EP104: Trading Small Accounts

Walter: That's the way to do it really is to make sure that you don't have a reason to stop because you've got to push through to the finish line...

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

Walter: Welcome back to the Two Traders Podcast. Walter Peters here and I have Darren -- hello, Darren -- on the line.

Darren: Hello, Walter.

Walter: All the way -- from the miracle of the internet -- all the way from the other side of the world, Darren. I don't know why I add that in, I just thought it was funny. So, we're talking about -- before we hit the record button today -- talking about small accounts and trading them really aggressively.

I've read this interview of a trader and he was talking about how... I think he actually trades for a fund or was involved in some fund or something but the point is he said, "Look, this is what we do. We'll trade quite conservatively and then if we'll build some profits, we'll take a large chunk of that profits and we'll break it off into a smaller account and then trade that really aggressively."

They don't even care and, to be honest, I've done this as well with... I used to trade with a trader who was really good but he would make money upon money from months and months and months and then he would just completely blow up.

We did the same thing with him where we just basically give him a small amount, like a 1, 2% amount of the available funds and we let him just go for it. He would build it up and we pull it out, pull it out, pull it out knowing that sooner or later, he was going to come back with his tail on his leg.

So, that's the thinking here. It's not a new idea but I like to get your thought on this idea of having a small account that you break off and you trade completely differently in terms of money management or position sizing than you would a "normal account".

Darren: I think that's smart. I think both ways, both trading conservatively and trading aggressively, can both make money. You just need to understand that there's different risk involved with both and different potential returns involved with both.

I think that most traders start out trading a small account aggressively. I think most of us start out that way. You need to pinpoint how you want to trade. What your long term goals are from trading and adjust how aggressively you trade accordingly.

The danger from this is when people start out as a beginning trader that perhaps you've got a good job, or had a win for, or lots of savings and they start with a relatively large account, trading aggressively before they really understand the risk involved and then they've lost a lot of money and put themselves in a bad place.

Walter: Yeah and all you've really got to do is go to the free forums out there like Forex Factory to see this in action.

Darren: Yeah, and I think both can work. You really need to find a bit of a middle ground and you need to find out exactly what you want to achieve as well. If you want to make a million dollars in a year and you're trading really conservatively, so likely it's almost impossible for you to achieve that so, you kind of marry your wants and beliefs into it as well

Walter: Yeah, and accept the risk. So, if you're going to trade like a safe F or Optimal F -- and I can put in the **shownotes** the formula references to those -- but if you're going to trade something like that, you've got to mentally prepare yourself.

You're going, "Okay, this account can go to zero. Like I can lose all these money but I'm saying that the risk, if I'm trading 3% of my normal account in the small account, knowing that I had this pine in the sky goal, and working out the math and knowing that yes, I have the x percentage chance of it all going bad but I also have an x% chance that it's going to work out."

What it comes down to -- and I can give the listeners access to this spreadsheet if they want because I always found this to be quite useful for me -- what it comes down to is really the secret of winners and losers.

In other words, how lucky you are. And, if you start out really lucky and you're really aggressive with your position sizing, that means that you can build up a nice little cushion and you can get going alright.

If you start out unlucky specially when you have a small account like you're trying to build up, it stinks because it take some time to get out of that hole. But, either way, you're going to run into a drawdown.

Either way, you're probably have -- even with thee high win rate system, if you're very aggressive with your lot sizing -- you're going to run into some patches so my number one advice for people when you do this is you've got to prepare yourself mentally.

You've got to look at execution and pay off execution a tenth execution. It's almost like you just want to play the game to the end. "Is the account at zero?Okay, I'm still trading then." That sort of thing instead of trying to adjust on the fly.

I think when you adjust on the fly with this sort of approach, that's where you'll end up in trouble. I think you need to set the rules up in the beginning and just go for it.

Darren: Yeah, definitely having a plan is important. When I started out trading, I didn't really have a plan. I've just decided, "Well, that's how much I want to risk on each trade." I haven't done any calculations. I really didn't understand the probabilities.

To be fair, it's just getting used to the whole process of trading at that time, really, rather than looking behind and sort of planning out, making a plan if you like for the longer term.

In general, the advice out there is to be too conservative and I think a lot of the time, that advice comes from people who've been traders for banks or firms and they've been basically told, "This is how you trade. This is how much you'll risk," and then they'll give advice to retail traders.

It doesn't necessarily translate perfectly from that world to the world of retail trading. I don't agree with being over too conservative but, at the same time, you can say the same about being overly risky.

You need to find that middle ground and it does feel good when you do get it planned out. You tend to deal with your drawdowns much better and your losses much better because you have a better idea of what really to expect from your trading. Definitely, you need to plan it out. You definitely need to have realistic expectations.

Walter: Yes, exactly. So, the thing about this is I think that... Here's a hint, if you're going to do this, I think sometimes what happens is people get really gung ho on a particular system. My advice would be if you're going to follow this, think about trying to trade that small account quite aggressively with complimentary system.

So, maybe you're trading it with a swing trading system and a trend trading system, or break out system and a reversion to the mean or whatever. What we're trying to do here is we're trying to make sure that we don't run into a drawdown like it kills the account because that's the real concern.

When you go this way and take this approach, what's going to end the experiment is when you're having a drawdown that just completely obliterates the account. Now, you can mute the returns so that they're not going to be as nice by trading complementary systems but it's also going to be mute your drawdowns too.

The key here is that they're complementaries. You don't really want them to be correlated or you don't want them to work really well in the same type of market. I

think traders get into trouble when they think that they're going to do this when I just said by trading different markets, an uncorrelated forex pairs, currency pairs because that doesn't really work as well.

I don't know what you were trading today, Darren. There was a weird move on the EUR and that might have caught a lot of people today as the day that we're recording this. There's a weird spiky move on the Euro and that might have caught some people.

But, that's the thing. That means that all EUR pairs are at that spiky move. The EUR/GBP, the EUR/AUD, the EUR/NZD all of them have it just looking at the chart. That is not something that I think you can get away with.

A lot of traders think that the different markets are going to say, "It's the note." Really, it's the system that you should really be focusing on. If you're going to use this approach, focus on execution, mentally prepare yourself and try and see if you can get complementary systems involved so that you can mute your drawdown.

Darren: I've seen that similar approach where the same entries on the same instrument but different exit strategies. One would let his trades really run with a much wider sort of trailing stop and one would be more aggressive with the trailing stop so, when the market isn't moving so well, exit B would perform better. When the market was really perfect, then they've both performed well and it just muted those drawdowns, like you say.

Walter: Yeah, exactly.

Darren: I did caught on the Euro today, the EUR/JPY.

Walter: EUR/JPY, yeah. I saw that on the EUR because I have like a longer term trade on the EUR/NZD and I saw that move and then I saw some people are talking about it. I thought that was when I heard you mention that -- I don't know if you mentioned it on the last podcast or was it on this podcast? I've heard you mentioned about the trading so I figured that would be the case.

That's the thing. Like, the fact that I wasn't even looking at the EUR/JPY. I was looking at the EUR/NZD, the EUR/AUD, the EUR/GBP and the EUR and I saw the spike and yet, obviously, it happened to you on the EUR/JPY.

Darren: I think that whole switching to different instruments is generally a bit of a curve-fitting thing, isn't it?

Walter: Yeah, exactly.

Darren: You'll see the AUD/USD moving really well and you jumped to that and then the instruments you were trading starts to move well so you've just kind of chasing your tail.

Walter: Okay. Well, I don't really have much more to add on this. I've kind of shut my bullets on the small account thing. It's just really all about being mentally prepared, trying to trade different systems that are complementary that don't do well on the same market and focus on the execution.

I don't know if you know the story, Darren, about Larry Williams. You probably heard the story about Larry Williams. He entered a contest back in 1981 or something. It was a futures trading contest.

To be honest, I don't know much about Larry Williams. I haven't read his books and things like that. I know he has some books out there and stuff but what he did was he took a... I think it was a $10,000 account upto a Million or something like that over a course of a year.

It was something like that and so that's 10,000% return. What's interesting is that he was actually up to almost 2 Million, like 1.9 Million or something like that, and he's actually in a drawdown at the end of the year in December when the contest was over. He actually said when he was doing this.

The reason why he was able to do this was because he had worked with Ralph Vince, the guy who came up with the Optimal F, and he told Ralph... He said, "Hey, Ralph, you tell... Like, I've got systems here but you tell me how much I should be trading on this system. I want to win this contest." That's basically the birth of the Optimal F, it was through that.

What was interesting to me is that he was actually up like 19,000% and was in a drawdown at the end. He even said, "I know I was going to win the contest." It was clear 4 or 5 months into the contest that he was going to win it.

He said, "Well, should I just stop or should I keep going? No, I'm a trader. I'm going to keep going." He did that too and he lost in the last month and a half or whatever. He lost another 40, 50% of his gains and even though he ended up with this record-setting performance, it was actually half of what he had had he stopped trading just before that.

That's the kind of thing you should expect to see if you're going to do this. If you're going to do this, expect to see the 70% drawdown. These are the sorts of things that you just have to keep going and just keep chopping.

Don't stop if that's what you needed to do, just keep, keep going. That's the critical thing here because in a normal account, you might go, "Well, I'm down 30%, it's not working. Time to reassess, change" or whatever but in this sort of a situation, you really just need to, I believe, for me, just go until it's either you can't take another trade or the time is up.

That's another thing, you can set timer on this. I'm going to do it for a month, or 6 months, or a year, or whatever it is and then you can allow yourself to take a rest and reassess or whatever but maybe that's the way to do it.

It's to make sure that you don't have a reason to stop because you've got to push through to the finish line. That's another one that I would probably say.

Darren: I think, really, most people when they start out trading a small account are going to trade aggressively anyway regardless of what or anybody else says. I think most people do that and it's probably a good way to start because one, you can't lose too much money presuming it's a small account and that is not a significant amount to you.

Two, trading a small account aggressively will teach you a lot. It will teach you some important lessons. As long as you pick up on those lessons and then use them going forward, you might lose 2 or $3,000 but if you want to be a trader long term, you might as well pick up some really important lessons.

Walter: That's a great point and if you read the Market Wizard book, they've all basically learned lessons that way, haven't they? They've all come from --

Darren: I think we all have, haven't we?

Walter: Yeah, absolutely. From learning that, "Okay, I don't want to have that feeling again." It's like avoidance. Motivation via avoidance. "I want to avoid that feeling. I want to avoid that situation so I am going to do this instead." That sort of thing.

Darren: As long as you can pinpoint exactly what happened and why.

Walter: Yes.

Darren: As long as you've learned a lesson.

Walter: Exactly. And you're guy, Taleb... Nassim Taleb he did that too because his mentor, Victor Niederhoffer... His mentor was basically writing options, writing his naked options so that he was making money everyday and then one day, he owed all these money and he didn't have the underlying assets so he would go broke.

I know Niederhoffer basically gone broke at least twice doing that and rumored to be 3x but that's just allegedly. I mean, that's what out there on the internet but what Nassim Taleb did... And Taleb, for those of you who don't know, it's fair to say, Darren, you're pretty big fan. I'm a pretty big fan of Antifragile, The Black Swan. There's another one too, I haven't read. What's the other one? There's another trade-related one.

I'll put it in the shownotes. "Fooled by Randomness".

Darren: "Fooled by Randomness", yeah.

Walter: Yeah, that's the other one. So, what did Taleb do? He did the opposite. Taleb takes a trade every week, every day. He's like lose money, lose money, lose money. He calls it the "Bleed System". And then one day, he wakes up rich because the market has completely... There's a crash or whatever.

So, that's when he makes all his money but no one sees it coming. He took what his mentor did, what he learned from training and he said, "This guy is crazy. I'm going to do the opposite," and it works for him.

So, that's another way of seeing, avoiding what happens to you when you trade really aggressively with a small account. Avoiding what you see other traders do because you think, "Why would they do that?" That's another way to define yourself as a trader, to see what you don't want. That's a really good point too. That's a wrap!

Thanks so much for the time, Darren. We will see you in the next episode. Thanks guys for your time.

Darren: Okay. Thanks, Walter. See you soon

Walter: See you.