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Trading Psychology and Investor Behavior

The market price of a stock at any exchange never represents the company's fair value. The stock instead is trading either above or below that valuation. Over the past couple of years, the potential discrepancy between market capitalization and fair value became painfully obvious to investors. Supported by analysts' unrealistic price forecasts, many high-tech stocks reached untenable high prices and then, in some instances, became worthless because there was no *real* value behind these companies.

In general, the market price fluctuates higher or lower around the fair value, depending how the market sentiment values the company.

GUIDELINES FOR INVESTORS

In the following sections, we list some rules that can help investors improve their investment decisions. These guidelines come from our experience and are not necessarily based on new theories.

1. Know Yourself

If you start sweating when you watch the price swings of a product you have invested in, you either have the wrong trading concept, are in the wrong products, or your positions are too big.

2. Put Your Ego Aside

The biggest losses happen after investors make their first big profits. If you accumulate profits with a proven, tested investment strategy, you can pride yourself on its success.

However, if you make profits without an investment strategy, you may lose not only all your profits but your total investment. Unexpected price moves do not have to mean big losses; they occur because investors work with the wrong trading concept.

3. Hoping and Praying Do Not Guarantee Success

Many traders keep repeating the same mistake: They take small profits and let the losses run. The main reason to work systematically with an investment concept is to get the best average performance. This requires placing a stop-loss with *every* trading position and calculating the profit target when opening a position.

Hoping that losses will become profits by waiting a "little bit longer" is gambling. It might be appropriate once in a while, but in the long run, it ruins every account.

4. Investors Must Learn to Live with Losses

It is easy to enjoy profits, but everyone hates losses. A market price that drops below the entry price is not the only reason for a loss. If a position with a 100 percent profit is liquidated at the entry price, this is also a big loss in the account, although it may not seem as damaging.

5. Never Double Your Losses

Dollar-cost averaging is one of the best strategies for investors if they execute it systematically as part of a long-term strategy.

Almost all huge bankruptcies in trading companies worldwide happened because they doubled up losing positions. Hoping to recover losses through additional leverage never works unless someone is really lucky.

6. Know Your Pain Level

Investors create their biggest problems when they change their investment strategy without sufficient reason. The trouble begins when traders jump from one trading strategy to another to follow the short-term sentiment, mainly because a product seems to have changed.

Each investment strategy has its advantages and disadvantages. Someone who has expertise in picking stocks should continue to use this approach, despite the risk of big drawdowns. A perfect trading concept does not exist, unless someone has discovered a niche product and keeps quiet. At the same moment that this niche market becomes common knowledge, the profit potential disappears.

Each investment strategy has a predetermined pain level that investors can identify. It is important to know this pain level before executing an investment strategy.

7. Diversify the Risk

No matter how promising the future of a product may seem, diversify the risk. Many traders profitably trade the same product every day and are especially successful in intraday trading. But these traders are disciplined and have specific product knowledge that is not available to most people.

In general, diversifying the risk with a systematic trading approach will result in a much more stable equity curve than investing in a single product.

8. Making Money by Trading Is Hard Labor

Many people believe that that it is easy to make money by investing in stocks, bonds, stock index futures, or commodities.

The opposite is true. Investors who show quick profits through trading either have inside information or are remarkably lucky. Average investors have neither of these advantages.

All traders must develop a personal profile of risk preference and find a systematic trading style that fits the profile. Then they have to execute it. Months or years of systematic trading may be necessary before real-time trading results confirm that the trading concept works.

9. Intuition versus Execution of a Tested Trading Concept

All of the information that comes over the tickers, from newsletters, and through the Internet is already old when we receive it. There will always be someone with faster access who can take advantage of that information. Speculating with this "old" information is dangerous.

Trading concepts that have been tested and have good historical track records on paper provide valid information only if the advisor is willing to share how the trading concept works.

Real-time trading records are only reliable if market behavior does not change. Many of the successful fund managers in the 1980s did less well in the 1990s because the market patterns were very different. Investors must be highly skilled to identify trading concepts that did not perform well in the past but will perform well in the future.

10. The Importance of a Trading Plan

The secret of success on the exchanges is not to make money fast, but to make it consistently.

One of the most difficult accomplishments for traders is to create a portfolio that builds up equity over the long term, independently of market conditions. To reach this goal, it is essential to work with a reliable investment strategy and to guard against being greedy.

11. Feel Comfortable with Your Trading Strategy

Successful traders begin the morning with a trading concept that they can use comfortably for executing trading signals throughout the day, no matter what the markets are doing.

Feel good about your trading strategy as long as the real-time trading results are in line with the historical test results. If the maximum drawdown gets bigger than the drawdown of the historical test results, reevaluate the trading concept.

12. Nothing Is More Important than Discipline

Discipline is always the most important attribute of successful traders. Many traders fail or have limited success because they cannot control their emotions and execute their established trading strategy in any given market situation.

13. Value of Available Trading Concepts

Many worthwhile trading concepts are available. But none of them will always make money. An effective trading concept does not have to be difficult, but it must be executable. The trader has to believe in it and be willing to trade it even after a string of losses.