2 TRADERS

EP73: The Theory of Everything

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Walter: If you want to be good at this, typically, what you have to do is put that to the side and just execute and keep executing and then come up for air every so often and have a look. "How am I doing?"...

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. Good day, Darren. How are you today?

Darren: Hi, Walter. How are you doing?

Walter: Great! Darren, I have this weird idea and I am really interested to see where this goes. I have this theory, I have been thinking about it for, I do not know, three years? Three or four years now and I am still trying to punch holes on this theory and I cannot come up with any which probably means that, of course, I am locked in confirmation bias or one of those cognitive biases that we are so aware of but I would love to get your thoughts on these and obviously apply it to trading.

Here is my "Theory of Everything". My Theory of Everything goes something like this: every single disagreement, war, conflict, or issue you've had in your life is essentially due to one thing and that one thing is that you want someone else, something else, to do something that they do not do.

You are, basically, putting your expectations on others whether that be as a country or President. Putting your expectation on another leader or another country or whatever; a spouse, a relative, an employee, a friend.

You put those expectations, you want them to do something and they do not do it that is why you end up with all of these conflicts and issues. The solution, of course, to this is to somehow disengage and allow others in your life to have freedom to choose what they want to do, which sounds funny and obvious, but we never do that and that is my belief.

In essence, if everyone were able to do that, just let go, then what you would see is people would get along more. There wouldn't be as many arguments, there wouldn't be any issues.

In fact, as the theory goes, it wouldn't be any at all. Now, some of you listening may think "Well, if there aren't any expectations or responsibilities or anything like that but you would also have ultimate chaos".

I can see where you could say that like if there were no laws or rules, policemen or whatever, making sure that people were doing what we want them to do. I know and I understand that.

The context is if you have these idea that this is the Theory of Everything and every conflict, pain and suffering has come from this, then how is that apply to trading? That is the jumping off point, Darren. I'd love to get your thoughts on this idea.

Darren: Sounds a little bit like Buddhism, really, to me. Sounds like this notion that what you want the most is what gives you the most pain in the end. The outcome you desire the most is not necessarily going to be the best for you.

Can you give me your view in terms of trading first because I am a little bit confused where to put it in terms of trading? What is your view with trading?

Walter: Absolutely. The Buddhism thing, obviously, I knew that will probably come up. One of the things that you find when you dig into Western interpretation of Buddhism is you'll see people talk about this idea of non-attachment which is typically meant or applied to the physical world. If you dig into the standard Buddhism teaching, you'll see that it applies to everything. It is not just physical things.

Typically, if you'll look at these stuff up, this idea of non-attachment, because that is one of the things I thought about. I studied religion a lot when I went to University in my 20's and did a Degree in Religion just because I wanted.

I felt like it is good to be well-rounded and see where everyone else's is coming from in the world and, obviously, this idea of non-attachment comes really close to what I am talking about.

Some people would say that it is exactly that, that is no different. They are saying "What you were saying, Walter, is to practice non-attachment". Fair enough, that is cool if people want to do that. I think when it comes to trading, it is a little bit different because one of the driving factors for most traders is that they want to get from where they are today to some place different.

I suppose you could say that about everything. What are the driving factors for students at Universities? They are at some place now, they want to get some place different with the degree. In theory, they think that the degree will get them there.

For traders, whether that is a big pile of money, or some time off, or freedom from your job or whatever it is -- a little bit of work instead of a lot of work when you divide up your hours of the day, whatever it is. Traders are after something different from what they have.

There is a striving for something, that is my belief. If you are able to practice this idea -- will call it non-attachment -- which I think, if you dig into Buddhism, they apply it to more than just the material things. They also apply to what I am talking about which is just, basically, your expectations for others. Let's talk about this, what would you do as a trader? You would probably have practice non-attachment for the next trade. You do not care what the next trade does.

You also might practice non-attachment for your trading account. Do you really care what your trading account equity curve looks like? Does this means that you are going to take wild risks?

Not necessarily but, you might not freak out if you are at 9% drawdown. If you were to practice non-attachment for your trading career, then maybe you have no expectations for what is going to happen between now, in three years from now, or in ten years from now.

Are you going to get any better at this? In other words, you are just focusing on the task at hand and not really looking farther than that. That might sound weird to people who set goals and have all these Western ideals of "If you want to get someplace, you've got to do this... This and that", sort of a logical fashion.

I think that is an interesting way to approach trading because, in essence, what you should be doing is just focusing on the moment, sort of a really chopping wood for the sake of chopping wood type of way and focusing on the execution of your trade.

You are not worried about what is going to happen in four hours now, four days from now, when you find out what this trade ends up. Is it a loser, a winner, a break even? Do you get slipped? Do you pay a lot of swap? Those sorts of things.

That is one way that you could apply this to trading. Does that make sense?

Darren: Yeah, I am with you a bit now. I am thinking along these lines of what we expect from the market. We quite often plan how are we going to trade and how realistic expectations from the market but when you are actually in the moment, all of a sudden our subconscious expectations take over. They tend to be unrealistic and not really in line with what you are really going to experience.

As an example, you could backtest or trade a system and know what your win rate was and your drawdowns but what you are really experiencing in them. On a subconscious level, you are expecting to, somehow, the results to be much better than they really are going to be and dealing with that in the moment can be an issue.

I like that idea about chopping wood. It's like that. You've kind of blank that off the stuff out although you can't really because it is all part of the process. All of the decisions you were making, you rely on emotions to make those decisions.

There is also that expectations of ourselves, I suppose, rather than others or the market. I think, generally, we all view ourselves as being perhaps more skilled or somehow more of a winner than the market has ever going to let us be.

That is an issue, as well. I see a lot of people in trading who are highly skilled, successful people, well educated, well read, and I think that their expectations of themselves can sometimes be a little bit unrealistic as well.

With other people, I think that is really -- we are talking about the market here, aren't we? Rather than other traders -- and certainly keeping those expectations in line is really difficult to do. It is certainly a problem for me and every traders that I worked with.

Walter: You touched on a great point. I think that being successful in other areas or being "highly intelligent" or whatever, or accomplished, I don't think that'll worked. I think that is a negative.

I really do for traders, and the reasons why I think that is a negative, there's a couple of reasons. Number one is if you were really successful in business, sometimes the way that you do that is you are just completely ruthless and you just want to destroy and win, win, win, do whatever to do that.

I do not think that necessarily translates well in the trading arena. I think learning to lose and learning when to walk away is critical. For some people who are used to just that tenacious kind of crush the competition sort of thing, that ends up translating as adding to losers or changing your position size after several losers and to try and make that all back in Martingale style.

Those characteristics works against you as a trader. I know a guy who is really a successful -- a good friend -- who is really a successful businessman by any standard. He's succeeded in multiple arenas and he keeps pressuring me to help him trade.

I finally relent it but we'll see how it goes because I do not necessarily think that being someone who is been able to do well in other areas means you are going to be a good trader.

There is a really good study done by Ralph Vince. Those of you who are familiar with the money management stuff in trading know exactly who Ralph Vince is. He's written those books on "Optimal F" and things like that.

Supposedly, Larry Williams... When Larry Williams won a bunch of trading contests, he hired Ralph Vince to help him figure out the position sizing and the whole risk management for his trading accounts.

Now, Ralph Vince got to study where he got forty Ph.D.s. They weren't Ph.D.s in Statistics or Mathematics or anything like that. They were Ph.D. students in different areas and he gave them, basically, this trading game and they were trying to make money with the $10,000 account.

Any guesses as to how many of them actually made money after the game was over?

Darren: 5%?

Walter: Less, yeah. Well, let's see, 2 out of 40. What's 2 out of 40? That's a ...

Darren: Half of a percent.

Walter: I think that is 5% because 10% will be 4 right?

Darren: Yeah, 5%.

Walter: Yeah, it is 5%. You nailed it. That is exactly right.

Darren: So, it's true what they say.

Walter: It's so true. It's so fascinating that these people who, in theory, who should be able to work it out, they are smart people. In other words, it's crazy that the turtles were able to make money and then these Ph.D.s was a complete wash out.

2 out of the 40 made money so, to bring your point home, that's basically it. I agree. I think that having success in other area does not necessarily translate. I think that wanting to win, doing everything and trying to win at all cost, really hurts you.

I think that those who aren't intelligent -- hopefully this bolts well for me -- those people who aren't necessarily intelligent, they are going to do better than those people who are highly intelligent who probably have a little bit too much confidence and think that they can "work this stuff out", this trading stuff out.

It is an interesting thought about this idea of just focusing on just the process, just chopping wood in order to get to where you want to go. You are not really focusing on the process, you are focusing on the actual execution.

Darren: That is obviously something that happens in the moment because how many times have we heard someone say "I backtest the system, these are the results and everything looks easy". A week later, somehow, the system does not work anymore because they had a losing week.

There is something that happens in the execution phase where the expectations get jumbled up. It's like the subconscious expectations take over from all of the study and fact and hard work that they've put in beforehand. Somehow, that gets driven aside.

All those research suggests that it is emotions, basically, of course that difficulty. I think, also, that's like a timeframe for trading that needs to play out. It's like you need to go over a certain period of time before the actual expectations from your process start to take over those subconscious expectations.

You need the bulls to work through that and I think you need to fail a lot of times, almost get to the point where you've run out of things to try. Just stubbornly force yourself through that barrier and then you can start building these -- I think they call it the plasticity of the brain where you start to learn a different habit but you need to force yourself to learn these different habits.

Slowly but surely, it gets easier to reduce those mistakes that you were making in the execution. I cannot think of a better way to describe it, really, but it is almost like you say. You just have to say "Right, I am just going to put my head down and chop wood, not look at the profit and loss for a while". Slowly but surely, you can see things working out.

It is because trading systems need to play out over a longer period before you can see the realistic expectations and then they start to match with what you saw in the backtesting.

Something happens to us before we get to that stage where it gets too much and then we have to sabotage and get out of the scenario and start again. It is weird. It's like we get right to the finish line, we blow up before we could start to build those different habits and different ways of dealing with the loses if we like.

Walter: That sounds familiar with people who are unfortunately stuck in some sort of addiction, doesn't it? If you are addicted to something like, take for me, it's always been ice cream but for other people it could be cocaine or cigarettes or something like that.

It's almost like you've got to hit that rock bottom and then you claw yourself out of it and go "Okay, I am not going to be an alcoholic anymore" or whatever it is. That sort of thing.

Darren: You've got to think with ice cream, haven't you?

Walter: Yeah, I have. To be honest, it's been three months. I am feeling like I've hit rock bottom, Darren, so I do not know. It's been three months, that's the thing. You look at some of these traders in the Market Wizards and, rarely, I think there is only one there. I remember one trader I've ever heard of who basically made money from the get-go. Two, actually, two that I know of.

Most of them have these horror stories of risking too much. What you were talking about earlier about chopping wood, about execution, about putting your head down, I think that is much easier if you have a slightly less aggressive target.

If you look at sort of -- and we could probably do a whole podcast on this -- idea of your money management, how you approach risk in your trading is, essentially, a glimpse into what you are trying to achieve with your trading.

If somebody is trying to achieve something spectacular, they'd grip them. It's a great appetite for risk and that might make it more difficult for them to put their head down and chop wood.

I think your point about chopping wood is a great one, Darren. And when you look at trading, one of the things that -- one sort of filter -- that you can look at trading through is that our money management, our risk management on our trading accounts offers a window into what we are trying to achieve as a trader.

In other words, you could argue -- we could probably do a whole podcast on this -- which is your risk management rules are, essentially, your trading goals defined. I know it is an extreme point but I do believe it to be true.

What you are saying here is if someone is chopping wood and just puts their head down and really focuses on the execution, which I believe is the key to successful trading, is to really make that your goal and your focus. That person can do that if they have less aggressive goals for their trading.

In other words, their risk management is somewhat obtained. Now, somebody who has aggressive risk management system or rules in place, they are going to feel those drawdowns.

They are going to feel those losing streaks more and they are going to possibly give up sooner. That is the way I see this. There is that interplay between the execution and your risk management.

If you do not have that risk management right, what ends up happening is it basically takes your eyes off the ball -- to use a baseball term. You are not focusing on what is important because that risk management keeps getting you messed up.

If you are risking 4% per trade and you keep having these losers, I'll send you down 22% and you are freaking out. This is the sort of thing I think you might have a perfect trading system for you and you might have everything in place and you might say "Yup, I am going to focus on execution. I am going to put my head down, I am not going to take a breather until I put 50 trades in my account and see what happens from there".

One of the issues with that is if your risk management is wrong and it is too aggressive for your tolerance, for drawdowns and all of that, then you're never going to get to 50 trades. You are going to give up before that.

That is one thing that I notice in other traders. Working with other traders, if they do not get that piece right, they get everything else right and they can basically ruin it for themselves because they do not understand what they are doing by being too aggressive with their goals, which is basically translating into risking too much.

Darren: Are you saying that it is a money thing or is it the relative size of the loss? Is it because they are uncomfortable about the amount of money that they are losing? They are uncomfortable with those figures or is it just losing per se?

Walter: I think it is the amount. In other words, two traders are trading the same systems and executing the same trades. Let's say exactly the same, which is never going to happen, but let's say it is happening. One trader is risking three quarters of one percent and then another trader is risking three percent.

What happens is the guy who is risking three quarters of one percent, he runs into a 7.5% drawdown. The guy who is risking 3% per trade, he runs into a 30% drawdown. So now, what happens?

The guy in the 30% drawdown says "The market has changed, the system does not work anymore, this sucks. I can't get this trading right." He threw his arms up and he goes back to the drawing board.

Whereas, the guy who is in the 7.5% drawdown is able to dig out of that and ends up positive on the month or the year or whatever. That is how I see it. People get too aggressive with their trading goals and that's translate into risk management and that means that they are not able to execute.

Darren: So, really the advice is we should really stay as small as possible to build that long term memories of executing something over a period of time and see the results of that before increasing our size because then, you have those new habits built up. It'll be easier to reference those feeling of letting things work over a longer period of time.

Walter: Yeah, and build up some wins. Do it slowly. If you are afraid of snakes, what do they do? Well, they'll put you in a room with a snake then next week, they'll put you in a room with the snake and they'll take off the lid of the aquarium. Then the next week, they'll put you in a room with a snake and you've got to take three paces towards the snake.

That is the same thing that you can do with your trading. You do your backtesting in forex tester, you do your forward testing in the demo, you do your forward testing in small live account, -- maybe get another live account that's a little bit bigger -- and then, finally, you're in a sort of standard size trading account for that system.

You sort of build up. Along the way, you build your confidence, you get all those trades under your belt. Yes, it is going to take longer. Yes, you are going to get impatient but the advantages when you've finally hit that payday of trading the real standard size account, you've got all of these executions under your belt, so to speak.

Now, you're good. You are going to be pretty good. You can still screw it up by risking too much and freaking out when you are in a drawdown but the point is, it is basically what you are saying, Darren. You are building up all of these memories of success using that particular system.

Darren: You do have to be a special, unique person, really, to just walk in trading and do the right things because these are all of the human traits that's, I suppose, you could call negative human traits that we've all got.

Being impatient, being greedy one in short term gratification, we all come with that. I suppose it is unusual to find somebody that does not have those biases and flaws in our character.

It is why I always say if something feels uncomfortable or sounds unusual in trading then, that is usually where the good ideas and the good information lies. It is also why I always question trading ideas, or systems, or techniques that everybody seems to agree with and stuff that is popular.

Does not mean that popular stuff has no merit at all but I am always cynical or suspicious or questioning those things now. It is clearly that what we are drawn to, what we want to naturally do, are the elements that lead us down the wrong path and, of course, have so much difficulty trading.

Walter: That is why Martingale systems are so popular. Trading systems where you win one out of twelve times but make an absolute madsa every time you hit the jackpot are widely popular but people just don't trade them.

They are much more likely to be drawn to the Martingale style of money management and less likely to be drawn to that trading system that has a sub percent win rate but has a 30 to 1 reward to risk ratio.

Those are the things that you see in trading. It is riddled with examples of really good stuff that nobody wants to do and really bad stuff that everyone thinks is great, so true.

Darren: The stuff that really works nearly always has way more pain associated with it than we ever think the good stuff is going to have. More loses, more drawdown, longer periods of losing.

When I hear trend traders talk about having... Trend traders who've been around for ten, twenty years, and they talk about having a whole year of making their profit, we listen to that but how many of us could really trade that way?

Could we trade all year and not make any money? I think a lot of us could not afford to have a year without making money. A lot of us are looking for trading to be an income, not just something that we are building savings, investments, spare money with.

A lot of us are coming into trading expecting to stop work and pay all of our bills and put our kids to school and go on holidays and buy the stuff that we want and do that week in, week out. Some of us are expecting it everyday, lots of us every week, nearly all of us are expecting every month to be a winning month.

We are all trying to put a square peg in a round hole. We are trying to make trading something that it really isn't in reality.

Walter: People do not compound their money, people pull out. Do not save. If you really have a good month, they do not save a little bit of that. It is typical, isn't it? It's almost like the bubble mentality or the herd mentality.

Whenever there is a bull market in anything, everybody just piles in and they're along for the ride and, of course, you draw a straight line and go "Okay, it's gone up this much in the last month, it's gone up that much in the last year, that much in the last two years. We know that gold is going to hit $5,000 by next Wednesday".

It is obvious, right? I mean those are the things that we do, isn't it? We always assume things are going to be the same. That speaks to what you just said. If we really have a good month with our trading, we expect that next month it is going to be same.

If we had a really bad year with our trading, we expect that next year is going to be the same but that doesn't quite work out that way, does it? It is difficult for us to stay in the course when you have these issues, basically, cognitive biases working against us.

Darren: Yeah, definitely. I suppose you can plan it, you can plan out to learn these skills but none of really go into trading that way. We just want it too quickly. We want it too easily. We cannot wait or we cannot deal with pain.

I suppose that is why, like you are saying, any 5% or whatever the figure is eventually make it. On top of that, you actually need to have... Find a strategy with an edge and it needs to be real edge in it.

Sometimes, you can find something that works perfectly for a year and never works again. Strange anomalies and we are paying particularly crazy pictures on people, the one who trade.

I suppose, that is to a certain extent. The same with getting back to the original question, that stuff that we want the most is going to cost us the most pain in the long run.

Walter: That is the point here, really, this idea that all of our pain and conflicts and wars come from expecting something different on someone else. It is the same things to your trading.

So, when you place these expectations on your trading account -- and I know it is difficult to do that -- that is the whole draw of trading. You want something, you want freedom, you want away from your job, you want more money, you want a little bit of travel, you do not want to have to sit down and work for nine hours a day or whatever it is.

You want to see your kids, you want to see your grandkids, whatever it is. That is what you want but the ironic thing is that if you want to get good at this, typically, what you'll have to do is put that to the side and just execute.

Keep executing and then come up for air every so often and have a look. "How am I doing?" It is not coming up every one, two, three or five trades, it is coming up every fifty hundred trades and having a look to see how you're doing.

That is the way to benchmark yourself and see how things are going. That is, basically, I guess what I was trying to do here was take my Theory of Everything which was, of course, was stolen from Buddhism.

We all know that Marconi did not invent the radio because Tesla invented it at the same time and that sort of thing so same thing here. My Theory of Everything obviously is better off thousands of years.

I like to just pat myself on the back and say that I came up with it. Well, of course, I didn't but you can apply this to trading too. That was basically the idea.

Darren: Cool! I suppose, really, if I was going to start again and I wanted someone to give me a tip then I would say do your backtesting and then, perhaps, I'll build a scratchy with, like you say, a 100 trades and say you need to fill these in. And, before you do it right on top on the scratchy, what are your expectations for these 100 trades as based on your backtesting?

It would've been great if I have someone who's almost like a teacher that sat there with me at the end of each day saying "Have you filled in your trades? Are you still doing it?" and force me to get through to the end.

I think in the long run, something like that, something simple like that would've saved me a lot of time and anguish in the last five years.

Walter: Absolutely. Alright, Darren, will see you next time when we talk about chucking in the towels. Looking forward to it.

Darren: Okay, Walter. Will see you soon.