EP62: Risk Assessment

Darren: Whenever you have perceived risk, you should then be able to compare that to the actual risk before you make your decisions because, generally, we are pretty poor in perceiving the actual risk...

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. It's Walter here. Hello, Darren. How are you?

Darren: I am very good, Walter. Just relaxing.

Walter: Yes, you are. I am jealous. It's cold where I am at. I know it's really nice and tropical where you are. So, let's talk about this, Darren. We we're thinking about risk just before we turn on the recording here and talking about risk can how sometimes, we don't really rationally assess the situation.

I was talking about the idea that a lot of surfers, a lot of surfing friends I have, they'll start talking about shark attacks particularly when there are a few sharks sighted or shark attacks in a certain area. They'll say "Oh, that area is sharky. I don't want to surf there." Or, "It's quite sharky right now. I don't think I will."

These thoughts pop into your head which is not really that rational because, looking at the true odds, if you're waiting to cross the street and go to the beach and going to jump in the water, the odds are that you are probably more likely die crossing the streets.

Crosswalk or no cross walk than for you to have any encounter with the shark or anything like that. I found it fascinating how we -- and we all -- succumb to this but, we all have this problem assessing risk and I just would like to get your thoughts on this.

Darren: We are completely irrational. The strange thing is we are all fully aware of -- talking about crossing the street -- we're all aware that we are much more likely to die in a car than you are on the plane but the fear of traveling by plane is much more prevalent than traveling in the car.

We've got this information but we seem to discount it and I think that goes on a lot with trading. What people perceive as being risky, if you look at the facts, isn't. One of the example is having a wider stop. It's instantly presumed that the more pips you are risking on a trade, the more risky it is.

You are basically discounting the win rate in that assumption because, at the same time, we know that if you put your stop farther away from price, it is less likely to be hit. There's a balance on the effect with the win rate but we seem to discount that. Obviously, it is a cognitive bias because we all suffer from it. If you do not address it, then you're not really assessing risk with your trading and I think that's the problem that a lot of traders have.

Walter: Thinking about this then, what is the bottom line? If I ask a trader unable to really assess the true risk, this means a couple of things, right? A couple of things bring to mind. It means that I'm probably not going to be very good at figuring out the likelihood of certain scenarios because I overestimate some and underestimate others.

Darren: Yup. And I think there's a problem with position sizing, as well, because when I decide on my position sizing, I decide it on the loses that I've actually taken. I look at my loses and base my position size on that. I don't see a lot of traders doing that.

Walter: Right. Let's say, you look back and you say "Well, over the last two years my average loser has been... -- let's say, for example -- a hundred and fifty pips". Is that how you look at or you don't look at it in dollars? You look at pips, right? So you say "My average loss is a hundred fifty pips" or something like that?

Darren: Yeah. I mean you can look at it in monetary value, as well. If you are more cautious, you could look at your worst loss over a period -- say, your worst loss in your last year of trading was a thousand dollars. Say, then, you can set your position size and so if you repeat that worst loss then, that's the most that you're going to lose.

I think that's a more realistic way of working at your position size. I'm not saying it's the only way that will work but, for me, that is more logical.

Walter: Right. But does it mean then, if you have a loss -- if the next trade you take is a loss -- does that necessarily mean that it should be equal to the largest loss you've had in x amount of time? Or, is it just that that's the ultimate line in the sand that you draw? Do you see what I mean?

Darren: No. What I'm saying is this was the worst my system performed in the last year. I'm presuming it's unlikely that that is going to happen again. If it does, then I know this is the most I am going to lose and then I can decide, well, what is the most uncomfortable with losing and set my position size accordingly.

Now, the advantage of that is, in theory, your worst loss should be in a much greater than your average loss. If you have average losing week, it'll be less than the most you are prepared to lose in that week so kind of airing in the side of caution in that way.

Walter: Absolutely. But, the other side of that is depending on the amount of the volume of trades, the number of attempts, the number of trades you've take that you may underestimate your worst loss. In other words, you might have a future loss that is going to be greater than that largest loss, obviously. Right?

Darren: Yes, that is entirely possible but all you can really work on if you are going to work on data is the facts that you have to hand. Ideally, you've had a longer trading history to look at how your system really performs in the long run.

Obviously, unexpected things can happen and you could have a much worst week. In general, really, your trading should show some consistency and it shouldn't be wildly or all over it sharp**.** If it is not really consistent over a long run period of time then, you're probably making mistake on other areas, or it might just be that you've got your money management wrong in other areas.

Generally, what I see in my trading history is fairly consistent results whether they'd be losing weeks or profitable weeks. Possibly depending on how you trade, that might be different. For instance, your style of trading where you waiting for specific set ups: you might not have many trades in that week like you say whereas, my strategy, generally, generates the same amount of trades each week.

Walter: Yeah.

Darren: Roughly.

Walter: Yeah. Definitely!

Darren: But, the important point is that when I'm looking at the risk rather than a perceived risk I'm saying, "Well, what has happened so far?" That is the actual facts of me trading the system and I'm better to base my risk assessment on that than some assumption of what is going to happen.

Walter: This is fascinating. I am a big fan of taking the data that you pull out of the forex tester or whatever, simulating all you want because you can get a lot more data than... Especially if I am a new trader, what do I do?

I can go on the forex tester and I can pound a thousand trades. I can look at that and eyeball and go "Well, my worst loss looks like this. Maybe I can double that" and just kind of say maybe I'll have one twice as bad as that at two hundred percent of what that is and I can work out of that if I want to be really conservative. The same thing with drawdowns and things like that.

But, would you recommend doing that? I mean is that something that you'll recommend or you will just say "No, stick to the only real data that you have".

Darren: No. I would say that's definitely stage one. But then, as you go forward and you're actually trading the system live, then you should be continually reassess in that. Taking another look at your risk because if we ever repeated the same performance live as we do in backtesting because, really, then we're saying that there is not going to be any human error. That's not going to be any different emotions involved.

I think we can all agree that when you actually trade the system, what you're trying to do is get as close to your backtest performance as you can but we all know that's slightly unrealistic and because a lot of over practice is involved when you are trading live.

Walter: Absolutely,. What about gaps? If somebody is trading a system where they hold the position over the weekend which I'm guessing, in most cases, you wouldn't do the way that you trade is that. Right?

Darren: Sometimes, sometimes not. It depends on the time.

Walter: Okay. Right, fair enough. Because that's the big one that people come up with and so some people -- I find this, really to me, it's kind of backwards but I'll be interested in your take -- people will come up to me and they'll say "Hey, I don't really like holding daily chart trades" -- or, four-hour, eight-hour, weekly or whatever it is -- "because I've got a hold it over the weekend and the market make up on me when the market opens up again on Sunday or Monday" -- depending on where you at Sunday or Monday.

I think that's really crazy because the flipside of that is "Okay, maybe I should be trading the five-minute charts so I can be in and out and close my computer down and be flat at the end of the day, every single day".

The funny thing about that, to me is, If I am in a five-minute chart trade and some crazy news comes out. Somebody wins an election -- it was unexpected to win -- or someone is assassinated, or the Swiss National Bank decides they are not going to try weaken the CHF anymore, or tsunami hits Japan. Pick your poison, right?

Something like that comes out and then the market really moves, surprise interest rates decision or whatever. I can get slipped massively on my stop, on my five-minute chart trade by magnitudes of ten. I might have a ten pips stop and I can get slipped and lose twenty two pips on that trade instead of ten or something like that.

To me, the reason why I think that's crazy is because if I have weekly chart trade or my stop loss is four hundred and seventy-five pips away and I go into the weekend where the stop loss is -- let's say, I'm in the drawdown and I'm only three hundred pips away from my stop loss. The chances of the market gapping three hundred pips and even if it does, I'm still just going to get out of it about what I had risk anyway. Do you know what I mean?

To me, the idea that you can reduce your risk by getting in and out the market and being flat everyday is a little bit crazy because you're in the market with, essentially, in those trades that you're in, you have a lot riding on those. If the market really moves quickly, you may not get hit at your stop. It may go, it may spread and widen, all kinds of crazy things can happen. To me, it's a little bit weird that people think that way.

Darren: Maybe it's more a feeling of lack of control because of your positions in the market and you cannot really manage that trade. The only issue with it is if your broker does not honor your stops, if it gaps partial stops is the only thing really to be afraid of. Essentially, you are just holding a trade for two days and if you are trading the higher timeframes then that wouldn't be particularly unusual, anyway.

I guess being in that fear, I am not sure if my broker does honor stops if they gap and because it's does not usually come out on me. Again, people are irrational about fear. One snap of fear is out there and when it's talked about it becomes like a justified fear, as well.

You see it commonly on forums and then the rumor becomes truth because it's just been repeated so many times. I see it with concerns about brokers, as well. You know, I've traded for ten years, I think there's been one incident where I've had sort of reasonably large slippage.

Other than that, my broker has been fine, I've had no issues with them and I can take my money out when I want to. I'm not saying be flipping about picking brokers but, again, it's like it's a risk, going to feel as it seems to be over inflated by people just talking about it.

Walter: I believe what it comes down to is the "availability heuristic" which is this idea that when something you've heard about: "It's so-and-so slipped at in that broker so I'm not going to go and put my money with that broker"; or, "Somebody I know had an account here and then that broker shutdown and he lost all of his money".

Those things, those kind of stories float around and people freak out. It's hard, I think today, to find a broker -- there are few that will guarantee stops but most of them -- I believe, will tell you that they can't guarantee the stop and there are few, some of them, I think you have to pay more too.

Darren: I think you pay a widest part, don't you? To have a guaranteed stop and I did see somewhere someone did some sort of intense testing of it and they've found out by the time you're added up or you've actually paid, you're actually worse than just going with the regular broker contract.

Walter: Exactly. Well, it's insurance, isn't it? I mean, in the end you're probably better off in most cases not buying the insurance and then whenever the issue comes up, you have to pay. Right? Whatever kind of insurance it is but, people feel safe if they have the insurance that's exactly the same.

This is something that's interesting to me and I wonder what you think about this. There are some studies about this idea that when you're thinking about the likelihood of an event, if there's some recent information, then you use that. That's the "availability heuristic",right? That's what they called in psychology.

Basically, it just means, for example: if you're deciding whether to buy a stock, you just base your information of what you've heard recently about that company, you don't care about anything else. You just think "Well, it sounds like Apple is doing really well and they have sold a lot of iphone twenty-sevens, so I'm going to buy Apple stock" or whatever it is.

The same thing happens when people who remember the -- I don't know if they have this in the U.K, Darren, but in the United States they had this advertisements for drugs. So you can be sitting, watching tv and you're watching Seinfeld or whatever, Friends or whatever, and some tv show -- I don't watch that tv -- or the Modern Family or something like that -- and then, the ads will come up for like anti-depressants.

So, you're supposed to go to your doctor and tell your doctor I really want this antidepressants. But, they've done studies where people who can remember seeing antidepressant advertising, they are more likely to overestimate the prevalence of depression.

People who don't remember seeing antidepressant medication ads on tv or magazines or whatever, they won't necessarily overestimate the number of people who are walking around depressed.

I find that fascinating that this kind of thing operates. In other words, what I'm saying, Darren, is that depending on your point of view and the information that you're aware of that's going to determine how you make your decisions based on risk. What does that mean for the trader? I guess that's my question: what does this mean for the trader?

Darren: This is why I like to look at the worst case scenario because when it hasn't happened very often, so there is a low occurrence rate too. You decide what is the most you want to lose. If the worst case scenario happens, you've kind of max out your risk already and I think too many people look at "Okay, this is my average winning week. How much do I want to make?"

They're just looking at the best outcome and then, obviously, when you have periods of drawdown or a particularly bad week, it hits you psychologically and financially, hits you much more severely. That's just the way I look at it and, the same when, it comes to the actual position size of your entry.

If I have a widest stop, I still continue using the same position size because, in my mind, there's less chance the real risk has been stop out on that widest stop. If there's a less chance of that occurring than a tight stop then that balance is at the fact that I'm actually risking more money on the stop out.

To me, that's logical. Why would you risk exactly the same position size on something which is less likely to be stop out? It's like you're discounting one of the most important parts of the equation. To me, that's doesn't make sense.

I know that a way of always risking the same percentage of your account does work but, in my mind, I can't get comfortable with that notion because I'm thinking about the different win rates.

Walter: Totally. What you're saying is, basically, the disadvantage of risking the same amount per trade because the stop placement is different in, let's say, pips. Right?

Darren: Yeah.

Walter: So, the dollar amount at risk is the same but the pip placement is different. That means it maybe a hundred and eighty pips away from the entry price or maybe fifty pips away from the entry price.

Darren: Yeah.

Walter: And those two trades, theoretically, would have different win rates even if it's, essentially, the same reason why you're getting in. It does not really matter. The fact is, you are only fifty pips away from your current price, your entry price. The other one, you're a hundred and eighty pips away, so over three times farther away. So you're saying that's got a higher win rate.

Traders listening to this are going to say "Yes, but the advantage is: yes, you've got a very small likelihood that if I have this stop really far away. It's going to get hit but, when it does, it strikes the account".

It's a real body blow to the account. I mean, that's a big chunk that if you are risking a lot, if you are risking more relatively because you say "Well, it's unlikely to hit". Then when it does, that takes the real buy out of the account, I guess. Right?

Darren: Well, yeah. But again I think you're being irrational about the fear because you should've first set your position size based on a long period of trading history. Looking at groups of trades to set your position size and if you are just focusing on that individual trade, it will appear significant. If I'm looking at my performance over a thousand trades and setting my risk based on that, that one loss shouldn't be significant.

Walter: That's right, it shouldn't. It would only be significant, of course if it, piles up. If you get and they all happened sequentially, right? That's when traders start to change, that's when they change their game.

Darren: Yeah, and that's like a perfect storm. The thing is, you can't avoid that just by adjusting your strategy on your risk because, sooner or later, there is going to be particularly an extended period of particularly bad market movements for your strategy. Throwing a bit of a bad luck and trading error, as well, you are going to have a really bad period at some point in your trading history.

The way I look at it, I've set my position size probably on the weeks that that happened because I'm looking at "Okay, what was the absolutely worst week". Generally, be probably twice as bad as my average losing weeks so I feel like I'm setting my position size on those really horrendous weeks where nothing work and, for me, that is sensible.

Walter: Okay, fair enough. Here is what I think traders should focus in on, I am not saying this is the only way to do it, but I think this is smart. You are, essentially, the one in control here with your position sizing and your risk management because you can say "Looks like I've got about a sixty-five percent win rate with this system".So, based on that, I can look and see what are the chances that there is a likelihood that I am going to have seven losers in a row.

This all comes down to probability theory. If you want to throw out the probability theory and say it's useless or whatever, that's fine but it seems to work pretty well for the casinos. You know what I mean?

What I am saying is instead of people freaking out going "Oh my God! I have a thirty percent drawdown, what is going on with the market?"; "The markets have changed, the system does not work, I've got to find something else. This is crazy. What am I going to do? Lost my life savings"; or whatever.

What you should really be doing is when you get into the game, in the beginning you say "Okay, now what is it that I want to avoid? I want to avoid a twenty percent drawdown. That's the goal."

"Okay what is my win rate? Alright, I've got that." So, now, what is the likelihood of x number of losing trades in a row based on that win rate? You can work backwards from there and you can decide what you want to risk.

That will help you avoid that twenty percent drawdown. It does not mean that you are not going to have it because, of course, you might. But, you can reduce the odds if you approach it that way.

So pat calls on that theory. What is wrong with that? I am sure you have an interesting take on that.

Darren: I don't think there is anything wrong with that at all. That is being rational about risk. Basically, what we are saying here is there is one more way to be rational about risk in trading. At the same time, as humans we are naturally -- because of biases -- pretty irrational about risk.

Be aware of that and, perhaps, consider there's small ways where we sometimes perceive a certain elements to be very risky. Just use the same rational process to go through that, see if you are being irrational.

I think people, they instantly jump to conclusions like, say when they get... Let's say you normally trade the NFT with your strategy and you trade it the last one and it worked out particularly badly.

In the next one, you are naturally going to think that trading the NFT all the time is a bad idea. At the same time, you may have done, say, two years of backtesting, paid no attention to the NFT at all and have a positive expectancy.

There are more than a single way to rationally plan risk in trading but be aware that there is going to be a lot of occasions where you can completely overestimate the risk and make assumptions.

Walter: When you say "overestimate the risk" is that that you overestimate the likelihood of something bad happening? Or, what do you mean?

Darren: Yes. Like you were saying, because the last time it occurred the outcome was bad you will instantly assume that that is consistent and it'll always be bad even though you may have data that you know about that says it's actually okay to trade through the NFT.

Walter: Exactly. And they've done studies with people and they say if someone can remember buying something really cheap at a store, then they can easily remember, like buying the Harry Potter book. Harry Potter Seven came out and I remember buying it for only $19 over that store and what they'll say is everything is cheap at that store. You know what I mean?

It was like you can paint anything with one brush. Same thing with our trading. It's not only risk that is part of this problem for us because, like you said, we really have this poor trade and we really lost a lot of money and we think that that is what is going to happen in the future but we do this with our trading too.

Where you go "Well, wow, that trade just barely miss the profit target", and then it came back and it end up a loser so next time that happens, "I'll just pull the plug on the trade even though it does not hit my profit target."

Those sort of things when you are trading the last trade. I think, people get into trouble when they do that. It does not have to be necessarily just risk. This sort of judgement error comes into play in a lot of different aspects of trading and in life, in general.

Darren: I think you have to with anything you consider by your trading, is that like the perceived risk and the actual risk. Both comes with variants over time but you should really be making -- whenever you have a perceived risk -- you should then compare that to the actual risk before you make your decisions. Generally, we are pretty poor in perceiving actual risk.

Walter: Absolutely. It usually boils down to what comes to mind because if it comes to mind, and then it is more likely. If it does not come to mind, then maybe it is not so likely. I cannot remember the last time I was concerned about a tornado but I have not lived anywhere where tornados are very... They are not big news, they do not just happen that often.

Whereas, some people are concerned about... If you live in South Africa, maybe you are concerned about getting cardiac every single time you get into your car because it is something that happens. It is something that is known, it is in the news, people know about it. They trick out their cars with flame throwers at the back, down underneath the car and stuff like that. Like, they've got these Batman cars, you know,

where they've got like knives, flame throwers. Yeah, they do. That is actually like a real thing. It gets crazy. That is something top of mind in that place and in other places it is not.

To me, it boils down to anticipating the worst with your trading and planning around that so that you can try and avoid that. Like exactly what you are doing which is in a different way and being aware of the fact that just because it's top of mind, doesn't mean it is more likely. That is my main message, I guess, for this episode.

Darren: You could also argue that the way I decide my risk, well, it might be that I am lazy and I do not want have to work out the correct position size for each trade all of the time. I tend to try and reduce the decision I have to make when I trade as much as possible. That might be why I decided to work out my risk that way.

Walter: Do you ever think -- like for example, when you have a bad loser -- do you ever think... You never second-guess yourself?

Darren: No. I do find myself sometimes thinking maybe I should just only take the trades where there are small bars and -- you get that impression. It takes five minutes to get back to the chart to realize that it is just wrong assumption and it is fear and you are overestimating the risk.

Most obvious ones is big bars just compare large pin bars performance to small pin bar performance. You'll see that there is a distinct difference in the win rate but, will instantly perceive that the large pin bar carries more risk.
I think the problem with that is also how some people decide on their exit. I mean, if you are going for multiple bar based on your risk, if you have a very large bar, then price has to travel much farther to get. Say, you trade a set three-hour risk/reward, if you have a twenty pip pin bar then a sixty pip movement seems more achievable.

Whereas, the way I trade, sixty pip win on either of the size stop would be equal the same amount of profit. It is just a different way of moving the pieces around.

Walter: I've really enjoyed the discussion, Darren, and I hope that the listeners have as well and I really appreciate it. Looking forward to speaking with you next time.

Darren: Okay. Thanks, Walter. See you soon.