TAYB 005 – The Psychology of Losing

[00:00] Hello, I'm Steve Ward and welcome to Trade at your Best. In these podcasts I'll be drawing on research and practice from the fields of psychology, physiology, neuroscience and peak performance combined with my own experience of working with thousands of traders at institutions across the globe to provide you with knowledge, insights, and practical strategies that I hope will help you to trade at your best and achieve your trading potential.

[00:37] In this episode we're going to look at the psychology of losing. Losses and losing runs happen to all traders. It's a part of the game. It's how you respond to them that matters. Imagine I invite you to take part in this game. Here's what happens. I'm going to flip a coin and you can call heads or tails. If you are incorrect, then you are going to lose $100 so you'll pay me $100 if you call incorrectly. What I want you to think about is how much would you need to win if you were correct in order to play the game.

[01:24] Now, some of you are probably thinking, is it a one-off throw or is it going to be multiple throws? So just for now, we're going to keep it as a one-off throw, so it's a one-off throw you're calling heads or tails. If you're incorrect, you're going to lose $100 that's the risk. What reward is needed in order for you to find attractive enough to play the game?

[01:51] Now I've asked this question hundreds, probably thousands of times in workshops over the years and the most popular answers generally come out somewhere between about $150 and $300.There were always some people who are probably a bit smaller, the one O one mark, sometimes even the hundred dollar mark, but primarily one O one particularly if it's going to be multiple times. But I think most people feel comfortable at between about $150 and three hundred and they're interesting numbers, because if we take say the average $200-250 in that kind of range and we look at risk-reward ratios, they quite often come out for many traders in that kind of one to two and one to three type range.

[02:37] This is a question from behavioral finance and what it's illustrating really is loss aversion and the general kind of premise from behavioural finance is that losses are twice as painful as wins are pleasurable and that's why the one to two ratio becomes quite significant. But of course nobody really likes to lose anyway so we have loss aversion bias and that's one part of the psychology of why losing is difficult, but at the ego level, we don't want to be wrong. There's also a socially conditioned stigma around losing. There can be personal factors around what a loss means for you, what you've learned growing up both in our households and at schools around losing and that can be an uncomfortable response in the body. Sensations are uncomfortable when we lose so the act of losing for most of us psychologically and physiologically is not always that pleasant.

[03:36] However, they are an experience. Losses happen in trading, so they are unavoidable. I mean the only way to avoid losing in trading would be to not to trade, which of course means there's no upside opportunity. So you have to be able to manage losses and you have to be able to manage losing and runs to be successful in trading and a part of that often is developed over time through experience. I guess it's evolutionary really because if you don't build up some competence at managing losses, then you probably won't survive in the markets for too long. So there is a part of it which I think happens through time, but I think they're also either informally taught techniques or people pick up little tips and techniques that can help to make that a little bit easier and I want to kind of shout a few strategies or techniques that you might be able to use that can help to make you more effective at dealing with losses when they do happen.

[04:37] The starting point for me and this is going back just like we covered in a previous episode is just about the idea about process versus outcome focus. So if you are overly outcome-focused, if you're overly focused on the results of your trades then when you lose the intensity is going to be higher than if you are a bit more process focused. So there's the attachment almost to the outcome, would determine to a degree the intensity of your experience of the outcome and actually that's true both for the highs and for the lows. So being able to just give yourself a bit of space to unhook a little bit from the outcome itself can be really powerful. How do I unhook from the outcome? I need to really get into the process thinking about the steps that I took to make the decision.

[05:29] And I share a quick example. I was coaching a trader very recently actually and it's an interesting situation because it's the start of a new trading year for them, and he put this trade on. I was quite confident in the trade, was expecting a good outcome and then there was a market event data-driven that was low probability in terms of its potential impact on the trade. However, it did have a much bigger impact than expected and that trade ended up losing money, and what was interesting about it was that the trader had to stop themselves out, which they managed to do, even though that was difficult with it being literally a few days into the new trading year, difficult time. After he'd done that a part of him knew he did the right thing, but yet there were still some thoughts and emotions and feelings coming through that were challenging and uncomfortable.

[06:22] And to be honest those thoughts and emotions could have had an impact from what happened the next day in his trading had he not being able to manage them, but he did. He did some reflection. He identified that he had done the right thing so he had followed the process of his trading. It had been a bad break so if we go back to our decision making quadrants that we discussed in an earlier episode, this was he did the right things, but the outcome was a loss, so a bad break. This is what I would call a losing trade, not a bad trade and he reflected, he would do the same thing again in the future. So it's a really great example of where A, there is a losing trade, it happens. That there was the experience of some challenging thoughts or emotions normal to the situation. Yet there was underneath all that a commitment to the action and a commitment to the process and a reflection on the process and then a commitment to the process on the next day.

[07:27] The other key thing that's really important around dealing with losses actually is what's the underlying mindset? What are your beliefs and perceptions about losses? Your mindset is a big filtering system, the information is coming in, the mindset is like a filter. You've got all these events happening in the markets and you're having responses to them or reactions and responses and part of that middle ground is your mindset. How am I perceiving this? So if you see losses in a threatening way as things that must be avoided at all costs and if you make a loss then you perceive yourself as a loser, for example, that's not going to be that helpful compared to being able to have the perception that losses are a statistical part of the game of trading. They're opportunities to get feedback on your strategy, the things that you can learn from. In each case, the loss is the loss. The money lost will be the same, but different perspectives, different perceptions, the mindset will generate different responses. So it's really useful to think about what is your mindset about losses? What's your perception? How do you see them? Is it possible that you could see losses in a more opportunistic way? What could you gain? How could you benefit from that in some way?

[08:53] And I think with losing and also actually I think let's cover making mistakes here, they're going to happen in trading so if you can develop a good kind of psychological framework around them, then it's really helpful. Now there's a really interesting book it's a book called Black Box Thinking, a guy called Matthew Syed, and the core premise of the book really is how failure plays a big part in success. And in that book he uses as a bit of the storytelling process. He contrasts the coaches in both the medicine industry and aviation and what he highlights is that in medicine there's quite a poor culture actually around mistakes and if they're made people try and cover them up. You try and avoid being sued and the outcome is that people don't learn from those mistakes. The same mistakes get repeated and performance doesn't really improve.

[09:51] Contrast is to aviation where there's a very open culture around mistakes, reporting mistakes, sharing mistakes across different airlines globally. Learning from those mistakes so that everybody can benefit from each individual's mistake. Many people benefit as a result performance improves and so it's really thinking about for yourself, what's your internal culture? What's your kind of way of working with losses and mistakes. Can you be more open to the idea of these as learning events? Things that you can gain and benefit from because if you can shift that perception, then you can shift the response.

[10:36] I think something else which is important around the psychology of losing is having the psychological skills to be able to work with the difficult emotions and the thoughts that losing trades and especially losing runs can bring. Big losses, tough period of drawdown are quite likely to result in some difficult thoughts and emotions showing up. It's going to be normal for most traders, but it's going to be what you do when it shows up that matters so I think as part of the process of becoming a better trader, and people often ask me actually about what are some of the key qualities that I think are important to be successful in trading and one of those is resiliency because we know that losing trades are going to happen. We know there's going to be times when traders are finding it hard to make money and that's going to be a test of resiliency.

[11:28] The skills and abilities to cope with tough times. How do I manage my thinking? Am I able to work with my mindset? Can I manage my thoughts on that kind of moment to moment basis? Am I able to manage and work with the emotions that show up? And we'll cover some of these skills in future episodes, but I think as part of your own kind of pathway of development, just be aware that I think that is a really, really core skill to develop that skill of resiliency. And I think a very pragmatic level just be aware of the impact of your risk-taking on your losses. The risks that you take, he's going to have a huge impact on the size of your losses and the size of the loss will play a big part in your experience of that, the thoughts, the emotions that show up. How it feels, the amount of stress that comes into the body.

[12:25] So knowing your own threshold for loss is really important and that's both financially, you know how much financially am I able to lose, but also emotionally. Can I deal with what shows up and thinking about keeping your risk at a level where you are able to execute your strategy as you would like to according to your process is for me fundamental to making good decisions. And then also ensuring that the risks that you're taking is at a level where you're able to take your losses and importantly also recover from them quickly, is where you should be probably aiming for.

[13:11] So if we just reflect back on a few key things from this episode, losses are a part of trading. Losing runs are going to be a part of trading. It's a part of the game and it's normal, but what really matters is how you're going to respond to them. So just be thinking about can I be more process-focused? Can I be less attached to the outcome that's going to be helpful? Is it possible with I can make a mindset shift? Can I change my perception? Can I in some way see losses as more of an opportunity than a threat? Where do I need to work on in terms of developing my psychological skills so that I have the ability to work with the difficult emotions and thoughts that might show up whilst I'm taking a loss after a loss or during a losing run?

[14:04] And finally again, just very pragmatically, just be aware of the link between risk and the stress response and the size of your losses such that you are making the decisions around your risking and your position sizing to allow you to have the best chance possible of executing as you would like to, but also being able to deal with the consequences as effectively as possible.

[14:33] The focus of these podcasts is to help you to improve your trading performance, to become a better trader, to move closer to achieving your trading potential. Improving performance requires taking action so I'd like to invite you to take a few moments to reflect on the contents of this episode. To think about what was interesting for you, what resonated and caught your attention, and to consider how you might apply it within your own trading.

[15:08] Thank you for listening to this episode of Trade at your Best. I hope you enjoyed it and found it useful. If you've got any questions or feedback about this episode or suggestions for future ones, then please get in touch through the podcast page, www.tradeatyourbest.com. This is also where you can find any links or resources mentioned in or related to this episode, and if you'd like to find out more about me and the work I do helping my trading, investing and banking clients to perform at their best, then please visit the Performance Edge Consulting website, www.performance edge consulting.co.uk.