INTERVIEW

Developing Winning Attitudes With

Mark Douglas And *The Disciplined Trader*

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The best teacher is experience, and from his experiences as a trader and a broker, Mark Douglas, consultant with his own firm, Trading Behavior Dynamics, and author of The Disciplined Trader: Developing Winning Attitudes, *has experienced the gamut of trading emotions. From observing his and other people's emotional states, Douglas has developed strategies to help traders do what most professionals will tell you is the hardest part of trading — trade using your head.* STOCKS & COMMODITIES *Editor Thom Hartle spoke with Douglas via telephone on October 17, 1996, about fear, self-trust, the difference between a belief system and a trading system and gaining that ever-important edge.*

Mark, when did you first start trading?

I started trading futures in 1978. I was managing a commercial causality insurance agency at the time, but I was bored with it. Then one day, I got a cold call from a commodities broker. I decided to give it a try, and I started trading gold futures. From that point on, I really got caught up in the process, the same way most everyone does.

Did you start off making money?

Absolutely! I would say that by and large, from my experience of working with traders, most everybody starts off winning.

Sort of sets the stage for what's possible.

Definitely. Then after having I don't know how many winning trades but certainly enough to hook me, I reached a point that trading had started to become my life. So I left the causality business, came to Chicago and started work for Merrill Lynch as a retail broker upstairs at the Chicago Board of Trade (CBOT).

You were off and running! But —

To make a long story short, within about nine months, I had lost virtually everything I owned.

That must have been devastating.

It was. But a couple of things made my situation unique, and they kept me going.

Which were — ?

First, right from the beginning, I always had a sense that trading was mainly a psychological endeavor. That it had more to do with my mental perspective than anything else. As a matter of fact, the first trading book I ever bought, back in 1980, was Jake Bernstein's *Investor's Quotient*. I knew that what I *thought* was important, so much so that I was keeping pretty extensive diaries by the time I went to work for Merrill Lynch.

What did you write about?

I wrote about my trading behavior, my state of mind, the state of mind of my customers. I wrote about the behavior patterns I was observing, not only in myself but in other brokers in the office, as well as in the floor traders that I became friends with.

The trading system just gives you an edge. In other words, you look at a particular trading system as a way to identify those patterns that exist in market behavior.

What insights did you gain?

When I first came to Chicago, I had

some really big dreams. But at the same time, I had these fears lurking in the back of my mind. Up to that point, I had been trading almost three years but I hadn't been able to trade profitably in any consistent manner. And my family and friends all thought I was crazy for leaving the insurance business. It was rarely acknowledged, but the fear of failure was always in the back of my mind.

But you were successful in other areas, right?

That's right. I was just 33, had a six-figure income, doing everything that I thought would make me happy, but I was miserable. So I left for Chicago to pursue a dream. Of course, because of the lifestyle I had managed to acquire, I was living in both Michigan and Chicago, and I was living high in both places. I *had* to make money as a trader. And there was all this evidence building up that this wasn't what it was cracked up to be, that there was something wrong here.

What other evidence was bothering you?

I didn't know anybody making money! I couldn't find the people who supposedly were turning their dreams into reality based on the potential that I could see every single day in the market. Then my dream turned into a nightmare, and I was living out my worst fears.

Ouch!

You know what was interesting about that whole process? I was in a situation where I could have continued to trade, though I wasn't trading my own money because I had lost everything. I didn't *have* to leave the business. Normally, people who truly tap out are done; they're out of the business, at least until they can get more money, but in many cases it's forever.

So did you stay?

I was still working for Merrill Lynch, and because I was able to handle my financial situation in another state — I still had a residence in Michigan — nobody in Chicago knew that I had lost everything.

What turned you around?

When I realized — and I don't recall how long it took — that I was going to be fine. Once I did, my fears just disappeared. I realized that there was more to who I was than just my possessions. I could still think, I was healthy, I still had talents. When I came to fully appreciate these assets, the fear disappeared.

So it wasn't the end of the world?

No. It wasn't as bad as I thought it was going to be. Literally, these blinders about the market came off and I knew what I needed to do. And because I was already living my worst fear and realizing that I was going to be fine, there was nothing more for me to be afraid of. I honestly felt that there was nothing worse than the situation that I was already in.

With those blinders off, what were you able to see?

I was able to see the many limiting behaviorial patterns in me and other traders, patterns that inhibit our success. And the things that traders needed to do to change their course became clear. By the summer of 1982 I started writing *The Disciplined Trader* and started my consulting firm.

What* are *the behaviorial patterns that inhibit a trader's success?

Well, who hasn't gotten into a trade too soon — before the market generated a signal — or too late — long after the market generates a signal? Or taken a much larger loss because you moved your stop? These are just a few of the behaviorial patterns that are the result of four basic fears that all but the best traders consistently operate from.

Which fears?

Most often, traders have four fears. There's the fear of being wrong, the fear of losing money, the fear of missing out and the fear of leaving money on the table. I found that basically, those four fears accounted for probably 90% to 95% of the trading errors that we make. Let's put it this way: If you can recognize opportunity, what's going to prevent you from executing your trades properly? Your fear. Your fears immobilize you. Your fears distort your perception of market information in ways that don't allow you to utilize what you know.

Where do you think the four fears come from?

Oh, they're culturally inbred. It's virtually impossible to grow up in any culture without learning to become afraid of something — of being wrong, or of losing something. Yet there are natural techniques, as well as learned techniques, for people to use to resolve or reconcile losses. And not just financial losses, but any kind of loss. Very few people are aware that these techniques exist.

What's an example?

For example, the most natural technique for reconciling a loss is grieving. Crying is a natural way of reconciling the imbalance between something that's inside our minds and something that doesn't exist outside us in the environment.

Go on.

So, for example, take something as simple as an expectation, which is our mental representation of what some future moment is going to look like, taste like, sound like or smell like. If the environment corresponds with our mental representation, we experience a state of satisfaction. But to whatever degree it *doesn't* we experience a state of emotional dissatisfaction. Right?

Sure.

Let's say one of nature's mechanisms for reconciling the imbalance between what is inside and what's not outside is through grieving or crying. The problem for men is that we grow up in a culture in which we're taught specifically to not cry. As a result, what we do is end up with a lot of these unreconciled losses that just linger in our minds and we don't know how to deal with in healthy ways.

And for traders?

As traders, we get into a situation where we're confronted with the possibility that a trade isn't working, but we don't want to acknowledge that because to do so may tap us into the accumulated pain of every single time we've ever lost something. That's why for most traders, a trade just isn't a trade. Most traders place far too much significance and meaning on each trade, making it difficult to cut losses or admit they're wrong. And as a result, what do we do? We avoid the possibility! And by avoiding it, it generally gets worse.

And then...

Then you go back and look at the situation and say, "Well, I knew what was happening here because this particular pattern told me that the market had the potential to go against me, but I didn't take advantage of it." And why didn't you? Because you've reached a situation where you don't trust yourself. You continue to build a self-image that says, "I can't be trusted."

But don't most people rationalize that away?

They do. Traders are constantly indulging themselves in rationalizations and justifications to hesitate or jump the gun or hoping the market will come back to cut their losses. It obviously doesn't work.

And we end up not trusting ourselves?

Yes. We end up not trusting ourselves to always act in our own best interests and consequently end up fearing our own behavior. This is one of the key issues. It's not the market that we've become afraid of, it's really our own response to the market that we're afraid of. Now most traders don't look at it that way, but this lack of trust is a major source for the lack of confidence that most traders experience.

So what are some steps that traders can take to change that?

You have to learn how to change your beliefs by reinterpreting what it means to lose, and what it means to be wrong. In essence, you have to change many of the beliefs that cause you to interpret market information in a painful way. You have to create a whole new set of beliefs that allow you to see the market from a carefree state of mind, as well as a set of beliefs that always compel you to act in your own best interests. You want to reach a point where you're trading without hesitating, very much like the way great athletes perform.

We've been discussing belief systems. What's the difference between a belief system and a trading system?

The trading system just gives you an edge. In other words, you look at a particular trading system as a way to identify those patterns that exist in market behavior. Belief systems, on the other hand, control how you perceive that pattern or market behavior, as well as how you respond to it.

And how do you define market behavior?

The market is the collective action of everyone participating in the market at any given moment. Individuals have behavior patterns. They will do the same things under the same circumstances over and over and over again. A group of individuals will consistently display the same kind of collective behavior patterns. All a technical system does is identify those patterns and quantify them so you have a statistically reliable outcome.

That's your edge?

I call that statistically reliable outcome your edge. An edge with a higher probability of one thing happening over another. But that's it. That's all systems do. They don't tell you what's going to happen next. There are no guaranteed trades. There are no guaranteed outcomes. Every person who participates in the market is a market variable. And no technical system will take into consideration or account for every person who may put on a trade and may contribute to that particular pattern at any given moment.

Which means?

Which means that anything can happen at any time. Traders may know that at some gut level — but that belief doesn't exist at a functional level. It doesn't exist at a level in their minds whereby they see the market in the most appropriate way and they act in the most appropriate way every single time. Otherwise, they would never have a problem defining their risk in advance and they would never have a problem getting out of a losing trade.

That's pretty profound.

Think about it. If you really truly believed that every person who traded was a market variable with the potential to cause prices to go in any particular direction, and there was no possible way you could get into the mind of every trader with the potential to put on a trade, then how in the world could you ever know, *for sure*, what was going to happen next?

There's uncertainty with every trade?

There is indeed, and that means the market produces patterns, and the patterns in turn will generate an outcome with a higher probability of one thing happening over another. The outcome to each individual pattern is random. But people don't believe that! And that's the problem.

So what you're saying is that the outcome of every individual trade is a coin toss?

Yes! The trading public doesn't understand that, or they wouldn't have the kind of problems that they do in their trading.

If the outcome of every individual trade is a coin toss, and you have a series of losing tosses, it would be easy to become emotionally caught up in the next trade.

Exactly, and this is where the best traders really separate themselves from everyone else. They know at the very core of their trading personality that this trade is statistically independent from the last trade and act accordingly. Everyone else, on the other hand, associates this trade with the outcome of the last trade, or the last two or three trades. If the last two or three trades were losers, then of course they're associating this next signal with the last two or three trades and they're only seeing the risk. If the last two or three trades were winners, they're in a state of euphoria and they're not perceiving any risk at all, which allows them to make all the errors on the other side of the ledger. They overtrade, or they believe the current trade couldn't possibly be a losing trade.

Which still brings them back to why they need a system.

They need a way to define what works and what doesn't, but more important, they need the proper attitude to be able to utilize that system to its full potential. Without the proper attitude, they're just trading randomly. And randomness is the antithesis of consistency, is it not?

Hey, who's conducting the interview?!

You are! And I'll bet that if you asked every trader out there what they really wanted, what they would say they wanted was consistency. They see all of these opportunities that present themselves every moment of every day and what they *really* want is a steadily rising equity curve. But they trade randomly and don't realize that if they aren't going to focus their attention on determining what works and what doesn't, none of it's going to do them any good. What they're going to get are random results in their equity curve. They're going to have an equity statement that looks like a sawtooth pattern, with an up-down, up-down look.

So the trader creates for himself exactly what he* doesn't** ***want. This reminds me of your discussion in* The Disciplined Trader *on how our fears function to create the experience we're trying to avoid.

What traders don't take into consideration when they start out is how much of a mental endeavor trading really is. The market has absolutely no control over how you perceive it or how you interpret the information. There are specific mental mechanisms that control the process of perception and interpretation. As traders, if you want to make the most money, you have to create consistency. And the best way to create consistency is to control the process of perception and interpretation so that you operate out of an objective frame of mind and as carefree a state of mind as possible.

Carefree? Can you really be carefree when you're trading?

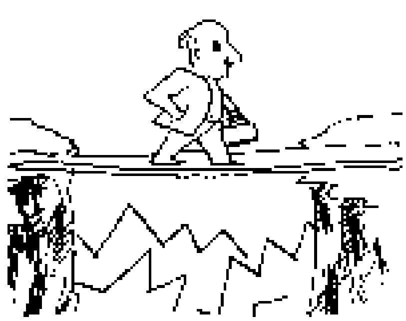
Carefree in the sense that one is relaxed. Because a mind that's not relaxed can't stay focused, or you get distracted and make errors. And errors are very costly, especially for traders.

Is there a primary cause of trading errors, in your opinion?

One of the primary factors that create errors for traders is fear, because our minds are wired to avoid pain. Many mental mechanisms exist, some of which we're conscious of and some of which we're not; it's really the ones we aren't conscious of that create the big problems.

How so?

First of all, people generally don't understand that fear. Not only does it debilitate us physically, but it also weakens us perceptually. Fear causes us to narrow our focus. With all this information available at any given moment, what fear will do is cause us to narrow our focus onto the object of our fear. Our fear is a natural mechanism that



tells us that there's a possibility of experiencing pain. To avoid that pain, what am I going to do? I'm going to focus my attention on it so that I can get away from it and protect myself.

Your self-preservation instinct takes over?

That's right. With trading, it's more insidious because the market doesn't just generate painful information. It generates what can be perceived as painful information and pleasurable information almost simultaneously.

Meaning—?

Meaning one tick can be painful but the next tick can be pleasant, depending on interpretation. For example, say I'm in a trade and the market is moving against me, but typically, the market doesn't move every single tick against me. The market will give me a tick in my favor. But overall, let's say what's happening is that the market's moving say four ticks against me to every tick in my favor, if we average it out.

So in that situation, you're long the market.

Yes. Let's say I bought the market, but over time the market's making lower lows and lower highs. Unfortunately, each small rally gives me something to hang my hat on. That momentary relief will give me something to hope for. My fear causes me to focus my attention on the upticks because I place significance on the ticks that go in my favor and then I do everything possible, consciously or unconsciously, to rationalize that I'll be okay.

So you don't see the true trend.

Right. I place all the significance on the ticks going in my favor, and even though the market continues to trend against me, I'm not perceiving it as a downtrending market. Instead, I'm perceiving every tick that goes in my favor as a bottom. I'm perceiving that the market is ready to start an uptrend.

And the fear within you is causing this inappropriate behavior.

If I'm operating from a fear of being

wrong, what my fear is going to do is cause me to narrow my focus on only information that will confirm that I'm right and exclude from my awareness any information that tells me I'm wrong. I'm doing this to myself because admitting that I'm wrong could tap me into the accumulated pain of every time I've been wrong in my life. My fear of being wrong causes me to stay in a losing trade too long.

And then what happens?

Then another fear pops up. Every downtick is going against me, so now I've also got a fear of losing money. When my fear of losing money is one degree greater than my fear of admitting I'm wrong, then I'll get out of the trade. Then when I look at the chart after I've gotten out of the trade, I'll see the downtrending market and I'll ask myself why I didn't just go short.

A missed opportunity. Doomed if you do and doomed if you don't.

Sure. Your inability to recognize a good opportunity for going short is caused by the way fear acts on your perception of information. So basically, we're prevented by our own fear from taking the most appropriate action for ourselves.

This also ties in with the discussion in your book about traders getting exactly what they believe they deserve.

Fears are not the only source of the kind of trading errors that create a lack of consistency. There's a substantial category of errors that can be the result of self-valuation issues.

Meaning?

Meaning that a person really has to believe that they deserve the money. If they don't, then there'll be other kinds of errors, errors preventing them from accumulating money.

Despite learning a method and having the confidence to use it?

A person can learn how to redefine the way they perceive the market so they can trade in a state of mind without any stress or fear, virtually carefree. They can learn to look at the market objectively, but they can still have issues of self-valuation that cause errors.

Otherwise they enter into self-sabotage territory?

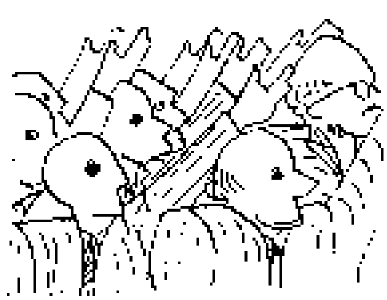
Yes. A person really has to train him- or herself to recognize when these things are happening, while or before they happen, as opposed to looking at it afterward. Simple things like where you intend to buy the market but you make an error. You tell your broker to sell, and he calls back with your price. You're surprised! You challenge the trade, and then he plays you back the tape and you clearly told him to sell, not buy. These things are not accidents.

If it's not one thing, it's another!

People generally assume that these behaviors are accidents, but they're really not. They're usually the result of self-valuation issues. Say we took every experience in our lives and listed every experience that contributed to a positive sense of self-valuation, where the experience basically says I'm a good person and I deserve it. And I'm worthy. I'm worthy of success. I'm worthy of making money. I'm worthy of happiness.

Okay. And then?

And then tally every experience that contributed to a negative sense of self-valuation. And we've all had our share of those, when someone may have implied that you deserved something bad to happen to you or you deserved something not going your way, or else it wouldn't have happened. What that translates to is that every time you experience pain, our minds can easily associate the pain with that hurtful statement. And then it translates into a negative sense of self-valuation by thinking that you really did deserve the bad experience.



The old "I blame myself."

Yes. Now, if you match all the positive experiences against all the negative ones, what you're going to end up with is a net sense of evaluation, positive or negative. There's a net bottom line. You've got more positive energy than negative energy, or you've got more negative energy than positive energy. If you have more negative energy than positive, you're going to have a hard time accumulating money as a trader. I'm not implying that you *can't* accumulate money, because there are ways in which you can compensate, but that goes 'way beyond the scope of this interview.

How would you outline some of the steps to success?

Well, I consider traders to be in one of three groups of development. The kind of steps I suggest people take is based on their level of development.

So what are the three groups?

The three stages are what I call mechanical, subjective and intuitive trading. The stage of development you're in will depend on your attitude. In the *mechanical* stage of trading, you're learning to stay focused on what you need to do, when you need to and then do it without hesitation. In the subjective stage of trading, you no longer have the potential to define and interpret market information in painful ways.

And if you can't?

Until you can, I strongly suggest staying in the mechanical stage of trading. At this stage, you're reducing your variables, because the market can generate a ton. And you need to be able to contend with the variables in terms of market information and patterns.

And your own variables as well?

You have to sort it *all* out to determine what works and what doesn't, both in the market and in yourself. The best way to do so is to trade mechanically, where market variables are known in advance, and you don't change them over time unless they warrant changing. I suggest to people that they commit themselves to taking the next 20 trades, as opposed to just taking the next trade. And if they can execute those signals flawlessly, without hesitation, without fear, they can look at their variables and say, this works and this doesn't.

And only then should they modify their system?

If they want to tweak their system, then they can tweak it, but only after at least 20 trades. Otherwise, they're not giving their variables a fair test. They're also going to find out how much of themselves is working properly, so they can determine what they need to work on to be able to trade effectively.

Then what?

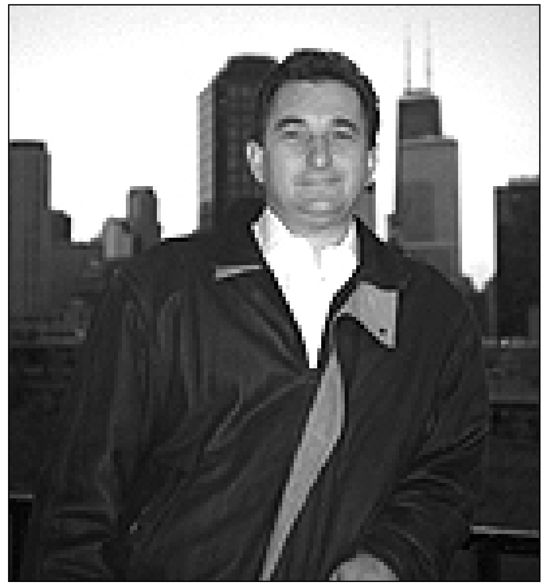
Once they've gone through the mechanical stage of trading — and going through that entails being able to do at least two or three of these sets of trades without hesitation, without fear, without error — then, and only then, can they trade subjectively.

And that is —

That's when they can use everything they've ever learned about the market to generate a signal. For example, if you're in the mechanical stage, I would never, *ever* suggest altering your strategy midway. If you put a stop in the market and the market looks as though it's going to hit your stop, and it looks like I can save myself a few dollars by getting out, in the mechanical stage of trading you wouldn't do that. You would just let yourself get stopped out.

But in subjective trading?

Whereas in subjective trading, you *could* get out early. There's a difference in terms of your development, because by then you've learned to trust yourself. You aren't rationalizing by then; what you're doing is looking at the market from an objective perspective and saying: "I can get out of this right now. I don't need to get stopped out."



To trade intuitively on a consistent basis, you have to learn how to properly integrate the rational and creative parts of your brain.

What about the third stage?

That's the intuitive stage. My belief is intuition comes from the creative part of our brain. Creativity, by definition, brings forth something that didn't previously exist. On the other hand, the rational part of our brain contains everything we've already learned, which means, by definition, it already exists. So the creative part that generates the intuitive hunch or gut feeling can and often is in direct conflict with the rational part of our thinking process, simply because creativity exists outside the rational framework. The hunch or gut feeling was perfectly correct, but because it can't be justified rationally, it isn't acted on. To trade intuitively on a consistent basis, you have to learn how to properly integrate the rational and creative parts of your brain.

Thanks for your thoughts, Mark.

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