Diagnosing the Trader Enhancing Performance Through Self-Assessment

By Brett N. Steenbarger, Ph.D.

For 19 years before I came to the world of proprietary trading in Chicago, I taught in a medical school department of psychiatry. My job was to help medical students and residents become better helpers. The medical world is steeped in the ethic of "Above all else, do no harm." That means that physicians need to take the time to understand problems before they undertake cures. Diagnosis precedes treatment.

Alas, this is not always the case with traders, whose motto often seems to be, "Above all else, keep trading." When traders detect problems with their profitability, rarely do they undertake the equivalent of blood workups and imaging studies. Without examining their trading in detail, it is difficult to accurately diagnose performance problems—and figure out what to do about them.

In this article, I would like to propose a simple diagnostic scheme for trader performance problems that might guide traders in the process of self-assessment. Because the cure to trading ills generally must follow the diagnosis—solutions must be tailored to problems—such a diagnostic effort can pay off handsomely. Ready to become your own psychologist? Let's go!

Eliminating Garbage Categories: Trading and Lack of Discipline

When people don't understand the nature of their problems, they generally turn to simplistic explanations. Couples that come in for marriage counseling invariably attribute their difficulties to "communication problems". Traders cite "lack of discipline". These are garbage categories—catchalls that reflect the results of problems, not their causes. Before we embark on a more promising diagnostic scheme, it will be helpful to understand why that ubiquitous term in trading psychology—"discipline"—is of limited value.

When people seek help for problems, it is because they have a pattern of thought, emotion, and/or behavior that is disrupting their life, creating unwanted consequences. Think about what that means:

1) Our behavior is patterned;

2) Some of our patterns are unwanted;

3) We cannot always change our patterns on our own.

Every psychological problem has, at its root, a pattern that is not fully in our control. It might be an emotional pattern such as depression; a behavioral pattern such as substance use; or a cognitive pattern, such as perfectionism. Indeed, we might say that every psychological problem is a problem *because* it takes away a piece of our free will. When we are under the influence of a psychological pattern, we do not fully control what we do or what happens to us. That is why some of our patterns are unwanted.

Every psychological problem, in that sense, results in a "lack of discipline". If free will enables us to act in a deliberate manner and seek goals of our own choosing, our negative patterns are the reverse: They disrupt our plans and interfere with the achievement of our goals. When I got married, my marriage vows were part of my life plan. To the degree I cannot control my anger, my gambling, or my close-mindedness, I am diverted from that plan. Such "lack of discipline" is not the cause of my problem, but the effect. All psychological problems have the effect of making us less purposeful, less able to act upon our priorities.

FIGURE 1: A Diagnostic Grid for Traders

Traders are all too familiar with the forces that interfere with their plans. When we set stop-loss points or establish maximum position sizes and then violate these, the results are painfully apparent in our profit/loss (P/L) statements. We might overtrade and take trades that don't meet the criteria of our setups; we might undertrade and fail to act upon valid setups. Either way, we have a problem with our ability to act upon our plans. Something is diminishing our free will in the marketplace. The loss of discipline is the result of this "something". The goal of diagnosis is to figure out just what that something is.

The Diagnostic Grid

Above is a fourfold scheme that I carry in my head whenever I begin work with a trader. It is my way of making sense of a trader's difficulty in following his or her plans. The grid consists of two intersecting dimensions: The primary source of the problems and the chronicity of the problems. (See ***Figure 1***).

The source of the problem reflects whether the disruption of trading plans is caused primarily by a trading problem—a deficiency in how the trader is approaching the markets—or whether it can be traced to specific, psychological difficulties. In other words, what we're trying to differentiate are emotional problems caused by bad trading and trading problems caused by emotional upheaval. This, as we'll see, can be challenging to sort out, as trading problems and emotional ones can affect each other in a circular fashion. Determining which is primary, however, is absolutely crucial to improving trader performance.

The chronicity of the problem reflects the degree to which the difficulties are longstanding and consistent versus. recent and situational. Sometimes problems only appear in very limited circumstances, often because of a difficulty that has arisen in a particular situation. Stress over a job change would be a common example; grief over the loss of a loved one would be another. Other times, problems are chronic: They have been present for a while and do not markedly change with circumstances.

The intersection of these two dimensions creates four quadrants, which are my diagnostic categories:

- Chronic trading problems – These are generally the result of poor trading habits developed over the course of a trading career;
- Situational trading problems – These often result when traders change markets or when markets change on traders, reducing their edge;
- Chronic psychological problems – These reflect ongoing psychological difficulties among traders;
- Situational psychological problems – These occur when recent events in traders' personal lives interfere with their trading.

That's it. I like to keep the categories simple and straightforward. When I first meet with a trader, I have a little checklist in my head:

- Does this person know how to trade? Have they ever been truly successful?
- Has something changed in the trader's market? Has volatility or trending shifted significantly during the period of trading problems?
- Does this person have a history of psychological difficulties outside of trading?
- Has something recently changed in the trader's personal life during the period of trading problems?

If I cannot answer these questions accurately, the odds are good that I won't be of much help to the trader. I have to know the person as a trader and the person as a person. Similarly, when you are diagnosing yourself, you need to sort out what is ongoing and what is situational; what is a function of trading and what is a function of your personality.

<u>Trading Problems: Chronic vs. Situational</u>

Let’s face it- some people don’t know how to trade. It’s not their fault. Most traders have never been trained in trading. Surgeons and musicians go to school to learn their craft; athletes train in team sports throughout childhood and young adulthood. There are few comparable training programs for traders, however. A seminar, book, or video course wouldn’t teach us how to master golf or chess; how could it possibly train us for trading?

Chronic trading problems generally are the result of a lack of training. That is how people develop bad trading habits. A good example is poor risk management. A trader starts with a small trading stake and puts a large portion of it at risk each time he or she makes a trade. The result is that P/L swings wildly as a function of portfolio size. These P/L swings cause emotional swings, which in turn further interfere with trading. But the primary root of the problem is poor trading.

Suppose, for instance, that a trader with a $25,000 portfolio has 60 percent odds of winning on each trade. The trader trades once a day, trades 10 lots on the S&P e-minis, and limits each trade to a stop loss of five points. Such a trader has a near mathematical certainty of encountering five consecutive losses in the course of a year. If each loss draws the portfolio down by 10 percent (five points on a 10-lot), the trader almost certainly will lose a substantial portion of his or her trading stake. This is likely to generate frustration, upset, depression, and faulty efforts to change the trading system.

Such a trader may think he or she has an emotional problem, but the root of the problem is a lack of understanding of risk and trading fundamentals. Poor training has created a chronic trading problem.

As a rule, if you have never sustained success as a trader and you are experiencing frustrations with trading, the odds are good that you need training, not psychotherapy. Your trading methods may lack a valid edge; your frequency or size of trading may be eroding your profits and exposing you to excessive risk. These are not problems that will be solved by emotional self-help tools.

Other times, the trading problem is situational. The trader may have fine trading behaviors and will have a history of trading success. Recently, however, the P/L has gone south. Profits are no longer flowing and trading is becoming frustrating. Very often, this is the result of changes in the marketplace. Markets periodically shift their trends and their volatility. What worked and provided a solid edge in one market no longer works in another. I recently conducted a series of studies that showed the S&P 500 Index to be at historically low levels of both trending and volatility. The result is that traders who used to make their money by riding the back of momentum can no longer count on this strategy. The market offers less movement, and it tends to reverse movement when it does occur. Once again, the answer is not to consult a shrink. Either you need to find a new market that will follow momentum, or you need to develop a new, countertrend method of trading your current market.

The best way for me to identify a chronic trading problem is to watch a trader trade. If we're watching the screen together and I make a comment such as, "The large locals are leaning to the short side," the trader might respond, "How do you know that?" At that point, I have a pretty good idea that the trader is having trouble discerning supply and demand in the market auction. That tells me that training, not counseling, will be helpful, and we'll end up discussing how to track volume occurring at different price levels, the proportion of volume occurring at bid versus. ask prices, etc.

If I see that the trader can read supply and demand, however, but is staying in trades too long or entering with too much size, I have a sense that the problem is situational. Often this occurs when a trending market consolidates and becomes slower and more range bound. The trader does not adapt to the shift in market conditions and overtrades the slower market. Such traders might simply need a tool to help them identify market shifts as they occur, such as a monitor of current market volume as a proportion of the usual volume at that time of day.

As a psychologist, my training taught me to look for psychological causes of psychological problems. Having worked with traders every day in a professional firm, however, I have learned to respect the fact that many emotional disruptions of trading are caused by trading problems. A lack of training and difficulties adapting to changing market conditions can hurt P/L, and that can disrupt emotional well-being.

<u>Emotional Problems: Chronic vs. Situational</u>

There are other times when emotional difficulties truly are at the root of trading performance concerns. A chronic psychological problem is one that predates trading and that shows up in facets of life that have nothing to do with trading. An example would be a tendency toward depression and/or anxiety: a personality trait that psychologists call neuroticism. Such traits show up early in the lifespan and tend to persist. Their expression can be modified, but they don't radically change. If a person was active and highly distractable as a child, the odds are good that they will carry some of these features into adulthood. These can interfere with trading and create subsequent frustrations.

Not all chronic psychological problems are the result of diagnosable disorders. Sometimes personality traits of traders do not match their trading styles, creating chronic problems. For instance, there are personality traits that are associated with the ability to tolerate risk. People who are risk averse but who try to trade aggressively will experience considerable stress on a regular basis. They are unable to cope with the swings generated by their portfolios. The upset generated by this mismatch can disrupt trading over an extended period.

When such chronic emotional difficulties occur, psychological assistance can be invaluable. Such problems as major depressive disorder, bipolar disorder, and attention deficits are highly treatable with the right medications. Many such problems can benefit from talk therapy as well. Cognitive therapy, for example, has a proven track record in treating depression. Behavioral techniques have a similar record of reducing stress and anxiety.

In cases where chronic distress is generated by a mismatch of personality and trading style, tweaking one's trading will be more helpful than trying to change one's personality. My experience is that two variables—trading frequency and trading size—are two of the most important variables to tweak. Both are related to risk and the volatility of returns; both also affect the cognitive process of trading. For instance, traders who make decisions analytically may need longer time periods between trades than traders who process information more intuitively. One's trading frequency and holding time for positions should reflect one's cognitive style.

On other occasions, situational personal problems can interfere with trading and reduce profitability. For instance, emotional disruption from relationship problems or trading slumps can cause traders to lose their focus. One of the most common situational disturbances involves trader finances. When traders incur unexpected expenses in their personal lives, they often alter their trading to try to make more money. The result is that they lose their edge in the marketplace and actually perform worse. Many times, such added expenses are the result of positive life events, such as marriage, a new home, or a new child. Anything—even a positive—that leads to an overemphasis on P/L has the potential to divide attention and interfere with performance.

When trading difficulties are situational, short-term counseling can be extremely helpful. Performance anxieties due to slumps or heightened expenses can be conquered through such stress management methods as systematic desensitization and exposure therapy. Similarly, cognitive methods to change self talk patterns are useful. (Articles on these methods, including ones from past issues of **SFO**, are available on my website.) Tweaking indicators or order execution methods when life is intruding on trading is less likely to be of help.

<u>What This Means for You</u>

What we have here is a chicken and egg problem. Trading problems can cause emotional disruptions, and emotional disruptions can play havoc with trading results. The steps you need to take to cure trading woes depend crucially on the nature of those problems. Some trading challenges benefit from teaching and training; others from self-help methods; still others from professional assistance. There is no "one size fits all".

If you are underperforming as a trader, ask the right questions before you pursue answers. If you seek mentorship, make sure your mentor knows enough to ask those questions. Proper treatment always follows from accurate diagnosis. It's amazing how quickly traders can turn their problems around if they just figure out what those problems are!

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