

WHAT IS THE NUMBER ONE MISTAKE TRADERS MAKE?

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Volatility in financial markets has made active trading very popular, but the influx of new traders has met with mixed success. Why is this and how can losses be avoided?

We've analysed anonymous data from over 100,000 live IG accounts to examine the traits of the most successful traders – as well as the least successful. 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 it?

Why do most traders lose money?

We looked at tens of millions of real trades placed on IG's trading servers, and came to some interesting conclusions¹.

The first is encouraging: traders made money most of the time, as they closed over 50% of all trades at a gain. In other words, traders were 'right' more often than not. This was true across a broad range of markets.

Percentage of all trades closed out at a gain and loss across 15 top markets

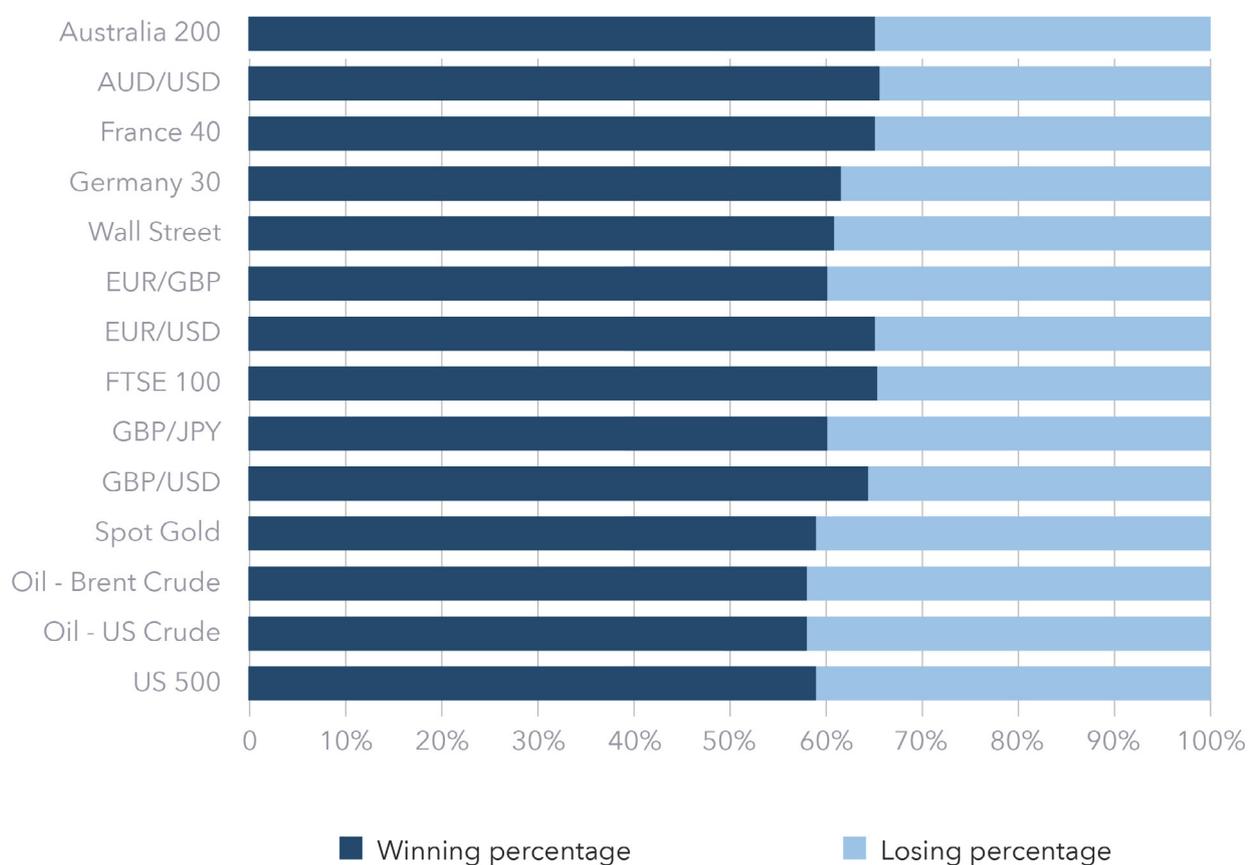


Figure 1. Data source: IG accounts and trades excluding clearing accounts, money managers, and eligible contract participants. 01/01/2016 to 12/31/2016 across 15 of the most traded markets.

The above chart shows results of over 30 million real closed trades conducted by IG 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 light blue bar shows the percentage of trades which ended in a loss. For example, the [EUR/USD](#) saw an impressive 64% of all trades closed out at a gain.

But if traders were right more than half of the time, why did most lose money?

¹ Data sourced from calendar year 2016



Average profit/loss per winning and losing trades across 15 top markets

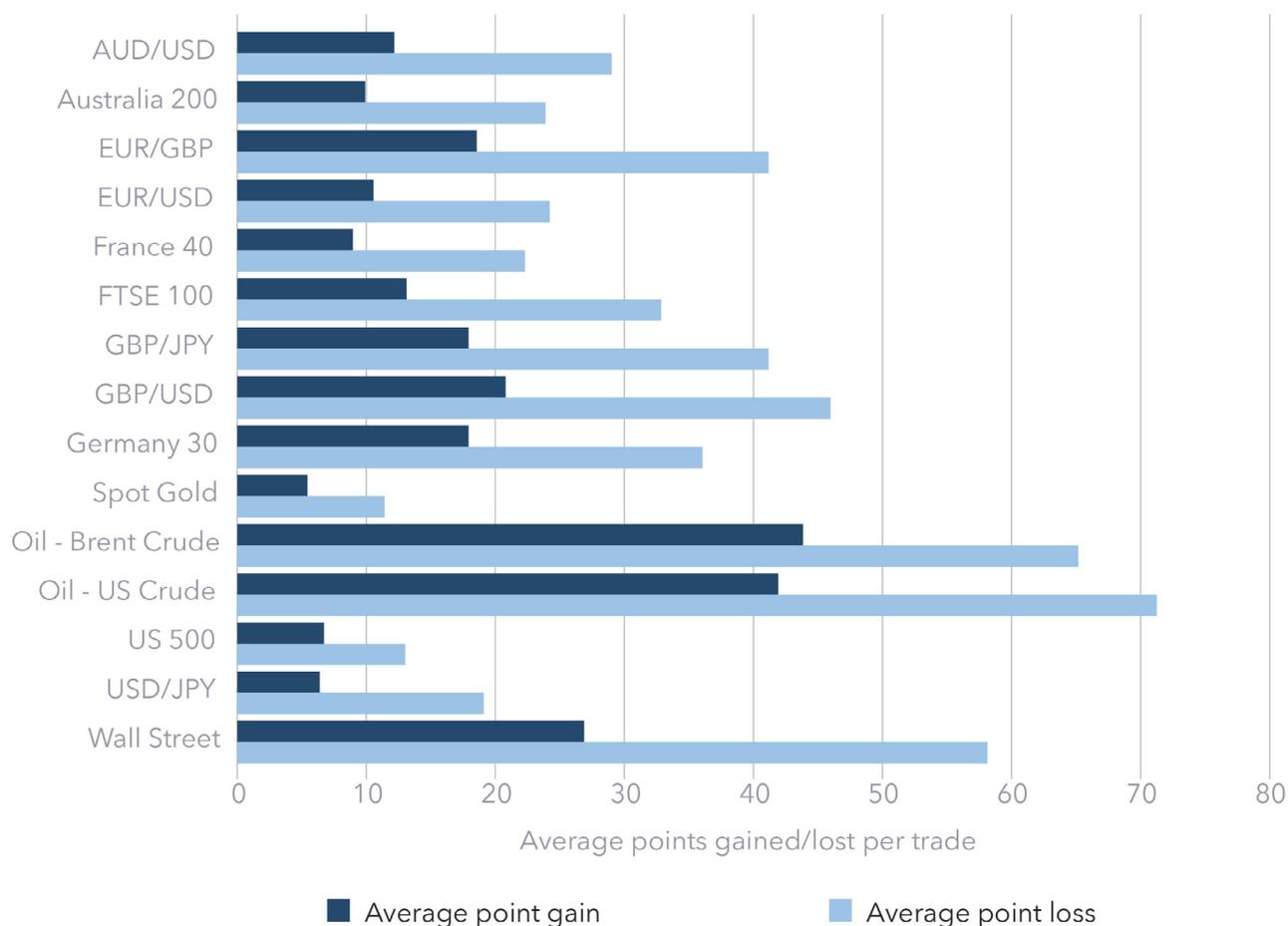


Figure 2. Data source: IG accounts and trades excluding clearing accounts, money managers, and eligible contract participants. 01/01/2016 to 12/31/2016 across 15 of the most traded markets.

This chart says it all. In blue, you see the average number of points which traders earned on profitable trades. In light blue, it shows the average number of points lost in losing trades.

We can now clearly see why traders lose money despite being 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, while figure 2 shows the average losing trade was worth 35 points – yet the average winner was only 15 points. Although traders were correct nearly two-thirds of the time, they lost more than twice as much on their losing trades as they earned on winning trades. A similar pattern can be observed across the entire range of [popular markets](#).

So what could be the reason for this?

Cutting losses and letting profits run

Our data shows that traders were very good at identifying profitable trading opportunities and closed over 50% of all trades at a gain. Ultimately, though, they still lost overall 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 an inevitable part of trading. Identify when a trade has gone against you and close it out at as small a loss as possible. Failure to do so could see a losing trade wiping out your trading capital before you can take advantage of the next opportunity.

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

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

As humans we have natural tendencies which cloud our decision-making. Let's look at a basic thought experiment to explore this further.

A simple wager – understanding decision making through winning and losing

What if you were offered a simple wager? You're asked to guess the result of a single coin flip. Assume it's a fair coin which is equally likely to show 'heads' or 'tails'.

If you guess correctly, you'll win \$1000. Guess incorrectly, and you'll receive nothing. Let's call this 'choice A'. But to make things interesting, you'll also be given 'choice B' – a sure \$400 gain. Which one 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 the mathematical 'expected return' is \$500, which would maximise profit. To calculate the 'expected return', we used this formula: (probability of winning x gain) + (probability of losing x loss) = expected return. That means the mathematical probability of winning \$500 is greater (50% x \$100 = \$500) than losing \$0 (50% x \$0 = \$0).

Choice B isn't wrong per se – with zero risk of loss you couldn't be faulted for accepting a smaller gain. And it goes without saying you stand the risk of making no profit whatsoever with choice A – in effect, losing the \$400 offered in choice B.

It's no 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 about potential losses?

Using the same coin, you're offered the equal likelihood of a \$1000 loss and \$0 in 'choice A'. 'Choice B' is a certain \$400 loss. Which option 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 minimises losses and appears to be the logical choice – 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 is hardly something to lose sleep over, but this natural human behaviour is clearly problematic if it extends to real-life decision-making. And it's this dynamic which explains the most common mistake in trading.

But how can you prevent it?

Losses hurt psychologically far more than gains give pleasure

Daniel Kahneman and Amos Tversky published what has been called a 'seminal paper in behavioural 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's usually assumed that a rational person would make decisions purely based on maximising gains and minimising losses. Yet this is empirically false – look no further than our real trading data.

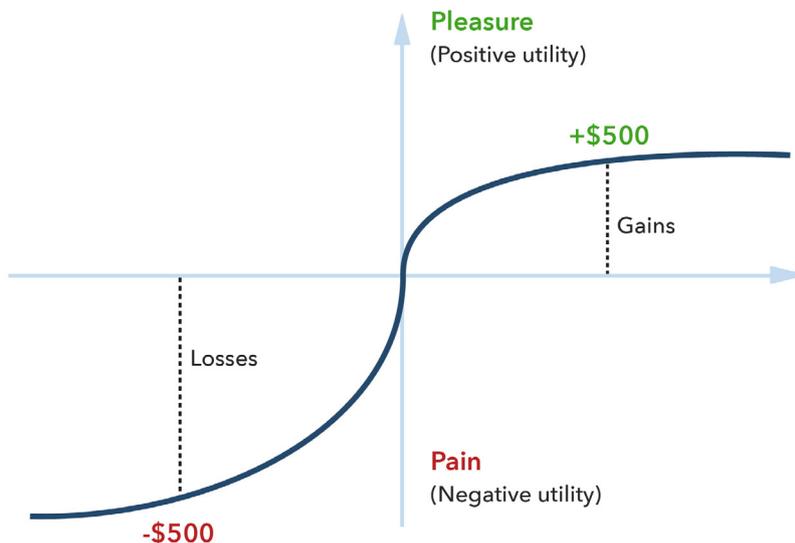
Our data suggests traders felt it was 'good enough' to take an average 15-point gain on winning FTSE 100 trades, yet gave up an average of 35 points on their losers. Such a dynamic very likely helps explain why our data shows 64% of all of these FTSE 100 trades were winners – it was easy to take profits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

Ultimately we 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 desired goal was to maximise profits and minimise losses, a \$500-point gain would completely offset a \$500-point loss.

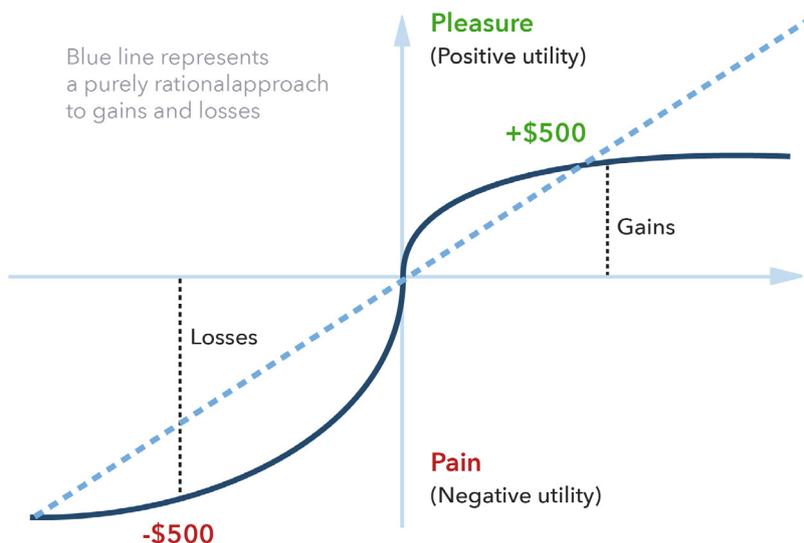
This relationship is not linear. Figure 3 gives us an approximate look at how you might rank your 'pleasure' and 'pain' derived from gains and losses.

Prospect theory – losses typically hurt far more than gains give pleasure



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

In practice, we need to find a way to straighten that utility curve – treating equivalent gains and losses as offsetting and thus becoming purely rational decision-makers. This is, of course, easier said than done.



Avoid the common pitfall

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

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

How do we put this into practice?

Stick to your plan – use stops and limits

Humans aren't machines, and working against your natural biases requires effort. Once you have a [trading plan](#) that incorporates a proper risk vs reward ratio, the next challenge is to stick to the plan. Remember, it's natural to want to run losses and take profits early, but it makes for bad trading. Overcome this natural tendency and remove your emotions from trading.

A great way to do this is to place a stop-loss and limit order right from the outset. This will allow you to use the proper risk/reward ratio (1:1 or higher) from the start, and to stick to it. Once you've placed your stops and limits don't touch them, with one exception: you can adjust your stop-loss to lock in profits as the market moves in your favour.

IG's platform allows you to add stops and limits hassle-free. And you can attach a guaranteed stop to close your position at exactly the price you've specified – giving you watertight protection against slippage. They're free to place, with a small premium payable only if your stop is triggered.

There'll inevitably be times when you've placed a trade and the market moves against you, triggering your stop-loss, and then quickly reverses back in the direction you thought it would go. This is a numbers game after all, and expecting a losing trade to turn in your favour every time exposes you to potentially very large losses. To argue against stop-losses because they force you to lose is self-defeating – this is their very purpose.

Managing your trading risk in this way is known as **money management**. It's one thing to be on the right side of the market, but practicing poor money management makes it significantly more difficult to make a profit.

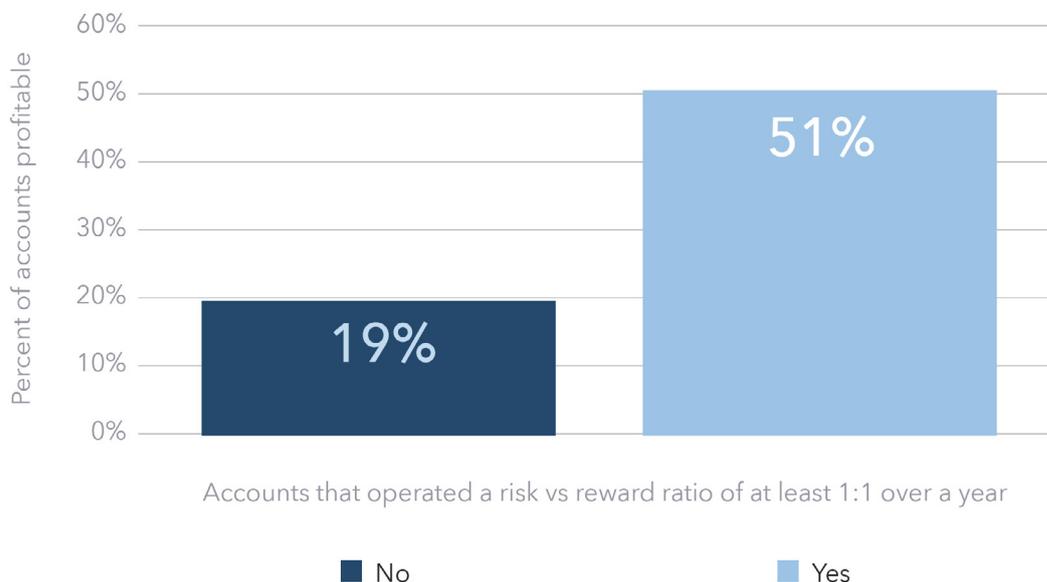
None of this is truly revolutionary, and it's quite likely you've come across the same guidance before. But why does a risk vs reward ratio of 1:1 matter so much?

Does using a risk vs reward ratio of 1:1 really work?

Our research suggests it does. We've gathered data from 15 of our most traded markets to determine which live account holders closed their average winning trades with a profit at least as large as their average loss – or a minimum risk/reward 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 indicates that 50% of all accounts that operated on a risk vs reward ratio of at least 1:1 turned a net profit over the 12 month sample period. Those under 1:1? A mere 19%.

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



Game plan – what strategy can I use?

Trade with stops and limits set to a risk/reward 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 profit.

The actual distance you place your stops and limits will depend on market conditions at the time, such as volatility and where you see support and resistance. You can apply the same risk/reward ratio to any trade. So 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.

Ready to put your new knowledge to work?

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