7 of the Most Common Trading Mistakes

and how to avoid them

investagility

About

This document has been prepared by Alex Douglas, a veteran of the financial markets who drew his first currency charts by hand in 1983. Alex has worked as a foreign exchange voice broker, as a trader on the floor of the Sydney Futures Exchange and as a highly qualified technical analyst with responsibility for a global team. In addition to being the founder and inaugural president of the Technical Analysts Society of Singapore, he is also a Past President of the Australian Professional Technical Analysts and a former director of the International Federation of Technical Analysts. Alex has held senior management positions with several companies, including thirteen years as managing director of the Australian arm of one of the largest securities brokers in Japan. He is the driving force behind Capital Markets Group (Australia) and is the creator of #investagility.

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Introduction - Don't lose money

> ***The first rule of investment is: Don't lose (money)***
>
> ***And the second rule of investment is: Don't forget the first rule***
>
> ***And that's all the rules there are!***
>
> ***Warren Buffett***

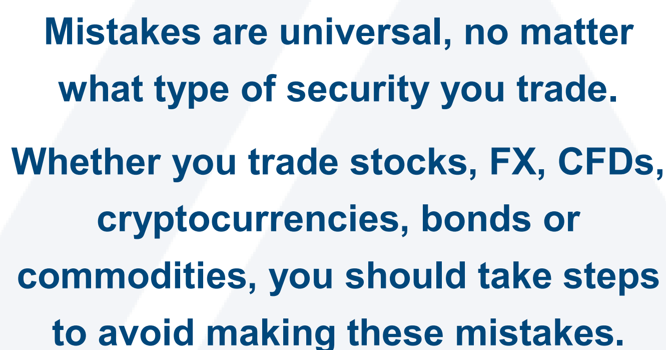
We all make mistakes. Some have little consequence, while others can be disastrous and expensive. One of the best ways to avoid mistakes is to learn from the mistakes of others.

As with all human endeavours, there are an almost limitless number of ways for traders to screw up. Listing them all would be a virtually impossible task. However, the seven mistakes outlined in this document are some of the most commonly occurring and financially destructive of them all.

This is not the typical list of trading mistakes that you will find on the internet. Although specific cases aren't mentioned, each of these mistakes has been witnessed multiple times in real life by the author during his long career as a broker and trader.

Some of these mistakes should be obvious, while you may not have recognised others as mistakes if they had not been framed in this way. Being aware of these mistakes should help you to avoid making them yourself.

It is important to note that the mistakes discussed here are generalisations and, of course, past outcomes are not a reliable indicator of future outcomes. There will always be exceptions and examples of people that have committed these mistakes and subsequently made great profits. They are the lucky outliers. You can either choose to try your luck at being one of the exceptionally rare lucky outliers, or you can learn from the mistakes of others and take the path that is more likely to lead to trading success over the long term.

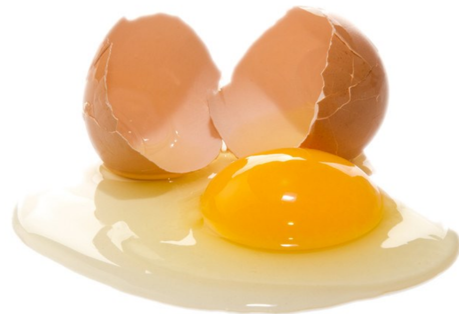


Mistakes are universal, no matter what type of security you trade.

Whether you trade stocks, FX, CFDs, cryptocurrencies, bonds or commodities, you should take steps to avoid making these mistakes.

Putting all your eggs in one basket

Most people would agree that investing all your money in one single stock (or any single security) is extremely risky. It's like putting all your eggs in one basket. If that specific asset underperforms or experiences a significant downturn, the impact on your portfolio could be catastrophic.



Despite this, there are a surprising number of people that will still go ahead and tip their entire account balance into a single investment. This is especially true for people following a hot tip or those that have formed an emotional attachment to a particular stock or theme.

There have been many books and research papers written on the relative merits of concentrated portfolios versus diversified portfolios, as espoused by Markowitz and followers of his Modern Portfolio Theory (Well, it was 'modern' when published in 1952).

In a nutshell, diversified portfolios help investors achieve their returns while reducing overall risk and volatility. More concentrated portfolios, if well constructed, provide the opportunity for greater returns, but this comes at the expense of greater overall risk and volatility. These concentrated portfolios would generally consist of around 5 to 30 securities. This is VERY different to placing everything into just one security!

Your personal tolerance for risk should inform your decision to follow either a diversified strategy or a concentrated strategy.

Anybody choosing to take the ultra-concentrated path of investing everything into one single security is taking onboard an extreme level of risk. While there might possibly be potential for large gains, you would have to weigh this up against the risk of potentially disastrous outcomes that could be avoided by having additional investments in your portfolio.

Lack of risk management

One of the biggest mistakes new traders make is ignoring risk management. It's like playing a high-stakes game without knowing the rules. Two common mistakes are not using stop-loss orders and poor position sizing.

Stop loss orders

A stop-loss order is like having a safety net. You should set your stop-loss order at a price level that corresponds with the level of risk you are willing to take on a particular trade, as determined before you enter the trade. If prices move against your position and hit the stop-loss level it will trigger an order to close out your holding. The automation is a great help for those that might otherwise give in to their emotions in the hope that the price may return to a more favourable level.

Experienced traders know to only ever tighten a stop-loss order. In other words, if you hold a long position, you would only ever move the stop-loss order to a higher level. If you allow yourself to loosen a stop-loss then you are overriding the safety mechanisms built into your trading plan, or worse, you might not even have a trading plan… You should also be aware that a stop-loss order is just a trigger point. For a long position, the stop-loss will be triggered if prices trade at or below the nominated level. In a fast moving or thinly traded market it is possible that the order will be filled at a price that is less favourable than the stop-loss level. This is a phenomenon known as slippage. Even if you don’t place an actual stop-loss order, you should have a pre-determined stop level in mind before you open a position.

Position sizing

In addition to using stop-loss orders, thoughtful position sizing can also help you to control how much money you risk on each trade. There are multiple books on this topic alone, but even applying the most basic position sizing techniques will put you ahead of many traders.

Let's suppose you have an account balance of $100,000 and you want to buy a stock trading at $25, with a stop loss level identified at $20.

If you wanted to tip everything into one stock (which would be unwise), you could buy as many as 4,000 shares ($100,000 / $25), if you ignore brokerage and other trading costs. However, this would expose you to a potential risk of losing $20,000, or 20% of your account, if prices fall to trigger your stop loss at $20.

To have better control of the downside, you can use your tolerance for risk to help determine your position size.

Let's say you have decided you are only willing to risk up to 1% of your total investment funds on each trade. With a current balance of $100,000, this means you are willing to risk a loss of $1,000 on a single trade.

From there it is a simple matter of dividing the amount you are willing to risk by the risk per stock to work out how many stocks to buy.

Maximum Funds to Risk per trade / Risk per share = Position size

In this instance: $1,000 / $5 = 200 shares

So, you could buy 200 shares of this particular stock while limiting your risk on that trade to 1% of your investment portfolio.

While losses are a part of trading, the use of stop loss orders and a risk based method of position sizing will help you to reduce downside risks.

As noted, there are many, more advanced position sizing techniques than the one outlined above but even using a simple calculation like this has the potential to greatly reduce your level of risk exposure.

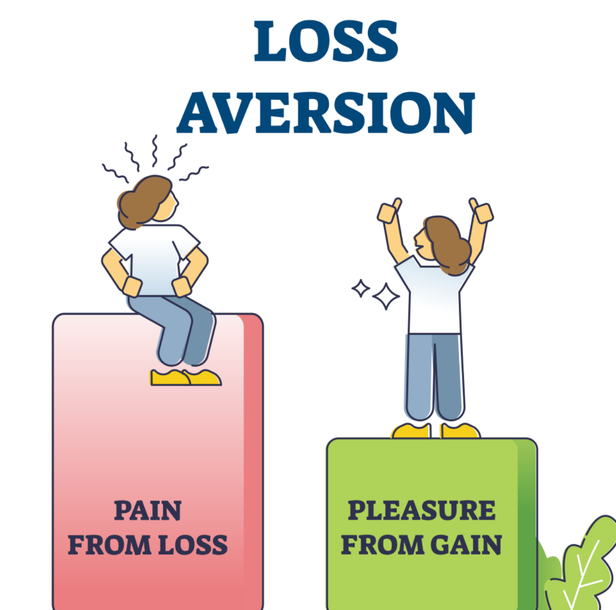
Holding losers and cutting winners

Traders often make the mistake of holding onto losing positions, hoping that the market will turn around and move their position back into profitable territory, allowing them to avoid a loss and keep their ego intact. This is especially true for traders that have publicly disclosed their position to other people. Unfortunately, relying on hope is not a great investing strategy.

The same traders are also often guilty of prematurely cutting their winning trades in order to lock in a profit. The idea that any profit is a good profit is sometimes reflected in the arguably misguided saying that; “You’ll never go broke taking a profit”. That may work in some industries, but it is a very risky belief to hold if you are a trader.

This type of behaviour is often influenced by a psychological bias called loss aversion, where people feel the pain of a loss more intensely than the pleasure of a gain. The term “loss aversion” was first introduced by Daniel Kahneman and Amos Tversky in 1979 and has since become one of the most important concepts of behavioural finance.

Holding onto losing trades can be particularly damaging. As the loss grows, it can create emotional stress and lead to poor decision-making. It's important to have a clear exit strategy in place before entering a trade. This includes setting stop-loss orders to limit potential losses.



To be clear, cutting losses does not mean that you need to immediately close your trade if the price movement puts your position into negative territory. However, once prices hit your pre-determined stop-loss level, you should act on it rather than giving in to the hope that things will turn around and move your position back into profit.

"...relying on hope is not a great investing strategy."

At the other end of the scale, cutting winners too soon can prevent you from benefiting from the full potential of a profitable trade. If you are fortunate to be on the correct side of a trending move, it is best to try to ride that move as far as you can. Using trailing stop-loss orders can help you protect profits while allowing the trade to run its course.

A well developed and robust trading plan that is suited to your personality and investment style can be of great assistance. Having clear entry, exit and risk management strategies will help you stick to the plan while limiting the influence of these potentially debilitating psychological biases.

Lack of consistency

One of the most common mistakes traders make is a lack of consistency in their approach. While having a trading strategy is crucial, it's of little value if you can't apply it consistently over time. Many traders fall into the trap of constantly jumping from one strategy to another, hoping to find the perfect one. This behaviour, often referred to as "strategy hopping," prevents them from giving any single approach enough time to prove its effectiveness.

For a trading strategy to work, it must be applied consistently. This means sticking with it through both good times and bad. Your chosen strategy should align with your personality, risk tolerance, and the amount of time you can dedicate to trading. For instance, if you can only trade a few times a week, it's crucial to choose a strategy that fits that schedule rather than one that requires daily monitoring.

Developing your own strategy can significantly boost your confidence in sticking with it, even when you experience a drawdown. When you fully understand and have ownership of a strategy, you're more likely to trust it and remain disciplined during tough times. On the other hand, if you're using a strategy created by someone else or a "black-box" system where the inner workings are hidden from you, it can be much harder to stay committed when things don't go as planned.

To build confidence in your strategy, thorough back-testing is essential. This process involves running your strategy on historical data to see how it would have performed in the past. Additionally, performing walk-forward testing on out-of-sample data - data not used in the initial development of your strategy - can help ensure that your strategy is robust and capable of handling different market conditions.

Once you've developed or selected a strategy you're comfortable with, it's crucial to stick with it consistently. Avoid the temptation to constantly tweak or abandon it at the first sign of trouble. Consistency in execution is key to long-term trading success. It's also wise to consider developing a portfolio of strategies, each designed to take advantage of different market conditions. This diversification can help smooth out your performance over time and reduce the impact of any single strategy's downturns.

In trading, patience and discipline are vital. Remember, sustainable profitability comes not from chasing the latest trends or quick fixes but from sticking with a well-thought-out plan and executing it consistently.

Chasing losses

Many traders manage to convince themselves that a falling price (if long) provides an opportunity to add to their position at a lower cost. This is often referred to as "averaging down". People that rely on fundamental analysis may use a lower theoretical "fair value" to justify adding to a long position as prices fall. After all, if it was worth buying at a higher level, then it must be a bargain at lower levels, right?

Traders that rely on charts aren't immune from this type of activity either. People whose experience has been gained mostly during a bull market have been rewarded again and again for "buying the dip".

So, on the surface, there appears to be some logic in buying more of a certain security as the price falls.. However, this mindset can lead to some of the most destructive behaviours in trading.

The act of adding to a losing position does indeed lower the overall average entry price for long positions. The intent of the trader is to hold onto that position, or even add more to it, until prices reverse and move beyond the average entry price, returning the overall position back into profitable territory. The allure of recovering losses can be a powerful driving force.

The problem with adding to long positions as price falls is that a corrective dip and prolonged move lower (potentially to zero) look pretty much the same at the outset. How can you be sure the fall is just a temporary aberration? You may be able to lower your average entry price by adding to a long position as prices fall, but that won't help you if prices keep falling! That would just be a case of throwing good money after bad.

Unfortunately, chasing losses in this way often leads to a downward spiral. As the position deteriorates, traders may find themselves risking increasingly larger amounts of capital in an attempt to recoup their initial investment. They start to think that the value has fallen so far that prices must be due to turn around soon. This is a recipe for disaster.

History is littered with examples of the catastrophic consequences of chasing losses. The collapse of Barings Bank, once a pillar of the financial world, is a stark reminder of the dangers involved. Nick Leeson, a trader at Barings in Singapore, engaged in speculative trading, continually doubling his positions while prices were falling as he attempted to recoup losses on earlier unauthorised trades. His actions ultimately led to the bank's bankruptcy.

To avoid this fate, traders must develop a strict risk management plan. This includes exercising the necessary degree of discipline in setting predetermined stop-loss orders to limit potential losses and adhering to position sizing guidelines. It's essential to accept losses as a normal part of trading and to focus on managing risk rather than trying to recoup every loss.

Lack of preparation

> ***"Failing to plan is planning to fail"***

There are many variations of this saying and it is difficult to pin down its exact origins, perhaps because it is so widely used and accepted. It's a phrase you will hear in the military, in sport, in medicine, even in high school classrooms.

When it comes to trading, there are many ways in which traders fail to plan.

The most obvious would be the failure of many traders to develop and adhere to a trading plan, incorporating strategy and risk management.

At a more basic level, it is perhaps surprising how many traders make mistakes based on nothing more than a lack of understanding. These mistakes often relate to either a failure to understand the mechanics of trading or misunderstanding the terminology that is used in the trading environment, some of which may vary from one broker to the next.

Not understanding how your trading platform works when you have live trades can be very dangerous. If you need to exit a position quickly or if you see an opportunity to take a new position or add to an existing one, you will want to know how to execute those actions quickly and accurately. Even professional traders have been known to sell instead of buy when moving onto a new trading platform. Take time to familiarise yourself with all the key functions of the platform before you trade.

Not understanding what various order types actually mean can be a source of major frustration for traders. One that often causes issues is the stop-loss order. Traditionally, the level of a stop-loss order is just the trigger point for the execution of that order. If prices are moving quickly or the market is thinly traded, there is a substantial risk that there will be slippage in the execution of the order and the final execution price may be worse than the trader had anticipated. It is worth clarifying with your broker exactly how they process stop-loss orders.

Not understanding the data on your charts can also cause problems. Does your data provider / platform plot the last traded price, or is it the bid price you are seeing, or perhaps the ask price, or even the mid-point between the bid and ask? Knowing this may avoid further confusion regarding whether or not certain orders should have been executed.

While you may be able to mitigate some of these risks by practising on a demo account, you will generally find that you learn far more once you have real money on the line. Building a strong foundation of knowledge is the first step towards sustainable trading success.

Getting scammed

Some mistakes are so embarrassing that the people that make those mistakes rarely talk about them in public. As a result, the prevalence of those mistakes is greatly under-reported and many traders may not be fully aware of them.

We all like to think that we're pretty good at using technology. We're used to navigating our way around our phones, apps, websites and trading platforms. But the truth is, scammers are also really good at what they do.

One area that scammers like to exploit is our natural desire to like and to want to be liked by other people. Social media is perfect for this. The scammers will often create a fake social media profile, using a photo of an attractive, friendly, trustworthy looking person - the kind of person you might want to be friends with.
If you accept their friend request they are likely to be exceedingly friendly and will probably engage in some chit chat to learn more about you and discover if you may be a suitable target.

AI generated social media profile

Scammers running a trading scam may give you some hot trading tips, often requiring urgent action on your part. The first few of these tips may indeed be successful. While there are many variations, one scam involves the scammer building up a large position in a low priced and unloved stock. They then start to give out hot tips about a potential surge in the stock price. They may even instigate a move higher by buying more themselves. By creating a sense of urgency and advising many of their victims to buy at the same time, the price surges higher giving the scammers the opportunity to get out and make a huge profit. Within days, when the buying from the victims dries up, the stock plummets leaving the new stockholders with significant losses. This is a classic “pump and dump” scheme. The surveillance division of many exchanges can catch these events in real time, but as people trade more international markets that protection is not always available.

These scammers create a sense of trust and camaraderie. They may even claim to have some inside information, perhaps from an uncle who works for the central bank. To protect yourself from these scams, exercise extreme caution when dealing with online acquaintances, especially those who want to give you unsolicited trading tips. Ask yourself; “What is their motivation?”

Remember, if it sounds too good to be true, it probably is.

If you want education or advice in relation to the markets, make sure you *acquire it from somebody with relevant, genuine credentials and experience* that can be verified through publicly available information.

BONUS MISTAKE - Needing to be right

One of the most challenging aspects of trading psychology for some traders is suppressing the need to be right. Many traders develop a strong attachment to their opinions and forecasts, especially if they have made them public, making it difficult to accept when the market moves against them. This desire for infallibility can lead to stubbornness, overconfidence, and ultimately, significant losses.

The market is a complex system influenced by countless factors, making it impossible to predict with certainty. Successful traders understand that they will inevitably incur some losses. Instead of focusing on being right all the time, they concentrate on managing risk and taking full advantage of opportunities when they arise.

By embracing uncertainty and accepting losses as a normal part of trading, traders can develop a more resilient and adaptable mindset. It's essential to remember that the market is indifferent to individual opinions. The goal should be to align with market trends rather than trying to fight them.

What is investagility?

investagility /ɪnˌvɛstəˈdʒɪlɪti/ [in-vest-uh-jil-i-tee] (noun):

A strategic approach to financial markets that accentuates the benefit of adjusting investments in response to changing market conditions. This concept integrates agile methodologies within the broader investment strategy, enabling investors to improve portfolios, seize opportunities, and mitigate risks. Investagility reflects a proactive mindset essential for navigating today's complex financial landscape.

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