Individual Psychology

4. Why Trade?

Trading appears deceptively easy. A beginner may cautiously enter the market, win a few times, and start feeling brilliant and invincible. That's when he starts taking wild risks and ends up with bad losses.

People trade for many reasons—some rational and many irrational. Trading offers an opportunity to make a lot of money in a hurry. Money symbolizes freedom to many people, even though they often don't know what to do with it.

If you know how to trade, you can make your own hours, live and work anywhere you please, and never answer to a boss. Trading is a fascinating game: chess, poker, and a video game rolled into one. Trading attracts people who love challenges.

It attracts risk-takers and repels those who avoid risk. An average person gets up in the morning, goes to work, has a lunch break, returns home, has a beer and dinner, watches TV, and goes to sleep. If he makes a few extra dollars, he puts them into a savings account. A trader keeps odd hours and puts his capital at risk. Many traders are loners who abandon the certainties of the routine and take a leap into the unknown.

Self-Fulfillment

Many people have an innate drive to achieve their personal best, to develop their abilities to the fullest. This drive, along with the pleasure of the game and the lure of money, propels traders to challenge the markets.

Good traders tend to be hardworking and shrewd people, open to new ideas. The goal of a good trader, paradoxically, is not to make money. His goal is to trade well.

If he trades right, money follows almost as an afterthought. Successful traders keep honing their skills as they try to reach their personal best.

A professional trader from Texas invited me to his office and said: "If you sit across the table from me while I day-trade, you won't be able to tell whether I am $2,000 ahead or $2,000 behind on that day." He has risen to a level where winning does not elate him and losing does not deflate him. He is so focused on trading right and improving his skills that money no longer influences his emotions.

The trouble with self-fulfillment is that many people have self-destructive streaks. Accident-prone drivers keep destroying their cars, and self-destructive traders keep destroying their accounts. Markets offer vast opportunities for self-sabotage, as well as for self-fulfillment. Acting out your internal conflicts in the marketplace is a very expensive proposition.

Traders who are not at peace with themselves often try to fulfill their contradictory wishes in the markets. If you don't know where you are going, you'll wind up somewhere you never wanted to be.

5. Reality versus Fantasy

If a friend with little farming experience told you that he planned to feed himself with food grown on a quarter-acre (1,000 square meters) plot, you'd expect him to go hungry. One can squeeze only so much from a small piece of land. There is, however, a field in which grown-ups let their fantasies fly—in trading.

A former employee told me that he planned to support himself trading a $6,000 account. When I tried to show him the futility of his plan, he quickly changed the topic. He was a bright analyst, but refused to see that his "intensive farming" plan was suicidal. In his desperate effort to succeed, he'd have to take on large positions—and the slightest wiggle of the market will quickly put him out of business.

A successful trader is a realist. He knows his abilities and limitations. He sees what's happening in the markets and knows how to react. He analyzes the markets without cutting corners, observes himself, and makes realistic plans. A professional trader cannot afford illusions.

Once an amateur takes a few hits and gets a few margin calls, he swings from cocky to fearful and starts developing strange ideas about the markets. Losers buy, sell, or avoid trades due to their fantastic ideas. They act like children who are afraid to pass a cemetery or look under their bed at night because they are afraid of ghosts. The unstructured environment of the market makes it easy to develop fantasies.

Most people who grow up in Western civilization have several similar fantasies. They are so widespread that when I studied at the New York Psychoanalytic Institute, there was a course called "Universal Fantasies." For example, many people have a fantasy in childhood that they were adopted. This fantasy seems to explain the unfriendly and impersonal world. It consoles a child but prevents him from being aware of a reality he'd rather not see—that his parents aren't that good. Our fantasies influence our behavior, even if we aren't consciously aware of them.

In talking to hundreds of traders, I keep hearing several universal fantasies. They distort reality and stand in the way of trading success. A successful trader must identify his fantasies and get rid of them.

The Brain Myth

Losers who suffer from the "brain myth" will tell you, "I lost because I didn't know trading secrets." Many have a fantasy that successful traders have some secret knowledge. That fantasy helps support a lively market in advisory services and ready-made trading systems.

A demoralized trader may whip out his credit card to buy access to "trading secrets." He may send money to a charlatan for a $3,000 "can't miss," backtested, computerized trading system. When that system self-destructs, he'll pull out his almost-maxed-out credit card again for a "scientific manual" that explains how he can stop losing and begin winning by contemplating the moon, the stars, or even Uranus.

At an investment club we used to have in New York, I often ran into a famous financial astrologer. He often asked for free admission because he couldn't afford to pay a modest fee for the meeting and a meal. His main source of income remains collecting money for astrological trading predictions from hopeful amateurs.

Losers don't realize that trading is intellectually fairly simple. It is nowhere near as demanding as taking out an appendix, building a bridge, or trying a case in court. Good traders are shrewd, but few are intellectuals. Many have never been to college, and some have dropped out of high school.

Intelligent and hardworking people who have succeeded in their careers often feel drawn to trading.

Why do they fail so often? What separates winners from losers isn't intelligence or secrets, and certainly not education.

The Undercapitalization Myth

Many losers think that they would trade successfully if they had a bigger account.

People destroy their accounts either by a string of losses or a single abysmally bad trade. Often, after the loser is sold out, unable to meet a margin call, the market reverses and moves in the direction he expected. He starts fuming: had he survived another week, he would have made a fortune instead of losing!

Such people look at market reversals that come too late and think that those turns confirm their methods. They may go back to work and earn, save, or borrow enough money to open another small account. History repeats itself: The loser gets wiped out, the market reverses and "proves" him right, but only too late—he's been sold out again. That's when the fantasy is born: "If only I had a bigger account, I could have stayed in the market longer and won."

Some losers raise money from relatives and friends by showing them a paper track record. It seems to prove that they would have won big, if only they had had more money to work with. But even if they raise more money, they lose that, too—as if the market were laughing at them!

A loser is not undercapitalized—his mind is underdeveloped. A loser can destroy a big account almost as quickly as a small one. An acquaintance of mine once blew out over 200 million dollars in a day. His broker sold him out—and then the market turned. He sued the broker and said to me: "If only I had a bigger account. . . ." Apparently an account with $200 million wasn't big enough.

A loser's true problem is not account size but overtrading and sloppy money management. He takes risks that are too big for his account size, however small or big. No matter how good his system may be, a streak of bad trades is sure to put him out of business.

Amateurs neither expect to lose nor are prepared to manage losing trades. Calling themselves undercapitalized is a cop-out that helps them avoid two painful truths: their lack of a realistic money management plan and lack of discipline.

A trader who wants to survive and prosper must control losses. You do that by risking only a tiny fraction of your equity on any single trade (see Section Nine, "Risk Management"). Learn from cheap mistakes in a small account.

The one advantage of a large trading account is that the price of equipment and services represents a smaller percentage of your money. The owner of a million-dollar fund who spends $5,000 on classes is only ½ percent behind the game. The same expenditure would represent a deadly 25 percent of equity for a trader with a $20,000 account.

The Autopilot Myth

Traders who believe in the autopilot myth think that the pursuit of wealth can be automated. Some people try to develop an automatic trading system, while others buy systems from vendors. Men who have spent years honing their skills as lawyers, doctors, or businessmen plunk down thousands of dollars for canned competence. Most are driven by greed, laziness, and mathematical illiteracy.

Systems used to be written on sheets of paper, but now they get downloaded on a computer. Some are primitive; others are elaborate, with built-in optimization and even money management rules. Many traders spend thousands of dollars searching for magic that will turn a few pages of computer code into an endless stream of money. People who pay for automatic trading systems are like medieval knights who paid alchemists for the secret of turning base metals into gold.

Complex human activities do not lend themselves to automation. Computerized learning systems have not replaced teachers, and programs for doing taxes haven't created unemployment among accountants. Most human activities call for an exercise of judgment; machines and systems can help but not replace humans.

Had there been a successful automatic trading system, its purchaser could move to Tahiti and spend the rest of his life at leisure, supported by a stream of checks from his broker. So far, the only people who've made money from trading systems are their sellers. They form a small but colorful cottage industry. If their systems worked, why would they sell them? They could move to Tahiti themselves and cash checks from their brokers! Meanwhile, every system seller has a line. Some say they like programming better than trading. Others claim that they sell their systems only to raise capital or even out of love for humanity.

Markets are always changing and defeating automatic trading systems. Yesterday's rigid rules will work less well today and will probably stop working tomorrow. A competent trader can adjust his methods when he detects trouble. An automatic system is less adaptable and self-destructs.

Airlines pay high salaries to pilots despite having autopilots. They do it because humans can handle unforeseen events. When a roof blows off an airliner over the Pacific or when a passenger jet loses both engines to a flock of geese over Manhattan, only a human can handle such crises. These emergencies have been reported in the press, and in each of them, experienced pilots managed to land their airliners by improvising solutions. No autopilot can do that. Betting your money on an automatic system is like betting your life on an autopilot. The first unexpected event will make your account crash and burn.

There are good trading systems out there, but they have to be monitored and adjusted using individual judgment. You have to stay on the ball—you cannot abdicate responsibility for your success to a mechanical system.

Traders with autopilot fantasies try to repeat what they felt as infants. Their mothers used to fulfill their needs for food, warmth, and comfort. Now they try to recreate the experience of passively lying on their backs and having profits flow to them like an endless stream of free, warm milk. The market is not your mother. It consists of tough men and women who look for ways to take money from you rather than pouring warm milk into your mouth.

The Cult of Personality

Most people pay lip service to their wish for freedom and independence, but when they come under pressure, they change their tune and start looking for "strong leadership." Traders in distress often seek directions from assorted gurus.

When I was growing up in the former Soviet Union, children were taught that Stalin was our great leader. Later we found out what a monster he was, but while he was alive, most people enjoyed following the leader. He freed them from the need to think for themselves.

"Little Stalins" were installed in every area of society—in economics, biology, architecture, and so on. When I came to the United States and began to trade, I was amazed to see how many traders were looking for a guru—their own "little Stalin." The fantasy that someone else can make you rich is always with us.

There are three types of gurus in the financial markets: market cycle gurus, magic method gurus, and dead gurus. Cycle gurus call important market turns. Method gurus promote new highways to riches. Still others have escaped criticism and invited cult following through the simple mechanism of departing this world.

Market Cycle Gurus

For many decades, the U.S. stock market has generally followed a four-year cycle. The broad stock market has normally spent 2.5 or 3 years going up and 1 or 1.5 years going down. A new market cycle guru emerges in almost every major stock cycle, once every 4 years. A guru's fame tends to last for 2 to 3 years. The reigning period of each guru coincides with a major bull market in the United States.

A market cycle guru forecasts rallies and declines. Each correct forecast increases his fame and prompts even more people to buy or sell when he issues his pronouncements. A market cycle guru has a pet theory about the market. That theory—cycles, volume, Elliott Wave, whatever—is usually developed several years prior to reaching stardom. At first, the market refuses to follow an aspiring guru's pet theory. Then the market changes and for several years comes in gear with the guru's calls. That is when the guru's star rises high above the marketplace.

Compare this to what happens to fashion models as public tastes change. One year, blondes are popular, another year, redheads. Suddenly, last year's blonde star is no longer wanted for the front cover of a major magazine. Everybody wants a dark model, or a woman with a birthmark on her face. A model doesn't change—public tastes do.

Gurus always come from the fringes of market analysis. They are never establishment analysts. Institutional employees play it safe—afraid to stick their necks out—and almost never achieve spectacular results. A market cycle guru is an outsider with a unique theory.

A guru remains famous for as long as the market behaves according to his theory—usually for less than the duration of one 4-year market cycle. At some point, the market changes and starts marching to a different tune. A guru continues to use old methods that worked so well in the past and loses his following. When the guru's forecasts stop working, public admiration turns to hatred. It's impossible for a discredited market cycle guru to return to stardom.

All market cycle gurus have several traits in common. They become active in the forecasting business several years prior to reaching stardom. Each has a unique theory, a few followers, and some credibility, conferred by sheer survival in the advisory business. The fact that each guru's theory did not work for a number of years is ignored by his followers. When the theory becomes correct, the mass media take notice. When a theory stops working, mass adulation turns to hatred.

When you recognize that a successful new guru is emerging, it may be profitable to jump on his bandwagon. It's even more important to recognize when a guru has reached his peak. All gurus crash—and by definition, they crash from the height of their fame. When a guru becomes accepted by the mass media, it's a good sign that he has reached his crest. The mainstream media is wary of outsiders. When several mass magazines devote space to a hot market guru, you know that his end is near. Mass psychology being what it is, new gurus will continue to emerge.

Magic Method Gurus

While cycle gurus are creatures of the stock market, "method gurus" are more prominent in the derivatives markets. A "method guru" erupts on the financial scene after discovering a new analytic or trading method.

Traders always look for an edge, an advantage over fellow traders. Like knights shopping for swords, they are willing to pay handsomely for their trading tools. No price is too high if it lets them tap into a money pipeline.

A magic method guru sells a new set of keys to market profits—speedlines, cycles, Market Profile, etc. It may have an edge in the beginning, but as soon as enough people become familiar with a new method and test it in the markets, it inevitably deteriorates and starts losing popularity. Markets are forever grinding down each method's edge, and what worked yesterday is less likely to work today and highly unlikely a year from now.

Oddly enough, even in this era of global communications, reputations change slowly. A guru whose image has been destroyed in his own country can make money peddling his theory overseas. That point has been made to me by a guru who compared his continued popularity in Asia to what happens to faded American singers and movie stars. They are unable to attract an audience in the United States, but they can still make a living singing abroad.

Dead Gurus

The third type of a market guru is a dead guru. His books are reissued, his market courses are scrutinized by new generations of eager traders, and the legend of the dear-departed analyst's prowess and personal wealth grows posthumously. The dead guru is no longer among us and cannot capitalize on his fame. Other promoters profit from his reputation and expired copyrights. One dear-departed guru is R. N. Elliott, but the best example of such a legend is W. D. Gann.

Various opportunists sell "Gann courses" and "Gann software." They claim that Gann was one of the best traders who ever lived, that he left a $50 million estate, and so on. I interviewed W. D. Gann's son, an analyst for a Boston bank. He told me that his famous father could not support his family by trading but earned his living by writing and selling instructional courses. He could not afford a secretary and made his son work for him. When W. D. Gann died in the 1950s, his estate, including his house, was valued at slightly over $100,000. The legend of W. D. Gann, the giant of trading, is perpetuated by those who sell courses and other paraphernalia to gullible customers.

The Followers of Gurus

A guru has to produce original research for several years, then get lucky when the market turns his way. While some gurus are dead, those who are alive range from serious academic types to great showmen. To read about scandals surrounding many gurus, try *Winner Takes All* by William R. Gallacher.

When we pay a guru, we expect to get back more than we spend. We act like a man who bets a few dollars against a three-card Monte dealer on a street corner. He hopes to win more than he put down on an overturned crate. Only the ignorant or greedy take the bait.

Some people turn to gurus in search of a strong leader. They look for a parent-like omniscient provider. As a friend once said, "They walk with their umbilical cords in hand, looking for a place to plug them in." A smart promoter provides such a receptacle, for a fee.

The public wants gurus, and new gurus will come. As an intelligent trader, you must realize that in the long run, no guru is going to make you rich. You have to work on that yourself.

Occasionally, when I give a talk or appear on TV, someone introduces me as a "famous guru." I shudder at those words and interrupt such introductions. A guru is someone claiming to lead the crowds across the desert for a donation. No such pitches here!

I always begin by explaining that there are no magic methods, that the field of trading is as huge and diverse as that of medicine, where one needs to choose one specialty and work hard to become good at it. I chose my path a long time ago, and what I do in front of a class is simply think out loud, sharing my modes of research and decision making.

Trade with Your Eyes Open

Wishful thinking is stronger than dollars. Recent research has proven that people have a prodigious ability to lie to themselves and avoid seeing the truth.

Duke University professor Dan Ariely describes a clever experiment. A group of people are given an intelligence test, but half of them are "accidentally" shown a response sheet, allowing them to look up correct answers before recording their own. Needless to say, they score above the rest. Next, everybody is asked to predict their grades on the next IQ test, in which there will be absolutely no cheat sheets—and those who predict correctly will get paid. Surprisingly, the half of the group that scored higher with cheat sheets predicted higher results for the next test. The cheaters wanted to believe they were very smart, even though their incorrect predictions of success would cost them money.

A successful trader cannot afford wishful thinking—he must be a realist. There are no cheat sheets in the markets—you can see the truth in your trade diaries and equity curves.

To win in the markets, we need to master three essential components of trading: sound psychology, a logical trading system, and an effective risk management plan. These are like three legs of a stool—remove one and the stool will fall. It is a typical beginner mistake to focus exclusively on indicators and trading systems.

You have to analyze your feelings as you trade to make sure that your decisions are sound. Your trades must be based on clearly defined rules. You have to structure your money management so that no string of losses can kick you out of the game.

6. Self-Destructiveness

Trading is a very hard game. A trader who wants to win and remain successful in the long run has to be extremely serious about his craft. He cannot afford to be naive or to trade because of some hidden psychological agenda.

Unfortunately, trading often appeals to impulsive people, gamblers, and those who feel that the world owes them a living. If you trade for the excitement, you'll inevitably take trades with bad odds and accept needless risks. The markets are unforgiving, and emotional trading always results in losses.

Gambling

Gambling means betting on games of chance or skill. It exists in all societies, and most people have gambled at some point in their lives.

Freud believed that gambling was universally attractive because it was a substitute for masturbation. The repetitive and exciting activity of the hands, the irresistible urge, the resolutions to stop, the intoxicating quality of pleasure, and the feelings of guilt link gambling and masturbation.

Dr. Ralph Greenson, a prominent California psychoanalyst, has divided gamblers into three groups: the normal person who gambles for diversion and who can stop when he wishes; the professional gambler, who selects gambling as his means of earning a livelihood; and the neurotic gambler, who gambles because he is driven by unconscious needs and is unable to stop.

A neurotic gambler either feels lucky or wants to test his luck. Winning gives him a sense of power. He feels pleased, like a baby feeding at a breast. In the end, a neurotic gambler always loses because he tries to recreate that omnipotent feeling of bliss instead of concentrating on a realistic long-term game plan.

Dr. Sheila Blume, director of the compulsive gambling program at South Oaks Hospital in New York, called gambling "an addiction without a drug." Most gamblers are men who gamble for the action. Women tend to gamble as a means of escape. Losers usually hide their losses and try to look and act like winners, but are plagued by self-doubt.

Trading stocks, futures, and options gives a gambler a high, while looking more respectable than betting on the ponies. Gambling in the financial markets has a greater aura of sophistication than playing numbers with a bookie.

Gamblers feel happy when trades go in their favor. They feel terribly low when they lose. They differ from successful professionals who focus on long-term plans and don't get particularly upset or excited over any single trade.

The key sign of gambling is the inability to resist the urge to bet. If you feel that you are trading too much and the results are poor, stop trading for a month. This will give you a chance to re-evaluate your trading. If the urge to trade is so strong that you cannot stay away from the action for a month, then it is time to visit your local chapter of Gamblers Anonymous or start using the principles of Alcoholics Anonymous, outlined later in this chapter.

Self-Sabotage

After practicing psychiatry for decades, I became convinced that most failures in life are due to self-sabotage. We fail in our professional, personal, and business affairs not because of bad luck or incompetence, but to fulfill an unconscious wish to fail.

A brilliant friend of mine had a lifelong history of demolishing his success. As a young man, he was a successful pharmacist but lost his business; became a broker and rose near the top of his firm but was sued; turned to trading but busted out while disentangling himself from previous disasters. He blamed all his failures on envious bosses, incompetent regulators, and an unsupportive wife.

Finally, he hit bottom. He had no job and no money. He borrowed a quote terminal from another busted-out trader and raised capital from a few people who had heard that he had traded well in the past. He started making money for his pool, and as the word spread, more people invested. My friend was on a roll. At that point, he went on a speaking tour of Asia but continued to trade from the road. He took a side trip into a country famous for its brothels, leaving a very large open position in bond futures, with no protective stop. By the time he returned to civilization, the market had staged a major move and his pool was wiped out. Did he try to figure out his problem? To learn? No—he blamed his broker! Afterwards I helped him get an attractive job at a major data company, but there he began to bite the hands that fed him and was fired. In the end, this brilliant man was going door to door, selling aluminum siding—while others made money using his techniques.

When traders get in trouble, they tend to blame others, bad luck, or anything else. It hurts to look within yourself for the cause of your failure.

A prominent trader came to me for a consultation. His equity was being demolished by a rally in the U.S. dollar, in which he was heavily short. He had grown up fighting an abusive and arrogant father. He had made a name for himself by betting large positions on reversals of established trends. This trader kept adding to his short position because he could not admit that the market, which represented his father, was bigger and stronger than he was.

These are just two examples of how people act out their self-destructive tendencies. We sabotage ourselves by acting like impulsive children rather than intelligent adults. We cling to our self-defeating patterns. They can be treated—failure is a curable disease.

The mental baggage from childhood can prevent you from succeeding in the markets. You have to identify your weaknesses and work to change. Keep a trading diary—write down your reasons for entering and exiting every trade. Look for repetitive patterns of success and failure.

The Demolition Derby

All society members make small allowances to protect one another from the consequences of their mistakes. When you drive, you try to avoid hitting other cars, and they try to avoid hitting you. If someone cuts in front of you on a highway, you may curse, but you will slow down. If someone swings open the door of a parked car, you swerve. You avoid collisions because they are costly for both parties.

Almost all professions provide safety nets for their members. Your bosses, colleagues, and clients will warn you when you behave badly or self-destructively. There is no such safety net in trading, which makes it more dangerous than most human endeavors. The markets offer endless opportunities to self-destruct.

Buying at the high point of the day is like swinging your car door open into the traffic. When your order to buy reaches the floor, traders rush to sell to you—to tear off your door along with your arm. Other traders want you to fail because when you lose they get your money.

Markets operate without normal human helpfulness. Every trader gets hit by others. Every trader tries to hit others. The trading highway is littered with wrecks. Trading is the most dangerous human endeavor, short of war.

Controlling Self-Destructiveness

Most people go through life making the same mistakes decade after decade. Some structure their lives to succeed in one area, while acting out their internal conflicts in another.

You need to be aware of your tendency to sabotage yourself. Stop blaming your losses on bad luck or on others, and take responsibility for your results. Start keeping a diary—a record of all your trades, with reasons for entering and exiting them. Look for repetitive patterns of success and failure. Those who don't learn from the past are condemned to repeat it.

A trader needs a psychological safety net the way a mountain climber needs his survival gear. I found the principles of Alcoholics Anonymous, outlined below, to be of great help at an early stage of trader development. Strict money management rules also provide a safety net, while the diary helps you learn from your mistakes as well as successes.

7. Trading Psychology

Your success or failure as a trader depends on your emotions. You may have a brilliant trading system, but if you feel arrogant, frightened, or upset, your account is sure to suffer. If you become aware of fear, greed, or a gambler's high, close your trades.

In trading, you compete against the sharpest minds in the world. Commissions and slippage slant the field against you. Now, on top of that, if you allow your emotions to interfere with your trading, the battle is lost. My friend and partner in SpikeTrade.com Kerry Lovvorn is fond of repeating: "It is hard enough to know what the market is going to do; if you don't know what you are going to do, the game is lost."

Having a good trading system is not enough. Many traders with good systems wash out because psychologically they are not prepared to win.

Bending the Rules

Markets offer enormous temptations, like walking through a gold vault or through a harem. They provoke great surges of greed and even greater waves of fear of losing what we've got. Those feelings cloud our perceptions of market reality.

Most amateurs feel like geniuses after a short winning streak. It is exciting to believe that you are so good that all your trades are sure to be winners. That's when traders start deviating from their rules and damage their accounts.

Traders gain some knowledge, win, their emotions kick in, and they self-destruct. Most traders promptly give their "killings" back to the markets, which are full of rags to riches to rags stories. The hallmark of a successful trader is the ability to accumulate equity.

You need to make trading as objective as possible. Be sure to follow money management rules. Keep a spreadsheet listing all your trades, including commissions and slippage. Keep a diary of all your trades with "before and after" charts. At the early stages of your trading career, you may have to devote as much energy to analyzing yourself as analyzing the markets.

When I was learning to trade, I read every book on trading psychology I could find. Many writers offered sensible advice. Some stressed discipline: "You cannot let the markets sway you. Don't make decisions during trading hours. Plan a trade, and trade a plan." Others stressed flexibility: "Don't enter the market with any preconceived notions. Change your plans when markets change." Some experts suggested isolation—no business news, no *Wall Street Journal*, no listening to other traders, just you and the market. Others advised being open-minded, keeping in touch with other traders, and soaking up fresh ideas. Each piece of advice seemed to make sense, but they contradicted one another.

I kept reading, trading, and focusing on system development. I also continued to practice psychiatry. I never thought the two fields were connected—until I had a sudden insight. The idea that changed how I trade came from psychiatry.

The Insight That Changed My Trading

Like most psychiatrists, I always had some patients with alcohol problems. I also served as a consultant to a major drug rehabilitation program. It didn't take me long to realize that alcoholics and addicts were more likely to recover in self-help groups than in classical psychiatric settings.

Psychotherapy, medications, and expensive hospitals and clinics can sober up a drunk but seldom succeed in helping him remain sober. Most addicts quickly relapse. They have a much better chance to recover if they become active in Alcoholics Anonymous (AA) and similar self-help groups.

Once I realized that AA members were more likely to stay sober and rebuild their lives, I became a big fan of Alcoholics Anonymous. I began sending patients with drinking problems to AA and related groups, such as ACOA (Adult Children of Alcoholics). If an alcoholic came to me for treatment, I insisted that he also go to AA because otherwise he'd be wasting both our time and his money.

One night I stopped by a friend's office on the way to a party. We had two hours before it began, and my friend, who was a recovering alcoholic, said: "Do you want to take in a movie or go to an AA meeting?" I had sent many patients to AA but had never been to a meeting, since I have never had a drinking problem. I jumped at a chance to attend an AA meeting—it was a new experience.

The meeting was held at a local YMCA. A dozen men and a few women sat on folding chairs in a plain room. The meeting lasted an hour. I was amazed by what I heard—these people seemed to talk about my trading!

They talked about alcohol, but as long as I substituted the word "loss" for "alcohol," most of what they said applied to me! My account equity was swinging up and down in those days. I left that meeting knowing that I had to handle my losses the way AA handles alcoholism.

8. Trading Lessons from AA

Almost any drunk can stay sober for a few days—until the urge to drink drives him back to the bottle. He cannot resist as long as he continues to think and feel like an alcoholic. Sobriety begins inside a person's mind.

Alcoholics Anonymous (AA) has a system for changing the way people think and feel about drinking. AA members use a 12-step program for changing their minds. These 12 steps, described in the book *Twelve Steps and Twelve Traditions*, refer to 12 stages of personal growth. Recovering alcoholics attend meetings where they share their experiences with other recovering alcoholics, supporting each other in their sobriety. Any member can get a sponsor—another AA member whom he can call for support when he feels the urge to drink.

AA was founded in the 1930s by two alcoholics—a doctor and a traveling salesman who began meeting to help each other stay sober. They developed a system that worked so well, others began to join them. AA has only one goal—to help its members stay sober. It doesn't ask for money, takes no political positions, and runs no promotional campaigns. AA keeps growing thanks only to word of mouth and owes its success only to its effectiveness.

The 12-step program of AA is so effective that people with other problems now use it. There are 12-step groups for children of alcoholics, gamblers, and others. I've become convinced that traders can stop losing money if they apply the key principles of Alcoholics Anonymous to their trading.

Denial

A social drinker enjoys a cocktail, a glass of wine, or a beer but stops when he feels he's had enough. An alcoholic's chemistry is different. Once an alcoholic takes a drink, he feels an urge to continue until he passes out or his money runs out.

A drunk may say that he needs to cut down on drinking, but can't admit that it's out of control. Try telling an alcoholic relative, friend, or employee that his drinking is out of control and damaging his life, and you'll run into a wall of denial.

An alcoholic may say: "My boss fired me 'cause I was hung over and came in late. My wife took the kids and left 'cause she had no sense to begin with. My landlord is trying to kick me out of the apartment 'cause I'm a little behind on the rent. I'm gonna have to cut down on my drinking, and everything will be all right."

This man has lost his family and his job. He is about to lose the roof over his head. His life is spinning out of control—but he keeps saying that he can cut down on his drinking. This is denial!

Alcoholics deny their problems while their lives are falling apart. As long as an alcoholic believes that he can "control his drinking," he is headed downhill. Nothing will ever change, even if he gets a new job, a new wife, and a new landlord.

Alcoholics deny that alcohol controls their lives. When they talk of reducing drinking, they talk about managing the unmanageable. They are like a driver whose car spins out of control on a mountain road. When the car careens down a cliff, it is too late to promise to drive carefully. An alcoholic's life careens out of control, while he denies he's an alcoholic.

There is a stark parallel between an alcoholic and a trader whose account is being demolished by losses. As he keeps changing his trading tactics, he acts like an alcoholic who tries to solve his problem by switching from hard liquor to beer. A loser denies that he's lost control over his trading life.

Rock Bottom

A drunk can begin his journey to recovery only after he admits that he is an alcoholic. He must see that alcohol controls his life and not the other way around. Most drunks cannot accept this painful truth. They can face it only after they hit rock bottom.

Some alcoholics hit rock bottom when they develop a life-threatening illness. Others hit it after being rejected by their family or losing a job. An alcoholic needs to sink to a point so low, so deep down in the gutter, so unbearably painful that it finally penetrates his denial.

The pain of hitting rock bottom makes an alcoholic see how deep he has sunk. He sees a simple stark choice—either turn his life around or die. Only then is an alcoholic ready to begin his journey to recovery.

Profits give traders an emotional high and a feeling of power. They try to get high again, put on reckless trades, and give back their profits. Most traders cannot stand the pain of severe losses. They die as traders after hitting rock bottom and wash out of the markets. The few survivors realize that the main trouble is not with their methods—it is with their thinking. They can change and become successful traders.

The First Step

An alcoholic who wants to recover has to go through twelve steps—twelve stages of personal growth. He needs to change how he thinks and feels, how he relates to himself and others.

The first step of AA is the hardest: to admit that one is powerless over alcohol. An alcoholic must recognize that his life has become unmanageable, that alcohol is stronger than he is. Most cannot take that step, drop out, and go on to destroy their lives.

If alcohol is stronger than you, then you can never touch it again, not even a sip, for as long as you live. You have to give up drinking forever. Most drunks do not want to give up that pleasure. They destroy their lives rather than take the first step of AA. Only the pain of hitting rock bottom can motivate them to take that first step.

One Day at a Time

You may have seen bumper stickers that say, "One day at a time" or "Easy does it." Those are AA slogans, and people who drive those cars are probably recovering alcoholics.

Planning for life without alcohol can seem overwhelming. That's why AA encourages its members to live sober one day at a time.

The goal of every AA member is to stay sober today and go to bed sober tonight. Gradually, days become weeks, then months, then years. AA meetings and other activities help each recovering alcoholic stay sober, one day at a time.

Recovering alcoholics receive—and give others—invaluable support and fellowship at these meetings. They are held at all hours, all over the world. Traders have much to learn from those meetings.

An AA Meeting

One of the best things that a trader can do is go to an AA meeting. I especially recommend it to any trader on a losing streak. Call Alcoholics Anonymous and ask about the next "open meeting" or "beginners' meeting" in your area.

A meeting lasts about an hour. You can sit in the back of the room and listen carefully. There is no pressure to speak, and nobody asks for your last name.

Each meeting begins with a long-term member getting up and speaking about his or her personal struggle for recovery from alcoholism. Several other members share their experiences. There is a collection to cover expenses—give a dollar if you like. All you have to do is listen carefully, and every time you hear the word "alcohol," substitute the word "loss" for it. You will feel as if the people in the meeting are talking about your trading!

9. Losers Anonymous

A social drinker enjoys an occasional drink, but an alcoholic craves alcohol. He denies that alcohol controls and destroys his life—until he reaches a personal crisis. It may be a life-threatening illness, unemployment, abandonment by the family, or another unbearably painful event. AA calls it "hitting rock bottom."

The pain of hitting rock bottom punctures an alcoholic's denial. He sees a stark choice—to drown or to come up for air. His first step to recovery is to admit that he is powerless over alcohol. A recovering alcoholic can never drink again.

Loss is to a loser what alcohol is to an alcoholic. A small loss is like a single drink. A big loss is like a bender. A series of losses is like an alcoholic binge. A loser keeps switching between different markets, gurus, and trading systems. His equity shrinks while he is trying to recreate the pleasurable sensation of winning.

Losing traders think and act like alcoholics, except that their speech is not slurred. The two groups are so similar that you can predict what a loser will do by using alcoholics as a model.

Alcoholism is a curable disease—and so is losing. Losers can change by using the principles of Alcoholics Anonymous.

The Urge to Trade

Successful traders treat drawdowns the way social drinkers treat alcohol. They have a little and stop. If they take several losses in a row, they take that as a signal that something isn't working: perhaps their system isn't in gear with the current market environment. It's time for a break and a fresh look at the markets. Losers, on the other hand, cannot stop—they keep trading because they are addicted to the excitement of the game and keep hoping for a big win.

A prominent trading advisor who has since busted out wrote that to him the pleasure of trading was higher than that of sex or flying jet aircraft. Just as alcoholics proceed from social drinking to drunkenness, losers take bigger and bigger risks. They cross the hugely important line: the one between taking a business risk and gambling. Many losers don't even know that line exists.

Losers feel the urge to trade, just as alcoholics feel the urge to drink. They make impulsive trades, go on trading binges, and try to trade their way out of a hole.

Losers bleed money from their accounts. Most of them bust out, but some turn to managing other people's money after losing their own; still others sell advisory services, like burned-out drunks who wash glasses in a bar.

Most losers hide their losses from themselves and from everyone else. They keep no records and throw away brokerage statements. A loser is like an alcoholic who doesn't want to know how many ounces of liquor he drank.

Into the Hole

A loser trades in a fog and doesn't know why he keeps losing. If he knew, he would have done something about it and become a winner. A loser tries to manage his trading the way an alcoholic tries to manage his drinking.

Losers' desperate hopes for magic solutions help advisors sell their services to the public. They switch to new trading systems, buy more software, and look for tips from new gurus.

As losses mount and equity shrinks, a loser grows desperate and converts outright positions into spreads, doubles up on losing positions, reverses and trades in the opposite direction, and so on. All of that does him no more good than switching from hard liquor to wine can help an alcoholic.

A losing trader careens out of control, trying to manage the unmanageable. Alcoholics die prematurely, and most traders bust out of the markets and never come back. New trading methods, hot tips, and improved software will not help a person who cannot handle himself.

A loser keeps getting high from trading while his equity shrinks. Trying to tell him that he is a loser is like trying to take a bottle away from a drunk. A loser has to hit rock bottom before he can begin to recover. You have to change how you think in order to stop losing and begin your recovery as a trader.

Trader's Rock Bottom

Hitting rock bottom feels horrible. It is painful and humiliating. You hit it when you lose money you cannot afford to lose. You hit it when you gamble away your savings.

You hit it after you tell your friends how smart you are and later have to ask them for a loan. You hit rock bottom when the market comes roaring at you and yells: "You fool!"

Some people hit rock bottom after only a few weeks of trading. Others keep adding money to their accounts to postpone the day of reckoning. It hurts to see a loser in the mirror. We spend our lifetime building up self-esteem. Most of us have a high opinion of ourselves. Your first impulse may be to hide, but remember, you are not alone. Almost every trader has been there.

Many traders who hit rock bottom slink away from the market and never look back. Many who trade today will be gone in a year, if not sooner. They'll hit rock bottom, crumble, and leave. They'll try to forget trading like a bad dream.

Some will lick their wounds and wait until the pain fades away and then return, having learned little. They'll be fearful, and their fear will further impair their trading.

Fortunately, some traders will recoil from rock bottom to begin the process of change and growth. For these individuals, the pain of hitting rock bottom will break the vicious cycle of getting high from winning and then losing everything and crashing. *When you admit that your personal problem causes you to lose, you can begin building a new trading life. You can start developing the discipline of a winner.*

Trader's First Step

Just as an alcoholic needs to admit that he can't control his drinking, a trader needs to admit that he cannot control his losses. The first step of an AA member is to say: "I am an alcoholic, I am powerless over alcohol." As a trader, you have to take your first step and say: "I am a loser, I am powerless over losses."

Recovering alcoholics struggle to stay sober, one day at a time. A trader can recover, using the principles of AA. Now you have to struggle to trade without losses, one day at a time.

You may say that's impossible. What if you buy, and the market immediately declines? What if you sell short, and it turns out to be the bottom tick, and the market immediately rallies? Even the best traders lose money on some trades.

The answer is to draw a line between a businessman's risk and a loss. As traders, we always take businessman's risks, but we may never take a loss greater than this predetermined risk.

For example, a storekeeper takes a risk every time he stocks new merchandise. If it doesn't sell, he'll lose money. An intelligent businessman takes only risks that will not put him out of business, even if he makes several mistakes in a row. Stocking two crates of merchandise may be a sensible business risk, but stocking a full trailer is probably a gamble.

As a trader, you are in the business of trading. You need to define your businessman's risk—the maximum amount of money you'll risk on any single trade. There is no standard dollar amount, just as there is no standard business. An acceptable businessman's risk depends, first of all, on the size of your trading account. It also depends on your trading method and pain tolerance.

The concept of a businessman's risk will change the way you manage your money (see Section 9, "Risk Management"). The absolute maximum a trader may risk on any trade is two percent of his account equity. For example, if you have $30,000 in your account, you may not risk more than $600 per trade, and if you have $10,000, you may not risk more than $200. If your account is small, limit yourself to trading fewer shares, less expensive futures, or mini-contracts. If you see an attractive trade, but a logical stop would have to be placed where more than 2 percent of equity would be at risk—pass on that trade. You may risk less, but you may never risk more. You must avoid risking more than 2 percent on a trade the way a recovering alcoholic avoids bars.

A trader who blames high commissions on a broker and slippage on a floor trader gives up control of his trading life. Try to reduce both, but take responsibility for them. If you lose even a dollar more than your businessman's risk, including commissions and slippage, you are a loser.

Do you keep good trading records? Poor record-keeping is a sure sign of a gambler. Good businessmen keep good records. Your trading records must show the date and price of every entry and exit, slippage, commissions, stops, all adjustments of stops, reasons for entering, objectives for exiting, maximum paper profit, maximum paper loss after a stop was hit, and any other data necessary to review and fully understand your trade later in the future.

If you bail out of a trade within your businessman's risk, it is normal business. There is no bargaining, no waiting for another tick, no hoping for a change. Losing a dollar more than your established businessman's risk is like getting drunk, getting into a brawl, getting sick to your stomach on your way home, and waking up in a gutter. You would never want that to happen.

A Meeting for One

When you go to an AA meeting, you'll see people who have not had a drink in years stand up and say: "Hello, my name is so-and-so, and I am an alcoholic." Why do they call themselves alcoholics after years of sobriety? Because if they think they have beaten alcoholism, they will start drinking again. If a person stops thinking he is an alcoholic, he is free to take a drink, then another, and will probably end up in the gutter again. A person who wants to stay sober must remember that he is an alcoholic for the rest of his life.

Traders would benefit from our own self-help organization—I'd call it Losers Anonymous. Why not Traders Anonymous? Because a harsh name helps focus attention on our self-destructive tendencies. After all, Alcoholics Anonymous doesn't call itself Drinkers Anonymous. As long as you call yourself a loser, you'll focus on avoiding losses.

Several traders have argued against what they thought was the "negative thinking" of Losers Anonymous. A retired woman from Texas, a highly successful trader, described her approach. She is very religious, prays every morning, and then drives to an office where she actively trades. Whenever the market starts moving against her, she cuts her losses very fast because it would not please the Lord for her to lose His money. I thought that our methods were similar. The goal is to cut losses due to some objective, external rule.

Trading within a businessman's risk is like living without alcohol. A trader has to admit that he is a loser, just as a drunk has to admit that he is an alcoholic. Then he can begin his journey to recovery.

This is why every morning before trading I suggest saying: "Good morning, my name is so-and-so, and I am a loser. I have it in me to do serious financial damage to my account." This is like an AA meeting—it keeps your mind focused on the first principles. Even if you take thousands of dollars out of the market today, tomorrow you say: "Good morning, my name is so-and-so and I am a loser."

A friend of mine joked: "When I sit in front of my quote screen in the morning, I say, 'My name is John, and I'm gonna rip your throat out.'" His thinking generates tension. "Losers Anonymous" thinking generates serenity. A trader who feels serene and relaxed can focus on looking for the best and safest trades. When a sober man and a drunk enter a race, you know who is more likely to win. A drunk may win once in a while, but the sober man is the one to bet on. You want to be the sober man in that race.

10. Winners and Losers

We come to trading from different walks of life and bring along our mental baggage. Many of us find that when we act in the market the way we do in our everyday life, we lose money. Most of all, your success or failure depends on your ability to use intellect rather than act emotionally. A trader who feels overjoyed when he wins and depressed when he loses is at the mercy of market moves and cannot accumulate equity.

To be a winner in the market you must act coolly and responsibly. The pain of losing drives people to look for magic methods. At the same time, they discard much of what is useful in their professional or business backgrounds.

Like an Ocean

The market is like an ocean—it moves up and down regardless of what you wish. You may feel joy when you buy a stock and it explodes in a rally. You may feel drenched with fear when you go short but the market rises, melting your equity with every uptick. Those feelings have nothing to do with the market—they exist only inside of you.

The market doesn't know you exist. You can do nothing to influence it. The ocean doesn't care about your welfare, but it has no wish to hurt you either. You can only control your behavior.

A sailor cannot control the ocean, but he can control himself. He can study currents and weather patterns, learn good sailing techniques, and gain experience. He can learn when to sail and when to stay in the harbor. A successful sailor uses his intelligence.

An ocean can be useful—you can fish in it and use its surface to get to other islands. An ocean can be dangerous—you can drown in it. The more rational your approach, the more likely you are to get what you want. On the other hand, when you act out your emotions, you cannot focus on the reality of the ocean.

A trader has to study trends and reversals in the market the way a sailor studies the ocean. He must trade on a small scale while learning to handle his account. You can never control the market, but you can learn to control yourself.

After a string of profitable trades, a beginner may feel he can walk on water. He starts taking wild risks and blows up his account. On the other hand, an amateur who takes several losses in a row often feels so demoralized that he cannot place an order even when his system gives him a signal to buy or sell. If trading makes you feel elated or frightened, you cannot fully use your intellect. When joy sweeps you off your feet, you will make irrational trades and lose. When fear grips you, you'll miss profitable trades.

A sailor whose boat is being battered by ocean winds battens his sails—reduces sail area. The first remedy for a trader battered by the market is to reduce the size of his trades. Trade small while you're learning or when feeling stressed.

A professional trader uses his head and stays calm. Only amateurs become excited or depressed. Emotional trading is a luxury that nobody can afford.

Emotional Trading

Most people crave excitement and entertainment. Singers, actors, and professional athletes command much higher incomes than such mundane workmen as physicians, pilots, or college professors. People love to have their nerves tickled—they buy lottery tickets, fly to Las Vegas, and slow down to gawk at road accidents.

Emotional trading can be very addictive. Even those who drop money in the markets receive a fantastic entertainment value.

The market is a spectator sport and a participant sport rolled into one. Imagine going to a major-league ball game in which you are not confined to the bleachers. Pay a few hundred dollars and be allowed to run onto the field and join the game. If you hit the ball right, you'll get paid like a professional.

You would probably think twice before running onto the field the first few times. This cautious attitude is responsible for the well-known "beginner's luck." Once a beginner hits the ball right a few times and collects his pay, he is likely to get the idea that he is as good as the pros or even better and could make a good living from the game. Greedy amateurs start running onto the field too often, even when there are no good playing opportunities. Before they know what hit them, a short string of losses destroys their accounts.

The market is among the most entertaining places on the face of the Earth, but emotional decisions are lethal. If you ever go to a racetrack, turn around, and watch the humans instead of horses. Gamblers stomp their feet, jump up and down, and yell at horses and jockeys. Thousands of people act out their emotions. Winners embrace, and losers tear up their tickets in disgust. The joy, the pain, and the intensity of wishful thinking are caricatures of what happens in the markets. A cool handicapper who makes his living at the track does not get excited, yell, or bet the bulk of his roll on a single race, or even in a single day.[1]

Casinos love drunks. They pour gamblers free drinks to make them more emotional and gamble more. Casinos also throw out calm and intelligent card-counters. There is less free liquor on Wall Street than in a casino, but at least here, they do not throw you out for being a good trader.

In Charge of Your Life

When a monkey hurts its foot on a tree stump, he flies into a rage and kicks the piece of wood. You laugh at a monkey, but do you laugh at yourself when you act like him? If the market drops while you are long, you may double up on your losing trade or else flip and go short, trying to get even. This is acting emotionally instead of using your intellect. What's the difference between a trader trying to get back at the market and a monkey kicking a tree stump? Acting out of anger, fear, or elation destroys the chance of success. You have to analyze your behavior instead of acting out your feelings.

We get angry at the market; we become afraid of it and develop silly superstitions. All the while, the market keeps cycling through its rallies and declines like an ocean going through its storms and calm periods. Mark Douglas writes in *The Disciplined Trader* that in the market, "There is no beginning, middle, or end—only what you create in your own mind. Rarely do any of us grow up learning to operate in an arena that allows for complete freedom of creative expression, with no external structure to restrict it in any way."

We try to cajole or manipulate the market, acting like the ancient emperor Xerxes, who ordered his soldiers to horsewhip the sea for sinking his fleet. Most of us aren't aware of how manipulative we are, how we bargain and act out our feelings. Most of us consider ourselves the center of the universe and expect every person or group to be either good or bad to us. This does not work in the market, which is completely impersonal.

Leston Havens, a Harvard University psychiatrist, wrote: "Cannibalism and slavery are probably the oldest manifestations of human predation and submission. Although both are now discouraged, their continued existence in psychological forms demonstrates that civilization has achieved great success in moving from the concrete and physical to the abstract and psychological, while persisting in the same purposes." Parents threaten their children, bullies hit them, and teachers try to bend their will in school. Little wonder that most of us grow up either hiding in a shell or learning how to manipulate others in self-defense. Acting independently doesn't feel natural to us—but that is the only way to succeed in the market.

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[1] I carry in my wallet a free lifetime pass to New York's Belmont racetrack that belonged to my late great friend Lou Taylor. It looks like an employee card, but on the "position" line it says—winner. He won many handicapping championships and continued to take money from the racetrack until a few months before he died.

Douglas warns, "If the market's behavior seems mysterious to you, it's because your own behavior is mysterious and unmanageable. You can't really determine what the market is likely to do next when you don't even know what you'll do next." Ultimately, "the one thing you can control is yourself. As a trader, you have the power either to give yourself money or to give your money to other traders." He adds, "The traders who can make money consistently... approach trading from the perspective of a mental discipline."

All of us have our own demons to exorcise on the journey to becoming successful traders. Here are several rules that worked for me as I grew from a wild amateur into an erratic semiprofessional and finally into a calm professional trader. You may change this list to suit your personality.

1. Decide that you are in the market for the long haul—that is, you want to be a trader even 20 years from now.
2. Learn as much as you can. Read and listen to experts, but keep a degree of healthy skepticism about everything. Ask questions, and do not accept experts at their word.
3. Do not get greedy and rush to trade—take your time to learn. The markets will be there, offering more good opportunities in the months and years ahead.
4. Develop a method for analyzing the market—that is, "If A happens, then B is likely to happen." Markets have many dimensions—use several analytic methods to confirm trades. Test everything on historical data and then in the markets, using real money. Markets keep changing—you need different tools for trading bull and bear markets and transitional periods as well as a method for telling the difference (see the sections on technical analysis).
5. Develop a money management plan. Your first goal must be long-term survival; your second goal, a steady growth of capital; and your third goal, making high profits. Most traders put the third goal first and are unaware that goals 1 and 2 exist (see Section 9, "Risk Management").
6. Be aware that a trader is the weakest link in any trading system. Go to a meeting of Alcoholics Anonymous to learn how to avoid losses or develop your own method for cutting out impulsive trades.
7. Winners think, feel, and act differently than losers. You must look within yourself, strip away your illusions, and change your old ways of being, thinking, and acting. Change is hard, but if you want to be a professional trader, you have to work on changing and developing your personality.

In order to succeed, you need drive, knowledge, and discipline. Money is important, but less so than any of those qualities. If you have enough drive to work through this book, you'll acquire much knowledge, and then we'll close the circle by returning to the topic of discipline in the final chapters.