Trading Psychology Dealing with Drawdown

Trading psychology is the most important aspect of a trader's success. This may surprise some readers, specifically those that are new to trading. However, the psychological makeup of a trader is more important than market knowledge, market analysis, and even money management. The reason psychology is so important is that even the best information can be distorted by a poor mindset.

Most new traders think the key to profiting in trading is knowing more about the market. For instance, most new traders clog their screens with every indicator they can find, read up on European GDP trends, and feel that pro traders have some sort of secret knowledge. However, this inevitably does not provide the lofty results the novice trader expects to achieve.

After realizing that excessive market information doesn't help (and may hurt) results, the next moment of truth most traders have is money management. Instead to trading 1 lot every time, or even trading the maximum lots their account will allow, these traders realize losses will happen no matter what. When you realize that everyone loses on occasion, it is easy to see why money management is necessary. This is a big step, but does not ensure success.

Now, don't get me wrong, you need to have some form of analysis and some form of money management to profit in the long term. In other words, you need an edge that when applied with proper money management leads to positive returns over the course of many trades. Great money management with no edge will only mean you lose your money more slowly. A great strategy without money management will lead to an inevitable blow up. However, without the proper mindset, it is nearly impossible to continue to get good results in the long run.

The bottom line is that a poor mindset can sabotage even the best trading strategy or money management strategy. I could write about this at great length, but we will look at one key example for now. The biggest test in trading psychology occurs during a drawdown. This occurs when a trader gets in a "slump" and has bad results for a given period of time. Usually the most devastating drawdowns eliminate a significant amount of a hard earned profit.

Keep in mind, draw downs are completely normal. Everyone has them on occasion. However, the key is reacting properly to drawdowns. This is why trading psychology is so important. The natural reaction during a drawdown is to change your strategy. Sometimes traders will even take trades for no reason whatsoever except for a desperate chance at a profit. Assuming you believe your methodology is sound, there is no reason to change anything during a drawdown. In fact, that is the most important time to follow the basics. Think about a baseball hitter in a slump. Sometimes they will change their stance, but usually they keep the same basic stance and swing. Instead, they focus on the fundamentals of keeping their head still, keeping their hands back, and so on. For some reason traders tend to panic in this situation and change everything up. This leads to a larger drawdown, which usually ends when the trader reverts back to their primary strategy.

In conclusion, the steps above illustrate the general process a trade takes on the road to achieving consistent results. Virtually all traders only become successful after they able to put together a strategy that gives you an edge, money management, and proper trading psychology.

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We all know that having trading losses is normal and is part of the entire trading business. Managing drawdown has nothing to do with money management or trade management.
Recovery of drawdown is much more difficult that the normal trading itself. Managing drawdown is in fact focus on how to manage the trading psychology when you are in a drawdown period and how you react to drawdowns.

Some things which traders must know when drawdown situations:

You do not blame the strategy and start making changes to the strategy or in worst case change the strategy.

You must recognise that drawdowns are inherent in all systems due to unforeseeable adverse market conditions.

You must believe that your trading methodology, money management and trade management are all sound and drawdowns is not a reason to make any changes to these.

Avoid the temptations to increase more trades hoping that it will help recover losses quicker.

Instead, go back to the basics of your system, review and make sure you are following your system rules and trade plan.

Do not make any change to money management thinking that it will help you recover the drawdown quicker. Only consistent trade management over time will help you recover the drawdown.