

GREED AND FEAR: TRADING PARTNERS

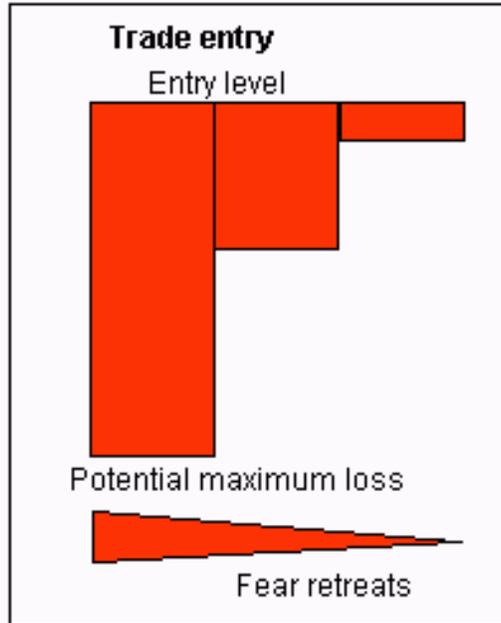
By Daryl Guppy

Traders never trade alone. They trade with two partners – fear and greed. Over the years I have come to know greed quite well, but it never fails to surprise me just how greed can change its nature. In its most common form, greed encourages us to buy very cheap stocks and hold onto them until they become very expensive. Greed is built on dreams of 1000% returns and every now and then the market proves this is not just a pipe dream. This aspect of greed is easy to recognize and its impacts are nullified by basic stop loss strategies and target trading.

Greed acts most dangerously in the exit. It is greed that keeps the trader in deteriorating trades - he hopes prices will climb back to old levels so he can exit. It is greed that keeps him in losing trades - hoping prices will climb back to break even after his stop loss has been passed.

Defining the exit conditions helps control greed. The best exit conditions are based on a set financial return from the trade. The worst are open ended positions that depend on a set of indicator signals. Signals invariably given after the most recent high, here the exit is made more difficult because the trader compares what could have been with what is. So he waits, often with disastrous results.

Over the last few days I have caught myself consorting with a new face of greed. I have an open position that is currently showing around 30% return. Objectively the trend is very strong and likely to continue. So why do I find myself sweating on a stop loss exit signal? Why do I have to resist the temptation to change my stop loss triggers so it takes me out of this trade early? Part of the answer is the desire to trade some other interesting opportunities that offer the **potential** for a profitable trade. Closing the open position would free up some cash to use in buying other trading opportunities. Clear the emotional attraction away, and it seems inconsistent to want to chase a potential trade by abandoning a trade with actual open profits. Another part of the problem is created by target trading. This stock has reached, and exceeded my targets for the trade. It has not developed a reversal signals, and in fact gives the appearance of a strong continuation pattern.



When we first enter a trade our attention is focused on protecting capital. Our entry price is matched with the position size to ensure that we do not place at risk more than 2% of our total trading capital. Fear is the dominant partner at this stage of the trade. As the trade improves the level of risk is reduced. A few days after entering, any exit triggered by a stop loss condition puts at risk less than 1% of our total trading capital.

Perhaps week after entry, we might put at risk just \$50 if our stop loss conditions are triggered. Fear moves away and is replaced by greed. Once we know the trade will not lose us money even if we act on stop loss conditions, our friendships change. We shake hands with greed.

Fear is still in the background, but it becomes a silent partner.

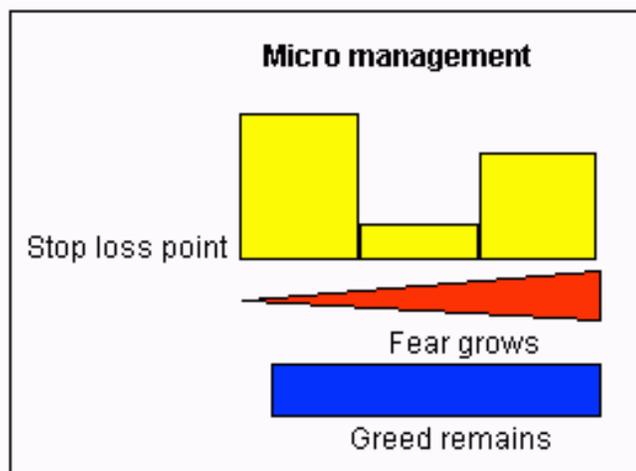
Once the trade starts to make a profit, our greed grows. Initially we hope that the trade will continue to develop and reach our planned targets. These might be set using a pattern projection technique, a defined percentage return on the trade over a set period, or be based on a set of indicator conditions.



As the profits begin to grow we feel more satisfied with our correct analysis. We also feel increasingly greedy. By the time the trade approaches our trading targets there is a growing reluctance to close the trade, particularly if it appears to continue higher. It is always difficult to get out of a trade at your target price and then watch prices rise even higher.

Rationally we know this is good because it means there is enough left in the trade to encourage others to buy our stock. It should be less disappointing than watching a stock hit our price targets but not trading enough shares to allow us to exit our position at that price. Rationality is easily overwhelmed by many emotional reactions. We feel disappointed when prices keep on going because it suggests we were wrong to get out early.

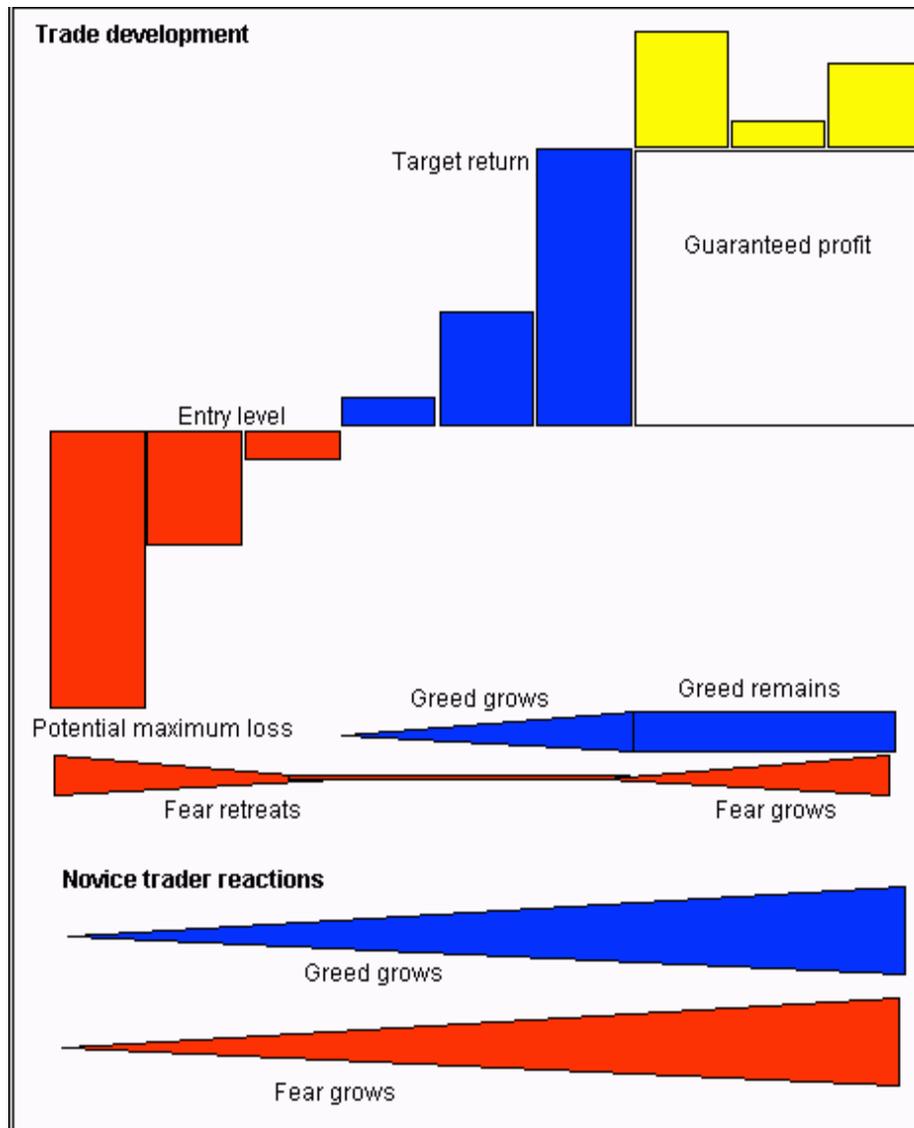
This is a perfect opening for greed. By staying in the trade we can get an even better return and the stop loss will protect us.



This sets up an interesting battle of emotions. Now our two trading partners demand equal time. Greed encourages us to stay with the trade, but we are also worried that we will lose our open profits. If greed triumphs the trader rides prices to the very top of the trend, and then all the way back down to a loss on the position. He does this because greed encourages him to hold on and recapture the maximum profits he missed by not getting out when his stop loss was triggered.

Fear triumphs when the trader is so worried about his open profits that he sneaks up the level of the stop loss, eventually taking him out of the trade well before the final price peak is reached.

Kept in balance these two emotions can help us to make a better trade. What allows one or the other to triumph is the way we forget the open profits that are already guaranteed if we observe our standard stop loss rules.



There is a danger that when we turn to micro manage the exit that we become concerned only with the profit lying above the current stop loss level. If our stop loss is triggered, greed encourages us to ignore it because to act would mean missing out on the maximum profits that were available at the peak of the trend. We know we should ignore this reasoning, but greed – the reaching for forgone profits – encourages us to make allowances and modify the stop loss conditions.

Initially this does not eat into the existing open profit, but left unchecked greed has the perverse capacity to destroy all the open profits and plunge a once profitable trade into a losing trade. This sounds almost unbelievable, but take a look at your own portfolio. Do you find any trades that were once profitable but which are now sitting in the red? How did they get there? Greed helped because as prices fell you secretly believed that they would recover and hand back the imaginary profit that had been surrendered by your inability to act on the initial protect profit stop loss.

When we micro manage the exit we sometimes forget the existing open profit. This guaranteed profit becomes invisible as we focus on the price action above our stop loss point. Fear grows stronger because we are afraid of losing the maximum potential profit available from the peak high of the trend. In this close up view it is easy to forget that there is a guaranteed profit that can be realized by acting on the stop loss. We should not let our fear of missing out on the maximum potential profit prevent us from acting on the stop loss. Nor should we allow this fear to tighten our stop loss conditions so that we close the trade prematurely.

On paper, trading looks simple. Buy low and sell high. In practice, our trading partners make every entry and exit decision difficult. For some novice traders greed grows from the moment they enter a trade. They are in for a wild ride because greed makes it difficult to close a trade. There is never enough return, or they have missed the maximum return they feel they are entitled to. For other novice traders, every trade is dominated by growing fear. They worry about losing their capital, and then they worry that the trend is going to end. They jump out of the trade early, limiting their profits.

Examine your trading and determine which emotions dominate your trading approach. There may be advantages in putting each of your trading partners in their appropriate place. Fear is a good companion when the trade is opened. Greed is welcome as the trade moves towards your planned exit conditions.

When you seek a balance between greed and fear when it comes time to micro manage the exit as the trend unexpectedly continues upwards, remember that you do have a guaranteed open profit. Watch the big picture as well as the intra day bars. The trade is not a loser, unless you make it so by your own actions. Greed and fear will always be with you. Good traders learn to control these emotions, and to recognize them when they change shape.