PSYCHOLOGY AND DOLLAR RISK TOLERANCE LEVELS

By Daryl Guppy

Readers' questions in recent weeks have revolved around the dollar size of loss in trades and how this relates to portfolio loss. This comes back to a better understanding of risk, and how we react to risk. Knowing the theory is one thing. Applying the theory has another set of challenges.

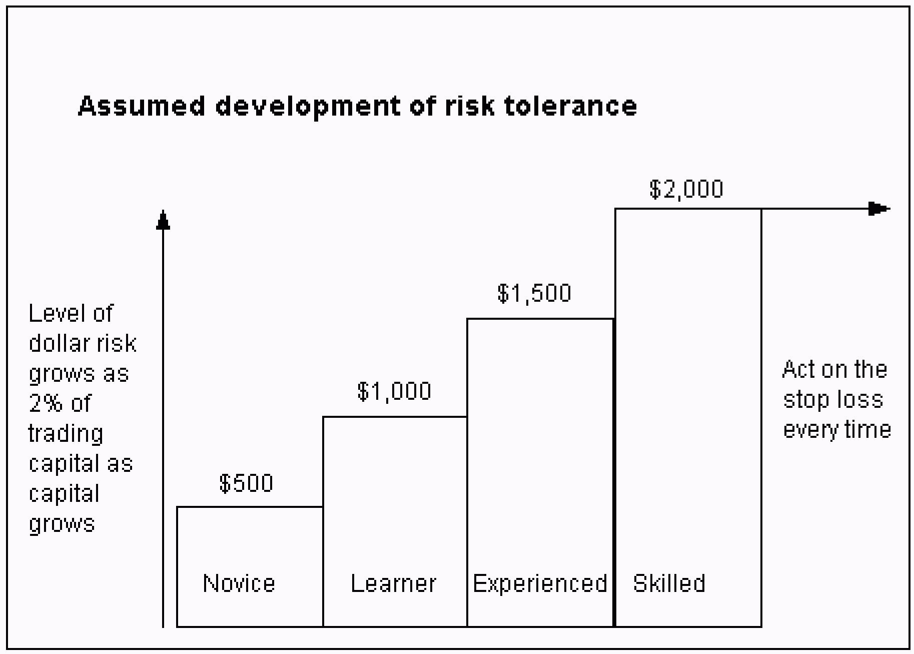
Trading is not an objective, it is a process. When we start we tend to think that there is an achievement goal that we can reach. Once it is reached, we like to believe that essentially nothing more is required as we are fully trained. This idea includes some very significant misunderstandings of the relationship between trading and the way our skills develop. More importantly, it ignores the way we develop as traders. An experienced trader is not just someone who knows more than the novice. The experienced trader is a different person from the person he was when he was a novice. As our skills change, and our experience accumulates, we change.

This means solutions that were appropriate when we were novices are perhaps no longer appropriate as we become experienced traders. The personality changes that develop are in response to a range of factors. Among the most significant are:

- Our trading experience
- Our maturity as we grow older and encounter a wider range of non-trading related experiences.
- Lifestyle changes not related to trading. This might include relationship breakups, experiencing a major trauma such as a car accident or a bushfire.
- Our age. Our approach to spending money is different when we are 30 to when we are 60.

When we develop our trading strategies we must take into account the way we are changing, and the way the market is changing. It is a dangerous myth to believe that there is a single solution to trading. We readily accept that no single 'black box' can provide a solution, but we are less willing to accept the idea that the trading solution we were comfortable with at age 40 is no longer comfortable at age 50. Our trading solutions are a combination of several shifting targets and by applying a closer analysis of our assumptions we can improve our trading responses.

One of the basic assumptions of trading success is that as our skill and experience grows that it becomes easier to act with discipline when stop loss conditions are triggered. If we accept this, then it is easier to move onto the next step which allows risk to grow in dollars terms as long as it remains at or below 2% of total trading capital. This is a valid theoretical relationship, but it ignores the way the dollar value impacts on ability to act. If the dollar size becomes too large it has a corrosive impact on our trading discipline. The result may be that we start to ignore stop loss points because we feel uncomfortable with the size of the dollar loss.



A diagram of these assumed changes includes the development stages for a single trader Novice, Learner, Experienced and Skilled. The risk for each is limited to 2% of their total trading capital at each stage of development. This is just $500 for the novice trader. Although $500 is nearly two thirds of his weekly wage, he still feels relatively comfortable in crystallizing loss at this size if necessary. When the time comes to act he is not prevented by the size of the dollar loss. It hurts, but it is within acceptable limits.

Learner trader has made a number of successful trades and grown his capital. He has much more confidence and is able to increase his loss per trade to $1,000. Just as he was when he was trading as a novice, he finds that he can tolerate a loss of $1,000. Trader Experienced is also comfortable with a larger loss of $1,500 because he knows it is just 2% of his total trading capital. Trader skilled has lifted his market performance to the level where $2,000 is an acceptable loss on any single trade.

The assumption is that as our skill and patience grows there is no impediment to increasing the dollar size of the loss on any trade, as long as it remains no more than 2% of our total trading capital.

This assumption is often very wrong. It is incorrect in two significant ways.

Despite taking large profits and growing portfolio capital, the trader may not be comfortable taking a loss beyond a certain dollar limit. This reluctance may be due to a whole range of factors not directly related to trading, but this reluctance will have a significant impact on his trading success.

A series of losses in the market may make the trader 'gun shy.' Markets change, and traders are not always quick to adapt. Systems that worked in the past may suddenly start to fail. The dollar loss acceptable in one or two losing trades scattered amongst a string of winners is no longer acceptable when losers start to outnumber winners. The usual suggested solution is to reduce position size, but this does not tackle the key psychological barrier that prevents the trader from acting on his stop loss conditions.

The second diagram is a better representation of the relationship between risk, the dollar amount of loss, and the ability of the trader to take action. The acceptable dollar loss generated by the theoretical financial calculation based on portfolio size and the 2% rule is not necessarily the size of the dollar loss that is acceptable to the trader. In this diagram we show the acceptable dollar loss at $1,000.

What happens as we develop as traders? As a novice with limited capital, our dollar loss is under our $1,000 threshold. Developing discipline is easy. As we move to the Learner stage the acceptable dollar loss exactly matches our tolerance level. This match means we might not even be aware of the role this plays in developing our trading discipline.

When we advance to the experienced stage the mismatch between our preferred loss and the actual loss generated by our trading system becomes larger. Initially we are protected by our trading discipline which we developed when the dollar loss was kept at an acceptable level. It hurts much more than it should when we take the $1,500 loss. Our developing skill keeps the losing trades to an acceptable percentage of our performance. Some losing trades will be closed at less than a $1,500 loss.

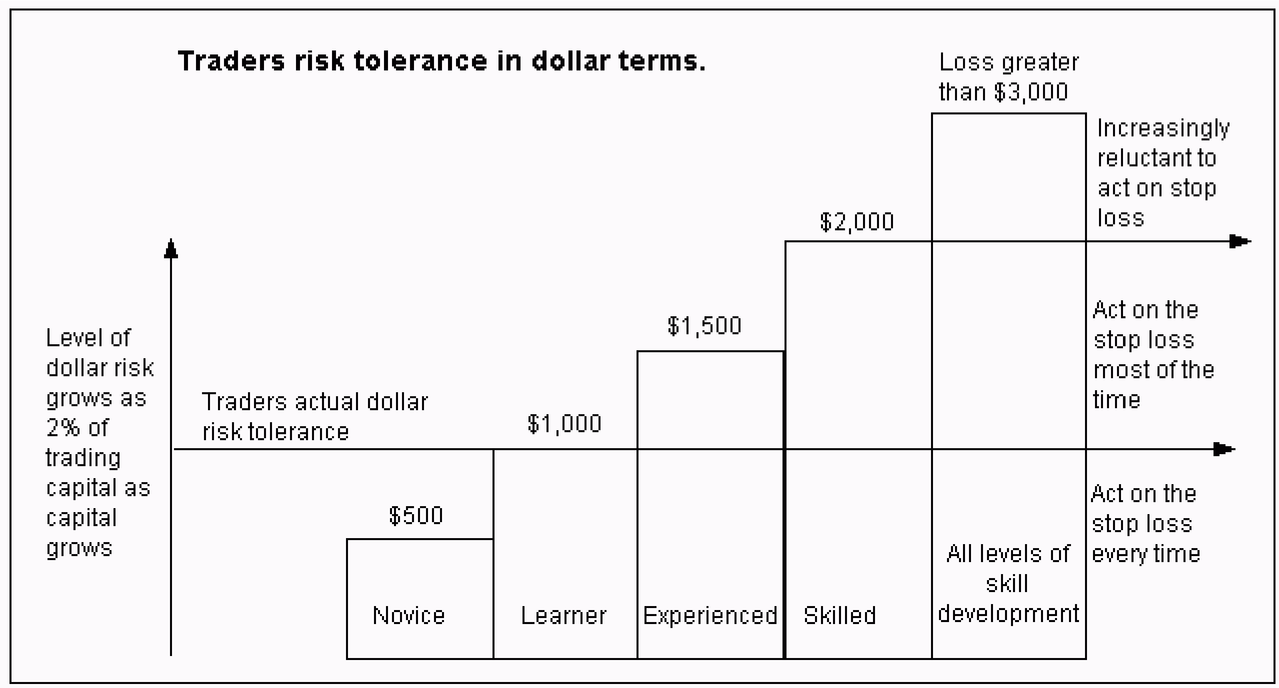
Depending on market conditions, it may take some time before we realize that there is a developing problem with our ability to act on stop loss points. One or two larger losers may creep in, even to the extent where the trade has bombed totally. Once the loss grows to $3,000 we freeze at the wheel, unable and unwilling to act. There is no way we will take a loss of this magnitude because we simply do not feel comfortable with a loss at this dollar size.

Some of these big time losers may come from stocks like SRP where there is an unexpected development and prices gap dramatically below our stop loss point. These are early warning signs, too frequently ignored. When SRP dropped in February many traders and investors went looking for excuses to stay with the trade and not take action.

Why? Perhaps because the size of the dollar loss was so large that they found they could not act. We all have a dollar point beyond which we freeze. In the diagram this point is $1,000.

In bullish market conditions we expect a fairly high success rate with trades. We may move from an experienced trader to a skilled trader without ever fully realizing our growing inability to act once the dollar loss grows beyond $1,000. The clues are there, but we don’t want to see them.

The clues include trades like SRP where the exit has been deferred. It includes one or two trading ‘mistakes’ where an exit was ignored because we felt we hade placed our stops too tight. It’s a long road towards the top, and inevitably there are times when we feel we are on top of the market. When the market does not behave as our trading plan has anticipated, we decide to hold onto the stock. One of the hidden reasons for this action may be because the dollar loss is greater than we can tolerate, even though it is with the 2% rule limits.



These contradictions in our behavior are revealed when circumstances change. It does not have to be a change in the market. This type of change means our tried and true trading approaches do not work in the current market. More often it means we have changed as individuals, usually in response to external factors not related to the market. This affects our ability to act on stop loss points.

The pattern of trading may include swift exit action where the stop loss point is less than $1,000 due to an accidental choice of positions size or entry point. Combined with this pattern are a number of open, losing positions, where the loss is larger than $2,000 or 2% of total trading capital. The good exits made at less than a $1,000 loss obscure the growing problem with delayed exits greater than $2,000. Examine these trades and write down the list of excuses you use to avoid closing the trade. They can be quite interesting.

Unless you have excellent discipline, it is unlikely you will close these trades. However they are particularly important as a warning signal of the need to change and reassess your trading approach. A bullish market may obscure your true dollar tolerance level. A change in personal circumstance may change your dollar tolerance level and make it inappropriate to trade with stops set at these points.

The traditional advice when traders lose touch with the market is to reduce the position size. Instead of trading at $20,000 a trade, the trader trades at $10,000. By spending less in total on each trade the idea is that the trader gives himself time to develop and test new trading strategies at a lower cost.

This solution is based on the assumption shown in the first diagram. It works if the trader still has the mental discipline and capacity to take a $2,000 loss. It does not work if he true dollar tolerance level is lower, at $1,000.

A better solution is to reduce the risk on each trade – not the size. We do this by scaling back the position size to the level where the dollar risk in each trade matches our dollar tolerance level, $1,000 in this example. This is achieved in two ways.

CHANGING DOLLAR RISK TOLERANCE

EQUITY DETAILS	Theoretical
Equity name	xxxx
Maximum # of shares	1,694.9
Purchase price	14.820
Net cost	25,118.64
Av Brokerage	0.00
Full cost	**25,118.64**
RISK PARAMETERS	
Equity risk @ 2%	2,000.00
Risk on this trade	**1,000.00**
Stop loss exit price based on full cost	14.230

Proposed entry price

Dollar risk adjusted to match traders dollar tolerance

Chart based support

The first applies the standard position size and stop loss calculations. These are described more fully in **Better Trading.** The key to success is to reduce the dollar loss on the trade to $1,000. This has a flow through impact on positions size.

In the example we can buy 1,694 shares at $14.82 with the stop loss set at $14.23. The theoretical dollar risk is $2,000 or 2% of our $100,000 trading capital. We reduce this by inserting $1,000 in the cell for the risk on this trade. Under these conditions we spend $25, 118 on the trade. This reduces the maximum position size, using these parameters, from $50,237.

Reducing position size is the standard solution for traders who find they have lost touch with the market. When combined with a reduction in the actual dollar loss it can be an effective solution.

CHANGING ENTRY POINT TO REDUCE DOLLAR RISK

EQUITY DETAILS		Theoretical	Actual
Equity name		xxxx	xxxx
Maximum # of shares		1,694.9	1,695
Purchase price		14.820	14.240
Net cost		25,118.64	24,135.38
Av Brokerage		0.00	0.00
Full cost		**25,118.64**	**24,135.38**
RISK PARAMETERS			
Equity risk @ 2%		2,000.00	2,000.00
Risk on this trade	$16.95	**1,000.00**	1,000.00
Stop loss exit price based on full cost		14.230	**13.650**

Number of shares unchanged

Entry point just above stop loss level

Cost of trade reduced slightly

Dollar loss with an exit at the orginal stop loss of $14.23

The second solution is to keep the same position size, but to time the entry so it is closer to the stop loss point. This works effectively when the financial stop loss point is at the same level as the logical chart based stop loss point. This might be the value of a sloping trend line, or a support level. An entry close to this level means that prices do not have very far to fall before the stop loss is triggered. In turn, this means that the dollar loss on the trade is quickly reduced to within our dollar loss boundaries.

Here we buy the same number of shares, 1,694, but we enter at a much lower price closer to the planned stop loss point of $14.23. We try to get in at $14.24. This marginally reduces the cost of the trade to $24,135, but it has a dramatic effect on the dollar risk in the trade. An exit at the original stop loss level now incurs a loss of $16.95. Prices can fall all the way to $13.65 before we actually lose $1,000.

The dramatic change comes from our entry point, not from manipulating the number of shares we buy, or the amount we commit to the trade. Taking a $16.95 loss is a cinch. Apart from the churn factor which our broker will really appreciate, this gives us the opportunity to test new trading ideas and rebuild the discipline of trading. We have used an extreme example here, but the principle remains valid.

Reducing the dollar loss to under our tolerance level improves our ability to act on the exit signal. Markets change and we change as traders. We must recognize the psychological changes that stand in the way of effective trading discipline. A string of losing trades is a warning sign. A growing portfolio of stocks where stops have been ignored is a clear signal that you need to reexamine the level of dollar stop loss that is appropriate for you at this point in your trading development. The most effective solution is to reduce position size and to reduce the size of the dollar stop loss until you are able to act consistently and with confidence when the stop is hit. It is better to start from the bottom, say $500 and work upwards until you hit your particular barrier level, say $1,000.

The longer you trade the more you come to understand that psychology has a vital part to play in your trading success. Our first understanding of this impact is when we confront fear and greed in an unrestrained fashion. Making more money than we ever dreamed possible for what looks like little work is a heady experience. It has many interesting, and unexpected consequences on our behavior. Some of them are not very pretty to observe.

Fear becomes an intimate companion when our hard earned cash is gobbled up in a falling market. This is no thrill ride with a guaranteed safe ending like a theme park roller coaster. We react in quite unexpected ways and they are not always pleasant. Greed and fear are the base emotions that trigger psychological reactions. When we move beyond these raw emotions we find that there are many other factors that come into play.

Experienced traders find that success rests as much upon understanding more about themselves and their motivation than it does on understanding the market. For some traders there may be a need to seriously address underlying psychological issues that stop them achieving trading success. These issues are also likely to play a role in their non-trading life. For most traders the issues are less crippling, but still significant.

Recognizing repeated self-defeating behaviors like failing to act on a stop loss, is the first step towards overcoming, changing, or neutralizing these responses.

Ignoring them will not make them go away. Everybody has different psychological reactions in detail, but it is useful to examine the broad psychological factors that can inhibit trading success.

Next week we consider how these psychological factors impact in different ways when we come to trade blue chip or speculative stocks.