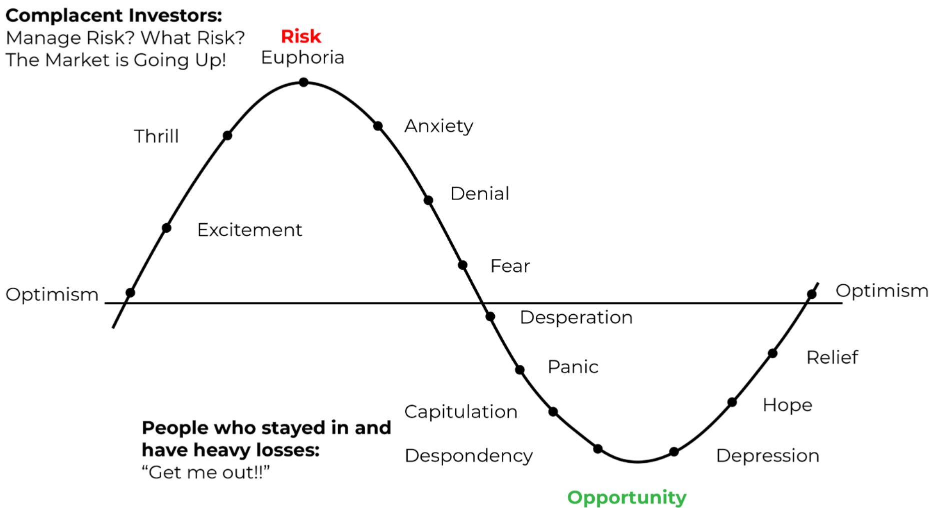
6 Psychology

6.1 Understanding the Psychology of Trading

The saying that trading is 90% psychological and 10% technical is very true. It is important to understand the psychological aspect of trading because this will have a great impact on your success and or failure. Technically anybody can place a trade and be profitable, it's simply a press of a button. However, not everybody can be "consistently profitable" at trading, this is because edges are thin.

To be consistent, traders need to think and control emotions differently from those who do not trade. This is where the psychosocial nuances have a great impact, such as Fear a Greed. Traders need to master these emotions to become profitable. Low emotional intelligent traders will have continued difficulty to achieve consistency. They are simply more prone to impulsive decisions that arise from fear and greed. Traders can be lucky and get away with a few impulse decisions, but in the long-term, it will not serve them well.

6.2 The different emotions that a trader faces



The following is a diagram of emotions that runs through the different market phases faced by traders in the market. Emotions can be widespread, or it can be unique to the individual during the market cycles. Each trader will however, to a high degree of certainty, experience all the following emotions in their trading careers. It us up to the individual to work on their emotional intelligence to recognise and be aware of when such emotions arise. This will help keep traders from making unreasonable decisions with no discretion.

Optimism

Optimism bias is an emotional reasoning where a trader is hopeful and confident that certain events will occur only for the better. This emotion is usually triggered in the early stages of a major up-trend.

Excitement

This emotion causes a trader a feeling of greatness and enthusiasm, especially during an established uptrend. The enthusiasm causes traders to take on greater risk, this is because they have an eagerness to be right.

Thrill

Thrill is caused by a sudden spike in excitement and pleasure, traders are prone to this emotion when the markets have been in a strong uptrend for a while. Thrill again often leads to taking even greater risk with no real risk management in place. Thrill is usually indicative of a market top being nearby.

Euphoria

This emotion is experienced at peak bull market cycles, they cause traders to be in a state of pure bliss and excitement. Traders tend to be the happiest at this stage and are willing to take on more risk. Euphoria is typically the stage in the cycle where a top is set, leading to a reversal.

Anxiety

This emotion causes a feeling of nervousness or an unease in the outcome of a certain event. In other words, when a peak is established, the first major correction will cause the recent bias (Euphoria) to shift in the mind of a trader. The euphoria stage has now passed, causing the trader

to second guess the market, thus anxiety starts to linger.

Denial

The Denial emotion is a difficult one for traders to overcome as it causes traders to avoid/ deny a certain outcome over another. In other words, traders simply fail to acknowledge a potential trend change after a long bull market.

Fear

Fear is the emotion that is considered the hardest to master when it comes to trading. Fear causes a trader a horrid feeling due to perceived threat or danger. They put traders in a state of mind that avoids any harm or pain, even if there are opportunities present.

Depression

Depression is an emotion that causes a trader feeling of strong unhappiness and hopelessness. This is because they fail to recognise the downtrend whilst maintaining a bullish bias. Traders also lose confidence in their ability to stay in tune with market conditions, thus avoid trading opportunities.

Panic

Panic occurs in traders when the fear or depression becomes uncontrollable, leading to unreasonable actions. This occurs when traders make decisions impulsively because on a psychological level, they have no control towards calculated discretionary decisions.

Capitulation

Capitulation by theory means to surrender or give-up, traders close their positions as they can no longer deal with the emotional pain of loss. This emotion is felt at the most lows in a bear trend before a major reversal. Mastering this emotion is critical for traders, as capitulation periods have the highest probabilities of significant market lows where the long side is favourable.

Despondency

Despondency is an emotion in the market where traders feel most discouraged or depressed. They experience their peak lows with their performance leading to misery and unprecedented decisions. This typically occurs at the absolute end of a bear trend prior to starting a bull-trend.

Hope

Hope is an emotion that triggers a feeling of expectation and desire towards a certain market outcome. This is usually felt at the starting of a new trend where traders start to gain confidence and can be sanguine.

Relief

Is a feeling that causes traders to experience relaxation and reassurance after an emotional tilt. This is typically felt when a trend change is confirmed on the higher timeframe from bearish to bullish. Traders can solidify certainty towards an expected outcome in the market.

6.3 How to master Trading Psychology

Overcoming psychological issues comes from mental clarity with a trading routine combined with repetition and mental rehearsals. This will help the process of decreasing the overall vulnerability when it comes to the human mind. Mistakes will be inevitable, meaning they will always surface. The job for a trader is to reduce and control the impact of these mistakes on a psychological level and the overall bottom line.

The following are techniques by traders to increase their emotional intelligence and avoid poor discretionary decisions:

- A Trading Routine
- A Trading Journal
- Trading Plans

6.3.1 Trading Journal

A Trading Journal is by far one of the most effective tools for a trader as it measures their overall performance. The journal allows traders to take

notes of the emotions felt through a trade with fine detail. This enables traders to understand their specific thoughts and emotional triggers on each and every trade.

A collection of notes will also allow traders to define their specific strengths and weaknesses. Because these notes are observations over a period, certain behavioural patterns will show up. This pattern can then be studied and exploited for better overall performance.

The following is a list of what needs to be included in a trading journal:

- Strengths and weaknesses of the trade
- Feelings towards the trade (Fear, Confidence, Hope etc.)
- Execution process and potential errors (solutions to these errors)
- Emotional Triggers within the trade
- Skills acquired or improved from the execution of the trade

6.3.2 Trading Routine

Having a trading routine in place will improve a trader's performance when it comes to dealing with stress and pressure that comes from the markets. Trading is like any other sport, for example, Bodybuilding. Every bodybuilder has a warm up routine before starting their working sets. This is also true for traders; they need to have a pre-trading routine that helps get them into the zone before any executions. This will help greatly in avoiding unnecessary discretionary decisions.

By having a trading routine in place, it will help you stay disciplined and avoid bad habits such as impulse trading. A routine sets a level of expectation for the human mind, reaching this level on a daily basis greatly helps with better overall performance. The decisions in the market will be reasonable where little errors can be easily avoided.

6.3.3 Trading Plans

A trading plan is another key component for traders in overcoming trading psychology nuances. A plan helps solidify what actions need to be taken in the market only when certain conditions are met. They essentially outline the rules for the trade that if not followed will yield an emotional decision. This means that traders need to stick to their trading plans to

avoid unnecessary actions such as emotional exits.

Trading plans should be written but can be adjustable according to new market information. This is because of the market dynamics where probabilities are constantly shifting. A strong plan needs to accommodate for this, it needs to define a proper entry/ exit criterion with a defined stop loss. Traders simply need to adhere to their trading plans for long term consistency.

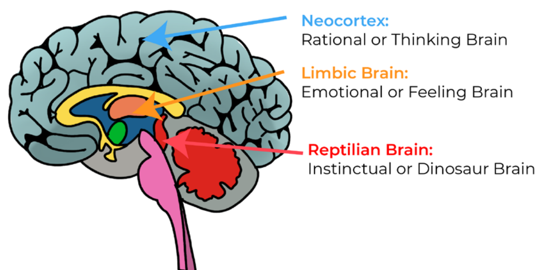
6.4 Understanding Human Emotions

Human emotions are a complex topic because of the many nuances it consists of. Having a sound understanding of how the brain works can assist in why traders make certain errors when it comes to high pressured situations. The human brain can be divided into three categories, that is, the Neocortex (thinking brain), the Limbic Brain (or feeling brain) and the Reptilian Brain (the instinctual brain). All these categories will influence the trader's overall performance.

The following is a visual representation of the three different brains:

Your Actions
Are Not Your Own

Your Three Brains



Neocortex and the Limbic Brain: for a trader, the Neocortex is the part of the brain that is responsible for all the rational and discretionary decisions in the market. The functional decisions are reasoned and deliberate,

meaning they have been thought-out. Consistently profitable traders will naturally have a higher emphasis on the Neocortex. This is true because consistently successful trading aims to avoid mental flaws through proper trading plans and executions. This can only be achieved by the slow and cognitive brain which again is the Neocortex.

The Limbic brain on the other hand is responsible for less rational and impulsive decisions in the market. That is because this area accounts for behaviours that are needed for survival such as being in a fight or flight mode. When traders are more emotionally prone to the market, they will naturally rely on the limbic brain to make quick decisions. Traders need to be aware of such emotional states to avoid unnecessary discretionary decisions.

The Reptilian Brain: this brain is the oldest and is conditioned to control important functions such as breathing and balance. They are like the reptile brain; hence it has been in development for over centuries. It is known to be reliable when it comes to judgment, however, it tends to be very inflexible and obsessive. Traders need to understand that the human brain has been developed since our ancestors whose main priority was survival. This is essentially the mind that is brought to trading, that if not controlled, can lead to unwanted consequences.

Overall, the human brain is made to keep a bank of memories that create patterns. These patterns create neural pathways that help solve problems and make decisions in any situation. It is critical to understand that these decisions precede behaviour i.e., physically entering a trade or exiting a trade is not an actual decision. It is rather a response to a decision that has already been made within the human brain.

6.5 Importance of Confidence, Strength and Risk Management in Trading

Trading in general is a very difficult endeavour, it has an over 90% failure rate with only 1% succeeding. It is considered one of the hardest professions because traders need to have a deep understanding of themselves thoroughly to make a good job out of it. Understanding chart patterns and the different technical analysis will help with the process. However technical analysis has little to do with actual trading. Trading and Analysis are simply two different things inside the human mind. Analysis is

less prone to emotions as risk is not involved, trading on the other hand includes real risk where emotions will naturally rise. This phenomenon proves that trading is more psychological than technical.

Despite the difficulties, it is a skill set that can be mastered where the returns can be astronomical. Think of trading as a performance-based endeavour that can be managed and tweaked to max efficiently. All professional athletes use this approach, they train with trial and error to achieve their max potential. This requires traders to develop Strength during rough times such as drawdowns. They need to understand that the probability model of their system is playing out, the winner will start kicking in eventually. No trader in the world has a 100% win rate, so drawdowns are to be expected. How these drawdowns are managed is the pure difference in each trader, usually the confident trader prevails.

Confidence is a trait that is common between successful traders in our modern age. Confidence is needed as it helps traders to execute based on their trading methodologies. It helps eliminate dis-serving emotions that promote fear and greed. It brings the mind into an equilibrium, a state of mind that is in tune with the market. Ultimately, this helps the trader to make well informed discretionary decisions. Decisions are simply not impulsive or out of fear as this would mean that the trader is trading with a lack of confidence. It is also important for traders to not trade with overconfidence. This can lead to making mistakes such as oversizing on positions and breaking Risk Management Rules.

Risk Management is a critical area for traders to master if they wish to stay in the game long enough. Risk needs to be treated with respect where a proven criterion needs to be followed. These are simply a list of rules that need to be adhered to when executing trading activities. Risk Management helps trader's tailor their processes to their own specific risk tolerance. For example, risking 3% on a high probability trade and 1% on a mediocre trading setup. This helps protect the downside and to avoid unnecessary emotional swings. Other forms of risk management include setting stop loss placements and take profit areas. A trade will always be a risk on endeavour until it is closed. This is why it is important for a trader to determine where trading activities will occur on the chart before-hand.