Trading Mistakes 101

Steve DeWitt takes a look at common mistakes made in Forex trading that cause traders to lose money. He also shares strategies that can be used to avoid making these mistakes.

Huge amounts of money can be made trading Forex. While profits are definitely there for the taking, this article was written to help you learn how NOT to make the common mistakes of a losing trader. Being aware of these mistakes, combined with a solid trading plan can lead you to success more quickly. We see traders make these mistakes time and again. If these losing traders would just take a step back and consider why they are making these mistakes, they could turn the corner and become profitable.

The following list contains the most common trading mistakes that we will cover in this article.

1. Not using a "trading plan"
2. Not having a money management game plan
3. Not using protective stop loss orders
4. Closing winning trades early and letting losing trades run
5. Overstaying your position

6. Averaging a losing trade
7. Increasing your risk with success
8. Overtrading your account
9. Failure to take profits from your account
10. Changing your trade plan in mid-trade
11. Not having patience
12. Not having discipline

Now, let's dive into each one of these areas one by one.

1. Not using a "trading plan"

Any coach in any sport will tell you, "You must have a game plan!" Well, the same thing is true in trading. I am in constant contact with hundreds of traders and I am truly baffled that, trade after trade after trade, one of the most common mistakes a trader makes is not having a defined trading game plan.

A trader who thinks a market is about to go up will usually say something like –"I think the EUR/USD is going up to $1.3000. Where do you think I should buy it?" My response is usually something like, "What are you risking on the trade? In other words, "Where are you going to get out if you are wrong?" Often the response is silence, or perhaps a puzzled "Huh?" No thought was ever given about being wrong or where to place the stop. My next question, "If it does go up, how and where are you going to get out?" I often receive the same response.

More than 90% of the Forex traders that I come in contact with have no trade plan. That means that they do not know what to do if they are wrong and they do not know what to do if they are right. The large paper profit they made often turns into a large realized loss because they did not know where to get out.

The most important move a Forex trader can make is to develop a trade plan, before entering the trade. The trade plan should consist of these guidelines.

- Know how and where you are going to enter a trade.
- Know how much money you are willing to risk on the trade.
- Know how and where you are going to get out if you are wrong.
- Know how and where you are going to take profits if you are right.
- Know how much money you are going to make if you are right.
- Have a protective stop loss in case the market does the unexpected.
- Have an approximate idea of when a market should meet your trade objective. When should the market begin to make its move, and if it does not move as expected, get out!

2. Not having a money management game plan...

I am constantly amazed at the number of Forex traders and brokers that have no concept of 'money management.' Money management is controlling risk through the use of protective stops or hedging, while balancing the potential for profit against the potential for loss.

Here is an example of poor money management that I see almost daily... many traders refer to a trade that might lose $500 if they are wrong and make $1,000 if they are right as a two-to-one risk/reward ratio. This is usually considered a "decent" trade. What is wrong is that it is just as important to know the proper win/loss ratio as knowing how much you are going to lose if you are wrong and how much you are going to make if you are right, but what are the odds of making money... of being right? What are your odds of losing money, or being wrong?

Good money management means knowing a trade's profit objective and the odds of being right or wrong and controlling the risk with protective stops. You are better off with a trade where you might lose $1,000 if you are wrong and make $500 if you are right, if the trade works eight times out of ten, than to take a trade where you make $1,000 if you are right and lose only $500 if you are wrong, but the trade works only one time out of three. Developing and testing money management concepts is the way to overcome this problem. An entire book could be written on money management principles, but the key is to know your win percentages along with proper risk/reward ratios.

3. Not using protective stop loss orders...

This mistake fits right in with the lack of a trade plan and money management. It is the failure to use protective stop orders once you enter a trade – not mental stops, but real stops that cannot be removed. All too often, Forex traders use mental stops because they have been stopped out in the past and subsequently watched as the market moved in their direction. This does not invalidate the use of pro-

tective stops – it means that the stop was most likely in the wrong place, as it was likely not a good technical stop. When a protective stop that was determined before a trade was entered is hit, it means the technical analysis was probably incorrect... your trade plan was wrong.

With a mental stop, as soon as the market has gone through the protective stop price, you no longer act like a rational human being. Now, you are likely to make decisions based on fear, greed and hope. How many times have you had a mental stop and tried to make a decision whether or not to take a loss? Typically, by the time the decision is made and acted upon, the market has run further against you. Invariably, you decide to hold onto the trade hoping that you can get out on a Fibonacci retracement to your previous stop price. Unfortunately in many cases, it never touches that price again and you end up taking a large loss. Or, you make the mistake of holding the trade an extra day because you hope the market moves higher the next day. But the next day, the market is lower yet and by then the loss is so large you cannot "afford" to get out of the position – and what should have been a small loss turns into a disastrous loss.

There is an old saying that 'the first loss is the smallest.' It is also the easiest to take, even though it may seem hard at the time.

The only way to overcome this mistake is to have an unbreakable rule with the discipline to follow it that a protective stop loss order or hedge must be placed on every trade. I have found the easiest way to take a loss is to place the protective stop order or hedge limit order the moment or immediately after entering the trade.

Do your homework when the markets are slow. Place your orders while the market is still quiet. Another rule to follow – under no circumstances should an initial protective stop order be changed to increase the risk on a trade, but only to reduce it.

4. Taking small profits and letting your losses run...

A very common mistake among Forex traders is taking small profits and letting losses run. This is often the result of not having a trade plan. After one or two losing trades, you are likely to take a small profit on the next trade even though that trade could have turned into a large winner that would have offset your previous losses. Letting losses run often happens to new traders and is not an uncommon problem among even professional Forex traders. After entering a trade, you do not know where to get out. Once you start losing money on a particular trade, the tendency is to let the loss get larger and larger as you hope that the market will retrace to let you break even – which of course, it seldom does.

This mistake is overcome by using pre-determined protective stop loss orders or hedging to prevent your losses from running, and following your trade plan to take profits at your profit targets.

5. Overstaying your position...

One of the most common mistakes of trading currencies is overstaying a position, or simply failing to take profits at a predetermined level. There seems to be a natural law that the market is only going to allow one individual so much money before it starts to take it back. Yet, it is when you have these profits, especially real profits in your account that you often try to get the last nickel out of a trade. If the market meets your profit objective and you are in the trade without an exit order, then you are overstaying your position... period!

All too often the market breaks sharply through your "mental stop" and you watch as your profits disappear before your eyes. Then, you decide to hold the trade hoping for a small rally and the market never rallies enough. The trade profits fall back to break-even, and now you really begin to hope. Next thing you know, you are sitting on a loss. Be aware that a large profit can turn into an even larger loss.

The only exception to this would be if price action were moving strongly in your direction. In this case, you can move your protective stop to your profit target or use a trailing stop.

6. Averaging a loss...

This mistake is usually a holdover from trading equities or futures. In Forex trading, with 100 to 1 or greater margin, averaging a loss can be disastrous to say the least. A typical approach is that once you have entered a long position in the market and it drops lower, you might figure that since it was a good buy then, it is a better buy now. You may justify averaging down by figuring you will have a lower average entry price and require a smaller move to break even. Unfortunately, you will lose twice as much if the market continues against you, as it almost always does.

There are approaches that allow you to buy a market at one price level, add to the position at a lower level and add on again at even a lower level, as long as this was your predetermined game plan before you entered the trade initially. Personally, I never trade this way but it is some manager's

strategy. You must also have an unmovable protective stop loss order that takes you out of the entire position.

This mistake is easily overcome by having a strict rule to never average a loss unless your predetermined plan calls for averaging the trade in the case the market moves against you. This can be done with a pending unmovable protective stop loss order to exit the entire position if it is hit.

7. Increasing your risk with success...

One of the most common mistakes I see Forex traders make is increasing risk exposure because of a perceived winning or losing streak. Just by being successful on a few trades, more dollars will be risked per trade because more money is in the trading account. Because you have more money (and confidence) when successful, you are also likely to take larger percentage risks. Not surprisingly, this ruins more Forex traders than a series of small losses.

Not allowing the risk percentage to unreasonably increase as profits are realized and discipline in maintaining protective stop losses can overcome this mistake. What I mean by 'unreasonably increase' is this – on a typical trade, your risk should be in the range of 6% to16% of your account size depending on trade confidence. As you see yourself on a winning streak, you are tempted to increase risk percentages. Never increase your risk percentage to more than 25% of your account balance on any single trade.

I have also seen traders risk more after a losing streak and risk less after a winning streak. Their thinking is that after a string of winners, a loser has to come at any moment so it is time to reduce risk. The other side of this is increasing the size of their risk after a string of losses thinking that a winning trade is imminent. Do not fall into this 'thinking' trap! Those percentages of 6% to16% and 25% are listed for me because of my high level of confidence in trading my proven system. If you are new to trading, your risk should be between 1% and 5% for a typical trade and 8% maximum loss on any one trade.

8. Overtrading your account...

Assuming risk that is too large a percentage of your account balance on any single trade, either with too large a dollar risk per contract or by trading too many contracts for any single trade or by trading too many currency pairs.

This can also happen after a period of choppy market consolidation when you "know" that the market is going to do something. You are so certain that this is going to be a big move that you risk much more than the maximum 8% of your account balance. Already emotionally out of balance, all it takes is a couple of limit moves against you and you are bust.

To prevent this mistake from occurring, you must have a hard and fast rule that you can risk no more than a certain percentage of your account balance on any trade regardless of how good the trade looks. My personal hard and fast rule is to only have one position on at a time period. This does not count if I am hedged because with most brokers hedging does not take up margin. This limits any possible overtrading. Overtrading is the quickest way to lose the capital in your account.

9. Failure to take profits from your account...

It is almost a natural law that over a given period of time, the Forex markets will allow you to make only so much money and then you are going to have to start giving some back. Yet, probably no more than 1% of all Forex traders I know have a rule to take profits out of their account.

(However, they are quick to deposit money into their accounts when funds drop to untradable levels). You cannot believe how often I see traders leaving profits in their accounts and then go for the "big trade" – the one that will give them a real "killing," which usually kills their profits.

This problem can be overcome by predetermining an equity level at which you will remove profits from your account.

When you make profits in the Forex markets, take some money out and put it somewhere else. Your trading will move in cycles. You will make some, lose some, make some, and lose some. By taking money out of your account when you are profitable, you will not make the mistake of losing larger amounts of money when a down cycle occurs.

10. Changing the trade plan mid-trade...

During prime trading hours, you are subject to emotional reactions of fear and greed much more than you are when the market is quiet. Have you ever noticed that when you sit down during the slow Asian session, you can very calmly determine what you want to do during the busy London session? But, shortly after the London session opens or when the market gets busy, you do exactly the opposite of what you had planned.

With rare exception, the best approach is to not change your trading strategy during prime trading hours unless there is a breaking news event or market reaction.

Overcome this mistake by developing your trade plan before busy market hours and having the discipline to not change your trade plan afterwards.

11. Not having patience…

… Or trading for the excitement, not the profit.

The average life of a Forex trader is between five minutes and nine months. Not all Forex traders trade because they want to make money. Many individuals trade because they want the action. Think about it – is it necessary to trade everyday, or can you patiently wait for higher probability trades, even if it means staying flat the market for 2 or 3 days or even a week? I warn my clients not to get mad at me if they do not see a trade for a week. I would rather have clients get mad at me for not trading, than trading and losing money.

12. Not having discipline…

It has been my experience in trading Forex and helping other traders trade Forex that the greatest cause of loss is the absence of self-discipline. You need self-discipline to follow your trade plan, to be patient, to take losses, to take profits… and, to practice sound money management. When starting out after learning a trading system and funding a trading account, one of the best ways to develop self-discipline is to watch the market for a whole day without doing one trade. Even if the perfect trade comes along, do not do anything. This will prove to yourself that you can that you have the discipline to be patient and not trade.

Here are a few more tips I learned over the years.

It is following a string of profitable trades that you are most likely to lose large amounts of money. If you began trading with a $5,000 account and limit yourself to a maximum 8% risk, you could lose a maximum of $400 per trade. With profits increasing your account size to $10,000, it is possible to lose $800 per trade. Worse yet, flushed with success you are more prone to break your rules and "wait a day" when you should have been stopped out of a position.

When I was a new Forex trader, I found that some of my largest losses occurred from my smallest positions. After making large profits, I let these small positions run into extremely large losses because I was overconfident. That is why for the last 4 years, I have traded only one position and always the same size.

Trading Forex is a game of psychology. It is a game of balance. Emotional extremes create an imbalance. In your quest to make money, you will make mistakes of greed. In your reluctance to take losses, you will make mistakes of fear. The tremendous emotional release you will feel when you finally close out a large losing position is amazing. You will fight the market, while knowing it will to go against you, but wanting it to go in you favor, hoping for it, worrying about it, praying for it.

After a few hours or a few days of that, it will feel as though the weight of the world is removed from your shoulders when you finally take the loss.

One of the early signs that you have made a serious mistake in a trade is when you change your routine and start to tell your spouse and friends the "reasons" the market should go your way. Or, polling the internet looking for traders taking your same position, asking your Forex broker what he thinks you should do (like Forex brokers really know the first thing about profitable trading) or hoping that some government action will bail you out. What I am talking about is not Forex trading – it is hope. Hope is the most devastating of all emotions in trading the Forex markets because it can lull you into complacency. Know that when you find yourself hoping, you are wrong and should immediately get out of the market. But, it takes an unusual amount of self-discipline to take that very large loss.

For those of you who wish to learn how to make money in the Forex markets, rest assured that it is possible. However do not expect to make money on each and every trade. If you concentrate on not breaking the 12 Common Mistakes of Forex Traders, you will have a greater probability of making money over a period of time.

Certainly, you will have losing trades. Certainly, the markets will do the unexpected at times and you will lose more money than you expected, but if you steadfastly avoid making these mistakes you must make money.

Steve DeWitt has been involved with Forex trading for over 8 years. During his years of experience, he has won many international Forex trading contest including "The Biggest Forex Contest" ever. He has also trained over 10,000 people how to become successful at trading the Foreign Exchange markets. Steve founded Forex Confidential over 3 years ago to train individuals how to trade properly and for profit. Steve also hands out excellent trading signals for those who do not want to learn but want profit. Steve can be reached at steve@forexconfidential.com or by visiting his website www.forexconfidential.com.