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Curtis Faith

TRAIN YOUR GUT LIKE A MASTER TRADER

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Neuropsychology has taught us that the physical structure of the brain is prewired with certain tendencies designed for survival and reproduction of a species. These tendencies or instincts function similarly to a series of prime life lessons that are with us when we are born and that the brain applies opportunistically. These prime lessons are also referred to as cognitive biases, and some would suggest that these biases represent faulty thinking processes. This is incorrect. In most circumstances, cognitive biases are very useful. However, in specific limited scenarios—particularly in trading and finance—they can trip you up.

To become a master trader, you need to retrain your gut to override cognitive biases in specific trading circumstances. Traders also need to understand these cognitive biases to avoid *herdthink*. When you've gained control over your cognitive biases, you can choose the appropriate course of action: anticipating the herd, doing the opposite of the herd, or avoiding any action while the herd panics.

Gun-Shy: He Who Runs Away Lives to Fight Another Day

The instinct for avoiding unnecessary risk can be very powerful. This is a trait that ensures survival under conditions of danger and uncertainty. When deciding whether to risk getting eaten by a crocodile, a lion, or another dangerous animal, humans needed to minimize risk as much as possible. The rule "Better safe than sorry" makes sense for most people most of the time. Driving at a prudent speed, eating a healthy diet, keeping in shape, using child seats in the car, and avoiding unnecessary risks pay off in longer life expectancy.

But in trading, avoiding risk will prevent you from becoming a good trader, let alone a master. Traders trade in risk; it's that simple. Master traders view risk as an important and necessary ingredient in any potential trade. They know that the very best trades are often the ones that are hardest for most people to make because of the perceived high risk. The very fact that a trade is difficult to initiate makes it less likely that others will also make that particular trade. The lack of a large number of traders taking a similar position makes it much easier to make money during the subsequent price movement.

News and Noise: Listening to What Matters

Your brain wants to save energy and storage, so sometimes it takes shortcuts. One of the most common and useful instincts is the shortcut of ignoring the details in a complex picture by focusing on and retaining only a few specific points. The brain's sensory-perception system is architected to do this. People have three kinds of memory. Sensory memory lasts from milliseconds to seconds and holds information from the senses that the perception system then processes. The perception system uses working memory, lasting from seconds to minutes, and sorts and filters information that cognitive systems need to process. Your cognitive systems are consciousness and attention. These systems process the information from our perception system, discarding anything unimportant and retaining key information or anything that it believes might be useful later in *reference memory*, which lasts for hours, days, or years. Much of the time, your visual perception system is processing and then discarding most of what you see. Your working memory holds on to images that are noteworthy—things you find especially interesting or novel, things that might harm you, anything that presents opportunities for food or mating, and anything that might affect your social standing. All these types of visual images represent, either directly or indirectly, the images that are most likely to affect your ability to survive and procreate.

If you overload the sensory system, it will go numb and start to ignore the signals it receives. This is one of the reasons 24-hour financial news channels can be so harmful to traders. *Too much data exists, and much of it is irrelevant.* The financial news programs create the illusion of market movement when nothing significant has happened, in order to have something to report. They build the story and reasons behind the market going up or down even when the market moves up and down in only meaningless amounts.

The perception system is designed to look for outliers, the standouts. If you spend too much time listening to news channels or reading the wrong blogs and Twitter streams, you can start to lose the ability to distinguish the standout from the noise. Most of the time, the markets are not doing anything that merits our attention.

Your perception is normally very good at filtering signal from noise. One of the more interesting examples that illustrates this point is a person's ability to tune out noise to focus on a single conversation during a cocktail party or at a large table at a restaurant. Scientific studies have shown that, to your mind, the conversation to which you are paying attention appears louder than it actually is, sometimes as much as three times louder.

However, if the noise is too loud, your perception system cannot distinguish among the different conversations, and you will have trouble focusing on your own conversation. The noise will overstimulate your sensory system and cause it to function less efficiently. The same thing happens when you overstimulate your perception system by watching the markets too closely, watching financial news incessantly, or obsessing over every tiny up and down the market makes. Master traders have learned to pay attention to what is important and to ignore noise. Your brain is naturally good at this if you train yourself to not overstimulate it.

If you get bored waiting for something significant to happen, you should do something else while waiting for the market. Trading can certainly be exciting at times, but it is not entertainment. Don't treat it like it is. Sometimes doing nothing and being patient is the right thing to do.

As Jesse Livermore famously said, "The market does not beat them. They beat themselves, because though they have brains, they cannot sit tight."

Good Decision, Bad Outcome

Perhaps the most insidious instinct for traders is the brain's tendency to equate the quality of a decision with its outcome. The brain is not designed to process the type of low-probability outcomes that traders often encounter, where losing is part of the game. Therefore, new traders will often make a trade, lose money, and then think to themselves, "I shouldn't have made that trade." In behavioral finance, this tendency is known as *outcome bias*.

Master traders know that any particular trade could be a losing trade and that good trading strategies often bring losing trades. Therefore, they have learned to undo the effects of this outcome bias and to focus not on the outcome for a trade, but instead on the quality of the decision behind the trade.

Right-brain-dominant traders have an advantage in this area. The right brain naturally focuses on the big picture—the forest instead of the trees. This is the correct approach when examining a series of trades. The big picture matters—the effect of a large number of trades.

The individual trees don't matter except in how they contribute to the overall forest.

Left-brain-dominant traders will find it harder to retrain their instinctual tendencies toward this bias because their nature encourages them to logically evaluate every trade on an individual basis to determine whether it was good or bad. Traders can't really make this sort of evaluation. Individual trades are neither good nor bad. Only when the trades are considered in aggregate can any sort of evaluation be made—and that evaluation is not of the trades themselves, but of the strategy that produced them.

What Have You Done for Me Lately?

The brain's perception system weighs recent data more heavily than data that preceded it. In behavioral finance, this tendency is called "recency bias." This is a temporal instinct. In trading, this tendency is responsible for some of the patterns that emerge in price charts.

Although the most recent prices are sometimes important, focusing solely on the most current information to the exclusion of all other data creates problems for market participants. This tendency can often magnify the effects of mental inertia. Mental inertia will cause many traders to discount the rise in price as indicative of anything significant. This will make them less likely to want to buy. A focus on recent pricing will cause many traders to view the new prices as "high" in relation to recent prices.

Because many traders, especially new traders, don't like the idea of buying when the price is "high," they avoid trades at relatively high prices. They want to buy when prices are "low" and sell when prices are "high." Master traders consider the recent past but do not weigh it more than is justified. Therefore, they have no problems buying when others consider the price "high" or selling when others consider the price "low." Master traders also understand how this tendency to focus too much on the recent past can cause other traders to miss opportunities and to react too slowly during major market shifts.

Follow That Herd

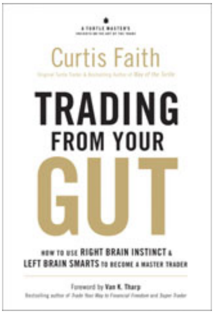
One of the mental shortcuts that our brains are programmed to make is the belief that doing what others are doing is safer than doing something different. Human beings are social animals. We take cues from others in our social circle. This tendency is a mental shortcut that saves us valuable effort. In a small tribe or band, following others makes good sense. It serves as the basis for much of our learning. We learn by following the example that others set. We learn what foods are good to eat by eating what others eat. We learn our culture. We learn our preferences.

Marketers have used this tendency to increase demand for their products, knowing that consumers take their cues from prominent individuals. That's why the use of celebrity endorsements is so effective. We have no logical reason to care what kind of car Tiger Woods drives, but we are nevertheless influenced in our purchase decision by that knowledge.

This tendency, which is known as the *bandwagon effect* in finance, causes major problems for traders who are not aware of how it impacts the market. Too many people jumping into a market almost always results in bubbles and busts. The stock market bubble of 2000, the real estate bubbles of 2003 and 2007, and the oil and commodities bubbles of 2007 and 2008 were all caused by too many people jumping on the bandwagon at the same time.

Master traders don't make trades because others are making them. They make trades for their own specific reasons. They look to get aboard before bubbles develop, and they are quick to exit at the first sign of trouble. However, those who get caught up in herd mentality join the bubbles long after the market starts rising. Then they exit only when the herd itself exits, which is after the bubble has burst and all the profits have dissipated with it.

If you want to be a master trader, you need to develop your own reasons for making trades, and you need to avoid doing anything just because others are doing it. Independence of mind and spirit is one of the hallmarks of a master trader.



If you liked this Element, you might like the book by Curtis Faith, *Trading from Your Gut: How to Use Right Brain Instinct & Left Brain Smarts to Become a Master Trader* (ISBN: 978-0-13-704768-0).

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