2 TRADERS

EP109: Dud Trades

www.2traderspodcast.com

Darren: All we can really do is look how you're executing that plan. That's the only real true measure of your trading…

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 and I've got Darren on the line. Hello, Darren.

Darren: Good afternoon, Walter.

Walter: So Darren, we were looking at this email that's come through from listener Chris. I'll just read it for everyone because there's a lot to unpack here. There's a lot going on and I think Chris brings up several really good points in regards to trading. We thought that it would make a good episodes. Here's what Chris says:

"*Hi, my name is Chris. I love the Two Traders Podcast. Actually, I find it quite relaxing*" -- and just so other listeners know, the reason why Chris' question made the cut was because of this first line. With that one, just kidding. Alright.

"So, I was wondering if you'd be able to do an episode around the idea of dud trades as this is something that I've been thinking about lately. What I mean by this is no matter how stringent the process or how many checks you put in place, a dud is going to turn up in the bash from time to time. This is across the board from any area of life. Just look at President Trump, haha.

Anyway, if you work in any area of manufacturing, you will see this repeatedly. Doesn't matter how many rules, guidelines, or systems you put in place. From time to time, you're just going to get a dud up on the box or, from the statistical point of the view, an outwire that really excuse your results and can be down to absolutely anything.

For example, my analogy going back to an apple-picker. Maybe the apple-picker didn't get enough sleep that night or maybe part of the machine that would usually pick up the dud was not working or needs cleaning or something like that.

Anyway, I think this applies to trading and sometimes there are moments when I look at my trades and I just wonder what on earth did I take that trade no matter how many rules or criteria I have in place. I just can't ever truly eliminate these outliers from cropping up.

Furthermore, I found not to worry about it but if I know it's going to happen and this is the best way for me going forward and at the same time, this can actually make the best trades that even cause you to question your whole approach."

I think this is the key to his question here when he says this, *"I found out not to worry about it. It's going to happen. And the best way to going forward for me is that this can actually be the best trades that caused me to question my whole approach."*

"Sorry for the long written essay. I just thought this was something that you, yourself and Darren, might find interesting as we are often taught to cherry-pick our trades and I know that this is something that I struggle with for myself.

From time to time, from one reason or another, and I'm sure that other traders out there must be also. Anyway, thanks for taking the time to read this. I love the podcast. I hope to hear from you. All the best".

So, that's Chris' question and what are some of your initial reactions?

Darren: Well, I think he's kind of... He's coming at this from two angles. He's talking about his execution, I think. Because, when he says a dud trade, does he mean a trade that was fit in all the rules? It looked perfect.

I'm imagining that he's doing his alliance sort of discretion to come into it as selection of trades. I'm presuming that what's he's saying is, "I have a perfect setup that doesn't work out."

I think that is a case of not accepting the uncertainty of the situation. You know you're going to get variance in your results. Something that fits all the rules and looks like a perfect setup is still not a guarantee to workout the way you expect.

I think from that point of view, that's just a case of accepting that to be a fact but he does touch on the point of execution as well. I think that is something that you're never going to perfect that but you can certainly train yourself to make less mistakes.

Walter: Yeah, I think that's right. I think there's a few things this kind of folded up here in the question. For me, this idea of, he says "I found not to worry about this dud trade, that they're going to happen, that the best way forward for me is that sometimes these are going to be the best trades and cause you to question your whole approach."

To me, that's the danger because I agree that you need to look at these from a long term point of view. In fact, I would say, if you're looking at trades and you're trying to figure out how things are going, I will break it up into chunks of 30 or 50 trades when you're examining your win rate or whatever, your average winner. If there's something

that you're worried about, I would definitely not look at just one trade. Do you agree with that?

Darren: Yes, definitely. I think the style of your trading, the mechanics of your system, have to be taken into account as well. If you're trading a very low win rate system with a big risk/reward then if you're looking at small number of trades, it's not really going to give you an accurate idea of what's going on whether it's good or bad. Something with a higher win rate, then I suppose a smaller batch can give you a better idea.

Walter: Yup. It's interesting that you say that because that's like, you've sounded like one of my statistics professors. You're right though. I mean, it's true that when you're looking at proportions -- this is a really critical point I think for traders because you've nailed it.

When you're looking at like percentages, proportions for example like a win rate, if your win rate is down at the extreme end, if you are like... If you have a 98% win rate or like a 5% win rate, somewhere on the extreme edge of the scale, then you need more sample to actually nail down what is the exact.

If you're trying to put a confidence in, for example "I'm 98% confident that my win rate is in this area", you need more data. Whereas, if you have a 50% win rate, you actually need fewer data. Isn't that weird?

I mean it makes sense. You think about it because you're kind of like you're almost off the scale, aren't you? When you have a 98% win rate or a 7% win rate so, you need more data.

This is something that people often don't think about is that to use your example, if you have a 35% win rate then you're going to have a lot of losers. You're going to have occasional big winners that you just can't look at 5, 6, 7 trades and say all these things totally doesn't work anymore.

Darren: Yeah, and you have to look at the market condition as well. You can test one year and it might just be that there was 3 or 4 instances in that year that the market conditions were perfect for style of trading.

And then in the current year you're trading, let's say any two of those periods occur, it's going to make a massive difference to your results but it doesn't necessarily mean that your system is broken. Because, I think all systems are generally designed to work on certain market conditions and they can occur for shorter or longer periods of time.

I mean, there's many factors that can change that so it's really difficult to label individual trades as dud trades or not. All you can really do is you've got a plan of attack. All you can really do is look how you're executing that plan. That's the only real true

measure of your trading and it might just be that this is a bad year for your system but you've got no control over that.

Walter: Exactly. I think that the focus for the traders should be on you, the trader. If you're a discretionary trader, actually, even if you're trading your robots or expert advisers or whatever you should really be looking at yourself.

That's kind of a little bit different because you're also babysitting those things. But, if you're a discretionary trader and you're making decisions like I'm going to buy here, sell here. I'm going to put my stop here. No looking at taking profit there. Your focus should be on you. Your focus should be on what are you doing. Serve like a coach.

Like a coach who's looking at a team and saying, "What's my weak link here? Who's the player that I need to replace?" or whatever and that's the same thing I think that you should be doing as a trader.

What I look at in my journal is, "Am I actually executing my trade correctly? So, that means entry. That means exit." These are the sorts of things that I think that are going to help you as a trader.

That's why it gives me pause when I read this part of Chris's question. It's a great question. I think a lot of traders run into this but when he says that sometimes these could be the best trades and cause you to question your whole approach, I don't necessarily agree with that.

If you have a really weird dud trade, I'm concerned that questioning your approach can lead to changing your approach. Adding a filter, adding a rule. You know trying to over -- to curve, it basically. That's my main concern with this.

Darren: Yeah. That's definitely curve-fitting thing kicking in, isn't it? I'm presuming by what he's written that he's a discretionary trader and he is making some assumptions here. But, what I presume is that he's looking at the chart.

He's looking for particular chart condition to set-up and if he gets that right then he has a winning trade. I'm imagining that sometimes he takes the trade that doesn't fit any of those rules and it turns out to be a really big winner. That's probably troubling him.

There's a lot of tests out there. You can trade with random entries and still make money. The fact that your approach is to wait for specific set-up... Let's say, you're waiting for momentum.

You're going to try and get in on a retrace or that momentum, that's a valid approach, but it doesn't mean that you can just slap there an entry at anytime and use the right money management and make money.

Trading is always going to tear you in that way. It's always going to. You'll always going to see opportunities that were there. The opposite of what you do and if you're losing at the time, you're going to be drawn to, "Well, am I doing the right thing here? Maybe I should just stand too randomly. Maybe I'll do better that way."

You have to remember that it's not a case of finding the best trading strategy. It's just finding one that's okay and that's consistent and that you can execute consistently overtime. You just have to accept that sometimes you'd be better off not trading that way.

Walter: Yeah. Do you think that one of the big rabbit holes for traders is trying to find a "better system" or to improve a system?

Darren: I think so. I think it's more a case of where it's our expectations are too high. We want too much success, we want to win more than we have to, we want to make money everyday.

Generally, the things we want. Let's say, you want a high win rate and you want massive returns. Generally, high win rate systems mean that you're going to have a shorter risk/reward. Shorter risk/reward generally means smaller returns. We tend to like we want our cake and we want to be able to eat it too and that's just not possible.

You've got to decide which camp you're going to sit in. You want to get big returns and you're going to have to let your trades run. If you're going to let your trades run then, probabilities are that you're going to have a lot more losers and longer drawdowns. You see, you can't have it all.

Walter: Yup. I think we talked a lot about the cognitive biases and why trading could be so difficult. I think this is one of the big ones I can see how it would happen. Just imagine you're coming to trading because you read a book about some trader or you watched some documentary or something or you heard about some guy that's making money.

I could just see where you would assume the reason why because I did, I remember, right? The assumption will be that somehow this guy or this trader or this fund or whatever had cracked the code.

So, it's really about learning the code. Undoing, unravelling what's going on here in the market which sort of implies that you're right more than you're wrong and that trying to win is the answer.

I think that's really at the heart of a lot of what goes wrong for traders is because, like you say, this high reward/risk ratio system, it's like the best traders are getting paid for learning how to lose.

Darren: Yeah, 100%. And it's tough.

Walter: Yeah.

Darren: It's really tough.

Walter: Exactly.

Darren: When I've seen people do stop loss and take profit optimization, generally, their really big returns at downhill, at sort of win rate of say the 30% mark. Once you get over like a certain amount risk/reward and optimization, say like over 10 to 1, the win rate doesn't really drop anymore.

It gets to the point where if you stock in random trades and hold them long enough, then you know you're gonna get a certain amount of winners just by the nature of how price moves up and down. You're going to catch some tops and bottoms just purely out of luck.

In all the testings I've seen, that is kind of where it lies. But convincing yourself that you need to lose, you're going to lose that much to make money, is just completely counter intuitive. That's why most people don't go low. People don't even attempt to go there.

Walter: It's psychologically painful, isn't it? It's like going to the dentist or whatever and you know it's going to hurt. For a lot of people, it's just not worth it. They don't go. They just don't go. It's not worth it.

Darren: Yeah. But, I think half the problem is that most people aren't doing it. The masses are telling you that I prefer to take profits early and I prefer a high win rate and small risk reward and I'm doing really well doing that. It's quite hard to confront that fear and do something different.

Walter: Yeah.

Darren: I find once you start doing it, the buzz you get off the big winners and watching how that the difference that makes in your profit, after a while those consistent losers, they hurt less and less.

Walter: Yeah.

Darren: You know, because you're expecting it. Pretty much every trade you put on, you're expecting it to stop high and when you do get one go -- you know, run -- you're like, "That's quite a change. Wasn't expecting that at all."

Walter: Yeah.

Darren: And it's a difficult mindset to take on. I think a lot of people try but they just give up too soon.

Walter: Probably the best way I've seen to sort of get this across is to play a game. If you have like 10 pieces of paper and you mix them up with a ball or something like that, you'll have and what you write so you've got 10, you've got 1 of them that's 20-R.

That's 20 return on your risk and then you have like 1-5 R so that's 5 return your risk. That leaves 8 and the remaining 8, you've got 5 that are 1 R losers so negative 1R and then 3 that are negative 2R. You've kind of get slipped or whatever and stopped out. And then, what you do is you just keep drawing those up, just keep taking those trades over and over again and see what happens.

It's like you say, you're just waiting on that big winner. It's kind of addictive. I mean, like in Psychology. We know the most addictive form of reinforcement which is just when you reinforce through behaviorism.

This idea that you reward someone and that your behavior is more likely to be duplicated in the future. It's one of the few Laws of Psychology. Something is rewarded, it's more likely to happen in the future.

Well, the most addictive one, the "Schedule of Reinforcement" as it's called, the most addictive is the same one that you're talking about the same one that you get when you go and play the slot machines.

You go to the pokey machines and you play them. You'll never know what's going to happen, if you're going to get a big pay out or if you'll just lose a little bit of money. That's the most addictive Schedule of Reinforcement and that's basically trading.

I mean, that's all trading is. When you're at that point where you're playing the long game -- and I think this is the other thing that Chris brings up in his email -- that's so critical. He talks about this idea of manufacturing.

You'll see that no matter how many guidelines or rules or systems you put in place, you're going to get a dud apple that comes down the line so to speak time and time again it's going to happen.

What I've found -- and I learned this from Ralph Vince. Ralph Vince is the guy who wrote the "New Money Managemen"t. He was the Math guy who's also is completely self-taught which is fascinating. He helped Larry Williams win the trading competition years and years and years ago, and whatever it was 1988 or '83 or whenever it was.

Basically, Larry Williams said to Ralph Vince... For those of you who don't know, Ralph Vince he said, "Look you tell me how much to place on, how much risk to place on each trade and I'll do rest." That's how we was able to make 10,000% that year by using the Optimal F Strategy that a lot of people are familiar with.

Well, Ralph Vince was talking about this question: How do you know when you've just got a regular dud that's come down the assembly line? First is, when your system is actually breaking. When either the markets change or my system doesn't work anymore.
Which are other two common complaints that traders have. They'll say, "the markets change or my system doesn't work anymore. Now, it could be that. It could be that. What I think most of the time, it's just a drawdown.

Ralph Vince, the way he's tackled the problem and the way that I've been doing this is the same way which is that they look at manufacturing. Which is when you get something that comes down the line, what you need to do is to compare it to the gold standard and say, "Is this the right win rate? Is it the right average winner, average losers? Is this fitting?"

The key though, the key shift I made was not to look at it trade by trade. What you do is look at chunks of trade. What that means like for if you're trading, let's say, you trade and you take maybe an average of 12 trades a month, you're not really a high frequency trader. Then you might look at your trades and examine them every 30 trades but if you're a trader and you trade let's say you take 20 trades a week or more, you might look at chunks of 50 trades and compare them to the gold standard.

Gold standard of course, being your average winner, average loser and your win rate. Those are the key metrics that you want to look at. I think Chris here has really pulled up something that is critical which is this idea of using the assembly line point of view.

This I believe is one of the best ways for you to identify whether or not your system's breaking. The key again is to look at chunks of trades instead of units of trades. That's where we go wrong as we look at 1 individual trade or 2 individual trades, then we go, "Oh! everything's broken." I think that's one of the biggest mistakes that traders often make. At least I have known myself to make it.

Darren: Yeah. Is it because we stop with the wrong expectations, basically?

Walter: Probably. I mean, I do think that when you're coming to trading new, there's this assumption that someone who does well at trading does it because they've cracked a code or they've figured out some secret thing. That's kind of the assumption.

I don't know. Maybe I'm wrong but that's how I look at it. I remember the amount of time and effort that I put in trying to learn Gann. It's ridiculous. I look at it now and I laugh. I think, "This ridiculous". I was like turning autistic or something.

I just had this calculator that I carried around and I was drooling and I was just like, all I do is just look at this calculator and I was trying to figure out again the code. It was maddening.

I've been sitting, I've been places where I was not even paying attention to my environment because I was so keyed in on trying to crack the Gann code. And then, I'd look up and everyone will be gone.

I remember one time I was at the mall and I was at the food court of the mall. I had my calculator and I had some food at lunch time. I was punching away trying to figure out this Gann thing and then I looked up and there was literally nobody around and the mall is like closing. You know what I mean? Like security guards are going to send me out.

It was the weirdest thing and I was like, "Oh! I'm really into this." I was starting to question myself of whether or not what I was doing. Like, I'm still convinced that I had. I was just around the corner from figuring it out but I'm so glad that it didn't go that way in terms of my trading. Because, I think that puts a lot of pressure on yourself to assume that you've cracked the code, that you have everything right.

I don't know what those people say when they are losing trades. Like, what do they say? Like, the market's wrong or something. Like, I don't know. I don't know how you deal with that.

So, I think that the more fruitful path is to focus on your execution and simply understand and that you get paid as a trader for absorbing those losses. That, I think, is probably the lesson for me here is that absorbing the losses is the key to becoming a high risk/reward trader.

I don't know that Chris is doing that but I do think that that's one of the key things here that comes out of his email is, learning how to accept those losers. And then, if you want to look at how things are unfolding, I think using that assembly line approach, using that quality control approach makes a lot of sense. But, I think the key there of course is to chunk it out and look at chunks of trade instead of individual trades.

Darren: Yeah, I'm with you Walter. I think the only dud trade that really exists are failures in execution. Your system is naturally going to give you dud trades, that's part of it. But, as long as it kind of fits in with your approach and what realistic expectations are for that approach. If you have a 50% win rate, you can still get 10 losers on the chart and it's about having knowledge about realistic expectations for the way you're trading.

Walter: Yeah, exactly. Thanks so much for the question Chris and we will see you next time, Darren.

Darren: Thanks, Walter.