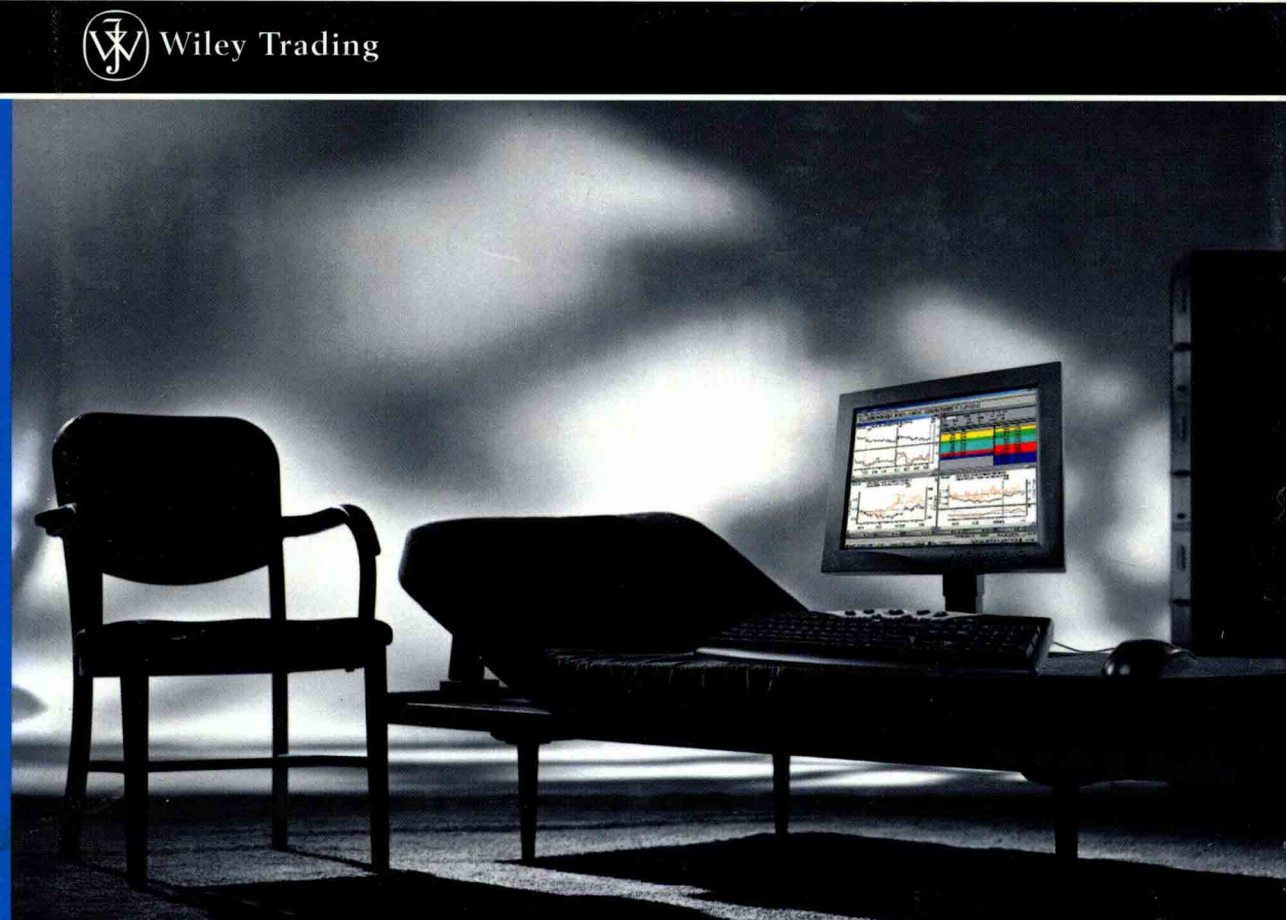




The Psychology of Trading

TOOLS AND TECHNIQUES
FOR MINDING THE MARKETS

Brett N. Steenbarger, PhD

THE PSYCHOLOGY OF TRADING

Tools and Techniques for
Minding the Markets



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Preface

In our debts to others, we find the true measure of our wealth.

If there is a single theme to this book, it is this: *Trading is a microcosm of life.** In trading, as in life, we pursue values. In both trading and life, we manage the risks of those pursuits: lost opportunities and realized losses. How we seek values and manage the associated risks will determine our personal and professional success.

Many times, our responses to the uncertainty of outcomes interfere with the achievement of our goals. In careers, romantic relationships, and trading, we find ourselves enacting self-defeating patterns: cutting promising situations short and lingering in unprofitable ones. It doesn't matter that we are virtuous people, hardworking and otherwise successful. It doesn't matter that we have attended all the latest seminars, read the hottest books, and purchased all the best trading tools. If our coping with risk distorts our efforts at

*The term *trading* is used in this book to cover all active forms of managing one's financial investments. Anyone who attempts to time investments, whether over hours, days, weeks, or months, is a trader.

pursuing values, we will fail to attain the stature that can be ours—as traders and as human beings.

For the past 20 years, I have provided counseling and therapy services to approximately 130 people a year. Almost all of these people have been high-functioning individuals tackling demanding career fields. I learned during these years of practice that the problem patterns of physicians, executives, students, and traders are surprisingly similar. These patterns arise when strategies for emotional risk management—efforts to minimize pain and maximize pleasure—fail to make it possible to successfully navigate life's matrix of risks and rewards. Every problem pattern we experience is a once-successful coping effort that has outlived its value. Conversely, newly created patterns that meet life's present challenges lead to success. We are best positioned to achieve our goals when we can extract ourselves from the mindless repetition of the past and fashion fresh life solutions.

The purpose of this book is to help you identify your patterns of success and failure and exercise greater control over these. My deepest hope is that the case studies, the research, and the ideas contained in these pages will provide you with the intellectual and emotional ammunition to face yourself and to transform your approach to life's risks and rewards.

The following pages can help you cultivate new ways of thinking, feeling, and acting; but they cannot perform magic. For the trader, no amount of psychological assistance can substitute for concrete trading plans that have been tested across a variety of markets. As Robert Krausz neatly stated in his *New Market Wizards* interview with Jack Schwager, self-help methods by themselves can no more make you a great trader than they can make you a great chess player or baseball star. You can only learn to master the markets by immersing yourself in the markets.

Indeed, there is a sense in which the process of developing and testing your market strategies is the best of all methods for cultivating a positive trading psychology. Many traders fail with mechanical systems simply because they cannot tolerate the inevitable periods of drawdowns or flat performance. When you create and test your own approaches to the market, you develop an inner knowledge of how those methods work. During periods when the market throws a curve ball, your confusion is more readily replaced by the sense of "been there, done that." *Nothing* substitutes for the confidence born of experience.

Still, it is difficult to underestimate the degree to which traders can utilize identical trading methods and arrive at wildly different results. Possessing the

right tools is necessary, but not sufficient, for success. As Krausz observed, traders have an uncanny knack for acting out their repetitive and destructive emotional patterns in their trading. Such enactments will derail even the most carefully constructed and tested systems.

An important goal of this book is to help you approach trading the way a psychologist approaches his or her clients. I call this “trading from the couch,” which means learning to utilize your thoughts, feelings, impulses, and behavioral patterns as *market data*. Trading from the couch entails an important shift from traditional thinking. Instead of trying to overcome or eliminate your emotions, this self-aware trading calls on you to *learn* from your reactions. Your goal is to turn yourself into a finely calibrated instrument for detecting and acting on the patterns of both the trader and the trading.

Note that cultivating such sensitivity does *not* mean simply going with your feelings in placing orders! As you will see in the coming pages, it often means the opposite: learning to use excess confidence and risk aversion as valuable *contrary* indicators. Surprisingly often—for the trader, as for the therapist—acting counter to one’s initial impulses is the winning move.

In trading from the couch, you become your own psychologist. That is not an easy task in the markets or in everyday life. The rewards, however, are considerable. Trading, like competitive sports, is a powerful crucible for cultivating the emotional skills crucial to life success. In few arenas are the pursuit of values and the management of risk so tangible and immediate. Nothing so drives home lessons in self-understanding as brutal hits to one’s bottom line.

Self-aware trading also presumes a vital symmetry: In mastering the markets, you can further yourself as a human being; and in developing yourself as a person, you can enhance your trading success. *Once you are able to extract the information contained within your emotional, cognitive, and behavioral patterns, you will be better equipped to identify and to exploit the patterns that appear in the financial markets—and vice versa.*

BRETT N. STEENBARGER

*Fayetteville, New York
November 2002*

Acknowledgments

My appreciation for the emotional intricacies of trading expanded exponentially when I began writing trading psychology columns for a web site that was known as WorldlyInvestor and for MSN's Money site (www.moneycentral.com). In response to those columns, I heard from traders around the world who were experiencing difficulties strikingly similar to the ones I had encountered in my years of trading. Some of my correspondents were neophytes, trading by the seats of their pants, engaging in little more than gambling. But most were dedicated practitioners, who had dutifully read books, learned trading methods, and undertaken their own research. With remarkable frequency, I heard the plaintive refrain: Inconsistency was robbing them of profits and exposing them to occasional, debilitating losses. It is difficult to express how frustrating trading can be when success seems so tantalizingly close and yet remains ever so elusive.

How is it that we can *know* the right things to do—regular exercising, healthful eating, good parenting—and yet so often fail to follow through? What distorts our trading, preventing us from acting on the information clearly in front of our eyes? These are the questions that have haunted me for nearly two decades as a professional psychologist and market participant. My attempts to answer them have taken me from the literature on trading and psychology to philosophy and leading edge research in cognitive neuroscience. If I have accomplished anything in this book, it is in synthesizing contributions from these fields, contributions that are far worthier than my own.

Authors face a curious paradox indeed: With each intellectual debt accumulated, they are enriched manyfold. In that regard, I feel wealthy indeed, having benefited from the insight and the assistance of many inspiring influences.

My first forays into writing about the markets came through the Speculator's List, an online group of traders, money managers, academics, and accomplished individuals in the arts and sciences. I am forever indebted to Laurel Kenner, Victor Niederhoffer, and James Goldcamp for their role in establishing the List and for their kind encouragement of my many posts to the group.

When I needed to understand the dynamics that distinguished successful from unsuccessful traders, Linda Raschke was incredibly supportive, allowing me to study the many individuals who participated in her seminars. I quickly found that Linda was a worthy model of exemplary trading and an accomplished mentor. I am deeply grateful for her friendship and for her insights into the business and human sides of trading.

Some of my most important influences have been those who have pushed me to write with ever greater clarity and precision. Jon Markman, editor at MSN Money, has been a valued friend and colleague, as well as a role model for his trailblazing research. The book has greatly benefited from my editor at Wiley, Pamela van Giessen, whose humor, practical bent, and commitment to quality have carried me through the long writing process.

To be sure, none of this would have been possible without the salutary influence of my academic colleagues in the Department of Psychiatry and Behavioral Sciences at SUNY Upstate Medical University, most notably Roger Greenberg, Mantosh Dewan, and John Manring. My good friends and trading correspondents Henry Carstens, Saurabh Singal, and Steve Wisdom have enriched this book with their inspirations and ideas. I am also indebted to Mark Mahorney for his excellent work on the Great Speculations site (www.greatspeculations.com) and to Frank and Kris Linet, Susan Niederhoffer, and Arnold and Rose Rustin for their warmth, humor, and insight. To Yale Hirsch, Andrew Lo, Sam Eisenstadt, and Jeff Carmen, my hat is off in salute and appreciation for their exemplary research and personal support.

Finally, I gratefully acknowledge my family for their ongoing love and encouragement. My parents, Jack and Connie, have been role models and inspirations for longer than they realize. The support of Marc, Lisa, Debi, Peter, Steve, Laura, Ed, Devon, and Macrae has meant more than I can express. But no single person deserves credit for this book more than my

wife, Margie, who has taught me most of what I know about life, love, and the navigation of risks and rewards. It is my greatest joy to dedicate this book to her.

A VIEW FROM TALL SHOULDERS

I count July 4, 2001, as a special day. That marked the completion of the first draft of this text. Until that day, I hadn't explicitly identified why I had written the book. Yes, I had wanted to share insights and ideas, but that wasn't the major purpose. After all, I had written the book with no publishing contract in hand. And although I wanted to see it published, it was clear to me that the writing held a personal significance beyond its status in the marketplace.

On July 4, sitting in a Seattle hotel lobby with laptop at my side, I suddenly recognized the source of that personal significance. Feeling the need to capture my insight in words, I took out the laptop and composed the following letter to my friend and mentor Victor Niederhoffer:

Dear Victor,

Nothing is quite so conducive to reflection as travel. The combination of distinctive scenery and breaks from normal, daily schedules helps us think in new ways, see things in a new light. What we vacate during vacation are our routine ways. It is during those breaks from the routine that creative impulses are most likely to find expression.

This was particularly evident to me during this past holiday, as I brought my book manuscript on a trip to the West Coast. I expected that the writing would find inspiration on the road, and I anticipated that the writing would be most enjoyable without the distractions of the workaday world. I was not disappointed in these respects. More surprising, however, was my emotional reaction to the writing. As I crafted page after page, I found myself experiencing a profound humility. I recognized, with a deep emotional certainty, the extent to which so few of my ideas were truly original. With each line I could recognize an inspiration from another source: a teacher or mentor, a

book I had read, a piece of research I had studied, a personal hero. There was little on these pages that was truly my own. Instead, the writing was a synthesis of what I had absorbed from those greater than myself. At a profound level, I could appreciate Newton's statement that if he had seen farther than others, it was because he had stood on the shoulders of giants.

Perhaps this is why the immortals do not write for self-aggrandizement and why charlatans are so quick to credit themselves and deny credit to others. The greats recognize the fountainhead of their inspirations. Their dominant emotion is the humility of gratitude, of having been the recipient of gifts that can never be fully repaid.

In this state of humility, I also gained a unique perspective on your own book. My first reading of *The Education of a Speculator* [John Wiley, 1997] focused on its personal story: the formative experiences that contributed to success in the markets. Upon rereading, I saw the book in a different light: as a tribute to those moral and character influences—particularly those of your father—that made for success as a human being. After this vacation, however, a wholly new reading became possible. I could appreciate your book as a broader tribute to the exemplars in your life. It is a testimonial and a statement of thanks to Arthur Niederhoffer, Jack Barnaby, Tom Wiswell, Francis Galton, and those many others who gave more than can ever be wholly repaid.

And yet, in writing a book of tribute, perhaps we do repay at least some measure of indebtedness. Even the great ones die. Their voices are stilled, and subsequent generations never gain the privilege of sitting by their sides and hearing their words. My children will never directly encounter Artie or Galton and absorb their personal examples. Through a book of tribute, however, exemplary individuals gain a degree of personal immortality. As long as the book graces the shelves of libraries and bookstores, there is hope that the lessons taught by the greats will not be lost, that their examples can live well beyond their years.

This is the beauty of writing a book: In telling the stories of heroes, we contribute to their immortality and immeasurably enrich generations to come. Before I went on this vacation, I vowed to write a book that informed, entertained, and enriched. Now, however, I have

set the bar far higher. I will only be satisfied with a work that does justice to those who have inspired the best within me.

As I sit here now, writing early in the morning, it strikes me with sincerity and gratitude that the only way to stand on the shoulders of giants is to hoist them on our own.

Sincerely,

Brett

Trading, indeed, is a microcosm of life. If you long to develop yourself, as a person and as a trader, search high and low for the immortals. Find the heroes and the heroines who have lived their lives with passion, nourishing all who have come in contact with them. Discover those who have lived, breathed, and studied the markets, enriching the world with their ideas. Then hoist them on your shoulders, remaining ever mindful of your debt. You will be surprised how high you stand, how far you can see.

B. N. S.

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Chapter One

The Woman Who Could Not Love

Solutions are the patterns we enact between problems.

I suppose it's only natural that you would expect a book on the psychology of trading to begin with a description of the various emotional afflictions experienced by traders. In this chapter, however, we are going to approach the topic from a different angle. We are going to adopt what is known as a "solution focus" to trading and explore how many of the answers to our problems are *already occurring*. If you have a template for identifying and understanding what you are already doing right, in life and in the markets, you are well on the way to creating a model for your future success.

MANUFACTURING CARS AND SUCCESS

Many years ago, I read something in a management text that made a lasting impression. At that time, Japanese car manufacturers were making distinct headway in their competition with their U.S. counterparts. On both price and quality, the Japanese seemed to be winning the race.

The account I read described the difference in the management approaches