

Why Don't We Keep Stops?

by Vadym Graifer

With everything said and written on the subject of stops, it should be given that everyone is conditioned to keep them religiously even before they start trading. No matter what source a newer trader turns to, utter importance of stops will be underlined and emphasized up to the degree that keeping them is heralded as the ultimate key to success. We all heard adages like “Take care of your losses, profits will take care of themselves”.

Do all the stern warnings work? Not really.

Time and again traders blow their stops, widen them in a course of a trade, hold losing position in false hope it will make them whole. If this destructive behavior continues despite all the warnings, there must be deeply rooted reasons for this. As with most trading flaws, failure to keep stops roots in fundamental misconceptions about the very nature of the market and trading. Such misconceptions cause incorrect psychological makeup which, in turn, results in behavioral patterns harmful for a trader’s performance. In order to re-condition oneself it is necessary to work out fundamental, even philosophical if you will, understanding of the market as an environment in which a trader operates.

Let us list and analyze the misconceptions that cause failure to keep stops.

Right action must result in profit.

This misconception stems from misunderstanding of the very nature of the market as an uncertain environment. Newer trader sees a market as a conglomerate of firm links between reasons and outcomes. In such a conglomerate, every reason results in single possible outcome. The simplest case of such link would be “good news – up, bad news – down”. We know it’s not true – price reacts to news in a wide variety of ways.

Similarly, an inexperienced trader applying the setup he knows “should work” expects every trade to be a winner, providing all the components of the setup are right. Have you ever heard complaints like “Everything was exactly like in that book, yet the trade failed”? That is direct result of this misunderstanding. Everything may be right, yet the trade fails – just because markets work in probabilities and not in certainties.

If a system produces certain percentage of wins over time, it’s just statistics – and, as it is always the case with statistics, it cannot predict an outcome of a **particular** trade. **No matter how good the setup is, any given trade can fail.** That’s why it’s imperative for a trader to distinguish between two kinds of losses.

The first kind is a loss caused by a trader’s mistake – failure to follow all the rules of system applied, or impulsive entry without any reason at all. Such losses must be taken as a lesson. The second kind is the case where every piece of puzzle was in place, yet the trade failed – such losses must be written off as a part of trading game, as a tribute to uncertainty of the markets.

Of course, if you identify a component of your trading system that regularly causes trade failure, you can and should tweak your system in order to minimize failures. However, during the trade a stop must be taken as soon as signal of failure appears. The line of thinking “The setup was so good, it must work eventually” is a disaster waiting to happen.

Failure to perceive the market as an uncertain environment can result in another misconception:

Losses can be eliminated.

In a paradoxical way, this erroneous notion leads to more losses. A trader tweaks his system endlessly trying to get rid of losses completely. In such constant adjusting and re-adjusting, the system evolves into something totally different, losing its original logic, or even stops producing entry signals at all. As a result, a trader either abandons his system, which was not a bad one to begin with, or in a worst case, simply refuses to take losses. After all, he made his system so perfect by eliminating all the reasons for failures, it just **MUST** work! Meanwhile, had he stayed with original approach, maybe with some minor tweaks, it would continue producing steady results.

My trade is who I am.

This is one of those hidden subconscious misconceptions that cause us to refuse to take our stop. A trader perceives the result of his trade as a reflection of his personality, his abilities. A trade failure makes him feel as though he is a failure. Winning makes him feel "right", while losing makes him feel "wrong". Nobody likes to be a failure, to be wrong. That's why, in order to avoid being wrong, we refuse to take our stop. You can be right and still lose on this particular trade. You can be wrong and win, too.

It's important to differ between good and bad trade, and we will be back to this later, in the Random reinforcement part. At this point it's important to separate your self-perception from the result of your trade. Taking a stop loss, you are stopping your loss – nothing foolish about that. The major trigger for the right approach here is a realization that by accepting the market as an uncertain environment, we already have accepted the possibility of losses. If we haven't expected the market to work in our favor every time, there is no reason to feel foolish when it doesn't.

A loss is just a paper loss until it's taken.

This is a big mistake in thinking. If a loss gets out of hand, it's very real. It paralyzes you, it clouds your judgment, and it makes you miss plenty of other opportunities. Instead of taking a pre-determined loss and moving on to another trade, you sit and watch your losing one, twitching in pain and feeling remorse. Your chance to take a small stop is long gone. You are agonizing now over big one that is going to deplete your account too much and inflict serious emotional wounds. You hardly notice many other opportunities. The market has moved on, other sectors and stocks are in play, and you still nurture your losing trade, hating it and not being able to finally drop it. At some point you will ask yourself "Why was this trade so important to me? What made me hold onto it?" And this takes us to the next common error:

Putting too much importance into single trade.

A newer trader tends to see each trade as overly important, as if it's going to make or break him. The market is an endless stream of opportunities. The next trade is right around the corner. No single trade is so important that it would be worth abandoning all other opportunities. Perceive your trading as a process, not as separate events. With the correct approach trading becomes natural, like breathing. Each entry is inhale, each exit is exhale. Breathe in and breathe out. Don't choke yourself trying to hold onto each given breath.

Random reinforcement.

This is an important concept to understand. The market is not always rewarding right decisions and punishing bad ones. The practical implication is that a trader runs a risk to stop applying proper techniques if he sees wrong ones being rewarded sometimes. Take a stop, observe a stock reversing and going into profit zone – and you get tempted to skip your stop next time. If you try it and it works, there is significant chance that you continue doing just that – the bad habit gets reinforced. You may win several times by breaking your rules. What happens eventually is that one trade that does not reverse destroys your account. It's important to define what good and bad trades are. Unlike many think, a good trade is not always a winning trade; a bad trade is not always a losing trade.

- A good trade is a trade where you kept all your rules that you know to be working in a long run. A good trade can be a winning one when the market acts accordingly to what your system indicates. It can be a losing trade when the market acts against it, but it's still a good trade.

- A bad trade is a trade made against your better judgment, against your rules. It can be a losing trade when a market acts as it "should". It can be a winning trade when the market rewards your bad judgment, and it can be a very dangerous trap as a bad habit gets reinforced.

The last thing to say in conclusion is that a certain psychological barrier for a trader to overcome to start applying his stops with no hesitation. When this barrier is taken, things suddenly become so clear and automatic that a trader can't even believe it was ever a problem for him. When this barrier is overcome, you feel that stops became natural part of your trading, that you take them with no slightest hesitation and forget about them instantly, moving on to search for your next trade, that taking stops do not trigger any negative emotions. This is wonderful feeling of total self-control. Not only will it do plenty of good to your trading performance, it's a very rewarding feeling in itself.