HOW OUR BELIEFS AFFECT OUR DISCIPLINE IN TRADING

By Jason Mitchell

2015 is going to be a challenge with so many commentators claiming the US market will fall in 2015. They made these same claims in 2014 and 2013 using the same flawed analysis but that's not going to stop them making the same calls in 2015. How do we trade in this environment?

Unfortunately, discipline and emotional control is where the majority of people fall down in their trading. The statistic that is thrown around regarding the market is that 90% of people will <u>not</u> be successful traders. This high rate of failure is not caused by a secret society keeping the profitable trading methods hidden, but by the inability of most people to remain disciplined or maintain emotional control.

I know you have heard about the importance of discipline a hundred times, but today I want to cover one of the ways in which I have been able to improve on this aspect in my trading. While the subject of discipline in trading could fill an entire book, in this article I am going to take a brief look specifically at how our discipline is affected by our beliefs on trading.

Beliefs can be formed through both learning and experience. A child that touches something very hot quickly forms a belief that doing so will lead to pain and they are unlikely to touch it again – this is an example of experience. Experience forms the strongest beliefs as it is backed with an emotional response. The person who uses power tools, however, prefers not to have to cut their hand off to learn that the tools they are using are dangerous. They get their belief through learning. This is a slightly weaker belief as it has not been backed with an emotional response – although the fear associated with power tools does make this a pretty solid belief.

When we begin trading, we start out with some weak beliefs borrowed from other traders and what we have heard about the market. Unfortunately, most beginners just read a few books and think they have the concept down. The trouble is their sub-conscious, or what ever area brings up our emotions (I am no psychologist), does not seem as easily convinced. Maybe it has been bombarded with plenty of information regarding the markets and it has trouble distinguishing the good information from the bad due to lack of experience.

While things are working out in our trading, there is no problem – we <u>think</u> we know what we are doing. The minute we come across trouble, however, we start to wonder whether our decisions are going to be the best ones. We might think "Should I sell on the close below the trailing stop or wait for the Long Term Guppy Multiple Moving Averages to Compress?". Alternatively, we may see a decline in price and think (as I remember one person putting it):

***"the companies are fundamentally sound with good prospects…the price decline defies common sense…"*.**

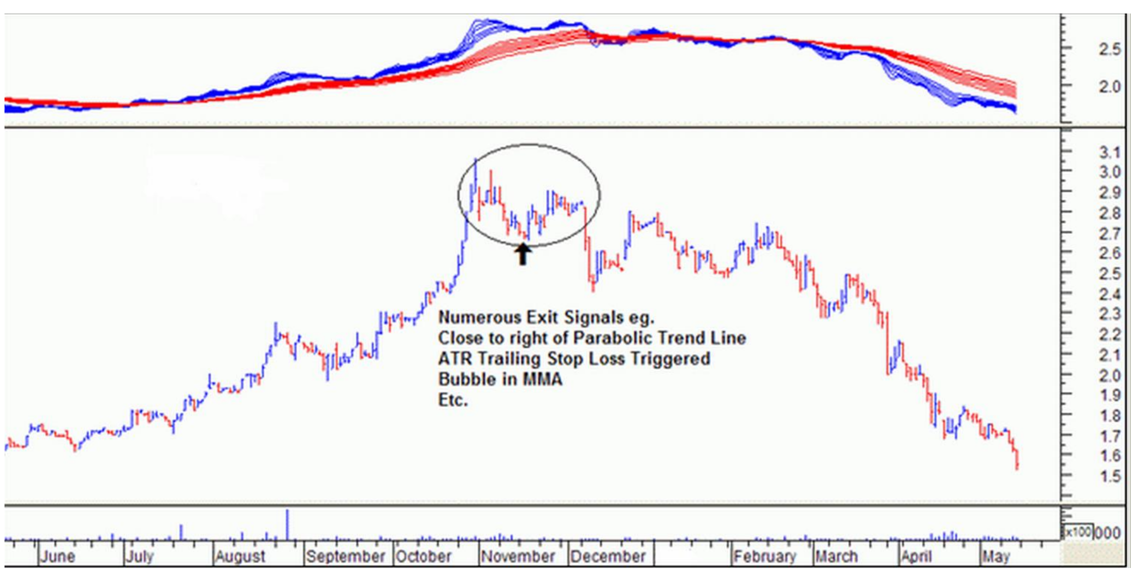
In terms of our beliefs, the two different scenarios illustrate two possibilities: The first is that we have no beliefs or they are very weak. If we believed that trailing stops worked best with our system, then we would have no problem acting on the signal. If we believed that Guppy Multiple Moving Averages were better as a management tool for the system or stock, then we would have no problem waiting for this signal. If we don't know, then maybe we really don't have a belief on the subject and we just know somebody else's theory, but not how it relates to ours. To trade effectively, the theory must become our own based on our research and experience. We must have a strong enough belief to put our hard earned money behind it.

The second possibility is that our beliefs are conflicting. One belief may be to act on a price decline below the trend line or trailing stop, while the other may be that the company is such a good prospect fundamentally that this pull back in price could be nothing more than temporary. We then remember the times we acted on a stop only to see the trade run ahead. Suddenly the conflicting theories have confused us.

The chart below illustrates an example of this. I am not saying this is a fundamentally sound company, I haven't looked at it and I don't care. I have however noted it in a few fundamentally based newsletters as a buy recommendation since about March this year. Back in November, a number of exit signals were given. At the same time, this stock was being mentioned as a buy by some fundamentally based analysts and newsletters.

At this time the market was expecting favourable news regarding a project and there were conflicting signals in the technical vs. fundamental argument. Using a parabolic trend line, it would have been reasonable to get out very close to the top. But if you used fundamental analysis as well and don't know how to fit it in with technical analysis, then the earlier statement regarding the decline defying common sense may have seemed relevant.

Later in December, the news was publicly released and was less than favourably received. Since then, the stock has fallen 50% from its high – the cruelty of numbers means it now needs to rise 100% to come back to previous highs. I am not suggesting fundamental analysis does not work (some fundamentally based traders are a lot richer than I). However, we must ensure we know where each piece of the puzzle fits in our system before we use it. If not, we may be thinking "*this price decline defies common sense*", leading to a difficulty in acting.



Now that we can see how our beliefs may affect our trading and discipline, we need to look at ways to overcome these issues. As I said earlier in the article (and again I am no psychologist - these are just my opinions based on my experiences), our beliefs are formed through both learning and experience. Based on this, the only way it would seem we would be able to change our beliefs is to improve on or increase the learning side of things or stay in the game long enough to gain the experience.

We believe the cheaper option is to set about doing more research and learning. When we talk about research, we are not simply referring to subscribing to every newsletter and reading every book; we also mean looking over and over at a single technique or system until we can see where it works and where it doesn't. This type of research allows us to form plans and gives us the confidence to act on these plans as they are based on our theories and our beliefs.

This type of research is not always exciting stuff and for me it meant spending hours in front of the screen testing, re-testing and analysing results, trades and spreadsheets. I use Metastock, Microsoft Excel and Tradesim as the tools for the majority of my research. (These work well together and are either cheap or common – see my site for details on Tradesim). These three products combined can allow us to access a huge range of past information at the click of a few buttons.

For example, using these products, we could easily analyse every moving average crossover from every stock in the last 500, 1000 or 1500 periods. This could be done in minutes instead of the years it would have taken before these products were available. Seeing factual results is hard to deny and repeated testing getting similar patterns allows us to form stronger and stronger beliefs, allowing us to act with more conviction.

Many newcomers to Technical Analysis (T.A.) are surprised when they talk with me and find out that as much as 70% of my time involved in trading is spent doing research. Experienced traders are not surprised. It only takes seconds to place an order or see that a sell signal has been generated, so that part of trading takes very little time. Knowing when to buy and sell, however, is what is the key and this is why the majority of my time is spent researching this aspect. Once I know this, I know what I am looking for from the chart and each indicator. If I know what I am looking for, it becomes much easier and quicker to find and I know what to expect (within reason) by trading that way.

Trade discipline does not mean holding out against the torture of falling prices by refusing to sell. This does not prove how tough you are, or show how much money you have. It simply highlights the actions of a losing trader.

Trading discipline rests upon trade planning. The trade plan sets out in advance the range of possible options for price activity. It tells the trader how to recognise when the trade is moving in his favour, and how to recognise when the trend is changing direction. It provides an entry signal, and the conditions for exiting the trade to protect a profit or cut a loss.

Trading discipline is the trader's ability to follow the trading plan. When markets dip and there is general panic in the air, it takes discipline to stock with the trading plan. It takes courage to back your analysis. In the past 10 years of case study portfolios we have amply demonstrated the benefits of trading discipline.

Trading discipline means that success can be repeated, and errors consistently avoided.

Trading success rests upon repeatability. Success is not a gamble, or a stroke of luck. It is the repeated application of a sound trading plan implemented with discipline. This is the real trading edge.

This small article only begins to touch on some of the more simple concepts of discipline and I am not suggesting that research alone will give you discipline and emotional control. Indeed, the journey of trading is about conquering these aspects and it is impossible to change our character traits completely based on some simple testing of stock market figures and systems. It is, however, part of the way in which we have helped this aspect of our trading and we have noticed many successful traders have spent thousands of hours on their research.