MONEY MANAGEMENT: TWEAKING YOUR TRADING FOR THE BETTER IN THE NEW YEAR

by: *John F. Carter*

Looking at the right setup and not the pot at the end of the rainbow can help keep traders from booby-trapping themselves, but this takes practice.

"He who conceals his disease cannot expect to be cured."
– Ethiopian Proverb

Traders certainly know that not all trades are going to work out. However, they do get a distinct feeling right after placing every trade that this trade is going to work out.

A study done by a pair of Canadian psychologists documented this fascinating aspect of human behavior. Just after placing a bet at the racetrack, a person is much more confident about his or her horse's chance of winning than immediately before laying down the bet. Obviously, there is nothing about the horse that changes, but in the minds of bettors, its prospects improved significantly once they placed their bet and got their ticket.

Without getting into a large psychological treatise on why humans behave like this, I simply will say that it has to do with a strong, underlying social influence to appear consistent with our choices. Once we make a choice, we respond to external and internal pressures in such a way as to justify our earlier decisions. If we made a good choice, then this process works out very well for us, and we will continue to build upon our good choice. However, if we made a bad choice, whether it is regarding a trade, a job or a girlfriend, then this process will take the bad choice and make it emphatically worse. We simply will refuse to let go and move on, being more concerned about trying to act consistent regarding our earlier decision.

These factors perpetuate a vicious cycle, with the end result being a trader who, instead of following a game plan with which to exit a position, spends his time justifying why he is right. Unfortunately, he will end up closing a position for one of two reasons only. First, the pain of holding becomes so great he cannot "take it" any longer. Once he reaches this "uncle" point, the trader frantically starts banging his keyboard to sell (or cover) "at the market" in order to relieve the pain. Second, the trader's broker politely offers to help out by giving him a phone call, gently letting the trader know that he should exit the position. This also is called "getting a margin call." This trade is placed "at the market." In these situations, there is no plan, no thought and no objectivity. Just a batch of forced sell orders, or in the case of someone who is short, a batch of forced buy orders, or covering. This act of capitulation — traders exiting a position because they have to, not because they want to — is emotions-based trading at its finest, and this is what moves the market.

The pressure of traders trying to act "consistent with their original choice" combined with those who are trading way too big for their account, leads to more disasters in trading than anything else – disasters for most people, that is. For every ten to 20 traders who are blowing up their accounts, there typically are one or two traders who are making a mint. After all, the money doesn't just disappear. It simply flows into another account – an account that uses setups that specifically take advantage of human nature.

A False Sense of Security?
Show me a guy with a system, and I'll show you a guy who is welcome in my casino.

This is an old Las Vegas saying that applies equally well to the financial markets. Having a system gives people a sense of security – nothing can go wrong. Every time I walk into Mandalay Bay or Bellagio in Las Vegas, I am reminded that people who thought they could beat the blackjack tables paid for all these fabulous structures. The owners of the Luxor borrowed $550 million over 20 years to build the place, and they were able to pay it off in less than three. Tell them at the front desk that you have a strategy, and you'll most likely get a presidential suite and a private table.

Why don't the strategies work in Vegas? The reason for this is twofold. The house has an edge with percentages, and as soon as the system falters a couple of times, the human mind gets to work trying to tweak it to make it perfect. This eventually screws up the entire process. In the casinos, as in trading, it takes only one stupid bet to blow the whole wad. Casino owners know this, and this is why they sell the strategy books right there on the property, prominently displayed in their own gift shops. This elevates the concept of the fox guarding the hen house to a whole new level.

It's the same process with the markets. The odds are against the trader surviving because the market has an edge – it doesn't have any emotions. Like the river making its way to the ocean, the markets ebb and flow with total disregard for the objectives of the people hanging on for the ride. Humans tend to try to imprint their will on the markets. This is like trying to get a tornado to shift course by yelling at it.

The "Right" Mental Outlook (Don't Turn Your Computer on without It)
First, traders must understand the psychology, and then they can learn about the setup. It's like two pieces of a puzzle, and these two pieces have to snap together snugly in place before the trader can expect to trade for a living without repeating the same mistakes over and over again.

I've spent a lot of my career focused on trader psychology – not only working on myself, but also working with hundreds of other traders. I've spent a lot of time in large trading rooms with hedge funds and prop traders, executing orders right alongside hundreds of other traders. I've watched fear, elation and greed permeate a room and a group of traders like a disease. I've literally seen money from accounts on one side of a room flow into the accounts on the other side of the room, as each group of traders focused on different setups and parameters.

In addition, I've worked with more than 100 traders who have come up to my office to watch me trade and to have me look over their shoulders while they trade. I'm the first to say that I'm not a shrink, but let's just say my experiences have left me with a clear roadmap of the process most traders go through when they first start to trade. Every person is unique, but when it comes to money the differences are quickly stripped away. A herd of thirsty cattle will drop all pretenses and stampede to get to water.

I also learned a lot of this firsthand through the best teacher that the market has to offer: extensive pain and suffering. My stepfather, a broker with Morgan Stanley, got me started trading options when I was a sophomore in high school. Of course, I'm not sure if he was introducing me to a great career or just trying to generate enough extra commissions to pay the mortgage, but it all worked out in the end.

I continued to trade actively through college, where I started out studying business in California, used my trading stake to finance a year abroad studying history in Cambridge, England, and eventually graduated from the University of Texas at Austin. During this time, I quickly developed a very consistent approach to my trading. I would routinely turn a $10,000 account into high five or low six figures over the course of a year. I would then buy myself a piece of rental property and a couple of nice gizmos. Then I would sit back and decide what other bigger and better things I wanted to buy. Once I figured that out, I would go back to trading. Armed with these visions of bigger and better things, I would dive back into the markets – and promptly give back the rest of my trading account in less than a month. This happened not once but three times.

The most memorable trade happened right out of college, when I was able to give back a $150,000 trading account in less than a week. (That's what happens when you buy 200 OEX puts at $7.20 and sell them a week later for 75 cents). Lucky for me, I had enough real estate at this point to be able to sell one of the properties to raise a new trading stake.

The Trick: Keeping the Cash

At this point, of course, I had to sit down and figure out what I was doing wrong. I knew I could make money trading – why couldn't I keep it? My studies in history had a huge impact here. I could see clearly that since the beginning of modern civilization, the world had gone through a repetition of similar events all driven by human decisions. This insight really changed my focus and how I looked for opportunities in the markets. I stopped looking for the next great indicator and started looking for repeatable market patterns based on human nature.

During this time I also came across a book by Mark Douglas called The Disciplined Trader. This book was a real eye-opener in that Douglas showed how to turn everyday stressful trading situations into "normal" successful trading behavior. His follow-up book, Trading in the Zone, also is excellent. His books have had a huge impact on me, and they are required reading for anyone I'm working with. Douglas' insights, as well as my long discovery period, finally gave me the answer: Whenever I focused on the setups and not the results, I did fine. But whenever I focused on the results and not the setups, I got killed.

Why is this? Once I got my hands on a decent-sized trading account, I would start to think of things like, "I want to turn this account into a million dollars." Instead of focusing on the setups, I would focus on making a million dollars – and just like the guy who placed his bet at the racetrack, I became very confident that "this next trade" was going to work out. Because I "knew" it was going to work, I jumped into the trading habits that ruin all traders: betting it all on one trade, not using a stop because the trade "had to work out," and focusing on making a million bucks instead of waiting for a high-probability trade setup. Sure, it would have been easier just to blame it on my mother for hitting me with a wooden spoon once when I was a kid, but at some point we have to step up and take responsibility for our own actions.

Take the Profits Away

Once this revelation sank in, I started to do two things differently: First, I started wiring any profits out of my trading account at the end of each week. This kept me focused on producing a steady income as opposed to making a grand killing. I also discovered it was a great way to protect profits – the market can't have them if they are safely tucked away out of reach. Second, I started a competition among the various setups I used. In this way I could measure the performance of every one of my setups at the end of each month. The setups that made money I kept using. The setups that lost money got dumped. This was incredibly important to my trading. The only way I could keep my competition going was to execute my trade setups the same way each and every time. Any time I deviated from a standard setup, I would mark this down in my trading journal as an "impulse trade." I kept track of the performance on these, too. After about six months of tracking my impulse trades I realized that they were not making me any money and were, in fact, preventing me from making a living as a trader.

Stay Away from Impulse Trading

In working with other traders, I see impulse trading as one of the most common reasons for people getting their heads handed to them. They don't have a plan. They just get long when that feels right, and they get short when that feels right. I've literally had traders in my office who have come up to work specifically on their impulse trades – only to sneak in orders when I wasn't looking. It's that powerful of an urge to jump in and be a part of the action. It's like a drug addiction, and like most addictions, it never works in the long run.

My method for dealing with them is to simply sit next to them and watch them trade – and to do exactly the opposite of what they're doing. At the end of the day or the week, we compare our profit and loss statements, and that usually tells the story. This is a win/win situation because it is a great lesson for the impulse traders – there are actually people out there doing the exact opposite of what they are doing and making money – and it is a profitable exercise for me. The cure for impulse trading is patience. Patience is such an important quality for a trader – both in learning what setups work best and in waiting for those setups to occur.

Impulse traders who cannot own up to this bad habit need to stop trading and go to Vegas. The end result will be identical. They will lose all their money. But at least in Vegas the drinks are free.

Breaking up Is Hard to Do

If people are stuck in a relationship with individuals who berates their best efforts and undermine their dreams, then it is time to leave and move on. It is in this vein that I "broke up" with my impulse trade. I liked my impulse trade. It was fun. It made me feel good. It was exciting. But the bottom line is that my impulse trading undermined my potential and prevented me from realizing my dreams of being a full-time trader. Once this realization took hold, I took immediate steps to cut that cancer out of my life. In the end, I stuck with my friends who believed in me – my setups that worked when I gave them half a chance. I got away from justifying my own actions and instead forced my setups to justify themselves to me. Once I was able to follow my setups consistently, exactly the same way each and every time, I was able to make the transition to trading full time.