Success in the markets, as in life, depends on having a healthy and clear strategy for emotional risk management. Too often, our emotional responses to the uncertainty of outcomes interfere with the achievement of our goals. In our careers, personal relationships and investing practices we find ourselves enacting and reenacting self-defeating patterns: cutting short promising situations and lingering too long in unprofitable ones. It doesn't matter that we are intelligent people, hardworking and otherwise successful. It's irrelevant that we've attended all the latest seminars and read all the hottest investing books. If our ability to cope with risk is distorted by unseen emotional forces, we will inevitably fail to attain the success that should be ours — both as investors and as human beings.

In *The Psychology of Trading*, Dr. Brett Steenbarger, a leading New York psychologist, explores the relationship between emotional risk management and investing success. In doing so, he presents his readers with cutting-edge ideas in investing psychology by combining the wisdom gained from his years as a practicing therapist with his considerable knowledge of day trading. In an engaging manner that provides practical solutions to real trading problems, Dr. Steenbarger walks us through the most common emotional pitfalls that distort our ability to rationally identify and exploit market patterns. He then describes specific techniques derived from years of clinical practice to help you become an effective observer of these pitfalls and take steps to avoid them.

By blending state-of-the-art research from psychology and cognitive neuroscience with detailed case studies, *The Psychology of Trading* provides traders with all the intellectual and emotional ammunition they need to better understand their trading behavior and positively transform their current approach to risk and reward. What follows is but a sampling of the many valuable insights from Dr. Steenbarger's book.

**Trading from the Couch**

Behavioral finance research suggests that market swings are not entirely random, but reflect systematic cognitive and emotional biases among masses of investors. In Dr. Steenbarger's own experience, many of these personal biases appear to flow from people's well-documented tendencies to misperceive the overall direction of markets and wrongly appraise their own particular talents as investors.

While there are a number of behavioral biases that affect individual investor performance, the two that stand out for Steenbarger as the most problematic are "misattribution" and "overconfidence." In *The Psychology of Trading*, Steenbarger teaches us to recognize these inherent biases within ourselves so we can avoid falling into their traps. He then offers up some practical advice to help us turn
some of our emotional encumbrances into genuine trading advantages.

**Emotional Bias #1: The Misattribution of Outcomes**

It is human nature to seek causes for events, says Steenbarger. A large body of social psychological research documents something called a “fundamental attribution error,” in which observers tend to overestimate human causes of certain events and underestimate the contributions of other factors, such as the environment. Moreover, he points out that researchers have long noted the tendency toward positive attitudinal biases in which people are more likely to attribute favorable outcomes to particular decisions they have made, but blame negative ones on outside forces that are beyond their control.

In his own counseling practice, Steenbarger has observed these dynamics at work in the minds of many of his investor patients. In fact, the majority of the traders he’s worked with have indicated that they have, at various points in their trading careers, tried to outperform the markets by analyzing charts and historical data. To Dr. Steenbarger, this behavior suggests that many of his patients seem to have a highly favorable view of their own ability to intuit future market trends. Yet, when the Good Doctor has asked them to actually rate their performance as traders, only a handful said that they are consistently profitable. In fact, most reported being consistently unprofitable, or at best, breaking even.

During the market’s last great decline of 2001, Steenbarger noticed a similar misattribution of outcomes in the letters and e-mails he received every time one of his regular financial advice columns appeared in print. A constant theme ran through the reader correspondence: feeling optimistic about their successes in 2000, the writers decided to become day-traders. But when the bubble burst, the letter writers attributed their losses to poor decisions by the Federal Reserve, or the over-optimism of market analysts. As a result, not one writer reported having changed his investment stance throughout the market drop. By attributing losses (but not gains) to outside and transient forces, Steenbarger reasons they were protecting their psychological views of themselves — at the expense of their own portfolios!

**Emotional Bias #2: Overconfidence**

Although many market participants feel that a lack of confidence is a major stumbling block in their performance, Steenbarger believes that overconfidence is a far larger problem for the average investor.

To demonstrate this point, Steenbarger cites research by Terrance Odean, a professor at the University of California, which shows how overconfidence tends to play out in the real world. Dr. Odean followed a group of more than 1,600 investors who switched from traditional brokerage accounts to online trading accounts over a period of a few years. He found that these investors tended to be unusually successful prior to the switch, beating the market by more than 2% per year. Yet afterward, they significantly increased their frequency of trading, apparently confident in their ability to discern prospective market trends. The
result was that the vast majority of them then underperformed the market by more than 3% annually. His conclusion: these traders had been taking too much credit for their own successes and this led to overconfidence.

Three Resolutions

The question is, "can investors and traders take active measures to reduce their vulnerability to misattribution and overconfidence?" Dr. Steenbarger thinks they can, and so he offers three simple resolutions.

Resolution No. 1: Treat Investing Like A Business

"A person who fails to plan his entry into a business field might as well plan to fail," writes Steenbarger. "Investing is no different."

Throughout his career, Dr. Steenbarger has found that most of his clients tended to underestimate the initial learning curve involved in mastering the markets. Different strategies in both investing and trading have different risk exposure, so individuals need to know their own tolerance for draw-downs and losses before they take a position. According to Steenbarger, any plan for market success must begin with a sober analysis of the capital one can commit, the risks one can assume and the likelihood of those risks being incurred. Understanding the variability of returns for various investments over different time frames ensures a proper risk/reward balance.

Resolution No. 2: Be Rule Driven

"Trading is a high-performance activity," writes Steenbarger. "Like other high performance domains, trading requires considerable mental effort. The football team going into a big game draws up a game plan; the army about to fight a war develops a battle plan; the master psychotherapist goes into sessions with a coherent strategy for assisting a patient. These plans are actually sets of interwoven rules that, as a whole, orient the performer as to the challenges that lie ahead. And to the extent that the peak performer has a decision tree mapped out in advance, responses to situations can be made rapidly and decisively. It is when rules are not clear and well-understood that the whole system tends to break down."

In many fields of endeavor, be it the trading floor or the operating room, the difference between success and failure can come down to a matter of seconds or minutes. Therefore, according to Steenbarger, cognitive efficiency becomes a prime ingredient of peak performance. As such, by drawing-up a clear game plan before you sit down to make a purchase, trading success can be improved dramatically.

In his clinical sessions, Steenbarger has found that the investors and traders who perform best over time are the ones who have developed a clear methodology or approach they can follow consistently. This might include price-based rules (e.g.
setting a pre-determined percentage that one is willing to lose on a particular stock before bailing out) or indicator-based rules (e.g. automatically getting out of a position if the Dow drops below a certain range).

Of course, a given strategy might not work as well from one year as the next, and some may never work at all, but Steenbarger cautions that the person who jumps from one approach to another is subject to Murphy's Law. The strategy that is being abandoned is usually ready to kick in just as another strategy peaks. So once you find a strategy that fits well with your trading personality, stick with it!

Steenbarger goes on to say that, in his experience, some people have personalities that simply are not well-suited to trading. Not everyone possesses the necessary blend of flexibility and analytical decision-making required to become a successful trader. In his view, trading will be an uphill battle for anyone who’s generally prone to high degrees of emotional distress (e.g. anxiety, depression, anger). He also feels it would be extremely difficult to succeed in the markets if you’re overly impulsive or not particularly conscientious in your everyday life.

Fortunately, this is why they invented stock brokers and financial planners — people whose job it is to assist with decision-making and who can recommend strategies to minimize trading anxiety and mitigate overly hasty decision-making. One of the greatest benefits to knowing thy trading self is recognizing when you may be in over your head and then seeking out the wisdom and guidance of a more seasoned, professional trader.

Resolution No. 3: Play Good Defense

As mentioned above, Steenbarger believes that too many traders become overconfident by exaggerating their own abilities based on a few relatively small successes. Then, once they invest their dollars in a position, they also become emotionally invested in it, making it difficult to exit if expectations are not being met. Steenbarger’s experience is that the top professional traders always play defense before playing offense.

"It is vitally important to know the point at which an investment or trade is not working," writes Steenbarger. "You have worked hard to build up your initial capital. Protect it so that you can continue to be a participant in the markets for years to come."

Conclusion

It is becoming increasingly common these days to hear traders assert that mental self-control is the key to success in the stock market. Dr. Brett Steenbarger's new book suggests that the reverse is equally true — staying grounded in solid trading rules and plans is one of the most powerful ways of maintaining a positive trading psychology.
As Steenbarger reminds us, different rule systems may work better for different traders, depending on the time frames they’re working under and the markets they’re playing in. But ultimately, the rules you decide to follow must be well-suited to your personality, including your own personal risk-tolerance. Reading about the various rules and plans, and then putting a few of them into practice using small initial investments, is, for Steenbarger, the best way to build up your trading confidence and overcome some of the mental barriers that can easily get in the way of consistent trading success.

The challenge, in a nutshell, is to stand above our emotional reactions and, indeed, to learn from them. Because when we take the time to know ourselves first, it becomes that much easier to know the market. So relax and listen. Your emotions are trying to tell you something, and it just might be important!