2 TRADERS

EP16: Blinded By The Charts

www.2traderspodcast.com

Walter: We have to be aware that we don't see new things that pop up, and so as a technical trader, if you trade off the charts, that's something you have to take into account.

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

Walter: In this episode of the 2 Traders podcast, Walter and Darren tackle the topic of change blindness. What is change blindness and what does it mean for traders, especially those traders who use technical analysis? Walter also talks about the elephant and the magician, and Darren talks about why it is that traders are misguided by putting too much psychological energy into the wrong part of the trade. All this and more in this episode of the 2 Traders podcast. Welcome back to the 2 Traders podcast. I'm Walter. I've got Darren on the line. How are you going, Darren?

Darren: Very good, Walter.

Walter: Last time, we were talking about this idea, Darren, of change blindness or when something new pops into your visual field and you don't notice it. Apparently, this is like a weak spot for humans, and I'd like to get your thoughts on the topic, especially, obviously, as it relates to traders.

Darren: Well, can you go first, and then can I come back at your ideas?

Walter: Sure. I have a couple thoughts on this. Many listeners may not know that I was a magician growing up as a kid. It was really interesting, actually. I think about it today and it probably did a few things for me. When I say "from a kid", I mean I was performing from like about age 7 until about 21, and then I gave it up.

I was doing shows every weekend as I was growing up. Then even when I got into my teens, it was probably totally illegal, but I was doing shows at nightclubs and things like that as a cute little opening act for dirty hypnotists and things like that. Those kinds of acts. It was really cool because it brought me out of my shell, because I was quite a shy kid for a number of reasons, and also, I became a voracious reader. I would read about the history of magic and, obviously, learn a lot of your magician's tricks through books and things like that.

One of the things that it enables me to do now, looking back on it, is to see things like change blindness. I'll give you a good example of this. Like I said, at one stage, I locked into becoming the opening act for this dirty hypnotist, off-color show that he did, that I definitely shouldn't have been in the nightclubs and I definitely shouldn't have ... It was totally illegal. Anyway. I was doing these shows because it was cute to have a kid up there as the opening act, and he was teaching me all these things about the world.

One of the things he taught me was how he knew a magician who basically would make an elephant appear on the stage, and the way that he did this was fascinating. He would have a bunch of Vegas showgirls dancing in a line up at the front of the stage, and then the background was black. What they would do to make the elephant appear was they would just make sure that the girls were really dancing and giving a good routine.

Meanwhile, in the back, there were a couple of guys that had this elephant that they literally would just pull over from stage left. It had a big, black sheet over it. If you looked carefully, you could see the people herding this elephant into the middle of the stage, but because he knew, the magician knew that everyone would be looking at the women ... The women were looking at the women because they were thinking, "Oh my god, she doesn't look good in that," or, "Would I look good in that outfit," or, "Why is she wearing that outfit?" The guys were looking at the women for obvious reasons.

It was like this distraction thing where people didn't recognize the fact that the assistants in the back, these 2 guys, were literally pulling an elephant on stage. Then they pulled the black sheet off it, and a puff of smoke went up, and the elephant appeared. It was the big finale to this guy's show. It was one of those things that really makes you think because you think, "How can people be so blind to something that's obviously right in front of you?"

That's really what change blindness is all about to me. It's this idea that when something pops up in your chart, you don't really see it. Now I think it's a little bit more, perhaps, shall we say, accentuated when you're in a position. One of my principles is if you're in a position and you're trying to interpret the charts as a neutral observer, you're probably not going to be able to do it. It's very, very difficult.

The best way, if you're in a trade and you're not sure whether to get out or whatever, if your system allows for some discretionary decision making, then perhaps the best thing to do is just simply get out of the trade and then reassess because I think when you don't have a stake in whether the market goes up or down, it's a little bit easier to be neutral. I think a lot of people fall into that trap of seeing the market from only one side, especially if you're along the Euro, then everything you see looks like the Euro, it's more clues that the Euro's going to go up. That's a confirmation bias.

On the other side of it, this change blindness is, what if you actually see a candle there that actually suggests that the market should be sold? Maybe you don't see that because you're in that position. I think overall, the interesting thing to me about change blindness is that we don't really see ... We have to be aware that we don't see new things that pop up, and so as a technical trader, if you trade off the charts, that's something you have to take into account.

Maybe there are solutions to that that we can get into I guess at the end of the podcast, but for right now, it's just important to present this idea and for you to think about this. What does this mean for my trading, this change blindness idea? That when there's a change in what's in front of us, literally in front of our eyes, and we don't notice it. What does that mean as a trader? What about you, Darren? What are some of your thoughts about change blindness?

Darren: Yeah, Walter. Essentially, it's when your senses are set on something, it's very hard to take in new information. That's what we're saying here, yeah?

Walter: Yeah, exactly.

Darren: Yeah, this is why I've gone more and more down this route of reducing the amount of information I need to trade. Obviously, we need to use a certain amount of information to trade, but I've tried to strip that down to the bare minimum. The way I've gone about that is by making my entries very black and white. Almost zero discretion and very few elements to that decision where I enter.

I've become very aware of this. When we're trading, we're interacting with the charts, with our senses, and we're taking in information visually and from our feelings, but that information really is meaningless. The only way we can give it some meaning is on past experience and what we've learned, basically.

It's the context that that information is coming in that is important. Let's say we trade in a very technical way and we use a confluence of, say, a trend line with some price action with, say, RSI, and we're watching and waiting for a particular setup to meet all of those criteria, then we've already got a very strong idea about what is going to happen and what the outcome is going to be.

Often, when that information that we take in doesn't marry up with that expectation, we don't see that. The problem comes, and then you're always second-guessing your decisions. I think the best way to remove that problem is to have it really black and white about what your entry is and have a limited amount of information you need to marry up before you went to enter a market. Does that make sense?

Walter: Yeah, that makes sense. The question that comes up from me when I hear this is, well, why don't you just have an automated system then? Because what we're trying to do is restrict ourselves from breaking out of the rules, so what the automated traders will say, and I'm certainly not one of them, but what these guys will say, they'll say, "Well, Darren, then what you need to do is you need to just program it." That way, the computer doesn't make the mistakes that you might. What do you say to that? I know what I'll say to that, but what do you say to that?

Darren: Yeah, that's taking it too far. What I'm saying is the brain is really good at making these decisions, but up to a certain extent. The way I see it is your decision to exit is the element that decides whether you make profit or loss based on the way I trade. Where I decide to exit my trades over a large series of trades will define how much profit I make, and that's partly down to the market as well. Obviously, if it's a favorable market, then I stand a greater opportunity of making that profit.

In other words, I am the deciding factor in how much profit I make, the decisions I make. I think that my brain has got a certain capacity for making those decisions well. If I use a lot of that brain energy and power up on the entry, then there's more likely... that when I come to make the exit decision as well, then I'm more likely to make an error.

I'm saying that you need to make those judgement calls, but I'm saying, "Okay, which areas can I make it really simple for the brain, and then which areas am I going to say, 'Right. Now I need to make an important decision?' Am I fresh and ready, and have I got the mental capacity left to make a good decision there?'"

For me, I've decided to make the entry almost, you could almost say, it's a random entry. Then the important decision, well, I'm going to have to make a good judgement call based on information and experience as well. For that, I'm still fresh and I'm ready to make that bad decision.

Walter: Right. Yeah. That makes perfect sense. I suppose the thing that I always think of, because I think you've nailed it here, the thing I always think of, along these lines about this psychological energy, is when people get out of a trade, if you're a discretionary trader and you're in a trade and then you say, "Oop, the market has given me a reason to get out," then my question is, and it seems so obvious, but a lot of traders don't think if this, why wouldn't you not reverse there?

If you had this signal that said to get out, for a lot of traders, if they were flat, that would also be a signal to get out, to reverse it, but the reason why we don't, of course, is we've expended all of this energy on the trade. As you say, the money is really made on the exit, which is so true, and anyone who questions that should just flip a coin and then apply a really good exit, a really good reward/risk ratio exit to your strategy, and just flip a coin to get in. You'll see that.

That's my question, is we spend all this money, and as you say, you're putting it in the right spot which is the exit according to your beliefs, and I agree, but why don't traders reverse when they get out of trades? If they actually get a signal that says, "Okay, the market is not going this direction anymore. It's not going up anymore. It's given me this big, dirty bearish candle," or whatever it is, then they just exit and they often don't reverse.

Darren: Yeah, I think it's to do with that mental tiredness. It's to do with the emotional reaction to taking a loss, and then to then go straight back into another difficult judgement scenario is really difficult for human beings to do. There's a really good visual experiment. If you put your bike on the side and you spin the wheel around and the spikes look like they're spinning in one direction, and then if you blink quickly and open it, they can then look like they've switched and go in the other direction.

I believe that's because the information is coming in so quickly, you know from experience that the wheel is spinning, but you can't judge from that amount of information coming in quickly which way it's spinning, so the brain just flips between the one and the other. You know it's spinning, but you can't work out which way it is spinning, so the brain just makes it up.

I think that's what happens. I look at the way a lot of traders trade, and I just think there's so many extra elements they're adding into this that really are not making any difference to the outcome. They must be expending so much thought process and energy when things don't go their way and it's an unfavorable market, and then they have a string of losses. I think how can they then take the next entry?

Obviously, there's so many different ways to trade and so many different ways to different people, but there are things that we also all have in common. One of them is the way that we deal with sensory information. If we just understand a little bit about that, I think we can actually then look at how we trade and actually write a better trading system.

We all think that a better trading system is about back-testing and see which one worked best on a certain period of time. I really don't believe in that anymore. I believe much more in it's about learning who you are as a person, and why you do the things you do, and how you react to the sensory information that you get coming in, and then building a strategy that basically allows you to operate successfully within it.

Walter: Yeah. Let me throw another element into this. What about the effect of your outside environment? In other words, other people? For example, the classic, of course, is the bubble where everybody is gung ho on something and they're all, "Buy, buy, buy, and greed, greed, greed," and then when it comes down a little bit, the general reaction is, "Ooh, great. Time to get it now. We just got a bit of a discount," and that sort of thing. Then, of course, when it collapses, everyone gives up and there's despair.

I guess the reason why I think this relates to change blindness is, Darren, we know these studies and experiments and the psychology where they sit you down in a room and you're the one subject, but you think you're in a room with several other subjects and they're all stooges. They draw the line on the blackboard and they draw a couple of lines and say, "Okay, which one is longer?"

Everyone picks the wrong one. Then by the time it's your turn, you look around at everyone else and you think, "Am I crazy or what?" and you go along with everyone else. You actually choose clearly the wrong choice because everyone else is doing it. I wonder how that interacts with change blindness.

If we're paying attention to Bloomberg TV or Sky News or whatever it is, or we're reading the business paper, or even listening to what our Forex mentor has to say, does that mean that we are even more likely to miss out on important things that pop up in the market, and specifically on our charts? Does that accentuate and magnify change blindness?

Darren: Possibly, yeah. I don't know for sure.

Walter: I guess my question is if change blindness is the fact that as humans we ignore small changes ... It's like the frog. The classic is the frog in the pot of water, and they slowly start to turn up the heat on the water, and he doesn't feel it, and he dies in the boiling pot. There's that part of it, which is we ignore small changes, and then when there's big changes, we overreact to them in the markets. Those are the 2 sides of being blind to what's happening visually, and specifically for technical traders, it's the charts.

If we've got this background of chatter, we're reading whatever website it happens to be, FXStreet or, like I said, you're watching CNBC or Sky News or whatever it is in your country, and you see everyone harping on about the Euro and the Euro, "The Euro is only going to go down," or whatever, does that mean we're going to miss that really good bullish setup on the Euro because we've got this background of chatter that primes us to take the wrong point of view?

If there's one thing we know about the markets, the large majority of participants in the markets are wrong and the highest majority are wrong, you've got these specific turning points. In other words, when the markets reach its peak, you'll find more bulls than at any other point, and when the market reaches its bottom, its trough, and it's going to bounce for them and start going up for years, that's when you'll see the largest proportion of bearers. That's what the markets are.

It's almost like the perfect storm, isn't it? If you have this underlying belief that's influenced essentially by the wrong opinions, and then you have this cognitive bias which is to miss out on the important changes around you visually, it's almost like we're set up to fail.

Darren: Yeah. Well, I suppose we are set up to fail. It's very difficult, isn't it? We've all got expectations when we trade about what the outcome is going to be, and it's very difficult to take in new information when you have these expectations. I think if you're coming from a period of, say, losing just before as well, then, yeah, it gets magnified.

Walter: Absolutely. I guess the question is what do we do? How do you combat this? What I would say is if you're concerned about this, one way to do it is to bounce it off somebody else. Somebody else that's not ... If you're in the forum or whatever and you see this on the chart, you can throw the chart up and say, "Hey, what do you think about this?" You're going to get many different opinions, and hopefully you'll see the other side of it if you can't see that.

The other thing is what about if you have an alert or something like that in your chart where your chart fires off an alert every time there's a specific signal. Let's say you trade engulfing pattern. Every time the market prints an engulfing pattern, it fires off an alert. What that means is the chart will actually hit you in the face with an alert if you get an engulfing pattern that goes against your current position. In other words, it's saying, "Hey, you should look at this. You're getting a reversal here. In other words, do you want to stay with this or do you want to get out?"

Those are a couple of things you can do, but it's one of those things where it's like how do you deal with this? If we're literally hardwired for this cognitive error, what do you do to overcome this? As I see it, you can let other people see it and see if they see the same thing, or you can, I guess, let the computers take over and automate it so that you get these alerts that say, "Hey, look. You should take a look at this." What do you think?

Darren: The way I've approached it is by the brain ... The way the brain sees stuff is by learning from past experience. If we take a sentence, a written sentence, and take labels at the side, when we look at that sentence, we can just fill in the blanks. We haven't really given it much thought because we've learned from recognizing the patterns of letters, so we know where letters are missing and where they're not missing. We can do that really simply by ... That has just come about just by repetitive learning. From learning to read. We've learned how the patterns of letters go together to make words.

With trading, what I try and do with the traders in my group is I try and teach them to remove this analysis from the entry and just take the entry no matter what. For that to work, you have to have an entry system that relies on no analysis. If there's 3 or 4 questions to answer to equal a correct entry, then that's not going to work. It needs to be very black and white.

Then they learn to deal with these biases by being methodical and just taking the entries, the simple setups for entry all of the time and not leaving any of them. It's really difficult for traders at first, but with time, you learn. You learn to learn that this can still be profitable. You remove all of that decision process from the entry. Traders get really good at it quickly.

I always notice with the traders, whenever we get a set of bar that's slightly bigger than average, I know I'm going to get 3 questions about why do I take this entry. When we do back-test then of the strategies, we take every entry because the context is different then because you're not risking any money. You haven't just been there for the last 3 days trading and had 3 losses. The context of that slightly bigger entry is different then.

It's about learning methods to eradicate those biases and the fact that we're set up to lose and being methodical. That's for me. That's how I believe trading works. I know a lot of people don't see it that way and I know other ways of trading can be equally more successful, but I really think that analysis prior to entry is a really difficult thing to learn. I think it's one of the hardest things to learn. I know it can be a really successful way to trade.

I know that we're at odds here because you use a lot of analysis before you enter, but I think for a lot of traders, that's really difficult to do, to step into a risky scenario where they've got to deal with various bits of information about what the market is going to do. Say, some price action, some higher time frame support and resistance, and other elements like that. I just think that makes it harder for the brain to deal with. I don't think it's ... It's not required. You don't have to trade that way.

Walter: Yeah, that's right, absolutely, but the question is if you have a few simple rules to qualify your entries, does it make it easier for you to believe in the trade? Another way of asking this question is what percentage of traders can actually at any given point say, "You know what? It doesn't really matter. I'm just going to get in the market now, and then I'll work on my exit." It's difficult, isn't it? You want to have this illusion of control. You need to have an illusion of control.

Darren: I think you have to change your mindset. I think a lot of traders start out with the mindset as that I'm going to be able to pick winners. You have to change that mindset to, "Okay, there's lots of opportunities here. I'm going to keep taking trades and make the best of the opportunities that go my way."

It's about making that switch in mindset of, "I'm skillful. I'm clever. I'm going to be able to pick winners," to, "You know what? I don't know what the market is going to do, but I do know it's going to go up and down and present me with opportunities. When I manage to pick an opportunity that runs, I'm going to make the best of that opportunity." It's switching from the point of entry as being the important part to when you get lucky enough that you nail one that runs for you, you're going to learn to make the best of that opportunity.

Walter: Yeah, absolutely. It gets down to the dichotomy we've talked about before, which is, do you want to be a high reward/risk ratio trader, which means you're going to lose

more often, or do you want to be a trader who feels so good about himself because he picks so many winners and has a high win rate, but that reward/risk ratio isn't really so hot? That's like what you ... but I agree.

You have to decide which side of the fence are you going to play, but the other thing is how many traders out there can trade without wanting to have that illusion of control? I know we're getting to the end of the podcast here, but I think this idea of illusion of control is probably worthy of its own episode where ...

I think what you're saying, Darren, is you're highlighting one of the ... It's another cognitive bias, really, which is that we feel like ... It's like when you pick your lotto numbers. Okay, a lot of people will go and play lotto, which is a tax on people who weren't good at statistics. We know that's what the lotto is. Your odds of winning are virtually nil, but of you don't play, there's no way you'll win.

People who feel like if they pick their lucky numbers, they have a better chance of winning, versus those people who just let the computer pick it for them. It's like what you're talking about here at training where do we feel like we have to have some control over when and why we get into the market? I would argue that most traders do. Most traders do have that, that need for an illusion of control.

Darren: I'd say about 95%.

Walter: Yeah, exactly. Exactly.

Darren: Yeah, I think so. Yeah. We want to know why and we want to know that we have somehow this control over the market. I'm at odds with so much of the thinking about trading. For me, I'm going to say the gambling word where I know we've got different opinion on this. I think the outcomes is uncertain, so you're risking money on an uncertain outcome. You're gambling.

The other one I like to use is luck and chance as well. Whenever I see this mentioned, I see traders get really angry about it. "Oh, well, if you're relying on luck and chance, then you're going to lose all your money." Well, let's say you traded in a completely structured, technical way and you won 65% of your trades. How can you prove that luck and chance was not at play in that test period? You can't. If you're always stuck in this zone of not really knowing, then why not just stop fighting against it, and go with it, and basically simplify your trading, and reduce the pain?

Walter: Yeah, because you don't have any say in the issue. You're not to blame, are you?

Darren: No. If you listen to a lot of traders who have been very successful, what do they talk about? Well, they always talk about the one thing you can't control is your risk, and that's because they've accepted that they can't control how much profit they're going

to make year in and year out. A lot of that is market-dependent. There's luck and chance involved as well. They know that really the only thing they've got a handle on is their risk and how much they're going to continue to risk on their trades.

Walter: Yeah, absolutely. I think what you're saying brings up another point, which is the distinction between an advanced or an experienced trader versus a newbie trader. What you're saying is the experienced trader basically says, "Well, it depends on whether the market presents an opportunity or it depends on the market conditions, how this month, this year, this week is going to go for me," whereas the newbie trader is looking at, "Well, I really need to trade the lower time frames because I need to maximize my trades."

They're looking at, "Let's inflate my account to billionaire status as quickly as possible." They're looking at it from almost like a mechanical thing. "Well, if I take 20 trades a day and I do this over the course of 3 years, then I'm going to hit my goal of this, this, and that." That sort of thing. I don't think the experienced traders look at it that way.

Darren: I think they're making assumptions on what they've learned from some past data and they've said, "Well, okay. Well, if I went down to the 5-minute on high market that's been moving recently, I would have made all this money," but the problem is then they make the decision or assumption that that's going to continue. Then when the market condition changes, they don't notice that change, and then they lose all their money. Then they think, "Oh, well, actually, I should have gone with a wider stop." They're forever just making assumptions on what's just happened, the information that they recently learned.

Walter: Yeah. Absolutely. That's probably something we should talk about, is just this idea of what do traders do when the market changes, or even just changing your time frame and adjusting how you approach your trading. You're a 4-hour trader and, like you say, a lot of these traders say, "Oh, well, this works good in the 4-hour. I might as well trade it on the 5-minute. This is going to be so much better for me." Maybe not for a number of reasons. Okay, so to wrap up, Darren, what are we going to do about this change blindness? You're saying there is some way for us to basically counteract it or in some way help us to overcome this problem.

Darren: Well, yeah, I think so. I think all of these problems come back to how we deal with decisions in uncertain and stressful environments, but your core mindset about what the market is and how it works is going to be important in this as well. I go down the route of removing as many decisions as possible.

I would perhaps suggest for traders who don't necessarily want to trade how I trade, have a look at how you're trading and the elements that you think are important. Perhaps list them down, the elements that you think are important that are making a

difference to your bottom line and how much profit you are. Then just spend a little bit of time and see how many of those that you could actually do away with and not make any difference to your outcome. I'd be surprised if there isn't a few traders out there that can find that basically they're adding in stuff that's not needed.

Walter: Yeah. Absolutely. I would suggest perhaps you can learn a lot from a different perspective. Maybe if you're concerned that you're missing out something, post a chart. Let someone else give you their point of view, or make it a habit. Make it a habit. Before you get out of a trade, send your chart to your trading buddy and see what they say. Don't tell them whether you're long or short. Just say, "What do you think about this chart?"

These sorts of things, because we can obviously prime someone by the way that we ask the question, so maybe in these ways you can highlight some of your change blindness as well and what you're possibly missing. Yeah, good session, Darren. I look forward to next time. I guess next time, is it all right if we jump into talking about traders and the changing markets and how traders deal with changing markets?

Darren: Yeah. That sounds cool, Walter.

Walter: Okay, great. See you, Darren.

Darren: Cool. Cheers. Bye.