The Most Important Chart in Investing

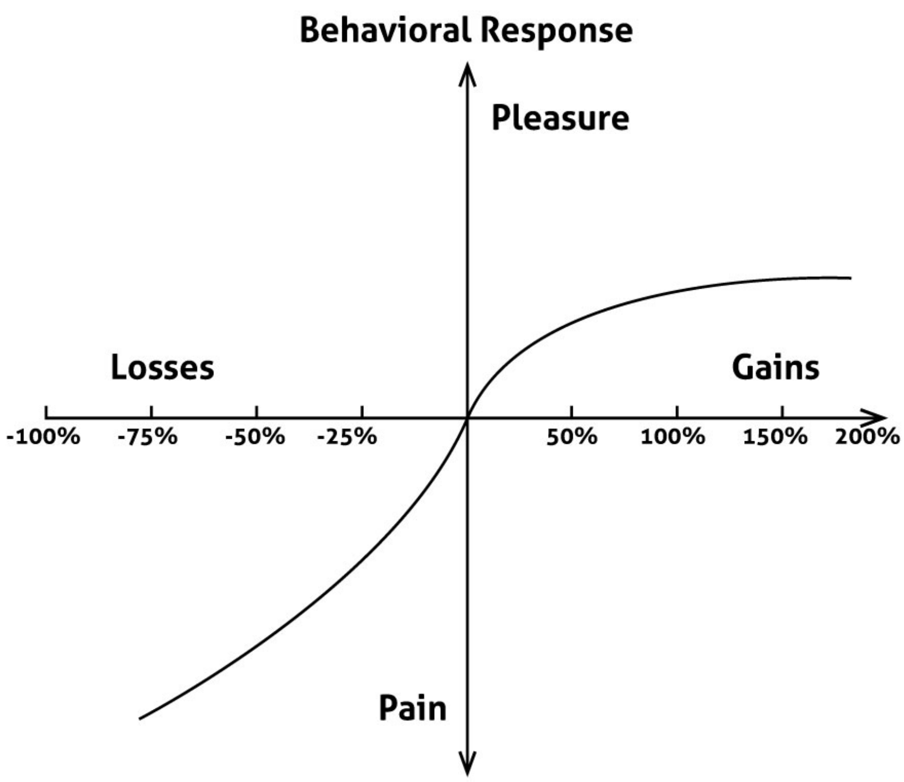
By Richard M. Smith, PhD

"If you don't know who you are, this is an expensive place to find out…"
Adam Smith, *The Money Game*

Today I'd like to share with you what I believe to be the most important chart in investing.

Queue the drums! Raise the bugles!

The Average Investor's Response to Gain & Loss



Kind of simple, huh?

Deceptively simple.

This chart captures what I believe to be one of the most important challenges that all investors must overcome in order to really succeed in the markets – the tendency to *prefer* our losers over our winners.

I know this to be true… from first-hand experience.

You see, I have a Degree in Mathematics from Berkeley and a Doctorate in Systems Science, and it didn't help me one bit with my early investments. In fact it nearly cost me everything I had.

But I turned everything around, with a simple solution that I now share with my subscribers at TradeStops.com.

More on that shortly but let's return to our chart for a few minutes.

So, what exactly do I mean by "prefer our losers over our winners"?

Our wonderful chart shows how we respond to gains and losses in the markets. The vertical axis here, behavioral economists call this the academic descriptions of "value" or "utility".

I like to think of it as the emotional impact on us of our gains and our losses.

As our gains get bigger, the emotional impact of those gains, the pleasure we get from the gains, tapers off. If we get a 100 percent gain, that's fantastic. If we get a 200 percent gain, you know, it's great but, emotionally, it's not *twice* as great as a 100 percent gain.

On the other hand, when it comes to losers, as losses increase to the left the impact of those losses doesn't taper off in the same way as it does for the gains.

As losses get bigger, the emotional impact, our *attachment* to those losses, intensifies.

If we get a 25 percent loss, that hurts. But if we have a 50 percent loss it hurts a whole lot more. A 75 percent loss is a real killer.

Losses hurt… and bigger losses hurt more.

As losses grow they become very consuming. We get very attached to those losing positions. We can't let go of them.

That's why I say that many investors *prefer* their losers… *because they hold on to them.*

Stuck in Our Losers

Most people get stuck in their losers, emotionally attached to those positions. It's hard to let them go.

Maybe we'll even double down on those losses and try to get back to "break-even" quicker. Right?

I can't tell you how many times I've heard people say, "I'll get out when it gets back to break-even."

The deeper the hole we dig for ourselves, the harder it is to get back to break-even.

Let me show you what I mean.

Let's say that you bought a stock at $100 and, instead of soaring right out of the gate, it stumbles. The table below shows what it takes to get back to break-even at various levels of loss.

Current Price	Current Loss $	Current Loss %	Break-Even Gain
$100	$0	0%	0%
$90	$10	10%	11%
$80	$20	20%	25%
$50	$50	50%	100%
$33	$67	67%	300%
$10	$90	90%	900%

Think about it. If you started out at $100 and it got down to $50, that's a 50% loss. But now your investment is worth $50 and to get back to break-even at $100 you need a *gain* of $50. If you're starting from $50 and you need a gain of $50, that's a 100% gain!

So for a 50% loss, you need a 100% gain to get back to break-even. 100% gains aren't easy to come by. And if we let losses get away from us even more, the odds of getting back to break-even become nearly impossible to overcome.

If you ever hear yourself say, "I'll get out when it gets back to break-even," it's time to get out now. It's a sign that, regardless of what happens with the stock, your mind isn't in the right place about it.

Intermediate Investing

Benjamin Graham, the father of value investing and mentor to Warren Buffett, once said, "The investor's chief problem and even his worst enemy is likely to be himself."

That certainly rings true for me.

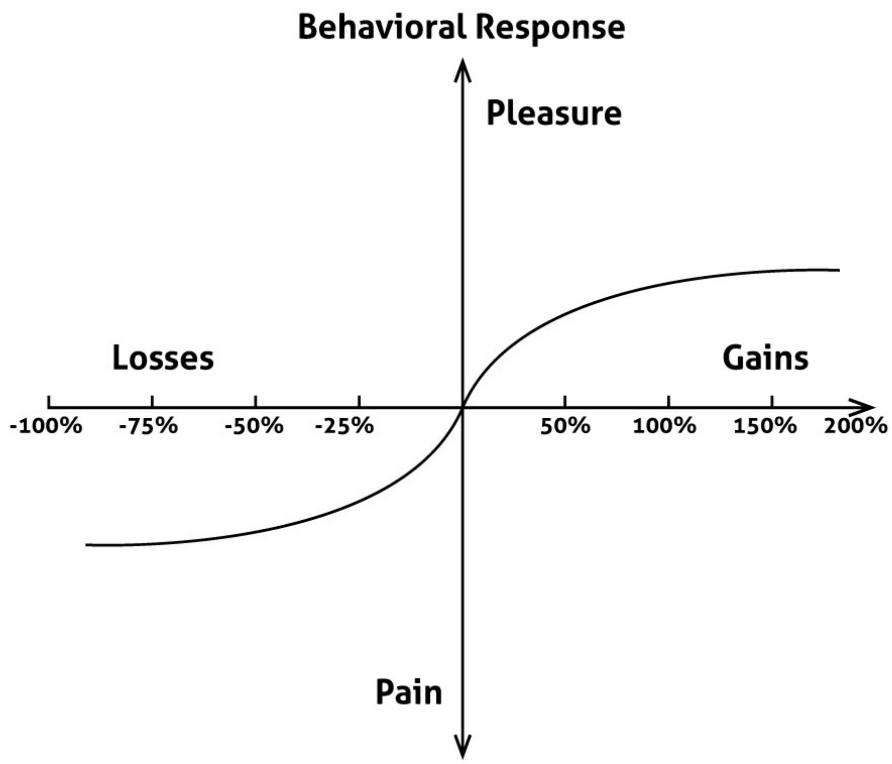
Many investors, after getting burned a few times, realize that taking big losses is a really bad idea.

Not only is it tough on your portfolio but it's tough on you psychologically. It beats you up and discourages you from taking advantage of future opportunities.

That's why many investors pretty quickly agree with the idea that you've got to cut your losers.

If we refer back to our original chart, we might say that this more "experienced" type of investor can get his or her behavior chart to look like this:

The Intermediate Investor's Response to Gain & Loss



This "intermediate" level of investor has stopped the bleeding by learning to limit losses.

Few investors, however, every truly master the art of staying in their winners.

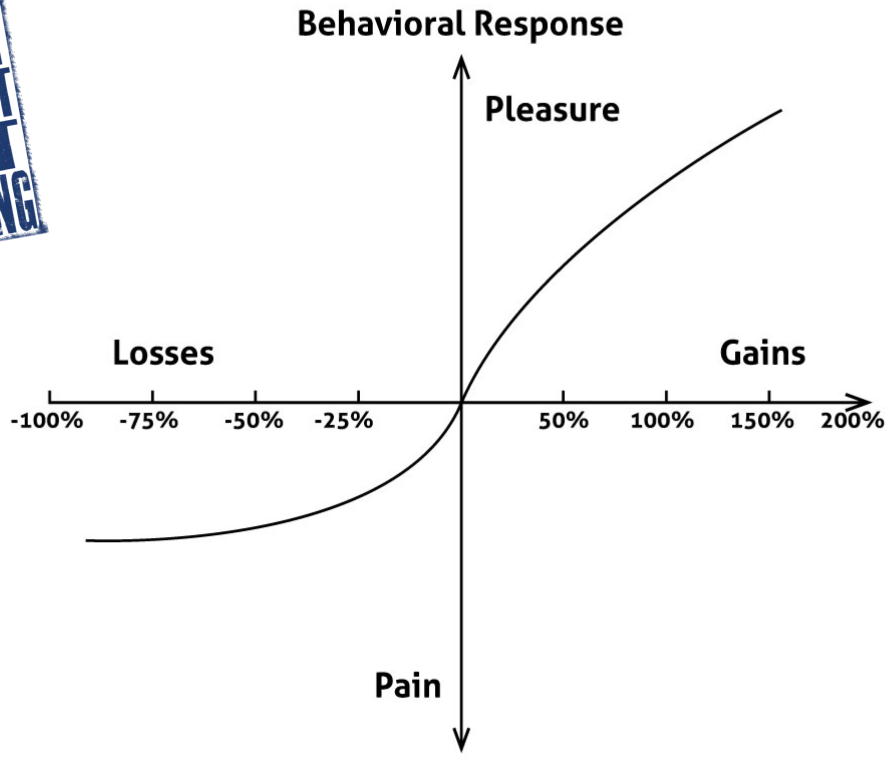
Making Market Madness Work For You

There's a famous saying, I think that it was by John Meynerd Keynes – "Markets can remain irrational longer than you can remain solvent."

That's true! Financial markets regularly go places that no one expects them to go.

The key to life-changing gains in the stock market is to make that market madness work for you instead of against you – turning our original chart on its head so that it looks like this:

The Advanced Investor's Response to Gain & Loss



How many of us have had winners of 200%, 300% or even 500%?

Believe it or not, these kinds of gains happen all the time in the stock market – especially over a multi-year period. Unfortunately, most investors don't know how to stick around long enough to take advantage of these kinds of opportunities.

Most investors see a 100% gain and think, "Wow, that was better than I expected… I better take that money off the table before I have to give it back!"

On the flip side, most investors see a 50% loss and think, "Man, I better double down on this one so I can get back to break-even quicker!"

Can you see where this is headed? How about doubling down on our winners instead?!

Finally, a Solution to the Investor's Chief Problem

Remember, I'm sharing with you what I've learned from first-hand experience in the markets… and it wasn't my math PhD that saved me.

Speaking of PhD's, not many people know this, but the great Isaac Newton himself lost a bundle investing in the South Sea bubble of 1720.

After losing nearly all of his wealth he famously quipped, "*I can predict the motion of heavenly bodies but not the madness of men.*"

Here's the thing, Isaac… just as the sun is going to rise in the morning, financial markets, and individual stocks, regularly go bonkers.

Those investors that understand this, *and have a system to profit from it*, will reap the rewards. Those investors that don't understand this, will get an education… and one that they didn't expect to have to pay for.

That's why I created TradeStops.

I believe in the power of the self-directed individual investor. I believe in you. No one cares more about your money than you do. No one is better positioned to grow your wealth than you are.

More than anything, growing wealth via the financial markets requires you to find your own comfort zone as an investor – to position yourself for long term success by finding your seat at the investment table… and staying there.

You've got to do it… but I've made it easy for you to do so.

I have spent nearly 15 years and hundreds of thousands of dollars researching and developing proprietary risk management algorithms, and then turning them into easy-to-use tools to help the self-directed investor become an extraordinary investor.

I've back-tested hundreds of individual stocks and portfolios of some of the top advisors in the world with my systems, and I've been able to demonstrate significant improvement over their already-impressive past performance. Many of these same advisors have since switched to using my tools and systems.

Moreover, my systems and tools make investing fun again. Investing is fun, no doubt about it… and it's even more fun when you're making money!

From the very beginning of TradeStops over ten years ago, it has been my top priority to keep it simple.
I want my mom to be able to use TradeStops, even though she doesn't know a whole lot about investing.

So come on aboard and give TradeStops a try. It's easy, affordable and risk-free.

The only thing that you've got to lose, is your losers!

Sincerely,

Richard M. Smith, PhD
Founder, TradeStops.com