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Trading Psychology

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Many people make the costly mistake of ignoring the influence of human psychology on the mind of the trader. In fact, when trading manually, traders tend to make costly mistakes mostly because trading decisions are primarily driven by an emotional response. Traders, using their emotions, often rely upon their experience and expertise when faced with tough decisions. These triggers are called emotional triggers which are used to decide what trading action to take.

Fear and aggression are a part of trading, whether we like it or not. The challenge here is to control one's emotions as they tend to get the better of us, especially when trading. A lot of this can be attributed to a trader's Fight or Flight instinct, which is an emotional response.

What is the Fight or Flight Response?

First described in the 1920s by a famous American psychologist, Walter Cannon, the fight or flight response is an acute psychological reaction, which mainly manifests itself when facing something terrifying, either physically or mentally. When people are facing imminent danger, the body releases stress hormones.

While trading, this in-built fight or flight mechanism can have immense control over how traders behave under certain conditions. For instance, if a trader finds him/herself in a losing trade, the brain's automatic response is to cut the losses for fear of losing money. A lot of times, the decision to exit a particular trade is taken without considering the whole market scenario. Traders tend to lose a lot of positive trading opportunities because they had exited their trade earlier than required, due to fear.

1. **When winning trades start badly:** Traders often make the mistake of branding any trade that starts off badly as a losing trade. This is, however, far from the truth as many winning trades can also start badly. Novice traders are thus advised to always trade with the trend.

In such a circumstance, if a novice trader enters a trade based on a trend-based system, he/ she must be mindful when the trend has pullbacks. They often make the mistake of exiting the trade when the price action looks worst. However, in such a circumstance, traders are advised not to exit and hold on until their next exit criteria have been fulfilled. This is because trends that have a strong pullback almost always have a strong rebound as well, as the price rises.

2. **Exiting too early:** Many traders have the urge to exit a trade when the price goes in their favour after a short period of time. Traders tend to panic and exit the trade out of nervousness. Traders are advised to resist the temptation of exiting the trade by eliminating the fear of losing profits. They should wait for the price to reach a target or trigger an exit according to a pre-determined exit criterion.

3. **Smoke and Mirrors (In trading):** Smoke and Mirrors refer to a particular circumstance, where the price action makes a move that hints at a move in the opposite direction of the trend. This usually happens just before the market makes a big move. The quick price move has a tendency to entice amateur traders, who tend to trade in that direction.

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Tips to Tackle the Fight and Flight Response

Traders are always advised to enter trades based on the rules of their own tried and tested system, and not to succumb to emotion. This can be explained in the following points below:

- Target levels and criteria should be set for all trades when exiting at a profit, even if the target is not met.
- The reasons for entering a trade should always be based on a proven system.
- A physical stop level should be added as a safety feature to prevent a complete wipe-out of your account.
- All trades should have a specific criterion which notifies the trader if he/she is wrong.

What Type of Trader Are You?

Based on the details of their trading methods, traders can be classified into different types such as Day Traders, Swing Traders, Momentum Traders, and others. However, the psychological aspect of such traders is often overlooked while judging a trader.

Traders can be classified into the following categories based on certain traits or their forex trading psychology.

Arrogant Traders: Traders with arrogance tend to make decisions based on their ego and to prove that they are right even if it's an unfavourable situation.

Trend Traders: Traders who only ride a trend to make money.

Scared Traders: Traders whose main priority is not to lose their own capital.

Novice Traders: Traders who do not have much idea about the nature of the markets and are only there to gather knowledge and experience.

Greedy Traders: Traders who take large risks in the hope of scoring big.

Perma-Bear Traders: Traders who have the singular goal of shorting trades.

Perma-Bull Traders: Traders with the sole purpose of long trading.

Paper Traders: Traders who have studied the market over some time but still do not directly plunge into real-money trading.

Prophet Traders: Traders who only focus on predicting market movement.

Rich Traders: Traders who consistently make money and have built up immense capital over the years.

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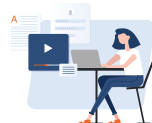
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Answering the Question: What Type of Trader Are You

Many traders, especially in the forex market, are confused about their own set of trading strategies and go by instinct. However, it is crucial for a trader to be aware of the type of trader he/she is, before going any further.

Day Traders: These are traders who usually pick a side at the beginning of the day, act on their bias, and finish with either a profit or a loss before the market closes for the day. They are called "Day" traders because they do not hold on to their trades overnight.

Swing Traders: Traders who prefer to hold on to trades for many days at a time are referred to as Swing traders. Their trading practices usually involve dedicating a couple of hours towards analyzing the market every day, as they cannot always monitor their charts on a 24/7 basis.

Scalpers: Traders whose main objective is to grab very small amounts of pips many times throughout a trading session are known as scalpers. They usually operate in the busiest trading hours of the day and hold on to trades for a few seconds or a few minutes before exiting.

Position Traders: Traders who enter into trades that last for several weeks, months or in some cases years, are known as position traders. Their trading decisions are usually based on some fundamental themes that they predict to be a predominant factor.

THE IMPORTANCE OF A TRADING PLAN

A forex trading plan acts pretty much like a road map, guiding the trader to successful forex trades, turn by turn. Taking decisions blindly, without a set plan, can be challenging for experienced traders too. Forex trade plans are used not only by novice traders but by successful and experienced traders as well.

A pre-set trading plan helps traders to practice forex trading in a more organized way. This aids in identifying opportunities and taking advantage of them.

A sound trade plan provides a significant level of clarity, clearly defining the objective and the crucial steps to be taken. This clarity acts as a boon when the traders are required to make swift decisions in order to make the most of the fast-moving market.

Having a plan with clearly set objectives boosts confidence, allowing the trader to involve fewer emotions and trade factually. In risky ventures like forex trading, the confidence to trade even after bearing losses can be a big factor differentiating between failure and success.

The complexities and technicalities involved in forex trading can be puzzling, appearing to be chaotic. A plan helps traders in ordering out the "noise" or chaos and making sense of the market's behaviour.

When traders diligently follow a trading plan, they are able to control the characteristics of emotions in psychology. This prevents them from making any emotional decisions that could lead to loses.

Drafting a Forex Trading Plan

To sum up, a sound forex trading plan helps a trader in making informed and clever trade decisions. A trading plan does so by helping the trader in four key areas of forex trading:

- **Setting Objectives and Identifying Goals**
- **Organizing Trading Activities and Market Research**
- **Decision Making Related to Currency Positions and Movement Direction**
- **Managing Risk and Emotions when placing a trade**

Though it might seem like a very complex undertaking to draft a trading plan, it is fairly simple, and you have the complete freedom to dictate its complexity. Most traders follow and a basic plan that can be undertaken easily and inculcates the technical indicators clearly. When drafting a plan, the following basic elements should be clearly defined and incorporated into it:

- **Profit Goals**
- **Evaluation or Position Sizes**
- **Guidelines and steps to manage and maintain the positions**
- **Clear trade objectives to follow when choosing, placing or closing trades**
- **Provision for adjusting the trading strategy as per the changing conditions of the market**

Keeping a Trading Journal

As apparent from the amount of research already conducted on this topic, there are several evidence-based approaches which suggest the practice of journal keeping for forex traders. It has an immense implication on a trader's discipline, emotional psychology, and ultimately on the overall trading psychology of the individuals involved.

There are many traders who have maintained a trading diary and have attained success later on. However, there are other traders, who maintained journals but committed some common mistakes while maintaining them. These are described in brief below.

Isolated Entries: Traders tend to make the mistake of not making entries chronologically or without labelling them properly. For instance, a trader who maintains a daily forex trading journal but whose entries do not reference one another is of no use. This does not fulfil the purpose of journaling in the first place, with the trader getting little cumulative benefits from the practice. This is a very common mistake with traders failing to look over their own diary entries from a week or a month ago.

Inconsistent: Traders who do not practice journaling the proper way, tend to create detailed entries on some days, while maintaining really sketchy ones on the other days. The frequency at which journal entries are made might also differ, sometimes being more frequent and sometimes being less. The problem occurs when the frequency of the journal entries does not match the frequency of trading, which ultimately does not solve the purpose of maintaining a journal.

The Narrowness of Facts: Many traders maintain journals which focus only on one of two main areas of the trader's activities and not the overall trading session. For instance, a trader may choose to focus more on psychology and not on trading decisions. The journal might also focus just on the market entry and exit points, avoiding other crucial aspects such as risk management and overall position.

Proper Reporting: Many traders think that maintaining a journal only involves the recording of important trading events. However, many overlook the crucial aspect of analyzing why certain events happened in the market, rather than just noting them down. This results in a group of journal entries which end up being more descriptive rather than being prescriptive, using the journal as more of a reporting tool rather than a performance building tool.

Maintaining a journal with frequent entries help traders address problem patterns before they occur, with the goal of cultivating positive habit patterns.

Learning and Rectifying Trading Mistakes: By maintaining a daily trading journal, traders maintain records of their daily trading actions. By examining them, traders can identify what was done right or wrong, or why an event was desirable or not. For example, journal entries can identify a way of scaling into a position, based on past trading decisions made by the trader. Subsequently applying that in future trades can lead a trader towards success.

Reviewing Entries: After setting a goal and a plan for reaching a goal in journal entries, traders should also allocate a little time towards reviewing the steps taken to reach the goal. They can also review any shortfalls and hurdles that came in the way of achieving their trading goals. A lot of times traders can find out important information from past profitable trades, which help them to incorporate into their daily strategy for earning profits.

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