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Emotional trading - fear & hope

It goes without saying that understanding the nature of the forex market, knowing how to apply fundamental and technical analyses, and being able to assess the direction of a trend are necessary skills for every trader.

However, one of the most important, yet also most overlooked aspects of trading is related to emotions. Successful traders are aware of their emotions while trading and have learnt how to be disciplined and make rational rather than emotional decisions.

The two emotions that can cause most damage are fear and hope. Fear, which usually creeps up on traders while in profit, can make them doubt the likelihood of taking their initial desired profit amount. This may push them into getting out of a trade too early and realise a much smaller profit than initially planned. It may also prevent them from taking advantage of a good trading opportunity. Hope, which creeps up when a trade is losing, can cause the trader to hold onto a poor trade for far too long.

Small profits and larger losses are the last thing we want to see in our trading accounts, so why do we do it? If you can relate to what you have just read about emotional trading, read on as we look at a few examples when emotions lead to bad trading decisions and assess how we can fix it.

Alex

Alex's two previous trades closed with a loss, and this is weighing on his mind. He is afraid that the next position he takes will result in a loss too. Because of his fear of loss, he delays placing another trade when his methodology tells him to do so and waits for extra confirmation that his idea is okay, at which point it is too late. His hesitation causes him to miss a perfectly good entry opportunity.

Anna

Anna opens a trade with a take profit amount of $1,000, and the trade goes into profit. It jumps from $200 to $550 to $750, and Anna continues waiting for her $1,000 target. Because prices don't usually move in a straight line, the price temporarily reverses, bringing her unrealised profit down to $200. When Anna sees her profit fall, she starts to worry that she will miss her chance of taking any profit at all, and this fear becomes intensified as the profit drops to only $50. She closes her trade the moment she sees it back up at $200. The emotion of fear causes her to take a much smaller profit than what she initially targeted. In this example, had she waited another 10 minutes, the price would have continued moving in her favour and her deal would have closed with her target profit of $1,000.

Mark

Mark sees a potential opportunity and opens a trade, but it quickly turns against him. As he didn't plan to lose his margin so quickly, he decides to wait for some time, hoping that the market will move back in his favour. He sees the loss on the trade grow from -$100 to -$400 to -$850 in minutes, approaching his margin amount of $1,000, and because he doesn't want to take this loss, he quickly increases the margin to $2,000. He thinks that if he keeps his stop loss a safe distance out, it is just a matter of time before the price turns around and he closes the trade at zero. After some waiting, his loss shrinks to -$300 and then -$150, and he continues watching the trade for a chance to close with zero losses. Unfortunately, the market moves against him again and he sees the loss at -$450, and then later at -$900. At this point, the hope of avoiding a loss completely controls his trading decisions; he may move his stop loss even further out so that the market does not take him out, or he may ignore the trade hoping that it will get back to at least break-even. What was supposed to be a day-trade turns into a position trade of a few days, and may even become a long-term 'buy and hold' strategy, with Mark unable to discern the right time to close the deal. After a lot of waiting and hoping, the trade closes with a -$3,000 loss because he added even more money to his margin in the hope of saving the trade.

Plan your trade and trade your plan

Had Alex demo-tested his trading strategy until he was happy with it and had he been aware that even a winning strategy can sometimes have a series of losing trades, he may have been more confident and taken advantage of the good trade set-up that appeared. Similarly, had Anna known that her impulse to close the deal is emotional rather than rational and probably not a good idea, she would have ended up with a bigger profit. Lastly, if Mark stuck to his planned maximum loss of $1,000, he could have afforded to place three losing trades instead of just one, and chances are, some of his trades would have been profitable and boosted his account!

So, we can see these traders are making mistakes by acting on their emotions of fear and hope. Does any of the above sound familiar?

The good news

There are ways in which traders can put their emotions aside and avoid the above mistakes. In order to avoid missing trading opportunities, you should have a strategy which gives clear entry and exit signals when a number of pre-defined factors coincide. Realise that just as some trades will win, some will lose, and it is no cause to panic or doubt a tried and tested strategy. Test your strategy extensively on a demo account or a live account with smaller deals, until you are confident to follow it without question. The next step is to enter and exit the market every time the pre-defined signals arise, irrespective of the performance of your last few trades, and irrespective of your 'feelings' about what the right move is. Every successful trader realises that no matter what trading strategy they use, each and every losing trade might turn in their favour, or might hit their stop loss. The stop loss is in place to minimise potential losses, and should remain in place no matter what. It is the trade strategy that should dictate where the target profit and loss levels are and not the trader's fear or hope.

The easyMarkets advantage

One of the great benefits of trading on the easyMarkets platforms is that you can set stop loss and take profit limits that allow you to take some of the emotion out of trading. Plan and test your strategy, set your limits and keep your goal in sight.

A trading plan in five simple steps

1. Define your trading strategy

A consistently successful trader always has a defined trading method. Guessing or going by your gut doesn't always work. Without a defined trading method there is no way for you to know what constitutes a buy or a sell signal, or to even consistently identify the trend. Decide what your method is, which technical indicators or other tools (e.g. candlestick analysis, etc.) you will use, what your buy or sell signals are, and finally define how you plan to exit a position, with a take profit and a stop loss in place.

2. Be disciplined

Once you have defined a method or a system that works for you, follow it. It is important to stick to the levels you selected for your stop loss and your take profit, always targeting a larger profit than the amount you are willing to lose. Adding to your margin and moving your stop loss further is likely to result in larger losses. Your stop loss should be placed at a level where you can accept that the market has moved against you and you are willing to take the loss.

3. Be realistic with your expectations

The goal for every trader in their first year of trading should simply be to stay in the game. You can't experience above-average returns without exposing yourself to above-average risk and as a new trader you should not take on more risk. Remember, you should only risk what you can afford to lose. So be realistic with the stop loss and take profit limits you set.

4. Be patient

Markets trend only 20-30% of the time, and the rest of the time they are not moving in one clear direction. This means that you need to be patient, and wait for trends to form and give you good trading opportunities. For example, if you're a medium-term trader, there will usually be only two or three good trading moves in the market in any given week. All too often, because trading can be so exciting, new traders want to trade all the time. But this means you are probably over-trading, and doing it at a much lower standard too. Patience is important, so be prepared to wait and stick to your trading strategy.

5. Manage your money effectively

This is a very important point, and it explains why many traders lose the balance in their account after just a few trades. While new traders may risk half or even their entire free balance on one trade, experienced traders tend to limit their risk on any given position to 1- 5% of their portfolio. If we apply this rule to ourselves, then for every $5,000 we have in our trading account, we can risk only $50-$250 on any one trade. If you have a small trading account, then trade small, or top it up so that you can trade the deal sizes you want.

And remember: plan your trade, and trade your plan. Always!

easyMarkets and you

Since 2003, we have guided many new traders like yourself into the exciting world of forex trading. In our experience, education and information are key to successful trading. When people fail, it's usually because they risk too much too early, before they understand what to do. We encourage and help you get the information and understanding you need before you start to trade. This way you will have the right tools, the right knowledge, and the right attitude to trading.

ARE YOU READY TO TRADE?

OPEN AN ACCOUNT

Trading could lead to a loss of your invested capital

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