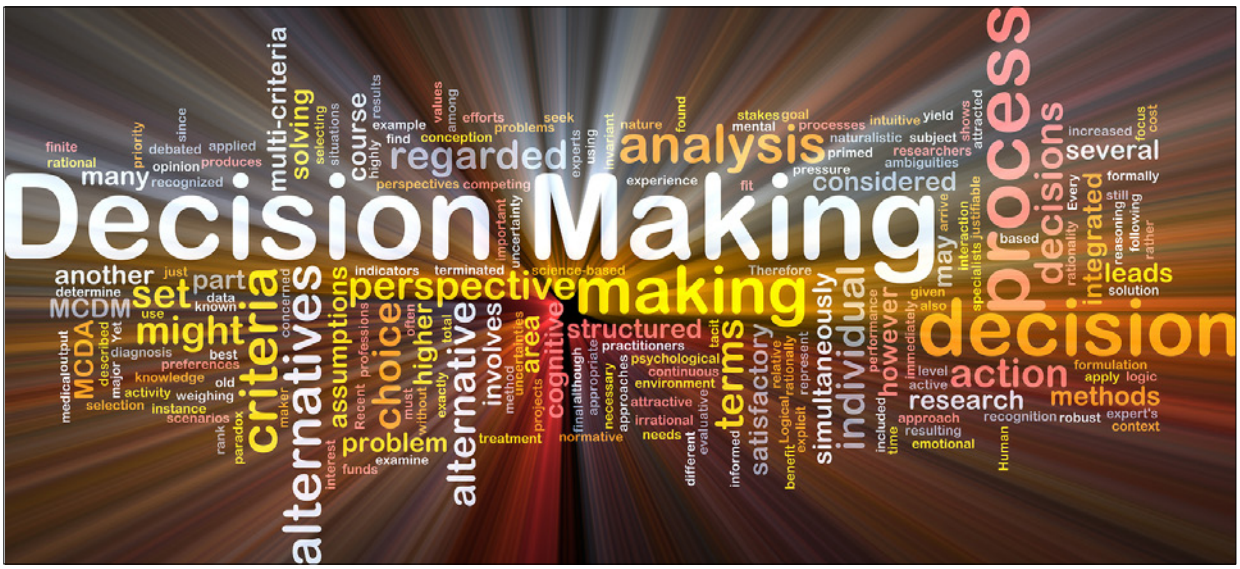
3 STEPS TO IMPROVING YOUR TRADING DECISIONS



INTRODUCTION

Making decisions under conditions of risk and uncertainty is not easy. The findings of research in behavioural finance and neuro-economics have helped us to gain a better understanding of our decision making process and the factors that affect it but many traders have found this knowledge hard to implement consistently in real time.

In this article, which I am incidentally writing whilst on a tour of Asia speaking to fund managers and traders about how to improve their decision making, I will share with you some of the key points of my presentations to them highlighting the need to go beyond simply understanding but also to increase awareness and utilise specific decision making techniques and strategies in order to improve the trading decision process.

THE 3 STEPS

When I am working with clients on helping them to improve their decision making I utilise three key approaches:

1. Developing an understanding of the decision making process and the factors that affect it
2. Creating an awareness of their own unique decision making processes, their strengths and weaknesses and the factors and situations that have the greatest impact on their decisions
3. Teaching some practical strategies and approaches to help them to improve their decision process

Understanding

Let's start with a question for consideration - What is a good trading decision?

Is it one where the trade was a winner? Or one where the process was good?

Trade outcomes can be classified under the following categories from 'Winning Decisions' by Russo and Schoemaker (2002).

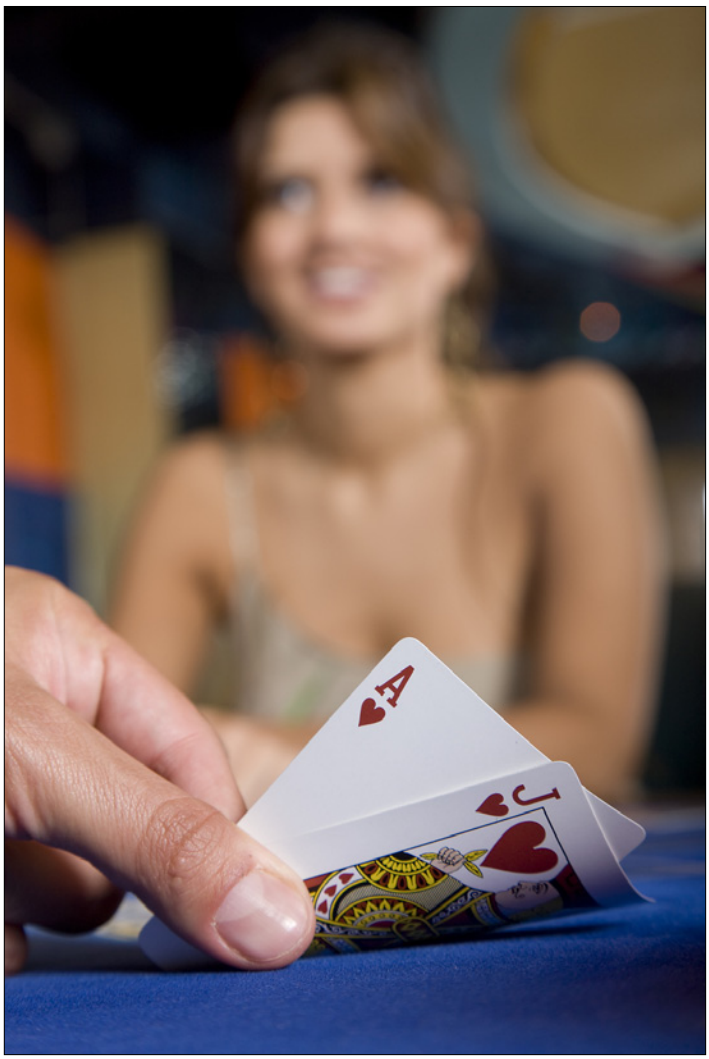
	Good Outcome	Bad Outcome
Good Process	*Deserved Success*	*Bad Break*
Bad Process	*Dumb Luck*	*Poetic Justice*

An illustration of dumb luck would be playing blackjack, being dealt 18, where statistically your best option would be to stick, but choosing to take a card, getting a 3, and beating the dealer with your 21. Good outcome but a poor process when executed over time.

A good trade is one where the process was good, where you followed your rules, implemented your strategy and were disciplined. Assuming your process is good, and your strategy has a positive expectancy, then over time you will be profitable. Ideally the aim is to keep your trading outcomes on the top row. I have in the past asked some of my clients to consider prior to the execution of a trade what the possible outcomes could be, which helps to raise awareness of times when a poor process has been used.

Keith Stanovich at the University of Montreal states that 'If you teach intelligent people about the types of mistakes they might make in making decisions then in doing so you improve their ability to make decisions'. Knowledge is certainly power, and by understanding more about how you make decisions and the types of traps that you may fall into then you can develop a level of inoculation against them.

The rise of behavioural finance has provided the perfect opportunity for traders to develop their knowledge of the process of making financial decisions and the factors that may affect them. I would highly recommend both 'Thinking Fast and Slow' by Daniel Kahneman and 'Behavioural Investing' by James Montier as core texts for developing your own understanding of decision making under conditions of risk and uncertainty and of the cognitive and emotional biases that affect them.



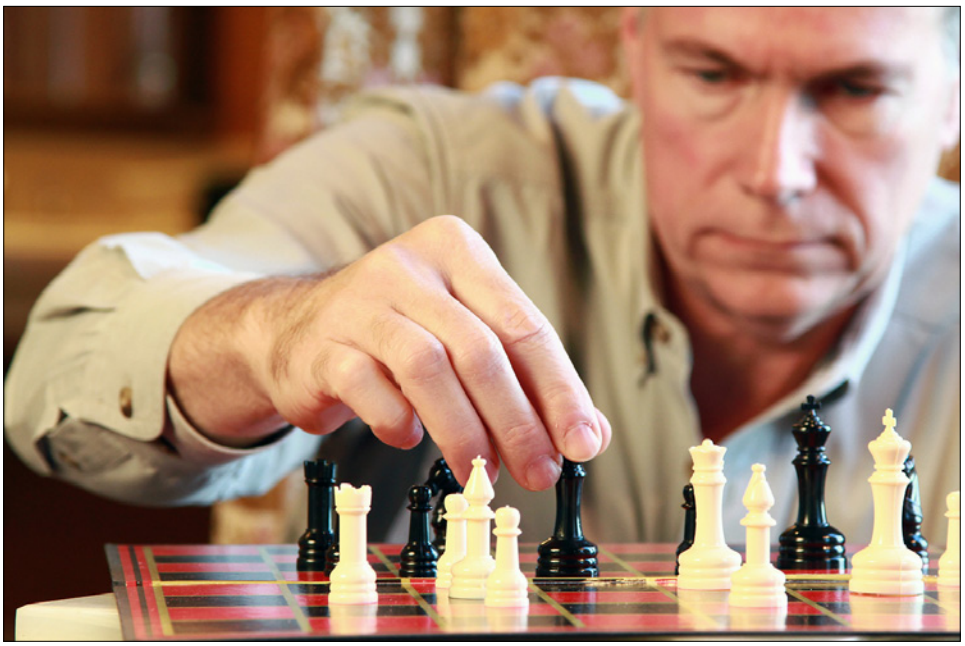
Awareness

'Know thyself'...The concept of self-awareness is not a new one, in deed almost every self-help book ever written will urge you to be more self-aware; and they are right, but how do you achieve it?

For me awareness of your decision process occurs at three key levels:

Reflective Awareness - This is the process of reflecting back on the decisions you have made and evaluating them, recognising patterns and looking for opportunities to learn from your experience and improve your decision making capability.

In order to do this effectively and with lower levels of hindsight bias it is important that you keep a record of your trading decisions, a journal or log. It is also worth noting that generally people are outcome biased and as a result of this we tend to spend more time looking at outcomes that were perceived as 'bad' and less looking at those perceived as 'good'; we are also interestingly more prone to attribute success to ourselves when we get a good outcome and consider the role of luck and outside events less, whereas on the downside it is the reverse! Research conducted at Harvard University shows that there is a lot of value to be gained by looking at the times when we are successful, to look for patterns and factors that are consistent, and to then utilise them and attempt to replicate them.



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Keith Stanovich

Performance Awareness – This is the process of contrasting and comparing your best decisions with your worst to look for similarities and differences. What helps you to make good decisions? What helps you to make your worst decisions? Is it your mindset, emotions, behaviours, or the context – market, work or life events. NB this process is only really possible if you evaluate your good trading decisions and outcomes with the same vigour as your bad ones.

Situational Awareness – This is the ability to identify in the moment at a given decision time what level of decision making error risk there is, deciding how vigilant to be, and managing your own thinking, feeling and behaviour accordingly. As the risk of decision making error becomes higher – this might include times when stress and pressure are high, there is greater volatility or uncertainty in the market, you are fatigued, your mood and emotion is at an extreme, following a big loss or win, following a string of losses or winners – you need to become more aware of your processing, and good advice is to counter the reflexive instinctive part of the brain that wants to take over in such situations by also engaging the reflective, analytical part of the brain and 'think twice'.

Management

Alongside developing your knowledge of your decision making process and the factors that affect it and raising your awareness, there are also specific techniques and strategies that you can employ that can help you to make better decisions. I have included a few below.

- Focus on the process – identify the key components or stages of making a good trading decision, and the critical factors such as information or indicators you base them on, and focus on them as you go through your process. One reason for underperformance in trading decisions is performance anxiety, which is largely attributed to an outcome focus.

• Checklists – Harvard Surgeon Atul Gawande, author of 'The Checklist Manifesto' tells of how they reduced surgical error in hospitals significantly when they introduced checklists pre, during and post-op. Whilst checklist may not be sexy, and may have the feeling of 'more paperwork' the fact is that they work – would you want to fly on a plane where the pilots had not done their pre flight checks? – and Gawande stresses that they should be short and effective. Checklists can be particularly effective in reducing errors in situations which are common and where processes are more automated.

• Become more mindful – mindfulness is a phrase used by neuroscientists to describe the experience of being in the present moment and is the opposite of being mindless where little conscious attention is being paid to what is happening. Mindfulness is a skill and can be gained through meditation or attention training and by actively focussing on having your attention in the moment – can be practised when you are eating, drinking, walking, exercising – and the research by neuroscientists shows that the benefits of such practise include greater cognitive function, a heighted awareness of unconscious processes, greater executive function, a stronger ability to control urges and impulses, greater behavioural control and improved ability to process information. The rise of the use of mindfulness over the last decade is probably best illustrated by its use by the US Marines who have utilised the 8 week Mindfulness Based Stress Reduction (MBSR) course before deployment to active duty in war zones.

• Consider being a Satisficer rather than a Maximiser – Satisficer is a combination of satisfactory and suffice and is best summed by getting to the point where a decision is 'good enough'. At the other end of the continuum is the maximiser, where perfectionists live, where there is an almost endless search for all the required information to make a decision. Generally satisficers are happier than maximisers and deal with bad outcomes to their decisions more effectively and are able to move on to the next one more quickly – anyone day trading would want to be more towards the satisficer end. Einstein said it beautifully 'keep it as simple as possible, but no simpler'.

• Regulate your emotions and energy – good decisions come from harnessing the right emotions; you cannot make a decision without emotion but you need the right ones. Professor Sam Wang a neuroscientist at Princeton advises 'Try to avoid making a decision at an emotional extreme' – extreme stress, extreme anger, extreme confidence even extreme happiness. Developing the ability to manage your emotions is an important part of the decision process, recognising your mood and emotional state at decision points is a key skill, having the discipline to not trade if you are at an extreme, and developing the ability to regulate your emotions through changing your self-talk and/or your physiological state such as utilising breathing techniques or other relaxation approaches. Underpinning emotional management is energy management, being healthy and well which is helped by factors such as sleep, nutrition, exercise and getting sufficient rest and recovery.

SUMMARY

Making trading decisions, under conditions of risk and uncertainty is not by nature easy to do, but by developing your understanding, increasing your awareness or implementing a simple technique or strategy you can enhance your decision making and improve your trading performance.

Steve Ward