Trading Psychology and Risk Management

Chapter 12

Introduction

- It is generally noticed that when we invest or trade our focus is on potential gains rather than dwelling on possible losses. But in order to be successful trader, we must keep our mind open to the potential losses and we should know how to manage and control those losses.

- If you are making huge profits in the market on a very small or average trading account, May be you are lucky for one or two days that has earned you windfall profits. But you have exposed yourself to an abnormally high "Trade Size." If you continue trading in this manner, probabilities indicate that very soon you would land up with series of losses and you may loose your entire capital.

- Novice traders tend to focus on the trade outcome as only winning and therefore do not think about risk. Professional traders focus on the risk and take the trade based on a favorable outcome.

Use of stop loss

- A trader should always put Stop Loss and trade a fraction of his capital.
- He should be aware that it is possible and inevitable to have a losing streak of five losses in a row. This is called drawdown.
- This awareness will help the traders prepare as to how to control risk and choose their trading system.

Qualities of successful traders:

- Always use stops
- Trade size should be determined on the basis of trading account equity, and stop loss price for every trade.
- Never trade more than 10% on any give sector.
- Never exceed a loss of 2 to 5% on any given trade
- Always trade with risk capital, money you can afford to lose.
- Never overtrade with borrowed money and don't overtrade based on the time frame you have chosen to trade

Golden rules for traders

- **Avoid being emotional:** Without a system of discipline for your decision-making, impulse and emotion will undermine skills as you chase the wrong stocks at the worst times.

- **Many short-term players view trading as a form of gambling:** Many short-term players without planning or discipline jump in the market. The occasional big score reinforces this easy money attitude but sets them up for ultimate failure.

- **Technical Analysis teaches traders to execute positions based on numbers, time and volume:** This discipline forces traders to distance themselves from reckless gambling behavior. Through detached execution and solid risk management, short-term trading finally "works".

Do's and Don'ts in trading

- **Forget the news, remember the chart:** You're not smart enough to know how news will affect price. The chart already knows the news is coming.
- **Buy at support, sell at resistance :** Everyone sees the same thing and they're all just waiting to jump in the pool.
- **Trends test the point of last support/resistance :** Enter here even if it hurts.
- **Trade with the TICK not against it :** Don't be a hero. Go with the money flow.
- **Price has memory :** What did price do the last time it hit a certain level? Chances are it will do it again.

- **Bulls live above the 200 day, bears live below :** Sellers eat up rallies below this key moving average line and buyers to come to the rescue above it.

- **Beat the crowd in and out the door :** You have to take their money before they take yours.

- **Trends never turn on a dime:** Reversals build slowly. The first sharp dip always finds buyers and the first sharp rise always finds sellers.

- **Bottoms take longer to form than tops.** Greed acts more quickly than fear and causes stocks to drop from their own weight.

Rules to Stop Losing Money

- **Don't trust others opinions -** It's your money at stake, not theirs. Do your own analysis, regardless of the information source.
- **Don't break your rules -** You made them for tough situations, just like the one you're probably in right now.
- **Don't try to get even -** Trading is never a game of catch-up. Every position must stand on its merits. Take your loss with composure, and take the next trade with absolute discipline.
- **Don't believe in a company -** Trading is not investment. Remember the charts and forget the press releases.
- **Don't seek the Holy Grail -** There is no secret trading formula, other than solid risk management. So stop looking for it.
- **Don't forget your discipline -** Learning the basics is easy. Most traders fail due to a lack of discipline, not a lack of knowledge.

- **Don't trade over your head -** Concentrate on playing the game well, and don't worry about making money.
- **Don't chase the crowd -** Listen to the beat of your own drummer. By the time the crowd acts, you're probably too late…or too early.
- **Don't ignore the warning signs -** Big losses rarely come without warning. Don't wait for a lifeboat to abandon a sinking ship.
- **Don't count your chickens -** Profits aren't booked until the trade is closed. The market gives and the market takes away with great fury.
- **Don't forget the plan -** Remember the reasons you took the trade in the first place, and don't get blinded by volatility.
- **Don't join a group -** Trading is not a team sport. Avoid acting on messages, flashes and financial TV. Your judgment may be more correct than all of them put together

- **Don't ignore your intuition -** Respect the little voice that tells you what to do, and what to avoid. That's the voice of the winner trying to get into your thick head.

- **Don't hate losing -** Expect to win and lose with great regularity. Expect the losing to teach you more about winning, than the winning itself.

- **Don't fall into the complexity trap -** A well-trained eye is more effective than a stack of indicators. Some time Common sense is more valuable than a complex set of indications.

- **Don't confuse execution with opportunity -** Overpriced software won't help you trade like a pro. Pretty colors and flashing lights make you a faster trader, not a better one.

- **Don't think its entertainment -** Trading should be boring most of the time, just like the real job you have right now.

Choosing the Right Markets to Trade

- It is a common misconception that you need to follow a lot of stocks to be a successful trader. This is not true. For most traders, choosing six to eight stocks to follow should be adequate.

- It is important to allow some diversification among the markets you follow however, so as to allow for the maximum number of trading opportunities.

- You would not want to choose all power stocks to follow, or all grains if trading in commodities. By taking one or two picks from each category you should have enough of a cross section to catch most of the opportunities within that category.

Importance of discipline in trading

- **Trading discipline** – One's own trading plan is very important to success. It should be followed strictly. Emotions have no place in trading and it could easily lead to losing of money. Proven techniques and strategies should not be edited for any reason; follow the plan and let it work for you.

- **Understanding risk** - Difference between gambling and investing is what is called as managing risk. Profitable traders can quickly calculate how much of a drawdown they are willing to incur before cutting a position. It is important to have a plan for pruning losses and minimizing the damage of drawdown.

- **Stick to your niche** - Niche trading is considered to be the best strategy to remain profitable. Sticking to an area in which one specializes is the best way to minimize losses. If one is best in high volume trading, then only trade during periods of high volume. Finding your trading niche will help you to become more a more efficient trader.

- **Trading is affected by emotion** – It is difficult to get away with the trading. Holding open positions can increase the amount of stress. Day traders should try and limit the exposure and keep the stress at lower level.

- **Trade as your capital allows** –High levels of margins can be easily exceeded by the day traders that greatly exceeds there trading capital. Exceeding the credit limit can be very dangerous and it can accumulate losses as fast as gains. Momentum trading with many different entry points can end up in costly mistakes if your account becomes overextended.

- **Set stop losses and take profits** – The most profitable trading is one in which we "Set and forget". Once should remember to place exit along with placement of trade.

- **Don't watch minute to minute** – The minute to minute movements should be avoided by the traders. It is difficult to have a potentially profitable trade after having minute to minute movements. Small ups and downs create temporary stress.

- **Don't get attached** –one should not be too attached with the stock. Investor should be ready to dump it off when the price is right.

- **Talk to other traders** – Communicate with other traders and share their experiences. Aim should be to get trading down to a point where it comes naturally to you.

THANK YOU