

Market Mastery

Putting Peak Performance to Work for You



Psychological Issues

By

Van K. Tharp, Ph.D.

When Jack Schwager visited Ed Seykota to interview him for his book *Market Wizards*, Jack found that he was the person being interviewed, not Ed. Jack would start to say things and Ed would indicate how the assumptions behind Jack's questions revealed his psychological issues. As a result, Jack returned to New York with no interview. Instead, he mailed a set of questions to Ed to answer. Again, Ed turned the questions around into Jack's issues. However, once they'd done this process about five times, the result was one of the best interviews in *Market Wizards*.

Ed's approach is full of danger as a teaching tool. Socrates, who was well-known for turning questions back on people, which is called the Socratic method of teaching, was poisoned. And Socrates didn't usually enter into the most dangerous of areas—asking questions about the psychological assumptions behind what people do. Most

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A Conversation with Van K. Tharp

By

Van K. Tharp, Ph.D.

This month's interview is a continuation of a position statement in which I'd like to share a number of new ideas and developments with you. These include:

Part I: Factors That Build Consistency Into Your Trading Performance.

Part II: Factors Involved In System Testing and Development.

Part III: The You Factor: Consciousness, Discipline, and Inner Work.

Part IV: Financial Freedom and the SafePaths branch of the Van Tharp Institute.

This series started in July, and I suspect that it will take several issues of Market Mastery to completely cover all of them. Many of these questions were generated by you, but some were self-generated just to convey a point I wanted to make.

Part II Continued: Doing Great Research to Develop A Great System

Last month, in part two of this interview, I introduced you to concepts that tend to produce great trading systems. We went through 1) knowing yourself—especially your strengths and weaknesses and your beliefs about the market; 2) Types of strategies that work; and 3) the general principles of low-risk ideas. In the rest of part two I'd like to cover the types of systems that typically don't work (and why); how

to get to know your system really well so that you have the confidence to trade it; and some of the psychological issues that come up with respect to trading systems.

Great, so let's jump in. What types of systems have you seen that don't work?

In my opinion, there are certain types of fundamental analyses that just

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don't work. And the major one I'd like to cover here is talking about the future prospects of a company. For example, I frequently get newsletters that talk about the potential future earnings of a company. Let's say company ABC is a small startup company. It's a microcap, worth about \$50 million. But let's say it has some new technology that could change the way we live our lives. Let's say XYZ has a new drug that will allow people to eat normally (i.e., the way they've always eaten), yet cause them to safely lose about a pound each week while taking the drug. The idea sounds great, doesn't it? You could buy into that sort of stock, right?

Absolutely, so how would the analysis of the stock go that would convince you to buy it and why wouldn't it work?

First, the analysis would convince you of the potential market for this new technology. In this case, you might learn that 30% of all Americans are obese. You might also learn that another 30% of Americans who are not obese are fanatical about weight loss and would use this product if it were safe.

Second, the analysis would convert this potential market into the potential income for the product. So let's say that 150 million people need the product and that 15 million use it regularly in the first year it comes out. Let's say it cost \$2 per dose and the average person needs 5 applications each day. That's \$10 per day or \$300 per month. The analysis might say that the profit margin is about \$250 per month per user or \$3,000 per year per user.

Now the math begins to add up and you learn that \$3,000 per year per customer in profits times 15 million

potential customers equals \$45 billion. This company currently has a market capitalization of \$100 million and it could earn \$45 billion in the first year. That suggests that the price of the stock could go up 450 times. Wow, you are really excited and you buy 500 shares of the stock at \$18 per share for a total investment of \$9,000.

Next, the analysis might talk about the safety of the technology and give all the evidence that suggests that it is perfectly safe with no side effects. So you have a stock with a potential of going up 450 times or more and it's safe. Wow.

Okay, so what's wrong with the analysis? What happens?

Everything is wrong. It's mostly what I would call hype. Everyone who works in a company and produces this sort of product will give this type of analysis to the manager of the company. And the typical response of the CEO of the company is "how come we have these great new products with huge potential, but we only manage to grow our company 5-10% a year when the market is that good?"

The bottom line is that I would guess that less than 5% of these companies really take off (and that's 5% of those that look really good to the analyst). And of the 5% that take off, I'd also guess that less than 5% of those really take off big – up 10 times or more. That means, you have about a 0.0025 chance of such a stock taking off. If you risked \$1,000 on each such company, then your overall expectancy is probably way less than zero.

So just be careful.

So does this mean that I should avoid newsletters and brokers who

give me tips based upon the fundamentals of the company?

I would generally avoid brokerage house tips period. They often recommend what the brokerage company insiders want to sell and the broker who doesn't recommend those stocks could easily lose his/her job. Thus, I'd never follow a broker's recommendations unless the broker has a strong track record and does independent research. However, since brokers are only trained to sell, these people are very rare.

By the way, this isn't supposed to go on in today's market, but my belief is that it does. Brokers used to tell me that was happening and it is hard for me to believe that brokerage companies have really changed.

And what about newsletters?

I'd also recommend avoiding newsletters that give you recommendations based upon fundamentals, meaning that they analyze the potential for good earnings growth. These are among the examples that I just mentioned and they just don't work. Be very careful here.

Are there other types of fundamentals?

Yes, when you learn to buy something that's at a discount to its liquidation value, you are talking about a totally different type of investment idea. Here you must ask yourself: (1) What is the company worth if you liquidated it in a year; (2) Convert that to a dollar per share valuation and compare it to today's price. If you can buy it today at a substantial discount to the liquidation value then it is a bargain.

Benjamin Graham made 17% a year during the Great Depression finding this kind of stock. His best student, Warren Buffet, has a similar sort of

track record. But that kind of fundamental analysis is totally different from predicting future earnings growth. And, in my opinion, you can make good money with that sort of methodology. However, it does take some work. Sound methods generally require work.

You can probably apply that method in many areas.

Exactly, I apply it to rare stamps. Stamps are so unpopular now that it is possible to buy rare ones and make a 100% profit in a short period of time. I'm currently writing a book on the topic.

What other kinds of strategies don't work?

Most simple option strategies do not work. The people who price options are very sophisticated. They look at the uncertainty of price movement – how much variability does the underlying instrument have and how long is it until the option expires. And using that information, they can price it in such a way so that 90% of all options expire worthless.

Thus, you can buy an option and be totally right about the future price movement of the underlying and still lose money – because you are paying too much premium for it.

If 90% of all options expire worthless, can't you make money writing or selling naked options.

When you do that, your profit potential is limited to the price of the option and your risk is unlimited. You'll generally make money 90% of the time, but when you lose, you'll probably lose so much that you'll wipe out all of your profits. And that can happen in minutes without warning.

I actually had a friend with a million

dollar account. During the 1990s he was doing very well with that account because he was selling naked puts. And since the market went up, they all expired worthless. However, in September of 2000 he sold a lot of puts naked and then left the country for a three month trip. When he returned, his million dollar account was worth about \$50,000. He was in his 70s and he doesn't get to take too many trips any more.

So what are options good for?

Well, in our options workshop we teach option equivalence strategies. You learn how to price options without a computer and you learn how to use options to lower your risk and guarantee a more steady return. You learn how to use options instead of stops. These are some of the most useful strategies you could ever have. However, most people just want to know what to buy and sell (and when) and don't get excited about these strategies. That means that it is even more of an advantage to those who do use them.

What's an example of that?

Specific strategies are beyond the scope of this interview, but let me give you an example of how it helped one person, Mark Cuban. He sold his Internet stock Broadcast.com to Yahoo for over five billion dollars in stock during the Internet Bubble. He then used put and call collars around the stock to guarantee his fortune. As Yahoo dropped 90% — Mark kept his stock and used the spreads to get cash, not losing any of his fortune. That's a great example of that. Incidentally, Mark Cuban is now the star of a new reality series called *The Benefactor* — so he's running in the same crowd as Donald Trump and Richard Branson, the British billionaire.

When you understand those types of strategies, they are great at helping you keep your money and even adding to it. That's why we have an options workshop in which those are covered.

I get nervous when dealing with options!

You should, because more people lose money in options than any other area of investing, in my opinion, including high-leveraged futures. And that's because they mask under the guise of being safe. But they are only safe when you know what you are doing.

You talked about systems you liked last month...are there any others to add to those?

Yes, I really like statistical systems. What you do is sample the market in various time frames. When the market moves to statistical extremes (in several time frames), it is usually poised to bounce back in the other direction. Thus, you can have a real tight stop.

And in the event you are wrong, a stop-and-reverse is usually a great trade because these are sometimes extreme trends.

So how would you do that.

You'd look at various time frames and get lots of samples (different samples for each type of market). When you have say 250 samples, you start looking for extreme moves (i.e., how far does a market usually move in time frame x before it reverses). When you get moves above two standard deviations (less than 5% probability of occurrence), then the odds are pretty good for a bounce in your favor. And if you can get several time frames to line up (i.e., hourly, daily), then you really have

a good trade.

So what do you do?

You play for a move in the opposite direction (i.e., a bounce) and you keep a tight stop.

However, this procedure requires that you have software that collects this type of data and continually updates you on the probabilities. I only know of one person who had that kind of software, and he developed it himself. If everyone had that type of software, it probably wouldn't work.

Okay, let's move into how to get to know your system really well.

I'm a big believer in understanding the R-multiple distribution of your system. Remember that R stands for the initial risk in your trade. You might think of R as the risk per unit when you get stopped out (i.e., \$5 per share on a \$50 stock) or you might think of it as the total risk taking position sizing into account (i.e., if your risk is \$5 per share then you would have \$500 risk on 100 shares).

R-multiples can now be described as a way of expressing your final result in terms of your initial risk. Thus, if you risk \$500, and you make \$2000 in profits, then you had a 4R gain. If you lose \$750 on the trade, then you had a 1.5R loss (i.e., either you didn't keep your stop or you had some problems getting out at the price you wanted). When you have fifty or more such results from closed out trades, I would call that an R-multiple distribution of your results.

If you have a big enough sample, then your R-multiple distribution can help you determine what to expect from your system – at least for the types of markets you have traded.

What do you mean by that?

There are basically six types of markets.

1. Up-volatile
2. Up-quiet
3. Sideways-volatile
4. Sideways-quiet
5. Down-volatile
6. Down-quiet

When you get an R-multiple distribution, you need to know what kind of markets you had when you got your results.

For example, during the late 1990s you might have traded high-tech stocks and thought trading was very, very easy. You had a hugely positive system. However, most of your trading was in an up-volatile market. Great, now you know your high-tech system does very well in an up market. But what about a down market (2000-2002) or a sideways market (2004) – how does that same system perform in those types of markets? If you didn't think about some of these things, most of you probably discovered the answer the hard way by losing money.

However, if you actually traded a high-tech system (not buy and hold) during that last ten years, then you would have a great collection of R-multiples and you'd know how it would perform in any sort of market.

What would you do with that?

You'd probably have some filters that tell you, "I don't want to trade this sort of system when we have these sorts of markets." And you'd also be able to thoroughly simulate your system to know what to expect from it in the types of markets you really want to trade. And, as a result, you'd understand how to trade the markets

to best achieve your objectives (i.e., use position sizing to meet your objectives).

Okay, what do you mean by simulation?

In my opinion, one of the best ways to determine how to meet your objectives in the markets, once you have an adequate distribution of R-multiples, is to simulate it. You make the assumption that your sample represents the overall types of trades that you might see from the market. However, you don't really know how they'll show up. You might only lose 40% of the time, but what's the likelihood of 10 losses in a row or of 20 losses in the row. These and many more questions can be answered through simulation.

My good friend, Chris Anderson, developed a simulator for IITM. It allows you to take an R-multiple distribution and ask certain questions. You'll start out by saying I'll make 20 trades each month and about 240 each year. Knowing that you will typically make 240 trades per year with a certain R-multiple distribution, you now simulate a year's worth of trading 5,000 times. And from that simulation you ask questions such as:

- What are my average results, what are my best results, and what are my worst case results?
- What is the number of consecutive losses, what's the size of my cumulative drawdowns in terms of R that I can expect?
- How long is the drawdown likely to last in terms of months?
- What percentage of years/months can I expect to make a profit?
- What's my average gain going to be each year?

And if your R-multiple distribution is correct, the simulator will answer all of these sorts of questions for you.

That sounds terrific. What else will it do?

You can look at your objectives in terms of how much you'd like to make each year and when would you decide to quit trading. Thus, you might say, my objective is to make 100% in a year. You might also decide to quit trading if your account was down 25%.

You can then simulate a years worth of trading 5,000 to 10,000 times, risking different percentages until either the year is up or you reach the "stop trading" level. The simulator will then tell you what kind of probabilities to expect for each risk level.

Can you elaborate?

Let's say you want to make sure you don't have a 20% drawdown which you can "ruin" because you are managing other people's money and you think they'll pull their funds if you have that sort of drawdown. Now you can ask the question, what sort of percent risk algorithm should I use to make my chances of ruin be 1% or less. The simulator might tell you that your chances of a 20% drawdown are less than 1% if you risk 1.3% per trade (assuming you use 1/10th of a percent increments). That's very useful to know.

Similarly, you might just want to know what sort of percent risk will give me the maximum chance of making 100%. The simulator might show you that risking 3.7% gives you an 87% chance of making 100%. However, if you risk more or less than 3.8%, then your chances of making 100% start to diminish. Thus, you'd have a fairly good idea what to risk if that were your goal.

What does that optimum risk level do to drawdowns?

Remember that optimum risk is only defined in terms of what you want to accomplish – in this case make 100%. That definition does not take ruin into consideration. You might also find that risking 3.7% gives you a 9% chance of ruin. Perhaps that figure would be unacceptable. In that case, you might find that you are looking for the percentage risk amount that gives you the biggest difference between meeting your objectives and experiencing ruin and call that optimal. For example, you might find that risking 1.3% gives you less than a 1% chance of ruin, but also gives you only a 2% chance of meeting your goal of making 100%. However, when you look at the differences, you might find that risking 3.1% gives you an 81% chance of making 100% and only a 2% chance of ruin. That 79% difference is the largest difference, suggesting that for you, risking 3.1% might be the way to go.

But what if the R-multiple distribution you plugged in is not accurate?

You can do two things to minimize the chances of that occurring. First, you need a large sample of say 100 trades. Second, you need to be sure that every type of market (of the six possible market types) that you intend to trade is well represented. For example, if you have a bear market system, you might want 100 trades from down-volatile markets; 100 trades from down-quiet markets; and perhaps even another 100 trades from flat markets. If you do that, then you probably have a good idea what to expect. And here I'm assuming that you can make sure that if the market is going the wrong way you stop trading the system. Thus, if you

have enough samples from each type of market, then your simulation is likely to be accurate.

To be safe, you might also add a few extremely large losing R-multiples just to simulate some condition that you might not have seen yet. If your simulation shows that you can profit from that, then you probably have a pretty good system.

Can you elaborate on that step?

Well, assume that you have a 5% chance of a 5R trade against you with your system. What if you made that 10%? What if you assumed that you also had a 2% chance of a 10R against you? If you also plug these kinds of results into the simulator, what can you expect? If it still performs well, you probably have a good chance of making money.

Okay, but you don't sell the simulator. Why not?

The reason we don't do that is that we are afraid that people will plug unrealistic numbers into the simulator and then jump to unrealistic conclusions about the position sizing they use. When they lose money, they might just say that it was my fault because my simulator told them to trade that way. While I like to assume that everyone assumes personal responsibility for their results, past experience has suggested that is not the case. People ask for recommendations and then blame me when they lose. That's why we've decided to now be very safe with what we do.

Instead, we allow you to get reports on your system. That way, we can see how many R-multiples you are using, what kind of markets they represent, and warn you about possible misinterpretations in the report. It actually takes quite a bit of training to use the simulator properly. Thus,

our solution is to help you get a report on your system.

However, we are considering a simulation class in 2005 in which we would include the simulator software as part of the class.

Are there any problems with this sort of simulation?

Yes, it doesn't cover certain cases. For example, suppose you day trade and have great results with tight stops. You probably can only trade 1000 shares without influencing the market and with the tight stops you might only be risking one quarter percent per trade. If your system is good enough, our simulator might tell you to risk 2-3% which you really cannot do because your tight stops would cause you to have such a large position that you'd strongly move the market.

In addition, the simulator doesn't do well with correlated positions. It assumes that all of your trades occur one at a time. But quite often you might have an entire portfolio of trades. Suppose those trades all assume that we are going to have an inflationary bear market and that turns out not to be the case. Suddenly, all your trades would go against you and our simulator doesn't account for that sort of thing.

The last thing that we cannot account for very well is complex position sizing in a trade. Suppose you scale into a trade to get a full position. And then suppose you scale out of the trade as your objectives are met. Those might have to be treated as different trades, but if you did they'd be highly correlated. Or perhaps you'd need to lump them together as one R-multiple. That's possible, but it still could be correlated with other trades in your portfolio. Thus, we still have problems of this nature

trying to determine exactly what will happen in a portfolio.

Okay, now let's look at some of the psychological issues in trading system development. What are the typical problems that you see?

First, people want the easiest way out. Good trading takes a lot of training and a lot of work, and most people are not willing to pay for the training or not willing to do the work! They want a simple solution. Thus, people would first prefer to have someone do the trading for them. We find that all the time. People want to put money with the people we've trained or worked with. And, of course, we get blamed if they end up losing money. Thus, we don't recommend anyone any more.

Next people look for a good investment advisor. Most successful advisors are not that good at giving advice, but they are good at publicity.

For example, someone might say that if you invested \$15,000 and took every one of my trading recommendations, you'd be up \$60,000 at the end of the year. That sounds like you'd be up 400%. However, it might also mean that if you risked \$15,000 on each trade, then at the end of the year you'd be up \$60,000. That really means that you'd be up 4R at the end of the year. That's actually a terrible result. So you see, even a terrible result can be phrased in such a way to convince you to subscribe to the service. Even worse are the advisors who mention the results of specific trades, but not the overall results. However, people want to be told what to do. It's the easy way out because they don't want to do the work. The net result is 1) they never really understand the trading process; 2) they move from one bad

advisor to another; and 3) its always the advisors fault when they lose money, so they never learn from their mistakes. This happens over and over again with many people.

So what you are basically saying is that trading requires the skill of being a brain surgeon, but it doesn't have the entry requirements of brain surgery.

Exactly. People can open up an account and lose a fortune in a week – no problem. Unfortunately, they don't have to go through any screening criteria to practice the art of trading. A professional trader knows that spending \$10,000 on three or four workshops is probably equivalent to the cost of a few trading losses and if they can prevent that, they've paid for the education many times over. The average person doesn't see that connection.

Perhaps you should establish criteria so that people who meet certain skill levels will be pronounced "fit to trade."

That's an interesting possibility if there is enough interest.

So what kinds of issues tend to get in the way of developing a trading system?

Whatever issues you have will get in the way. For example, if you have certain issues like needing to be right. You start out trading someone's advice, but you hate to be wrong so you hang onto losers (hoping they'll turn around) and you sell your winners quickly because you are right. The net result is that you do the exact opposite of what is necessary for success in the markets – you cut your profits short and let your losers ride.

However, you decide that you are losing money because you are fol-

lowing someone else's advice. And you decide the solution is to get your own system. However, the issue will still show up in your search for a good system. You'll want a system that will make you right. Thus, you might start looking for a system that's right 90% of the time. This usually means an option system that ends up being a net loser. You'll end up searching a long time for the system that makes you right – never finding it. Or you'll start trading various systems and then reject them because you become "wrong" too much or you simply do the same things with the system that you used to do with your advisor's recommendations.

That's interesting, so how do people solve these problems?

The key is becoming aware of the issue. However, I've noticed in the forum that when someone asks a question and I post something that points out their issue, they tend to get upset. A typical comment is: "What's wrong with you – can't you just answer my question? Do you always have to turn it into an issue?" Obviously, I've not helped that person solve their problem. They've turned it into my problem. And the bottom line is that people really resist looking at their issues. But, in my opinion, this is one of the keys to success.

The second article in this month's issue covers this topic.

In the next issue of *Market Mastery*, we'll move on to Part III: The You Factor in Trading/Investing Success.

I think this section is the real key to success in the market. If you really understand this section you'll have really come a long way.



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*Psychological Issues
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people don't want to know their issues. Indeed, they interpret anything designed to get you to look inward as a real threat.

Let me give you an example.

How do I develop a system in which I can be right at least 60% of the time?

Van: You seem to have a fascination with being right?

What do you mean? I just asked a reasonable question can't you answer it.

Van: What if you could make money being right 40% of the time? Would that be acceptable?

You're not answering my question. I want to know how do I develop a system that's designed to be right 60% of the time. But I will answer the last question – no I want to be right 60% of the time or better.

Van: I was looking at the assumption under your question. You seem to have a strong need to be right. You'd probably be a much better trader if you didn't have that need. What would happen if you were wrong? How would you feel if you were wrong.

How can I learn anything? Why are you asking all of these silly questions. I'm not interested in being wrong, I'm interested in being right. Understood? You want to turn everything into a psychological issue. Not everything is psychological. It's really hard to learn anything from you when you are always throwing out all of this psychological stuff. Can't you just answer a simple question?

That's an example of resistance to the issue. Neither of us get

anywhere. But what if the conversation went a little differently?

How do I develop a system in which I can be right at least 60% of the time?

Van: You seem to have a fascination with being right?

Well, I do like to be right, naturally, doesn't everybody?

Van: Why do you want to be right?

Well, I've always worked to do a good job, to get good grades, and be successful. To accomplish that, you have to be right.

Van: Do you? What if you could be right 20% of the time and make huge profits – just because you cut your losses short and let your profits run. If you had eight 1R losses and two 10-R wins, you'd only be right 20% of the time, but you'd be ahead by 12R...that's pretty good.

I never thought about it that way.

So what if you just accepted losses when you got them, allowing them to be small losses and let your profits run when you have a good trade? Don't you think that might be a good idea. And you'll have trouble doing that if you want to be right all the time – for example, if you had nine 1-R gains and one 10R loss, you'd be right 90% of the time and still lose money.

Again, I never thought about it that way.

Van: So why don't you just play around with the idea that you can be wrong and still be successful. That being right or wrong is a meaningless invention of your mind. Instead, what if you just developed a good system and practiced following it.

A loss has nothing to do with being wrong. Instead, a loss has everything to do with following your system and not making a mistake. Doesn't that put losses in a different framework?

When you start looking at yourself, you'll find that there are lots of things that come up for you. You'll start noticing the patterns that you repeat over and over again. And that's one of the most valuable lessons you could ever learn.

So, let me ask you a simple question: How do you respond when someone turns what you say into a question about your psychological assumptions?

More Examples:

Q: What do you consider good performance in a system? How does my system compare?

Response: Why haven't you set objectives? Do you have a need to be the best?

Q: I am considering purchasing a system. Does anyone have a recommendation for one that works that allows you to see code?

Response: What you really mean is that you don't feel comfortable developing your own system. Why Not?

Q: Here's my strategy. What do you think of it?

Response: You appear to need other peoples approval to determine if your strategy is any good. Why? How about testing it to see if meets your objective?

