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What is the Number One Mistake Traders Make?

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Big financial market volatility has made active trading very popular, but the influx of new traders has been met with mixed success. Why?

The DailyFX research team has looked through anonymized trading data from over 100,000 IG Group live accounts in order to examine the traits of the most successful traders. Some clear patterns emerged which separated profitable traders from those who ultimately lost money. And indeed, there was one particular mistake we saw repeated over and over again. What is the single most important mistake which made traders lose money?

Why Does the Average Trader Lose Money?

Human psychology makes trading difficult, and we look to one set of particularly important set of behaviors which help explain why the average trader loses money.

We looked at tens of millions of real trades placed on the IG Group's trading servers in calendar year 2016 and came to some very interesting conclusions. The first is encouraging: traders make money most of the time as they closed over 50% of all trades at a gain. Or in other words: traders were 'right' more often than not. This was true across a broad range of markets as evidenced by data summarized below.

Percent of All Trades Closed Out at a Gain and Loss across 15 of Top Markets

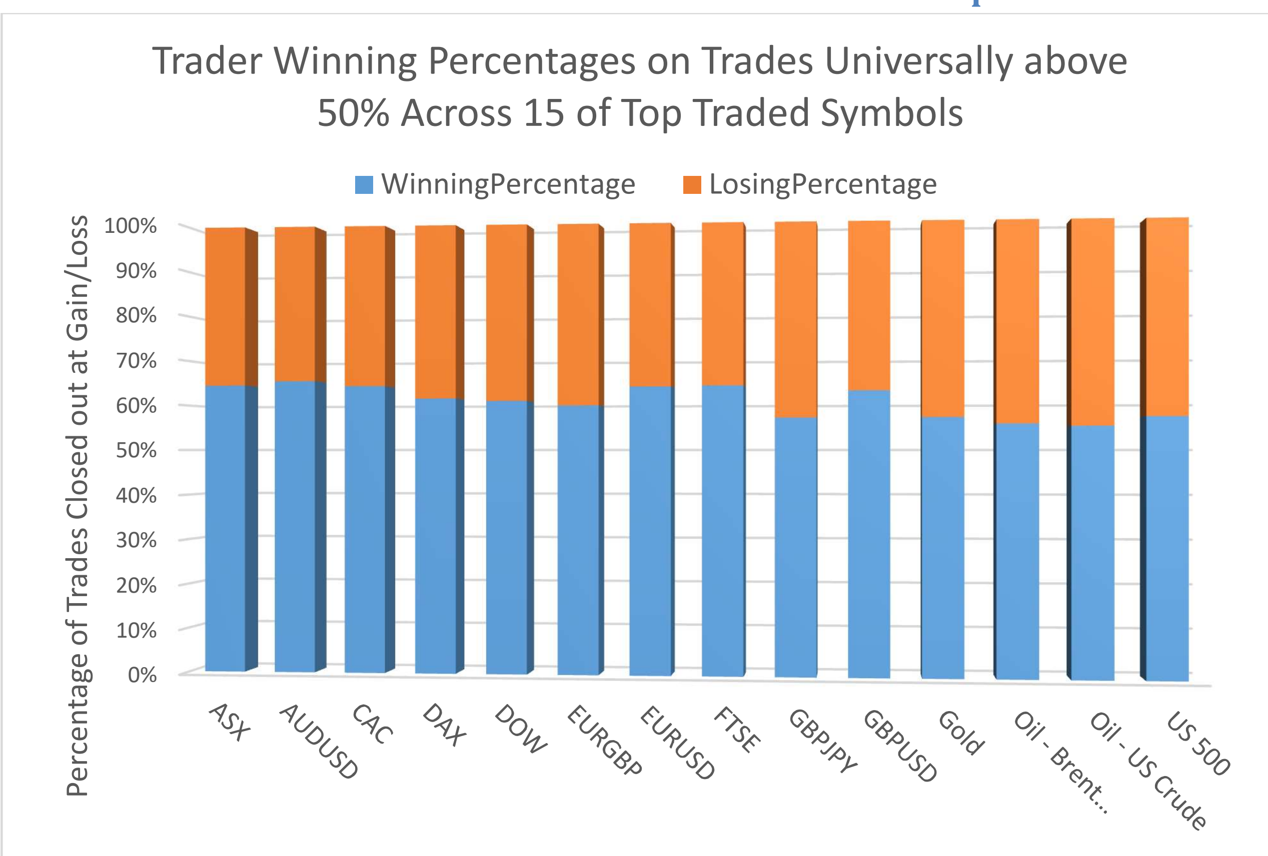

Figure 1. Data source: IG Group accounts and trades excluding Clearing Accounts, Money Managers, and Eligible Contract Participants. 1/1/2016 to 12/31/2016 across 15 of the most traded markets.

The above chart shows results of over 30 million real closed trades conducted by IG Group clients worldwide across 15 of the most popular markets. The blue bar shows the percentage of trades which ended with a profit for the client, while the orange bar shows the percentage of trades which ended in loss. For example, the EURUSD saw an impressive 64% of all trades closed out at a gain. And all winning percentages were above 50%.

If traders were right more than half of the time, why did most lose money? We look to one critical factor to each of those trades:

Average Profit/Loss per Winning and Losing Trades Across 15 of Top Markets

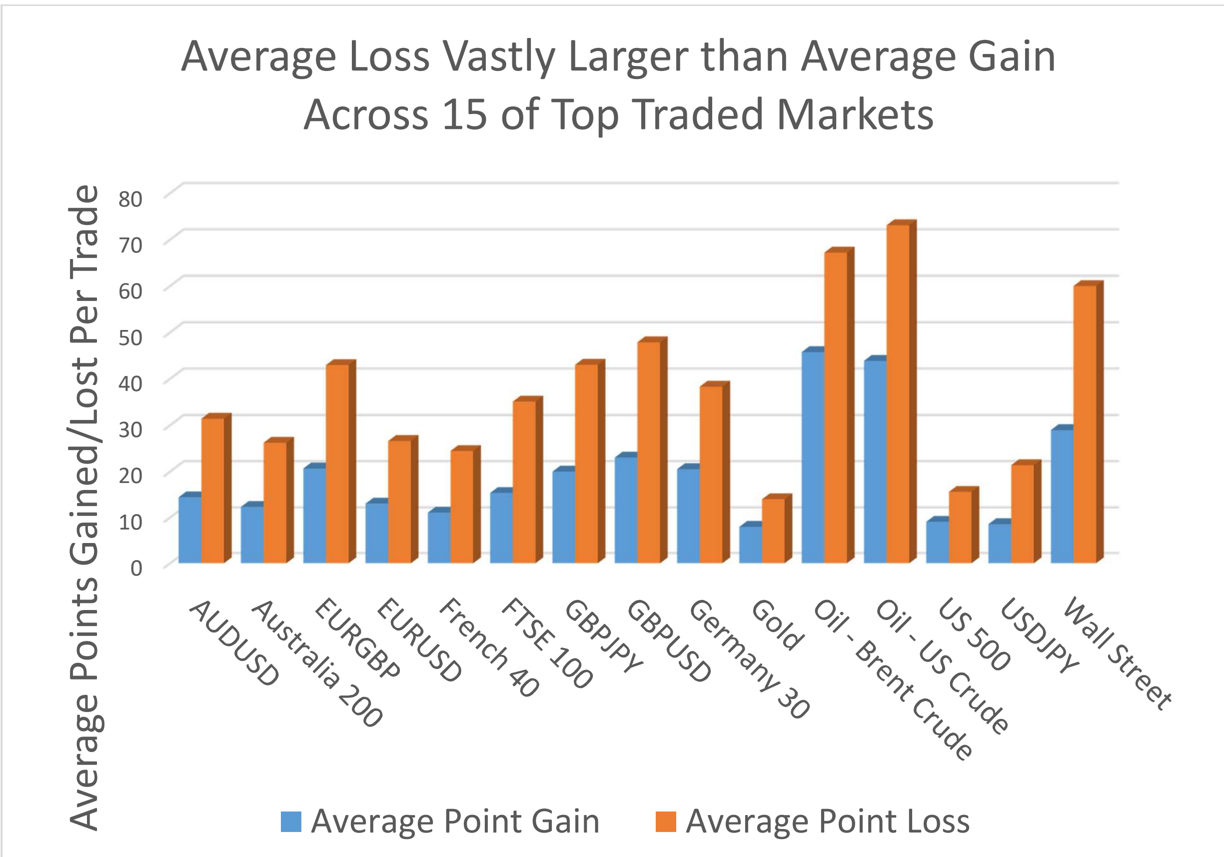

Figure 2. Data source: IG Group accounts and trades excluding Clearing Accounts, Money Managers, and Eligible Contract Participants. 1/1/2016 to 12/31/2016 across 15 of the most traded markets.

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

Let's use the FTSE 100 as an example. Figure 1 shows us traders closed 64% of all FTSE 100 trades out at a gain, but Figure 2 shows the average losing trade was worth 35 points while the average winner was only 15 points. Traders were correct nearly two-thirds of the time, but they lost more than twice as much on their losing trades as they earned on winning trades. The track record followed a similar pattern across the entire range of popular markets

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

Cutting your Losses, Letting Profits Run

Our data shows that traders were very good at identifying profitable trading opportunities and closed over 50 percent of all trades at a gain. Ultimately they lost, however, as outsized losses more than offset winning trades.

Open nearly any book on trading and the advice is the same: control your losses and let your profits run. Losses are inevitable; identify when a trade has gone against you and close it out at a smaller loss. Failure to do so will mean that losing trade may wipe out your trading capital before you can take advantage of the next opportunity.

The flipside is equally important: if a trade is in your favor, let it run. It is clearly tempting to accept a 'sure thing' and close a trade at a small gain. Yet consistently doing so while taking outsized losses is almost certainly a losing strategy.

If the solution is so simple and advice ubiquitous, why is this issue so common? The clear answer: human nature.

We as humans have natural tendencies which cloud our decision-making. We will draw on simple yet profound insight which earned a Noble Prize in Economics to illustrate this common shortfall. But first a thought experiment:

A Simple Wager – Understanding Decision Making via Winning and Losing

What if I offered you a simple wager? Assume it is a fair coin which is equally likely to show "Heads" or "Tails", and I ask you to guess the result of a single flip.

If you guess correctly, you win $1000. Guess incorrectly, and you receive nothing. But to make things interesting, I give you Choice B—a sure $400 gain. Which would you choose?

		Expected Return
Choice A	50% chance of $1000 50% chance of $0	**$500**
Choice B	$400	**$400**

From a logical perspective, Choice A makes the most sense as you can expect to make $500 and thus maximizes profit. Choice B isn't wrong per se; with zero risk of loss you could not be faulted for accepting a smaller gain. And it goes without saying you stand the risk of making no profit whatsoever via Choice A—in effect losing the $400 offered in Choice B.

It should then come of little surprise that similar experiments show most will choose "B". When it comes to gains, we most often become *risk averse* and take the certain gain. But what of potential losses?

Using the same coin, I offer you equal likelihood of a $1000 loss and $0 in Choice A. Choice B is a certain $400 loss. Which would you choose?

		Expected Return
Choice A	50% chance of -$1000 50% chance of $0	**-$500**
Choice B	-$400	**-$400**

In this instance, Choice B minimizes losses and thus is the logical choice. And yet similar experiments have shown that most would choose "A". When it comes to losses, we become *risk seeking*. Most avoid risk when it comes to gains yet actively seek risk if it means avoiding a loss.

A hypothetical coin flip exercise is hardly something to lose sleep over, but this natural human behavior is clearly problematic if it extends to real-life decision making. And it is indeed this dynamic which explains the most common mistake in trading.

How might we fix this?

Losses Hurt Psychologically far more than Gains Give Pleasure

Daniel Kahneman and Amos Tversky published what has been called a "seminal paper in behavioral economics" which showed that humans most often made irrational decisions when faced with potential gains and losses. Their work wasn't specific to trading but has clear implications for our studies.

The core concept was simple yet profound: most people make economic decisions not on *expected utility* but on their attitudes towards winning and losing. It was simply understood that a rational person would make decisions purely based on maximizing gains and minimizing losses. Yet this is empirically false—look no further than our real trading data.

Our data suggests traders felt it was "good enough" to take an average 15-point gain on winning FTSE 100 trades yet gave up an average of 35 points on their losers. Such a dynamic very likely helps explain why our data shows 64 percent of all of these FTSE 100 trades were winners—it was easy to take profits but hurt too much to take losses.

We ultimately aim to turn a profit in our trades, but to do so we must force ourselves to work past our natural emotions and act rationally in our trading decisions.

If the ultimate goal were to maximize profits and minimize losses, a $500 point gain would completely offset a $500 point loss.

This relationship is not linear, however; Figure 3 gives us an approximate look at how most might rank their "Pleasure" and "Pain" derived from gains and losses.

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

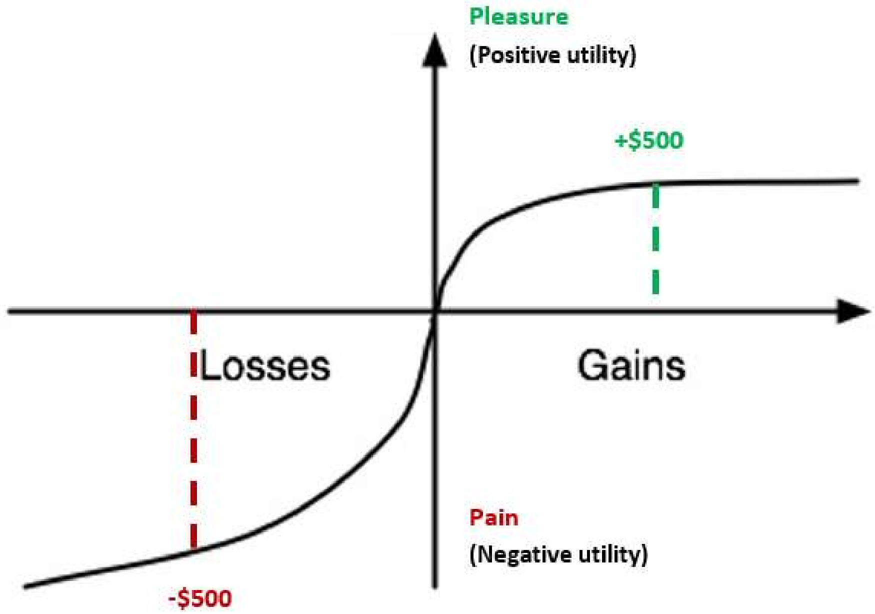

Figure 3. Licensed under CC BY-SA 3.0 via Wikimedia Commons

The negative utility from a $500 loss can be substantially larger than the positive utility from a $500 gain, and experiencing both would leave most feeling worse despite causing no monetary loss.

In practice, we need to find a way to straighten that utility curve—treat equivalent gains and losses as offsetting and thus become purely rational decision-makers. This is nonetheless far easier said than done.

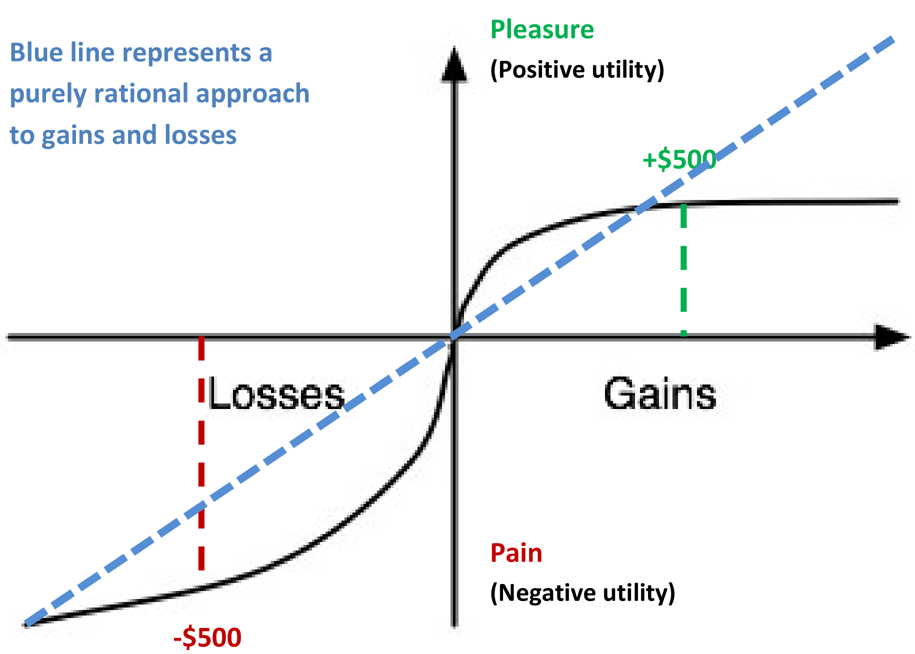

Figure 4. Licensed under CC BY-SA 3.0 via Wikimedia Commons

Avoid the Common Pitfall

We need to ensure that our trading decisions treat losses and gains the same, and this means always follow one simple rule when trading: always seek a potential reward *at least* as large as your potential loss.

We typically refer to this as a "**reward/risk ratio**". If you risk losing the same number of points as you hope to gain, then your reward-to-risk ratio is 1-to-1 (sometimes written 1:1). This simple rule makes it possible to lose on half of your trades and break even. It is certainly possible and in some cases advisable to use a reward/risk ratio above 1:1. Yet as a **bare minimum we recommend using a 1:1 reward/risk ratio** in your trading.

How do we put this into practice?

Stick to Your Plan: Use Stops and Limits – Good Money Management

Humans aren't machines, and working against our natural biases requires effort. Once you have a trading plan that uses a proper reward/risk ratio, the next challenge is to stick to the plan. Remember, it is natural for humans to want to hold on to losses and take profits early, but it makes for bad trading. We must overcome this natural tendency and remove our emotions from trading.

A great way to do this is to set up your trade with Stop-Loss and Limit orders from the beginning. This will allow you to use the proper reward/risk ratio (1:1 or higher) from the outset, and to stick to it. Once you set them, ***don't touch them*** (One exception: you can move your stop *in your favor* to lock in profits as the market moves in your favor).

There will inevitably be times a trade moves against you, triggers your stop loss, and yet ultimately the market reverses into your favor. But this is a numbers game; expecting a losing trade to turn in your favor every time exposes you to very large losses. To argue against stop losses because they force you to lose is very much self-defeating—this is their very purpose.

Managing your risk in this way is a part of what many traders call **"money management"**. It is one thing to be on the right side of the market, but practicing poor money management makes it significantly more difficult to ultimately turn a profit.

It is at this point we'll admit none of this is truly revolutionary, and it's quite likely you have seen the same advice before. But why does a 1:1 reward/risk ratio matter so much?

Does Using 1:1 Reward to Risk Really Work?

Our data certainly suggest it does. We use our data on 15 of our top markets to determine which trader accounts closed their average winning trade with a profit at least as large as their average loss—or a minimum reward/risk of 1:1. Were traders ultimately profitable if they stuck to this rule? Past performance is not indicative of future results, but the results certainly support it.

Our data shows 50 percent of all accounts which operated on at least a 1:1 reward to risk ratio turned a net-profit in our 12-month sample period. Those under 1:1? A mere 19 percent.

Traders who adhered to this rule were nearly 3 times more likely to turn a profit over the course of these 12 months—a substantial difference.

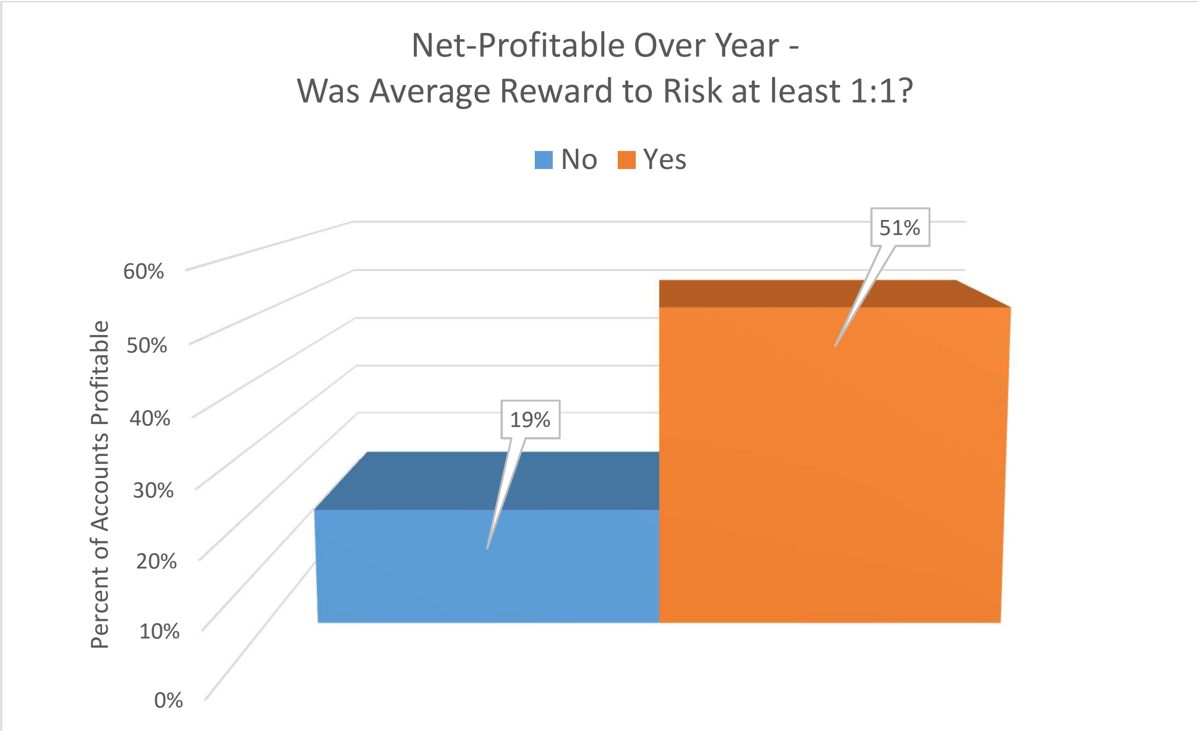

Figure 5. Data source: IG Group accounts and trades excluding Clearing Accounts, Money Managers, and Eligible Contract Participants. 1/1/2016 to 12/31/2016 across 15 of the most traded markets.

Game Plan: What Strategy Can I Use?

Trade with stops and limits set to a reward/risk ratio of 1:1 or higher

Whenever you place a trade, make sure that you use a stop-loss order. Always make sure that your profit target is *at least* as far away from your entry price as your stop-loss is. You can certainly set your price target higher, and probably should **aim for at least 1:1 regardless of strategy, potentially 2:1 or more in certain circumstances.** Then you can choose the market direction correctly only half the time and still make money in your account.

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

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