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Easy way to cut losses

by Malcolm Robinson

I have successfully given up two unhelpful behaviours, one was smoking which I stopped 10 years ago; and the other was drinking alcohol, which I gave up last year. Most people these days agree that smoking is a bad habit, but equally most people still consider drinking to be perfectly healthy in moderation.

I no longer have that opinion about alcohol, but I have no interest in attempting to change anyone's view about either drinking or smoking. I bring this subject up because I think there are parallels to trading. If we go back to basics we know that to be successful trading we need to cut our losses and let our profits run.

I think everyone agrees on this, it is stated in virtually every trading book ever written. The fact of the matter is though, that we all seem to be hard wired to do exactly the opposite. If you look at your trading results over any period of loss, you will see that your losses come from trades that you did not cut.

Difficult

It is unlikely that your losses are attributable to a large number of small losses, far more likely that they came from a few large losing trades, i.e. trades that you did not cut. If this is the case for you, then success in trading will not depend on you finding the right trading system or idea, it will depend on your ability to learn to ruthlessly cut your losses.

The question is why is it so difficult? I smoked from the age of about 12 until I was 25. During that time I made many attempts to quit, like most smokers, but it was far too difficult, so I never succeeded. That was until I read a book called "The Easy Way to Stop Smoking" by Allen Carr. Allen Carr's book got me to consider whether I actually enjoyed smoking and I discovered that I didn't at all.

Once I made this discovery I stopped smoking, I stopped smoking and have never had the desire to smoke again. It really was easy. The reason that I had found it so hard to quit before, was because I was under the illusion that I enjoyed smoking and that there were benefits to be had from smoking. So even though I was also aware of all the negatives of smoking I couldn't give up.

Beneficial

Yes, because I was giving up something that I loved doing (or so I thought). What has this got to do with trading? Well what I have learnt from my experiences of giving up smoking and drinking is that I only do things that I am motivated to do, i.e. I only do something because I think there is a benefit to me in doing it. As soon as I realise that there is in fact no benefit whatsoever, I stop, without a single thought.

I found this to be the case with both smoking and drinking, when I realised that the benefits I thought I was receiving were in fact illusory, I just stopped having any desire to drink or smoke. With trading I realise that when a trader finds that he repeatedly lets his losses run, he cuts his profits short, it is because (perhaps on an unconscious level) he believes that it is beneficial for him to do so.

So what possible benefits can a trader think he will receive by not cutting losses? I think this question cuts to the very core of the difficulty of achieving consistent trading success. When we offer advice, in any situation, we are making one big assumption: that the person we are advising has a choice.

So if I say to a losing trader: “Cut your losses when they are still small”, I am assuming that he has a choice and that up to now he has been making the wrong choice. He simply has to take the option to cut his losses early and hey presto... Now of course this is excellent advice and would stem the bleeding; but it is useless.

It is useless because the trader doesn't have a choice. He is not letting his losses run because he chooses to, if that was the case his problems would be solved the first time he read about cutting losses. It must be that the trader doesn't have a choice; he can't help himself! But why? I think the answer lies in our upbringing and, more specifically, what we were taught and what we learnt about success.

Our psyches

Whether in business or in the sports arena, we are taught to be persistent, to persevere against the odds. We are taught to be steadfast and not a quitter. We are taught to be decisive and not fickle. We are taught to conquer and overcome problems through our decisiveness and the application of our intelligence.

And perhaps the overriding rule of life we are taught is to be a winner and not a loser; our aim in every endeavour is to win not lose, it is hard wired into our psyches from an early age. So how does this attitude to success stand with trading? With this attitude we come to the market with the desire to conquer it with our all-powerful intelligence.

Why else would we spend hours studying charts and testing systems, trying to find the key that no one else has found? With this attitude we attempt to overcome the market through our steely determination, how many times have we heard of the gold digger who quit an inch from a rich vein? With this attitude we are determined to persist until the market submits its treasure to our greater powers.

Broke...

Why else do so many traders go broke before they quit? And cutting losses... well, cutting losses is akin to fleeing at the first sign of trouble; it is weak, fickle and dishonourable. No wonder we hold on for dear life!

Everyone wants to make money, that's a given and that inevitably leads us to look for ways to take money out of the market. The strange thing is, though, that the harder we search the more inaccessible profits become. Why?

I think there is a fundamental flaw in our approach. Our approach is to seek out and deploy a trading system or strategy that will ensure a steady stream of profits. That is why we all spend so much money on books, courses and seminars. We think that out there, somewhere, is the idea, the system, that will turn us into successful traders.

Yet, even when we think we have found the missing link, it doesn't seem to work, we are not converted into big time, consistently profitable traders. Don't get me wrong, this does not mean that I think trading ideas and systems and strategies are useless. Far from it, they are an essential element of successful trading, for sure, but they are not the only, or even the biggest requirement for successful trading.

Anticipating the market and execution

I divide trading skills into two distinct elements: anticipating the market and execution. The anticipating part is reading the market, whether through charts, systems, technical indicators or intuition. Anticipating/reading the market is the trading skill that most of us focus all our energy on, and it is the subject covered by most trading books and seminars.

The execution part, meaning the actual trading part, is an often overlooked skill of trading. A good way to clarify the distinction between being able to anticipate the market and being able to effectively execute the trades is to describe the difference between the brokers and the locals on the floor of the exchange. (In Europe the floor no longer exists as all trading is now electronic).

Locals on the floor are independent traders trading for their own account (profit). Their motivation is (like ours) to make money and their preoccupation is (like ours) to be able to anticipate the market. The job of brokers on the floor is to execute orders from traders not on the floor. These orders may be from bank traders trading in an office or independent traders trading from home.

Ruthlessly efficient

Either way these orders are generated from somewhere 'off the floor' and they need to be executed 'on the floor' by a broker. So what makes a good broker? Think about what you

would want from a broker. You would want someone who executes your trades with the utmost efficiency i.e, no hesitating, no indecisiveness, no coyness.

A broker needs to be sharp and alert to what is happening in the market so that they are always in a position to immediately execute any trade that they are given. A good floor broker is a joy to watch, they are ruthlessly efficient. They can go from idly chatting in a quiet market, to disseminating an endless flow of orders in a busy one.

Now imagine having to trade through a broker. What would it be like trading through a novice broker? Someone who doesn't know one end of an order from another. Not a pleasant prospect! Now imagine what it would be like trading with a highly skilled and experienced broker... Quite a different experience I think you will agree.

Anticipation and execution

Locals have to both anticipate the market and execute their own trades. If you think of all the possible combinations:

Good anticipation / poor execution,

Poor anticipation / poor execution,

Good anticipation / good execution,

Poor anticipation / good execution,

It is obvious which we would all rather be, good / good; but which combination would you say you are? I suspect there are a lot of good anticipation/poor execution traders out there who lose money despite their anticipation skills. So not only do we need good anticipation skills we also need good execution skills to succeed in trading. We need to develop the attitude of a broker when it comes to the task of actually executing our trades.

A broker is judged by his execution skills. It does not matter to a broker whether the trade he has just executed for a client is profitable or not. The broker, his boss and his client are only concerned with his ability to execute the trade efficiently.

So a broker gets to fulfill his need to be successful, to be a winner, by doing his job efficiently and effectively. That is all we can ask of a broker, it would be crazy to hold him responsible for the outcome of the trade. Going back to my earlier analogy of the trading floor, a local trader, on the other hand, is responsible for the outcome of his trades.

The local is trying to make money by anticipating the market. So a local has to decide whether it is a good time to buy or sell and then execute the trade. He is doing two things, deciding when to trade and then executing the trade. A local therefore has two aspects of his trading to judge, the accuracy of his market anticipation and the execution of his trades.

Poor execution or anticipation?

We know that trading is a numbers game, i.e. our success is not dependent on the outcome of the next trade; our success is dependent on the overall profitability of many trades. So while we are trading, whether the last trade we did was profitable or not is not important; there is no point drawing conclusions on the outcome of just one, or even a few trades.

We can only access our anticipation skills when we have made a reasonable number of trades and we can see the longer-term result of our actions. This contemplation is best made when we are not trading, when that markets are closed or when we are taking a break. When the markets are open and we are engaged in trading, the only thing it is appropriate to judge is our execution skill.

When we are trading our goal should be to focus on executing our trades with ruthless efficiency and to judge only that. If you consider the ways that you lose money trading, I think you will find that it is down to poor execution, rather than poor anticipation.

Appraise and amend

- You fail to place a stop loss according to your predetermined loss limits,
- You place a stop loss but then move it as the market approaches,
- You hesitate and miss an opportunity that you had clearly seen,
- You trade out of frustration or anger,
- You fail to use a trailing stop to protect your profit,
- You let a winning trade turn into a losing trade etc...

All the above (and there are more) fall into the category of poor execution rather than poor market anticipation. So if you want to turn your trading round, or make it more profitable, then cut out the above mistakes by focusing all your energy on executing your trades. Only judge yourself, when trading, on your execution. You can appraise and amend your strategy/approach when the markets are closed.

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Good Trading

Best Regards
Mark McRae

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