

The Market Guys¹ Are You Out of Your Mind?

How many times have you looked at your trading diary and realized that you're missing a simple key to success: if only you had bought when you sold and sold when you bought, you'd be showing a handsome profit? There are some people who can best be described as reliable contrarian indicators. Watch what they do and then take the opposite position. While we laugh at the irony of this example, the fact is that we often find that we're working against ourselves when we take a close look at our trading style. This article will explore the psychological aspects of managing trading risk and how we can accommodate our own limitations.

Are You Out of Your Mind?

Research has shown that our own minds work against our financial best interest. For that reason, when we develop a plan to manage trading risk, it is imperative that the plan be designed in such a way as to minimize our interference in the execution of the plan. Simply, we need to create a foolproof plan and recognize that it is ourselves that we're protecting against.

To illustrate this, we can look at a popular experimental economics game referred to as the "Ultimatum Game". In the Ultimatum Game, two players are given the opportunity to divide a sum of money and there is no reciprocation. That is, each player only has to make one decision and the game is over. To start, player A is told to divide an amount, say \$10, between player A and player B. The split can be any ratio with one exception: player A cannot keep the entire amount. The worst case split for player B is that player A will choose to keep \$9 and give \$1 to player B. The next step is for player B to decide whether to accept or reject player A's offer. If player B accepts the offer, then both players get the amount of money set forth in the offer. If player B chooses to reject the offer, then both players walk away empty-handed.

Here's the key question: When is it advantageous for player B to reject an offer? The answer, of course, is never! In the worst case scenario, if player B accepts the offer, he will still receive \$1 that he otherwise wouldn't have. However, experimental results show that offers of less than 20% (\$2 in our example) are often rejected. Subsequent investigation reveals that there is an element of "fairness" that's considered by player B and if the offer is perceived as "unfair" then the offer is rejected. Player B would choose the defense of perceived fairness rather than improve his financial condition if they appear to be mutually exclusive choices.

Before you think that you're the exceptional trader who can overcome this propensity through sheer determination, consider this: A research study scanned the brains of Ultimatum Game players as they responded to fair and unfair proposals. The results were published in a 2003 article in *Science* magazine entitled "The Neural Basis of Economic Decision-Making in the Ultimatum Game". It was shown that unfair offers elicited activity in brain areas related to emotion which suggests an important role for emotions in decision-making. The conclusion for the trader is that we have to recognize that our emotions are an integral part of our financial decision-making and then take the necessary steps to ensure that we don't harm ourselves in the process. Of all professions, the trader must take care to address this point since financial decisions are made every trading day.

Gambling With Losses

An extension of the concept of perceived fairness was developed by Daniel Kahneman and Amos Tversky, in their landmark research into Prospect Theory. The short description of Prospect Theory is that people are much more willing to gamble with losses than with profits. This concept is actually quite familiar to traders because we are quick to lock in a profit while allowing losses to continue, in the hope that our patience will be rewarded by a rebound in the stock price. Gambling with a loss is known as Loss Aversion: the tendency for people to strongly prefer avoiding losses over acquiring gains. However, when we quickly lock in our profits, we're exercising Risk Aversion: we shun any risk when we have a profit in hand. Some studies suggest

that losses are as much as twice as psychologically powerful as gains. This phenomenon serves to dramatically increase the level of risk that a trader will accept with a losing position. We don't want to accept the negative emotions that come with a loss and will go to great lengths to avoid a loss. However, many times the losses are not avoided but rather deferred. When we practice Loss Aversion and watch the unrealized losses continue to grow, we'll eventually reach a point where even the unrealized loss becomes untenable and the position is closed. In the markets, the movement that occurs when masses of traders finally realize a loss that has become unbearable is known as capitulation selling. The rapid downward drop in price with a corresponding spike in volume is often the result of emotional decision-making rather than a thoughtful, well-executed risk management plan.

Accepting the Loss

A key difference between a successful, experienced trader and a novice is the ability to accept a loss. One might even go so far as to suggest celebrating a loss if the loss is small and within the defined risk plan. As a trader, logging losses into your trading diary is the surest evidence that you have a plan that is working to protect your positions. If your trading success rate is exceptionally high, you should be concerned about your Loss Aversion. A warning flag in any trading plan is a low loss rate coupled with high drawdowns. This is nothing more than a manifestation of the age-old belief that a loss isn't really a loss until the stock position is closed. Traders are some of the best players of this game. While that belief may hold true from a profit/loss analysis of closed positions – and the possibility exists that your position may yet recover – a loss exists any time your position moves against you, regardless of whether or not you close the position.

The biggest fear for most traders is that they'll get caught up in seller's remorse. This occurs when you decide to close your position for a loss, only to watch the stock turn around and move in the direction you wanted it to go initially. The trader regrets selling the stock at the wrong time and vows not to make that mistake again. The proper response to that situation is to congratulate yourself for accepting a loss according to your trading plan. The next step is to re-evaluate the trade based on the current technical setup and, if the conditions warrant, open a new position. Many traders have trouble accepting a new position in a stock that they just took a loss in because of the concept of perceived fairness. They think to themselves that they were unjustly robbed of a profit by the volatility in the stock price and they refuse to be beaten by the stock again. An even worse response to the same scenario is to try to exact some form of revenge from the stock that just dealt them their loss. In the same manner as a warrior going into battle, the trader will persistently attack the same stock with the goal of finally extracting a profit and proving to themselves and any observers that they were right after all. This process may yield many losing trades in the pursuit of the one winning trade that satisfies the need to be victorious.

It's not surprising that this condition exists since most of us come to trading from other professions. Due to the technical nature of financial markets and the challenge of pitting oneself against the ranks of highly intelligent and worthy traders, the trading profession especially attracts successful individuals from such fields as engineering and the sciences.

For an example, let's look at the case of a medical doctor specializing in the field of obstetrics. Throughout his education, internship and practice, he's taught to exercise his profession at a level that permits no failures. It is beyond consideration to accept a "loss" in the sense that we're describing. To reason that there is an acceptable loss level and that the successes will offset the losses on balance doesn't even enter into his thinking. Furthermore, by continued study and practice, this doctor will only raise his expertise and the likelihood of a "loss" diminishes to virtually zero. Now this same doctor, after years of practicing medicine, decides to take his accumulated earnings and trade his personal portfolio. His experience has taught him that a loss is unacceptable and now he begins to apply that logic to his trading. In short order, he realizes that his selfimposed requirement of a zero-loss strategy is the very recipe for his failure. When he

discovers that it is possible to lose on seven out of ten trades and still be a successful trader, he has to shed the mindset that brought him to his initial level of success. If his first profession accepted only a 30% success rate, he would certainly not be welcome in the delivery room!

Mental Preparation for Managing Risk

The goal for the trader entering the markets is threefold: 1) recognize that risks exist which will result in losses, 2) accept the fact that the risks are neither fully identifiable nor quantifiable and 3) develop and execute with discipline a plan to protect against these risks. Nassim Nicholas Taleb, in *Fooled By Randomness: The Hidden Role of Chance in Life and in the Markets*, has the following observation:

There is nothing wrong with a risk taker taking a hit provided one declares that one is a risk taker rather than that the risk being taken is small or nonexistent. Characteristically, blown-up traders think that they knew enough about the world to reject the possibility of the adverse events taking place: There was no courage in their taking such risks, just ignorance...They all made claims to the effect that "these times are different" or that "their market was different," and offered seemingly well-constructed arguments (of an economic nature) to justify their claims; they were unable to accept that the experience of others was out there, in the open, freely available to all, with books detailing crashes in every bookstore.

Of the three points listed, the second is the most difficult for traders to reconcile. We convince ourselves that with sufficient analysis and training, we can fully quantify the risks that we'll face in the markets. With our biased perspective, we come up with technical and fundamental reasons why a stock will not move beyond a certain level, or at least not at this time. After the position begins to move against us, we justify continuing to hold the position with more well-constructed arguments. These arguments include all sorts of good logic such as the strength of the company's management team, the history of the stock price in the same quarter of previous years, the convergence of the perfect candlestick pattern with a major support level, and so forth. These are nothing more than tools of the trade for the trader who is practicing Loss Aversion.

Make no mistake that taking risks is good. Every trader is, by nature, a risk taker. But you need to enter your market with a realistic assessment of the risks that you'll face and a plan to deal with them as they arise. For now, take heart in knowing that you are not out of your mind...but that might not be such a bad thing after all!

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