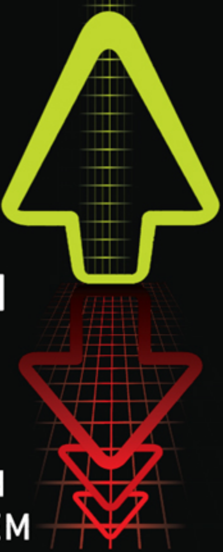
20 MOST COMMON TRADING MISTAKES AND HOW YOU CAN AVOID THEM



KEL BUTCHER

TRADING WISDOM FROM VAN K THARP, JAKE BERNSTEIN, BRETT STEENBARGER, RUSSELL SANDS, LOUISE BEDFORD, CHRIS TATE, LARRY WILLIAMS, GLEN LARSON, RYAN JONES, GARY STONE AND MORE ...

20 MOST COMMON TRADING MISTAKES AND HOW YOU CAN AVOID THEM

KEL BUTCHER

Wrightbooks

First published 2009 by Wrightbooks
an imprint of John Wiley & Sons Australia, Ltd
42 McDougall Street, Milton Qld 4064
Office also in Melbourne

Typeset in Berkeley LT 11.3/14pt

Reprinted in 2011

National Library of Australia Cataloguing-in-Publication entry:

Author:	Butcher, Kel.
Title:	20 most common trading mistakes: and how you can avoid them/ Kel Butcher.
ISBN	9781742169293 (pbk.)
Notes:	Includes index.
Subjects:	Investments.
	Stock exchanges.
	Investment analysis.
Dewey Number:	332.02401

Printed in China by Printplus Limited
10 9 8 7 6 5

Disclaimer
The material in this publication is of the nature of general comment only, and does not represent professional advice. It is not intended to provide specific guidance for particular circumstances and it should not be relied on as the basis for any decision to take action or not take action on any matter which it covers. Readers should obtain professional advice where appropriate, before making any such decision. To the maximum extent permitted by law, the author and publisher disclaim all responsibility and liability to any person, arising directly or indirectly from any person taking or not taking action based upon the information in this publication.

Contents

Acknowledgements *ix*

Introduction *xi*

1 It's not my fault—I didn't even know it was a mistake!
Mistake 1: defining a trading mistake (with Dr Van Tharp) 1

2 The horse goes in front of the cart
Mistake 2: jumping into the market before having learned the required skills (with David Hunt) 13

3 Failing to plan is planning to fail
Mistake 3: not having a clearly defined and documented trading plan (with Justine Pollard) 23

4 Get that monkey off my back
Mistake 4: not trusting your own ability (with Louise Bedford) 35

5 Nice knowing me
Mistake 5: not aligning your trading strengths (with Brett Steenbarger) 45

6	**Easy come, easy go** Mistake 6: overcomplicating the entry process (with Russell Sands)	57
7	**Complex complexity** Mistake 7: making trading too complicated (with Davin Clarke)	65
8	**Too many contracts, not enough shares** Mistake 8: not understanding money management (with Ryan Jones)	73
9	**1000 per cent return in three days—sure, it happens all the time** Mistake 9: paying good money for a dodgy trading 'system' (with Wayne McDonell)	87
10	**Heads, I win; tails, you lose!** Mistake 10: failing to understand the numbers (with Gary Stone)	97
11	**Bet big to lose big** Mistake 11: misusing leverage and margin (with Christopher Tate)	111
12	**What's the time, Mr Wolf?** Mistake 12: confusing time frames and trading strategies (with Jake Bernstein)	125
13	**Where the ^!*# is the exit?** Mistake 13: not having a clearly defined exit strategy (with Larry Williams)	135
14	**But the guy on TV said it would go up tomorrow!** Mistake 14: listening to the advice of media and others (with Glen Larson)	147

15 **Half price and still too expensive**
Mistake 15: averaging down (with Tom Scollon) 157

16 **I'm right! The market's wrong**
Mistake 16: lacking discipline (with Dr Harry Stanton) 165

17 **The emotions of a robot**
Mistake 17: emotive and subjective trading (Kel Butcher) 173

18 **Overworked and underpaid**
Mistake 18: overtrading (various) 185

19 **Fat fingers, 10 000 too many, and busting trades**
Mistake 19: operational errors (with John Robertson) 197

20 **I'm sure I filed that somewhere …**
Mistake 20: avoiding the paperwork (with Jason Cunningham) 207

Glossary *217*

Index *225*

There are no mistakes. The events we bring upon ourselves, no matter how unpleasant, are necessary in order to learn what we need to learn; whatever steps we take, they're necessary to reach the places we've chosen to go.

Richard Bach

Mistakes are the only universal form of originality.

Mason Cooley

Acknowledgements

Writing this book would not have been possible without the involvement of the 18 interviewees. Each of them gave freely of their time among their own busy schedules to ensure deadlines were met and editors kept happy. My utmost thanks go to them for their open, honest and often candid responses to the questions that were posed to them. I would also like to thank them for their ongoing contribution to the education of other traders throughout the world. I am honoured that each of them has willingly contributed to this book.

As always, I am grateful to, and inspired by, the many other traders and students of the markets I have met over the years who have encouraged and supported me in my journey.

Kristen Hammond and the staff at John Wiley & Sons have once again been pivotal, encouraging and supportive as a vague idea of 'yet another trading book' crystallised into the book you are now reading.

My wife Cate and sons Jesse and Ollie provide the balance, support and love that makes it all worthwhile!

Carpe Punctum

Introduction

This is a book about trading mistakes. It is not, however, a negative book. Each mistake is followed with the information and steps you can take to ensure these mistakes need not happen to you. The mistakes discussed within the pages of this book are the more common mistakes made by traders in general, the world over, regardless of the markets they trade. They apply to stock market traders, foreign exchange traders, traders using tic charts to scalp the equity indexes, traders using long-term breakout systems to trade futures or stocks, and everything else in between.

While the title refers to 20 mistakes, there are actually far more than that covered within the examples and experiences shared by the interviewees. I encourage you to read and study the contents of each chapter carefully and look out for the hidden gems. Often the remedies for the varying mistakes are similar—one remedy might cure a number of ills.

Trading is a wonderful business for those prepared to take the time to learn about themselves and the markets and to do the hard work necessary to become consistently successful. Disciplined, patient and consistent traders will be well rewarded for the time and effort they put in. Those who lack discipline and patience will suffer at the hands of the master of fear and the mistress of greed. They will bounce around from one idea to the next, one broker to the next and one system to the next with no clear plan in place for what they are doing and what they hope to achieve. Eventually they will dwindle away their trading accounts to zero, or stop trading altogether through frustration and stress.

Too often impending traders are sold the dream that trading is easy, and that once you have mastered a few basic skills you can lie on a beach on a deserted tropical island and watch the cash roll into your bank account in a protected tax haven. Nothing could be further from the truth. As with any profession or business, trading requires learning and skill development, a plan and lots of 'blood, sweat and tears' before it becomes rewarding. Despite the media hype, no-one is an 'overnight' success in trading—or any other venture in life, for that matter. Many of the traders interviewed in this book struggled for years before becoming an 'overnight' sensation or whiz kid. They were then able to build on these experiences and what they had learned from the markets to become well recognised for their trading prowess.

All of the interviewees will openly admit that they never stop learning—and neither should you. The markets will continue to change and evolve in the years ahead as new products are made available and technology continues to advance and change the way we trade. As traders we need to constantly evolve, learn and grow with these changes. Through education, awareness and studying the results and experiences of those who have gone before us, we can continue to actively participate in these markets without necessarily having to reinvent the wheel.

Regardless of your level of skill or knowledge you will learn from the experiences shared by the traders and market professionals who have contributed their time and knowledge to this book. Be it the simple necessity to always trade with a predetermined stop-loss, the personal issues of how to manage your own biases and psychology, or more complex issues concerning money management and risk management models, the examples and testimonials of these market professionals are enlightening and encouraging. Many have been happy to openly share personal examples of the mistakes they have made and how they have learned from these mistakes. This honesty and acceptance is what makes them all true professionals in their field.

If you aspire to consistent, rewarding and profitable trading you will gain much from reading the stories shared within.

Trade well.

Kel Butcher
MacMasters Beach, NSW, Australia
April 2009

It's not my fault — I didn't even know it was a mistake!

Mistake 1: defining a trading mistake

The greatest mistake you can make in life is to be continually fearing you will make one.

Elbert Hubbard, *The Note Book*, 1927

My guess is that most of you are probably inquisitive as to what constitutes a trading mistake. Given that this is a book about trading mistakes and how to avoid them, it seems only logical that the first chapter needs to define what mistakes are, and highlight some of the many mistakes that are discussed in the following pages.

Trading mistakes inevitably stem from two main sources: believing that trading is easy; and not having a well-defined plan for engaging the market. Invariably, all mistakes that traders make emanate from these two things. Much of this chapter is from an interview with leading market educator and world-renowned trading coach Dr Van Tharp, whose comments appear in bold throughout this chapter. He offers the following definition of a trading mistake:

A mistake can be defined in one of two ways:

1. **First, I consider it a mistake to make the assumption that trading or investing is easy and that you don't**

need to do a lot of work to be successful. In fact, if people don't go through the five steps [outlined on page 3], then everything they do is probably a mistake. The second definition has to do with the results of the first step.

2. It is a mistake to not follow a complete set of rules and guidelines as a trader; this should be written down in your working business plan. A mistake occurs when you break any of your rules.

A great pick-up line

The romantic notion and lure of trading attracts people to the promise of profit from buying and selling anything from shares in companies, through foreign exchange, to the global commodity markets. It is one of the last great free market activities available to anyone with a computer and a telephone. The entrepreneurial spirit in all of us is kindled by the thought of actively buying and selling gold futures, currencies and a wide range of other markets. It also makes great cocktail party conversation when people enquire as to what you do: 'Oh, not much', you reply casually, 'I'm a trader'. Instantly a world of fast cars, glamorous people and sailing in Monaco flashes before their eyes. Little do they realise that the reality of trading is brutally different from this glossy, shallow image portrayed in the marketing hype of many of the lesser respected promoters in this industry. It takes persistent hard work to become a consistently successful trader.

> Trading is a profession like any other. Most people go through many years of schooling and training to learn their profession, but not for trading. Entry is easy—just open up a brokerage account. It is comparable to the average person walking into a hospital and telling the staff, 'I'd like to practise brain surgery today'. If they'd allow it (as they do trading), then the results probably would be fatal to the patient just as the results in trading are usually fatal to your account if you are one of the typically ill-prepared traders. *The first major mistake people make is not having the appropriate training.*

There are five steps people should go through to get the training they need before engaging the market:

1. Extensive self-examination and working through psychological issues. This is an ongoing process that never truly ends, but I'm willing to say that most people have completed this step when they have solved five major psychological issues. For example, someone might say, 'My self-esteem is low and I have a lot of anger because my father always used to criticise me and put me down. However, I've worked on my anger through various feeling-release techniques and now it seldom comes up'. When people have solved five issues, I think that they can handle most other things that come up and are ready to move on to step two. *Not knowing your common patterns and how you might self-sabotage is a major mistake.*
2. Develop a working business plan to guide you through the trading process. This should include a statement of who you are (resulting from step one); objectives; an assessment of the big picture; at least three trading systems that fit the big picture; a complete set of business systems (like how to do research, how to manage data, and so on); a worst-case contingency plan; position sizing strategies to meet objectives (these would be a subset of the systems); and a psychological management plan. *Being ill-prepared for the unexpected is also a major mistake.*
3. You need several non-correlated systems that fit the big picture. One of the biggest mistakes that people make is to develop one trading system and then try to fit it to all market types. You cannot do it. But you can design a really good system, perhaps even a Holy Grail–type system to fit any particular market. For example, there is a huge difference between a quiet bull market and a hugely volatile bear market, or even a hugely volatile sideways market. And all three markets probably need different systems. You need to understand how to look at market type (in a way that

fits how you trade) and only trade markets in which your system works well. *Trading without a system (defined below) is a mistake. Not knowing how your system will perform in each market type is a major mistake.*

4. You need a great set of objectives that fit who you are and then you need a position sizing™ strategy that fits your objectives. Position sizing is that part of your strategy that tells you how much to risk throughout the course of the trade. Most people don't realise (again a mistake) that it is through position sizing that you meet your objectives. A great system just makes it easier to meet your objectives through position sizing. Not having objectives is a mistake. *Not having a position sizing algorithm designed to meet your objectives is also a mistake.*
5. You need to monitor your trading to minimise the impact of mistakes. This shows that, if you've completed all five steps, a mistake only results from not following your rules. *Not having a plan in place to monitor and correct your mistakes also is a mistake.*

How much did that cost?

When all is said and done, mistakes cost us money—either through not exiting a losing trade at a predefined stop-loss point, not taking trades according to the rules of our trading system due to some arbitrary or emotional influence on our thinking, or just doing things that should never be considered as viable or sensible trading decisions in the first place. All traders need to identify the point at which they accept defeat and cut losing trades as well as a way to monitor their overall performance based on the extent of these losses.

> One of the cardinal rules of good trading is to always have an exit point before you enter into a trade. *Not having an exit point is another mistake.* This is your worst-case risk for the trade. It's

the point at which you would say, 'Something's wrong with this trade and I need to get out to preserve my capital'. Your initial stop defines your initial risk, which I call 1R (where R stands for risk). If you know your initial risk, then you can express all of your results in terms of your initial risk.

Say that your initial risk is $10 per share on a $40 stock. If you make a profit of $50 per share, then you have a gain of 5R. If you have a loss of $15 per share, then you have a 1.5R loss. Losses bigger than 1R will occur when you have a sudden big move against you.

Let's look at a few more. If the stock goes up to $140, what's your profit in terms of R? Your profit is $100 and your initial risk is $10, so you've made a 10R profit. It's quite interesting because portfolio managers like to talk about 10-baggers. A 10-bagger means a stock bought at $10 per share that goes up to $100 — in other words, a stock that goes up in value 10 times. However, I think a 10R gain is much more useful to think about and much easier to attain. When our 1R was $10 per share, then the stock had to go up by $100 to get a 10R gain. But to fit the portfolio manager's definition of a 10-bagger, it would have had to go up 10 times the price you bought it for, going from $40 per share to $400. But the $360 gain in terms of R-multiples when your initial risk was $10 would be a 36R gain!

Thus, another cardinal rule is to have profits that are many times your initial risk. *When you take a trade, if you don't think you can make at least 2R (3R is better), then you are probably making another mistake.* Your profits and losses should always be stated as some multiple of your initial risk, which I call an R-multiple.

In my opinion a trading system is defined by the distribution of the R-multiples that it generates. From that distribution, you can get a mean (average) value which is the expectancy of the system. If a system has an expectancy of 0.8R, on average over many trades, you'll make 80 per cent of your initial risk in your trading system. *Having a system that doesn't generate a positive expectancy is also another major mistake — so is not knowing the expectancy of your system.*

Now that you know about R and R-multiples, you can also start thinking about mistakes in terms of R-values and that's where we've been doing some research.

Analyse to understand

I've been asking the traders that I coach to keep track of their mistakes in terms of R. For example, if you enter the market on emotion and you make 2R, then that counts as +2R towards that mistake. If you do it again and you lose 4R, you now have -2R towards that mistake. If you do that for about a year, you'll have a good idea about how efficient you are as a trader and what your efficiency costs you.

One of my clients was a futures trader, running a $200 million account. We estimated that over nine months he made 11 mistakes, costing him 46.5R. Thus, he made 1.2 mistakes per month, costing him 4.23R per mistake. Overall, his profit was probably 50 per cent less than it could have been because of mistakes. If he made 20 per cent profit, he probably could have made 70 per cent profit. Now can you begin to see the impact of such mistakes?

Another client was a long-term position trader, primarily trading exchange traded funds (ETFs) with wide stops. In a year of trading, he made 27 mistakes costing him 8.2R. Thus, over a year he made 2.25 mistakes per month. However, because he was trading long term with large stops and no leverage, his mistakes were not as costly. Each mistake was costing him 0.3R. During the year of trading he was up 31R (and about 30 per cent). Had he not made any mistakes, he would have been up 39.2R. His mistakes cost him 20 per cent of his profits.

What are your mistakes costing you?

Oops, sorry, my mistake

Mistakes generally fit into two main categories: one broadly relating to overall market interaction; the other relating to everyday operational mistakes. A third category, execution errors, is also discussed in chapter 19.

The first main mistake category are 'global' mistakes — such as not having a trading system and not having a working business plan. Most of the types of errors I've mentioned so far are global mistakes.

The second category includes the types of mistakes where people break specific rules. Here are some of the most common that I've documented:

- Entering on a tip, an emotion or something that doesn't correspond to one of your well-considered systems.
- Not exiting when you should be stopped out.
- Risking too much money on any given trade.
- Doing anything because of an emotional reaction, including exiting too soon.
- Not following your daily routine.
- Blaming someone or something for what happens to you rather than accepting personal responsibility.
- Trading multiple systems in the same account.
- Trading so many trades in the same account that you cannot keep track of them.
- Trading a system when the market type has changed and you know the system will now perform poorly.
- Concentrating on the entry for a system and not the potential reward-to-risk ratio in the trade.
- Taking a profit too quickly or not taking a loss just to be 'right' or prove a point.
- Not having a predetermined exit when you enter the trade.
- Not keeping track of the R-multiples and the general performance of your trading system.

Of course, there are many more mistakes. The more common ones are detailed in this book.

Prevention is better than cure

The good news is that mistakes can be avoided. Through appropriate training and education, including reading this book, you can learn how to avoid the mistakes that the vast majority of people make. If you take the time to learn from the experiences of the contributors to this book, you will be a long way down the road of avoiding many of these mistakes. You can also practise not making mistakes through daily positive reinforcement of a non-mistake making belief system.

I recommend that at the beginning of each day you go through a process called mental rehearsal. Ask yourself, 'What could go wrong today that might cause me to make a mistake?' Suppose you have nothing to do because you'll either be in your positions or get stopped out. Thus, you might decide that the only thing you might do that would be a mistake is to override your stops. For example, you might hear some guru on the television making comments on some stock you own and decide to sell and not keep your stop.

So when you come up with that particular idea, you rehearse how to avoid it. You could turn the television off. You could watch the television without any sound if you must look at charts and prices. Or you could go through some procedure where you neutralise any comments that are said about stocks you currently own.

The market always presents us with events that one would probably never imagine. We've recently had market volatility that is 10 standard deviations bigger than the norm. That has almost a zero probability of occurring if market volatility were normally distributed, but it is occurring. If you are not prepared to trade in this sort of climate, it could be a disaster.

Similarly, who could have imagined that the US stock market would actually close for a while because the World Trade Center was destroyed? Did you predict that one?

I recommend that everyone do a daily mental rehearsal by asking, 'What could go wrong today to cause me to make a mistake?' Become creative and think of everything. For everything you come up with, rehearse how you'll perform to make sure that it doesn't have a significant impact upon your trading.

One day you might meet that big losing trade in the markets that has your number on it. Wouldn't it be a good idea to be prepared for it ahead of time? If you make one mistake in every 10 trades, then you are 90 per cent efficient as a trader. Increasing your efficiency from 90 per cent (that is, one mistake every 10 trades) to 98 per cent (that is, one mistake every 50 trades) could actually double your return rate or more.

First time it's a mistake, second time it's my fault, third time I'm an idiot

As well as being financially costly and emotionally devastating, repeating any mistake more than once is just plain stupid. But it need not be a part of your psyche if you choose to not make the mistake again, and if you choose to work through a process to review mistakes to ensure they do not recur.

Repeating the same mistake over and over again is a form of self-sabotage. And it's one that anyone should be able to understand. At the end of each trading day, I recommend that you take a minute to review your trading and ask yourself, 'Did I make any mistakes?' If you didn't, even if you lost money, then pat yourself on the back. You actually did well.

If you made a mistake, then look at the situation that led to the mistake. What happened that you need to look out for in the future? This is probably a mistake that you did not deal with in your mental rehearsal. You need to mentally rehearse the situation to make sure that you don't repeat the mistake. Rehearsing your solution in your conscious mind several times puts it into your unconscious mind and helps you make