PART TWO

LESSONS LEARNED

Good judgment is usually the result of experience,
and experience frequently the result of bad judgment.

—ROBERT LOVETT

What started as a search for the secret to making money had turned into a search for the secret of how not to lose money. Why is it is so important to learn how not to lose? Because when people lose money in the markets, they usually look for a new approach to make money. Obviously, the previous method was defective; it's never the investor's or trader's fault. Given the myriad of how-to methods, you could spend a lifetime trying, and failing, to make money with each one because you don't know how not to lose. On the other hand, if you learn why people lose and thereby control losses, profits will follow.

Basically, what I found is that there are as many ways to make money in the markets as there are people in the markets, but there are relatively few ways to lose money. When I say lose here, I don't mean that there won't be any losses. You don't win every point in every game in every set in every match in tennis; you win some and you lose some. There will be lots of losses, just as there are losses in any business. Former Citicorp CEO Walter Wriston said that a lender who doesn't have loan losses isn't doing his job. And it's the truth. Trying to avoid taking losses altogether is the loser's curse. But the losses you are trying to avoid are the ones for which you hadn't made allowances, the ones that sneak up on you and the ones that ultimately put you out of business.

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Losing money in the markets is the result of either: (1) some fault in the analysis or (2) some fault in its application. As the pros have demonstrated, there is no single sure-fire analytical way to make money in the markets. Therefore, studying the various analytical methods in search of the "best one" is a waste of time. Instead, what should be studied are the factors involved in applying, or failing to apply, any analytical method. Even when equipped with accurate analysis, correct forecasts, and profitable recommendations, people still manage to lose money. Why can't people match the profitable performance records of the market advisory services they subscribe to? They can't because of psychological factors that prevent them from applying the analysis and following the recommendations.

Psychological factors can be categorized as either (1) the pathological mental disorders and illnesses that require professional help or (2) the psychological distortions all of us engage in even though we are basically mentally healthy. We are interested in the latter.

MARKET LORE TO IGNORE?

Most remedies for market losses due to psychological factors are old market saws that are too ambiguous to offer any means of practical application. People recite these catchphrases as if they were self-evident truths. After repeating them so often they become trite clichés used out of unthinking habit. But pearls of trading wisdom are more easily repeated than implemented. Repeating maxims, as if mere verbalization will activate the underlying principles, will not work. For example, simply following the dictum "Don't discuss market positions because the pros don't," won't automatically make you a pro. You must understand those principles before you can benefit from the maxims. Pros don't discuss their positions *because* they understand what triggers discussing positions in the first place, as well as the dangers of doing so. A maxim is a succinct formulation of some fundamental principle or rule of conduct. Memorizing and repeating clichés is easy; grasping their underlying principles is more difficult.

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For instance, consider what must be the most quoted maxim in the business: "Cut your losses short." Sounds great, but what does it mean? Do you get out of a position as soon as it shows a loss? What constitutes a loss? How do you define a market loss? At some point in almost every investment or trade the position is going to show a loss, so how do you know when it is really a *loss*—something to get rid of—and not a position that is going to come back and be profitable?

Or how about: "Don't follow the crowd. Go against the herd." Okay, but how do you measure the crowd's position in the market? What are the truest bellwethers of public sentiment? Do you determine what the crowd is doing by looking at volume and open interest? Put-call ratios? Put-to-call premiums? Consumer confidence? Odd-lot shorts? Sentiment numbers and consensus of investment advisors? Besides, doing the opposite of what everyone else is doing doesn't guarantee success and there are times when "trading opposite the crowd" can wipe you out.

And then there's that oldie but goldie: "Don't trade on hope or fear or make emotional decisions." Sounds simple enough, but as you will see later in the book, emotions in general, and hope and fear specifically, create a unique paradox for the market participant.

This book will not instruct you on the specifics of how to confront your fears or how to "get in touch with your feelings and emotions." It will not reconcile your ego's legitimate internal psychological needs with your participation in the markets. I don't have a battery of tests for you to take to determine your particular psychological profile or your internal conflicts. I don't have a test to determine if you should be participating in the markets at all. I am not, nor do I pretend to be, a psychologist. But I don't have to be a psychologist to know that losses caused by *psychological* factors presuppose your *ego's* involvement in the market position in the first place, which means you have personalized the market. Knowing what causes something is the first step in preventing it from going into effect. If we can determine how a market position gets personalized (i.e., how ego gets involved), we will be well on our way to preventing it from happening. Then the losses due to psychological factors can be prevented.

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Some of the ideas in the rest of the book may sound like semantic quibbling. However, it is precisely those confused semantics that are largely responsible for the confused thinking that, in turn, leads to the losses due to psychological factors. To clear up that confusion let's attach clear, specific meanings to the terms we use. Let's start at the beginning by defining psychology and seeing how it applies to us when we are in the market.

The American Heritage Dictionary defines "psychology" as the study of the mental processes, behavioral characteristics, and emotions of an individual or group. Since we're interested in market losses due to psychological factors, we will examine each of the three parts of the definition as they relate to us when we have those types of losses. Therefore, the second part of this book examines the mental processes, behavioral characteristics, and emotions of people who lose money in the markets.

1. Mental Processes

Chapter 6 explains what happens when a market position, especially a loss, gets personalized. It presents the difference between external, objective losses and internal, subjective losses. Next, it looks at the mental process an individual goes through when experiencing an internal loss: denial, anger, bargaining, depression, and acceptance. Most people equate *loss* with *being wrong* and, therefore, internalize what should be an external loss. Then they start to experience the Five Stages of Internal Loss, and the loss gets larger as they progress through the stages. Finally, the chapter makes a distinction between losses from discrete events (e.g., games) and continuous processes (e.g., markets) and shows that only the latter are subject to the Five Stages.

2. Behavioral Characteristics

Chapter 7 discusses the most common way people personalize market positions. The chapter introduces the five types of participants

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in the markets: investors, traders, speculators, bettors, and gamblers. The type of participant a person is, is determined by the behavioral characteristics he displays, not by the activity in which he is engaged. In other words, all stock purchases are not investing just as all card playing isn't gambling. The chapter also shows that the source of most losses in the markets is people betting or gambling, as defined by the characteristics of their behavior, on a continuous-process risk activity.

3. Emotions of an Individual or Group

Chapter 8 explains that emotions are neither good nor bad; they simply are. Emotions per se cannot be avoided. Emotionalism, on the other hand, can and should be avoided. Emotionalism is decision making based on emotions. The entity that best describes emotional decision making is the crowd. The chapter explains that the crowd is the epitome of emotions in action and discusses the crowd not in the familiar terms of contrary opinion or as a stage of a runaway market but in terms of a process that can affect a solitary individual. Being a member of the crowd is not a function of quantity of people. Rather, it is a function of the characteristics displayed. We will also look at two models that describe the stages an individual passes through as he becomes a member of a psychological crowd.

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