

# Are you a trader?

When someone trades a stock, it is for a short period of time, generally between one day and six months. The trader is not looking for the next 'the company'; they are just looking for a stock that will move up (or down) a few percent quickly.

The goal of the trader is to make quick profits on price differences. Traders often short shares in anticipation of price decreases, thus seeking to profit on both price rises and falls. Traders buy and sell often, frequently using borrowed money to fund trades.

Professional trading is nothing like gambling, but many amateur traders act as if it is and trade excessively for the same reasons as an ordinary gambler. Every active trader should learn to trade instead of gamble. Here, we'll take a look at traders' tendency to trade excessively and examine the way this behaviour can affect a portfolio.

## Evolution of a trader

As traders develop skills, each one travels virtually the same path: Initially as a discretionary trader, then as a technician and ultimately as a strategist or systematic trader. A trader first analyzes the market direction or trend and then sets targets for the anticipated move. Correctly reading or predicting the market then becomes the highest priority, so the trader learns as many new indicators as possible, believing they're like traffic signals. This search for a magical combination of indicators leads to the inevitable realization that multiple scenarios might exist. A trader's focus then moves to the probability of each outcome and the risk-reward ratio.

Advancement to the successful professional ranks is not achieved until emphasis is placed on strategy. Excessive trading, or the excessive buying and selling of stocks, may also be referred to as overtrading. It occurs within each step and correcting it often enables a trader to progress to the next level. The three most common forms of overtrading are bandwagon trading, hair-trigger trading and shotgun trading. Each manifests itself differently and to varying degrees, depending on whether the trader's style is discretionary or technical.

## Discretionary over trader

The discretionary trader uses non-quantifiable data such as advice from a broker or perceived expert, news reports, personal preferences, observations and intuition to determine entry and exit points. Position sizes and leverage are flexible. Although such flexibility can have its advantages, more often than not it proves to be the trader's downfall.

Discretionary traders often find inactivity the hardest part of trading. As a result, they're prepared to embrace any development that will allow another trade. This impulsive behaviour, in fact, isn't trading at all - it's gambling, similar to that described earlier. And just like in the casino, the odds are not in the over trader's favour.

## Technical over trader

Traders new to technical indicators often use them as justification for making a predetermined trade. They have already decided what position to take and then look for indicators that will back up their decision, allowing them to feel more comfortable. They then develop rules, learn more indicators and devise a system. If it's right more often than not, they believe they've finally beaten the odds and may reason that if a solid 60% of their trades are successful, they'll improve their profitability with increased trading. Unfortunately, this is another example of overtrading and it can have severe consequences for these traders' returns.

### Hair-trigger trading

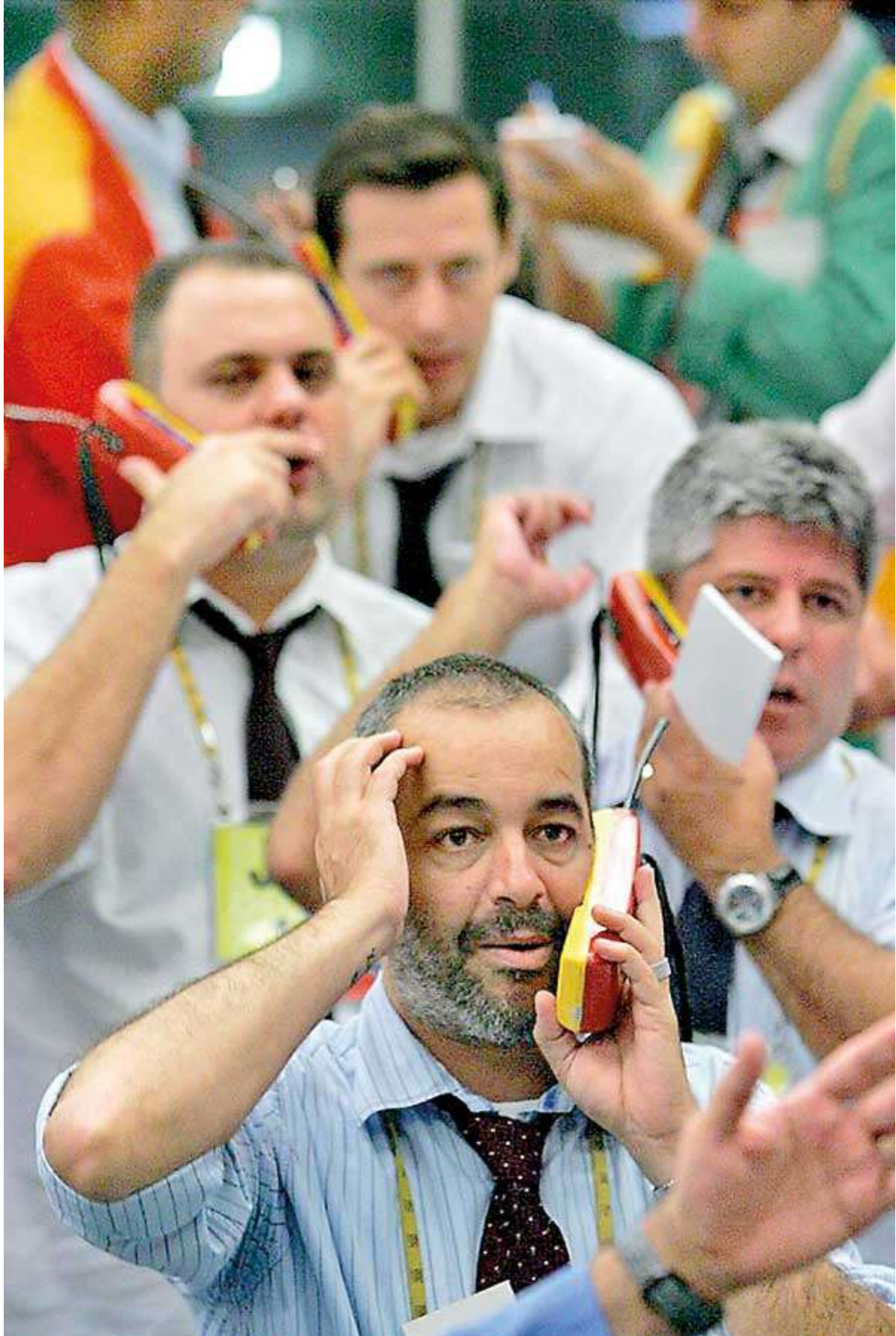
Hair-trigger trading is enhanced by electronic trading, which makes it possible to open or close a position within seconds of the idea forming in the trader's mind. If a trade moves slightly against the trader, it is sold immediately; if a market pundit shouts out a tip, a position can be opened before the ad break. Hair-trigger trading is easy to identify. Does the trader have many small losses and a few wins? Looking back over trade logs, did the trader overestimate his wins and conveniently dismiss his losses? Were trades exited almost as soon as they were entered? Are some positions continuously opened and closed? These are all classic, easily identifiable signs of hair-trigger trading.

But the fix is also easy: Only enter what you 'know' will be a good trade (i.e., a high probability trade according to your research and analysis, meeting all your predefined trade criteria). If there is doubt, do not make the trade. Losses are far worse than inactivity and compounding losses are devastating.

### Shotgun trading

Craving the action, traders often develop a 'shotgun blast' approach, buying anything and everything they think might be good. They might justify this by the fact that diversification lowers risk. But this logic is flawed. First, true diversity is spread over multiple asset classes. Second, multiple bad trades will never be better than just a few. If a trader has isolated a promising trade, concentrating capital on that trade makes the most sense. A telltale sign of shotgun trading is multiple small positions open concurrently. But an even more firm diagnosis can be made by reviewing trade history and then asking why that particular trade was made at the time. A shotgun trader will struggle to provide a specific answer to that question.

If you're attracted to the diversification aspect of investing, it's far better to buy and hold a blend of the market indexes. This puts the 'house odds' in your favour. Be very selective when trading individual positions and trade only the highest probability trades: A respectable success rate trading one position at a time can quickly degrade to less than 50% success with multiple positions.



### Bandwagon trading

Bandwagon trading is a deliberate attempt by discretionary traders to piggyback or mimic those they consider to be 'in the know'. This ploy is fundamentally flawed for two reasons. First, even experts don't have all the answers and they can't predict the future. Their experience and talents are merely two factors among many. The second reason is that when many traders follow the same path - led by a pundit, a biased stakeholder or the results of many technicians inadvertently using the same indicators - the initial move may degenerate rapidly. This is a basic economic principle: Competition reduces margins. In trading, this manifests itself when bandwagon traders compete to exit identical positions as early as possible, often causing a price stall or reversal.

To make matters worse, novice traders are most likely to trade on the bandwagon and most likely to exit prematurely, exacerbating this effect. The strongest signal of bandwagon trading is adhering to someone else's recommendations, or a system devised by someone else. Is there a dependence on popular indicators with the same settings as taught to beginners? Has the 'hot' new system or indicator lost its reliability? If you find comfort in crowds and conformity, buy the index. If you want to trade, first develop your own system, do your own research, customize your indicators and finally - test, experiment and test some more before you trade.

### Movers and shakers

The market is not always smooth sailing. Instead of large trending moves, it sometimes shakes about in a choppy, sideways direction. Many novice traders will overtrade by assuming that minor market corrections are the beginning of the next trend. They'll then jump in and out as the expected trend forms and fails. They may even compound the situation by doubling their positions.

This can be the most destructive form of overtrading. Confident that the reversal is imminent, the trader doubles the size of a losing trade in the belief that he or she has averaged down to a better entry price and will therefore make a bigger profit on the move. Most often, however, this just increases losses. On the other hand, successful traders sometimes double winning trades - never losses - and are quite content to sit out the market, waiting for the right conditions under which to re-enter. An unskilled trader, however, will be continuously drawn back in.

### The bottom line

The various forms of overtrading can be explained by the amateur's order of priorities. First and foremost, the beginner trader wants to confirm the advisability of his trade by taking profit whenever possible. Secondly, the novice trader wants to reduce his emotional discomfort either by selling as soon as a loss appears or by immediately re-entering the market after a loss or period of inactivity, hoping to 'win it back' just like the casino gambler. Overtrading makes only a broker happy; the true professional's priorities will look like this:

- Minimize volatility
- Avoid losses
- Minimize risk
- Maximize returns

Stick to these simple guidelines and you'll be able to steer clear of overtrading.