The Psychology of Trading

Understanding the Behavioral Forces Behind Investment Decisions

By Robin Kaukonen
Sr. Portfolio & Trading Manager
Summit Global Investments

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Do you ever wish that you had a precise model that told you when to buy and sell a stock? How many times have you sold your winning positions too early and held your losing positions until you got sick of looking at them? Or even worse, until the company declared bankruptcy? Or maybe you averaged down in a losing position when your thesis was no longer intact? You are not alone. I would like to explore the psychology of trading and why we do what we do. Perhaps we can all avoid some of these common pitfalls going forward.

Analyzing a company's financials, reading economic reports, understanding technical analysis and macroeconomic data is only half the battle. The much harder part is surviving your own biases. In my view, one of the most important differences between investors who successfully build wealth over time and those who experience setbacks isn't simply investment knowledge — it's the ability to remain disciplined when emotions and markets are working against them. Behavioral finance research has shown that emotional reactions and cognitive biases can contribute to investment decisions that undermine long-term results.*

The Bull Case: AI Could Be a Historic Productivity Revolution

Behavioral scientists have a name for the most common mistake investors make: the disposition effect. Simply put, it's the urge to cash out your winning stocks way too early while holding onto your losers. Why do we do this? It comes down to a quirk in human psychology called the prospect theory. People evaluate gains and losses differently, feeling the pain of a loss much more intensely than the pleasure of an equivalent gain. If you don't sell a losing stock, the unrealized loss feels like an abstract "paper loss." Selling makes the loss real. In turn, you are forced to admit that your thesis or timing was wrong. Thus, instead of selling a loser, this mindset has turned you into a reluctant "bagholder," keeping your cash trapped in a losing investment; meanwhile you are missing out on trading/investment opportunities elsewhere.

Conversely, when a stock becomes profitable, the fear emerges of giving back gains. Investors feel an urgent impulse to "lock in" small profits. By selling winners at the first sign of a modest advance while letting losing positions slide unchecked, this can work against them. They could create an asymmetric profile of small, frequent gains swallowed whole by occasional, catastrophic losses. Not to mention if you are in a taxable account, the tax short-term capital gains could eat away at your profits.

How to Take Profits Without Regret

Knowing you shouldn't cut winners too fast doesn't mean you should hold a stock indefinitely. Taking profits is smart, you just need a game plan. If a company hits the financial target you set for it, taking some chips off the table isn't a bad idea. It helps you:

- Rebalance your portfolio to prevent single-stock concentration risk.
- Build up cash to deploy during broader market pullbacks.
- Lock in realized gains that solidify long-term financial goals.

Note: Trimming positions may forgo further appreciation and may trigger taxable gains.

Behavior & Disposition Effect:

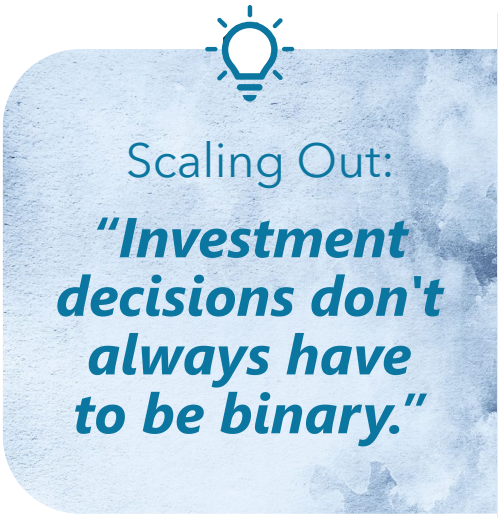
"The much harder part is surviving your own biases."

* Investor Bulletin: Behavioral Patterns of U.S. Investors | Investor.gov

The Power of Scaling Out

What if a price target has been reached, but the underlying business continues to demonstrate strong momentum?

Investment decisions don't always have to be binary. Rather than viewing the choice as simply holding an entire position or selling it completely, investors and their advisors may consider whether a staged approach to reducing the position is appropriate based on the investor's objectives, risk tolerance, tax circumstances and view of the investment.



For example, an investor might consider an approach such as:

Tier 1 — Target Reached:

An investor might consider whether reducing a portion of the position is appropriate, allowing some gains to be realized while maintaining exposure to potential future appreciation. This approach involves trade-offs: scaling out may limit future gains compared with continuing to hold the position, while maintaining exposure leaves the investor vulnerable to potential declines. The appropriate approach depends on individual objectives, risk tolerance, portfolio considerations, taxes, and the investor's outlook for the investment.

Tier 2 — The Run Continues:

If the investment continues to appreciate and the original thesis remains intact, another partial reduction could be considered as part of an ongoing review of the position's size, valuation and risk within the overall portfolio.

Tier 3 — Reassess the Remaining Position:

As appreciation continues, the investor and advisor might evaluate whether further reductions are appropriate while potentially maintaining a portion as a longer-term holding.

Scaling out of a stock may help you avoid common psychological traps. By locking in some gains, you've taken some risk off the table. By leaving part of your position on, you may reduce seller's remorse that sometimes occurs when a sold stock continues to trade up.

Please note that selling can mean missing further gains. Stop or exit levels can be reached during temporary volatile periods and no strategy assures a profit and unless you are buying downside protection (perhaps buying puts – this warrants another discussion) you are not protecting yourself against losses.

Price vs. Valuation: Don't Confuse the Two

As Warren Buffett, citing Ben Graham, put it, **"**Price is what you pay; value is what you get."

Price is the instantaneous intersection of supply and demand, the figure at which one party is willing to buy and another is willing to sell at a single second in time. Price is volatile and heavily influenced by short-term noise: momentum, algorithms, liquidity sweeps, margin calls, and media.

Valuation is an analytical appraisal of what a business is actually worth. It is rooted in structural fundamentals including, but not limited to cash flows, earnings, return on invested capital, competitive moat and growth projections.
When you mix these two up, you fall into common traps. Below is a hypothetical example for illustration purposes only.

- **The "Cheap" Stock Fallacy:** A stock drops from $100 to $50, and you assume it's a steal. But if the company's business model is crumbling, the earnings forecast has been cut in half, cashflows have turned negative, it might actually only be worth $10. It's not a bargain; it's a trap.

- **The "Expensive" Stock Fallacy:** A stock has doubled in two years, so you assume it must be overvalued and sell. But if the company's profits tripled in that same period, the stock might actually be cheaper relative to earnings and sales forecasts.

Focusing on valuations rather than the fluctuating price acts like a shock absorber for your emotions. When the price of a fundamentally sound company drops during a market panic, the valuation-focused investor views the discount as a buying opportunity rather than a personal defeat. Conversely, when irrational exuberance drives price far above any defensible valuation, the prudent investor may consider trimming their position aggressively.

Building a resilient psychological operation system

Mastering the psychology of trading requires building a rules-based system before you enter an order, removing emotional improvisation from the equation.

- **Know your price targets (exit point) before you buy.** Also have an invalidation level where the thesis is not working and a loss must be taken.

- **Grade your process, not just the outcome.** Sometimes a reckless, dumb trade makes money on pure luck. Sometimes a smart, disciplined investment loses money because of a freak event. Don't reward yourself for bad habits just because you got lucky.

- **Use the "Replacement Test":** If you are holding a struggling stock in the hope of getting back to even, ask yourself: "If I were 100% in cash today, would I invest fresh capital into this company at its current price?" If the answer is no, an investor might consider discussing with their financial advisor whether exiting the position and reallocating the capital may be appropriate. Any decision should reflect individual circumstances, investment objectives, portfolio considerations, tax consequences, and risk tolerance, recognizing that future risk-adjusted returns cannot be known in advance.

Behavioral scientists have a name for a common mistake investors make: the disposition effect. By conquering the disposition effect, treating profit targets as flexible scaling zones, and anchoring decisions to fundamental valuation rather than fluctuating prices, you may be able to insulate your portfolio from the psychological traps. That said, behavioral frameworks have important limitations.

While they may provide a more structured approach to investment decision-making, they do not eliminate investment risk, prevent losses, guarantee adherence to a particular process, or ensure that an investor will achieve better results than they would without such a framework.

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