

Five Guiding Principles of Trading Psychology

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When I recently participated in an online chat presentation for John Forman, I assembled my ideas into ten basic principles that have guided my thinking about the psychology of traders and the psychology of markets. In the very near future, if my testing continues to be promising, I hope to present a market indicator for swing traders that rests firmly upon these principles. Stay tuned! In the interim, here are the five principles that pertain specifically to trading psychology. Next up will be five principles for trading the markets.

Principle #1: Trading is a performance activity - This is the core idea behind my most recent book. Like the playing of a concert instrument or the playing of a sport, trading entails the application of knowledge and skills to real time performances. Success at trading, as with other performances, depends upon a developmental process in which intensive, structured practice and experience over an extended time yield competence and expertise. Many trading problems are attributable to attempts to succeed at trading prior to undergoing this learning process. My research suggests that professional traders account for well over three-quarters of all share and futures contract volume. It is impossible to sustain success against these professionals without honing one's performance--and by making sure that you don't lose your capital in the learning process. Confidence in one's trading comes from the mastery conferred by one's learning and development, not from psychological exercises or insights.

Principle #2: Success in trading is a function of talents and skills - Trading, in this sense, is no different from chess, Olympic events, or acting. Inborn abilities (talents) and developed competencies (skills) determine one's level of success. From rock bands to ballet dancers and golfers, only a small percentage of participants in any performance activity are good enough to sustain a living from their performances. The key to success is finding a seamless fit between one's talents/skills and the specific opportunities available in a performance field. For traders, this means finding a superior fit between your abilities and the specific markets and strategies you will be trading. Many performance problems are the result of a suboptimal fit between what the trader is good at and how the trader is trading.

Principle #3: The core skill of trading is pattern recognition - Whether the trader is visually inspecting charts or analyzing signals statistically, pattern recognition lies at the heart of trading. The trader is trying to identify shifts in demand and supply in real time and is responding to patterns that are indicative of such shifts. Most of the different approaches to trading--technical and fundamental analysis, cycles, econometrics, quantitative historical analysis, Market Profile--are simply methods for conceptualizing patterns at different time frames. Traders will benefit most from

those methods that fit well with their cognitive styles and strengths. A person adept at visual processing, with superior visual memory, might benefit from the use of charts in framing patterns. Someone who is highly analytical might benefit from statistical studies and mechanical signals.

Principle #4: Much pattern recognition is based on implicit learning - Implicit learning occurs when people are repeatedly exposed to complex patterns and eventually internalize those, even though they cannot verbalize the rules underlying those patterns. This is how children learn language and grammar, and it is how we learn to navigate our way through complex social interactions. Implicit learning manifests itself as a "feel" for a performance activity and facilitates a rapidity of pattern recognition that would not be possible through ordinary analysis. Even system developers, who rely upon explicit signals for trading, report that their frequent exposure to data gives them a feel for which variables will be promising and which will not during their testing. Research tells us that implicit learning only occurs after we have undergone thousands of learning trials. This is why trading competence--like competence at other performance activities such as piloting a fighter jet and chess--requires considerable practice and exposure to realistic scenarios. Without such immersive exposure, traders never truly internalize the patterns in their markets and time frames.

Principle #5: Emotional, cognitive, and physical factors disrupt access to patterns we have acquired implicitly - Once a performer has developed skills and moved along the path toward competence and expertise, psychology becomes important in sustaining consistency of performance. Many performance disruptions are caused when shifts in our cognitive, emotional, and/or physical states obscure the felt tendencies and intuitions that lie at the heart of implicit learning. This most commonly occurs as a result of performance anxiety--our fears about the outcome of our performance interfere with the access to the knowledge and skills needed to facilitate that performance. Such performance disruptions also commonly occur when traders trade positions that are too large for their accounts and/or do not maintain sound risk management with their positions. The large P/L swings cause shifts in emotional states that interfere with the (implicit) processing of market data. Cognitive, behavioral, and biofeedback methods can be very useful in teaching traders skills for maintaining the "Yoda state" of calm concentration needed to access implicit knowledge.

The most important question I can ask an aspiring trader is: ***Are you engaged in a structured training process?*** Education--simply reading articles in magazines, websites, blogs, and books--is important, *but it is not training*. Training is the systematic work on oneself to build skills and hone performance. It requires constant feedback about your performance--what is working and what isn't--and it requires a steady process of drilling skills until they become automatic. No amount of talking with a coach or counselor will substitute for the training process: not in trading, not in athletics, and not in the dramatic arts. Training yourself to proficiency *is* the path to a positive psychology.