Forex Profit Matrix

PRESENTS

Forex Profit Solution

Trading Psychology

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Forex Profit Matrix ©

Published by

Old Tree Publishing CC

Suite 509, Private Bag X503

Northway, 4065, KZN, ZA

www.oldtreepublishing.com

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I. Introduction

Did you know…

> “ *Research shows that <u>there is no innate trait that successful traders are born with;</u> any personality type can sprout a successful trader with proper instruction and training.* ”

Most people think that there is an archetypal trader's personality; for example, a good trader is one who is a vivacious and extrovert risk taker or a gambler. However, there are no common innate personality traits amongst traders. This means that traders are not born but made – made through instruction and habit. Most traders, who lose money in the market, really get into the trades, emotionally, and make decisions based on their gut feelings. This just brings about some questions… Why does your gut feeling tell you to go with your gut? Are you a bad trader or are you just doing something wrong? Where do instinctive feelings come from and why is it so often so wrong?

Your brain did not evolve to take risks, although this is exactly what trading requires. We did not get to the top of the food chain or survive the ice age by risking things. Our brain has evolved to distort risks and probabilities, which we are already poor at predicting, to save us from potential harm.

What I will discuss in this report will help you **understand how your innate behavior is affecting your trades**, and then, compensate for it. This report will also break some very strongly held misconceptions that you probably have about the brain and reasoning.

Trading psychology is not an arbitrary science; every trader should have an understanding of how things work inside their brain when they look at a chart.

II. What is Trading Psychology?

Trading psychology involves the change in perception that you feel when you become emotionally invested in a trade; which may happen when you switch from a demo account to live trading account or when a lot rests upon the outcomes of your trades.

FACT
We want to receive more information than we need or can process.

Traders are not robots and are not immune to being biased or making nonobjective judgments. It is a psychological fact that we want to receive more information than we need and can process. Thus, we selectively take in the information which suits our needs and goals. The information that we do process, and how we process it, is greatly affected by our psyche.

The degree to which psychological factors influence one's trade depends on one's emotional investment in the outcome of the trade. Traders are only human and their performance depends on their emotional self awareness as much as on their technical skills. Your emotional state and your financial performance influence each other.

The field of trading psychology consists of the study of the psychological state of the crowd and the psychological state of the trade/investor. The psychological state of the trader is the combination of his or her intellectual and emotional bearing.

A trader's rationality has always been a hotly debated issue. Some will argue that traders and investors are rarely rational; plagued by biases such as overconfidence, miscalculation, overreaction, greed, fear etc.

Ask yourself:
What kind of a trader are you?
Do you see opportunities that you have missed or do you have difficulty controlling the number of trades you place?
Do your emotions sway with the prices?

I will teach you, in this report, about the distortions of risk that your brain paints in efforts to protect you. You will not only have a better understanding of how your brain works but will be able to ignore the gut feeling that can lead you in the wrong direction. Knowing that you are getting the wrong picture is more than half the battle and that is what I try to do.

III. A Trader's Personality

Anyone with any set of personality traits can become a trader through practice and good habit.

It is possible to find common ground between the systems that traders use. However, this should not be taken to imply that there is common ground between the personality types that these traders have.

A 2001 **study by the National Bureau of Economic Research (NBER), which sampled 80 traders, showed that there is a negligible correlation between having certain personality traits and trading performance.**

The point being that to be a successful trader, one does not need to have any specific innate and archetypal trader personality. The traits required to succeed at trading can be learnt.

Interestingly, the same study also showed that males and younger participants tend to enter trades much more frequently than females and older participants.

IV. Apophenia

Understand that the patterns you instinctively see may not be there at all.

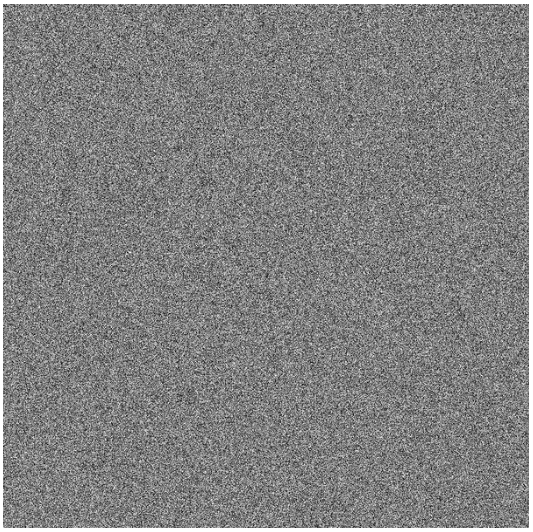
There is no need to scorn at this word, it may be unfamiliar but we have all experienced what it refers to: the human tendency to find meaningful patterns where none exist. This is also known as patternicity.

Psychologists treat patternicity as a cognitive error, believing in a false positive, a Type I statistics error. However, calling it an error perhaps inspires misunderstanding. It is not an occasional error but is behavioral. How many times have you seen figures, faces or fingers in shadows?

FACT
Our brains come up with beliefs, first, and then look for evidence for it.

Michael Shermer, a neurobiologist with 30 years of cognitive research experience, wrote that **our brains are "belief engines" that look for patterns instinctively** and that that these beliefs arrive first. Our brains then gravitate towards information that resembles the beliefs and slots it into a category. This is known as belief dependent reality. This accounts for beliefs held in important spheres such as politics, religion, paranormal phenomena, etc. Birds, rats, worms and us; we all do it too.

Look at the static image on the right. What do you see?



You will instantly begin to see some lines which your brain will try to assemble into a known image. Try finding a face, mushroom cloud from a nuclear explosion or a rabbit in there. In actual fact, the image is white noise from which we can derive whatever we want. Even the lines aren't there.

Did you see all of the mentioned items before you were asked to look for it? Probably not. You see, the belief comes first and then the brain will find information and patterns to support the belief. Unless you are looking for something, that image will be just static to you. The same thing happens in trading. If you are looking for a buy trade, to perhaps desperately make up for some losses, then you will see buy trade opportunities.

Try it again with the image to the right. What do see?

Now look for a face. Try butterfly, insects or just eyes. Once an idea has been implanted in your mind, the brain will instinctively look for patterns that fit it.

We have evolved to do this subconsciously because there is an evolutionary advantage to making a type I error, a false positive.

If an animal hears a rustle in the grass and assumes it to be a predator, when there is actually nothing there, it can survive. However, if it assumes it to be just a rustle when there truly is a predator, the cost may be its life. The evolutionary advantage lies in assuming the safest because we are very poor estimators of such probabilities.

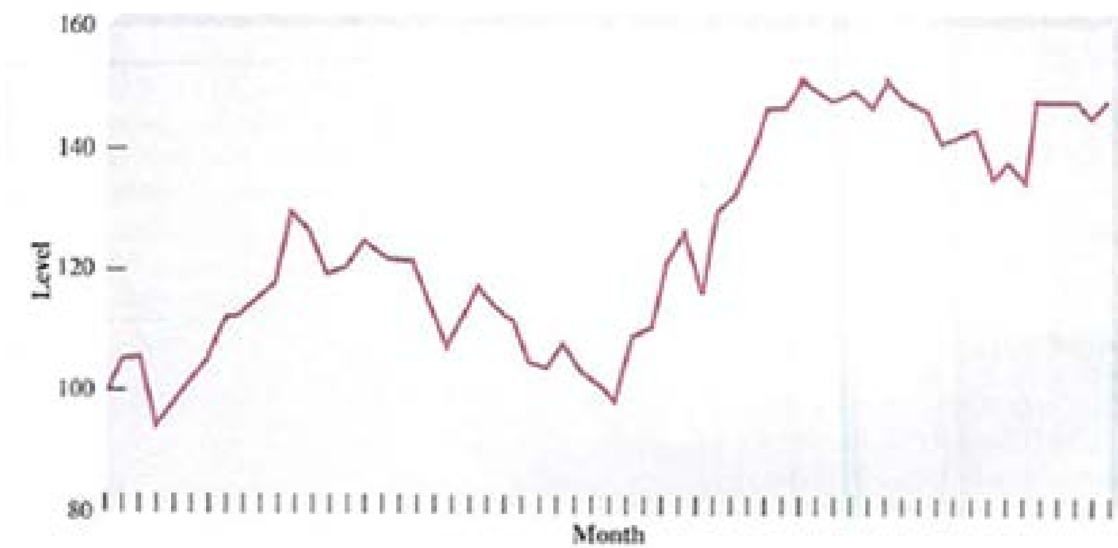
False patterns in the market

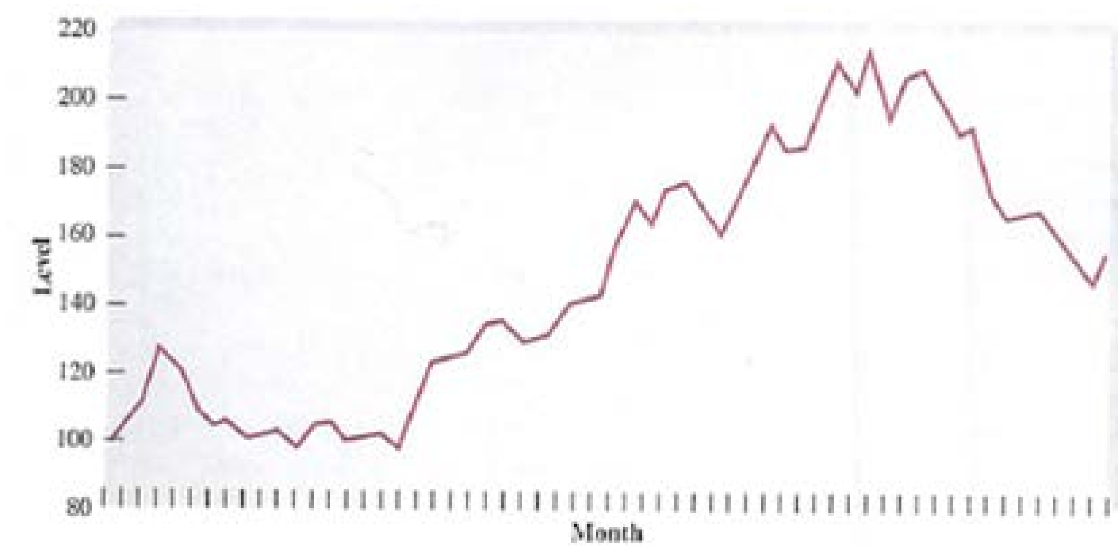
Now, if you are a trader and a *Homo sapiens*, then you are susceptible to finding patterns that you are looking for, even if it isn't there. You will most likely rationalize a wrong decision.

Consider that you are playing a game where you invest $100 to begin and then toss a coin at the end of each week. If you get heads, then you win 3% of your current asset and if you get tails, you lose 2.5% of your current asset. Here, getting heads at the end of the first week will win you $3 and bring your holdings up to $103. A 5 year simulation is run based on this game and the holdings are charted. I will show it to you in the next section.

Let's have a look at a different scenario. Say that we invest $100 in the S&P 500 companies. The actual price action of the S&P 500 is charted as well.

Can you distinguish between the two charts below and determine which is which? If you had to buy or sell with these charts, what would you do?





The chart at the top is the S&P 500 while the one at the bottom is the coin toss game.

You will find patterns where you are looking for them. If you had to trade with the bottom chart, you could justify a sell trade despite the fact that the chart was created with a truly random independent event.

V. Risk Aversion

Your natural state is to fear risk; this makes you rethink trades more than you need to.

Every trade is a risk and trading psychology, naturally, incorporates the interesting ways in which people react to risks.

Studying, defining and predicting risk taking behaviors is not easy. Psychologists have tried to study how risk manifests itself in different areas of social and personal scenarios.

The word *risk,* itself, implies a situation where a decision is made whose future outcome have known probabilities. When we make a bet, we take a risk of losing, and then we tend to behave differently, especially, when the probabilities of the outcomes are definitively known. That means operating on a hunch would produce different decisions than those made when operating analytically. The less exact we know of the future, the more fear we have of taking a risk.

If the price action follows a random walk, then what do you think you know about the future?

This was demonstrated in an interesting and old, yet still applicable, study by Kahneman and Tverky conducted in 1979 where everyday people were asked to choose between a guaranteed $3,000 or 80 % chance of winning $4,000. You already know what you would have picked; the same decision was made by almost all participants of the study. People preferred the $3,000 over a relatively safe gamble. Mathematically speaking, the expected return on the gamble is 4000 x 0.80 or 3200 dollars. Despite the expected return of the second option being greater than the amount of the first option, people prefer to not risk anything at all.

This fear of risk is known as risk aversion.

The result is the hesitation that you feel before taking the leap of faith, which can result in some serious decision making errors.

Let’s take a look at a non trading example of risk aversion and how it distorts our reasoning. It will be a stretch to relate this back to trading but should give you a good idea of the effect that risk aversion can have.

If you are at a party and notice that your friends have had one too many drinks, you are probably going to take away his keys and ask him to walk home to avoid the risk of an automobile accident. This is risk aversion; we associate a risk with driving drunk and avert it.

FACT

Per mile, you are 8 times more likely to die walking drunk than driving drunk.
Still, which do you prefer?

However, did you know that if you were to walk home drunk for a mile, then you are 8 times more likely to die than if you drove that mile home drunk? This statistic holds true even when compensated for the different types of neighborhoods one could be in. So why do we still take the keys away from drunk people and not their shoes? The answer is because we have been trained to associate risk with driving and not walking. In the efforts of avoiding a risk, we end up taking one. We see a risk, we skirt it, no questions asked.

Explaining Risk Aversion

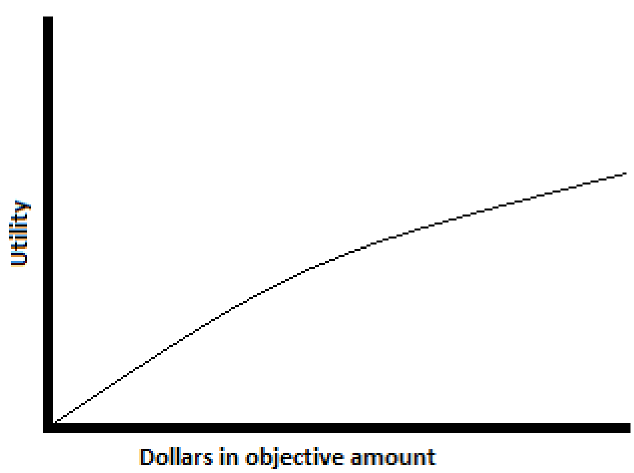
Risk aversion is a natural and universal behavior but how does this relate back to trading?

When presented with the possibility of winning some money, we, intuitively, do not see the situation objectively. We look at the future through the lenses of the past; which in the case of price movements is not smart move. If you roll a dice ten times without getting a 6, then you are unlikely to be willing to bet on getting a 6 on the 11th roll. However, objectively, you are as likely to get a 6 on the 11th roll as you are on any other. The probability of getting a 6 is still 1/6 but we tend to show increased risk aversion which makes us believe that the probability of getting a 6 is actually lower.

Another concept which is often used to explain risk aversion, introduced by Daniel Bernoulli, is called the utility concept. A utility refers to the subjective value of the money that you can potentially win and Bernoulli believed that “any increase in wealth, no matter how significant, will always result in an increase in utility which is inversely proportionate to the quantity of goods already possessed”. In laymen’s term, the more you have the less you will value the gains and will take bigger risks. A move from $1,000 to $2,000 is a bigger jump, psychologically, than a move from 20,000 dollars to 21,000 dollars. Money has decreasing utility, in Bernoulli terms. This drives investors and traders to take bigger and bigger risks leading to potential disaster. This isn’t a flaw; rather it is innate human behavior.

FACT
Your brain does not view profits objectively as numbers.

To the right is a simple illustration of the Bernoulli Utility function showing negative acceleration with more gains.



VI. Emotional state and trading performance

Don't become emotionally attached to each trade and let your emotions get the better of you.

As I said above, we show natural aversion against or fear of risk and there are probably no archetypal innate personality traits that traders have. So what psychological factors set aside unsuccessful from successful traders?

FACT
Those who show less emotional reaction to profits and losses tend to perform better.

The answers were highlighted in a series of studies by Steenbarger, done in 2002, which presented clear links between emotions and trading performance. The 2001 NBER study by Andrew W. Lo *et al*, sampled 80 day traders, and found "that subjects whose emotional reaction to monetary gains and losses was more intense, on both the positive and negative side, exhibited significantly worse trading performance".

That is the same as saying that the more invested you are in the trades you make, the more reckless decisions you are likely to make. This provides psychological backing behind the money management strategies that many traders use. If you are risking a very small fraction of your total assets, you are less likely to launch into a loss recuperating crusade.

If you believe that you always become emotionally invested in your trades and overreact, then don't give up on trading because you are not the only one. A 2002 study by Lo and Repin, which sampled 10 seasoned and professional Securities traders, monitored participants with skin conductivity and cardiac sensors. Their surprising conclusion was that even the most experienced and successful traders showed strong emotional response, even if they tried to suppress it superficially. In other words, all traders respond to the trade emotionally, at some level, and this can interfere with the decisions they make. Emotional investment can make you so irrational, at times, that you might as well be called ignorant.

So if there isn’t a stereotype for a trader personality type, humans show natural risk aversion, and all traders are emotionally invested and, if, emotionally invested traders make bad traders, how does one become a good trader? The answer is proper instruction, practice and discipline.

Allow me to make an analogy… Trading is like trying to paint while being color blind. You must realize that you see red as green before being able to do a good job and, that requires training and practice. Studies show that, without seeing the true color, color blind people can use clues such as, position and context, to accurately determine what color something is. For instance, by knowing that the red light is always at the top on a traffic light, they will say the light is red without ever seeing true red.

Trading Around Emotions: Greed and Fear

We tend to place excess emphasis on the technical skill and the IQ of the trader while forgetting about the EQ (emotional intelligence quotient) or the self awareness of the trader. Being self aware and being able to point out the times when judgments are emotionally charged, are just as important as having the technical skills.

Typically, when trading psychology is brought up in a discussion, the issue gets boiled down to two emotions that influence the risk aversive behavior of the trader. These are greed and fear. These are natural and innate feelings which have evolutionary advantage. They can neither be suppressed nor can you suddenly stop feeling them.

It is true that successful trading requires the use of the prefrontal cortex and higher brain functions such as logical thinking, reasoning and predictions.

However, did you know that basal feelings, such as fear, anger or greed, that originate from the center of the brain, called the amygdala, trump higher brain functions that take place in the cortices? This response, once upon a time, had evolutionary advantage for survival but is ill-fitting for trading.

FACT
Over 40% of traders admitted to feeling fearfully with their bets, regularly.

A good approach is to realize the degree to which your bets are swayed by how you are feeling and negate it. Successful traders have been known to look at situations very objectively. One of the best ways to force an objective outlook in you, as a trader, is to use a system; trust the numbers and the mathematics.

Facing up to trading fears

Fear has many facets, just like any other emotion, and one of its faces – risk aversion or the fear or taking a risk, i.e. entering a trade, was introduced earlier. Let's explore the intricacies of fear and its effects with regards to trading psychology further.

Fear is our innermost psyche, hardwired into our brains to protect us from potential harm. Potential harm is what every trade is and, thus, every trader has felt some hesitation before entering trades. This isn't generalization, its biology.

Fear or paranoia of mistake is or missing out on key price movements common amongst most starters. They start buying after a resistance level is broken through, while the experienced traders, who managed to predict the break out, sell the commodity.

Novice traders will often enter trades on impulse without even being aware of their limited consciousness. And, let us not forget the greatest fear of all which pushes trader out of the field – a fear of not being competent enough. The brain treats these situations as potential dangers because, even though we don't risk bodily harm, the potential losses can still be threatening.

If you feel your heart rate change, if your palms sweat and if you have to let out a sigh after you close a potentially devastating trade, then you are letting fear get the best of you.

Influence of greed and overconfidence

“Do not fly too close to the sun.”

We all know the story and we have all probably heard the proverb, well, Icarus did too, look where he is now. Traders have been known to fall into a pothole while waiting for that one extra pip. Greed is commonly the result of overconfidence inspired by a winning streak. However, there are other variables when it comes to the source of overconfidence and greed.

When the Bernoulli utility of the possible reward is high, we become subconsciously eager to take the risk and distort the probabilities of success. A 1991 study by Heath and Tversky found that traders are more overconfident when their predictions are made in fields where they have become self-declared experts.

FACT
Studies showed that Traders are more overconfident when they are self taught.

This allows them to rationalize risks that would otherwise be averted. Once more greed, a basal emotion originating in the amygdala, trumps the higher brain functions. A very famous example of this sort of emotion, in this case pride**, incited overconfidence was demonstrated by a public survey in Sweden, where 90% of the people rated their driving skills to be above average** (a mathematical impossibility of course).

Traders need to understand that they perceive the monetary gains as Bernoulli utilities and not as an objective number of dollars. The utility of the gain decreases as more money is reeled in and with some success, traders become self made experts and overconfident. They begin to paint a distorted picture of the probabilities of each trade and eventually land up in a recklessly placed bet. It sounds familiar doesn’t it?

BBC business reporter Laurence Knight calls it the “Gekko syndrome”; after the antagonist from the movie *Wall Street* who so frequently said, ‘greed is good’. By aiming for the last pip, traders merely confirm the belief that they are not self aware.

Greed is not always good and by having a system with a target profit, beyond which you should exit the trade, is the way to skirt emotions. Always ask yourself whether you are making a rational decision and be honest with yourself. Greed can be overcome by testing and then relying on a system which delivers consistent profit. Stick to that system and know that by following that system's rules correctly, you will make profit and do not need to hold on to trades to squeeze out every last pip and do not need to enter every potential trade.

VII. Conclusion

Let us summarize the above discussions on trading psychology. Psychological personality assessment studies have shown the there is no archetypal trader personality profiles or traits, such as aggressiveness or extraversion, that all successful traders have. Successful traders have a heterogeneous mix of traits, many of which are not innate. Therefore, contrary to common folk wisdom, studies have shown that there are no born traders. This implies that all necessary traits that successful traders have can be learnt with proper instruction and practice.

Also, remember that your brain naturally makes a type I error and finds patterns where there are none to confirm your beliefs. If you are desperately looking for a buy entry, you will find one. This is natural behavior which has helped our species survive up till now, but if you want to survive in the Forex market, Apophenia must be avoided.

Emotional responses to investment and potential harm are crude evolutionary tools that are too out of tune when it comes to 'financial fitness'. We show natural risk aversion when it comes to dealing with probable outcomes. Risk aversion is a natural phenomenon which results in us forgetting about Bayes' Theorem when calculating probabilities and giving too much weight to past outcomes.

When probabilities are involved, we also do not look at the rewards objectively but instead view them as Bernoulli utilities, whose value depends on the already possessed assets.

And because trading requires the use of higher brain functions and because basal emotions interfere with the function of these higher brain functions, one of the qualities that successful traders have, is emotional stability and self awareness. These feelings are innate and cannot be blocked but can be dealt with by becoming aware of when they are influencing decisions and ignoring them by sticking to an objective system.

Ultimately, how do you work around the curve balls that your brain throws at you?
Put faith in the technical analysis and the system. Faith is not reason and is not belief that will force your brain to look for evidence. Once you find a good system, you should be able to rely on it, even when your gut feeling says don't. The numbers are reliable but what your brain tells you isn't.

Maintaining objectivity in the face of innate behavioral response can be hard but the only written memento that will get you through it is: be objective, be introversive, try to keep your emotions stable and put your faith in a system and numbers.

Wesley Govender

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