FOREX

What Can Separate Successful Traders from the Rest?

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As a follow-up to his initial Traits of Successful Traders series from the beginning of 2015, ***David Rodriguez****, of DailyFX.com, reexamines the question, "What separates the successful forex traders from the unsuccessful ones?" David thinks the answer revolves around risk management.*

• We looked through 43 million trades in our original Traits of Successful Trader Series

• An examination of nearly 30 million trades since then backs up our findings

• Here is what we believe to be the number one mistake that separates the successful traders

What separates many successful traders from those unsuccessful? To find out, we studied over 43 million real trades and published our *Traits of Successful Traders* series six months ago. Since then we've collected another six months of data and nearly 30 million trades since original publication.

How have the lessons stood the test of time?

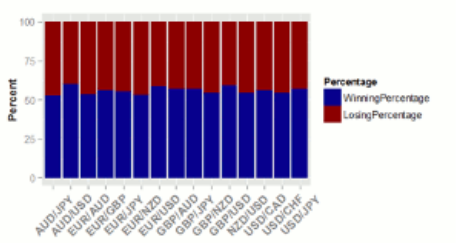
What Separates the Successful Traders, and Why Do Most Traders Lose Money?

The average forex trader loses money for a simple reason: poor money management. Our study of real trader behavior from Q2, 2014 – Q1, 2015 showed that traders actually captured profits on individual trades more often than they took losses. Yet they ultimately lost money.

We re-examine the same theme with trading data in the past six months to see if the same pattern held. Obviously, we would love to claim that our research and findings materially changed the behavior. Unfortunately there is no clear evidence to support this, and indeed, we're reminded of the same lessons.

First we highlight a fact that may surprise you: the average retail FX trader captures profits on their trades more than 50% of the time.

Percentage of All Trades Closed Out at a Gain and Loss per Currency Pair, Q2, 2015 – Q3, 2015



Data source: Derived from FXCM Inc. accounts excluding Eligible Contract Participants, Clearing Accounts, Hong Kong, and Japan subsidiaries from April 1, 2015, to September 30, 2015, across 15 most traded currency pairs.

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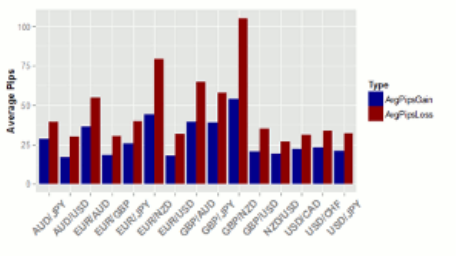
The above chart shows results of over 19 million trades conducted by FXCM clients worldwide from Q2, 2015 through Q3, 2015 across the 15 most popular currency pairs. The blue bar shows the percentage of trades that ended with a profit for the client. Red shows the percentage of trades that ended in loss.

For example, the euro saw an impressive 59% of all trades closed out at a gain. And, indeed, every single one of these instruments saw the majority of traders turned a profit more than 50% of the time.

If traders were right more than half of the time, why did most lose money?

Average Profit/Loss per Winning and Losing Trades per Currency Pair, Q2, 2015 – Q3, 2015



Data source: Derived from FXCM Inc. accounts excluding Eligible Contract Participants, Clearing Accounts, Hong Kong, and Japan subsidiaries from April 1, 2015 to September 30, 2015, across 15 most traded currency pairs.

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The above chart says it all. In blue, it shows the average number of pips traders earned on profitable trades. In red, it shows the average number of pips lost in losing trades. We can now clearly see why traders lose money despite bring right more than half the time. They lose more money on their losing trades than they make on their winning trades.

Let's use EUR/USD as an example. We see that EUR/USD trades were closed out at a profit 59% of the time, but the average losing trade was worth 32 pips while the average winner was only 18 pips. It is worth noting that these figures are fairly significantly changed from what we saw in our last study, but the ratios remained nearly the same. The average trader lost nearly 80% more on their losing trades than they gained on their winners.

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The results are even worse in the volatile GBP/NZD pair: traders captured profitable trades 54% of the time with an average pip value of 54 pips. Unfortunately, the average loss was nearly double that value at a sizable 105 pips.

What gives? Identifying that there is a problem is important in itself, but we'll need to understand the reasons behind it in order to look for a solution.

Cut Losses, Let Profits Run—Why Is This so Difficult to Do?

In our data we saw that traders were very good at identifying profitable trading opportunities over 50% of the time, but ultimately they lost as the average loss far outweighed the gain. We discussed a clear reason for this in our original Traits of Successful Traders Series: human psychology.

It should surprise no one that we would advocate a very simple rule: cut your losses early and let your profits run. This point is so obvious to be banal, do less of what is bad and more of what it is good.

Yet it's likewise clear that traders continued falling into the same trap through the past six months. Let's take a closer look at why this simple rule can be so complicated.

Why Is It So Difficult to Practice Good Money Management?

Why is good money management so difficult? Human nature.

As we noted in our original study, this is not at all limited to trading. We'll draw on the work of a Nobel-prize-winning psychologist to help us understand a key shortfall in how humans treat gains and losses.

A Simple Wager—Understanding Human Behavior Towards Winning and Losing

What if I offered you a simple wager on a coin flip? You have two choices. Choice A means you have a 50% chance of winning 1000 dollars and 50% chance of winning nothing. Choice B is a flat 450 dollar gain. Which would you choose?

				Expected Return
Gains	**Choice A**	50% chance to Win $1000	**50% chance to Win 0**	**Expect to win $500 over time**
	Choice B	Win $450		Win $450

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Most people will pick Choice B despite the fact that their expected gain will be less than that of choice A. This suggests that people would rather capture a sure-fire gain than make more money. If I only offered this gamble once this might make sense, why risk *losing* $450? But if you're regularly presented with this choice the rational decision would clearly be Choice A. How about losses?

				Expected Return
Losses	**Choice A**	50% chance to Lose $1000	**50% chance to Lose 0**	**Expect to lose $500 over time**
	Choice B	Lose $450		Lose $450

Click to Enlarge

We flip the wager and now losses are guaranteed, but the severity of those losses will vary. With Choice A you now have a 50% chance to lose $1,000 and 50% of 0 losses...over time you can expect to lose $500. Choice B offers certainty of a lesser $450 penalty. Choice B is clearly the more rational decision, particularly if this wager is played over and over again. But most will actually choose A. What gives?

Most people avoid risk when it comes to taking profits but then actively seek it if it means avoiding a loss.

Losses Hurt Psychologically Far More Than Gains Give Pleasure—Prospect Theory

Nobel prize-winning clinical psychologist Daniel Kahneman developed Prospect Theory as an attempt to model how people make decisions. It wasn't geared towards trading per se, but we'll see that it has obvious implications for the trader.

The findings showed something remarkably simple yet profound: most people took more pain from losses than pleasure from gains.

It feels *good enough* to make $450 versus $500, but accepting a $500 loss hurts too much and many are willing to gamble that the trade turns around. This makes no rational sense: a $500 loss will more than offset a $450 gain but the reverse is not true.

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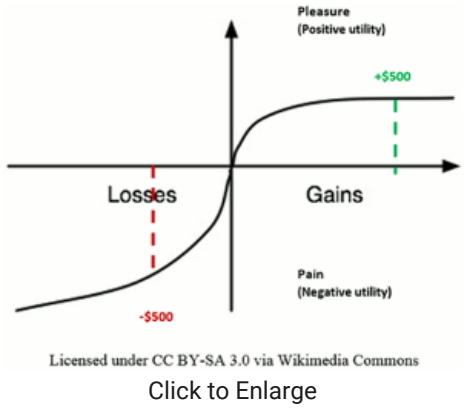
Why should we then act so differently?

Let's imagine that we can measure total pain and pleasure on an absolute scale and let's compare that to trading wins and losses.

To a perfectly rational actor, it might make sense that a $500 gain would give enough Pleasure to completely offset a $500 loss. Yet clinical studies will show that this is not the case, and indeed, the chart below models this relationship and why it might be problematic.

Prospect Theory: Losses Typically Hurt Far More Than Gains Give Pleasure



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Real studies of loss aversion in human behavior suggest that a loss can hurt a person anywhere from 2 and 2.5 times more than the equivalent gain will give pleasure. Most would have to be compensated anywhere from 2 and 2.5 to 1 in potential gains versus losses to be left neutral.

Again, we have to emphasize that this makes little sense for the rational trader: you shouldn't have to make at least $1,000 to offset the psychological harm of a $500 loss.

And yet this is what we see in real trader behavior. We as humans will avoid losing at all costs: we will allow an unprofitable position to remain open while closing out a winner at a more modest gain. Our data shows why this can ultimately force traders to lose money.

Plan to Avoid the Common Pitfall

Humans are not robots and no amount of rationalization is likely to erase the effects of real cognitive biases for most people. But traders aren't most people, a person opens a trade account in an attempt to gain. If all-too-common behavior will result in losses, that trader should take steps to avoid them and ultimately avoid wasting his or her time and hard-earned capital.

If extreme loss aversion and relative indifference to gains is the problem, the solution is straightforward: treat losses as equivalent on a 1:1 basis with gains. From the start of any trading decision, know that you stand to gain at least as much as you stand to lose.

In trading terms this is called having a reward:risk ratio of at least 1 to 1. This simple rule could allow you to ultimately make money in trading if you turn profits on at least 50% of your trades.

The concept is so obvious that you might feel let down after reading this far into the article. But it is obvious because it likewise rings true in trading.

Does Using 1:1 Reward:Risk Really Work?

Our data certainly leads us to believe that it does. We used our anonymous trader data to profile over 93,000 real trading accounts which places at least 2 trades in our top 15 currency pairs. We then categorized those trading accounts by average reward:risk ratio in those trades and determined whether they turned a profit.

Our data shows that 52% of all accounts which operated on at least a 1:1 reward:risk ratio turned a net-profit in our six-month sample period. Those under 1:1? A mere 20%. This is nearly unchanged from the same study conducted in the 12 months before.

Traders who adhered to this rule were over 2.5 times more likely to turn a profit over the course of these six months, a substantial difference.

				Expected Return
Gains	**Choice A**	50% chance to Win $1000	**50% chance to Win 0**	**Expect to win $500 over time**
	Choice B	Win $450		Win $450

Data source: Derived from FXCM Inc. accounts excluding Eligible Contract Participants, Clearing Accounts, Hong Kong, and Japan subsidiaries from 4/1/2015 to 9/30/2015 across 15 most traded currency pairs.
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NEXT PAGE: What's the Next Challenge?

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Game Plan: Which Techniques Can I Use to Avoid This Common Mistake?

Trade forex with stops and limits set to a risk:reward ratio of 1:1 or higher. Our data shows that the average trader is far too eager to take small gains in winning trades and allows losses to grow substantially larger. This is not rational behavior if the aim is to ultimately turn a profit in trading.

Make sure your profit target is at least as large as your maximum loss on any given trade.
And just as critically, establish a maximum loss via a stop loss order from the outset. You can certainly set your price target larger than your stop loss and you should aim for at least 1:1 regardless of strategy. Our data suggests this can have a significant impact on whether or not a trader ultimately turns a profit.

The actual distance you place your stops and limits will depend on the conditions in the market at the time, such as volatility, currency pair, and where you see support and resistance. You can apply the same risk:reward ratio to any trade. If you have a stop level 40 pips away from entry, you should have a profit target 40 pips or more away. If you have a stop level 500 pips away, your profit target should be at least 500 pips away.

We will use this as a basis for further study on real trader behavior as we look to uncover the traits of successful traders.

Stick to Your Plan: Use Stops and Limits

Once you have a trading plan that uses at least a 1:1 reward:risk ratio, the next challenge is to stick to the plan. Remember that you have to fight human tendencies towards strong loss aversion every step of the way. It becomes more difficult to ignore emotions when there's a sense of ownership in a trade: set up your trade with maximum loss and profit targets from the beginning, before you even place that trade.

Once those stops and limits are set, don't touch them except to move them in your favor. There are countless stories (and hard data) to show the dangers of moving a stop order to accommodate a bigger loss.

Managing your risk in this way is a part of what many traders call *money management*. Without proper money management even the absolute best strategy stands a substantially diminished chance of ultimately turning a profit.

Can you turn a profit using a strategy that uses a reward:risk ratio below 1:1? Certainly, it's a question of probability and expected outcomes. Yet our data shows the simple fact that most who use an inferior reward:risk profile are substantially less likely to ultimately turn a profit.

By that same token, 1:1 is a bare minimum; certain lower-probability strategies benefit from reward:risk ratio of 2:1, 3:1, and so on.

We will discuss different trading techniques in further detail in subsequent installments of this series.

The Traits of Successful Traders

This article is an update of our *Traits of Successful Traders* series. Earlier this year we studied over 43 million trades placed via parent company FXCM's trading platforms over the course of 12 months. Through this we sought to answer a simple question: "What separates successful traders from unsuccessful traders?"

We take a look at over 29 million real trades placed in the six months that followed in order to see whether changing market conditions has affected our conclusions. The short answer is a resounding "no."

Through this guide we hope to establish some of the *best practices* that successful traders follow, such as the best time of day, appropriate use of leverage, the best currency pairs, and more. Stay tuned for further updates on the *Traits of Successful Traders* series.

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