Transcript

THE ARTFUL TRADER

Episode 7: Applying the science of psychology to the art of trading with Brett Steenbarger

Michael McCarthy: So many times traders are told to follow their heads, and not their hearts. But can traders be more self aware, and apply the science of psychology to the art of trading?

Dr. Brett Steenbarger: So my role is to help them literally think about their thinking. Step back, become aware of that perfectionistic self talk so that they can truly serve as their own coach.

Michael McCarthy: Today we chat to Dr. Brett Steenbarger, a psychologist and performance coach for hedge fund portfolio managers, who analyzes the cognitive, behavioral, and emotional reasons why traders make the decisions they do.

Hi, and welcome to The Artful Trader. I'm Michael McCarthy, the Chief Market Strategist at CMC Markets Asia Pacific. In each episode we'll hear the highs and lows from the trading experts, and discover their journey to mastering the art of the financial markets. Dr. Brett Steenbarger is a psychologist and performance coach to traders. He has written several books including The Psychology of Trading, The Daily Trading Coach, and his latest book Trading Psychology 2.0. Each week he has coaching sessions with traders and hedge fund managers in the US, Europe, and Asia. Giving them techniques to better understand the vagaries of the markets, and offering critical advice to improve performance. He applies the latest research and findings in psychology and behavioral finance to give traders practical takeaways. Unlike many other psychologists, Brett is also a trader, giving him that deeper perspective into the thinking behind the trades. Joining me from New York, welcome Brett.

Dr. Brett Steenbarger: Hi, how are you?

Michael McCarthy: Going well. How are you?

Dr. Brett Steenbarger: Doing very well. Thank you for having me. I appreciate it.

Michael McCarthy: Thanks Brett. Brett, you're a psychologist and a trader. So in many ways you've got a unique perspective on the markets. What goes on in the minds of traders is an important part of your brief naturally, and we'll get to that. But what came first for you, was it the psychology or the trading?

Dr. Brett Steenbarger: Yes. The psychology came first. I have a PhD in clinical psychology, and I worked for many years applying psychology to professionals in the field of medicine. I've had a longstanding interest in trading myself. I began trading in the late 1970s during my graduate school time, and it was always a side interest of mine. So while I was training to be a psychologist I was following financial markets and trading. It was only later in my career that I decided to put those together and write a book called The Psychology of Trading. That was discovered by some firms, and by some traders, and that's how I started applying the psychology to their work.

Michael McCarthy: So each week now you're at different trading firms coaching traders and hedge fund managers. You're coaching people all over the world from the US, to London, to Asia. Is there a main issue, or a common theme that you see recurring in traders all over the world?

Dr. Brett Steenbarger: There are common issues and challenges. Many of those are based on the experience level of the trader. So that we have more beginning traders who are dealing with the challenges, and the frustrations of their learning curve. We have more experienced traders who may be managing significant capital, and are dealing with the pressures of making and losing large amounts of money when markets move quite a bit. So there are different issues depending on where traders are at in their developmental curves.

Michael McCarthy: What are some of the problems more experienced traders face?

Dr. Brett Steenbarger: There are several. They experience performance pressure issues. So for instance, if they draw down, if they lose money they feel a lot of pressure to make that back. They have a responsibility to the investors. It's the investor capital that they're managing. So they can feel quite a bit of pressure. They have to make sure that that pressure doesn't unduly interfere with their trading decisions. So that's one common set of issues. A second set of issues happens at the other end of the spectrum when the portfolio managers have been making money, and making money, and they become confident, and then they become overconfident. When they are overconfident that can interfere with good decisionmaking. So those are a couple of scenarios that I help them with.

Michael McCarthy: It's a good time to be talking about this, given that Richard Thaler was awarded the Nobel prize. He described what you were just talking about there, the hot hand theory. That one of the dangers for traders is that they'll extrapolate their current success into the future without taking the time. Do you see that much?

Dr. Brett Steenbarger: That's right. Richard Thaler has done some very good work in behavioral economics. Many of his studies have shown that we are less rational than we like to think of ourselves as being. So we will fall victim to what are called recency biases. So if recently we made money we think that that's going to extend to the future. If recently we lose money, we can also extrapolate from that. When in fact many periods of winning and losing are just relatively random occurrences.

Michael McCarthy: How do you coach a trader through that hot hand experience? How do you bring them back down to earth?

Dr. Brett Steenbarger: That's a good question. What we try to do is help them stand apart from their recent experience. So when a trader feels that he or she has the hot hand, it's my job to press them with questions of, what would tell you you're wrong in this situation? How would you recognize that? Helping them make that a regular part of their process. To be self aware, to be asking themselves those questions. It's during the overconfident times that we tend to not doubt ourselves. So I will use exercises where they have to pretend that instead of making a lot of money recently, they've lost money. Would you put those same trades on if your recent experience was losing money instead of making money? Those kinds of questions and exercises help them be a little more thoughtful, a little more self aware.

Michael McCarthy: But is it possible to coach anyone to become a trader?

Dr. Brett Steenbarger: It is definitely possible to help coach them to be a trader. It's definitely not possible to necessarily coach them to be a successful trader. That's an important difference. Trading is a performance activity, no less than athletics, no less than being a virtuoso opera singer. Can anyone become a professional athlete? Can anyone become a professional on the stage, or as a musician? No, I don't think so. I think people can become competent with practice, but it takes particular inborn talents, and it takes real ongoing training to reach a level of expertise.

Michael McCarthy: So what are some of those characteristics?

Dr. Brett Steenbarger: Of a successful trader?

Michael McCarthy: Yes.

Dr. Brett Steenbarger: It depends on the type of trading it turns out. I've done research at several different firms about what makes traders successful. It's very interesting, different skills and talents play into different forms of trading. For instance, I work with some firms that emphasize day trading. They're trading very actively, very frequently, every single day. The average holding time of positions can be measured in minutes. That requires unusual capacity for concentration and focus. It requires very quick mental processing. It requires quite a bit of parallel processing. Being able to take in lots of information from different places all at one time. That's quite different from working with hedge fund investors. Let's say equity managers that are trading a long/short portfolio. They are looking at investment ideas, of strong companies and weak companies. They're looking for those to play out over multiple months, and even years. So research and analytics become important to their success, not so much the very fast thinking.

Michael McCarthy: Can you give me an example of some of the issues that you might work through with those different kinds of traders?

Dr. Brett Steenbarger: Yes. So with the very fast traders, one of the issues that comes up occurs when there is a loss of focus. There's research on attention span, or what the psychologist Roy Baumeister calls willpower. It turns out that it's a finite resource. That we can stay focused, and we can concentrate, and we can follow our will to a degree. But then we overtax those willpower muscles, and we end up losing focus. So traders end up making more impulsive decisions, more emotional decisions, more decisions that they haven't thought through when they become fatigued, when they lose focus. So my role is to help them sustain their focus, but also help them recognize when they are starting to lose that focus so that they can renew themselves.

Michael McCarthy: How do they renew themselves?

Dr. Brett Steenbarger: By getting away from the screens. That certainly is one way. In other words, if you are taxed in a certain cognitive area, it helps to switch gears and function in a different area. So for instance, they will get away from the screens and do some vigorous exercise. Or they'll get away from the screens and engage in some social interaction. I have money managers who have taken breaks during the day, midday, when markets are slower, and they've jogged. One firm I've worked with actually has a room set aside where people can take power naps. There's interesting research about how power naps can rejuvenate us. So they're all different ways, but they involve switching gears, and getting away from that constant focus that trading can require.

Michael McCarthy: Other experts we've spoken to have talked about things like meditation as a tool.

Dr. Brett Steenbarger: Yes. I'm glad you brought that up. Meditation can be helpful in a number of situations. At the very least because you're controlling your body's physiological responses, deepening your breathing, increasing your focus, at the very least it could help dampen the flight or fight responses when we're under stress. So that by itself is useful. But sustained meditation, sustained practice in meditation I do believe strengthens those focus muscles. I mentioned willpower, and the research on that earlier. I've found that traders who meditate frequently can during the middle of the trading day use their deep breathing, use their focus to center themselves like you said. When the crash happens, or when something is going on in markets that they don't understand, they automatically get themselves in the zone, so to speak, which helps them make better decisions.

Michael McCarthy: When does a firm reach out to you Brett? Where are they at?

Dr. Brett Steenbarger: That's a really good question. Firms reach out of me in two scenarios. One, when they're doing really well, and one, when they're doing really not well. When they're doing really well often they're trying to expand their firm. They're expanding teams within the firm. So they rely on someone like me to help with the hiring process, to help with that expansion. It is a lot of fun work, because things are going well, and you're really building on success. The other time obviously is when firms are struggling, when traders are struggling, and they're trying to make some changes, and make some improvements. So my work is to help them figure out what they do well so that they can do more of it. But definitely some people are more open to coaching than others. That's something that I play with. So that with some people we might meet on a very frequent structured basis, and other people it's just as wanted, as needed, very occasional.

Michael McCarthy: It's tailored to the individual.

Dr. Brett Steenbarger: It's very much tailored to the individual. One size fits all does not work in this business. You really have to get to know the person, and you have to get to know their trading to figure out what will be most helpful for them.

Michael McCarthy: So what are the physiological responses of a trader's body when a crash happens?

Dr. Brett Steenbarger: Actually that was studied by Andrew Lo at MIT, and his team. There were two different studies. In fact, I recently referenced those on my TraderFeed blog. What they found was that in crash type market scenarios experienced traders responded with moderate physiological levels, but beginning traders, early traders responded with very high emotional arousal. So what the author speculated was that the experienced trader is using their emotional experience as intuition, actually as information. That they were feeling some level of arousal because something special was happening. Whereas the beginning trader was experiencing a huge level of arousal, which felt like panic, and led them to make more panicky trading decisions.

Michael McCarthy: Brett, for most of us who have been in markets for a while, a period from late 2007 to early 2009 is imprinted on our brains. What was your experience during this time? Were you suddenly more in demand?

Dr. Brett Steenbarger: Yes I was in demand. It was a different kind of demand in that 2007 to 2009 period. Obviously volatility was quite high. We had quite the bear market during that period. What happened at a number of places is that strategies that had been working in prior years, particularly in less liquid markets, some emerging market strategies for instance, really lost liquidity during that time. There were blowups simply because of that. So my role was to help managers in those strategies figure out exit plans, and figure out emergency steps, because the environment was so different from what they had seen in prior years. But there were other traders who really benefited from the enhanced volatility, and were able to make money on the downside. One of nice things about hedge funds is that they can hedge. They can sell just as easily as they can buy. So there were a number of people I met with who did very well at that time. That's extremely different from now when volatility has been crushed in many asset classes, and markets just don't move in a nice straight directional way. So the choppiness can be very frustrating for traders, and for firms.

Michael McCarthy: Brett, let's get down into the weeds. Consistent losses for traders often stem from a behavioral pattern that coaches can identify. In fact, it has been said that most trading problems are persistent, and happen over and over again. Are there behavioral patterns that you can identify, which lead to consistent losses or trading problems?

Dr. Brett Steenbarger: Yes. But I'm going to qualify my response, because I find it's just as common for poor trading practices to lead to psychological upheaval, as for psychological problems to cause poor trading. In other words, when people speak with me they assume that the emotional issues come first and disrupt the trading, and that's not necessarily so. So for instance, if you have a manager who has a number of positions in their book. They have what they believe to be a diversified portfolio, then within a short amount of time correlations among those assets rise. So that instead of having a nice diversified book, suddenly they have five positions all moving the exact same way doing the same thing. That creates undue volatility in their PNL, which means they respond, they react in a much more exaggerated emotional way. So their problem actually was a problem of portfolio construction, and the failure to adapt to a changing volatility regime. That's what caused the psychological issue. It wasn't that the psychology caused the poor trading.

But to your point, there are repetitive psychological issues that occur with people, and I do help them with that. So for instance, one of them involves just the self talk that traders engage in, particularly when they are not making money, or when they're losing money. Traders tend to be very achievement oriented people. They are demanding of themselves. So when they don't perform well they can become their own harshest critics. That creates undue emotional upset, which then can skew their subsequent trading decisions. So my role is to help them literally think about their thinking. Step back, become aware of that perfectionistic self talk so that they can truly serve as their own coach, and talk to themselves in a much more constructive way.

Michael McCarthy: So is listening to self talk one of the ways traders can recognize their negative or unhelpful patterns?

Dr. Brett Steenbarger: That's right. So for instance, when we keep a cognitive journal they're actually writing out their self talk. By writing it out, suddenly you're seeing it in front of you, and you're able to see it more objectively. One of the exercises I talk about in my book is imagine yourself as a separate person. Or just imagine that you're talking to someone you care about in the situation that you're finding yourself in. So if someone who you care about has just lost money on some trades or investments, how would you talk to them? Chances are you're a reasonably sensitive human being, you wouldn't start berating them and kicking them when they're down. Yet that's precisely what we can do to ourselves. So by imagining that talking to someone else, they're able to identify a more constructive form of self talk.

Michael McCarthy: So we often talk about the emotional impact of trading, and the impact that emotions have on trading. Could we be more explicit about that? What emotions in particular do traders have to deal with?

Dr. Brett Steenbarger: Well there are many emotions that do impact trading, and they go beyond the usual discussion of fear and greed. Those certainly do impact. I find one of the most common emotions that impacts trading is frustration. Again, traders are achievement oriented. They want to win. They're competitive. So when they go through periods of time where they're not achieving returns they can become quite frustrated. Out of that frustration they can end up trying to make things happen, trying to force trades. That's precisely when a normal drawdown can become an actual trading slump. So frustration is a really big one. A second one that I mentioned earlier is over excitement, or over confidence. That traders see some big opportunities, and their eyes light up, they get overeager, and they can take some imprudent risks just out of that excitement.

Michael McCarthy: Let's go back to fear and greed if we could. I realize for somebody with your extensive history in markets and psychology that this is very much plain vanilla. But for some of our newer traders it's important for them to understand the impacts of fear and greed on their trading. Can you help them with that?

Dr. Brett Steenbarger: Yes. One of the ways that fear and greed impact trading is through our levels of risk taking. This is particularly true with newer traders. Many times they don't necessarily have very large account sizes. They're trading a relatively small amount of capital. Yet they have dreams that they're going to achieve riches, or at the very least, support themselves financially on this small capital base. That leads them to take quite a bit of risk on that low capital in order to make the larger returns. That's the greed part. Of course when they are wrong in some of their decisions, they can end up losing quite a bit of money quickly, and that is the fear part. So in many cases we see fear and greed oscillating, because people are taking too much risk for the amount of capital that they have.

Michael McCarthy: So do successful traders overcome their emotions, or do they work with their emotions?

Dr. Brett Steenbarger: Great question. No. Overcoming emotions, if that's really your goal then it makes sense to create algorithms with your trading rules, and let the computer make all the decisions, right? That would be emotion free trading. But if a discretionary trader really has some gut feel, or some intuitive insight into markets, then that gut feel is emotion, it's feeling. Being attuned to that can be real information.

Michael McCarthy: Using that as input to a trading system, using your emotions as data.

Dr. Brett Steenbarger: Yes. Using emotions as input for experienced traders, it takes quite a bit of experience to develop that intuitive base. So it's not something a beginning trader could do. But for the experienced discretionary trader, yes, that feel for markets is real data, real information. A great example is a trader I work with who had an idea about the markets, and a data release came out. His market should have really exploded his way based on this data release, and it didn't even budge. He immediately felt some frustration, and he felt surprise. He quickly engaged in self talk to say, wait a minute, if I'm feeling this, other people are feeling this, and maybe I shouldn't be in this trade. Maybe it's going to go the other way. He quickly flipped his position, and ended up making quite a bit of money. It was all because his talk around the emotional experience gave him a greater degree of flexibility so that his actions could be different.

Michael McCarthy: His self awareness was key.

Dr. Brett Steenbarger: Yes. His self awareness, and his market awareness. He was very much able to step apart from his position. We hear about traders who trade with "conviction". They have this strong, deep belief in their view. But many times that level of confidence or conviction can lock us into a view, and we don't have that cognitive flexibility. We don't that have that ability to flip the trade as it were.

Michael McCarthy: Brett, in your new book Trading Psychology 2.0 you talk a lot about positive psychology. How do you apply it to trading?

Dr. Brett Steenbarger: The research in positive psychology emphasizes four areas of positive emotional experience. One is happiness, having fun doing things. The second is meaningfulness, doing things that are deeply significant to you. The third one is energy, doing things that give you energy. Either physical energy, as in exercise, or maybe stimulate you in an intellectual sense. The fourth area are relationships, activities that bring you closer to the people who matter to you. So positive psychology encourages us to not just focus on solving problems, but to be firing on all four of those cylinders. To make sure every single week we're doing things that are fun and enjoyable. Every single week we're doing things that are deeply meaningful to us. We're doing things that energize us. We're doing things that keep us close to the people who matter to us. When we have those positives in our lives it really balances out the stresses we can face in our work.

Michael McCarthy: When we think of traders we don't often conjure up the term creativity, but you would argue otherwise.

Dr. Brett Steenbarger: Yes. In the recent book that I wrote, Trading Psychology 2.0, that was a major part of the book. The reason for that is that earlier versions of trading psychology emphasized discipline, emotional control as being the cardinal elements of trading success. But when markets change, and trending markets are no longer trending markets, volatile markets are no longer volatile, different approaches end up being successful. What worked in one market environment no longer works in the new one. So if all we do is stay faithful to a single trading approach, and call that discipline, we end up becoming dinosaurs. We end up not adapting to changing market conditions. What helps us adapt is creativity. Is being able to generate new and different ideas to guide the investment of our funds. There are exercises, there are books that talk about how we can enhance our creativity. That's an area of trading that has been neglected for too long.

Michael McCarthy: What are you looking for in new traders, in the hiring process?

Dr. Brett Steenbarger: Take a look at the trades they've made. In other words, you have to talk shop, you have to get under the hood, you have to talk about what they're doing, and how they're doing it. For instance, in the hedge fund world I know which trades are super popular, I know which ones are consensus, I know which ideas I've heard at the last five firms I've worked at. So if I talk with a trader who's applying for a position, and they come up with the same ideas that everyone else has, using the same information that other people have used, there's not much unique to their process. They're not going to help add relatively uncorrelated returns to any firm. If a trader on the other hand has a unique idea I haven't heard, and they've come up with that idea in a unique way, and it hits me upside the head, like wow, that's really interesting, why didn't I think of that, very often that' a good indication that they're doing something unique that's worth looking into. Originality of thought. The ability to think independently, to be different from the herd, and the ability to think in an original fashion, and to have the courage of those original convictions.

Michael McCarthy: Well that sounds like the perfect point to wrap up our chat today. Brett, thank you very much for your generosity, and your time today.

Dr. Brett Steenbarger: Well thank you for having me. I really appreciate it, and enjoy being able to share some perspectives with your audience.

Michael McCarthy: That was Dr. Brett Steenbarger. To read an exclusive article outlining Brett's four psychological strengths of successful traders, head to our website theartfultraderpodcast.com. There podcast listeners, are well as new and existing clients can also access some limited time offers. The Artful Trader is an original podcast series by CMC Markets, a global leader in online trading. To stay up to date with the new episodes, subscribe now on Apple podcasts, or wherever you get your favorite podcasts from. Make sure you share it with your friends, and leave us a rating. I'm Michael McCarthy, and this is The Artful Trader.