

Losing Trades; Part I

I'm always looking for the formula. There's a formula for everything. When it comes to holding on to losers and taking winners too soon, there's also a formula.

Kahneman and Tversky (K&T) wrote a paper in 1979 that advanced much of the work done in this field from the late 1930s all the way to the early 1960s. Their theory is called the *Prospect Theory*. Shefrin and Statman (S&S) took that work a step further, in 1985. Their theory is called *The Disposition Effect*. Barber and Odean (B&O) took it further and called their theory, simply, *Overconfidence*. All these theories can be grouped into a category called *Behavioral Finance*.

The common denominator from these studies (including two studies I haven't mentioned that were done in the 1930s and 40s) are startling considering the length of time taken into consideration. All of the studies state that traders hold losers too long and get out of winners too soon. But why? Why do traders do this?

Concerning losers, K&T explain that traders don't sell losers because of the *desire to avoid the regret of a losing trade*. It's that simple; a trader has not come to terms with the loss. This means they didn't do their homework. This means they didn't have a plan. A trader must answer four questions before getting into a trade.

1. Why am I getting into the trade?
2. Where am I getting into the trade?
3. Where is my stop?
4. Where is my profit target?

Answering these questions allows you to act analytically and leave the emotion out of it. Emotions will convince you, in the end, to hold on to the losing trade. Emotions will convince you to find a reason to stay in the trade.

K&T write, "...a person who has not made peace with his losses is likely to accept gambles that would be unacceptable to him otherwise."¹

Said differently, as a trader, you will hold on to losers longer if you don't have a plan in place before you enter the trade.

¹ Kahneman, D. and A. Tversky, 1979. Prospect theory: an analysis of decision under risk. *Econometrica* 47, pp286-287

The *mental-tennis* that accompanies a losing trade is familiar to all traders. The thoughts that run through a trader's mind, during a loser are all there to avoid having to cut your losses and get out.

For example the thoughts might range from:

1. *Why does the market always go against me?*
2. *Can't I get into at least one winner?*
3. *If I get out then the market will end up going my way, if I don't get out then the market will keep going against me.*
4. *Please please please come back to my price so I can scratch the trade.*
5. *I give up. As soon as I get out of this trade I'm going to change careers.*
6. *Maybe I should look at the 30 minute chart to see if it's still bearish? Just because the 5 minute chart went against me doesn't mean that the 30 minute chart did.*
7. *What about the daily chart? It's still bullish!*
8. *Maybe I can find a different indicator and that will support my position? I hate the MACD anyways. I'm going to try the %R.*
9. *This trading system stinks, I'm going to kill the guy who gave it to me, and it's his entire fault.*

How do I know? 'Cause I'm guilty of all of the above.

If I know what my risk is (what my stop loss is) then it takes all mental tennis (emotion) out of the equation. If I know my profit target, that also takes mental tennis out of the equation. Does that mean I can't change my profit target when the market gets there? Perhaps moving to a trailing stop? Of course not. I can change my mind about the profit once it's hit. But, not the stop.

If I know my max loss on a trade then I know all the consequences of that loss

1. It's within my daily stop loss limit.
2. If I get stopped out, then I'm going to have to work hard the rest of the day to dig my way out of the hole.

In the list above, number 2 is arguably the biggest reason futures traders don't take losers when they should. Think about it.

The three studies, introduced at the beginning of this paper, were based on investors in the stock trading world. There are two professors that moved *prospect theory*, *the disposition effect* and *overconfidence theory* to the futures trading world. They are, Locke and Mann.

Part II of this paper will be about their 1999 study of futures traders, *Do Professional Traders Exhibit Loss Realization Aversion?*