EP105: Gambling and Forex Trading (Part 1 of 2)

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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 to the Two Traders Podcast. Walter here. Hello, Darren.

Darren: Hello, Walter.

Walter: So, we're talking about poker players and I always love when we mix trading and gambling because that's just keeps people a round up. The question Darren is, professional poker players most often throw away their hands and wait for the very best hands to actually play them. What can traders learn from this?

The other analogy would be the fisherman that just sits on a pier or sits on the boat and just keep waiting for a bite. Maybe he throws its back off a bunch of fish and just wait to the ones that he really wants.

You see this a lot with the guys that play in these poker tournaments and I'd love to get your ideas on this.

Darren: Yeah, I've got two thoughts slightly conflicting on this. The first one is obviously that they have a strategy. They have a strategy and they're sticking to their rules.

Say, their strategy would be that they're going to wait for the specific hand. You could argue the better the hands before they're going to play because they know statistically that, that is going to give them the edge.

Obviously, in poker, you don't need to have a good hand to win because it's not about the hand you've got, it's about how you play the hand and there's element element involved there as well.

The interesting thing when it comes to trading is that you could argue the same point. That people prefer to wait for specific set ups because they believe that those set ups have a statistical edge and they're part of their strategy and that, in a long run, is going to make them successful. But, there is another side to this coin with on a psychological level, which is quite interesting for me and that is this idea of fear of future regret.

I believe that there's a lot of traders who leaves set ups and pre-set ups because they rely on doing some analysis on the set up at a time. I think some traders perhaps have looked at too much information on the entry and try to be too picky.

What happens is when you overload the brain with too much information, generally what it does is -- or generally what the trade is going to do -- is just do nothing. There's two sides for this coin.

There's a positive side which is they're sticking to their strategy and certain set up have a statistical edge based on their backtesting, what has happened on the past, and that's how they're trading.

The other side is they're leaving too much to discretion and then when set ups come along, they're looking at the trend. They're looking at their previous price action, they're considering the fundamentals and the brain just gets overloaded and it can't make a good decision and then they do nothing. That's what I see happen.

Walter: Right. So, can you talk a little bit more. What does it mean when you say, "leaving too much to discretion"?

Darren: I think when we're trying to make a difficult decision and there's something ain't right on it so we've emotionally involved in the outcome of that decision, we wanted to go a specific way.

If you have too many bits of information to consider, what they find that happens is investors and traders, they just do nothing. That's exasperated by the fact that we're constantly told that sometimes the best trade is just to do nothing so we automatically believe that leaving trades in some way an advantage and it's not. It's only advantage at the right time so you're right and wrong times to trade need to have a statistical edge.

I think it's that overload of information where let's say, you trade change in trend. What people tend to do, or what a lot of people tend to do, is to have too many elements to decide that the trend has changed where, really, you're probably better off with just having one simple rule to say, one or two simple rules. What we try to do to try and improve our results is we had too many elements.

The brain just cannot deal with that at those difficult decision times. You might disagree with me but that's what I've read and that's what I feel happens, personally. I think it happens to a lot of traders.

Walter: Yeah. I think there's a misconception in terms of essentially of what you're talking about which is, when people under stress, we always hear the term "flight or fight" but that's not true. I agree, it's freeze or fight. If you think back to when you, which is basically what you're saying, people freeze up.

If you've ever been in a situation where you were walking and you came upon a snake or a mountain lion or bear, or if you're ever in a trade that's gone really bad, in most cases -- when I think back to when I first started trading and I did everything wrong -- the two most common mistakes were: adding to a losing trade, which is basically fighting; and then freezing, which is having a losing trade and instead of taking a stop, you keep moving that stop to give it "a little bit more room" which to me is a kind of freeze.

It's like a no-decision. It's like, "I don't want this trade to end. I just want to, hopefully, keep working my way out of this" or something. You could argue that it's fighting but I think you're just frozen.

I've heard this from traders who sit there and they're taking this massive losses and you talked to them, "Why don't you just get out of the trade?" It's becoming a catastrophic loss. They'll say, "No. I should but I can't," and they're just frozen. I think that makes a lot of sense to me what you're saying.

When I think about the poker hands thing or the professional poker players, one thing that's interesting is I've met a sort of a friend of a friend. She played poker, she made money at it. She did well but I wouldn't call her a professional because she have another job.

A lot of her friends in this poker world, they were famous professional poker players in the United States. She was talking all the time about how, "Yeah, there's some luck involved but why the same guys keep winning?" Like, why does this keep happening? That was sort of her argument.

I don't know enough about poker. I know just enough to be dangerous but when I think about trading and poker, what it reminds me of this idea of throwing it away is taking losses. Throwing away your hand, you're just taking a small loss. You're not adding to that loss.

So, these poker players just know when they've got a situation whether they can bluff and possibly win or if they've actually got a pretty good hand and they can possibly win and that's when they go for it.

That's interesting to me because I was talking to a trader about a week ago at... like at a mastermind session. His main problem was that he knew he should let his exit strategy play out because his whole system was a trend following. It depended on having some really big winners and yet he would often try and come up with excuses and reasons why to get out of his trade early before his system told him to.

Of course, what that meant was he missed out on the biggest trade of the year. So far this year which is three quarters, in the way through, he had one trade that would've been his huge winner for the year and instead of following his simple trailing exit strategy rule, he didn't.

He got out early and that was the big one. That's often the case with those sorts of strategy. You might only get one or two of those a year if you're trading the higher timeframe charts and you really need to take advantage of those.

So, that reminds me of that too. I think there's a lot to be learned from this for traders. We can learn a lot from this approach of just throwing away, throwing away, throwing away and knowing when you're onto something and really milk on that.

That reminds me of adding to a winner, to throw away these losing hands or these hands that don't really have anything to do with because they think probably they're going to be losing hands and then they really milk the winning hands for all that they can. That's when they go in for the kill and try to take out their opponent in these poker tournaments. At least, that's the way I see it.

Darren: I think when you look deeper into it as well, you could... Let's say, there's a player that he hadn't place a hand, froze all of his hands away and when he finally placed a hand, everyone sees that the flop comes and everyone sees that it's a great hand.

Everyone else on that table now is thinking this guy only plays great hands. If everyone buys into that, he's got an advantage over everyone else on the table now because the next time he plays his hand, everyone is going to be presuming that it's a great hand so he can play a crap hand then.

It isn't just about -- in trading terms -- it isn't just about waiting for premium steups. It's about finding an edge over the rest of the crowd, the other crowd. I think that's the point there that is often missed.

We always think one dimensionally about what's really going on with trading and essentially it's not just about the chart. It's about what everyone else is going to be presuming from the chart, not your own presumptions.

Walter: Yeah, that's spot on. I agree. If you can think in terms of what are the other traders are thinking, that's a really great way to do it. I have this optimism bias as most people do, which is I overestimate how well things are going to go.

I often think if I was a poker player, my edge would be in sort of reading the other people. I think I would be quite good at that. Now, that could just be loney baloney and maybe it's not true but that's what I believe.

I might try and work my edge of trying to figure out whether someone so has actually got a really good hand or not, whether the other dude is really bluffing. It's funny how they wear hats and glasses and everything to try and stop you from reading them. The whole thing is hilarious.

It's great, I think. I mean it just sort of validates that they don't want someone reading them. They don't want someone to know what they're thinking or trying to figure what they're tell is or whatever.

It's hilarious but building off that idea that you just shared, what about this in terms of trading? What if you have a trade, a particular trade, which isn't necessarily a good one? In other words, I would consider a good trade where you get into a trade and then relatively soon, the market just takes off in your direction.

What if you had a trade where it wasn't actually a great trade because you got in and the market just waffled around a bit. You're in drawdown and then you're in a positive territory and then you're in a drawdown again. It's going against you. And for you, would you say then that part of this skill and how it relates to this analogy of poker tournaments and poker players would be that it's possible?

Like, if I were in a trade and it goes in my favor 30 pips and it goes against me 40 pips and then it goes in my favor 20 pips and then it goes against me 50 pips. It goes in my favor 40 pips and it goes against me 15 pips. If I'm able to actually turn that trade into a positive result which should be for me is not a loss.

So, either a break even or a positive result, would that be kind of along the same lines of the skill of the player in terms of as we're saying the poker player? Would you consider that to be in the same ball park?

Darren: I think so but those tactics come down to the individual trader. I've done a webinar on this before. You need to decide what's going to hurt you more. Is it going to be, "Okay, this trade doesn't really flown off so I'm just going to take a small loss and wait for the next set up" and then it raises off in the direction?

Are you going to be more annoyed that you missed out on the possible winner or are you going to be more annoyed if you didn't get out and it went and hit your stop loss? You have to sit in one camp or the other.

I suppose if you could test, if you test a thousand scenarios of that particular event and there was a clear edge to getting out of trades that don't go your way quickly and instantly, then sure enough right that in your strategy.

But, I think generally those sorts of things tend to be 50-50 on what's really more important. It's to decide which one is going to annoy you more. Me personally, once I'm in a trade, I let it do it's thing because for me it's reducing those amount of decisions I have to make again. I think the more decisions you have to make, the harder it becomes to trade but it's not to say that you can't just write a simple rule if it hasn't move within a certain amount of time or something than just cut your losses and wait for the next set up.

I think the confusion comes in the fact that we think that those little things really make an edge. I think if there is an edge in those sorts of decisions, it's slim most and really what you're doing is finding something that you can live with a type of trading that you're going to be happy with.

Walter: Right. So, why do you think these poker players, some of them they've become professionals and make money and other ones, they're just sort of struggling and they never really... It's never really their deal. What would be some of the reasons why some of them are able to make it?

Darren: That's a good question. I think that they probably have a good strategy to start with and I think they have good Psychology to go with it and then, there's an element of luck. I mean it's really the same as trading.

I think a strategy with a slight edge, then really good psychology, and then if you've got those two working, then you're going to get slightly more good luck than bad as well.

Walter: Right. So, if I were a poker player, I might do something where at the table, I might play twice. I might play my strongest hand. If I've got a really strong hand and I'll play it, play it all the way through, and then from there on I might consider bluffing or something like that.

That's kind of my edge, sort of building up the belief of the players around me that I'm going to... For example, only play -- like I said -- only play the strong hands and then after that, now I have a little bit more leeway where I can change that up a bit.

It's sort of like a baseball pitcher who throws the fastball. Throws the fastball and then all of a sudden, he throws a changeup which is really a slow pitch and the batter doesn't know what to do because it takes so long for the ball to get down there, that sort of thing.

It's kind of the same thing where you just gets someone conditioned that, "Okay, this is what he's going to do. This is what he's going to do..." Then you do something different. Is that fair to say? Would you consider that an edge or not really?

Darren: I think that that's probably a good strategy but I think the money management side of it probably comes into it more for the poker players who wins very often and over a long period of time.

If you're risking your whole part to win big blinds all of the time, you're going to win a lot of hands. But, the one time the guy opposite you got two aces, you're going to go all in and get blown out.

I think the good poker players, if there's not a lot to win there and you can't get hands, "Okay, they're probably just fold their hand. The one time that someone else is going in with a lot of money and you've got really good hand, then they play it because the rewards are big. I think on the money side, it is very similar to trading. You need to look at their risk to reward situation as well.

Walter: I find it fascinating that some of the money management principles have come from gambling that the traders used. I think the famous book is the Thorp book. I think the name is Edward Thorp called "Beat The Dealer" -- if that's right. I'm not sure but yeah, beat the market, "Beat The Dealer".

He wrote a book, "Beat The Dealer", then he wrote a book called "Beat The Market" so there you go. That's fascinating. I think you're absolutely right. So, where is it divert? Where is it different for the poker player in a tournament versus the trader, the retail trader, where is it different if there are at all?

Darren: I know we both slightly disagree on this. I don't believe there is any difference at all. I really don't. The poker player can control his risk/reward. He can control how much he risk on up to a point. Obviously, the small blinds and the big blinds are already set but for the trader that's commission and spread.

So, the Psychology is certainly very similar and strategies as well if you look at poker strategies, there's a lot of similarities. I think the problem is that people don't like comparing trading to gambling because of the negative connotations of the word, gambling. That it's acting irrationally and it's acting, it's being risky but the same can be said of trading.

I know we slightly disagree on this but for me, trading and gambling are the same thing. Even roulette. Roulette is the same thing but you've got to appreciate with roulette that you're odds are already fixed and you can't control. You can't really control that they're fixed. The house has an edge but in poker nobody has an edge over you, everyone is playing on the same table.

Walter: Right. What I'm trying to get you to say, Darren, what I'm trying to understand because my understanding is that when you approach trading you say, "Look, there's really... No, you don't really have an edge as a trader".

When I say this, I mean like an entry edge. You take a bunch of entries and you just try and manage this trades as best as you can to eat out more profit than loss. Is that fair to say? I mean, that's essentially what you... I mean, that's your approach.

Darren: Yeah.

Walter: By the way, Adam did a great -- make sure that you see the recording -- Adam did a really good job of presenting your trading strategy at the London Conference. It was fascinating.

I'm particularly interested. Haven't you seen it? Have you?

Darren: I have a note but was it recorded? He did mention it to me.

Walter: Yeah, I'll send you the recording. I'll give you the recordings because he did a great job but what was interesting to me, the most interesting aspect was the hedging part because I think that's the most difficult part for people to understand, including myself, but I diverge.

Anyway, the point is you're basically saying this, "Yup, there's no edge. Nobody has an edge. It's all an illusion and so when you get into a trade, you need to manage the winners as best you can and make those count." That's essentially what you're saying.

Is it the same thing with these gamblers, these professional poker players, who go into the tournament? They're playing at the table, they don't really have an edge or do they?

Darren: Statistically, you can prove that certain hands have a greater chance of winning than others, that's obvious. If someone has got two aces and the other person has got two 3's, he does have an edge there based on the cards but there's no saying that, "But you don't know that he's got two 3's," and there's no saying that he can't bet you out of the game.

He can bet in such a way that you'll start thinking, "Well, this guy has got a flash" or something. That element comes into it and I think the same happens in trading. We will convince ourself that a certain price action setup is guaranteed to win and then it all turn around and stop you straight out.

Walter: I'm with you. I get it. I'm thinking of the traders. There are some traders who are very quantitative-focused. Like, that's the way that they approach it and they do things like

they say, “Look, every time the market gets to the...” If you’re looking at for example, pivot points, they’ll say “Look, whenever the markets get to R3 or S3 -- which is the farthest pivot point -- it’s almost always going to retract from that and pull back.”

It’s very unusual that it’ll keep going and they will have the stats and they will show those stats just like you can have stats for certain hands and poker and blackjack and all that. You can say whatever, “This is going to win x number of times or whatever”.

They’ll do the same thing with trading and I guess what I’m trying to figure out here is, we’re fooling ourselves right?

Darren: Yeah, you are.

Walter: I mean, I guess in poker, it’s a closed system, isn’t it? Because in poker you know what cards are available. Like you know what a deck has in it. I guess with trading, it isn’t. What I’m trying to do is just fish out what the differences here and I guess that’s what it is.

I guess, that’s it. Like in trading, there is unlimited volatility, essentially. Theoretically, there is unlimited volatility. The market is going as far as it wants to whereas you’ve only got 52 cards in a deck.

Darren: Yeah. The problem with the analogy you made about pivot points, it always retraces from R3 but how far through R3 did it go? How far have you got your stop and then how far did it retrace?

I mean, if you had it all year, did it retrace 3,000 pips? How much are you going to take out of that retrace? You have to have those elements as well.

Walter: That’s all the time we have for today’s episode, Episode 105, of the Two Traders. However, in the next episode, you will get the double Ace of Diamonds card and how that affects traders.

You’ll also see how Darren uses the poker player exit strategy with his trading and why he does this. You will get the problem with really big winning trades and this can drive many traders crazy but it really shouldn’t and you’ll see why.

You’ll also get why focusing on making the “best decision” may not be the most profitable way to trade. Finally, you will see the poker player’s rule in the next episode and this can help every trader who pays attention to this rule.

It’s a little golden nugget of truth and I hope that you find it useful for your trade. All of these and more in Part Two, Episode 106, of the Two Traders. See you next time.