THE FOLLIES AND FOIBLES OF AMATEUR TRADERS AND SOME PRACTICAL FIXES

The title of this piece may evoke in you such thoughts as, "Ah! I know this stuff. In fact, I too can list many reasons behind traders losing money."

We have read quite a lot about the failures of traders, ranging from psychological and behavioral reasons to the scales of risk and reward. However, most of the content available on the internet is narrated in a broader style, and rarely have people explained the intricacies of the issues and the remedies to overcome them. In this piece, I won't be able to share anything that you haven't heard before, as that is beyond my scholarship. The endeavor here would be to throw some light on the characteristics of a trader experiencing net losses. I have been a victim of these shortcomings. Therefore, this piece is without judgment and without preaching. It is not something that I have read but learnt through my own experiences and by brainstorming with some of the best trading minds.

So, let's begin by discussing the five most common shortcomings of unsuccessful traders.

1. **Lack of realization of an edge:** Most traders trade just for fun, excitement, and recognition in life. There could be many reasons behind such behaviour, such as a monotonous job and lack of self-esteem, for which traders try to compensate through trading. I have spoken to several traders, and, to my surprise, very few knew exactly about their trading edge. If you are also one of them, unaware of trading edges, positive expectancy, and probability theory, a serious introspection is called for. Discussion on the technical aspects of these variables is beyond the scope of this piece. There is plenty of material on the internet on these topics.

2. **Lack of understanding of stats:** If you feel that Mathematics and Statistics are not your cup of tea and still wish to be a profitable trader, you should probably drop the thought. If you are trading in the markets and don't know how to compute equity curve, drawdowns, max drawdowns, profit factor, recovery factor, risk of ruin, return to MDD, Sharpe ratio you are destined to one day blow up your account. It's not a matter of 'if' but 'when'. This isn't meant to scare or demotivate you. This also doesn't mean that you need to have a Ph.D. in these subjects. It requires just an innate understanding of numbers and data distribution. As per my knowledge, this instinct is nurtured by processing data on a regular basis. We all subconsciously process loads of statistical data every day to take even the smallest of the decisions.

Let us understand the first two points discussed here with a fascinating example from nature. We all know that Cheetah is the fastest animal on land. But you would be surprised to learn that cheetahs can only sprint at their top speed for around 60 seconds. In comparison, a deer or a buck may not be as fast as a cheetah but has the stamina to maintain a very high speed for a longer time. That means while hunting if a cheetah couldn't catch a buck in a certain time, it is most likely that it will miss its prey. This is why cheetahs are successful only around 20-50% of the time, and even that makes them one of the best predators on this planet. To understand this data and the concept, you or I might require to read something, but this data is something that is already known to Cheetahs. This is why Cheetahs always target the slowest from the flock, mostly infants or a fawn, to improve its odds (edge). If you think deeply about this example, you will be blown by the fact that math and stats flow in nature. These are inseparable variables of successful trading.

3. **Wrong mental conditioning:** Through out our lives, we have been conditioned in ways quite different from the traits of a successful trader. We have been told that things have to be bought cheaper. This is the reason behind endless queues during a discount sale. We all love discounts, don't we? But in markets, especially in trading, the best way to turn odds in your favour is to buy at a high price and sell it even higher. This is known as momentum trading. Since childhood, we have been taught that the higher the success rate, the better it is, students with above 90% marks are always respected over those scoring 60-70% marks. But in trading, the best of the best traders has a success rate of 30 to 45%. Isn't that strange? We all in our trading careers run after a higher winning rate and completely miss out on the concept of expectancy. We have always been nurtured to be a winner, be fierce, and bounce back aggressively after a fall. This attitude always leads to revenge trading, resulting in blowing up the account. The market is not our opponent in a boxing ring you want to knock out with a powerful jab. Instead, you will have to learn to be a graceful loser, to be a devotee of the market and learn to honour its summons.

4. **Risking by not knowing Risk management:** If asked to define the job of a trader in two words, it would be risk management. A trader is not a buyer and seller; he is just a risk manager. There could be several driving methods, but a general rule is that driving should not be rash. In the same manner, there could be numerous ways of trading in the markets, but the most important thing is that it should not violate some basic risk management principles for long-term survival. By driving a car rashly, you might reach your destination a few minutes earlier 99 out of 100 times, but there could always be one time when you will not reach your destination at all. Risk management aims to ensure that you reach the destination 100 out of 100 times. It doesn't matter if you are delayed by a few minutes.

5. **Delusional mind and indiscipline:** I have combined delusional mind and indiscipline because they are highly interlinked, and there is no point in differentiating them. If you try to ponder over this subheading, you will notice that the first three points above eventually lead to a condition of a delusional mind. When you do not know your edge, when you do not know the statistics of your trading method combined by wrong mental conditioning, it will lead towards a biased and delusional mind, and a biased delusional mind eventually leads to indiscipline. A delusional mind is nothing but a state of believing that a certain method or a specific system works without any robust numerical proofs. You as a trader have to understand that market has this tendency to create an illusion around you by rewarding you for your wrongdoings, for not following your own rules. In trading, losing money by doing the right thing is much better than earning a hefty amount by following faulty practices. Capital preservation and long-term survival can only be achieved by a rational and disciplined mind. So get as real as possible, analyse your performance in terms of numbers. If the numbers are not positive in the long term don't be kind to yourself. There is certainly something wrong which requires thorough introspection.

SOME PRACTICAL SUGGESTIONS TO IMPROVE AS A TRADER

1. **Don't trade with the capital you can't lose or too small an amount:** It is a well-established fact that the lower the capital, the higher the expectation of returns. And higher than normal expectations of returns increase the chances of blowing up the account. Let's get it very straight; trading is not a business that can be done with a couple of lakhs. It requires a decent amount of money to diversify the risk and position at every possible level.
2. **Backtesting is a must:** Never trust your gut feeling or your instincts when it comes to trading. Always backtest your ideas or method which you want to implement. Analyse each and every variable in depth. Try to be a realist by visualizing the data in a real-world scenario. I would suggest you backtest with a coded simulation or if that is not convenient, then manual backtesting can also be done, but it will require a lot of unnecessary toiling. But yes, to backtest an idea, you should have an extremely objective set of rules, and there should be no room for any discretionary decision-making. This is how all successful traders operate.
3. **Know the power of compounding:** You should have a long-term goal in mind. Learn more and more about the power of compounding, which was described as the eighth wonder of the world by Albert Einstein. Enormous wealth is not built on just a few ingenious decisions but on consistency and compounding.
4. **Increase the odds in your current method:** There are few hacks through which anyone can increase the odds of his existing method in his favour. I am sharing a few of them here-

a) **Never challenge an ongoing trend:** It is always quite natural and intuitive to enter a position against an ongoing trend to make some quick bucks. But believe me, such a mean-reverting thought process is never rewarding in the longer run. By avoiding such trades, a trader can decently improve his trading odds.

b) **Use methods to position size:** There are several position sizing techniques that help improve the trading edge as well. It would be advisable first to understand the concepts of MFA (Maximum favorable excursion) and MAE (Maximum adverse excursion).

c) **Knowing the anatomy of the price movement:** One has to understand the probability of the price movement. If price is at x level, usually people think that there's a 50-50 probability of price moving on either side, but in reality, past price movement decides the short term and long-term probability of price movement. For example, if price crosses a moving average in a normal market on the upside, people usually buy and think that it will be a 50-50 probability of price touching the stop loss or target if we fix 1:1 risk to reward. But as we are entering after a certain move has already happened, there is a slightly higher probability of touching the stop-loss than the target because the price has a natural tendency to retrace even in a trending market. Price moves like the earth which revolves and rotate simultaneously; price, in the same manner, moves in the direction of the trend and sideways at the same time. Therefore, price probabilities are not independent probabilities; they are conditional and correlated. Therefore, it is wise to always enter in the direction of the main trend after a retracement in opposite direction in a trending market and buy at support and sell at resistance in a ranging market. This highly increases the odds.

d) **Trailing the gains:** Trailing is always advisable in a trending market in the direction of the trend no matter how many times you have to forego the already earned MTM, it creates an extra edge over the longer term. On the other hand, there is no point in trailing in a ranging market.

e) **Start using options:** If you haven't read in detail about options, do so at the earliest. Read all possible content on Greeks, on traditional and innovative options strategies, and get a complete hold over option pricing. Options are magical instruments in the world of finance that have an inherent edge inbuilt within them. We need to use them in favor of our trading method. Usually, people think that the only option writing has an edge, but I disagree with them. To illustrate my point, please consider two examples. One, writing an ATM option has an inherent probability of 66% of expiring in our favor in the longer term. Second, buying an option also has an inherent positive probability in the shorter term. When the price moves in our favor, the delta keeps increasing, giving profits at an increasing rate. Whereas when the price goes against us, the delta keeps dropping, giving losses at a decreasing rate, and eventually, the delta becomes 0 at a certain point, which means no further losses no matter where the price goes. Once you know enough about options, you will be able to identify the correct one to use at any given time. There are many strategies to neutralize the theta decay in an option buying as well. Apart from this, the impact cost and margin requirement while using options is extremely low when compared with futures. This also works in our favour in the longer term.

f) **Utilize weekly expiries:** While trading in Index FNO, optimum utilization of weekly expiries is extremely important in order to add a couple of percentages of odds to your position. It is a day when premiums of most of the strikes will turn out to be zero. This fact can be utilized while taking positions on the writing side. On the other hand, when buying an option, the edge comes from the theta value being extremely low, so a position can be created where there is no need to put a stop loss. These small additions to the odds can completely change the stats of the strategy and shift your equity curve upwards.

5. **Attain a calm mind :** However easy these pointers look while reading, they cannot be practiced without a peaceful, stable, balanced, and nimble mind. The less you focus on money, the better you become at earning it. There should be a perfect balance of ego, fear, and greed inside you. You already know what these three can do when they are in access. But the absence of one of these is as damaging as having it in access. Ego in moderation helps you maintain your confidence, fear keeps your risk management under check, and greed is the driving force behind the initiation of any trade and prevents you from cutting your winners short. Pain is another intrinsic part of a trader's life that has to be handled by the mind. Let me explain this with an example. Trend following trading is one of the most authentic ways of making money in the longer run. It usually has only a 35-40% hit rate. This means most of the time, a trader is witnessing losing trades. Now, these losing trades also have those trades which were earlier winners initially and then eventually ended up in losses. This would not be vise-versa because of small stop-losses it would be very rare that a losing trade would become a winning trade. This generates a lot of emotional turmoil within a trader, resulting in doubting his own strategy. That is the main reason behind the origination of an undisciplined psyche. Now you know why trading is so challenging and psychologically exhausting.

In a nutshell, to become a successful trader, one has to work intensively on his thought process and mind to achieve a state of equanimity. The mind of a trader has to be calm like a monk and at the same time fast and nimble like a panther. Meditation and other mind practices might help to get close to such a state.

CONCLUSION

Once a trader analyses himself honestly on the discussed parameters and identifies his shortcomings, half of the journey is complete as the realization is the toughest to achieve. Gradually by eliminating the weaknesses and improving the strengths, one can achieve the desired goal. You don’t have to be the best in every aspect but should be reasonably good in every related area. A tiger is neither the largest, strongest, or fastest animal in the jungle, yet he is the king of the jungle.

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Sannidhya Agrawal is a systematic algo trader who has traded in almost every liquid asset class available in India. He is an NSE certified technical and derivatives analyst. Apart from trading he is also looking after his two startups- a Publishing House and an Edutech Company. He is a member of Advance InvesTrades Forum.