Average Retail Investor

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What Many People Think They Know about Investing is…Naïve

Some people believe that if they can just find the right stock, they'll become rich. They see investing as a 3-step process: a) find a winner, b) buy it, and c) hold onto it forever. If it is "the right stock", then riches will shower down on them.

There are only two problems with this notion. First, you can go through your whole life without finding a big winner. Second, even if you find a big winner, you are going to have to sell it someday (unless you are happy basking in the glow of your monthly statements).

If you are in it to make money, here is how investing really works:

> When you are looking for a stock to buy, you are an analyst. Once you buy a stock, you have to become a risk manager. A lot of people are good at analysis, but only those who can make the transition to risk management once they have bought a stock will make money in the markets.

The key to making money does not lie in knowing what to buy or even when to buy it. Buying is easy. Selling requires a plan and discipline. It takes both a buy and a sell to put money in your pocket. There is potential in buying, but capturing profit (and minimizing losses) is in the selling. That is the heart of risk management.

Making and sticking to clearly defined rules on when to sell any given security are how you capture profits and avoid big losses. There are a variety of approaches to risk management.

A number of people recommend selling a stock any time it declines 20% or more from its last high. Some prefer 10% from the last high. There is at least one successful fund that uses a strict 7% stop on all their investments.

Some people sell when a security breaks down through support. Other investors use a 50-day average and a 200-day average to decide if a stock should be sold. The respected market analyst, Ned Davis, suggests using a 13-week average and a 34-week average to make both the entry and exit decisions. Pick a method that works for you and suits you.

I've heard some people complain, "Yeah, but if I sell it and then it goes up some more then I'll miss out." They see selling as a terminal event. They think when you sell something, that's the end. It takes some people a long time to get comfortable with the idea that even good securities get beaten down sometimes, and just because you sold it last month or last quarter doesn't mean it's not a good buy now that it is going up again.

There is psychological resistance to selling. If you made money, it makes you fear missing out on making more. This is *greed*. If you lost money, selling is proof you made a mistake. This is *ego*. You must overcome these psychological challenges in order to make money.

Manage your risks and the profits will come.

The Limited Importance of Entries

You cannot predict the future. Good entries are a pleasant experience when they occur and they can certainly improve your returns. The odds of picking a good entry point may be little better than 50:50, and a good entry is still no guarantee of making a profit on a position. No matter how good your analysis is, sometimes the market is going to back right over you, and you had better know what you are going to do before that happens.

Here is an excerpt from the excellent book *Trade Your Way To Financial Freedom* by Van Tharp:

> I was doing a seminar with Tom Basso (see his sections in Chapters 3 and 5) in 1991. Tom was explaining that the most important part of his system was his exits and his position-sizing algorithms. As a result, one member of the audience remarked, "From what you are saying it sounds like you could make money consistently with a random entry as long as you have good exits and size your positions intelligently."
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> Tom responded that he probably could. He promptly returned to his office and tested his own system of exits and position sizing with a "coin flip"-type entry. In other words, his system simulated trading four different markets and he was always in the market, either long or short, based upon a random signal. As soon as he got an exit signal, he'd re-enter the market again based upon the random signal. Tom's results showed that he made money consistently, even using $100 per contract for slippage and commissions.
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> We subsequently duplicated those results with more markets. I published them in one of my newsletters and gave several talks on them. Our system was very simple. We determined the volatility of the market by a 10-day exponential moving average of the average true range. Our initial stop was three times that volatility reading. Once entry occurred by a coin flip, the same three-times-volatility stop was trailed from the close. However, the stop could only move in our favor. Thus, the stop moved closer whenever the markets moved in our favor or whenever volatility shrank. We also used a 1 percent risk model for our position-sizing system, as described in Chapter 12.
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> That's it! That's all there was to the system — a random entry, plus a trailing stop that was three times the volatility, plus a 1 percent risk algorithm to size positions. We ran it on 10 markets. And it was always in each market, either long or short, depending upon a coin flip. It's a good illustration of how simplicity works in system development.
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> Whenever you run a random entry system, you get different results. This system made money on 80 percent of the runs when it only traded one contract per futures market. It made money 100 percent of the time when a simple 1 percent risk money management system was added. That's pretty impressive. The system had a reliability level of 38 percent, which is about average for a trend-following system."

One of the points here is this: It is a waste of time to agonize over your entries.

1. Find a security that is going up or is turning up and looks promising.
2. Decide how you will know the investment is not working. That's your bail out point.
3. Check for red flags (i.e., see if there are any reasons not to buy it).
4. Figure out how many shares or contracts you should buy. Then cut that number in half.
5. If there isn't any reason not to buy it, then buy a small position.

Laurent Bernut is a professional trader who manages over a billion dollars on a regular basis. He sums it up this way, "Focusing on the entry keeps people addicted to failure."

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I spent years and years trying to figure out a sure-fire entry indicator. I tried everything I heard of or read about, and I wrote many thousands of lines of code in the process of testing every idea. Eventually, I realized two things:

1. Given the nature of the markets, there are no sure-fire entry indicators. Not one.
2. It doesn't really matter.

What <u>does</u> matter is whether you have a good exit system. A well-designed exit system gives you both: a) a high reward/risk ratio at the beginning; and b) a reasonably high profit-capture once your position has moved in your favor.

Of course, finding high-probability entries will help. **But the problem is that — even with great analytical tools — you can never tell which entry is going to lead to a windfall and which one is going to lead to a deadfall.** So you constantly have to be ready to get out of a position as soon as you determine it is no longer moving in your favor. This means that you have to monitor your positions, and you have to have objective rules that tell you whether you should stay in a position or get out.

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References:

1. Trade Your Way to Financial Freedom, Van Tharp, McGraw-Hill Education, 2006

2. The New Market Wizards, Jack Schwager, McGraw-Hill Education, 1994