A TRADER'S GUIDE to Dominating the *Fear of Losing*

Special Report #2

THE Disciplined Trader
The Psychology of Profits

It can be a nightmare. You see your trading account starting to dwindle. You can hear your spouse's not so subtle comment on your reckless ambition to make easy money. You decide that you need to produce an impressive win and get her/him off your back. So, instead of buying your usual lot of 3 option contracts, you decide to double up and buy six. You feel good about this trade and you pull the trigger.

Before you can take a break and check the market, you hear the bad news on the radio and you realize it could impact your trade. You feel a tingle of fear in your spine as you pull up your trade on the computer. A lump forms in your throat as you see prices approaching your stop. Not another loss. You decide to give your position some room so you take off your stop. Just until lunch. You know you shouldn't do it but you do. If your spouse finds out you had another loss, they would give you that look that says "loser".

Making mistakes has different effects on individuals. When you're a child, not looking both ways can be life threatening. Putting coins into a wall outlet probably provided you with a close and personal view of a panic stricken mother. Your first bad grades might have evoked parental body language that made you feel small and worthless. We are so impressionable when we crawl through our single digit years and many of the corrective measures used to keep us safe and on the "right road" can have long lasting effects and unforeseen consequences.

Of course, every personality has a part to play in how we react to training and correction but for most of us during the tender years, it can be painful and much of that pain happens on a subconscious level. Many of us never get over the subtle emotional effects of learning from mistakes. Neural pathways have been formed and they inject an emotional component to our capacity to learn from mistakes.

If we understand "the big picture", making mistakes are just opportunities to learn. If not understood in a mature way, mistakes can be felt as a personal failing. When we learn as children, emotions are much more in play than logic. Depending on how adults handle the corrective process, children can learn or they can be traumatized by rejection from the most important persons in

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their lives-their parents or guardians. What makes it even more insidious is that parents or guardians may have had no intention of creating fear or negative emotions but the child perceives it as such and these emotional learning experiences can have a deep, long lasting effect-even through adulthood.

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Normally, it isn't until later in life that most of us learn that mistakes are valuable signposts to corrective behavior. Hopefully, we learn to accept our weaknesses and move on with new knowledge and the ability to recognize the pattern of behavior for the next encounter with a similar situation. Sometimes mistakes are inconsequential but on occasion, they can set in motion a sequence of events that can become ruinous. Learning to recognize and react properly to certain situations helps us survive the next potential threat. Indeed, at its base, learning is all about survival.

It's no different for traders. Making mistakes are to be learned from or financial integrity of the trading account can be put in jeopardy. Your trading account balance is your financial blood supply and if you lose too much of it, you eventually can't function as a trader. But to many, there is something even darker than losing money; being wrong. If you have been successful enough to amass an amount of money sufficient to trade, you probably are success oriented. You play to win. You aren't used to losing very often because you expect or others expect you to win. You get positive reinforcement each time you win and negative when you lose and you much prefer the positive. This is normal.

Trading is not a natural undertaking and we have no basic instincts to guide us. Like an infant, we must learn from scratch how to survive in a most complex and Darwinian environment. Lack of knowledge and understanding of the subject is a threat when trading in the cold unforgiving markets. But nothing ventured, nothing to fear losing. But as soon as something of value can be lost, the fear of losing looms over your shoulder and turns up the heat. For some unknown reason, many would-be traders seem to take the approach of "sink or swim" when starting to trade and jump in with little training or structure and very quickly lose some trades, and pain and fear quickly take over.

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Most who trade without preparation are destined to sink. So, the first order of business in avoiding the fear and pain of trading is education.

So let's talk about some basics on how to avoid the fear that can be part of trading.

One of the basic laws of trading is to develop and stick to a trading system. That means you have developed a trading system and have done enough paper trading to know what win-loss ratio to expect over a span of at least 100 trades. You must use the same criteria and procedures on every trade. No exceptions. You see, paper trading makes it safe because there is nothing to fear because there is nothing to lose. This should tell you that trying to develop a system with the pressures of not losing money is just too distracting. You just won't sit there and lose money in order to experiment to see what works. However, many will plunge ahead like fools and this is backed by the fact that 80-90% of novice traders fail mainly because they're not prepared. I guess that supports the Darwinian Theory; foolish behavior is not compatible with survival. So, take this to the bank: if you want to trade, you must prepare. If you don't, fear and pain await you.

"So, take this to the bank: if you want to trade, you must prepare."

Once you have developed a system and feel that you have developed the repetitive procedures to provide a mechanical framework within which you can identify risk-reward, pick a high probability trade, chose stops and entry and exit strategies, then you are ready to move up to the next level where you will encounter the most challenging part of trading; facing down the twin terrors of trading: losing money and being wrong.

Becoming a good loser

We have already introduced the concept of education and system development but education on investing just gives you the tools to trade with, not the temperament. Anybody can learn the mechanics of trading but few can learn the proper attitude. Indeed, it is the attitude that separates successful traders from the pack. Why is that? The answer is really quite simple: because losing can be painful and can easily undermine logic and consistency.

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Nobody likes to lose, particularly something of value- like money. Moreover, only a dolt would continue to tolerate losing something of value over a long and consistent period of time. But that's exactly what traders do. You see, every trader, no matter how smart or experienced, will lose and lose on a consistent basis. It comes with the territory because all traders play in an arena where the chaos factor reigns.

The chaos factor is the renegade variable that can't be forecast with any sort of certainty. It's the old butterfly flaps its wings in Africa and the small air current created by fragile little wings can evolve into a hurricane; little events can become compounded to create an event that will become an "outlier"; an event at the far edge of the bell curve; out beyond the second or third standard deviation. These events don't happen all the time, but they do happen.

The best that a trader can hope for is to identify high probability trades that have at least a 75% or better chance of turning out as expected. However, that still means that 25% of the time things won't pan out. Through knowledge, experience and good judgment, traders must learn how to gauge risk-reward and whether to act or pull away. In fact, the key to becoming a successful trader is not so much having big winning trades but having more winning trades than losing ones. Trading is indeed a "numbers game".

For the most part, learning how to accurately weigh risk and reward is mostly a combination of academic knowledge and experience. However, because the chaos variable of the unknown is always out there, no matter how well prepared a trader is, even the best traders will experience losses. Notice I said "experience" and not "suffer" which is usually the verb used with the word "losing". Traders understand the difference because traders learn how to become "good losers".

> *"Notice I said "experience" and not 'suffer'..."*

How do you learn to become a good loser in a society were losing equates with *being* a loser? Well, it's a two step process. First is education and logic. Once that is acquired, comes the emotional-psychological conditioning that helps bury the stigma of losing and create new neural networks that don't pull the strings on our subconscious memories and feelings.

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Hanging you hat on the win-loss ratio

As we mentioned before, once you have developed a system that produces an estimated win-loss ratio, you have the main logical factor to hang your hat on: the win-loss probability of the system. Of course, the big question is how do you establish a level of confidence in the ratio; how many tests do you need to run to have a statistically significant number of trials? Most statisticians will say that 100 trials should be enough, but the more trials the better the data.

The key point is that you need to have a reasonable level of confidence in your system. If your system produces a win rate of 65% of the time then you know that you should lose about 35% of the time over 100 trades. Your system is set up to skew winning profit margins above losing margins and that's the name of the game. So, intellectually, you are expecting to lose 35% of the time. How do you know that? Your system will only have validity if it is implemented the exact same way every trade. If that is done, then you isolate errors introduced by the trader and you can say with confidence that the system is where any problems will be.

That sounds like a logical proposition and if you have faith in the system, then trading becomes a more or less mechanical operation with the trader moving the levers and nothing else. But what happens if the system doesn't work well? How can you just sit there and watch your valuable resources dwindle away?

The answer is again two fold: you reduce the angst by making the money you lose not so valuable and you set limits to how much you lose before you put on the brakes and step back.

Money Management

Another of the basic laws of trading is establishing clear money management rules. In most of the trading world, money management is considered every bit as important as having a viable trading system.

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> *"Keep in mind that the more money means to you, the harder it is to trade."*

The first rule of money management for traders is to trade money you don't need. If you don't need it, it shouldn't have that much emotional impact if you lose it. Before trading, you must sit down and make sure that your lifestyle and financial obligations depend in no way on the funds you use for trading. Keep in mind that the more money means to you, the harder it is to trade. To a trader, money is just a means of measureing performance.

Trade limits

As a general rule, most traders feel that no more than 5% of the trading account capital should be risked on any one trade. For example, if you have a trading account with a balance of $15,000, you would limit your risk on any one trade to $750. After all, the basic premise of trading is to stay in the game and let probability work in your favor. But to stay in the game, you need a steady supply of trading capital. As a result, capital preservation is a fundamental factor. How do you do this important task?

What type of trading vehicle you trade will have a large bearing on how much trading capital you will need. If you trade stocks, your capital requirement will be high. If you trade mini contracts, your trading capital requirements will be much lower. For example, if you want to trade 500 shares of IBM, you would need about $ 55,000 at current prices or about $23,000 if trading on margin. However, if you trade IBM options, you would need about $3000 to trade 5 out-of-the-money contracts (500 shares). Of course with the $55,000 you own the actual stock but if you are a trader that really doesn't matter because traders only hold assets for a relatively short period of time; minutes to months. So, most traders look for a way to trade assets at the lowest cost. This leverage allows them to optimize the ROI (return on investment) and provide more available capital for trading. Again, the more investment capital you have to trade, the better the chances of probabilities working in your favor.

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Drawdown

Another important money management milestone is the maximum drawdown limit. Typically, an account drawdown limit is set at about 35% of the account balance and acts just like a circuit breaker. Once that limit has been hit, all trading stops and it is time to analyze what is happening. Why 35%?

As you can see from the table on the next page, once the account reaches about a 35% drawdown, the gains required just to catch up starts to go exponential. At 50% drawdown you would need 100% gains on the total balance just to get back to the original balance.

% Drawdown	% Gain required to recoup loses
10	11.11
20	25.00
30	42.85
40	66.66
50	100
60	150
70	233
80	400
90	900
100	busted

So, if the account hits the drawdown limit, all trading comes to an immediate stop. No exceptions. At this point, the trader asks the key questions:

- Is my system a bust? If so, how do I fix it?
- Am I not following procedures to the letter?
- What is my state of mind?
- How is my physical condition?
- What steps do I need to get back on track

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By following these simple rules of trade limits and drawdown limits, a trader can keep his or her ammo dry. No doubt about it, probability can produce a run of "bad luck" and give the impression that the system is not producing the expected result. Maybe the situation just needs some time to step back and take a pause. But the most common cause for trading anomalies is that the trader has strayed from the discipline of the trading system. Having money management procedures and rules act as the safety net and emergency stop signal to allow the trader to stay in the game and make necessary changes before getting too deep in the hole.

If a trader establishes and follows the well tested rules as presented in this report, there should be no fear of account blowout. The worst that will happen is that trading stops until things are changed or the trader decides to move to other forms of investments are made. Bottom-line, preservation of capital is not only central to a traders strategy but also provides a safety valve to insure that capital is preserved for other activities if trading has been found to no longer be the most appropriate investment path.

Training the mind

Up until now, we have established a set of rules and intellectual guidelines to help produce the intellectual framework and philosophy of trading. We talked about the importance of developing a trading system which incorporates the academic and intellectual techniques for executing trades. We talked about the need to use trading capital that doesn't have an impact if it is lost. Then, we introduced the concept of money management as an integral part of staying in the game and letting the probability of the win-loss ratio to work in the trader's favor. However there is one important subject we need to cover, as well.

Losing can become a trigger to negative emotions. Yes, trading capital is expendable and should have little impact if lost but losing in itself can set off a chain of behavior that can be destructive to trading. Cracks can appear in self-confidence, shame at squandering resources-no matter how worthless and anger at just losing to the competition on the other side of the trade can start

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"We start to subconsciously make slight alterations to procedures or in risk reward assessment."

to alter the delicately balanced trading system. We start to subconsciously make slight alterations to procedures or in risk reward assessment. If not controlled, the deterioration can feed off itself and all trading discipline can be lost. In other words, emotions take over the intellect and another trader bites the dust.

To help guard against losing control, traders need a system of reprogramming the conditioned responses to losing that most competitive human beings have. For centuries, philosophers and spiritualists have focused on the power of the mind to influence outcome. Indeed, most top performers who depend on real time performance for their success, take on a psychological trainer who helps them with the necessary training to maintain psychological equilibrium and cope with times of self doubt and lack of focus.

If you talk with most successful traders, they will tell you that a trader's attitude and state of mind is every bit as important as having a winning system. After all, a system is only as good as its implementation. Ideally, we as traders should model an emotionless robot and just facilitate input and output; however, the things that make us human are hard to suppress and it a trader wants to be successful (as opposed to self destructive), learning how to control emotions and handle the stigma of losing is an essential skill. Because this sort of training is still a bit unorthodox, it is hard to find trained practioners familiar with trading. The very fact that you are reading this article demonstrates that you have found one of the few practioners familiar with trading and I encourage you to make the effort because the training you receive is crucial to becoming a successful trader…or anything you decide to undertake.

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