2 TRADERS

EP141: Trading Edges (Part 1 of 2)

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Darren: Generally, if you want to make more then you've got to risk more...

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 Two Traders. It's Walter here. Hello, Darren.

Darren: Hello, Walter.

Walter: We're going to talk about edges, Darren. I know you're really keen on edges and the lack thereof. Two related questions: Are there these inefficiencies in the market? You can read a whole lot of books that will tell you that the markets are very efficient. If there are inefficiencies in the market, where does an edge come from? Does it come from those inefficiencies or is it just something totally different? That's really the question for this week. Do you wanna start off?

Darren: Yeah. The market inefficiencies is not really, I'll be honest, it's not something I'm an expert on. You know you could probably shed more light on that.

Walter: Well I guess, the basic idea with the efficient market hypothesis is really just that - and this is coming from a guy who has never done economic course so I really don't know. But, my understanding is from the academics. Basically, the idea is that these markets are really taking into account all of the information that's out there.

All of these market participants, they have information and based on that information they buy or sell. So basically, the markets are really where they should be. Right at any given moment everything's been incorporated. All the information has been processed. All of the bets have been placed, so to speak. And so that's why the price is where it is.

All of those arbitrage opportunities that come up when markets are really new. For example, in the cryptocurrencies. There's like a 14-year old I know and he basically makes money by buying on one market and selling on another. It's just that arbitrage opportunity that comes up a lot with new markets.

For example, right now as we are recording this, a lot of these cryptocurrency markets are fairly new. They're decentralized. You can actually take advantage of that. There are a lot of traders that are doing that right now. Basically, picking up nickels.

I think this kid that does this, it takes him about 35 minutes to do one trade. But, as long as he wants to sit there and pound them out, he can basically buy over here and sell over there. Once it's all done, he's got a nice little profit there just for funding those inefficiencies.

The academics would say NO. There are no inefficiencies, the markets are very efficient. You might think that you know what you're doing, that you have an edge, but you really don't because everything that needs to be accounted for has been accounted for and so these markets are right where they should be.

Whereas traders tend to say things like -- if you watch the economic channels or the finance channels people will say things like, "This share is undervalued" or "The dollar is overvalued" or whatever.

In their mind what they're saying is that the price right now for the Dollar or Pound or for Google stock or whatever is really wrong. That there's an inefficiency there, that their true price should be somewhere else. That's what enables them to make money or that's where they get their trading ideas from. I guess, that's how I see it. I could be totally off here and I'm happy to hear from anyone else. So, let me know that I'm wrong but that's kind of how I see it in my mind.

Darren: That sounds more reasonable to me, with markets being so complex and also people want price to move as well. They want the price to be wrong, don't they? You have that human element in there as well.

When I look at it, I say there are certain areas that I don't understand and there are certain areas that I don't feel I want to understand. But I look at the information, you know from my point-of-view and say, "This is how I see it. Is it possible for me to generate an edge from that?" Really, I'm just saying, "Can I make an edge from my beliefs?"

Can I impose my beliefs on what I think the market is and how I think it operates? Is there a systematic way of planning out the market? Does it look in the past like that it had an edge? My beliefs could be just completely made up in my head but it's still possible for that to have an edge.

Walter: Why?

Darren: Why? Because price moves. Price is always moving. So, if the price moves, there's always an opportunity and the movement of price is so complex that it's really hard to disprove edges, you know. It's really hard to disprove edges.

Walter: What do you mean by that? It's very hard to disprove edges. Why is it hard to disprove edges?

Darren: For someone to say that there's an edge, they need to test it on some data. If you want to disprove that edge, you can only really say, "Well, it's not going to work in the

future." And that would mean the future is measurable or you can predict what the future movements are going to be. That's not true in my mind.

Walter: I think, you're basically taking the Science… From my point of view, you're taking like what Science does. Science never says "this is a theory of how things work. We're going to do an experiment . This experiment will show and prove that this is how things work."

What they do instead is they set up the strong hand hypothesis and they knock that down. They'll say, "Well, since we knocked that hypothesis down, the most likely explanation is, our theory." You know what I mean?

They just keep knocking down this strong band and the idea is that the last thing standing is their theory. That's the whole scientific method in a nutshell, I guess. It sounds like that's what you're saying. You should really take sort of a scientific approach when you're trying to determine whether you have an edge.

Darren: Yeah. Then, when you've decided on your edge. I suppose you can go and look for information to make that assumption more robust. For instance, you determine the edge was the trends exist in the market. Well, that's fairly easy to test systematically based on past data. But you can also find a lot of successful traders that have traded using the trend as their edge. You could add that to it as well as more information to back it up.

If you want to go further, you don't need to try and show or try and prove that, that edge really was as a result of the use of some sort of trend or their definition of a trend. Because, sometimes you might think that your edge relies on your ability to pick specific levels or timing. But it might be another element on how you're trading that's really making the edge.

I think you can test that by taking things away. I've done that before with very simple trading strategies with very few moving parts. And then taking, say you have a particular entry, you have a particular way of deciding what the trend is, then taking those elements away and comparing results.

I don't know maybe that is curve-fitting in a way. But say for instance, I had a simple moving average crossover with a 5R target in a simple entry. And then I tested it, and it was profitable. What if I did the same thing but I took the moving average in this way and just flipped a coin.

Is it still profitable? Then you can start to say, "Well, maybe the moving average aren't really that important at all. Maybe it's the fact that I'm just letting my winners run and cut my losers short. That's how I approach it. I'm not saying that this is the perfect way

of doing it but in my mind that's the only way of really kind of measuring edges. I mean, maybe that's sufficient, maybe it's not.

Walter: So, it'll be like, if you had a system-- I've heard of this system where if there are 3 bullish days in row, then on the 4th day you sell. But, you could change that and go, "Well, what if it's just 2 bullish days in a row?" It's kind of like the moving **average** example you were saying **where** you use the 6 and then you use the 8 and 10 and 12. If it's just one setting that works, then you're in trouble. Right? It shouldn't be the case that ones like only the 5 moving average works.

Darren: Yeah, that's what I'm saying. This is why I have endless arguments about entry patterns. Because, I've done this until my eyes have been bleeding of taking the entry system and then making it more and more and more simple. What I find is that the edge doesn't go away. You just play with the figures, basically.

The simplest entry system will generate the most entries, will tend to have the most drawdowns and the most consecutive losers. But at the same time it tends to make great profit because it generates more winners as well. You're not waiting for so many stars to line up before you can take an entry.

Walter: Yeah. I've heard people talk about that. If you have two different systems and they're pretty much equivalent, go with the one that trades more often. And that makes sense to me, like that idea.

Darren: Yeah. And then it just becomes a matter of making sure you set their correct position size and then executing it correctly. The one I test the most is just a single bullish bar breaking out for a long signal. That's only really waiting for a very small bit of momentum in a direction. And you'll find it has really big drawdowns and has a really long consecutive losers. But, it never misses a winner. It might miss one or two but it gets them all.

Then I tested it. Let's say, 2 consecutive bars. You think you're actually changing the system but you're not. You're just waiting for a bit more momentum. You're going to miss a few more winners but you're also going to avoid a few more losers.

So defining edges in systems like that is difficult to do. I think you have to go back to a much more broader view of it in and just simpler big ideas. For instance, a simple big idea could be once price gets moving in one direction it keeps going further than you think.

In other words, there's an opportunity to get a few winners that are really big. So that's a really simple defined edge that you could look to exploit. Likewise, you could say pretty much every entry point, will at some point go in your favor. So if I put really wide

stop and I just get out when I'm in profit, I'll be able to maintain a really high win rate. That's another really broad simple edge to exploit.

I think that has to be the starting point. But it's difficult because everywhere you look there's really complex scientific ways of working out what an edge is. It's really hard to trade a simple idea when you see that going on. You think, "Well, am I just too stupid. Is that the problem?"

Walter: I think that's usually the problem with most things. No, I'm kidding. When you were talking about the system, like the 1 bar, the big bar breakout system and the 1 bar offers more trades than the 2 bar system but the 1 bar has more drawdown. How do you measure drawdown? It's kind of a byproduct of your risk management. The way that you manage your position sizes and all that like your drawdown in terms of dollar value.

But if you look at it in terms of R, I think that's actually a better way to do it. I've been looking at this lately, this idea of just looking at R drawdown. So if you were to run a bunch of Monte Carlo, you would get a distribution of R outputs over the next 200 trades or whatever. That would give you the range that you would expect to happen once you go live. Does that make sense?

Darren: Yeah. I always look in terms of R.

Walter: Yeah. That's the way to do it. For example, that 1 bar breakout system. The market prints a big candle. I guess if its a big bearish candle, you wait for the market to trade lower than the bearish candle and you go short. And if it's a big bullish candle you just wait for the market to go above the high of the bullish candle and you go long. Is that right?

Darren: Yeah. It doesn't need to be a big, big candle either.

Walter: Just a bullish.

Darren: Whatever you're using to identify, the trends says short. If you get a bearish close bar then that's a valid signal when you set-up a sell below the low and if it stops out and then you get another bearish bar then you sell again. Essentially, what you're doing is it's basically saying that the momentum's down.

The long term momentum is down. But you're looking for the best value, sell into that. It's basically a value entry into, if you think in terms of investing, you're picking a stock that's going up. This is a good value point to buy. That's essentially what you're saying.

Even simple things you can dress up as sounding like a really intelligent, well thought out trading strategy. Lets say, I want to see more confirmation that price is continuing to go

down. So I'm going to wait for a lower low, lower high to form and then I'm going to enter. What you're doing basically is waiting until it's not quite as good value. You're just waiting for a bit more momentum. But essentially the strategy is exactly the same.

Obviously, you're not going to generate as many signals because the momentum is not always going to be dropping when the long term trend is down. Sometimes it's going to be sideways and that more complex entry is just not going to happen but the very simple one is. That very simple entry is going to get in at the best value all the time. You have more potential of hitting a high risk reward.

Walter: But what if someone says, "Yeah. That's right, Darren. But I don't want to deal with the drawdowns that I get by trading every bar, every candle that goes in the direction that I expect." For example, I've seen systems that are really good, have really good risk reward, really solid hit rate but they just don't happen that often.

The argument is either one, this system you don't have a lot of data and this system is just really on the lucky streak over the last 5 years. You really don't have enough data points to know the true win rate of the strategy. You think it's going well. And it is going well simply because you've only got 30 data points or whatever for example. That would be one point of view.

The other point-of-view is this really works, you know it doesn't trade that often but when it does, I want to take advantage of it. So the temptation is to really lay it on thick in terms of risk. When you get one of those signals. What do you say to that? Obviously you and I both know the inclination is to want to win. When you first start trading you want to win.

And I've heard this over and over again, people who don't know anything about trading will say "Well, so long as you win more often than you lose, you'll be alright." That's kind of where we are coming from when we get into this game. Then later on you kind of realize not so much. So what do say to that. To the guy who says, "Hey look Darren, I got this strategy trades on the weekly chart. I don't get a lot of trades but tell you what, it's 5 to 1, it's got an 85% hit rate." Why don't I just trade that?

Darren: Because in my experience...

Walter: It's going to revert to the mean.

Darren: If you really want a low drawdown, you don't want to lose a lot. Then that's going to be reflected in your possible returns as well. Because if you want to make really big returns, when I'm talking big, let's say 50% a year. You've got to get comfortable with losing a lot to do that. Based on the evidence that I've seen.

I find it really hard to find better or more experienced traders than me to disagree with that but that doesn't mean it's not possible. But generally if you want to make more, then you've got to risk more.

Walter: Alright, that's it for Part One. In Part Two, you are going to hear about magicians in the markets. What this means for you and your trading. Also, how to know if your strategy is going to make money over the long term and what the Shakespeare monkey means for your trading. Whatever that is. You will also hear the Turtle bummer and how to test for your luck in your trading strategy.

Also, how to know if you actually have an edge or not and finally the story of the nervous Las Vegas gambler. What this means for your trading. All these and more, in the next episode, Part Two of the Two Traders Podcast.