ANDREW MENAKER

Develop your mental edge

FOLLOW EMOTIONS AND FIND THE MONEY

Let's get the assumptions out of the way first. Everyone has assumptions, and this writer is no different. For the purpose of this paper, the reader needs to understand that as someone with a background as a clinical psychologist, I come from the school of thought that says traders who attempt to eliminate emotion or trade without emotion are mis-guided.

There are some coaches out there who will tell you that the recipe for trading psychology is simply a matter of changing your thoughts and eliminating emotion (or changing your beliefs, or altering your values, or increasing your focus, or building self-confidence, or improving your attitude); those things may be helpful. But there is a critical missing component. These strategies tend to leave out a very important part of being human, the inner emotional life, including emotions that are sub-conscious. Many of the above strategies either ignore subconscious emotions or assume that access to what is sub-conscious can be achieved fairly easily without much work, often from just asking yourself simple questions while visualizing certain things. Sometimes it can be this simple, but often it involves deep, brutally honest self-examination that many people are not willing to engage in for a variety of reasons.

Many people are led down a path that is paved with hopefulness and optimism but still has rocks and other obstacles along the way. Some of the proponents of the 'trade without emotion camp' say that one can learn to completely eliminate the effect of the past on one's present and future actions. I subscribe to many self-growth concepts and practice several forms of Zen and mindfulness meditation, but I also know from personal and professional experience that it also requires attention to one's emotional life in order to develop, and maintain a profitable trading mind-set. Emotions, whether we are aware of them or not, have a profound influence on decisions and subsequent behavior, especially when we are operating in an environment of constant uncertainty and ambiguity. One of the core principals I teach my trading psychology clients is learning to do more of what works and less of what doesn't; which may seem obvious at first glance, but in reality most traders repeat the same mistakes over and over. Learning to actually do more of what works and less of what doesn't is part of the foundation of a good trading mind-set.

I have seen many personality tests, including 'trader personality' tests, but they don't capture the essential nature of the trader. Measuring internal emotional experience is very slippery and very far from an exact science. Why?

To best illustrate my thinking on this, you need to know a little about my background. I have both a masters' degree in experimental research psychology and a doctorate in clinical psychology. When I was a graduate student working on my masters' degree almost 25 years ago, we spent a lot of time working with personality tests, or questionnaires, that were designed to identify personality traits and other psychological characteristics, a field known as psychometrics. When I took the tests myself and gave them to others, it seemed that the results were not getting at the core, the true internal experience of the test taker. Attempting to categorize human experience based on responses to a series of forced choice questions (e.g. Likert scale or true/false) may be helpful, but has serious limitations.

Other significant limitations in psychometrics include the reality that people answering questions on a personality test may have a conscious bias or a desire to appear a certain way, such as a social desirability bias (wanting to appear likeable), or they are not being entirely honest with the test, or with themselves, and perhaps a bigger reason is that emotions are not always conscious (in our field of awareness) or able to be communicated verbally or by checking off a box on a questionnaire. Furthermore, many of the questions on such personality tests are asking the respondent to, "recall a time when…" or "describe how you feel when you….". The tests are asking the respondent to work from memory or a projected scenario; with the test assuming that emotional reaction around such memories and projected scenarios is identical to real-time emotional experience. That's a huge assumption. (As a side note, among the human sensory functions of visual, auditory, olfactory, and kinesthetic, can you guess which one has the longest 'memory'? The answer is olfactory.)

Emotions can be sub-conscious or conscious. (Some scientists have difficulty with the concept of 'sub-conscious, and choose to call it 'pre-conscious'). Along this continuum of sub-conscious to conscious are the concepts of implicit and explicit.

Explicit emotions are relatively easier to work with because they are relatively easy to identify, more direct and can be described as a feeling that one is consciously aware of. It's explicit because one can label it, it is also usually reflective, relatively rational, and is typically well defended.

Implicit emotions are more difficult to work with mostly because they are indirect in their expression or manifestation. They are implicit because they are difficult to identify and label, tend to be more automatic or reactive (as opposed to reflective), tend be non-rational, and are relatively undefended because they are outside of normal everyday awareness.

Although implicit emotions may be relatively undefended because they are outside of awareness, they tend to be well guarded in that we are either not consciously aware of them or if we are aware, we might choose to edit or censor before we express or verbalize it.

As humans it is relatively easy to mask our true feelings in front of others, and it is also easy to mask our deepest feelings from ourselves. Learning about and understanding what makes us tick as human beings, and how we make decisions, is not for the faint of heart.

Why is this important for traders? As traders we must continually make decisions in an environment of constant uncertainty and ambiguity, where our judgment of right and wrong is constantly being tested and evaluated with money as the measurement. Emotions act as a filter on our perception of the world, including the market. They also serve as a form of self-communication. This applies to both conscious and subconscious emotions, possibly even more so with the subconscious. One way to describe the effect of subconscious emotions is that they are responsible to a large degree for many of our habits, the things we do without consciously thinking much about it, like driving a car, breathing, entering into an impulse trade, over sizing a position, hesitating to pull the trigger, or repeating the same trading error that we've made many times over and have vowed to stop but somehow the behavior continues to appear.

The world of advertising has understood the concept of sub-conscious emotion for a long time, and in some ways the advertising industry has been ahead of traditional psychological and neuropsychological research in this area, probably because they follow the money! As traders, we want to follow the money as well. I have friends who work in the advertising industry and they will tell you that humans are powered by both emotion and rational thought, and when emotion and reason conflict, emotion will often trump reason and be a larger influence on our decision-making ability. Advertisers, especially brand advertisers, have understood this for generations, long before the scientists and researchers arrived on the scene.

It is impossible to separate thoughts from emotions, let alone determine which one comes first. Trying to develop a trading mind-set based on the assumption that thoughts can be separated from emotions runs counter to my common sense as a clinical psychologist, and a growing body of research from both neuroscience (including neuroimaging), and other researchers that study consumer advertising and 'brand behavior'. *Our thoughts, perceptions, and even memories are neurologically linked to emotional reactions, both implicitly and explicitly.*

Psychologists have developed tests that attempt to measure implicit emotions. Traditionally, the field of psychology would call these tests, 'projective', 'unstructured' or 'subjective' tests. The person is asked to verbally respond to ambiguous stimuli and the results are interpreted by the psychologist and often compared to responses from other individuals in similar circumstances. Many types of projective tests exist; probably the most well known is the Rorschach (ink blot) test. In contrast are tests that attempt to measure explicit emotions, and are called, 'structured' or 'objective tests' because they rely on forced choice (e.g. T/F or a Likert scale) answers to written questions. This type of testing is what constitutes the majority of psychology and personality tests; the most well known among them might be the MMPI (Minnesota Multi-Phasic Personality test) or the Meyers-Briggs Type Indicator.

More recently, a test known as the Implicit Association Test (IAT) is being used to measure implicit psychological process. The IAT was initially developed by social psychologists and designed to measure the strength of automatic association between mental representations of various pictures or symbols. The IAT test is now used in business and advertising research, and has shown some very interesting results. Overall, results show that we are not always conscious of our biases or preferences, and of course we may even try to 'present' ourselves differently from what we actually feel inside. A non-trading example is the person who buys a new car and reports that their selection was based on a practical consideration, but in reality they were also reacting to an emotionally charged image or internal construct that led them to purchase that particular model.

Implicit, or sub-conscious phenomenon that has not been adequately attended to is the primary reason why many people don't experience long-lasting beneficial change after utilizing certain approaches to self-improvement.

Over 15 years ago, I was given the opportunity for real on-the-job training in the areas of threat assessment and psychological trauma (please see my bio on the web site). I studied the major theories, read the important authors, practiced various approaches, but what made me very effective at that type of work was something else, something less tangible. Without getting into details here, I will tell you that although there is a lot of research in these areas, when the rubber meets the road, it is clinical judgment that makes the biggest difference. My success was a result of the ability to assess individuals and their situation, not whether someone fits into a particular category (which rarely happens cleanly) or how many boxes are checked on a questionnaire.

So, what is clinical judgment? I'll give you an example from the world of medicine, because medicine, like trading often requires decision-making in an environment of uncertainty and ambiguous data, and I have several friends who are medical doctors. Years ago I asked one of them, a combination Ph.D. and an M.D. who at the time was the chief resident at a top medical school hospital, University of California at San Francisco, UCSF) what is the most important criteria for selecting the best doctor? Should one look for someone who is a recent graduate and has been trained in the latest medical developments, or is years of experience more important? My friend answered that the best doctors are the ones with the best clinical judgment, which he said is usually associated with both experience and current knowledge, but he emphasized what is more important is how a doctor decides to apply their knowledge. Over the years I've talked with other friends who are physicians, many of them highly respected and nationally known in their specialty, and after they get through describing the science about an ailment I may have asked about, they usually end up talking about how much judgment or 'art' is required in assessing and interpreting symptoms, formulating a diagnosis, and developing a treatment plan.

Besides trading, and medicine, aviation is another prime example of making decisions under conditions of uncertainty, and ambiguity and has a strong emphasis on risk management (btw, retail traders pay less attention to risk management than professionals, and I wonder if small private pilots pay less attention to risk than professionals?) Brett Molesworth, a psychologist and expert in flight safety conducted a study that predicted pilots' risk taking behavior by assessing their implicit experience, measured by the IAT. Because risk management is an integral part of piloting, and the objective of the research was to see what psychological characteristic might predict risk-taking behavior, Molesworth had 35 pilots complete a battery of explicit psychological tests, and also included the IAT, in conjunction with simulated flight on a computer-based flight simulator. Of all the tests, the strongest predictor of a pilot's risk taking behavior was identified by the IAT. It might be concluded that a person explicitly communicating how they are feeling when facing a risk situation is not equivalent to what they really might be feeling inside, as measured by their implicit experience.

So, where does this leave us as traders? To quote a legendary psychologist, Fritz Perls, creator of gestalt therapy, "Awareness, in and of itself, is transformative." In other words, as a trader you must learn to identify what goes on under the surface of your normal everyday awareness by tapping into your ability for implicit learning. Identifying and acknowledging both implicit and explicit emotions will help you to do more of what works and less of what doesn't. Understanding how emotions impact trading decisions is part of the process. You must develop your own clinical judgment about how to make decisions as a trader, and one of the best ways to do that is by understanding what your emotions are telling you.

ANDREW MENAKER

Develop your mental edge

ANDREW MENAKER

Develop your mental edge