures should be independent. Some traders may not meet this assumption in their trading activity—especially those who tend to trade only in one or two stocks, options, or futures contracts. If you have several successive trades in one specific position (May soybeans), lump these together as one trade in your calculations.

3) You are assuming that your sample of successes and failures using the system are drawn from all possible trades. *If you only test your system during a bull market, then you have violated this assumption. You*

can only expect your results to be applicable to markets similar to those in which you tested the system. Therefore, test a new trading system over a wide variety of market conditions (i.e., over 5 to 10 years of trading with as many trades as possible).

4) If you use market information from a specific period of time to develop a trading system, do not use that same period of time to test the system. If you do, you will be amazed at your testing success and dismayed at your losses upon applying the system with your money at stake.

How to Use Confidence Limits. A success rate above 50% is not required to be successful if one follows a golden rule of investing:

CUT LOSSES SHORT AND LET PROFITS RUN!

For example, the hypothetical trader whose account is illustrated in Figure 7-4 only had four profitable months during the year. Large gains in the first, seventh, and ninth months made the account profitable overall.

We have found, however, that a trader is not likely to be successful unless the average success rate is at least 0.35 with an upper limit of at least 0.40. If your success rate is below 0.35, you need to revise your game plan.

Some traders have success rates of 0.50 or better, but are still net losers. The traders who manage this feat do so by taking profits quickly and letting losses run.

CALIBRATING YOUR ABILITY TO PREDICT

A well-known guru gave a seminar, charging $2000 per person to learn about his new commodity trading system. He claimed it would earn a minimum of 60% per year on a $35,000 account.

One of the attendees, who was somewhat of a skeptic despite spending $2000 to attend, said, "If this system is as good as you say it is, why are you selling it?"[11]

The guru said, "I have no fear of selling it, because for every one hundred people to whom I sell the system, only one will use it properly."

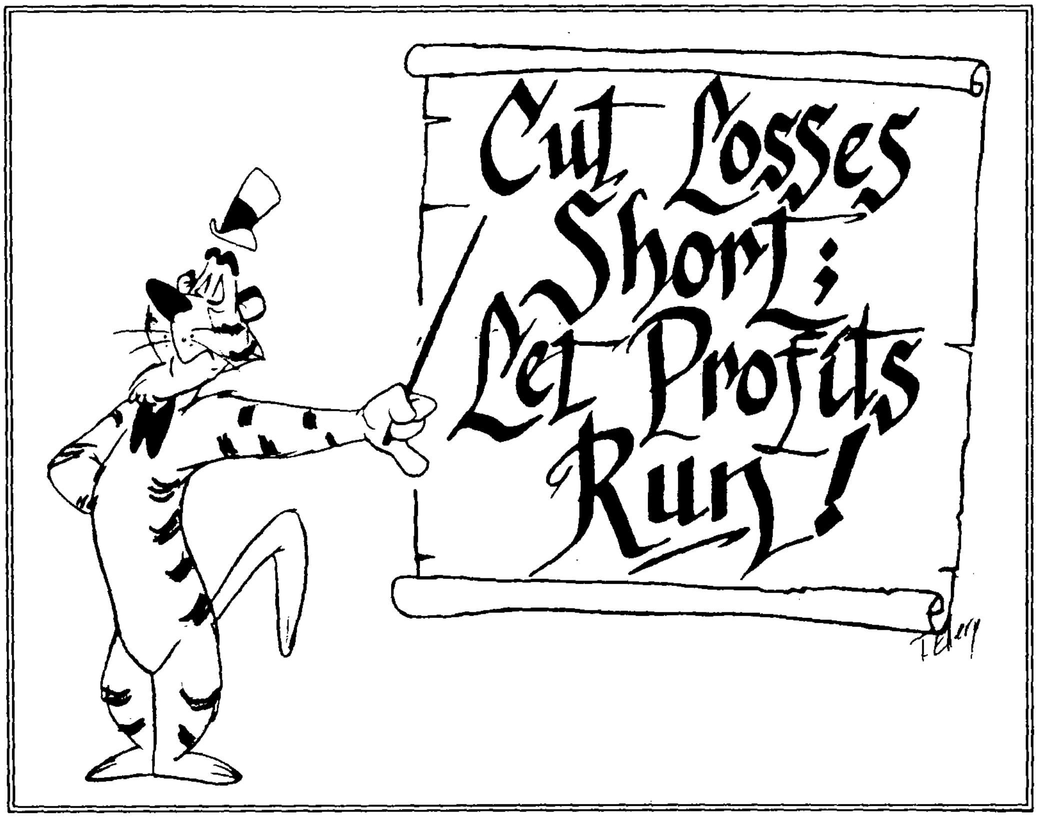


Figure 7-5 "Follow the Golden Rule"

And his estimate was conservative.

Over the next five years the system, used in the prescribed manner, was even more successful than promised. The guru then surveyed the people who had attended his seminars on the system. More than half of the people had *never* used the system; almost half of the attendees had modified the system before using it; and less than one percent had used it as intended.

One reason this tends to occur is because the trading methodology *per se* does not produce success. Success occurs by following the ten tasks of trading and by adopting the beliefs, mental strategies, and mental resources necessary to do so. See Chapters III and IV. The guru in this story only taught how he analyzed the market, which had little to do with how he made money.

The methods you have read about in this chapter provide you with an indication of the accuracy of your trading plan. Those methods tell you nothing about the other factors that are important to success. **You**, for example, are the most important factor in your success.

Calibrating Yourself. One method for estimating how well you can do with your game plan is to *calibrate yourself* with a test similar to the prediction test (see Chapter VI and Appendix I). The prediction exercise gives you certain parameters (i.e., daily bar charts with price and volume) and requires you to predict whether the price will be higher or lower in 2 months. You are then asked to rate your confidence in that prediction. In Appendix I, you are asked to rank your answers according to your confidence and determine how correct you are at each level of confidence. The curve plotting your percent correct (i.e., your hit rate) as a function of confidence is called a **calibration curve**. This self-test still gives the maximum performance level which you can expect because it does not account for many of the psychological factors which might further reduce your performance. Remember that successful trading involves developing low-risk ideas. It has little to do with prediction.

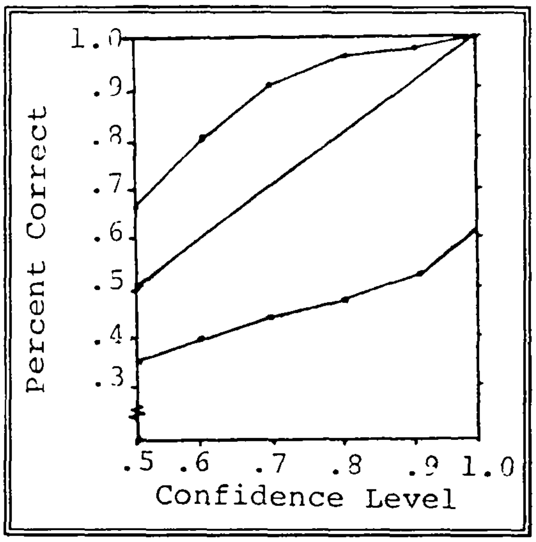


Figure 7-6
Exemplar Calibration Curves

Whatever system you use, you can design a similar exercise for yourself for the way you normally trade. For example, you might use daily bar charts in soybeans to determine if a trend will continue. If your idea is correct for at least three days, you might consider yourself correct. Have a friend provide you with the appropriate historical price charts with enough information removed so that you will not recognize them. You can then determine how you would act; rate your confidence in the ideas you develop; and calibrate yourself.

A calibration curve provides you with valuable information about yourself. For example, Figure 7-6 illustrates some exemplar calibration curves.

The center line in Fig. 7-6 shows a perfect calibration curve in which the percentage correct is equal to the confidence level at each level of confidence. The upper curve indicates underconfidence while the bottom curve indicates overconfidence.

Suppose you develop a prediction exercise for your system. You then make the following 30 predictions at the confidence levels indicated:

Confidence	No. Items	No. Correct	Percent Correct
0.9	3	2	.67
0.8	5	3	.60
0.7	8	5	.63
0.6	8	3	.38
0.5	6	2	.33
0.67	30	15	.50

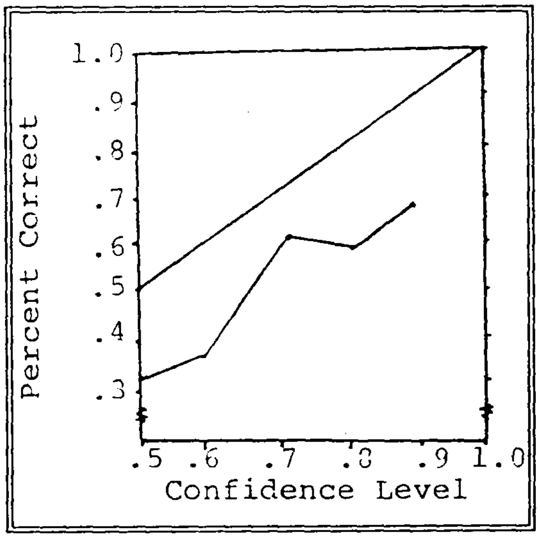


Figure 7-7 Calibration Curve of the Sample Data

These data are graphed in Figure 7-7. The perfect calibration line is the dark solid line in the center. Our trader's data is the lower line. The calibration curve easily shows that this person is overconfident and not very accurate. He seems to be well calibrated in the sense that his hit rate (i.e., his percent correct) improves greatly as a function of his confidence. This particular calibration curve, however, is a little bit deceptive as discussed below.

Hit rate, average confidence level, over-and underconfidence, and calibration can each be calculated mathematically.

1) The *Hit Rate* is the overall percentage correct. Divide the number correct by the number of predictions. In our example, there were 15 correct items out of 30 for a hit rate of 0.50.

2) The *Average Confidence Level (ACL)* is determined by the following formula:

$$ACL = 1 \div N \sum_{i=1}^{L} NiCi$$

where N is the total number of predictions L is the number of confidence levels used; and Ni is the number of predictions at confidence level Ci.

Although one could use an infinite number of confidence levels, we recommend that you use no more than the six levels given (i.e., 0.5, 0.6, 0.7, 0.8, 0.9, 1.0).

For our sample data,

$$ACL = 1 \div 30 \; ((3 \times .9) + (5 \times .8) + (8 \times .7) + (8 \times .6) + (6 \times .5))$$

$$= 1 \div 30 \; (2.7 + 4.0 + 5.6 + 4.8 + 3.0) = 20.1 \div 30 = 0.67$$

3) *Over- or UnderConfidence* is the **ACL** less the **hit rate**. In our example, the ACL was 0.67 and the hit rate was 0.50, so the difference is +0.17. Positive numbers reflect overconfidence, so our trader was a little overconfident. Negative numbers, on the other hand, indicate underconfidence. People with accuracy rates less than 50% will be overconfident by definition, since the six confidence levels do not permit the trader to predict that he is wrong (i.e., confidence levels may not go below 0.5).

4) The *Calibration (CB) Score* reflects the accuracy as a function of the confidence level. A trader is perfectly calibrated if, over the long run, the hit rate at each confidence level is equal to that confidence level. This may be expressed mathematically by the following formula, adapted from Murphy[12]:

$$CB = 1 \div N \sum_{i=1}^{L} Ni(Ci - Hi)^2$$

where Hi is the hit rate at confidence level, Ci; N is the total number of predictions; L is the number of confidence levels; and Ni is the number of predictions at each confidence level.

The following calculation can be made on our data:

$$CB = 1 \div 30\ (3(.9-.67)^2 + 5(.8-.6)^2 + 8(.7-.63)^2 + 8(.6-.38)^2 + 6(.5-.33)^2)$$

$$= 1 \div 30\ (3(.23)^2 + 5(.2)^2 + 8(.07)^2 + 8(.22)^2 + 6(.17)^2)$$

$$= 1 \div 30\ (3(.0529) + 5(.04) + 8(.0049) + 8(.0484) + 6(.0289))$$

$$= 1 \div 30\ (0.1587 + 0.2 + 0.0392 + 0.3872 + 0.1734)$$

$$= 1 \div 30\ (0.9585) = 0.0320$$

Interpreting Calibration Scores. The lower the calibration score the better it is. Theoretically, calibration scores range from zero to one. An individual who was completely confident with each trading idea (i.e., each of them is given a confidence rating of 1.0) and missed them all would rate a one, whereas an individual whose hit rate was exactly the same as his confidence level at each confidence level would rate a zero.

A score of one is very unlikely. People may only miss half of their predictions by chance. Thus if they were perfectly confident and missed half by chance they would get a calibration score of 0.25. Thus, 0.25 is a more reasonable limit.

Figure 7-8 "Whew, all these numbers!"

Since low ACL scores mean that the trader admits that he knows little about the system, CB scores become more meaningful with higher ACL scores. For example, a person who rates his confidence at 0.5 on every prediction will be perfectly calibrated if half of his predictions are correct, as they might be by chance, so a CB score of zero will have little meaning for a 0.5 ACL score. Thus, the CB score, to be meaningful, should increase as the ACL increases.

An acceptable CB score would be one that was less than someone might expect from chance predictions, i.e.:

$$\text{Acceptable CB score is less than } (\text{ACL} - 0.5)^2$$

A good score might be 90% of the acceptable level and an excellent score might be 75% of the acceptable level. The following table can be used to evaluate CB scores as a function of the ACL. See Appendix III for a method of calculating the significance of the calibration.

ACL	Acceptable Level	Good Score	Excellent Score
.55	.0025	.0023	.0019
.60	.0100	.0090	.0075
.65	.0225	.0203	.0167
.70	.0400	.0360	.0300
.75	.0625	.0563	.0469
.80	.0900	.0810	.0675
.85	.1225	.1103	.0919
.90	.1600	.1440	.1200

Look at the sample data again. Our trader had an ACL of 0.67 and a CB score of 0.032. The difference between 0.67 and 0.5 is 0.17, which when squared gives us 0.0289. Thus, an acceptable CB score is less than 0.0289. Our CB score is clearly too big to be acceptable. Although our trader appeared somewhat calibrated from his calibration curve, he is actually overconfident, inaccurate, and not well calibrated. The test of significance given in Appendix III confirms this conclusion that our trader was not well calibrated.

Some Precautions in Using Calibration Scores.

1) The CB score is clearly a psychological measure of how well one can use a system. Nevertheless, it does not totally measure how comfortable a trader is with a system. For example, other psychological variables may keep a trader from using a system properly, including: a) high stress; b) conflicts in belief systems; c) inability to maintain an appropriate mental state (i.e. discipline); d) the inability to execute the trading rules properly due to biases or ineffective mental strategies, etc; and e) the fundamental issue a trader may be bringing to the market. These issues are covered in subsequent volumes of the course. Thus, a good CB score still does not imply that a person can make money with the system. However, a poor CB score probably does indicate that the individual is not likely to make money with the system.

2) The CB score must be used with an exact system in the same manner that the system is used in the market. A prediction exercise, however, only allows one to simulate an up/down or true/false response. An up/down or true/false response does not reflect the hour-by-hour decisions a trader may encounter. In addition, all the parameters given in the prediction test must reflect the way the trader will actually see parameters in the market. This also may be an unrealistic assumption for many systems.

Although the CB score has some obvious limitations, it still is an important tool for the serious trader. It can save a trader thousands of dollars by preventing him from using a system with which he could never make money. It also will provide some measure of how well he can use a valid, useful set of trading rules.

CALCULATING YOUR INVESTMENT OVERHEAD AND SALARY

Chapter VI of this volume discussed some of the psychological factors involved in risking, emphasizing why traders find cutting losses short so difficult. These same factors apply to trading losses as a whole. Traders do not like to admit that an idea isn't working and quit, so they keep losing well beyond the point of ruin.

Many traders do not really know their bottom line figures until it is time for income taxes. Losses, on April 15th, are framed as tax write-offs and considered desirable. As a result, the trader continues to lose.

To help successful and unsuccessful traders avoid the April 15th trap, we have developed a worksheet and questionnaire to be completed each January. The worksheet, given in Figure 7-9, helps traders *frame* their investment activity as a business with an overhead and a salary.

Completing the Worksheet. A completed worksheet for a hypothetical trader is given in Figure 7-10.

1) *Trading Capital.* Take the amount of capital you had in your trading accounts (i.e., all savings and investment accounts) at the beginning of the year, adjust it for additions and withdrawals as described below, and put the resulting value on line 1. Additions or withdrawals of funds during the year must be adjusted for the amount of time the funds were in use. To adjust for the month funds were moved, multiply the amount of money by the percentage given in the following table. Add the adjusted additions and subtract the adjusted withdrawals from the starting capital value.

JAN	100%	MAY	67%	SEP	33%
FEB	92%	JUN	58%	OCT	25%
MAR	83%	JUL	50%	NOV	17%
APR	75%	AUG	42%	DEC	8%

For example, suppose you began the year with $40,000. You then added $10,000 in April, withdrew $6000 in September, and added $18,000 in October. Your trading capital for the year would be determined as follows:

100% of $40,000	= $40,000
75% of $10,000	= $ 7,500
33% of ($6,000)	=($ 2,000)
25% of $18,000	= $ 4,500
	———
TRADING CAPITAL	= $50,000

1. TRADING CAPITAL ___________

2. GROSS PROFIT/(LOSS) ___________ % OF LINE 1________

3. COMMISSIONS (__________) % OF GROSS PROFIT________

4. ADVISORY SERVICES, INFORMATION, AND SUBSCRIPTIONS(__________) % OF GROSS PROFIT________

5. SEMINARS & CONFERENCES(__________) % OF GROSS PROFIT________

6. MISCELLANEOUS EXPENSES(__________) % OF GROSS PROFIT ________

7. NET PROFIT/(LOSS)___________ % OF GROSS PROFIT________

8. T-BILL RETURN ON TRADING CAPITAL___________

9. INCOME TAX ADJUSTMENT. THIS IS AN OPTIONAL ADJUSTMENT WHICH SOME TRADERS MAY DESIRE SINCE INCOME TAX MAY PLAN AN IMPORTANT ROLE IN THEIR INVESTMENT ACTIVITY

____

10. REAL TRADING PROFIT/(LOSS) ____________

11. HOURS SPENT ON TRADING ACTIVITY EACH WEEK____________

11A. TIMES 52 WEEKS = ___________TOTAL HOURS/YEAR

12. REAL TRADING PROFIT (LINE 10) DIVIDED BY THE TOTAL HOURS SPENT ON TRADING ACTIVITY PER YEAR (LINE 11A)

=__________**HOURLY SALARY**

13. TRADING OVERHEAD (SUM OF LINES 3, 4, 5, AND 6) ________

% OF GROSS PROFIT______________

Figure 7-9 Investment Salary and Overhead Calculation Sheet

1. TRADING CAPITAL $50,000

2. GROSS PROFIT/(LOSS) $15,000 % OF LINE 1 30.0%

3. COMMISSIONS ($5,000) % OF GROSS PROFIT 33.3%

4. ADVISORY SERVICES, INFORMATION, AND SUBSCRIPTIONS($1,000) % OF GROSS PROFIT 6.7%

5. SEMINARS & CONFERENCES($1,500) % OF GROSS PROFIT 10.0%

6. MISCELLANEOUS EXPENSES($500) % OF GROSS PROFIT 3.3%

7. NET PROFIT/(LOSS) $7,000 % OF GROSS PROFIT 46.7%

8. T-BILL RETURN ON TRADING CAPITAL($4,500)

9. INCOME TAX ADJUSTMENT. THIS IS AN OPTIONAL ADJUSTMENT WHICH SOME TRADERS MAY DESIRE SINCE INCOME TAX MAY PLAN AN IMPORTANT ROLE IN THEIR INVESTMENT ACTIVITY N/A

10. REAL TRADING PROFIT/(LOSS) $2,500

11. HOURS SPENT ON TRADING ACTIVITY EACH WEEK About 6

11A. TIMES 52 WEEKS = 312 TOTAL HOURS/YEAR

12. REAL TRADING PROFIT (LINE 10) DIVIDED BY THE TOTAL HOURS SPENT ON TRADING ACTIVITY PER YEAR (LINE 11A)

= $8.01 HOURLY SALARY

13. TRADING OVERHEAD (SUM OF LINES 3, 4, 5, AND 6) $8,000

% OF GROSS PROFIT 53.3%

Figure 7-10 Investment Salary and Overhead Calculation Sheet

Thus, line 1 of figure 7-10 shows $50,000 of trading capital.

2) *Gross profit or loss, excluding commissions.* Although all your previous profit and loss calculations (i.e., the standard deviation and the confidence limits) have included commissions, do not include commissions as part of your gross profit or loss on this worksheet. Put only the gross profit or loss (cost minus sale price) on line 2.

3) *Commissions.* Put the total amount of money you spent on commissions during the year on line 3. For example, our hypothetical trader made 100 trades during the year with an average commission of $50 each. Thus, he put $5000 on line 3. Now divide this amount by the gross profit, to determine what percent of the gross profit your commissions are. If line 2 is a loss even before commissions, this calculation is meaningless.

4) *Advisory Services, Information and Subscriptions.* On line 4 total your expenses for newspapers, magazines, information, and advisory subscriptions that you paid for during the year. Do not include those you purchased primarily for pleasure, even if they are investment related. Also, include any computer services you might subscribe to, such as a service to get on-line stock, commodity, or historical quotes. Put the total amount on line 4, and then divide this amount by the gross profit (if you had one) to determine the percent of gross profit you spent on advice and information.

5) *Seminars and Conferences.* If you went to any seminars to learn a new trading system, hear experts forecast the economy, for any other reason related to trading include all expenses associated with these seminars and conferences on line 5. On the other hand, if you went to a seminar primarily because it was on board a cruise ship to the Bahamas, then do not put the expense down. Divide the total amount on line 5 by your gross profit, if any, to determine what percent of your profits you spent on seminars.

6) *Miscellaneous Expenses.* All miscellaneous investment-related expenses should be included on this line. If you bought a computer, software, or any major equipment for trading purposes over the last four years, include 25% of that cost on line 6. Our hypothetical trader, for example, spent $4000 for a computer and software over the last two years. He estimates that about 50% of its use is for investments, or $2000. Thus, he enters 25% of $2000 on line 6. Divide the amount on

line 6 by your gross profit, if any, to determine what percent of your profits you spent on this activity.

7) *Net Profit/(Loss).* Subtract all your trading related expenses (lines 3, 4, 5, 6) from your gross profit and enter the result on line 7. If you have a profit, divide this by your gross profit to determine what percent of your gross profit you actually made.

These figures may not agree with your income tax figures for the year, because the procedures for entering figures on this worksheet are not necessarily the same as for your income tax. You may not have taken the cruise or bought the computer if you had not been able to write it off as a deduction. But this worksheet is for you to determine your real expenses.

8) *T-bill Rate of Return on Capital.* A trader can put his capital into treasury bills (T-bills) with little effort or risk. Presumably, the reason you invested in commodities, stock, options, etc. was to get a higher rate of return. Were you successful? To find out, multiply your trading capital (line 1) by the approximate rate of return on T-bills during the year. We have assumed a 9% return on T-bills for our hypothetical trader, and entered $4500 (i.e., $50,000 x 9% = $4500) on line 8 as a loss. This figure also provides an inflation adjustment to your profit.

9) *Income Tax Adjustment.* We have chosen to ignore line 9 for our hypothetical trader, since this is meant to be a simple worksheet. However, income tax is a critical factor in the investment activities of many traders. You can write off (as of this writing) $3000 in capital gain losses every year, and this may be a factor in the losses of some people. Other factors may also influence your taxes depending upon the current mood of the government. As a result, we have provided a blank line for you to make an adjustment for income tax for the year if you wish to do so.

10) *Real Investment Profit/(Loss).* Subtract line 8 from line 7. Also subtract line 9 if you elect to use it. Put the resulting profit or loss on line 10. If line 7 shows a loss, your loss is even bigger because your funds did not earn interest during the year and whatever income tax adjustment you made probably did not equal or exceed the interest adjustment.

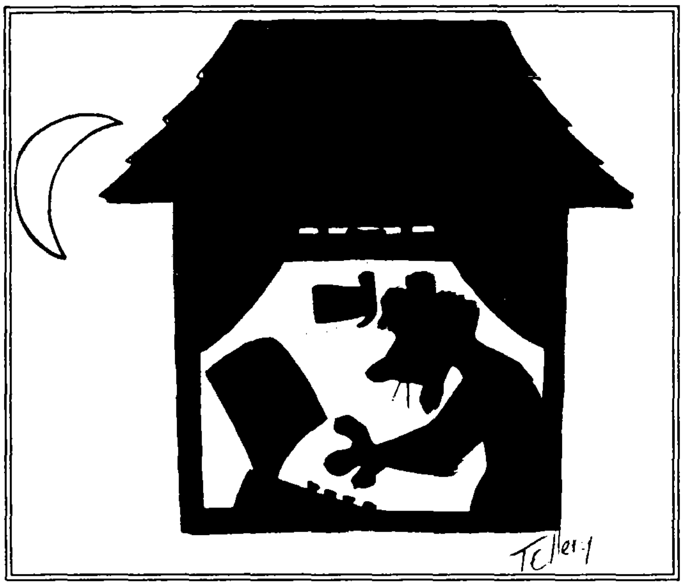


Figure 7-11 "How many hours?"

11) *Hours Spent on Trading Activity.* During an average week over the past year, estimate how many hours you spent working on your investments. Include time spent reviewing trading publications, going over charts, developing and reviewing your system, making trading decisions, etc. If you are paid a salary for some of this time (i.e., as a broker, financial planner, trading advisor, etc.), then don't include that portion of the time for which you are paid. Put your estimate down on line 11, and then multiply it by 52 to obtain the hours spent on trading activity during the year. If you only spent part of the year trading, multiply line 11 by the number of weeks you actually spent rather than by 52.

12) *Determine your hourly salary* from trading activity by dividing line 10 by line 11. If line 10 shows a loss, make this calculation anyway to determine how much you lost (i.e., paid) for each hour you spent on trading-related activity.

The point of the worksheet was to illustrate that your trading activity really is a business activity. The numbers on lines 10 and 12 represent the success of that business. How are you doing? What can you do to improve it?

Our hypothetical trader earns $8.01 per hour for his trading activity—an hourly rate he would never consider working for in his full time job.

13) *Trading Overhead.* A business is typically concerned with the amount of overhead. To determine your overhead as a trader, add lines 3 through 6 and then divide this figure by your gross profit (if any). One way to become a more successful trader is to reduce this figure. How can you reduce it?

Rate each of the following questions by putting the number that best corresponds to how you feel about the statement (according to the key below) in the space beside the statement.

7 -- strongly agree
6 -- agree
5 -- mildly agree
4 -- neutral
3 -- mildly disagree
2 -- disagree
1 -- strongly disagree

______ 1. I enjoy trading-related activity so much that market performance is secondary to my enjoyment.

______ 2. I like to take my vacation in conjunction with a seminar or conference related to trading.

______ 3. I have sufficient income to cushion any losses I might have.

______ 4. I feel financially secure.

______ 5. I would still invest in speculative markets even if I had all the money I could possibly want.

______ 6. I enjoy listening to financial discussions.

______ 7. Investments/trades are important to me for tax reasons.

______ 8. The relationship I have with my full-service broker is very important to me. (If you use a discount broker, put a one in the space).

______ 9. I enjoy reading newsletters and other financial publications.

______ 10. Market forecasting is a hobby with me.

__________ TOTAL SCORE

Figure 7-12 Trading Activity Enjoyment Questionnaire

IS TRADING A BUSINESS OR A HOBBY FOR YOU?

Answer the brief questionnaire on the previous page, Figure 7-12, before reading any further.

How to Interpret the Worksheet/Questionnaire. Trading can be a business or a hobby, and the way you evaluate your worksheet depends upon whether it is a business or a hobby. When you trade as a hobby, you enjoy what you do. A trading salary is nice, but not essential. Being a trader is what is important for you.

When you trade as a business, the amount you earn, i.e., your investment salary, is very important. If your salary figure is low or a loss, you need either to do everything you can to improve your profits and lower your overhead or to find another business.

The questionnaire gives you an indication of whether trading is a business or a hobby for you. Traders with scores over 40 tend to consider their trading activity as a hobby. The higher the score the more it tends to be a hobby. If you scored above 60, trading is pure pleasure for you. The trading-for-pleasure person wants to do well, but enjoyment is his/her priority. Trading salary (line 12) is not that important, just the profit (line 7). This person would not invest in T-bills, just because they have a higher rate of return. Dollars earned per hour are not as important as the fun of trading. The person who trades for pleasure need not even have a net profit if he/she makes enough to pay for the newsletters and conferences.

If you are an trade-for-pleasure person, but feel that profit is the bottom line for you, then you may have some real motivational conflicts in your life. You may feel guilty about trading for pleasure, which may affect your bottom-line profits.

Traders with scores under 40 are more business oriented. The lower your score, the more business oriented your trading activity is. For these traders the worksheet information is much more important.

If you scored under 30, you need to first examine whether you have a satisfactory trading salary. If you do not, you need either to devote your time to a more profitable venture and put your money in T-bills, or to examine your worksheet line by line to determine where to improve.

If your gross profit is very low or a loss, you definitely need to stop trading for a while and re-examine your trading system and yourself. Cut your losses short now, because a low gross or a total loss over a one-year period definitely suggests that something is wrong. But isn't that what we have been discussing throughout this volume?

This chapter has given you a number of important methods to measure risk. These methods include: 1) the standard deviation calculated over a fixed period; 2) your probability of success; 3) calibrating your ability to predict with your game plan; and 4) determining your trading salary and overhead. When you design your plan for generating low-risk trades (i.e., the last chapter of the last volume of this course), be sure to use all of these methods to determine what your risk actually is. If you avoid doing so, then you are neglecting the whole purpose of developing such a plan.

The last chapter has specific techniques for limiting risk and managing your money. Know the material in that chapter thoroughly.

CHAPTER VIII

TECHNIQUES TO CONTROL RISK AND SAFELY MANAGE MONEY

*"The key to long term survival and prosperity has a lot to do with the money management techniques incorporated into the technical system. There are old traders and there are bold traders, but there are very few old, bold traders."—Ed Seykota, **The Market Wizards**.*[1]

The purpose of this volume is to teach you about risk and how to reduce it, while you make bigger profits. You should now understand the psychological elements of risk. You should also know how to measure risk objectively. Your next step is to minimize it.

MONEY MANAGEMENT AND PYRAMIDING

There are several issues to discuss under the heading of managing your money. The first is the setting of stop loss levels. The second issue involves capitalizing on big moves in the market while still minimizing risk. You can do this by allocating different amounts of money to different types of trades or by pyramiding. I do not necessarily recommend either method. But one of them might be useful to you, depending upon your style of trading.

Setting Stop Loss Levels. A stop order is an order that is executed when the market reaches a certain price. These orders are used to limit losses and to protect open profits.

A stop loss order is a way of controlling risk. It means that when you enter the trade, you have a preset maximum loss that you are willing to tolerate. Most traders enter a specific stop loss order with their broker.

They have a specific price at which they are willing to admit their idea was wrong and get out of the market. Here's what some of the world's top traders say about limiting losses.[1]

> "Before taking a position, know the amount you are willing to lose." —Marty Schwartz, who entered ten U.S. Trading Championships and won nine of them by making more than all the other contestants combined.

> "If a stock drops seven percent below my purchase price, I will automatically sell at the market—no second guessing, no hesitation." —William O'Neil, founder of *Investor's Daily*, who has averaged over a 40% annual return on his stock investments over the last ten years.

> "You should always have a worse case point. The only choice should be to get out quicker." —Richard Dennis, a legendary trader who turned $400 into a fortune estimated to be worth over $200 million.

> "I have a mental stop. If it hits that number, I am out no matter what." —Paul Tudor Jones, a commodity fund manager whose funds have registered triple-digit gains five years in a row.

> "Combine that long-term objective with a protective stop that you move as the position goes your way." —Gary Bielfeldt, who started with $1000 and is now one of the largest bond traders in the world.

> "I set protective stops at the same time I enter a trade. I normally move these stops to lock in a profit as the trend continues." —Ed Seykota, who has realized an astounding return of more than 250,000% (after withdrawals for taxes) over 16 years.

Rules for setting your stop loss orders can be based upon a number of factors such as trend lines, trading ranges, relative highs and lows in the market, fibonacci numbers, or specific amounts of money. Your rules for setting stops should depend upon your particular techniques for determining risk in the market. You will determine these rules, if you have not already, when you develop your game plan for trading.

You can set such a stop loss point in three different ways. First, you can actually enter a stop order in the market. For most people, this is the best way. It removes the emotional element and the possibility of not acting. In addition, since your order is already with the market, it is the speediest way of executing your order. Thus, it is probably the safest. However, it also has the disadvantage of having your order in the market. When your order is actually in the market, traders tend to have the feeling that the market moves just enough against them to stop them out because the "market" knows that your order is there. Notice what you are doing if you think this way. You are blaming others for your mistakes. However, if you are stopped out constantly, then either think about the level at which you set those stops (are they consistent with your time frame for trading?) or use one of the other methods of setting stops.

The second method is to enter your stop loss order with your broker but not in the market. Let your broker monitor the market for you rather than enter the order. This method has the advantage that you know the market will not move to specifically take out your stop. However, it has the disadvantage of bringing in a human element—how trustworthy and reliable is your broker. If you shop around enough and your account size is large enough, you can find such a broker. Spend the time and effort to do so. On the other hand, if your account size is too small, then you may have trouble finding someone to reliably assist you.

Third, you can have a mental stop. A mental stop, if you are reliable, may be the best method to make sure that your risk is limited. It also has the advantage of allowing you to have the market tell you what is going on (e.g., if you understand the internal workings). If you are reliable and enjoy constantly monitoring the market, then this method is probably the best method for you.

The mental stop also has a few distinct disadvantages. The most obvious one is that it is difficult for most people to take losses. It's too easy to change a mental stop or to not act when your stop level is hit. If you have this sort of problem, then a mental stop is not for you. Second, having a mental stop forces you to stay glued to a monitor. This is not a very good way for most traders to remain objective about the market. Third, a mental stop may be the slowest way of exiting. For example, if the market starts to move rapidly against your position, your order will not be executed as rapidly as an order that is already in the market. Thus, you might take a bigger loss than you would if your loss was held by a broker with direct access to the market or if your order is already in the market.

Whatever your procedure is for setting a stop, I recommend that you make one important rule for yourself:

NEVER CHANGE YOUR STOP LEVEL
UNLESS DOING SO REDUCES YOUR RISK!

MAXIMIZING PROFITS

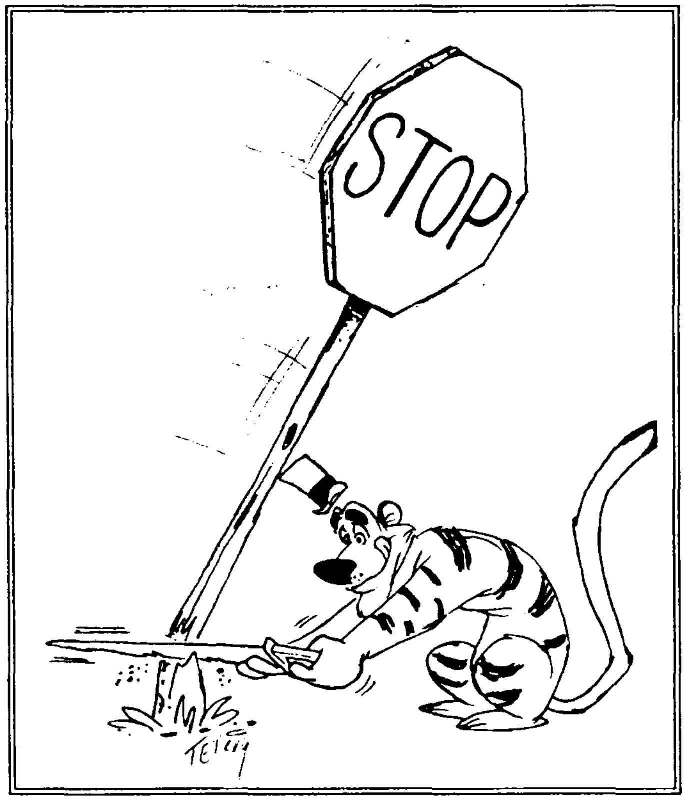


Figure 8-1 "Changing Stops."

Each market each year generally has several good moves in it. Find those moves and capitalize on them and you will overcome many small losses. My experience is that most successful traders reach that status by capitalizing on such moves while continuing to monitor and minimize risk.

Some traders develop the skill to easily spot major market moves. When such a move occurs, they enter it with a maximum sized position, thus producing maximum profits. Whether their overall trading is profitable depends upon what they do in the market the rest of the time!

The difficulty for most of these traders is their trading activity between such moves. For example some of these traders believe that they cannot recognize such a move unless they constantly remain active in the markets. If these are small positions and the trader has enough skill and discipline to break even with these trades, then he will be very successful. For example, such a trader might risk 0.5% to 1% of his trading capital on regular trades and 5% to 10% on maximum position moves.

Two significant issues are important to maximizing profits in major market moves and day-to-day activity in the market: 1) Whether or not one takes positions in higher risk day-to-day moves in the market; and 2) The trader's skill at recognizing low-risk, major market moves.

Day-to-Day Activity. If you are involved in higher risk day-to-day activity, the question to ask yourself is "for what purpose?". Do you believe you need to be active in order to spot the major moves? Do you just stumble into the major moves by your day to day activity? Or do you need drama in your life and the day-to-day activity serves that purpose.

If you are involved in almost constant activity in the market just to keep "market feel," then consider paper trading and keeping up your charts and tables by hand as an alternative. If you trade regularly because of some internal need for drama in your life, then aim to eliminate that need as a goal for yourself as you go through the remainder of this course. If you are a floor trader and you must trade daily, then consider only taking low-risk scalping positions. Don't try to make huge profits scalping, just consistent profits. But plan to position trade those large special moves in the market, because that is where you will make your big money.[2]

Many traders significantly raise their profits by eliminating as much of this higher risk activity as possible. How much can you eliminate?

Skill Level. What is your skill level at recognizing major moves in the market? Skill at recognizing major market moves does not necessarily translate into significant profits. Knowing your skill level and being able to use risk accordingly does!

First, can you accurately spot major moves and minimize your risk by reading the market? If so, you are exceptional. The advantage of having such skill is that you are reducing market risk by your ability to spot important moves. As a result, I would suggest that you only trade major moves and that you do so by putting on a major position (up to 25% of your trading capital depending upon the amount of leverage involved) when you spot such a move. I only recommend this strategy, however, if you are very skilled.

> "Whenever I buy something, I always try to make sure I'm not going to lose any money first."—James Rogers, Jr., one of the most astute fundamentalists of our time.

The second possibility is that you occasionally stumble on to a major move by your day-to-day activity. If so, then you need to continue to take low risk trades (1% of trading equity or less). If you get out of your losers quickly and allow your profits to run, then you will occasionally benefit from a major market move.

> "I develop an idea on the market and pursue it from a low-risk standpoint until I have been repeatedly proven wrong or until I change my viewpoint."—Paul Tudor Jones

When the market moves in your favor and you have locked in a profit, then that move probably deserves more of a commitment. Thus, you can further profit from the move by using an effective pyramiding plan as discussed below.

The third possibility is that you can accurately spot major moves, but you are often wrong. If you shoot for two major moves each year, but find that you need to open six to eight positions a year to catch them, then you should use some sort of pyramiding plan. Let the market prove your position and then add to it. This type of trading has the advantage of giving you minimal exposure to the market when you first enter a position and the market is most likely to move against that position.

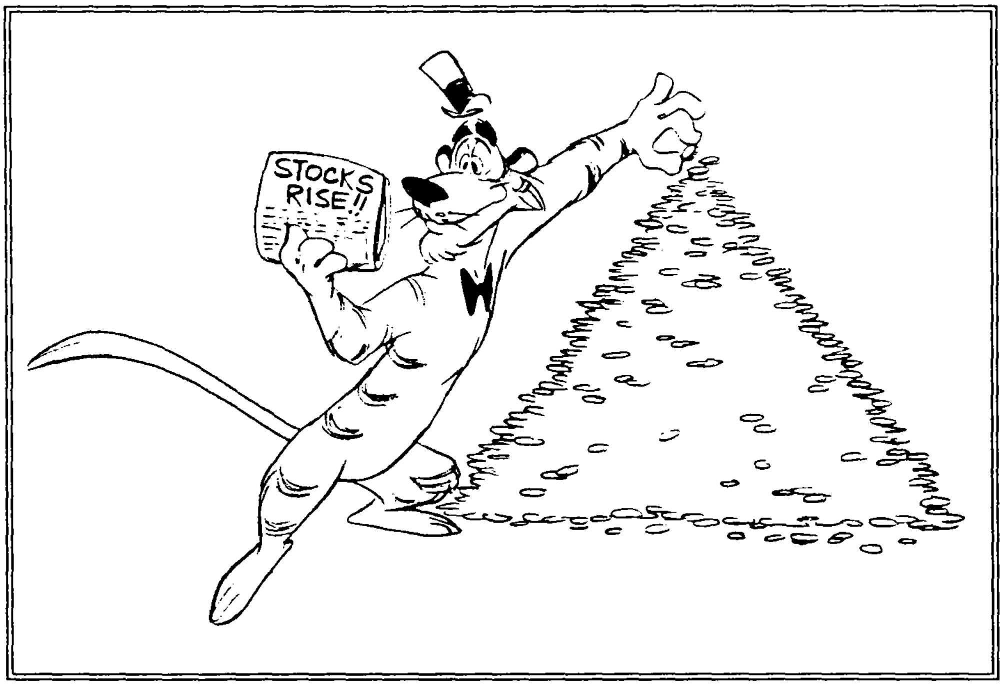


Figure 8-2 "Pyramiding Profits."

One form of pyramiding involves adding half of the prior position at each opportunity. Thus, one might start out with 16 units, and then add 8 at the next opportunity, and then 4, and then 2, and finally one. Thus, beginning with 16 units and adding four additions you would have a total of 31 units. This is the standard pyramid.

A second form of pyramiding involves adding one half of your total current position at each opportunity. Thus, if you started out with 16 units, you would add 8 more at the first opportunity. Since you now have 24 units, the next addition would involve half of that or 12 more units. Now you have 36 units, so the next addition would be half of that or 18 new units. In this case, beginning with 16 units and after four additions, you would have a total of 81 units. The risk builds up much more quickly with this sort of increment. Never use this form of pyramiding unless you can lock in your base at breakeven at the same time you add additional units.

A third form of pyramid involves adding equal units at each level. Thus, you might start out with 16 units and add 16 more units at each increment. In this case, beginning with 16 units after four additions you would have a total of 80 units.

Each of these pyramiding plans allows you to add to a winning position while taking a minimal amount of risk at the beginning. Most good traders believe that a profitable trade deserves more of a commitment. However, I strongly suggest that you adhere to the following rules:

1) *Your total number of units at the end of all additions should not exceed the maximum amount of capital that you were originally willing to expose to the market.* Thus, if your maximum risk exposure was 5% of a $100,000 account or $5,000 and your stop loss was $250 per unit, then your maximum commitment at the end of the pyramid should not exceed 20 units. One possible exception is that you might adjust your risk according to the value of your trading account at the time you wish to add positions. Thus, if your account increases in value through this move to $150,000, then you can risk $7,500 (or 30 positions) by the end of the move.

2) *Don't add to an existing position until the last unit shows a profit or if your intended stop loss for the new position would imply a loss for the entire position.*

3) *New units in the pyramid should always be smaller than the base.*

The disadvantage of pyramiding is that you have the largest holdings at the end of a move. When the market reverses against your position, your losses on the larger base will mount up quickly. In fact, **many traders have built a small amount of capital into a large fortune** in less than a years time through pyramiding **and then lost it all in a few days**. Can you manage your risk in such a way that such losses will not occur?

I have a client who has increased his six figure account well over 400% in the last 12 months through the proper use of pyramiding. He is able to do this because he is finding low risk situations, and he is controlling risk by controlling himself well. As a result, he is able to handle a high-risk pyramiding plan.

PROCEDURES TO MINIMIZE RISK

If you use all of the procedures that we recommend in this chapter for controlling risk, then you will seriously limit your profits. Therefore, you must select those procedures that best fit you. Remember, however, that your primary job as a trader is to avoid a career ending mistake.

Assume that a trade exists with your number on it and that your first consideration at all times is to take steps to avoid that trade.

Diversify Over Time. One of the best ways to reduce your risk is to diversify it over time. This means that you must always keep enough money in reserve for those special trades that occasionally come along or even for routine trades during entirely different market conditions. This is also called reducing your *exposure* to risk. If you win 90% of the time, but you risk much of what you have every time you trade, then you will eventually lose everything. This is one of the most common mistakes of small and novice traders.

Put a larger portion of your portfolio into cash or T-bills. If you have a futures account or option account, keep a reserve of 80% at all times! A 90% reserve would probably be even better. If 10% to 20% of your account is not enough funds for the trades you want to make, then the trade is too risky or you do not have enough funds to be in that market.

I cannot emphasize this point strongly enough. Most traders are looking for 100% returns or more on every trade. As a result, they overtrade. They risk too much capital on any given trade and end up going broke. Here's what some of the world's best traders say:[1]

> "Risk management is the most important thing to be well understood. Undertrade, undertrade, undertrade is my second piece of advice. Whatever you think your position ought to be, cut it at least in half. My experience with novice traders is that they trade three to five times too big."—Bruce Kovner, a fund trader with a rate of return of over 87% per year compounded over the last ten years.

> "Why risk everything on one trade? Why not make your life a pursuit of happiness rather than a pursuit of pain?" —Paul Tudor Jones

> "Never risk more than 1% of your total equity on any one trade. By risking 1%, I am indifferent to any individual trade. Keeping your risk small and constant is absolutely critical." —Larry Hite, a fund manager who has averaged over 30% per year compounded annually by practicing extreme risk control.

> "Never risk your family's security. Before taking a position, always know the amount you are willing to lose."—Marty Schwartz

> "The key is to lose the least amount of money when you are wrong."—William O'Neil

> "You have to minimize your losses and try to preserve capital for those few instances where you can make a lot in a very short period of time. What you can't afford to do is throw away your capital on suboptimal trades."—Richard Dennis

> "Most traders have a tendency to take risks that are too large at the beginning. They tend not to be selective enough when they take risks."—Gary Bielfeldt

> "The object is always to minimize your risk." —Tom Baldwin, a floor trader who is estimated to have made 30 million over the last six years.

> "No matter what happens, I know my worst case. My loss is always limited."—Tony Saliba, a floor trader with over 70 consecutive months of $100,000 profits.

Theses top traders have different strategies for trading. What is common to all of them is strong risk control.

To illustrate how risk is minimized by diversifying over time, let's compare two trading accounts. First, Figure 8-3 illustrates the trading activity of a successful trader.[3] The account is profitable over the year even though there are seven losing months and only four profitable months. The risk factor, measured by the standard deviation method, is 10.74—an acceptable figure for a good trader. His account value seldom drops below $35,000 and most of that money is earning interest in T-bills. He only makes 2 or 3 trades per month, which is reasonable, if not low, for this size account.

Figure 8-4 describes another hypothetical trader with the exact same record, except that his account is consistently worth $35,000 less than the account in Figure 8-3. Notice that column D, the gain/loss column, is exactly the same in the two figures. Our new trader does not have enough capital to trade commodities. Although he happens to be a net winner in the illustration, this is extremely unlikely. And it happens only *after being wiped out for two consecutive months.* Notice what under-capitalization does to this trader's risk factor—it becomes 160.54.

Many traders have too little capital to trade or they overtrade for the amount of capital they do have. Our trader in Figure 8-4 stayed in the markets (by borrowing?) after losing his entire capital for two consecutive months. Most traders would not last through that experience. Chances are excellent that even if this trader did not quit after these experiences, he still would not last through another six months. Commodity funds usually close down after losing 50% of their initial value. Individual traders frequently lack that kind of discipline and may even permit themselves to go heavily into debt before quitting. For a good example of this, see the interview with the compulsive trader in Volume 4 of the course.

Diversify Your Account. If you open several simultaneous positions, then trade only independent, low-risk ideas. If your positions are independent, then three different positions might be enough to diversify adequately. When one position goes down, another independent position might go up, thereby providing you with some protection. The stocks of two

A		B	C	D	E
ACCOUNT VALUE		ADDITIONS/ WITHDRAWALS	NET AMOUNT	GAIN/LOSS	%CHANGE
$37438	13 MONTHS AGO				
$41912	12 MONTHS AGO		41912	4474	11.95
$35411	11 MONTHS AGO		35411	(6501)	(15.51)
$36811	10 MONTHS AGO	$3000	33811	(1600)	(4.52)
$36550	9 MONTHS AGO		36550	(261)	(0.71)
$38892	8 MONTHS AGO		38892	2342	6.41
$38892	7 MONTHS AGO		38892	0	0
$43542	6 MONTHS AGO	($5000)	48542	9650	24.80
$43344	5 MONTHS AGO		43344	(198)	(0.46)
$48711	4 MONTHS AGO		48711	5367	12.38
$46776	3 MONTHS AGO	$1000	45776	(2935)	(6.03)
$45100	2 MONTHS AGO		45100	(1676)	(3.58)
$42395	LAST MONTH		42395	(2705)	(6.00)
				$\bar{X}$ =	1.56
				SD=	10.74

NUMBER OF CLOSED TRADES DURING LAST 12 MONTHS 33

NUMBER OF WINNING TRADES (INCLUDING COMMISSIONS) 15

NUMBER OF LOSING TRADES (INCLUDING COMMISSIONS) 18

COMMENTS:

Figure 8-3
The Risk In A Sample Trading Account

A		B	C	D	E
ACCOUNT VALUE		ADDITIONS/ WITHDRAWALS	NET AMOUNT	GAIN/LOSS	%CHANGE
$2438	13 MONTHS AGO				
$6912	12 MONTHS AGO		6912	4474	183.51
$ 411	11 MONTHS AGO		411	(6501)	(94.05)
$1811	10 MONTHS AGO	3000	(1189)	(1600)	(389.29)
$1550	9 MONTHS AGO		1550	(261)	(14.41)
$3892	8 MONTHS AGO		3892	2342	151.10
$3892	7 MONTHS AGO		3892	0	0
$8542	6 MONTHS AGO	(5000)	13542	9650	247.95
$8344	5 MONTHS AGO		8344	(198)	(2.32)
$13711	4 MONTHS AGO		13711	5367	64.32
$11776	3 MONTHS AGO	1000	10100	(2935)	(21.42)
$10100	2 MONTHS AGO		10100	(1676)	(14.23)
$7395	LAST MONTH		7395	(2705)	(26.78)
				$\bar{X}$ =	7.03%
				SD=	160.54

NUMBER OF CLOSED TRADES DURING LAST 12 MONTHS 33

NUMBER OF WINNING TRADES (INCLUDING COMMISSIONS) 15

NUMBER OF LOSING TRADES (INCLUDING COMMISSIONS) 18

COMMENTS:

Figure 8-4
The Risk With $35,000 Less Capital

international oil companies would not be independent, because the price movements of those stocks tend to move together. Similarly, gold and silver contracts would not be independent since both are precious metals and they tend to move together. Two stocks from entirely different industries would be more independent—but remember that most stocks tend to go down in a bear market. The more dependent your trades are, the more different trades you will need to diversify effectively. Adequate diversification might involve stocks, commodities, and financial instruments, since these all can be relatively independent. For example, a soybean contract, a German Mark contract, and the stock of a steel company would be good examples of fairly independent trades.

Here's what one of the world's top traders says about this topic:

> "Bet less than 5% of your money on any one idea. That way you can be wrong more than twenty times; it will take you a long time to lose your money. I would emphasize that the 5 percent applies to one idea. If you take a long position in two different related grain markets, that is still one idea."—Michael Marcus, who turned a $30,000 account into over $80 million.

If you diversify your account by trading many different markets, be certain you can handle a number of different markets. Traders who specialize in one market have the advantage of being an expert in that market. Traders who deal in many markets have the advantage of diversification and of having more good opportunities.

Or how about diversifying your account by trading different systems. Here's what another top trader suggests:

> "A third thing we do to reduce risk is to diversify...To provide balance, we use lots of different systems ranging from short term to long term. Some of these systems may not be that good by themselves, but we really don't care: that's not what they are there for."—Larry Hite

Reduce Leverage. Most traders play high leveraged markets in order to make greater profits. If you play such markets and take advantage of the leverage, then you must only bet small amounts of your capital as I have emphasized. In contrast, you can play such markets and reduce your risk by reducing the leverage involved. For example, earlier (see page 108, Chapter VII) I showed you an example of the risk involved if you had (or could have) traded the CMI index in 1983. If you only put up 4% of the value of the index, then the risk factor as measured by the recommended standard deviation method would have been 111. On the other hand, if you had put up 100% of the funds required, then the risk factor would only have been 4.45.

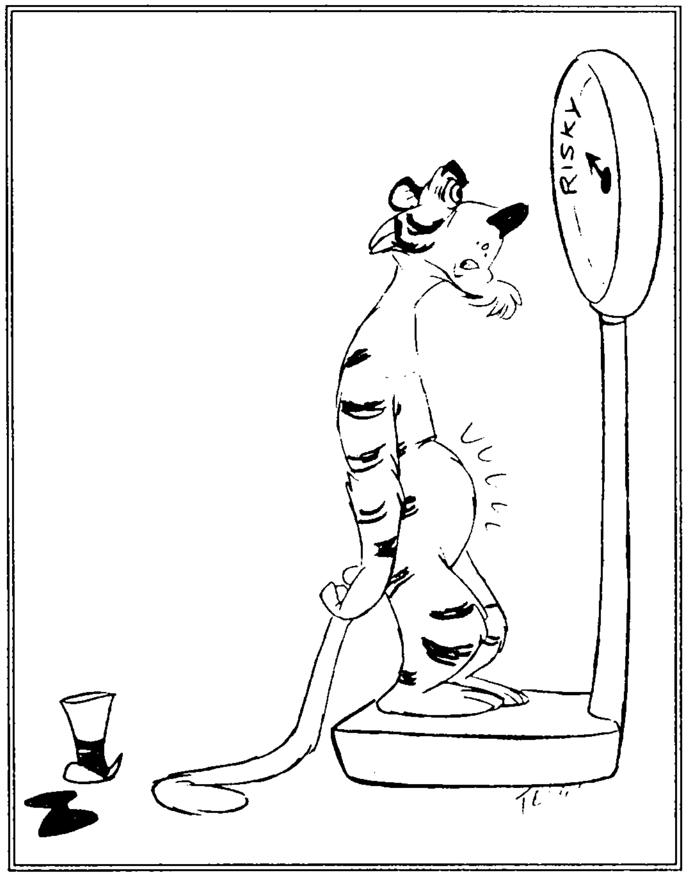


Figure 8-5 "Reduce Leverage."

Trade Only Low-Risk Ideas. Only make trades with a high probability of success. Remember that your job in trading is to develop low-risk ideas, to market those ideas to insure that they are low risk when you open a position, and to monitor your position and take action so as to minimize risk. If you follow this procedure, you will not be that active in the market. Reducing the activity of your account also reduces the risk involved in trading.

Make it okay to miss a trading opportunity. There will always be another trading opportunity later. As a result, make a point only to trade when you are ready.

Play the market only on your own terms.

Know the probability of success of your system and work to improve it. To reduce your risk, you must know the risk you are taking. Do not trade a system without determining its maximum success rate through paper trading or trading with historical data! In fact, most of you should not trade until you have completed your game plan as described in the last chapter of the last volume of this course. That game plan includes the step of determining your maximum success rate through paper trading. I described how to make the appropriate calculations in Chapter VII.

Make Adjustments. Trading is somewhat like shooting a moving target. Markets change and you must be able to adjust to those changes. In addition, you change and you need to be aware of changes in yourself. As a result, two of the top trading tasks involve making adjustments. These include the **daily debriefing** and the **periodic review**.

First, I recommend that you do a daily debriefing. This daily debriefing provides a transition between being in and out of the market. It gives you a chance to detach yourself from the market and notice what mistakes you might be making (if any). Remember that a mistake involves not following your rules. The daily debriefing gives you a chance to correct those mistakes.

Second, you need to do a periodic review of your game plan. You need to periodically remove yourself from the market to monitor the level of risk you are taking. Is it working for you? Do you need to make some adjustments? That is the purpose of the periodic review.

Take Profits. There are two elements in the expected value formula (see p. 80) and both of them involve taking profits. The first element of the formula involves the percentage of time you take profits. Some good traders do not make consistent, large profits—they just make consistent profits. They take twenty cents out of each dollar move. However, these traders are also consistently right about the market. In fact, part of that consistency comes from the fact that they take profits before they have a chance to turn into losses. As a result, if you have that kind of skill, then you can minimize your risk by taking profits consistently. In fact, if you have the luxury of consistently making money, then there is no risk to what you are doing.

The second element of the expected value formula relates the size of profits to the size of losses. Thus, if you are right only a small percentage of the time (i.e., 30 to 40%), then you must allow your winning trades to run their course. Having much bigger profits than losses is the only way that you will have consistently high rates of returns and thus low risk.

Control Yourself. You might have a solid game plan and do an excellent job of correcting mistakes and making game plan adjustments. If you do so, then you will know that the risk of following it is minimal. However, all of these procedures mean nothing unless you control something even more important—you.

You are the most important factor in your trading success.

If you do nothing else, at least notice when the market proves your position to be wrong. When the market shows you that your position is wrong, then get out quickly. If you take losses eight or nine times in a row, then remove yourself from the markets for a while. And when you come back to the market, reduce your exposure to risk.

Some of the most important tasks in our model, presented in Chapter IV, involve controlling you. Those tasks involve **self-analysis** and taking care of your personal needs when you are **out of the market**. If you want consistent success, you must do these two tasks routinely.

The remainder of this course deals with personal issues involving self-control. For example, if you are highly stressed, then that stress will affect your performance and you will have trouble minimizing risk. Volume 2 is a complete stress management course. Your stress is likely to be a symptom of conflict. Volume 3 teaches you how to deal with conflict and with beliefs that may make minimizing risk difficult for you. You also must control your mental state if you are to minimize risk. You might have a low-risk trade, but if you are afraid, you probably won't take it. If you are overconfident, then you are likely to also take high-risk trades. Volume 4 of the course teaches you how to control your mental state so that you can take low-risk trades and avoid high-risk trades. Finally, you must have a mental strategy that allows you to take signals when you get them. Volume 5 helps you understand your judgmental biases and develop a mental strategy that will support low-risk trading. The last volume will also help you put all of the material together in the form of a low-risk game plan for trading. Enjoy the journey ahead of you!