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Tips for Traders | 12/1/2008 10:02:00 AM

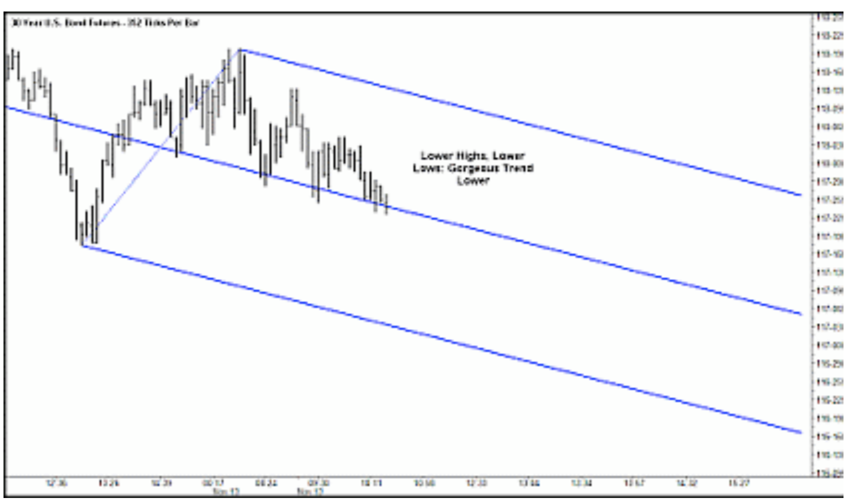
Loss in "Emotional Capital" Can Lead to a Crisis in Confidence

Most traders do not have the ability to identify all the major turns in a given market, but if you could, you would make a fortune, right? Reading the market correctly is only part of the story—though most traders cannot read the market well in real time. To make money consistently, you have to be able to read the markets, employ sound money management, and know when and where to take your profits. Sounds hard, doesn't it?

Wait a moment—I forgot another key ingredient! To be a consistently successful trader, you have to keep control of your emotions, and you can never run out of "emotional capital" when trading, or all that hard work and preparation will end in failure. I'm not trying to be an armchair psychologist. I'm sharing what I have seen in my own 37 year professional trading career, as well as what I have seen while teaching literally thousands of traders to trade or to trade better.

Emotional capital is very much like the capital in your trading account: If you run low on either, you are in serious trouble as a trader. And worse, you spend emotional capital while watching the markets, as well as when you make a winning or losing trade. Like focus, traders expend emotional capital whenever they are focused on the markets. And if you are trading with too little emotional capital [or focus], you will likely make poor trading decisions.

Several weeks ago, while working with one of the traders in my one-on-one mentoring program, I saw a perfect example of a gifted trader that tried to trade while low on emotional capital. The trades were quite striking—you can see the quality of the trade selections decline as he continued to take trade after trade. And although the day didn't cost him much, if he had been trading this same market, on this same day, and with a pocket full of emotional capital, I believe he would have had a huge winning day. Let's look at his charts and see if I can describe what I saw as I watched each of his trades unfold during our mentoring sessions that day:

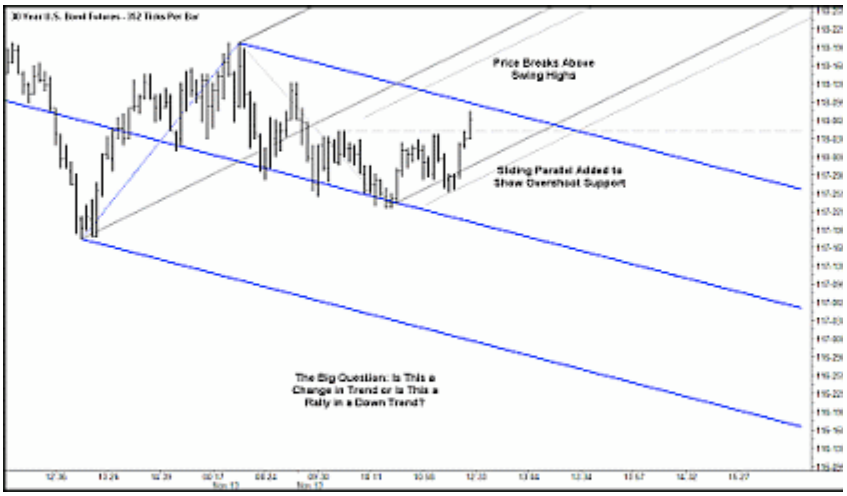


This is a 352-tick bar chart of the US 30-year bond futures. The trader had been waiting patiently for several days to catch a large move lower in the bonds. He had a feeling one was coming, but he was patient and he was waiting for the market to give him one of the high-probability trade entry set ups we go over and over in mentoring.

Note that price was making lower highs and lower lows—a classic sign of a cascade lower in a trending market. And also note that price was bumping along the center line, or the Median Line.

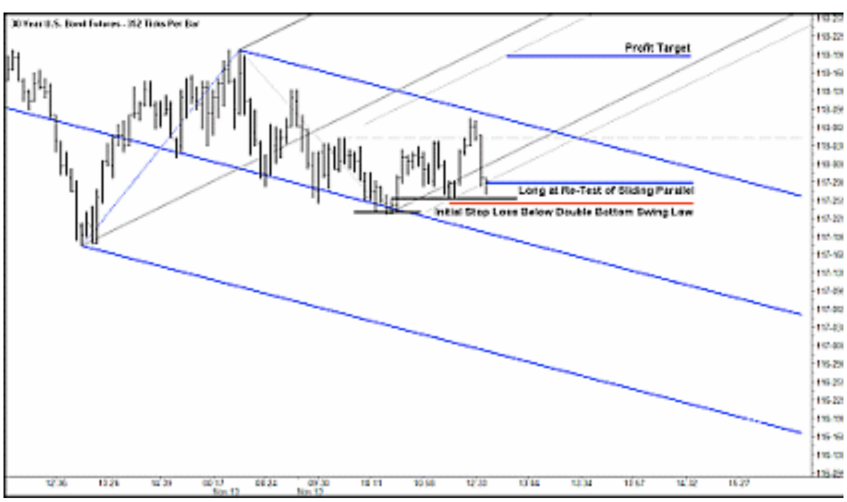
If price mounted a nice counter trend rally, the trader wanted to sell at the upper Median Line parallel; if price plunged through the center line, the trader was willing to sell a re-test of this center line if price rallied from below it. But viewing the charts, he was now fairly certain he'd get his chance to get short and grab one or two points in the bond futures. He had been watching for about three hours already on the morning this image was taken. He was anxious, waiting for a trade entry he recognized to appear.

Price began a nice rally over the next few hours. When it broke and closed above several prior swing highs, he added a gray up sloping Median Line and its upper and lower parallels. He noticed that price had briefly overshot the lower Median Line parallel, so he also added a sliding parallel to show where price would find likely find support should it trade back down through the lower Median Line parallel.



The question is always the same when a trader sees a change in behavior in the market: Is this a counter-trend move that will resolve itself at an area or support or resistance, leaving the trend intact; or is this a true change in trend? In the end, only the market knows.

As an aside, the trader had now been watching this market since 6:30 in the morning and it was approaching noon. Though he didn't realize it, he had already expended a great deal of emotional capital and focus without making a trade.

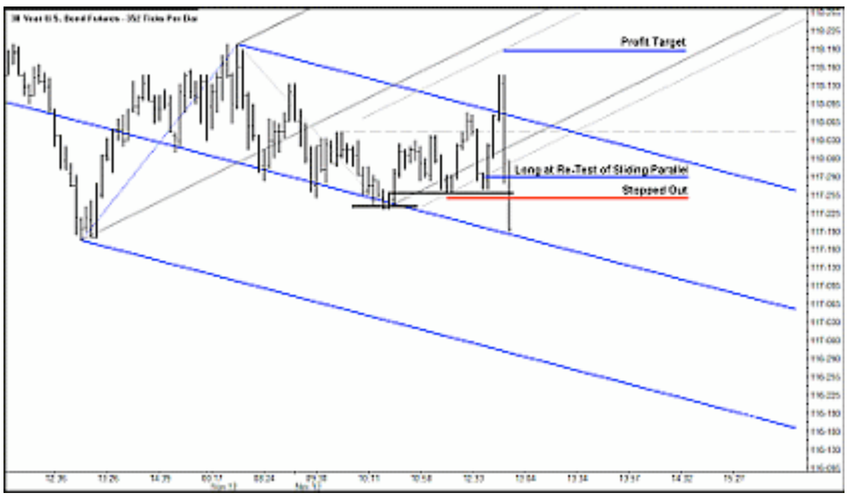


As the market made higher highs and higher lows, the trader began to really like this emerging rally. He marked the overshoot price made below the lower Median Line parallel and then, measuring it carefully, he projected it the same distance below the Median Line, a technique I teach in mentoring as well as in my seminars that gives a trader a high-probability target where price should run out of directional energy.

He liked the up sloping lines he had drawn, so he decided to enter a long trade at the re-test of the lower sliding parallel. He had a nice area to place a stop loss order, right under the prior double bottoms that also served as a swing low. There should be limit buy orders at the double bottoms, and these orders should act as a buffer to protect his stop loss sell order should price begin to trade below the sliding parallel.

And he had a very nice price target to lock in his profits. He'd leave a limit sell order at the inside sliding parallel, which was below the Median Line the same distance that the lower sliding parallel was below the lower Median Line parallel.

Though he had been anxiously awaiting an opportunity to get short this market for about six hours, he finally saw an opportunity to take a trade using a trade entry setup he recognized. All thoughts he had previously about the bonds trading lower went out the window when he added those up sloping lines. He had been waiting for a trade for over six hours and he was going to get one!



Just after he got long, news hit the market and bond prices rallied in a fast market. But they failed well before they made it to his upside target. Because he had been watching this market for over six hours, waiting for a trade, his focus wasn't particularly sharp. The bonds came down as fast as they went up and he hadn't moved his initial stop loss order to break even—and he was quickly stopped out of the trade.

Now that price had violated his up sloping lines, the thoughts he had before the trade came flooding back into his mind. He had been waiting for several days for a chance to get short this market, and this was an exhaustion rally! Rather than looking for a place to enter sell orders, he had got caught long—along with everyone else—and then stopped out—along with everyone else. He was angry with himself.

He had made two key mistakes, though he wouldn't realize them until the trading day was over: 1) He'd been waiting several days for an opportunity to get short the bond futures, and after waiting for six hours for a set up, he found one when he was low on focus, got long and was stopped out; and 2) He was now spending more emotional capital being angry with himself over the failed trade.

I teach the traders I mentor that at this point, they need to walk away from the screen and take at least a 15-minute break. Their eyes are glazed over from watching the markets for too long, they are low on focus, and probably low on emotional capital. If they continue to trade in this state, the quality of the decisions they make will deteriorate and they are at real risk of doing serious damage to their trading account capital. In plain English, they could lose a lot real fast!

But this trader wasn't thinking about taking a break…

He took a look at the charts, and to his credit, saw a high-probability entry at an Energy Point. An Energy Point is the intersection of a down sloping line and an up sloping line. They generally act as price attractors and are also areas where price often changes trend.

He got short at the re-test of an Energy Point, against a down sloping upper Median Line parallel, and his initial stop order was hidden above a swing high, where traders looking to get short had likely left a good deal of limit sell orders. And though it's not marked on this chart, his profit target was down at the lower Median Line parallel—a logical profit target that should net him about 1 ½ points in the bond futures.

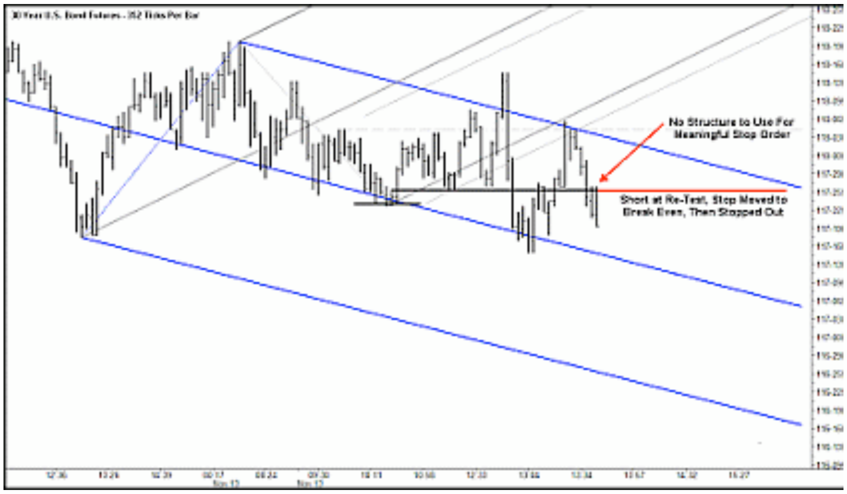
Where did it all go wrong? His orders were set up perfectly. Everything was thought out logically and he entered the orders into the market via his trading platform perfectly. Price rallied to fill his limit sell order and then started to sell off.

But remember, he was running low of emotional energy. Price sold off enough to show him three or four ticks in potential profits, and for a few moments, he was sure the sell off he had been looking for had finally materialized. He was ecstatic!

That was his third mistake of the day. He was spending additional emotional capital on a trade that was just beginning to unfold, and he didn't have the emotional capital to spend!

When price pulled back to his entry price, he was emotionally bankrupt. Now he was certain price was heading up to stop him out. He put in a limit buy order to exit his short position and was quickly filled. Then he cancelled all his orders. He'd managed to get out without losing any trading capital. But he'd spent a great deal of emotional capital and focus.

And worse, the bonds closed on their lows and then kept heading lower. And he was flat.



I teach the traders I mentor that at this point, they *must* take a break and clear their head. If they are really smart, they'll quit for the day.

He didn't quit for the day.

As bonds continued to sell off, he added in a horizontal line that showed what we call the "balance" of the action. It's a line with multiple highs and lows touching it, very much like a horizontal Center Line. When price breaks below this line, it is likely to be headed considerably lower.

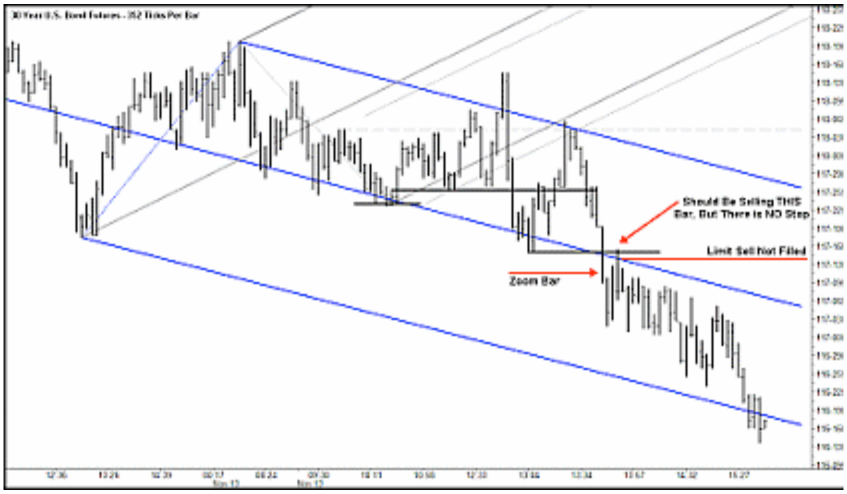
Note on the chart above that he correctly identifies this key line. And he also feels that once price breaks below it and closes below it, he should be selling any re-test of the line from below. He sees it and places his orders into the market.

But there is one key ingredient missing: There is no price structure for him to hide his order behind. Instead, he decides to enter without a safe stop loss order and puts in a five-tick cash stop loss order.

Once his limit sell order is filled, anxiety returns. He is short this market again—at a worse price— and this time, he doesn't have the protection of hiding behind the limit sell orders at a swing high or market structure. Price sells off three ticks and he starts to feel the anxiety disappear.

But then price comes right back to his entry price. He knows he is using a cash stop loss order. He really doesn't want to take a five-tick loss. Before he thinks much about it, he has entered an order to buy his short position back at break even. And in the blink of an eye, he's flat.

And then the market turns back down, making new lows for the move.



Price quickly breaks below the down sloping Median Line, a strong sign of weakness.

He hasn't had enough punishment yet. He's seen all the moves and all he has to show for his keen vision is a small loss on the first long bond trade.

He sees a potential high-probability trade unfolding right in front of his eyes. It's an entry I teach called "Zoom and Re-Test." When price accelerates through the Median Line (the Zoom), it should come back to test the Median Line within three to five bars (the re-test). If you can also identify a quality stop loss area, you sell the re-test and place your stop loss order and hang on for the ride.

He saw price zoom the Median Line. He watched as price re-tested the Median Line from below. Then he entered an order to get short only if price re-tested the Median Line. He was so tired and so emotionally drained, he identified the wrong bar to sell. He should have gotten short at the first bar that tested the Median Line after the Zoom; there is no need to wait for a second test unless it has been more than five bars between the Zoom and re-test.

And of course, there was no market structure for him to hide his stops beyond.

But he put a sell order into the market.

For better or worse, the market did not rally high enough to fill his poorly placed sell order. Prices sold off further from this point, eventually reaching the area where he should have been taking his profits from the first short bond trade (he would easily have gotten more than $1500 per contract). Of course, he missed the entire move down. And he finally shut his screens off and went out to clear his head.
Where did he go wrong? His first inclination was to identify an area in this market to initiate a short position. I find that a trader's first plan is generally the best. Early in the trading day, you have the most focus and you haven't spent any emotions on the markets. You are at your best at that point.

Rather than sticking with his original plan, he spent some emotional capital and focus chasing a long trade in the bonds. And he never got back in step with the market after that initial trade. He correctly identified each high-probability shorting area, yet walked away with nothing to show for other than a small loss from the long trade. He was quite lucky he didn't lose a great deal of real money. Although he saw the turning points in the market crystal clear, he was stumbling along blindly, getting out of his positions because of fear. This is a sign he was emotionally bankrupt.

Don't trade when you are not 100% recharged. When you trade with real money in the markets, you need to remember you are trading against the smartest and best traders in the world. If you have been staring at a screen for two or three hours, get up and take a nice 15-minute break! Clear your head, find your focus and get your edge back. Then come back and look for a high- probability trade entry.

I wish you all good trading.

Best,

Timothy Morge

timmorge@gmail.com
www.medianline.com
www.marketgeometry.com

Timothy Morge
President
MarketGeometrics, and Blackthorne Capital, Inc.
1870 Diamond Creek Lane
Aurora, IL 60504-3441
630/236-3441
Fax: 630/236-3448
Web sites: www.marketgeometry.com or www.medianline.com