Your Personality & Successful Trading

Windsor Advisory Services

DESTRUCTIVE EMOTIONS & THE MARKETS

"Money alone sets all the world in motion."
Pubilius Syrus Maxims
1st century BC

Most people dream of being totally independent and self-sufficient financially. These people spend millions of pounds on lottery tickets, hoping to be the lucky one to scoop the jackpot. There is another way to make a million, the highly leveraged futures markets. Everyone has heard stories of investors turning small stakes into vast fortunes, and it is this chance that attracts traders to open futures accounts and dream, just like the lottery ticket buyers, of receiving the big payout. The reality of futures trading is different; the profits always seem to be elusive so each time the trader trades he suffers consistent losses rather than consistent profits.

Trading looks deceptively simple, yet few succeed. If you read interviews with the great traders, you will perhaps be quite surprised to learn that very few are intellectuals, many have never been to college, and a considerable number even dropped out of school. Additionally, most will claim they have simple trading systems that almost anyone can understand.

So what separates winners from losers? The answer is not just knowledge of the trading environment, but also an understanding of our personality make-up and how it needs to interact with the market in order for the trader to emerge with consistent profits. In the following pages you will learn why an understanding of our own personality is the key to successful trading, and how the emotions of greed, fear, pride and hope are fatal to trading success.

"A cloud does not know why it moves in such a direction at such speed, it just feels a compulsion that this is the place to go now. By the sky knows the reasons and patterns behind the movements, and you'll know too if you lift yourself high enough to see beyond the horizon."
Richard Bach - Illusions

Take any price of any commodity and you will notice trends over a sustained period of time, where the price moves in a specific direction for a sustained period of time. Many analysts believe that prices are random and that trying to predict future price movement is futile and doomed to failure. However, behind the seemingly chaotic price movements there is order.

In the following pages I will give you an insight into how and why price movements occur and how, over a period of time, you can capitalise on these moves and how you can trade with the odds of success being firmly in your favour.

SELF CONTROL & DISCIPLINE

"To the destructive element submit yourself."
J. Conrad

Successful trading is 80% psychological and 20% methodical. As I have already said, self-knowledge is the key to market success. A trading method by itself, no matter how well thought out, cannot be successful if it is not applied in the correct manner. It is in the application of a trading method that many traders end up losing. Consider the analogy of a high performance-racing car. No matter how aerodynamic or technically advanced, it needs to be driven. An advanced piece of engineering such as racing car needs to be driven by a person who can drive it with care. Just as a disciplined driver is needed to race a car, a disciplined trader is needed to apply a trading method. All traders have heard the word "discipline", but few really understand what it is and why it is so important to develop it.

EMOTIONS AT WORK

"When dealing with people, let us remember that we are not dealing with creatures of logic. We are dealing with creatures of emotion, creatures bursting with prejudices and motivated by price and vanity."
Dale Carnegie

Intelligence, knowledge and talent have to be applied. Any person who is successful knows that application requires discipline, self-control and confidence in one's abilities. Bjorn Borg was a great tennis player, he had talent. However, what always gave him the edge when playing was his mental control, which earned him the nickname "Iceman". He combined talent and discipline to achieve his success and you must do the same.

We are all put in situations where, after they have occurred, we look back and feel that if only our emotional control had been better. You are going for a job interview and role-play Th a friend beforehand. You come over as assertive and confident. In the interview itself, however, the confidence goes. You practise a best man's speech, it flows well and sounds great; however, on the day, delivery suffers as you feel nervous and shy.

All the above we can associate with. The fact of the matter is, when the pressure is on, our actions are influenced by our emotions. The more important the scenarios, the greater the influence will be.

Trading is no different. As soon as money is committed, logic can go out of the window and basic emotions take over. Consider the difference between paper trading and trading real time. Whilst paper trading, you earn very good profits, you are confident and optimistic. You see a very lucrative business opportunity, so you now decide to open an account and trade for real.
On studying your charts you see an opportunity, a perfect double bottom and prices low in historical terms, now is the time to buy. You ring your broker to place the trade; however, the overwhelming confidence of paper trading has now deserted you. Perhaps you had better double-check the formation. After much deliberation you decide to phone the broker and the trade enters the market. For the next two days prices rise dramatically, your profits grow; you feel great, what an easy way to make a living. The next day prices drop and your profits are cut in half. You feel uncertain; perhaps you should take the profit now before it gets away. You decide to wait. The next day prices fall further and close below your mental stop loss. Your system is telling you that you should be cut. However, you only have a small loss and it should turn around and you will soon be back in profit. The next day, to your horror, prices have collapsed and the majority of your equity is now lost. Your reaction is now one of anger, why didn't you bank the profit when you had it! The market's move is totally illogical, you feel anger, pain and frustration, you are now totally disillusioned and fed up, and all you want to do is exit the trade.

Welcome to the real world of trading!

"Seeing is believing, but feeling is the truth."
Thomas Fuller

The above is a hypothetical yet common example of how traders who have made money on paper suddenly crumble under the strain of real trading. Many people deride paper trading and say it is of little use. However, providing you know the pitfalls in advance, it is a great way to mentally prepare yourself for the day you have to trade real money.

"The mainstay of training her is confidence. That's why we show them how to let a tank run over them - it gets their confidence up."
Officer in Charge
US Special Operations Command

Of course nothing will take the place of the real trading arena; however, practicing the basics on paper is a very useful exercise. To ridicule paper trading is similar to saying soldiers should not go on manoeuvres because the bullets are not for real! In conclusion, paper trading is useful if we adopt the right attitude to it, (i.e. we make it as realistic as possible and we don't cheat).

Going back to our hypothetical example, it is clear that the trader was making investment decisions based upon his emotions rather than logic. No matter how good the trading system was that he used, he would still fail due to his lack of discipline and self-control. This is not to imply that you can trade any system with discipline and be successful; however, a disciplined trader with a mediocre trading system has the edge on the best trading system in the world if its operator lacks discipline.

To develop discipline you need to acquire total confidence in your abilities, i.e. acquire self-control. You can do this by acquiring knowledge, practicing on paper and real time trading experience. Nothing replaces real time trading, but preparation in terms of understanding the markets and how you should relate to them will give you a distinct edge in the quest for the big profits.

CHARACTERISTICS OF THE MARKETS

The unique world of trading futures is one that encourages traders to reject objectivity and logic in favour of the basic human emotions of greed, fear, hope and pride, with disastrous consequences. Let's take a closer look at the markets and the psychological problems they create.

Operating in an unstructured environment. Trading requires you to operate in an environment with few rules and little structure. Most people need order and rules for guidance, it is the way their lives have been structured since childhood. Man is brought up in a society that is held together by rules and laws that are imposed by an external authority.

Society is structured, and it is its definitive structure that makes people feel comfortable. Laws and rules are perceived as protection when our security and well being are threatened. We can, for instance, go to the police or Courts to look into and act on our grievances.

In contrast, the trading environment has no clearly defined rules and no structure. It would be, in society terms, total anarchy. The market moves where it wants, whenever it wants. The society of trading has no governing body that makes or enforces rules; there is no judicial body to appeal to should the investor feel prices are not moving in the right direction. This anarchy can be extremely unsettling for investors if they think prices should go up and they actually decline. There is absolutely nothing we can do about it. The market does not care whether investors make or lose money, it has no conscience, and it is a natural phenomenon and never has to justify its actions.

A harsh and hostile environment. Every trader tries to take money from everyone else. Everyone is trying to make money at everyone else's expense. It is a uniquely harsh environment, everyone is against you and you are against everyone else. One analyst compares it to a medieval battle - a man used to go to the battlefield and hill his adversary while his opponent tried to do the same to him. The winner took the loser's weapons, his chattels and sold his wife and children into slavery. Today traders to battle on the Exchanges instead of on the field. When you take money away from a trader, it is not that different from drawing blood, he may los his home, his chattels, and his wife and children may also suffer. Is this description a bit exaggerated? Perhaps; however, there is no denying how hostile the trading environment feels when you trade in it, to stand alone can be, and is, uncomfortable.

Confronting your inner self. Standing alone is uncomfortable because it makes people do one thing that most feel uneasy about, which is taking responsibility for one's actions. Most people like to delegate responsibility, blame others and make excuses when they don't succeed. Most people simply cannot face the simple truth that they are responsible totally for the consequences of their actions. A person can go for a job interview and convince himself that he did not get the job due to a personality clash with the interviewer. A lawyer can drink too much before an important case and convince himself he lost because the Jury was biased, a salesman can convince himself that it was his product that was not up to scratch and not his presentation.

The trader, however, has nowhere to hide when interacting with the market. He is really competing against himself, and the market will judge every day how well he is doing. This confrontation with our own personality, our strengths and weaknesses graphically exposes, is something most people would rather avoid.

The work ethic does not apply. The normal work ethic of time, effort and reward that is common in most job situations does not apply in the markets. For example, a factory worker putting in overtime and working extra hours is rewarded with more money. As a general rule, the greater the effort we put in, the greater the reward we expect. However, no such work ethic exists with the markets. A trader can spend years creating a trading system, only to see his equity wiped out in a matter of days. A trader, however, may quickly develop a simple system and reap huge profits. Whether we acknowledge it or not, we normally believe that we deserve money under certain conditions where we have to expend a certain amount of effort to get our reward. For example, an investor sitting on a big profit feels he does not deserve it, and therefore tries to snatch it. When a trader loses, he feels that his input in terms of effort means he deserves a reward and he holds his loss. His subconscious mind constantly equates time and effort with reward, and this affects his objective judgment.

There is unlimited profit and loss potential. This is the one characteristic that brings out the worst emotions in traders and causes them to lose. They simply cannot cope with the unlimitedness of the markets' movements. This "unlimitedness" and the massive leverage available causes traders to create risk by their emotional desire to avoid it. This may sound illogical until we examine how an investor's emotions interact with his perception of risk reward.

Consider the following: If making money is important to you, as it is to most people, you will have difficulty taking a small loss. If you bear in mind a trader's self esteem and the fact that money is on the line, you will appreciate the psychological turmoil this can cause. Profits, on the other hand, are just as difficult to cope with. When a large profit occurs, he gets excited, and the bigger the profit becomes the harder it is to resist the temptation to take it now. However, profits need to be run to cover inevitable losses. In their efforts to avoid risk, investors actually end up creating it. Consider the following psychological test:

A group of people are given the following choice over a number of trades:

A 75% chance to win $1,000 with a 25% chance of getting nothing, or a sure $700. Four out of five subjects take the second choice, even after it is explained to them that the first choice leads to a $750 gain over time.

Another test gives people the following option; a sure loss of $700 or a 75% chance of losing 1,000 and a 25% chance of losing nothing. Three out of four took the second choice, condemning them to lose 50 more than they have to. So, in trying to avoid risk, investors create it.

Emotion causes most traders to act in a way that will lead to their ultimate demise.

They prefer a sure gain, however small, to a logically based speculation to seek a large profit. On the other hand, they actually seek risk in the realms of losses. They let losses run to avoid taking a small loss and, by doing so, they create greater risk for themselves. They expose themselves to bigger losses when they could have had a certain small loss.

THE PARTICIPANTS

Wall Street, the famous financial area of New York, is named after a wall built in Manhattan in the early settlement days, to stop animals wandering. Today the farming connection lives on in the language of the brokers; namely bulls, bears, hogs and sheep.

Bulls are buyers: a bull fights by striking upwards with his horns. A bear, on the other hand, fights by striking with his paws. Bulls look up, bears look down, and the price is a constant fight between the two. So, who are the hogs and sheep? These are the majority of investors trampled underfoot. A hog is greedy and takes positions that are too large and is wiped out by small, adverse moves, or holds profits for too long in the hope that prices will go on for ever. Sheep are passive and fearful followers of the media, gurus, brokers and friends. They bleat at everyone when they lose, and cannot accept they were responsible.

The farming analogy is very close to what happens in reality. Only strong bulls and bears make money. The crowd-following characteristics of the sheep, combined with the greed of the hog, characterises most losing traders in the market.

DESTRUCTIVE EMOTIONS

There are four that are really important in investing, greed, fear, hope and pride.

Greed Greedy investors tend to be over-confident and want to make as much money as they can in a short period of time. They want big profits and they want them now. The desire to make money, however, is in many instances unrealistic. If, for example, I gave you a small vegetable patch and told you to feed your family from it, you would probably think about it logically and deduce that you had insufficient resources at your disposal to achieve the aim. Contrast this with the amount of people I speak to who want to invest $5,000 in a commodity account, and earn a living from it and retire from their job. The chance of achieving their desire is almost nil, but over confidence and desire overcome logic and objective thinking.

Fear All people fear losing money, worrisome news in relation to their investments and savings stimulates more fear. Fear then spreads; a fearful man's psychology is contagious. If people around us are fearful, so are we. If we have suffered fear in the past, we retain all our past experiences in our subconscious mind. Finally we have the fear of losing. Also, if we see other people making money, we want to be in on the action as well.

Hope This is defined as the expectation of something desired. However, investment decision making should not be based purely on desire, but on a rational assessment of the facts. When a trader loses he hopes that things will get better when he really should be being objective.

If you read the great traders, you will constantly see them refer to Hope and Fear and their destructive power.
"Hope and fear: I have written about this often in my books, and I feel I cannot repeat it too often. The average man or woman buys commodities because they hope they will go up or because somebody advises them they will go up. This is the most dangerous thing to do, never trade on hope. Hope wrecks more people than anything else. Face the facts and when you trade, trade on facts, eliminating hope."

"Fear causes many losses. People sell out

because they fear commodities are going lower, but they often wait until the decline has run its course and sell near the bottom … never make a trade on fear."
W.D. Gann

"The successful trader has to fight … two deep-seated instincts, instead of hoping he must fear, instead of fearing he must hope. He must fear that his loss may develop into a much bigger loss, and hope that his profit may become a big profit. It is absolutely wrong to gamble in stocks the way the average man does."

"The speculator's chief enemies are always boring from within. It is inseparable from human nature to hope and to fear."
Jesse Livermore

After greed the average speculator, to achieve his desire, falls victim to both hope and fear and ultimately loses his money

PRIDE

"Price of opinion has been responsible for the downfall of more men on Wall Street than any other factor."
Charles Dow

Pride of opinion is a characteristic of losing traders that have not been able to see their inner selves; they do not know their own strengths and weaknesses. They do not understand themselves and their emotions. Pride is simply stubbornness and the inability to admit a mistake. Any trader who insists on holding a viewpoint in total contradiction to what is actually going on around him for no other reason that he cannot admit he is wrong, will meet the financial disaster. Price can be a direct reflection of the preceding emotions.

The market is all-powerful, it moves regardless of any man. You can do nothing to influence where it is going and you cannot control its behaviour. When you compete in the market only you can be wrong, and it can never be the other way around. Although the market is a harsh environment and does not care about your welfare, it is not, as many losing traders think, out to punish you.

Consider an analogy with the sea. A sailor cannot control the sea but he can control himself, and in doing so he can earn a reward. A skilled mariner knows that the ocean needs to be respected, but he does not fear it. He develops skills and discipline to help him benefit from it. By using his acquired skills, no matter what the weather, the sailor is confident of getting into port without harm, and earning his living. An ocean is like the markets, it can make a man money or he can drown in it, the choice is there for each individual.

Just as mariners follow rules to navigate from A to B, so must a trader follow rules to keep him from being sidetracked. The rules that I will outline are not new and they are not original. They will, however, help you reach your goal of consistent profits. If you do not have rules and guideline you will fall victim to outside influences and be influenced by your emotions, your objectivity will be lost and so too will your money.

THE SECRET OF THE GAMBONI

The secret of the Gamboni is the secret of how to survive in the financial markets. Understand it … really understand it … and you are on your way to success as a trader, speculator, or investor. So, here it is.
Joe was a card player, a good one. He was so good, in fact, that he had to move from city to city and find games where he wasn't known in order to play for high stakes. One afternoon, in a bar in the suburbs of Chicago, he's shooting the breeze with the bartender and asks, "Say, where can I find a good card game around here?"
"What kind of stakes are you talking about?"

"Big," Joe says, "the biggest game you know about."

"Well now, I hear there's a game out in the farm country. It's a bit of a drive, but these particular farmers play for big money. Let me make a call and see if it's OK."

So the bartender makes the call, and then gives Joe directions to the game.

That evening, after a long drive, Joe pulls up to this barn in the middle of nowhere. Tentatively, he walks inside, tiptoeing around the fetid piles on the floor. At the back of the barn, he spots a partially open door, with light and smoke pouring through the opening. The familiar rush of anticipation and energy sweeps through him as he enters the room and introduces himself.

Farmers in overalls sit around the table, chewing cigars and puffing their pipes. In a quick glance, Joe estimates the current pot to be about $40,000 - perfect. So he sits down. "Ante up," says the farmer holding the deck of cards. And Joe begins to play.

About an hour later, Joe is holding is own. He is about even when he draws three aces and two queens - a full house. With a large pot already on the table, he raises $15,000. The next two guys fold, but the leather-faced farmer across the table calls him and raises another $15,000, without so much as batting an eye. Joe, certain that the guy us bluffing, calls the bet and lays down his aces-high full house. The farmer lays down junk: three clubs and two diamonds of mixed numbered cards. Joe, suppressing a smile, starts to rake in the pot.

"Wait just a darn minute," says the farmer, a stern and reprimanding tone in his voice.

2Whattaya mean, wait a minute," says Joe, "you got nothin."

"Take a look at the sign over your right shoulder," smiles the farmer.

Joe looks:

THREE CLUBS AND TWO DIAMONDS CONSTITUTE A GAMBONI, THE TOP WINNING HAND IN THIS ESTABLISHMENT.

Joe is really angry, but after all, rules are rules, so he continues to play with what is left of his holdings. About an hour later, he draws three clubs and two diamonds … a Gamboni! He bets everything, and on the final round of betting with the same leather-faced farmer, he has to throw in his solid gold Rolex to make the call. The farmer turns over his cards, a queen-high spade flush. Joe turns over his Gamboni and starts to rake in the pot.

"Hold it there, fella," says the farmer, his grin cutting deep lines in his cheeks.

"But I got a Gamboni!" cries an exasperated Joe.

"Sure 'enough, but look at the sign over there," and he points over Joe's left shoulder.
Joe looks:

ONLY ONE GAMBONI WILL BE PERMITTED PER NIGHT IN THIS ESTABLISHMENT.

Joe, broke but thankful for the invention of credit cards, leaves the barn with dung on his shoes, and the leather-faced farmer drives his tractor home feeling the weight of a solid gold Rolex on his wrist.

So the secret of the Gamboni is this: if you want to win, you've got to know the rules; and also, you can't win if you're not at the table."

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See enclosed reading list.

Any gambler will tell you that to make money you need to keep the odds in your favour, and the same is true in trading, there are no certainties, only probabilities. To win, you need to speculate when the odds are in your favour, so succeed you need to accurately predict and play the odds. You need to know how to place your bets to maximise your profits and keep your losses small. To do this you need a disciplined trading plan. The following rules, if followed, will help you keep the odds in your favour, know and follow the rules and you will succeed. If you break any of the rules you will end up losing money.

"Luck, continued the gambler reflectively, is a might queer thing. All you know about it is it's bound to change, and it's finding out when it's going to change that makes you."
Berte Harte - The Outcasts Of Poker Flat

We stated earlier that when we trade we confront an unstructured environment and, to operate effectively, we need to create a structure for ourselves. The reason we need rules is we need to combat the destructive emotions referred to earlier and give us discipline. Assuming you have educated yourself and developed a trading method, you will now need to execute it with confidence, entering and exiting trades in a consistent manner. Without rules your emotions will dictate your decisions and lead you to financial disaster.

HOW THE MARKETS REALLY WORK

"It is remarkable that a science which began with the consideration of games of chance should become the most important object of human knowledge ... the most important questions of life are for the most part only problems of probability."
Pierre Simon De La Place
Theorie Analystique Des Probabilities 1812

Take a coin and toss it into the air. As the coin spins in the air you have no idea and cannot predict which way it is going to fall. Yet over many tosses the outcome can reasonably be predicted. Just as we can predict the tosses of a coin with probability, so too can we use probabilities to predict market direction. When you trade you need to trade with the probabilities and odds in your favour.

In recent years many academics have scoffed at the idea that markets can be predicted and they point to the theory of Random Walk. The theory is based on the assumption that markets are efficient. The market is one where a large number of equally well informed people actively compete to try and maximise profits. In such a market, at any time, the price will reflect all available information as well as all events expected to occur in the foreseeable future. The theory holds that as all current and future events are discounted, the individual's chances of over performing or under performing the market as a whole are even, i.e. you can never put the odds in your favour, and therefore will not be able to earn consistent profits. If the theory is correct, our rules and all our trading efforts will count for nothing.

It is amazing this theory has become so widespread and so many people believe it. It is, however, completely incorrect as it assumes that the decision-making process conforms to scientific theory. It quite clearly does not; the facts are there for all to see. However, we all make personal subjective judgements based upon our knowledge, understanding and emotions. Given the same information, we do not all reach the same conclusions.

If we discount the Random Walk theory and say that human behaviour is unpredictable, then how can we put the odds in our favour? The answer lies in probabilities discussed earlier. To trade the markets you need to trade to minimise risk, and maximise gains. The way to do this is to catch the trend. Take any chart over a period of time and you will notice trends and recurring patterns. If all humans think differently, how and why do these patterns emerge?
The answer can be found in the theory of "chaos", which postulates that certain

types of natural activity are chaotic except in terms of probability. To give an example, the heartbeat of a person can be charted but given certain conditions, a heart will go into random fibrillation during which time the heartbeat cannot be predicted or modelled. Mathematically, weather forecasting is another area where chaos theory applies. The unpredictability of weather forecasting comes from what is called sensitivity to initial conditions. Mathematical models fail in forecasting because the slightest divergence between simulated and actual conditions multiplies in a complex chain of cause and effect relationships, giving rise to results in the model totally different than in nature. The best meteorologists can do is to forecast weather within the limits of probability.

While admitting that certain events in nature don't follow a perfect mathematical order, chaos theory says that they can still be understood, predicted and controlled. It directly challenges Random Walk that there is no way of predicting market movement. There are no certain predictions but there is order to the chaos, and forecasts can be made on the basis of probability. To understand probability in financial markets, we need to look at the psychology of the participants.

Why chaos theory is so important.

"The organisation of the Universe demands that matters abandon itself to the games of chance."
H. Reeves - Atoms of Science

The theory of chaos is not a theory to help you make investment decisions, its usefulness lies in the greater understanding it gives us of the trading environment and how we should cope with it.

1. It shows us how human psychology influences price movement, why trends occur, and how they can end up being understood in terms of probability. The herd mentality is fully explained in our Special Situations Report available from the office. Human psychology has remained constant over time, and it is this fact that helps us predict the probability of price movement via technical analysis.

2. It disproves Random Walk theory; although market movements may appear random, under statistical tests they are not.

3. If it disproves that the markets are random, it also shows why the quest for the "Holy Grail" computerised or mechanical trading system is doomed to failure. It also confronts those disciples of such analysts as Gann and Elliott who believe the Universe is ruled by law.

4. It helps us to operate in an unstructured environment by giving us a greater understanding of it. The best you can do is understand the original conditions that give rise to probable future events, and act accordingly. This may sound disheartening, it is not. By understanding chaos, you will be able to keep the odds firmly in your favour. If you can do that, you will end up making a lot of money from your trading, year in year out.

THE MADDING CROWD

"Whosoever be the individuals that compose it, however like or unlike be their make of life, their occupations, their character, or their intelligence, the fact that they have been transformed into a crowd puts them in possession of a sort of collective mind which makes them feel, think and act in a manner quite different from that in which each individual of them would feel, think and act were he in a state of isolation."
Gustav Le Bon 1897

Chaos theory postulates that we can make accurate predictions in terms of probabilities and this is certainly true of market behaviour. Although all investors think differently, in the investment arena people change in crowds. In crowd's investors, as a whole, react to their emotions rather than their intellect, and it is these basic instincts that can be predicted and controlled by those investors able to stand aside from the crown and think in a rational manner.

Typically a bull market starts ina period of uncertainty or fear. As more buyers enter the market, prices rise and confidence appears. As prices rise, the more greed and hope that prices will continue upwards for the foreseeable future. After a period everyone has bought, and there is no one left to push prices higher, a small number of investors exit the market, fear emerges, and there is a mad scramble to exit the market. This scenario to a greater or lesser degree occurs in all investment markets.

1. Human nature in investment markets on mass is constant and repetitive over time.

2. Investors tend to be followers, not leaders, and this causes trends to develop.

3. Investors tend to generally exhibit the basic emotions of greed, fear and hope when making investment decisions.

4. The more bullish or bearish the market becomes, the greater the probability of a reversal.

Human nature has remained constant for thousands of years, and although all humans think differently, the influence of the crowd allows ut to predict market turning points and market trends with a degree of accuracy. I have covered the predictability of man's investor behaviour in greater detail in my "Special Situations" essay, which should be read in association with this work.

UNDERSTANDING OUR NATURE

"A man's character is his fate"
Heralatus

What actually is man, why does he think and act in the way that he does? What is the relationship between mind and body? What influences his behaviour? Since the ancient Greeks defined Psyche as the Goddess loved by Eros, philosophers have produced numerous conflicting theories of human nature.

In 1762 J.J. Rousseau wrote his famous test "Emile", which introduced a revolutionary theory of childhood and human nature that is still relevant today. Rousseau argued that man's nature was essentially good; however, his nature was influenced and corrupted by society. Rousseau believed that a child's mind was "Tabula Rosa" or a clean slate when the child was born, and it was at this stage that the child has the potential within itself to develop almost unlimited talents. The clean slate has experiences and rules written upon it as the child learns and develops. As a child moves from birth to adulthood, he effectively becomes a reflection of his experiences.

Rousseau's theory is very idealistic and perhaps naïve; however, he does pose two very important questions. First, how much of human behaviour is learned and how much is genetic? Secondly, how much influence does society have upon us? There are undoubtedly instincts and primary needs that we are born with, and no two infants are exactly alike, i.e. children have different responses to stress. However, it is the environment that is the major influence on our behaviour. Children take on the attitudes, behaviour and opinions of those around them. With investment there is no doubt that all aspects of investment behaviour can be learned.

"It's the psychosomatic form in which man experiences his estimate of the beneficial or harmful relationships of some aspects of reality to himself."
Definition of Emotion

As we have stated earlier, method and knowledge by themselves are simply not enough. If there is one crucial factor that makes an investor a winner, it is emotional discipline, which gives the will and ability to execute knowledge. In order to acquire it we need to look at our desire and motivation, and how these two conflicting emotions need to be reconciled in order that we can trade successfully.

All of us, at certain times, lack motivation. We may desire a whole host of different goals, yet we lack that spark of motivation to get us there. To fulfil our desires and reach our goals, we need to channel our desire through positive motivation.

Positive motivation is needed to get us to our goals. Without it, all our knowledge and desires are useless. Consider the area of weight loss. You can go into any bookshop and you will see countless scientifically proven methods of losing weight. Yet out of every 100 people who start a course, only 10 succeed in losing weight, and only 2 in 100 keep it off for more than a year. The success rate is less than futures trading! Ever seen those step-by-step language courses - just follow the tapes and in no time at all you will be speaking your desired language with fluency. Now everyone can learn a language, yet the success rate here is about the same as in the area of weight loss.

"People who deal with stress believe that an increase in the pain and strain must happen before the pain will go away. Their approach to stress and life is similar to Nietzche's statement 'whatever does not kill makes me stronger."
Salvadore Madd

There are two fundamental emotions that stand in the way of positive motivation. The two emotions are the need to avoid pain and the desire to achieve pleasure. In order of importance, the need to avoid pain dominates. If our desires remain unfulfilled we will, however, feel empty, depressed and dissatisfied. Our motivation to reach our goals is continually undermined by conflicting emotions.

To achieve our desires and feel fulfilled, we need to suffer some pain. It is the ability to see this pain in a positive way that will help us reach and fulfil our desires and give us happiness. In the case of the language course, it is working with boring repetitive material; with the diet it is the pain of being deprived of food we crave. If you think of the pain/pleasure relationship in trading, you should consider the fundamental rule of trading: cut your losses and let your profits run and you will see why the majority of investors find it so difficult.

Taking a loss, however small, is painful and ego deflating. It means an admission of being wrong. Rather than take the loss, people hold on and hope that it will turn around and become profitable, and therefore pleasurable. In the world of trading this very rarely happens - the result is normally a bigger loss and greater pain. Similarly, when we see a profit in the market, the pleasure we derive from this means that most investors take it before it has the chance to turn around and cause pain. To be successful, it is clear that one needs to be able to positively accept short-term pain to reach our ultimate goals and desires.

"Let me tell you the secret that has led me to my goal: my strength lies solely in my tenacity."
L. Pasteur

To achieve positive motivation you need to set clear, long-term goals and motivate yourself towards them. An acceptance of short-term pain, therefore, is inevitable. If you make a complete honest commitment on what you want from life, why you want it, and how you intend to fulfil your desires and goals, this personal honesty will release you from the pain/pleasure paradox that most investors suffer from.

INVESTOR PROFILES

I have worked in several commodity brokerages, introducing accounts, and now write books and newsletters in addition to running my own commodity brokerage. I have probably introduced around 6,000 investors to trading over the years, and have encountered a broad cross-section of investors. In his book "Beyond the Investors Quotient" J. Bernstein puts the investors he has come across into categories. I have done a similar exercise below, and tried to put investors into six main categories. They are not etched in stone and some categories obviously overlap.

The Universe is governed by law There is a huge marketing campaign in futures trading based around Holy Grail systems that are able to accurately predict future price movement based upon scientific law. They normally claim fantastic results and yet will only cost you a few hundred dollars.

Many systems are based around investors who are dead, and two of the most famous are R. Prechter and W.D. Gann. These two are promoted by a number of books, courses and software companies as two of the most successful investors of all time. The fact that they are dead means that they cannot answer some basic questions like if they were so good at predicting price movements, why did they not make much money? The reality is, Prechter died a pauper and W.D. Gann, who allegedly amassed a $50 million fortune, had to sell courses and books, as he could not support his family by trading. When he died, his estate was valued at a modest $100,000. You will see all types of scientific systems, many are based on astrology - how accurate are they - probably as accurate as your horoscope.

It amazes me how people fall for this hype. Clients who fall for sure fire systems vary from highly intelligent traders to newcomers. Alas, they don't last long, normally the first couple of trades shatter the illusion and it's back to the reality of working for a living. There are some good mechanical systems around however. Just like any good trader, they suffer periods of drawdown.

The Educated Fool

Just like Jake Berstein, I have come across this investor numerous times over the years, highly intelligent, knowledgeable, with a string of degrees and letters after their name. The problem they encounter is they feel the application of knowledge is all that is needed to make money. They create vastly complicated trading systems that look great, and then totally collapse in the market place. These people cannot translate theory into practice. They have no grasp of psychological aspects of trading and normally have great problems admitting their approach is wrong.

It's everybody's fault but mine This person refused to take responsibility for his trading decisions. If he makes a profit he shouts how wonderful he is, and when he loses he blames everyone from his broker giving him bad advice, his wife and even the market, which is acting illogically. This investor is normally insecure, unable to take responsibility, lacks confidence, and exhibits a lot of emotion in trading.

The Opinion or Advisory Service Junkie This investor has found the secret of investing. His logic is to get as many advisory services as possible and wait for them all to be looking at the same trade. Several heads are better than one he concludes. Once he has a trade that fits these criteria, he gains additional advice from brokers and friends. This trader's logic is flawed in that if everyone is looking at a trade to go in a specific direction, it will normally go the other way. This trader needs to study the theory of contrary opinion. The old saying "if it's obvious, it's obviously wrong" applies to his way of picking trades.

The Action Man

This investor likes to trade all the time, he loves the action. He will trade in and out of the market continuously, rarely holding positions for any great period of time. This trader normally has a reasonable understanding of market movements, but rarely makes any money. He cuts his profits and eventually his losses and commission charges erode his account. I have seen traders like this trade for five or six years every day, not making money, yet still cheerfully trading.

The Inability To Pull The Trigger

This investor is one who has great difficulty in placing an order and there are far more of them than you would probably think. Sometimes traders have a problem making the first trade, and this stems from a lack of confidence. They're always agonising over the perfect trade to so, and end up doing nothing. It also happens after a losing trade, confidence that was there goes. It's like the skier at the top of the hill who has had a bad fall and can't go down again. The problem is, if you are afraid to go downhill, you can't be a skier. If you fear to trade, you should find another profession.

So far the above traders fall into losing categories, and represent the bulk, say, 90-95%. The other 5% are all different individually, however, there are some points they all have in common that are outlined below.

SUCCESSFUL INVESTORS

Successful investors may use different systems or approaches to the market, have different educational backgrounds and be of various ages. However, they would have the following beliefs that enable them to reap profits from the markets:

1. Self-confidence. This comes from both knowledge of the markets and self-knowledge of their strengths and weaknesses. They effectively believe that they will make profits in advance. They believe the game has been won before they begin. If you are not self-confident in your own ability, it is unlikely you will ever become a successful trader.

2. Money itself is not important; this allows them to emotionally detach themselves from trading.

3. Losing money can and will occur, and is acceptable to these investors.

4. Profits will occur over a period of time and these can be run to a significantly larger size than their losing trades.

5. These investors love and enjoy what they are doing, and therefore have no problem devoting regular time to trading.

6. Open-mindedness and adaptability. Successful traders remain open-minded and receptive to new ideas when it is necessary. They find it easy to adapt and change and they are not concerned with admitting when they are wrong.

A well thought out and logical trading method, combines with the above beliefs, will give any trader an edge in the quest for profits.

BECOMING A DISCIPLINED INVESTOR

"A key to self management is the capacity for self-observation, it is not the same as over-criticism … it is rather a consistent monitoring of one's performance from a perspective significantly detached to allow accurate evaluation."
A. Garfield

It is clear that knowledge of oneself is just as important in trading as knowing facts, economic theories, news or trading methods. In the trading world, often emotion reigns supreme, facts are ignored and there is no wrong or right. The person who has control of himself due to his discipline and emotional self-control will ultimately emerge from the battlefield a winner.

However, coming to terms with our strengths, weaknesses and personal traits is not easy. It is not easy to analyse yourself objectively because you will naturally have a subjective perspective.

When trying to understand yourself, you must be willing to be totally honest with yourself. This can be difficult and painful. The person must have the ability to accept the results of looking within. Most people, however, find it difficult to admit they made a mistake. Ask a room full of people how many of them are happy admitting their mistakes and you will see few, if any, hands go up. Admitting mistakes, however, is a positive not negative attribute in trading, as it is in life. The world is full of people who want to be right, but the reality is everyone cannot be right all of the time.

"Learning is after all not whether we lose the game, but how we lose and how we have changed because of it, and what we take away from it that we never had before to apply to other situations' losing in a curious way is wining."

Richard Bach

All of us have physical and mental disabilities, which prevent us from achieving all our goals and desires. No one is perfect. It is possible, however, to isolate and work on weaknesses. This is similar to reviewing and working on your trading method. You must understand the strengths and weaknesses of the system and try to improve it, but realise perfection is impossible. Remember, in the final analysis you have inherent weaknesses and may not have all the required attributes for trading, but neither does anyone else. The more traits you possess, the greater your advantage, but the more you work at obtaining these traits, the better your chances for success.

THE SECRET OF MARKET SUCCESS

"For surely we are not … no simply contending in order that my view or that yours may prevail, but I presume that we ought both of us to be fighting for the truth."

Socrates

The aim of any investor is to make money by correctly identifying and acting upon the truth. The truth, however, is elusive, as there is no scientific method to get us to the truth. The truth is difficult to see as it can be totally different to what your emotions and natural instincts are telling you. Furthermore, the fact that the majority of people agree or disagree with you has no relevance in the pursuit of the truth.

To succeed in trading you need to understand that there are no certainties, only probabilities, and to seek the truth you need to have a deep understanding of yourself and the market you operate in, and how you relate to it. You need to stand-alone and, from your perception of what is going on around you, decide what the truth is.

I started this essay with a quote from Lao Tzu, who founded the Chinese philosophy of Taoism over 2,500 years ago. Many of the beliefs of Taoism are relevant to trading.

Trading is a reflection of life. This is why there are so many contradictory ideas and shades of grey instead of black and white answers. Just like life, trading is unpredictable; people who believe that there is a scientific law to investing that can predict commodity price movements are missing the point. Trying to reduce everything to numbers if, in Lao Tzu's words, like trying to catch running water in a bucket.

Many elements of Taoism hint at the psychological course of events. This is particularly relevant in trading. Tao in English means "the way". Tao is the missing link in trading, it is effectively the ability to see an event before it is definitely known, that is the key. It is really the intuitive ability to see and then to act.

In the world of Taoism you need the ability to use both analytical and intuitive skills. Relying on both right and left hemispheres of the brain to process and analyse information, this is the key to identifying and acting upon the truth. Once you have brought your thoughts to bear on the facts of a situation, then you need to let go. This is the incubation stage where you are letting your thoughts go where they may, without the influence of anyone else. When you learn to think and act in this manner, you will be surprised how you see many situations the crowd will never see.

Investors spend millions each year on "Holy Grail" trading methods, books and tapes that they believe will give them regular and consistent profits from the market, with low drawdowns. These people will never make money; in trading there are no certainties, only probabilities, and a trader must accept this if he is to make money.

FINAL WORDS

A scorpion wants to cross a river, but he can't swim. He asks a frog, who can, if he can hitch a ride on the frog's back. "You'll sting me," says the frog. "It would not be in my interest to sting you," says the scorpion, "because then I would drown."

The frog thinks about the scorpion's logic, finds it impeccable, agrees to take the scorpion on his back, and then braves the waters. Halfway across the river, the frog reels a burning spear in his side; the scorpion has stung him after all. As they sink beneath the waves, the frog cries out, "Why did you sting me Mr Scorpion, for now we both will die?" "I can't help it," replies the scorpion, it's in my nature."
(From the movie "The Crying Game" 1992)

We are all human, and we all have emotions that are inherent in our biological make-up, we can't rid ourselves of them. What we can do is understand them, and try to control them. If we don't, our trading will be doomed to failure.

Obviously there is limited space in this essay to cover all the psychological aspects of trading. I would, therefore, strongly recommend you consult the enclosed reading list for further information.

FURTHER READING

Some of the information enclosed has been from direct experience. However, a considerable influence on my trading has come from the enclosed material.

Recommended:

1. The Disciplined Trader
   Mark Douglas

2. The New Investors Quotient Jacob Bernstein

These books cover all aspects of psychological problems encountered in trading and give clear guidance on how to avoid the emotional traps that destroy most traders' equity. These two books complement each other, and are essential reading.