

Psychology and emotions of trading

Psychology and emotions of investing and trading

Robert Brain
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"The share market can seem mystical and almost like black magic; but with the right support and assistance, it just seems like magic."
Robert Brain

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Brainy's Share Market Toolbox

Set the scene...

- (1) Have you ever had doubts about an investment / trade?
- (2) Felt uncomfortable about the investment?
- (3) Had overwhelming feelings? (eg. butterflies, sweaty palms?...)
- (4) Worried about possible losses?
- (5) Perhaps had a "feeling" that all is not well?

Let's try to explain these, and more...

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Today's Agenda

1. Awareness of psychology and emotions:
 - (a) Brain functions and brain deception
 - (b) Feelings
 - (c) Emotions – F, G, H
 - (d) Cognitive bias – introduction
2. Share some strategies for overcoming the feelings, emotions and the biases.
3. Q & A?

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Psychology and emotions of trading

Brainy's Share Market Toolbox

Important Notice — No Advice!

- (1) This presentation does not include any advice.
- (2) For proper advice, your personal financial situation needs to be considered.
- (3) This presentation is pure education, only for your general awareness. 
- (4) There are no recommendations to take any action, or to invest any money in any way.
- (5) Always consult a properly licensed advisor before making investment decisions.

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Important Notice



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Brainy's Share Market Toolbox

About... Robert Brain

Consultant, educator and part-time* share trader
Web-based sharemarket-support business

- Many years experience as trainer, presenter, conference facilitator (*Scouts*)
- Share Market – active 15++ years* 
- Chartist ie. technical analyst (ATAA member and ex-national director)
- Provide tuition and support to traders and investors  [Brainy's Share Market Toolbox](#)
- Engineering Degree (structured thinking with an eye for charts and diagrams)
- 30+ years – professional experience (IT and management)
- **Do not hold AFS license! (Can't give advice)**
- BullCharts software (convenor Australian BullCharts User Group and authorised reseller with special pricing)
- Member Mensa

* - Not yet enough capital to live off the proceeds of trading (after trading as a hobby until a career change in 2008).

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**Brain
functions**

and brain deception

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AWARENESS

Brain functions

Everyone develops *opinions*:

- How things *should look*
- How things *should behave*
- And people's opinions are different to each other's
- And *automatic* and *sub-conscious* opinions can be different compared to *conscious* opinions

Further to this, *cognitive biases*:

- Make up the filter between what *actually* exists and what we *perceive* to exist.

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AWARENESS

Brain deceptions

The brain can process inputs from vision, sounds and smells and conjure up something a little different to reality.

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AWARENESS

For example

"I know where it should be..."
"I know how to do this..."

- **Street name signs** are up the lamp post or pole, not down at road level;
- **Car key ignition switch** is generally on the right hand side of steering column;
- **The 3yo toddler reading** a tablet eBook reader (and page flipping)...

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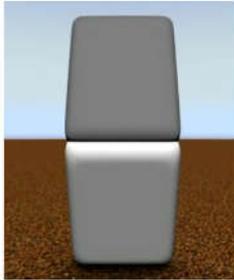
AWARENESS

Test Your Brain (video)

Watch the following video carefully...

Question: The two grey areas... are they the same shade of grey?

Answer: Refer to the National Geographic film clip for details.



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AWARENESS

The video...

So, the brain takes inputs, and it can make us think something a little different to the reality

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AWARENESS

Spot the difference



The same scene at a community festival...
(camera exposure settings are different)

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“Normal” exposure averages the light in the scene.



Exposure using “spot metering” to correctly expose inside the tent.



This is what the camera sees!

AWARENESS

Spot the difference

The human eye doesn't have this problem.
We can see reasonably well.
The brain makes automatic adjustments.



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 **AWARENESS**

Selective Attention Test (video)

Watch this short video...
Concentrate!
Count the number of times the whites pass the ball...
See the video for comment...



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 **AWARENESS**

The video...

Test of observation?
or
Selective attention?

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 **Feelings**

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 **AWARENESS**

How do you feel...?

1. Imagine that you missed a bargain sale.
You really wanted this very expensive item and you could have bought it for a big discount.
But, you missed out. Are you:

- (a) angry?
- (b) upset?
- (c) annoyed?
- (d) quite okay about it?

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 **AWARENESS**

How do you feel...?

2. Imagine that you . . .
Bought something last week, but this week it is 40% cheaper!!
You could have saved a lot of money.
Are you:

- (a) angry?
- (b) upset?
- (c) annoyed?
- (d) quite okay about it?

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 **AWARENESS**

How do you feel...?

3. Imagine that you . . .
Have some money to invest, and a hot stock is rocketing, and you feel you have to jump on board because you don't want to miss out (FoMo).
What do you do:

- (a) buy it without hesitation?
- (b) pause to consider carefully?
- (c) give it a miss?

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 **AWARENESS**

How do you feel...?

4. Imagine that you only have \$50,000 to invest.
Someone gave you a *hot tip*:-
to double your money within weeks, so you proceed.
It sounds like a sure fire bet, so invest the lot!
But within days it tanks!
Your \$50k is then worth 10% less.
Then after a few more days, it's down another 10% . .

How do you feel?
What do you do next?

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 **AWARENESS**

Feelings and emotion

It's easy for our
feelings and emotion
to take over our
decision-making and
cloud our judgement.

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 **AWARENESS**

Feelings and emotion

Everyone is different.

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Emotions

The feelings of: F, G, H

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EMOTIONS – F, G, H

Emotions

Three key emotions tend to drive many investment and trading decisions:

- Fear
- Greed
- Hope

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EMOTIONS – F, G, H

Fear (1 of 4)

Fear of making a loss (leads to regret)

- Some people are perfectionists, and want to be right 100% of the time, which means never making a loss (and admitting to it)
- Trading reality:-
 - This is not possible!
 - There will always be losses.
 - We need to minimise them.

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 **EMOTIONS – F, G, H**

Fear (2 of 4)

Fear of missing out (~Greed)

- An overwhelming desire to make an investment due to an underlying belief that if we don't, we'll be missing out.
- An investment opportunity is running away, and we feel terrible because we are missing out.
- Our fear of missing out strengthens that desire, and makes us rush to opt-in.

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 **EMOTIONS – F, G, H**

Fear (3 of 4)

Fear of being wrong

- We don't want to make a mistake.
- We don't want people to see that our investment decision was wrong.
- This fear can stop us from investing.
- Too many of us strive to be perfectionists, and to be right all of the time!
- For some of us, that is inherent in our earlier education (eg. engineers).

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 **EMOTIONS – F, G, H**

Fear (4 of 4)

Fear of missing out by taking money off the table:

- This can stop us from taking profits, and from protecting our hard-earned capital.
- If an investment has appreciated significantly then perhaps we ought to take some of it off the table => manage the risks and re-weight our portfolio.

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 **EMOTIONS – F, G, H**

Steps to overcome the Fear

- 1) Be able to recognise the emotion of *fear*
- 2) Look for sensible and rational ways to think through the fear and it's effects and consequences.

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 **EMOTIONS – F, G, H**

Greed

Simple Greed:

- Something is running hard, and you just don't want to miss out
- Tempted to leverage – margin loan, or just simply borrow some money
- Careful! – It leads to greater risk-taking
- Typically happens at market tops.

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 **EMOTIONS – F, G, H**

Greed

Greed can result from:

- Good recent stock performance
- Positive anecdotes from others (including the taxi driver!!)
- A feeling of “*I must have...*”
- Desperation to have a success
- A perceived high probability of success.

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 **EMOTIONS – F, G, H**

Greed – is easy

- Dutch tulip mania (price bubble) in 1637
- Poseidon stock market bubble – mining shares in late 1969
- Tech Stock boom (then bust) in 2000-2001
- The stock market “bubble” of 2003-2007 which was followed by the GFC
- Greed leads to the “Greater Fool” theory...

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 **EMOTIONS – F, G, H**

Overcoming greed

- Remember...
if it looks too good to be true...
- Action: Pause!
Take a step back and consider carefully.

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 **EMOTIONS – F, G, H**

Overcoming hope

- Prepare your trading plan,
- Do the research,
- Do the analysis,
- Do some testing
(eg. back-testing, paper trading)
- Gain the confidence, and
- Ignore comments from others
(or take with a grain of salt and scepticism).

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 **EMOTIONS – F, G, H**

Hope – another emotion

Wishful thinking

- The hope of making gains
- Inadequate research, and inadequate information leads to hope
- Just “hoping” that a share price will rise...
- Just “hoping” that a losing position will reverse.

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Cognitive Bias
(sub-conscious filtering)

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 **COGNITIVE BIASES**

Cognitive Bias

A tendency to acquire and process information by (sub-consciously) filtering it through one's own: likes, dislikes, beliefs and experiences.

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 **COGNITIVE BIASES**

Some cognitive biases

- Anchoring bias
- Confirmation bias
- Herd instinct

} Three biases that affect traders, for quick study today

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 **COGNITIVE BIASES**

Some cognitive biases

- Anchoring bias
- Confirmation bias
- Herd instinct

More biases:-

- Framing bias
- Consistency bias
- Recency bias
- Survivorship bias
- (many more)

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 **COGNITIVE BIASES**

Anchoring Bias

- A natural tendency to rely too heavily on just one piece of information (the "anchor")
- Once the anchor is set, there is a bias of *adjusting new information* to fit in with the anchor.

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 **COGNITIVE BIASES**

Anchoring Bias

- A natural tendency to rely too heavily on just one piece of information (the “anchor”)
- Once the anchor is set, there is a bias of *adjusting new information* to fit in with the anchor.

For example:

- Blue chip stocks are perceived to be “quality”.
- Our favourite stock has been profitable in the past, so we believe it will continue to be so.

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 **COGNITIVE BIASES**

Confirmation Bias

- A natural tendency to look for more information that *confirms our existing ideas or views*.
- It causes us to *subconsciously ignore* information that is *not in line* with our current perceptions or beliefs.

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 **COGNITIVE BIASES**

Confirmation Bias

- A natural tendency to look for more information that *confirms our existing ideas or views*.
- It causes us to *subconsciously ignore* information that is *not in line* with our current perceptions or beliefs.

For example:

- Any *bad news tends to be ignored* because we don't want to hear it.
- But we will readily accept more good news.

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 **COGNITIVE BIASES**

Herd Instinct

- We feel comfortable doing what others do, or simply agreeing with a majority;
- When a market is running hard (like a stock market bubble), and everyone is participating, it is difficult to go against the majority, because it doesn't feel right;
- We just feel comfortable sticking with the herd;
- We might actually feel uncomfortable going against the herd.

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 **COGNITIVE BIASES**

Cognitive biases

Can lead to seemingly *irrational behaviour*

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 **COGNITIVE BIASES**

More cognitive bias details?

A lot has been studied and written over the years about *cognitive bias*.

Some key words to search for:

- Cognitive bias
- Behavioural economics
- Behavioural finance.
- Simon Russell, *Behavioural Finance Australia*, <http://www.behaviouralfinanceaustralia.com.au/>

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 **COGNITIVE BIASES**

But how...?

How does all this happen?
and
How can we overcome it?

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Strategies

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 **STRATEGIES**

How to counter emotion and bias?

- Be aware of the emotions of *fear*, *greed*, *hope*
- Be more aware of the *cognitive biases* that can influence your decisions

STOP! and Step Back!

- Accept losses, and errors with investment decisions – it's a mind-set!
- Have a pre-defined approach and strategy (trading plan) to make the decision making easier and automatic.

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 **STRATEGIES**

Counter the fear of loss

- Use sensible money and risk management
- Limit the position size
- Use the "2% Rule" for risk management (as per van Tharp)
- Use a portfolio protection rule like: *"each position limited to 20% of portfolio"*
- Record and use some *rules* or *guidelines*.

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 **STRATEGIES**

Strategies

- (1) Devise a plan - an investing/trading strategy (more than one is okay)
- (2) Stick to the plan
 - If the plan is not working then revise it
 - Otherwise, stick to the plan.

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 **STRATEGIES**

Gain confidence

- Have a trading plan in place, which is tested and proven (but does not have to be 100% perfect)
- Monitor current positions periodically
- Record details about performance
- Review the overall portfolio position
- Feel confident when it is appropriate
- Keep things in perspective.

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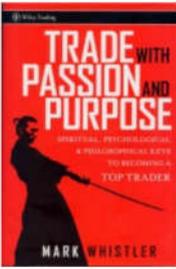
 **STRATEGIES**

Taking a loss – feelings?

How do you feel when you suffer a loss?

- Need to be relaxed
- Get over it quickly
- Move forward.

Good book:
“Trade with Passion and Purpose”
Mark Whistler
(price \$40-\$70)



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 **STRATEGIES**

Taking too many losses

- Losses cannot be avoided, so record all details for later analysis, and for a better understanding; ie. *write it down!!*
- If you suffer too many losses, then review the details and consider refining the approach;
- Remember that a Win:Loss ratio of only 40% can be successful, provided the Wins are large and the Losses are small.

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 **STRATEGIES**

Record-keeping

- We keep records for income and tax purposes
- And it can be useful to review all past investment decisions to decide whether to revise the plan
- Use a **trading journal** to:
 - (1) Record details about each investment decision at the time the decision is made (who, why, etc.)
 - (2) Record relevant information as the trade progresses
 - (3) Record details when the position is closed/sold
 - (4) Review the details periodically.

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 **STRATEGIES**

Flummoxed?



If necessary (in the *journal*):

- Stop, step back, and think
- Take pen and paper and:
 - (1) Write down the facts, and what is actually happening
 - (2) Describe any "feelings" (nervousness, doubt, etc.)
 - (3) Restate the facts
 - (4) Write down the possible outcomes
- Now re-think the alternatives.



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 **STRATEGIES**

Calm and sensible

- Try to bring a degree of calmness and sensibility to the situation
- Try to remove any emotion
- Don't automatically believe everything that we see and hear
- Watch out for the cognitive biases
- Don't rush into it.

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 **STRATEGIES**

A final thought...

Question:

- What things can impede our performance, or our ability to achieve our goals?

(see over...)

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 **STRATEGIES**

Barriers to performance
One common barrier – time management
“I just don't have time to do that”
What do you think about this “excuse”?

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 **STRATEGIES**

Barriers to performance
One common barrier – time management
“I just don't have time to do that”
What do you think about this “excuse”?



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 **STRATEGIES**

Barriers to performance
One common barrier – time management
“I just don't have time to do that”
What do you think about this “excuse”?

1. What if something very important comes up?
Would you make the time to address it?
2. Think about the standard “lunch break”...

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 **STRATEGIES**

The standard lunch break

- Many people have a very busy day most days.
- BUT, they still manage to down tools and take a lunch break at lunch time.
- For some people this means:
 - Read the paper, or tune into a favourite news report on TV or radio at a specific time (eg. 12 noon);
 - Visiting a favourite lunch shop for a yearned-for lunch item.
- But are there some spare minutes available?

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 **STRATEGIES**

Time management – Priorities

- Actually, it's all about **priorities**
- “Lack of time” is the same as saying:
“It's not high enough on my priority list”.

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 **Summary & Wrap up**

Summary

1. Awareness of psychology and emotions:
 - (a) Brain functions and awareness
 - (b) Feelings
 - (c) Emotions — F, G, H 
 - (d) Cognitive bias — introduction
2. Share some strategies for overcoming the feelings, emotions and the biases.
3. Any Questions? . . . 



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Downloadable materials

ProTrader Workshop participants can download materials:

- Handouts for the five sets of presentation slides
- "ASX Index Compositions" pdf
- "Single Candlestick Shapes"... pdf
- "Uptrend Candle Patterns"... pdf
- "Downtrend Candle Patterns"... pdf

<https://www.robertbrain.com/files/KL/>

Username: **protrader** (not case sensitive)

Password: **ProTrader2022** (this IS case sensitive!)

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Summary & Wrap up

Don't forget my Toolbox

- Brainy's **Share Market Toolbox**
 - (1) www.robertbrain.com
 - (2) Loads of eBook (PDF) Articles
 - (3) Info: share market, charting, BullCharts
 - (4) Weekly Market Updates and Watch List
 - (5) monthly e-Newsletter **special topics**
- Good software – BullCharts
www.robertbrain.com/bullcharts/
- My contact details:
web site above, or phone: 0438 355 910



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Summary & Wrap up

THE END

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