

Trading - A Probability Game

You may accept the undeniable fact that the stock market can do anything at anytime. If you're not convinced, consider that there are millions of traders trading for establishments, funds, stockholders, stock traders, scalpers, etc all acting together in different time frames and using differing kinds of research. Fact : Trading isn't about guessing the future as it can't be done. If you agree this fact, then it is far easier to take losses without destroying your self confidence.

You take a trade, you affirm that you do not know what will happen next. You haven't any expectations this trade will become a winner. Here is an example of a chance game : let's assume I roll a dice : - I pay \$1 every time I play - If I roll a three, a four, a five, or a six then I win \$2. If I roll an one or a two then I do not win anything. Obviously, each time I throw the dice I don't have any concept what the result will be. But I know that for each roll the percentages are in my favor. In the long term, I am going to win 4 times out of six, that means that I'll pay \$6 to win \$8. I'm going to be a consistent winner if I play long enough. In mathematical terms, your anticipated win every time you play is $(\text{four} / \text{six}) \times \$2 = \$1.33$ meaning \$0.33 profit (you pay \$1 to play) Another version of this game may be that you win \$3 if you roll a four, a five, or a six, and nothing if you roll an one, a two, or a three. In this example the expectancy everytime you play would be $(\text{three} / 6) \times \$3 = \$1.50$ meaning \$0.50 profit in the long term So how will we interpret this into trading? Everytime you shake the dice, you do not know the outcome, the same as for every individual trade.

But every time you throw the dice, you know the chances are in your favor to earn money, and you'll make money if you play long enough. So for each trade you enter, you have got to know the percentages are in your favor to earn money. As you can see in the second example, it doesn't mean that you've got to win more frequently that you lose. It also relies on how much you win when you win and how much you lose when you lose. How does one put the percentages in your favor? You've got to develop a trading edge using technical research, basic research, market internals, and so on. You've got to have a number of variables that has got to be present before you enter a trade and always use the same set of variables.

Your edge is your methodology to enter and exit trades and may be well outlined in your trading plan. All that may be summarised like the following : - For each trade you take, you do not know the end result, you agree that anything can occur, and thus you have got no expectation for that trade. - you have a belief in your trading method, that is you believe that for each trade you take the percentages are in your favor. - you suspect the result over a sequence of trades is comparatively certain and predicted. To go back to the dice example : will you get mad or feel dumb when you don't roll a winning number? No because with a dice you accept the incontrovertible fact that you can't know the result. You haven't got any expectation. Apply the same concept to your trades and save your self-confidence. This idea of treating trading as a chance game made a massive difference in the way I feel about losses. I learned about it in 'Trading in the Zone' by Mark Douglas. I highly recommend this book.

If you have got a good trading plan, with a tactic to enter and exit trades, then a successful trade is one for which you followed your intention, not really a winning trade.

About the Author

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