



Bradley Gareiss
TECHNICAL ANALYST

Sears Tower 233 S. Wacker Dr., Suite 5050 Chicago, IL 60606

312 831 4342
CHICAGO MAIN

800 465 4373
TOLL FREE

fx360.com
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Trading Psychology- Recency Bias

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Recency bias may not be a household phrase, but I guarantee that anyone who has ever traded has experienced it. Recency bias is the tendency for traders to place more importance on more recent trades and to place less importance on less recent trades. This phenomenon is not limited to trading of course. Another example would be the history of the all star game in Major League Baseball. If you asked the casual baseball fan who has won more all star games, most people would say the American League because they have not lost since 1996. However, the National League has actually won 40 games to the American League's 38.

Let's get back to trading. Recency bias can have a very negative effect on a trader's results. Let's say that two traders have the exact same profitability over the course of 2009. However, Trader A has won his last 3 trades, and Trader B has lost his last 3 trades. Even though they have made the same amount of money over the year, who do you think feels more positive? Trader A, of course. In fact, Trader A probably feels like he can run through a wall and will never lose again after winning 3 consecutive trades. Of course Trader A has lost plenty of trades, but chances are the past 3 trades will make him euphoric.

Euphoria will likely lead to bad decisions by Trader A. Trader A will ignore possible warning signs and enter a trade that typically does not fit his criteria. This increases the odds of a loss. Shaking his head, Trader A cannot believe he ignored those signs and gave back some of the profits from his recent win streak. Even if he is able to right the ship and go back to a neutral mindset, he still lost a trade due to a mental error. Of course, every trader will lose plenty of trades, but emotional errors (such as this one caused by euphoria) are the reason most traders that would otherwise be successful don't live up to their potential. If Trader A does not become emotionally neutral after his euphoria driven loss, the damage to his account can be even greater.

Back to our example, Trader B probably feels as if he will never win a trade again after losing 3 straight trades. Sure, he has won plenty of trades and is very profitable on the year. However, those 3 trades have him thinking very negatively. Trader B will likely make one of two mistakes at this point. First, he could abandon his rules and jump into a trade that does not fill their trade criteria because their criteria hasn't worked for the past 3 trades. This sounds irrational because that same criteria has led to long term profitability, but I would wager most experienced traders have done exactly what I just described at some point. Second, Trader B could pass up on a perfect trade set up that fits his criteria because he is scared of losing again. Both scenarios can be disastrous to a trader's mindset.

Clearly, it is important to avoid these mental mistakes and minimize the effects of recency bias. So how do we avoid succumbing to the negative mental influences that can be caused by recency bias? The first step is to keep a track record that includes every trade, how much was won or lost, and total equity. That way you can accurately track progress over a long period of time. This makes it much easier to think about results on a long term basis. If trades are not tracked, the past few trades will have a far greater impact on your mindset.

The second step is to write out a trade checklist with your trading criteria. That way, you are more likely to not enter a trade unless it fulfills all of the criteria. You also will be more likely to enter every trade that does fulfill your criteria. This

may seem meaningless, but it is much more difficult to ignore your trading rules if you have to physically put a check mark next to each of your criteria before taking a trade or passing on a trade.

The third step to minimizing recency bias is to know yourself. Some people are more emotional than others. If you are prone to making emotional decisions, take a day off from trading if you have lost or won 3 trades in a row. Trading under emotional distress is not profitable. If you handle your emotions well, perhaps waiting that day is not necessary. Usually a full night's sleep will help negate recency bias, especially if you have a detailed track record to go over the next morning that reminds you long term results are more important than the past couple of trades.

Remember, it is very challenging for the human brain to completely overcome recency bias. However, its effects can be devastating to a trader's mindset as well as their equity. Therefore, it is important to take the above steps to minimize the negative effects created by recency bias.

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