PART ONE

Psychology of Risk Control

CHAPTER 1

It Just Ain't Sexy!

Money management probably doesn't come up as the number-one item on your top-ten list of fun things to study. That is, not until you start making money as a result of getting really good at it. The key for every trader is to discover the financial benefit to sound money management—and then all of a sudden, it becomes totally fun. Once you see how effective sound money management can be at ensuring profit and avoiding the risk of ruin, it might just become your favorite part of trading!

WHY IS MONEY MANAGEMENT SO BORING?

Upon hearing the term *money management*, you may think, "Why does money management have to be so boring?" Well, maybe that's because it's so much more exciting to get into a financial market with a flurry of activity and not a care in the world. And it's just that kind of behavior that gets the average novice trader into trouble because they don't yet own the perception that risk analysis and money management really is important.

Isn't it much more fun to dream of the phenomenal huge financial outcome of one's newly entered trade than to plan for the seemingly remote possibility that there could be financial loss? After all, why be negative?

At first glance, it seems that placing a trade and getting in the game is thrill enough in itself. What more could you ask for? That is, what more could you ask for, until the position unexpectedly goes in the wrong

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direction, generating a loss of capital. But, that's only a paper loss you say, since the market will surely get back on track and go in the right direction. No problem!

Then it seems the market is not being cooperative, and for some reason, it does not comply with the plan (of making lots of quick cash) and it does *not* go in the desired direction. Instead, it continues in exactly the *wrong* direction. Isn't that when the thrill of entering a great position instead becomes the anxiety of wondering how to get out of a not-so-great position? Of course, the adrenaline kicks in, the heart rate increases, sweaty palms appear, and the physical metamorphosis from thrill to dread quickly evolves.

So, let's see, the position instantly gaps—again, it's going in the wrong direction. How can this be? That gut feeling was so clear and compelling when we entered the trade. It was a sure thing, wasn't it? We couldn't have been wrong, could we? Now at this point, the trade is so far gone, we can't afford to get out, can we?

Most of this evolution of a position gone bad has to do with entering the market and risking real cash without having a plan, a stop, and a tested money management system—*before* the entry.

It's a pretty common occurrence, actually. It's happened to the best of us. There are many reasons that it happens—ignorance, impatience, inability to admit we might be wrong, inexperience, or, worst of all reasons, an addiction to the adrenaline rush of taking on a position (for better or worse).

Regardless of the reason, I'm guessing that most of us would agree, it's not all that sexy to lose money. It's not much fun, either. The question is, do we find it painful enough to change our thinking and implement a money management plan now, or will it take another loss or two to bring the concept home?

The answer to that question is different for everyone.

PSYCHOLOGY OF RISK CONTROL

The psychology of risk control sooner or later begins with genuinely believing that you will benefit from a risk control plan. Then, it's a matter of directing your resources toward that goal. Regarding resources, you'll need to devote time to design a plan, allocate some money for purchasing tools and materials that will assist you, and then, most importantly, focus your emotional energy on rethinking how you look at money and the markets.

Maybe you'll be one of the few lucky ones who will own the belief that risk control is important right off the bat. More often than not though, most traders learn this lesson the hard way—by losing money. Regardless,

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developing your risk control psychology will be a crucial key in developing a personal money management plan that works.

When you've mastered your psychology, you'll experience less anxiety and will be able to implement your plan more consistently. There are often times when traders will design a terrific plan that emotionally they don't adhere to because their psychology is not fully developed. It takes time, but as the profits increase, resulting from a sound money management plan, your psychology will gradually strengthen.

STEP NUMBER ONE: MAKE IT SEXY AND MAKE IT FUN

To begin with, making money is sexy and making money is fun. So, if you can translate these two understandings into a money management system, you'll be way ahead of the game. For example, instead of dreading a *stop out* (which, by the way, is a natural part of trading) when your system tells you the trade has gone bad, think of it as getting one step closer to the winning trade.

From a probability standpoint, if your system generates six winners for every four losers, then the sooner you get the losers out of the way, the sooner you'll get to ride one of the winners. That's a whole lot more fun than focusing on some insignificant monetary loss from a stop out.

When I say insignificant, that's because what we'll be covering in the following pages is a strategy where all of your stop-loss exits will be set at a point where the most you will lose on any one trade will be 2 percent of your trading account. That is a manageable loss, and on a $10,000 trading account the most you will lose on any single trade will be $200. Not too bad, right?

By limiting your loss potential on each and every trade, you will reduce the anxiety associated with stop-outs and will automatically strengthen your psychology.

IMPORTANT NOTE: For some advanced traders, it is beneficial to risk more than 2 percent of their trading account. The amount these traders risk must be carefully calculated depending on their proven historical performance statistics. See Chapter 9 for the formulas to determine if your payoff ratio and win ratio performance warrant a higher risk than 2 percent.

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FEAR AND GREED ARE NOT THE ONLY EMOTIONS IN TRADING

In the movie *Wall Street*, Gordon Gecko says, "Greed. . .is good." Gordon may be a bit overzealous in his love of greed, but that is certainly an entertaining scene in the movie!

When the psychology of the markets is discussed, fear and greed are often the most common emotions that are bantered about. And yet, there are a number of other, equally important emotions in play.

Here are some *negative* psychological motivators (other than fear and greed) to consider when evaluating your own trading psychology:

- Regret
- Anxiety
- Blame
- Dread
- Anger
- Apathy
- Denial

Here are some *positive* psychological motivators to consider when evaluating your own trading psychology:

- Happiness
- Acceptance
- Anticipation
- Pride
- Appreciation
- Confidence

When evaluating your psychological and emotional motivators, you want to focus on ways in which you can reduce the occurrence of negative emotions and increase the occurrence of positive emotions. You may not decrease all the negatives, and you may not increase all the positives, but the growth goal is to strive in this direction.

PSYCHOLOGICAL MOTIVATORS

We're all driven by both positive and negative psychological motivators. What a sound money management system will do for you is diminish your negative motivators and increase your positive motivators.

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For example, if you know that the most you'll lose on your $10,000 account is $200 on any one trade, that decreases and relieves an enormous amount of anxiety. Stress and anxiety are negative motivators, and the less of these you have, the more profitable you will be (and the more you will enjoy your trading).

As you gain confidence in your plan, you will begin to see your profits increase. There is a certain amount of pride that comes from generating greater profits on each trade, and that increased pride is a positive psychological motivator.

These are just a couple of illustrations of how to view your psychology. Ideally, you want to look at your own personality and emotional tendencies to determine which negative and positive emotions you experience while trading. The goal is to enjoy the process of trading—to decrease any negative emotions you may have and increase the positive ones.