

2 TRADERS

[EP24: Uncertainty](#)

Darren: Just the numbers on their own is not enough without the mindset. I think when you get the mindset you rely less and less on the numbers.

Announcer: 2 traders, Darren and Walter, pull back the curtain on profitable trading systems, consistent money management, and profitable psychological triggers. Welcome to the 2Traders podcast.

Walter: Welcome back to the 2Traders podcast, I'm Walter Peters. I've got Darren here on the line. Hey there, Darren. How are you today?

Darren: I'm really good, Walter.

Walter: Darren, I talked about this in the last episode. I was thinking about exploring this idea of a quantitative number or ratio that essentially tells you, yes or no, are you going to make it as a trader? I think this is going to be interesting because I'm not sure we exactly had the same points of view. One of the reasons why this number I think is useful for traders is because some traders just need to have numbers. Some traders are very quantitative and they like to look at these and they basically use numbers to make their decisions. Let me explain what the number is. The number is what I call the trader ratio. Anyone can do this, it doesn't matter if you're trading live or if you're trading on demo or through Forex tester and back testing or something.

What you do is you take all of your winning trades, you add them up, and that's your sum total of winners. That goes in the numerator. Then down below what you do is you find your largest losing trade and you stick that down in the denominator. What you should come up with is a number. Ideally that number is a whole number because if it's not then things are really bad. If it's a whole number, the number that I look for people to shoot for is 6 at a very bare minimum. If you have a number over 6 like 13 or 20 or 10, that's great. That's really good. The idea here, the thinking behind this is that if you're doing well as a trader what will happen is if you have really tiny winners, you have so many of these little, tiny winners and they add up to be a big, fat pot of profit.

That means that even your largest loser does not dwarf, which is basically your biggest mistake, does not dwarf your big pot of winners. Likewise, let's say that you don't have a bunch of little tiny winners, but instead you have a few giant winners and a lot of medium or small winners. Even then you would still expect the same thing to happen, which is your numerator should be a much bigger number because you've had a few large winners, let's say if you use a trailing exit or something like that. Those winners will so dwarf your largest loser that you end up with a big, fat number on the top. That of course will give you a number of 6 or great. That's basically the idea behind this and I know you probably have some interesting thoughts about this,

Darren. Let's hear what you're thinking is behind this because I know your approach to trading is very different to most traders I've ever met, and so I think you might have some different views here.

Darren: Well, yeah. I mean, I've made it clear I don't like being overly reliant on measuring trading in terms of numbers because I believe so much in your belief. The problem I have with it is that I think that strategies are reliant on the market, and so dependent on how much data you put into it then that might skew your number. The real problem I have with numbers is because of the expectations. I really like this idea that the expectations you have and the mindset because of those expectations deciphers your experience and your results. If your expectations are too good then that can have a negative effect on your trading at the same time, if they're at the other end of the spectrum as well. I'm unsure about how it affects your mindset when your actual results differ from this number that you've got.

In other words, say you've got your number is 6. Then because the market's particularly unfriendly for your particular strategy over, say, the last couple of weeks, are you then led to think that there's something wrong with your strategy whereas it might be that it's just not a very good market or you've made mistakes? Do you not have that problem?

Walter: I think what you're talking about is a really good point. In fact, it reminds me of a book that I recently read. I don't read a lot of trading books, but I read this guy's book and it was fascinating because, essentially, it's a corollary to what you're touching on, which is these guys, it was a bunch of Forex traders, they got together. We could probably do a whole podcast on this book. I don't read a lot of trading books. I did read this book recently. The reason why I read it because it was a fascinating story of a group of traders basically making this mistake. The mistake was they went through and they back tested their system and they essentially decided that their system wasn't ... They literally thought it was the best thing ever and they couldn't find anything better than that.

They all pooled their money together and traded this system, but what had happened was they were looking at the euro. Now, the euro was a new currency, or new-ish at the time. It still is, really, isn't it? All they had were the data that they had on the euro, and so when they looked back and they did their testing, essentially the euro was in a trend. Now with hindsight they could see their error, but essentially they were depending on the euro to keep moving somewhere, to keep going. They didn't understand that their data that they used to project into the future was based on one phase of the market. Once they started trading live, the market wasn't in that phase anymore and it essentially destroyed them.

It was a fascinating way to see this error. I wouldn't really say it was over curve-fitting or over fitting the system. It was more just bad data in. Is that what you're talking

about here? Is that sort of the idea? I know there's another mindset point that I want to talk about that you're making, but in terms of the data, they put this data in their system and that same sort of data didn't show up in the future.

Darren: Yeah, I think it's more on a deeper mindset level that I try and make the flip. We're going to do a podcast about this placebo effect. There was like it's really interesting experiment done once. They took this group of maids and they split them in 2. They told one set of maids, "Look, what you do, your job, is actually exercise and really good exercise." Then to the other group they didn't say anything to them. What they found was that the maids that they told they were doing exercise lost weight and, well, I started eating more healthily, and in general after a period of time had much better health than the ones that they hadn't. Essentially what they're saying there is if your mindset is right, then the results you'll get from that will be very different. Essentially they're all doing the same thing, but because one group had changed their mindset and how they were thinking about what they were doing, they had different results

Rather than looking just at the numbers, I kind of look, "Okay, what really are you saying by making that calculation?" Really what you're saying is you either have to have a few very big wins to cover your losses or you need lots of wins to cover your losses. Essentially it just goes back to that key concept, am I going to give a wider stop and take more wins and exit my trades a bit earlier for smaller wins or ensure that I make profit, or am I going to take tiny, little stops and shoot for those ones that run and those big wins will cover my losses and give me a profit? Although the whole concept of the number I like is just a case of saying, "I'm not going to focus on just the figures, I'm going to think about what is the logic behind this."

Walter: Yeah. That makes perfect sense. I actually heard about that maid study just a couple weeks ago, actually. It's funny that you brought that up. I think we'll have a really interesting discussion when we get into positive thinking and the placebo effect and all that. I think that'll be great. I think that what you're talking about with the ratio is spot on. However, I would also add that your ratio would also go down if you were pretty poor at managing your stops. In other words, I don't know about you, Darren, but I've had this experience before, although I haven't done it in years, but I've had this experience where before what I would do is I'd be a trade and my ego was so attached to the trade that I would actually move the stop as the trade unfolded to give it "a little more room."

If you're doing that with your trades, that will also show up on the ratio, too, because it means that you're mismanaging your losers as well. I think that's a little bit of it. I'd like to clarify what your thought is on this. You're not really talking about this idea, like "The Secret" and all that where your thinking and your ideas about what's going to happen create the future. That's not really what you're talking about. You're talking

it's a little bit more mundane than that, isn't it, or am I off? Are you really talking about this idea that we create our future by our thoughts?

Darren: Not really, no. It's more a case of saying, "Look, if I know the numbers it's not really going to make any difference." It's like, "I believe in my strategy will work as long as the market is agreeable and that I make good decisions." Whether I know what the particular win rate is over the last week or month, it's not going to make any difference to me. It's like, look, this is my strategy. I believe in it. All I'm really interested in is looking at the end of the week. Did I make profit or loss?

Walter: Right.

Darren: For some people that's probably really hard to do, but for me, I find it easier. If I start delving into all the figures, I think, "Well, okay. Maybe I should be adjusting my stop and maybe I should be," and I find myself meddling with my strategy then. Whereas I think my strategies work on the basic logic that as long as price moves up and down, I'm going to make a lot of money when the market's favorable and I'm going to have not so good times as well. The actual figure of it, I just don't think it could be, for me personally, that you can iron it all out and make it ... I think essentially it's trying to get to this removing the uncertainty again. I really try and shy away from that and say, "Look, it's uncertain that it's going okay. Let's hope the market continues behaving in this way." I know people hate to trade that way, but for me that just feels right.

Walter: Right. You're talking about the focus should really be on, if I got this right, the focus should really be on executing your system and following your system and not trying to rely on these numbers for confidence that you're doing the right thing. Instead, you should really be focusing on the next trade and making sure that you execute that in the manner you should. Is that right?

Darren: Yeah, yeah. Much more methodical and less quantitative.

Walter: Yes. My question is, what about that guy, that trader, just to play on the other side of it here, the guy who says, because I've met these traders, "I need to know what all of this is going to look like before I ever risk a dollar." They've got this mindset, which is a little bit different to yours, and they need these numbers. Otherwise they feel like there's too much uncertainty, as you say. I mean, I know we get paid basically for uncertainty, basically, don't we? We get paid for putting money on the line in the face of uncertainty. That's really what trading it. However, there are some people, for which these numbers work quite well, where they can point to that number and say, "See? Aha! Now I'm going to make money. This trader ratio told me so."

Darren: Yeah. I just think that if you haven't already got to that conclusion from the strategy you're trading with, I'm just wondering what you're basing the belief in your trading strategy on. For me it's basically ignoring what the market is and, okay, there's this

kind of ... The market to be is chaos and order, and it's patterns and non-patterns. It's constantly in a flux between the 2. I find when you try and iron all of those things out and say, "This strategy is 65% win rate and my risk to reward is 3 to 1," I find that those figures fluctuate a lot. The average might be like that, but in the actual process of trading, I get drawn by those figures. "Well, okay. Why was my win rate less this week?" In the end it becomes more about the figures and less about the performance of trading. I guess really it's a personal thing for me.

Walter: Yeah, absolutely. I think it's interesting because if I were to guess and I say, "Darren, if we were to walk in and look at your trading desk. Would it be nice and neat or would there be things all over the place?"

Darren: Well, in the past it's been a real mess, but it's actually neater now. That's because I need to be ... For me it's all about being methodical and getting up and repeating the process without really thinking too much about the process or the outcome or the win rate or the number. It's more like playing sport, really, where you go out to bat cricket. You just go through the process and you're not thinking about your batting average when you're actually batting.

Walter: Yeah, exactly. I was going to guess that you had a chaotic and messy desk because that's how you see the markets. The markets would fluctuate and change and they're this nebulous, changeable thing. That was my hypothesis.

Darren: Maybe compared to yours it is, but in my eyes it's fairly organized.

Walter: Right. Fair enough. I guess one of the take home messages here is that there are going to be some traders, I suppose, that whether it's right or not what they want, they want these quantitative numbers that feel like something that they can hang their hat on. I suppose it's a lot like those traders who need indicators because the indicator told me so. I know the market's going to do this because the indicator told me so. It's like having numbers and having an indicator or similar in that they help you erase some of the uncertainty. The problem is not all traders fit into that box. Some traders embrace the unknown and they understand that there is uncertainty in the markets and that's basically what the markets are, I suppose. Are you suggesting that perhaps the traders that don't look to quantitative numbers to ease their uncertainty, they shouldn't even be trading? If I hear you correctly, they shouldn't even be trading until they're so certain in what they're doing that they know that they're going to make profit.

Darren: Yeah. I don't really want to go that far with it. What I'm saying is just the numbers on their own is not enough without the mindset. I think when you get the mindset you rely less and less on the numbers. I think maybe initially, yeah, you do need ... I mean, I do. I still back test the system I trade every week. When I finish trading, although I've not been thinking about the numbers, I do go back and look at pairs I didn't trade that

week, see how well the method worked on that. That's just keeping my confidence in the method high. I don't meticulously track the numbers. I say, "Okay, the strategy performed well there." You know the Dunn Fund the trend trading guy.

Walter: Yeah, down in Florida. Those guys down in Florida.

Darren: Yeah. He's been like 25 years he's been successful, hasn't he, but in that time he has slight periods where he has big draw downs. I think he has 20% draw downs in it, but every year he just makes profit. He makes profit and he says to people, "Don't ask me about the strategy. Don't ask me about the numbers. If you want to invest in the fund, you put your investment in and you don't ask any questions." You think, "Well, how does he deal with those draw downs if he then went and started crunching the numbers on them?" Sure that would sway his decisions, but he just keeps trading the same strategy over and over again. He knows it's going to come good in the end. I think that for me you have to have that belief to back the numbers up. I think just having the numbers alone is not enough to make you trade successfully.

Walter: Yeah, absolutely. If I understand it correctly, I believe they're always in the market. They basically have to decide, the market's going up or going down based on their system. Obviously they're going to get some whipsaws in there. One of the reasons why I'm so fascinated by trend followers and trend following funds such as Dunn is because I think it is so difficult psychologically to maintain your confidence when you have those massive draw downs. I find that fascinating. You're essentially saying that he's in the camp that you're in, which is, "Look, really what you need to look at here is whether or not this system's going to work for you, if it's going to make money. The way you find that out is you do it."

He's not really one for numbers. I think it's interesting that supposedly Ed Seykota is the same way where he says, "Look, we don't have any numbers. We don't offer any numbers. All we offer is this is a real account that start with this amount of money and it ended up with this amount of money." Whatever it was. They put in \$10,000 or \$3,000 and it's worth 3 million now. Whatever it is. Again, it's the same idea, which is the numbers don't really matter. It's almost like Machiavellian trading. By any means necessary we're going to grow this money and let's not talk about the numbers or the nasty side of it, the draw downs. We believe in it. We know it's going to work. Sure there's going to be bad times along the way, but this is the way that we do things. I suppose there's a lot of honor in that approach, in knowing, in being so certain. Although I would suspect that even Dunn and those traders have to spend a lot of time reminding themselves that what they are doing is profitable especially during those draw down periods.

Darren: Yeah. Talking about when we start to learn to trade as well, I can't talk for everyone, but I know a lot people and especially me. I went through a lot of strategies where I tested them and they were successful and the numbers were good. Then I'd go on to

lose money trading them. That's because I thought that as long as the numbers stacked up it was all right, but there's an extra element that you need to add to the numbers and that's the mindset. I don't want to sound like I'm saying that having these numbers is not useful. They are really useful and they're a great indication of how good your strategy is, but more importantly your results going forward need to match those numbers in some way. I think that comes from mindset. The danger is giving too much weight to the numbers and not thinking about the mindset and the fact that there is going to be fluctuation within those numbers.

Walter: Absolutely. I think you're right to put the focus on the future and on execution because I suppose there are going to be traders who look back to ... Perhaps these traders are drawn to systems that are automated where they can just point back and say, "Look, this is what it made. All we have to do is do the same thing going forward." It never really works that way and a lot of really systems traders do things like double the largest loser and anticipate that happening in the future because they know that inevitably the results are going to be a little bit different than what you've seen in the past. That, to me, is smart is to take a step back and go, "Yeah, this is what we've seen in the past, but we're pretty sure we're not going to see exactly that in the future."

You may have a lower win rate by 2% or your average winner may be a little bit smaller or your average loser may be a little bit bigger. Whatever it is. You don't want to be trading on a fine line where your position size is so inflated and maxed out that you actually end up pushing yourself over the edge into the ... When you blow up your account, when you get to that point where you've gone too far with your position size because you're so convinced that the numbers are right. I think that the big lesson that I'm getting from you here today is you really need to focus on the future.

You need to focus on execution and that's really where your efforts should be because the numbers can be a bit of a crutch. Although, I think, for some traders it's a good thing to have because some traders just need to see that. I think that for other traders they understand that the real important thing that you need is the right execution in the future. Otherwise all those numbers don't matter because if you're not executing as you should, you're not even trading that system in the past that made those numbers anyway.

Darren: Yeah. Also, if you look at the results of funds as well, it's not always the same 3 funds in the top 3 every year. It fluctuates. Funds have good years and bad years, and their results fluctuate. Also, their numbers are fluctuating. Do you see what I mean? Say you have a good year and you say, "All right, well, we can risk 5% per trade next year because this is our number." Then next year is not so favorable market-wise, conditions-wise. Then you lose more money, so you have to be able to react in the moment, as well, and make some sort of judgment calls which aren't based on numbers. That's something that you learn with experience.

Walter: Absolutely. I think that makes perfect sense. I think that's why there's a trader I know who employs traders, and he varies their position size based on how well they're doing. We can probably do a whole episode just on this idea of how do you do technical analysis on yourself? Which is basically what he does, which I think is fascinating and he's a very switched on guy. For today, I guess the point is really you need to decide. How are you going to approach the future? Are you going to make sure that you're doing what you've always been doing? Do you understand that things are going to change? Does that mean you're going to change your whole thing? As you say, these funds at the top of the leaderboard, they flip flop every year, don't they?

I always think it's funny when you read in some of the mainstream economics magazines and business magazines when they talk about, "Oh, trend trading is dead now." It's always when the funds like the Dunn Fund have had a really poor year that they say, "Oh, that's it for trend trading. These markets are too choppy because all the al-goes are in the market, they change the game, and this and that." Then it's almost too funny because as soon as those articles come out the next year they'll have a banner year. You can't do any better picking tops and bottoms in these trend following funds than watching what the mainstream business journalists have to say about them. It's just perfect.

Take the big picture, right? What I'm hearing, Darren, is we're going to take the big picture. That's the point of view that you should have. You know that execution is what's going to get you the money, and following your system, and understanding that you're going to have down years. A trader that I know, a really good trader who's now gone to a private fund, I remember he called me once. It was a few years ago. He says, "It's been a really tough year. How has it been for you?" It's been weird. These big shadows aren't working as much anymore. I said, "Yeah, it's true, but you have to be a little bit more picky and things like that and just understand that if you don't have a good trade you don't have to take a subpar one, and that sort of thing." Even he, who had been trading for a decade, had come up on this year where it was like, "Oh, no." He wasn't really questioning himself, but he just wanted to make sure that it was him, so he was asking me and that sort of thing. I thought that was interesting.

Darren: Yeah. One of the most famous, most recent good examples of this over reliance on the numbers was when they were bundling these mortgages up and reselling them on. Everyone thought that they couldn't lose and they were getting riskier and riskier with it because the numbers were good. Then you have that black swan event and that unexpected event, and then you get caught out because you were too reliant on the numbers. That's the takeaway is use these numbers to get a feeling for your strategy and if it appears to make profit but you need some more than that. You need to be able to react and not just blindly follow numbers.

Walter: Well said. Thanks for your time, Darren. I really appreciate it and we will see you in the next episode? What are we going to talk about next time?

Darren: Sabbticals.

Walter: Excellent. Well, we'll see you then. Take care.

Darren: Cheers, Walter.