

LEARNING MADE EASY



Trading Psychology

for
dummies[®]
A Wiley Brand



Discover how psychology is applied in real-world trading

Implement practical tips and see first-hand results

Gain the perspective and insight of a veteran trader

Roland Ullrich, CFA

Trading-Psychology expert



Trading Psychology

by Roland Ullrich, CFA

**for
dummies**[®]
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Trading Psychology For Dummies®

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Introduction

Trading psychology — the psychological basis of securities trading— generally isn't taken very seriously, even though experts maintain that your emotions and your mental state are actually what determine the success or failure of your trading business. Those in the know are clear on this point: Trading is 80 percent psychology and 20 percent methodology. Trading is fundamentally a matter of character.

Trading — the common term for the short-term trade in securities, currencies, and financial derivatives — has become increasingly popular recently. Discount brokers especially have been seeing record numbers since 2020. They promise they'll make stock market trading as easy as pie with the help of their various trading apps. This has a certain attraction for a younger, less experienced generation and encourages gambling. But a word to the wise: If you're looking for an adrenaline rush and you think that leveraged products will make you rich overnight, you're sure to hit the rocks sooner or later. Trading in financial instruments is a sophisticated business and requires not only lots of patience and discipline but a clear head as well. You don't stand a chance without a plan, a strategy, and processes you can rely on.

Regarding terminology, I'd like to make one thing clear from the start: When I say *traders* in this book, I'm referring to those private investors who independently invest their own money on the stock market at their own risk and on a short-term basis. The time period can be as short as a few minutes (scalping) or as long as a few weeks (position trading).

Fundamentally, trading in this sense is the opposite of a long-term investment. You're looking for calculated short-term profit. If you make regular contributions to a stock portfolio in order to prepare for retirement, you're a long-term investor, not a trader. Admittedly, you could turn a trading position into a long-term investment now and then, perhaps because you don't want to sustain a loss, so you use a bit of mental jujitsu on yourself and — *voilà* — your short-term investment is now presented as something you'd always intended as a long-term investment. (I talk more about this bias known as mental accounting later on in this book. I know: The suspense is killing you.)

The stock market is all about psychology, and trading places psychology under a magnifying glass. Limiting beliefs, self-doubt, a lack of self-control, unprocessed traumatic experiences from the past, those negative conversations you hold with yourself (*self-talk*, to use the current jargon), and harmful patterns of thought will all come to light sooner or later as you go about your work as a trader. As such, trading turns out to be quite an expensive way to work through your personality issues. After all, you're risking your own money on the markets — conceivably, money in the form of savings you worked very hard to accrue. And the numbers are against you because (according to statistics) over 90 percent of all private traders on the stock exchange don't earn any money. The vast majority close their trading account within a few months, feeling frustrated — often, after suffering a total loss. The success rate is particularly low for those operating in the short-term arena.

An old stock market proverb puts it well: If you don't know yourself, the stock market is an expensive place to figure out who you are. The traders who are successful have not only often learned some quite expensive lessons

but have also experienced quite the emotional roller-coaster ride. However, they have moved beyond themselves, overcoming that which initially limited them. It's worth the effort, as experienced traders will readily acknowledge. Having finally obtained their financial freedom, independence, and self-determination, they'll refuse to give up such hard-earned gains voluntarily.

When you have dealt with the trading business long enough, you discover that it's always the very same problems that continue to drive you up the wall — coping with loss, your fear, your own greed, your lack of discipline, the loss of control, stress, being overburdened, or overconfidence. All such ills are direct consequences of the special features of financial markets you have to contend with — namely, uncertainty, volatility, hyperbolic situations, barely visible actors, and, to top it all off, automated programs and algorithms that don't care a fig whether you win or lose. Price movements are neither as predictable nor as controllable as you think, and they happen to be more random.

You won't move the markets as an individual trader. You have no influence on what is happening in the market. What you *can* do is you can work with probabilities and patterns, and you can also change your perception of the markets — your attitude and point of view, in other words. You control those things that are within your power to control: yourself. You keep a clear head. This is how mental strength is created.

Never let the markets take control of you and your trader psyche. A successful process orientation and a fixed set of rules protect you from losing control. Protecting your portfolio is your top priority.

Our evolutionary heritage weighs heavily; we are not naturally suited to trading. The human brain isn't

designed to operate successfully on financial markets. The way the stock market works contradicts our naturally acquired ways of thinking and behavior. Therefore, it's even more important to internalize fixed routines and to systematize your trading so that you can protect yourself.

You'll develop as a trader when you find out what you can control, what you can change, and why. What are your trading goals? What are your expectations? What trading style matches your personality? Only then can you address the question of a) how you want to proceed and b) which methods you want to use. The challenge with trading is a psychological challenge. Trading platforms and systems are important but do not determine your success. You alone are responsible for what you earn with your trading — not the technology, not the systems, and not the markets, either.

About This Book

This book about trading psychology isn't one of those heavy theoretical tomes — I wanted it to be a practical book where I can offer advice. The idea is to provide you with multiple examples, practical tasks, and useful exercises designed to build the psychological foundations you need in order to prepare yourself for the specific requirements of trading. Beginners, in particular, underestimate the psychological stress factors involved in trading. Getting rich quick on the stock exchange is a tempting proposition but not at all realistic, as the statistics confirm. This book will save you from many painful and expensive experiences. I'll provide you with the mental armor you'll need in order to trade in a successful, brain-compatible manner.

Trading is a hard-core business that punishes mistakes and weaknesses immediately. You're playing with the top echelon right from the start. Whether you're a professional or an amateur, you're all competing in the same markets. Regardless of which market you choose to be active in, you'll be unable to move it one way or another. It's the other ones, the big professional actors, who move the markets. Let this fact teach you to be humble, but don't let it intimidate you too much. Your status as a small fish means that you're flexible; you're not subject to investment guidelines or other practical constraints. Your niche isn't competing with anyone. You're trading under the radar of the big fish, and you can profit from that fact.

This book is addressed to all market participants. Whether you're a short-term trader or a long-term investor, the psychological effects apply to you all, albeit to different extents. You'll be sure to profit when you understand how the distorted and biased way you make financial decisions affects your portfolio. Neither will it hurt to see to what extent your trading performance depends on your emotional state.

If you read this book from start to finish, you will

- » Be in a better position to know whether trading really and truly is something for you
- » Find out which character traits and core competencies are needed for trading
- » Familiarize yourself with mental self-coaching techniques and understand how to develop psychological resilience and mental strength
- » Understand that developing as a trader involves psychological development

Conventions Used in This Book

This book is written in the most practical and realistic manner possible, regarding the topic of trading psychology. I avoid complicated and extensive scientific explanations. I hope you can forgive me that my explanations about exciting discoveries in modern brain research tend to be a tad theoretical. After all, neurofinance is my passion. (If you're keeping track, most of the more theoretical paragraphs in this book sport the Technical Stuff icon.)

I am looking forward to your feedback and your opinions. I am grateful for any suggestions and corrections. Please share your experience. That will provide material for any revised editions. If the topics in this book speak to you or you realize with some embarrassment that you're not familiar with one particular corner of the trading world and you want to inform yourself, go to my website at www.roland-ullrich.com. There, you'll find a wealth of blog articles, videos, coaching materials, and workshops.

What You Don't Need to Read

This book is structured in a reader-friendly way — that means you don't need to read its 300 pages from beginning to end. Browse the book at your leisure and read the parts and chapters that interest you. The cross-references in the book provide you with more in-depth information on topics you want to know more about. The modular structure gives you the option to read individual parts of the book independently. This obviously has the

consequence that you will see repetition. If you read the book from end to end, you'll know all about the fact that such repetitions are the key to stabilizing the neural circuits and synaptic connections in your brain.

You can skip the text in the sidebar boxes, if you like. Those contain further information, entertaining stories, and anecdotes that aim to loosen up the book. (Of course, feel free to read them — they may bring a smile to your face.)

Foolish Assumptions

Because you're obviously interested in the topic of trading psychology, I assume that you have some experience with the stock exchange. That means you have presumably made profits and losses with your own money. There's a slight chance you may have experienced a number of involuntary emotional outbursts. In my experience, some people will have experienced more severe losses. In any case, you should understand that psychology plays an important role in trading.

Here are some further assumptions I have made about you:

- » You want to understand what goes on in your brain when you make financial decisions.
- » You want to know what influence evolution has had on your thought and behavioral patterns.
- » Sometimes, you can't get a grip on your emotions.
- » You need support when you experience fear and stressful situations.

- » You want to learn how to make better and smarter decisions.
- » You want to be able to deal with unavoidable losses in a more sensible manner.
- » You're looking for methods to develop mental strength and psychological resilience in trading.
- » You can't find a strategy, niche, or trading style that suits you.
- » You want to know which character traits and core competencies are important in trading.
- » You want to know whether trading is truly something for you.

How This book Is Organized

This book has six parts. Its simple structure is easy to understand, and it should help you navigate the content. The structure looks like this:

Part 1: The Sovereign Trader

Does the fact that it's difficult to consistently earn money on the stock market surprise you? The explanation is as simple as it is sobering: You're human! And that means you have all the genetic dispositions associated with being a human being. The first part of this book explains the evolutionary development process and the neural structure of the human brain. When it comes to brains, everyone gets the standard model — no upgrades are available.

It turns out that your fundamental nature isn't particularly suited to trading. Don't worry, though: You can learn to be suited for it, simply because the human brain is quite capable of change and development. You can learn the mental prerequisites for brain-compatible trading. With the right mindset, you can preemptively recognize and avoid trading errors. The innovative discoveries of modern neurofinance research have revealed the necessary success factors for brain-compatible — and therefore successful — trading.

Part 2: Making a Successful Trade

Successful trading depends on how consistently you practice trading and develop your trading skills. Using a demo account makes it easier for you to test your strategies; paper trading trains the sequences and processes involved in trading until you can automatically

call them up. In this part, I show you the advantages of frictionless trading processes and how you can profit from training plans. I introduce you to the secrets of explicit and implicit pattern recognition — the supreme trading discipline! You'll find out how to improve your profit opportunities while limiting your risk exposure. I show you how to get a grip on losing streaks impacting your portfolio as well as getting a grip on your psyche.

Part 3: Emotional Sovereignty

You'll get tons of very practical tips and notes in this part. The many exercises and tasks should help you develop your personality as a trader as well as help you act in an emotionally sovereign, strong-willed way. An important technical and psychological component to your development involves keeping a trading journal. It's the key to your personal development. With it, you'll be in a position to recognize and solve psychological patterns affecting your trading behavior. With all this knowledge, you'll be able to find a trading style that suits your personality.

A further important component involves self-coaching techniques. All the exercises I discuss are designed to provide you with the mental strategies you need in order to deal with losses, stress, and fear in a healthier way. You'll find out how you can work to set aside the beliefs you hold that are sabotaging your success as well as how to quiet that stream of negative self-talk that is holding you back. From this inner work, you'll gain confidence and strengthen your self-esteem.

Part 4: Making Decisions Safely

In this part, you'll lay the foundations for smart and well-thought-out trading decisions. You'll see how to deal with subconscious decision-making processes and how to

better manage your susceptibility to failure. After having grasped the evolutionary development of your brain, you'll be able to preempt irrational thought and behavioral patterns and to make use of the trading rules of thumb I introduce in this section. This is how to find the correct foundation for trading decisions.

Part 5: Keeping Bad Behavior in Check

This part is all about recognizing and understanding how irrational and biased your behavior has been so far, including when trading. Behavioral finance research has made some exciting discoveries in this area. Keep in mind that systematic miscalculations, cognitive and emotional biases, and a pronounced herd mentality tend to have grave consequences. You'll find out how to recognize this kind of incorrect behavior and avoid it. You'll also see how to better deal with your ego and better understand your feelings of fear and regret.

Part 6: The Parts of Ten

Picture The Parts of Ten as a hit list of important stock exchange knowledge. It's a significant component of the *For Dummies* series. Without attempting to be exhaustive, I present ten avoidable psychological trading traps that you should always keep in mind when you're trading. Then I show you the ten secrets of success of mentally superior traders. If you take these to heart, there is practically nothing standing in your way when it comes to becoming a successful trader. Finally, I explain the ten basic rules for the perfect trading day.

Icons Used in This Book

It's part of the *For Dummies* tradition series to use icons. They're meant to catch the eye and loosen up the structure of the book. In this book, you'll find the following symbols.



TIP

The Tip icon marks bits of information you will find particularly helpful. When you're skimming the book, these tips should pop out to give you a quick grasp of the topic.



REMEMBER

The Remember icon marks information that's important to keep in mind. Sometimes it reviews topics from earlier in the book that are relevant to the information being presented.



**TECHNICAL
STUFF**

The Technical Stuff icon marks information of a technical nature that is more important to someone working in the field who might need to see a bit more depth.



WARNING

The Warning icon points out bits of information you can use to avoid issues you might encounter.



EXAMPLE

Here you'll find examples that help get the point across.

Beyond the Book

In addition to the introduction you're reading right now, this book comes with a free, access-anywhere Cheat Sheet containing information worth remembering about the nature of trading psychology and the trading brain. To get this Cheat Sheet, simply go to www.dummies.com and type **Trading Psychology For Dummies Cheat Sheet** in the Search box.

What's Next

Now that you've had a chance to read the operating manual for this particular book, I hope you realize what you're in for. So, get going! Start wherever you want when it comes to its 300 pages. Look for topics that most interest you. Use this book as a reference book and advisor. Try out the techniques and exercises provided. They're definitely worth your while, and they will propel you further down the road of trading success.

I hope you have lots of fun with these lessons and that you have lots of success implementing them in the exciting world of trading.

Part 1

The Sovereign Trader

IN THIS PART ...

See why humans have such a hard time acting successfully in financial markets

Trace the evolutionary development and the neuronal structure of the human brain

Master the art of brain-compatible training

Build on your strengths and cope with your weaknesses

Chapter 1

Brain-Compatible Trading

IN THIS CHAPTER

- » **Seeing how human evolution has impacted financial decision-making processes**
 - » **Looking more closely at the trader brain**
 - » **Understanding neural circuits and biochemical processes**
 - » **Tracing the miracle of neuroplasticity**
 - » **Using process orientation for success**
-

In this chapter, I take you way back — *way, way* back. Across millions of years, the evolutionary selection process has made us humans what we are today. We must take that knowledge into account when we're surprised about behaviors that no longer fit in our modern time — including behaviors on the trading floor. To better understand what's going on, it pays to take a closer look at the trader brain. (I hope to convince you that this closer look will provide some answers.) Modern brain research has made some exciting discoveries about how the decision-making process actually takes place — which parts of the brain are involved and which biochemical processes occur simultaneously, for example. In fact, the research has progressed to such an extent that experts in the field are able now to predict financial decisions by the activity of specific areas of the brain.

By their very nature, your brain and its interconnections are not quite suitable for the trading business. But you can train them to overcome their inherent weaknesses. The human brain is changeable and can adapt to changing conditions. In other words, you can learn behaviors for *successful* trading — brain-compatible trading, in other words.

The key to successful trading is process orientation — what I call the *systemization* of your trading approach. You need professional rules and a proven trading strategy in order to survive in unpredictable markets. When you add that to a trading style that suits your personality, there may not be much holding you back when it comes to a successful trading career.

Recognizing the Human Barriers to Trader Success

In the last decades, science has closely investigated human behavior in the area of economic decision-making. The findings are sobering. The science tells us that humans are characterized by emotional patterns of thought and behavior that have been formed in the course of evolution. The science is also telling us that there's a good chance that these subconscious automatic behaviors are unsuitable when it comes to making wise financial decisions. In numerous studies, behavioral economists have demonstrated how irrational humans are when they're making investments. The truth is, financial decision-making behavior can be distorted by many factors, including these:

- » Overestimating your abilities

- » Learning from your mistakes seems beyond your power
- » Letting emotions, such as fear and greed, unconsciously determine your behavior when making financial decisions
- » Letting yourself get carried away by the crowd
- » Being unable to objectively assess risks
- » Letting the situation — rather than calculation — determine your appetite for risk
- » Taking profits too early and letting losses run on

Taking a closer look at the brains of investors and traders demonstrates why the failings listed here occur and how they impact the decision-making process. Laboratory experiments within the relatively young field of neurofinance provide some exciting answers.

Using Neurofinance to Look Deep Inside the Trader Brain

Neurofinance is an interdisciplinary area of research that resulted from the combined efforts of economists, behavioral psychologists, and neuroscientists in the 1990s. Neurofinance research, by making use of modern brain research methods, focuses on analyzing financial decision-making processes. These are the central questions: How does the human brain deal with money? Which neural structures are involved in processing financial decisions? What is the importance of the biochemical processes in the brain when it comes to dealing with money? Neurofinance studies of the drivers

of choice behavior pay special attention to the trading behavior of financial market actors, focusing on the central question of how behavioral and cognitive biases distort the rational decision-making of investors. Another aspect is the influence of personality traits on investor behavior.



REMEMBER The neurobiological correlates of financial decision-making processes have been decoded. A brain scanner can display the enormous influence of emotions, cognitive biases, and archaic instincts in real time. Most of the time humans may not act rationally. Many of the phenomena described in behavioral finance research can be explained by taking a closer look at the trader brain. Today, brain researchers are able to predict and influence investor behavior.

Professor Bernd Weber, a clinical neuroscientist and dean of the Medical Faculty at the University of Bonn, has come to the conclusion that, because of their evolutionary development, humans are incapable whatsoever of rational thinking and acting. That would also suggest (quite highly, in fact) that the human brain simply isn't made to invest successfully in the stock market. The laws and functioning of financial markets contradict learned human behaviors.

THE DEVELOPMENT OF THE BRAIN SCANNER

With the help of new measuring procedures, brain research in the past 30 years learned more about the workings of the human brain than in the previous 100 years combined. Neuroscientific research tools — in particular, functional magnetic resonance imaging (fMRI) — make the activities of the