8 RULES FOR BETTER INVESTING AND TRADING

The investment process is difficult and enormously complex, which was part of the appeal that led me to money management. I thought it might be helpful to others to offer some observations to make the task a little easier, based on study and hard-earned experience. The "rules" presented apply to both trading and investment. I find it at times difficult to separate the two, as even the longest investment starts and ends with a trade.

The list is not meant to be definitive and is necessarily brief. I could easily write a chapter on each topic. Most of the concepts are hardly new, but bear repeating because they have proven, in my experience, to be important.

1) INVEST/TRADE TO MATCH YOUR PERSONALITY

Everyone has their own unique attitude towards risk and volatility. Invest and trade in investment vehicles that reflect your temperament. I have long maintained that people are more risk averse than they think they are. Assuming more risk than you're comfortable with is stressful and emotionally destabilizing, which leads to poor decision making. There is an old saying, "if you don't know who you are, the markets are an expensive place to find out."

2) REDUCE POSITION SIZE

Position size and diversification are basic risk control tactics. Smaller position size reduces volatility and potential losses on individual positions. I have known professional traders that have notes pasted on top of their quote screens to remind them of this concept.

3) DON'T TRADE AROUND EARNINGS ANNOUNCEMENTS

The markets can severely punish the share prices of companies that miss their earnings estimates by even a slight amount. It is best to avoid initiating or adding to positions ahead of earnings announcements. Similarly, if one is thinking of selling a position, it is advisable to do so ahead of an announcement.

4) INVEST/TRADE ONLY WHEN THERE IS A SOUND REASON TO DO SO

There is a natural tendency, among both amateurs and professionals, to establish positions to be "in the game." The result is overtrading, or the assumption of marginal or poor quality positions. Investment results will improve if one can maintain the discipline to limit participation to situations that have compelling risk/reward.

5) PERFECTION IS IMPOSSIBLE: INVEST/TRADE WITH THE ODDS

As human beings we are fallible, so mistakes are inevitable. As well, even if your analysis is perfect, adverse results can occur through events beyond your control. Since nothing is certain, incorporating probability analysis into your investment process will help to keep the odds in your favour.

6) TRADE WITH A PLAN

Before an investment is made, the investor should have a clear understanding of why the investment is being made, why the current price is favourable, at what price the position will be sold if the trade goes bad and at what price the investment will be sold if the position is profitable. Of course, once the trade is established, the various parameters must be adjusted in response to new information.

7) TRADE WITH THE TREND

There is an old adage, "the trend is your friend." It is very important to identify the prevailing trend and trade in the direction of that trend. Positions should be established or added to on pullbacks against the major trend.

8) CUT LOSSES AND LET PROFITS RUN

Human psychology tends to encourage investors to both hold on to losing positions in the hopes of recouping the losses and taking quick small profits when they present themselves. This is the absolute opposite of what should be done for profitable investment. Establish a maximum loss you are prepared to take on a position and stick to it. If a position is profitable it should be held until a reason to sell presents itself, not because it has appreciated an arbitrary amount.

By Jonathan Baird CFA