
CHAPTER 3.3

Trading Psychology

Overconfidence Bias

Overconfidence bias is an over-inflated belief in your skills as a Forex trader. If you ever find yourself thinking to yourself that you have got everything figured out, that you have nothing more to learn and money is yours for the taking in the forex market, you probably suffer from an overconfidence bias.

Dangers of Overconfidence

Overconfident traders tend to get themselves into trouble by trading too frequently or by placing extremely large trades as they go for the home run. Inevitably, an overconfident trader will end up either trading in and out and in and out of trades—churning the trader's account—or risking too much on the one trade that goes bad and wipes out most of the trader's account.

Are You Overconfident?

If you want to know if you have any overconfidence tendencies, ask yourself, "Have I ever jumped right back into a trade I had just been

stopped out of not because I saw another entry opportunity but because I couldn't believe I was wrong?"

You can also ask yourself, "Have I ever put more on a trade than I normally would because I was just sure this trade was going to be the one?" If you have, you need to be aware of those tendencies.

Overcoming Overconfidence

The best way to overcome an overconfidence bias is to establish a strict set of risk-management rules. These rules should at least cover how many trades you will allow yourself to be in at one time, how much of your account you are willing to risk on any one trade and how much of your account are you willing to lose before you take a break from trading and re-evaluate your trading strategy.

By limiting the number of trades you are willing to be in and the amount of risk you are willing to take, you can spread your risk out evenly over your portfolio.

Anchoring Bias

Anchoring bias is a propensity to believe that the future is going to look extremely similar to the status quo. When you anchor yourself too closely to the present, you fail to see the dramatic changes that are possible as currency pairs fluctuate and the underlying fundamentals shift.

Dangers of Anchoring

Anchored traders tend to get themselves into trouble by convincing themselves that the current trend will never end and a reversal in the economic strength of a particular country is next to impossible. Alas, they become emotionally attached to the previous trend of a currency pair, and they continue to place trades that go against the new, current trend. With each trade, they lose more and more money because they are bucking the trend.

Are You Anchoring?

If you want to know if you have any anchoring tendencies, ask yourself, "Have I ever lost money because I couldn't accept that the trend had ended?" If you have, you need to be aware of that tendency.

Overcoming Anchoring

The best way to overcome anchoring is to look at multiple time frames on your charts. If you usually trade on the hourly charts, take a look at the daily and weekly charts every now and then to see where some of the longer-term levels of support and resistance are and what the longer-term trends look like. You should also take a look at the shorter-term charts to see when the shorter-term trends are reversing.

Broadening your perspective will help you avoid anchoring yourself to any one point.

Confirmation Bias

Confirmation bias is a propensity to look only for the information that confirms the beliefs that you already have. For instance, if you believe the EUR/USD is going to go up, you will look for the news, the technical indicators and the fundamental factors that support your belief.

Dangers of Seeking Confirmation

Traders who over-actively pursue confirmation of their beliefs tend to miss key warning signs that would normally have protected them from unnecessary losses. In an attempt to build a case for their beliefs, traders miss the facts. Ultimately, this leads to them fighting the trend and losing money with each ill-conceived trade.

Do You Seek Confirmation?

If you want to know if you have any confirmation bias tendencies, ask yourself, "How often do I look for signs that I may be wrong in my analysis?" If your answer is rarely or never, you may be a confirmation seeker, and you need to be aware of those tendencies.

Overcoming Confirmation Bias

The best way to overcome confirmation bias is to find someone, or a group of people, you can talk to about your trading. Hopefully the person, or people, you talk about your trading with will not always agree with you. Talking with traders with diverse perspectives and ideas will help you look at your trades from multiple angles. Sometimes you will strengthen your convictions by talking with other traders. Other times, talking with your trading partner will cause you to change your mind.

Keeping an open mind will help you catch new moves and avoid holding on too long to past beliefs.

Loss Aversion Bias

Loss aversion bias is based on the theory that the pain that is caused by losing \$1,000 is greater than the joy that comes from gaining \$1,000. In other words, fear is a more powerful motivator than greed.

Dangers of Loss Aversion

Traders who fear losses are much more likely to hold onto losing positions than traders who are able to accept short-term losses and move onto other, more-profitable trades. Holding onto losing positions jeopardizes the stability of your portfolio by not only incurring losses but also keeping you out of better trades.

Do You Fear Losses?

If you want to know if you have any loss aversion tendencies, ask yourself, "Have I ever held onto a losing trade past the point where I knew I should have gotten out because I hoped the currency pair would turn around and wipe out my losses?" If you have, you need to be aware of those tendencies.

Overcoming Loss Aversion

The best way to overcome a loss aversion bias is to trade with physically set stop loss orders. Many traders tell themselves that they will trade with a mental stop loss—a stop loss level that they think about and promise themselves they will act on if the currency pair ever reaches it. All too

often, however, traders fail to act on their mental stop losses. They let their emotions get in the way, and they start rationalizing their choice to stay in the trade until it turns around.

As soon as you enter a trade, you should set your stop loss order. Take your emotions out of the picture.



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