# 10 Common Trading Errors

Many novice and emerging stock traders charge full throttle into the markets with high profit expectations, but find out fairly quickly that making money consistently isn't as easy as they expected. For some, this realization can be quite discouraging, particularly because there are few pursuits that fuel human emotion as significantly as trading. The prospects of making money often lure people into the trading arena, but the reality of losing money can be a quick deterrent.

In truth, most professional Wall Street traders have made many trading mistakes, according to trading experts. The key to their eventual success, however, is that the professionals study their mistakes and learn how to minimize them going forward. "It's all right to make mistakes," admits Dr. Alexander Elder, psychiatrist and author of Come Into My Trading Room. He adds, "If you aren't making mistakes, you aren't learning. But it's absolutely unacceptable to repeat those mistakes."

Like most serious traders, Elder has made a significant number of errors in his trading career. "The wonderful thing about the stock market is that you always know when you're right or wrong. If you're losing money, then you've probably done something wrong. Eventually, if you learn not to repeat making the same errors, you'll start running out of them."

The following article takes a look at 10 of the most common mistakes made by active stock traders.

**1. Little Preparation or Training**

When you enter the market arena, you had better be prepared. However, few traders perform the necessary due diligence before moving headlong into the markets, says Robert Deel, CEO and trading strategist for Tradingschool.com. "If you are going to swim with the sharks, you better learn from the sharks," Deel suggests. "The market is a food chain — the big fish eat the little fish."

Deel says few books teach you everything you need to know about trading stocks, so he recommends stacking the odds in your favor by reading as many as possible. "You shouldn't underestimate the time, dedication, and commitment it takes to be a successful trader. You can't just walk into the market with a handful of money and expect to take money away from the professionals. If that's the case, you're gambling, not trading."

Dr. Elder agrees that many people underestimate what it takes to be a profitable trader. Not having the benefit of a business school education or on-the-job training with a financial firm, Elder says it took him a long time to become a successful trader. "I had to overcome a huge disadvantage — a formal education," he quips. Elder says that while a background in financial services would have been helpful for him, sometimes highly educated traders can tend to get too caught up in technical analysis. "The market doesn't always work that way," he says. "Markets have a high degree of volatility. How you function in an atmosphere of uncertainty can be much more valuable than the type of analysis you use."

**2. Being Too Emotional About Money**

According to professionals, the reason many emerging traders fail to consistently earn profits is because of their perceptions of money. Trading expert Deel says that he gives all of his students a psychological test when they come to class. On the test, students are required to describe — in one word — what money means to them. Nine times out of 10, the answers are "safety," "security" or "power," he says. "Too many traders get so emotionally involved in their trades, long or short," Deel points out. "If a trade goes against them, many feel they are losing safety. That's why they tend to react so emotionally."

Deel says that no one can properly prepare a trader for the emotional roller coaster of the stock market. "Many are afraid of being branded a loser," he says. "To keep from being wrong, many people often will let a stock go negative against them. Let's say they put a stop at 30. As it drops to 29, then 28, they sometimes decide to go against their original trading plan. To keep from selling at a loss, they suddenly decide to hold for the long term. That's often a painful error."

Dr. Elder agrees: "If you came into my trading room and sat across from me, you wouldn't know if I was making $10,000 that day or losing $10,000. I don't show that much emotion. I'm more concerned about the long-term outcomes of my trading. It's more appropriate to look at your account at the end of the month or year, as opposed to your daily results."

Fortunately, there are ways to desensitize one's emotional connection to money. Elder and Deel both suggest that by trading smaller share sizes, such as 100 shares per trade, emerging traders can teach themselves to be less emotionally charged. Trading in smaller quantities can help minimize both the losses and the emotional distress that often comes with losing larger amounts of capital. Over time, as a trader becomes more successful, experts suggest slowly raising the share size — without raising your blood pressure — until a personal comfort zone is reached.

**3. Lack of Recordkeeping**

It's understandable why traders become emotional when trading stocks. Elder says: "When you make a trade, everything is going up or down. It can feel like you have no control over what is happening. By the very nature of buying and selling, total strangers are giving you money or taking away money, and that can be very stressful."

To help bring these emotions under your control, Elder recommends you keep a trading diary. "Every time you enter a trade, print out the chart and write down why you entered the trade, whether it was fundamental, technical, or a tip," Elder says. "I write the entry on the left side and my exit on the right side." He says the diary helps you achieve two goals. "The first is to make money. The second is to become a better trader. You might not succeed on the first goal, but you must absolutely succeed on the second goal. You should try to become a better trader after each trade."

Elder believes keeping good records is essential. "Show me a trader with good records and I will show you a good trader. Even if you're losing money little by little, you're learning from your mistakes. I believe money management and recordkeeping are even more important than technical analysis — and I'm a guy who wrote two books on technical analysis."

**4. Anticipating Profits**

Most traders don't want to acknowledge that a trade could turn against them. They enter the market assuming they'll be successful, refusing to look in the rearview mirror. It's also common for emerging traders to use a

calculator to predict how much they'll make and how they'll spend the unrealized profits!

Deel thinks that it's dangerous to anticipate how much you'll make in advance. "Let the market tell you what you are going to make. Anytime you say 'I have to…' you're in for potential trouble. Remember: The market doesn't care about you."

He suggests that entering the market with a neutral attitude is a good approach. "My mantra: What is, is. If you're in an uptrend, go long. If you're in a downtrend, go short. If you're overbought, wait for a reversal and go short. If you are oversold, wait for a reversal and go long."

**5. Blindly Following Mechanical Systems**

A large percentage of traders use technology — in the form of online trading platforms that provide charting, research, and backtesting tools — to help them refine their strategies. A computer and software can provide important information about the technical and fundamental characteristics about stocks. However, many traders make the common mistake of relying too much on these tools without a full understanding of their capabilities.

"People think that the computer is a replacement for what is between the ears," Deel says. "They think the box is going to give them the answer. A lot of people gravitate toward mechanical trading systems that are supposed to take over the trading for them." He contends that if you don't know how these trading signals are generated, then you are using software to think for you. "When you give up thinking and analyzing," he says, "you are toast. If you are blindly following mechanical systems to buy and sell, it's likely that you're unsure of exactly what you're doing."

**6. Not Learning How to Short**

If you fail to learn how to utilize short trading strategies, then you have cut yourself out of a number of profitable trades, experts say. Many people think that shorting is un-American or too risky. However, by not learning know how to go short, you're putting up a roadblock to one of the potential trading avenues you have to earn profits, particularly during a declining market.

Deel is adamant about shorting. "I believe it's essential that traders learn how to short. It's one of my first rules: Thou Shall Learn How to Short. Because of fear or ignorance, many Americans never learn to short in their lifetime. They're afraid of unlimited risk. But shorting a stock is no more risky than going long." He cautions that traders need to be very disciplined when shorting. "You can't hang on. If the stock goes up, then you get out. It's that simple."

Dr. Elder concurs with Deel's view on shorting. "The market is a two-way street, and the person who doesn't short is missing a part of the game." Because stocks tend to go down faster than they tend to go up, Elder says that shorting may be best suited for short-term time frames. For emerging traders looking to learn how to short, Elder suggests that traders find a stock that they believe has poor prospects and sell short no more than 100 shares. Minimizing the size of a trade can help ease a trader into the strategy of shorting without incurring excessive risk.

*Editor's note: Margin trading entails greater risk and is not suitable for all investors. Please assess your financial circumstances and risk tolerance prior to trading on margin.*

**7. Lack of Specialization**

Many people are attracted to trading because they think it's an easy vehicle for making money. However, there are several types of securities that can be traded in today's markets, including stocks, options, commodities, futures, and currencies. For emerging traders, it can seem like a daunting task to learn the characteristics of each security type. Therefore, it's often helpful to specialize. "When emerging traders don't initially specialize in some segment of the markets," Elder says, "they could be susceptible to over-engaging in whatever hot market segment comes along. Successful trading takes time, so it's quite helpful to be dedicated and committed to a particular category."

Most trading experts suggest that if you want to trade successfully, you need an edge. What do you know that will give you some degree of conviction? "If you don't know the answer to this question," he continues, "then you have no business trading. My answer: I know a few things about technical analysis because I wrote a few books on it. I can analyze charts with some degree of depth. I've been trained to recognize what is real and what is fantasy. And I'm extremely disciplined."

**8. Improper Timing**

It's very common for emerging traders to make timing mistakes. Quite often, a trader may have a good idea, but discovers that he or she bought the stock at an inopportune price. Timing a trade is never an exact science, but it's important for traders to recognize that there are times when it might be prudent to lock in a profit or cut a loss.

"Smart people get in too early and beginners get in too late," Elder says. "If you wait long enough, a stock may start to look like a good idea, but by then it's often too late." To illustrate this point, Elder said Google (GOOG) seemed like it would have been a good short when it's share price recently dropped from 300 to 276, but the move had already been made. Waiting until a chart pattern has been fully established can often result in a missed opportunity.

According to Deel, smart traders should not look for just overbought or oversold conditions, but extreme overbought and oversold conditions. Taking advantage of extremes could help traders better manage their portfolio risk. However, there are no guarantees that the current trend for a stock in an extreme situation won't continue.

In identifying trading opportunities, Deel uses a one-year time frame because there are a lot of data points. He is very conscious about timing his entry and exit points. "It's those movements up and down that make money. I want to feel positive about a stock three days after I bought it. If not, something is wrong."

**9. Placing Improper Stops**

Many traders incorrectly place stop orders, causing their positions to get stopped out too early and failing to capture much profit. It's common for emerging traders to place stops according to a set percentage, such as 2%, or a set amount. How much a trader is willing to lose depends on his or her risk-tolerance.

Deel says that many traders have been given incorrect advice on placing stops. "You place stops according to what the market is telling you, such as support and resistance levels," he says, "not according to profit goals. The market doesn't care how much money you need to make." Deel says that early in his career, he was constantly stopped out early, roughly 60% of the time in his estimation. "What I discovered was the market tends to move within a certain range under normal circumstances."

Today, Deel no longer places stops according to a percentage amount or how much money he is willing to lose. "Now, when I place a stop, I let the stock's behavior, or standard deviation, tell me where the best stop placements are. When I let the stock tell me where to place the stop, I get stopped out only about 20% of the time."

Standard deviation is simply a range, both high and low, of a stock's normal volatility based on a certain time period. Deel typically places three different stops using standard deviations. "Every stock has a specific standard deviation," he says. "It's as different as a fingerprint." You can find the standard deviation by using Bollinger Bands, which give you stop losses and an upside price projection. Using Bollinger Bands, the stock price should be within the upper and lower ranges. "Ninety-five percent of all price activity falls within two standard deviations," he says. He plots Bollinger Bands using an exponential calculation, rather than simple. "You can determine a stock's high and low ranges and what it can move based on standard deviation and probabilities."2

**10. Not Calculating a Stock's Risk-Reward Ratio**

Many traders do not calculate the risk-reward ratio of a stock trade before they establish a position. A stock's risk-reward ratio is the relationship between an investor's desire for capital preservation at one end of the scale and a desire to maximize returns at the other end.

How do you determine a stock's risk-reward profile? Through experience, traders tend to find their own comfort level for determining this ratio — there is no magic number. There are three common components of a stock's risk-reward ratio: current stock price (a known); and a profit objective and stop exit price (both subjective). Calculating a profit objective and a stop exit for a trade often involves many factors, such as standard deviation or technical indicators, including Fibonnaci and moving averages.4

Deel looks for trades that give him what he believes is at least a 2.5 times greater reward (gain) than the possible risk (loss). At a minimum, if he calculates that he could lose more than $1,000 versus a $2,500 gain, he won't make the trade. For Deel, 2.5:1 is his risk-reward ratio. But once again, that number is an arbitrary one that works well for Deel. A stock's risk-reward ratio can be different for each trader based on personal preference or the particular type of trade being considered.

"Every stock is a turkey until proven otherwise," he says. "This is part of the screening process of a stock." Deel says he's very picky about the trades he makes. "I've sat by great traders who see a perfect setup but not the risk-reward. They get in, and it reverses. If I'm going to risk a dollar on a stock, I want to estimate that I can make $2.50 or more before I make the trade. Otherwise, I move on to the next stock."

Figure 1 (below) is an explanation of how Deel calculates the risk/reward profile of a stock.

Figure1: This image details a method for calculating the risk/reward ratio of stocks. Shown for illustrative purposes only.

**Recommendation:** Before you enter a trade, the first question you should ask yourself is: What is the risk-reward ratio of trading this stock? If you are a novice trader, using a low risk-reward ratio could help lower your potential downside.

**Bottom Line**

It's common to hear about the victories people have trading stocks, but you rarely hear about the losses. As a result, it's easy for emerging traders to get lulled into thinking that successful trading involves little more than knowing the ticker symbol of the latest idea from your neighbor, coworker or poker buddy. Most Wall Street experts recognize that trading is a complicated and challenging business requiring an ongoing commitment. As a child, you didn't learn to ride your bike without taking a few falls. You didn't learn to catch a baseball without dropping the ball at least a few dozen times. And you didn't master your profession without making several mistakes along the way.

It's no different trading stocks. Most successful traders are constantly studying their craft, looking for an additional edge that may help them make more-informed decisions.

Understanding that mistakes are part of the process and learning to reduce them could help you develop a more disciplined, consistent approach to trading.