Risk and Success

Brett N. Steenbarger, Ph.D.

www.brettsteenbarger.com

Sometimes you hear people debate whether trading success is attributable more to trading techniques vs. psychology. The answer, of course, is both—but the point where the two intersect is risk management. A huge percentage of trading success or failure can be laid at the doorstep of risk management. A recent book on risk management (that I'll be reviewing next week) observed that, across different traders and trading firms, 90% of all profits were attributable to 10% of all trades. While traders would like to think of themselves as making money on a majority of their trades, the reality for frequent traders is that a minority of trades are winners—and it is the few large winners that produce a favorable profit/loss statement (P/L).

The book goes on to observe that, if 10% of trades account for a majority of profits, it follows that a large percentage of trades have to be "scratched". A cardinal skill in trading is recognizing that a trade is wrong before it hurts the P/L. Time and again, I have seen good traders exit trades when the trades fail to move in their direction; bad traders exit only after the trade has moved against them.

And yet it is equally true that, if 10% of trades are going to account for the lion's share of profits, traders must be willing to milk very good trades. This not only means finding the sweet spot where you can "cut your losses and let your profits run"; it also means being willing to trade sufficient size to maximize returns from a good trade. The worst traders I know put on their maximum size when they're trading at their worst. Typically, they have just lost on one or more trades and now are trying to get the money back. The best traders are able to identify superior trading opportunities—and are patient in waiting for those—and will put size on to take advantage of these. This is how 10 good trades more than make up for 90 scratches and losers.

A favorite trading story that I tell concerns a very successful trader. He promised to tell me the secret of trading success. Of course, my curiosity was piqued and I asked, "What is that?" He responded with a question: "What the ratio of your largest position size to your normal size?" "Three-to-one", I told him. He smiled. "Consider 20-to-1," was his advice and his success formula.

I completely believed him. The reason he was successful had nothing to do with finding a better oscillator, regression analysis, or chart formation. He was successful because he had the ability to identify—and wait for—particularly profitable opportunities and then take maximum advantage of those. While 20:1 position sizing is—and will always be—rich for my blood, I think the principle is valid: success is partly a function of putting size on for the logical, not psychological, reasons.

This is one reason trading is so difficult. It is an unusual blending of traits that allows someone to be prudent with risk, scratching trades that don't move promptly as expected, while at the same time milking opportunity. It is easy to find traders who are risk-averse and stick with their one and five lot positions; it is also easy to find traders who will swing size freely, including times when they are frustrated with the trade. What is rare is to find the mix: the ability to accept and limit the 90% of occasions that don't work, and yet act aggressively on those 10% of times when there is a move to be exploited.

What is true for size is also true for time. Much can be learned simply by identifying how long a trader has held onto winning vs. losing trades. If a trader is quickly exiting trades that aren't going in the desired direction, the average holding times for such trades should be quite low. Conversely, with the good traders, it's not unusual to see a trading log that registers 10% of trades that are held for a lengthy period of time. Invariably, these are the winners that contribute significantly to the overall P/L. The truly unsuccessful traders will also display a minority of trades with long holding times—and these will be the losers. I recently asked a trader why he hung onto a long position for an unusually long period of time. He looked at me somewhat quizzically and replied, "Because I had the bottom!" He was willing to sit through a choppy trade as long as it went in his direction and as long as nothing happened to convince him that he didn't identify the bottom. That one trade made his entire day.

Perhaps this is a truism in all of life. The people who I have seen who have been very successful in dating and relationships have been willing to go on very many first dates, but not so many second and third ones. They "scratch" the unpromising dates and then focus their energies on the 10% that look worthwhile. The same is often true with respect to career and company success. A successful individual may take on ten projects over the course of a year, but focus efforts on a single initiative when it yields promise. A company may roll out ten products and quickly pull nine, making significant money on the one that finds ready acceptance in the marketplace. Even successful artists and inventors, researcher Dean Keith Simonton found, tend to churn out creative efforts, deriving their fame from the small minority of works that attract the attention of an appreciative world.

Successful traders risk manage their market exposure. Successful individuals risk manage their life exposures. It is not just how much we undertake, but how much we scratch in life that determines our ability to benefit from the episodes of promise that come our way.

Brett N. Steenbarger, Ph.D. is Director of Trader Development for Kingstree Trading, LLC in Chicago and Clinical Associate Professor of Psychiatry and Behavioral Sciences at SUNY Upstate Medical University in Syracuse, NY. He is also an active trader and writes occasional feature articles on market psychology for a variety of publications. The author of The Psychology of Trading (Wiley; January, 2003), Dr. Steenbarger has published over 50 peer-reviewed articles and book chapters on short-term approaches to

behavioral change. His new, co-edited book The Art and Science of Brief Therapy is a core curricular text in psychiatry training programs. Many of Dr. Steenbarger's articles and trading strategies are archived on his website, www.brettsteenbarger.com