EP75: Breaking Your Trading Rules

Walter: You know, as humans, we have this real tendency to take something really simple and complicate the crap out of it and make it really difficult and add rules and qualifiers and filters and then confirmations and all these sorts of things that we do as traders when we really don't necessarily have to do that...

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

Walter: Welcome to the Two Traders Podcast. Walter Peters here and I've got Darren. Hello, Darren.

Darren: Hello, Walter.

Walter: We are going to talk today about breaking your trading rules. The question is, does it even matter if you are breaking your trading rules? Is this something that we should be concerned about as traders? Where do you sit on the fence, Darren? Which side are you on this one?

Darren: I am one hundred percent that you should never break any of your trading rules. The reason is because I think you have to appreciate that trading is not a hundred percent skill endeavor.

It is a mixture of skill and luck. When there is luck is involved, and it's actually a lot of luck involved in trading, I would say as much luck as there is skill. When that is the case, then real edges can only be found over the long term.

Anything you find that works in the short term is likely just, more than likely, just luck. So, when our edges are found over the long term, it is very hard to keep those ideas in your mind in the short term and you're likely to miss the point of your strategy.

If you imagine a trend trader, if you would just look at very small sample of detour and drew his rules from that, you are basically curve fitting to the period you are looking at. What isn't happening there is good luck and bad luck aren't really being allowed to play out.

You are not defining rules that deal with the fact that there is going to be a lot of luck affecting your results. Although the idea is that, as we get better, we can learn the skill to make better decisions than our rules defined.

I do not believe that is true. I know I am contradicting myself here because in the past, I've always said that we cannot teach the brain to become more skillful and we can learn things with experience but there is a limit to that as well.

Really, you need that structure of rules to make sure you make profit in the long run and that is what we are all trying to achieve. In my mind, you have to have rules defined. Those rules can have some options, some discretions, if you like.

Even that discretion needs to be clearly defined and you need to stick to those over the long run if you want to survive and make a consistent profit.

Walter: I definitely agree. I think, probably, the one thing that separates the successful traders from the ones who are still trying to make it work, I believe, is that the successful traders have figured out a way so that they follow their rules more often.

If you do not have any rules then you are not really a trader. You are just making mistakes, you are just one mistake after another because who knows whether or not you are doing the right thing.

Rules set you up to know what you need to do to make profit and to follow some strategy. So, you've got to define that strategy with your rules and then the successful traders more often than not follow their rules.

That is what I believe. And, beyond that, that part where you're telling about the luck, I think that comes into play when you are talking about your sequence of winners and losers.

For example, if I were a person that only likes to bet on roulette and I bet, I go into casino and I only bet on black. I do not bet on any of the numbers. The way that roulette works, most people probably know or some people listening may know, you can bet on the number and if your number comes up, you get a big pay out.

You can bet on the color, red or black, and if that comes up you get a rather small pay out and then you can bet on sections like a third of the numbers or whatever, that sort of thing, or two numbers at once or whatever.

If you're a person that says "I'll just bet on the black numbers" and you happen to walk in the casino, you happen to walk up to the table and you happen to start to betting on black. As a run of blacks come up over and over again, then that just means that you were a little bit lucky.

If you keep betting on black from now until the next decade, you are going to lose because you have a losing expectancy betting on just about any bet. The casino is a losing strategy but that is definitely a losing one too.

You just happen to walk in at the right time and the same thing can happen for our trading. That is why I believe Monte Carlo Analysis is so valuable for traders because you get these upper and lower ranges of "Let's see what's going to happen if I was really lucky when I started trading a system versus not so lucky."

You can see the range of what is likely to happen given how lucky you are. I believe that luck mostly translates into the sequence of your winners and your losers and how those come up. Does that make sense?

Darren: I agree completely. That is how I see it as well and some interesting point is that people like to think that you can break some of the rules. You need to examine the motives behind wanting to break the rules to understand why it is not a good idea.

In the short term, our short term expectations are usually disappointed by the reality of the long term expectations of our strategy. There is that constant desire to perform better than it's to be expected, to win more often than it's to be expected. There is a constant urge to break rules and almost build a bit of a story around what's happening to back that up.

Whereas, really, what we should always be listening to is the long term narrative. The one that we tested, the one that we know has a slight edge over the long period of time and then, hopefully, we can capitalize on the good luck and avoid too much damage from any bad luck. That's really is what your rules set should do.

It should protect you from the worst times and mean that you capitalize in the good times. I know I always bring up **Dunn Capital** but if you think about Dunn Capital who's been going for thirty, forty years, trend trading strategy really successful.

We know they are highly skilled. He must have his strategy down to a T. He must know how to read trends and how to capitalize on them but still he has losing years. How is it possible that someone who is so skilled with all of that expertise, probably the best traders working for him, computers and knowledge, information, still can have losing years?

That is because of this luck element as well. What has kept him profitable over the long run would most likely be the fact that he's got a rules set and he sticks to it. He knows that he is not always going to work out in his favor. In the long run, he is going to make sure he makes money risking, increasing his chances of making money.

Walter: Yeah, and he is not focusing on the win rate. That is not his focus. I think there is a couple of brothers or something like that. Anyway, the other day in one of my test accounts, I had 25% profit.

Basically, what happened was a bunch of trade were triggered all around the same week and I have a lot of them that were sitting in profit. I could have closed them all out and book the 25% profit but I didn't do that.

The reason why I didn't do that because I knew that I need to follow my rules. I needed to do what I should do to increase the average winner and decrease the average losers. Some people would look at that and say "You cannot go pro by taking a profit, why don't you take all those trade off the board and book the 25% profit?".

Some of those trades are actually ended up being losers and some good chunk of them ended up break even results. A few of them are still long now and I am still waiting for them to hit the 4 to 1 target.

It seems weird that you would give up and not book the 25% profit, and now I am up something like 8% on those trades and who knows what is going to happen with those trades.

I mean they never hit the target but the point is, the reason why I did that was because I know that the edge in my system comes from having a large winner on average winner that's larger than my average loser.

The only way that happens is if I stick to my rules and wait for these trades to get to the point where they're ready to cash out at the big fat profit. This is one of the things that I think traders who've been doing this for a long time, they have a different perspective like you say, Darren.

They are looking at chunks of trades, they are looking at the long term. They are looking at trying to fatten up their profitable trades especially when they don't have a high win rate.

This is really where your edge as a trader is. Focusing on the execution and focusing on making sure that when you are right, that you really take advantage of that and so you do not have to be right that often.

It really does go against. It goes counter to all our human needs to be right, to be a winner, to take advantage of the situation, to dig your heels in and do what you can to win.

All of these things that might serve as well in business, athletics or other areas of life, just doesn't work with trading. You've got to learn how to lose, you've got to focus on the big picture and not really worry about how lucky you are or unlucky you've been this week, this month, this quarter, this year.

It is not that important and I think that is what Dunn Capital does. Those brothers in Florida, they understand that they may have a few trades a year that really make up for all the losers they have.

They maybe in a situation where it is very difficult to keep taking these trades especially when you have so many losers in a row but they know it's not really that important. The important thing is that they capture those big winners when they do come up.

So, I guess from my point of view, the advice that I would offer is that, as a trader, if you can focus on execution, focus on your rules then you are going to be performing at a higher level of efficiency.

You are going to be more likely to be making money if you have a positive expectancy system. You will be more likely to be making money than those traders who are focused on other things which are not rules, which are other reasons to change the system or improve the win rate or listen to what so and so is saying about the GBP and this and that.

These are the distractions that keep us from making money and really if we can just focused on following our rules, then everything else will follow but that is my point of view. It is so difficult because we are not built to take advantage of our trading system rules.

We are built to look at other things like win rate and reasons to tweak things. As humans, we have these real tendency to take something really simple and complicate the crap out of it and make it really difficult and add rules and qualifiers and filters and confirmation and all these things we do as traders where we do not necessarily have to do that.

Darren: Do you think that it is because a successful strategy is always generally disappointing? What we hold in our mind, what we envisage as being our trading results when we're finally successful, is it because those strategies really are not as exciting as we'd hope they'd be?

In other words, there is not as much alpha out there as people think there is so, you are going to be trading much closer to the mean than you are being an outlier and someone who is really hitting a lot of home run. What I am trying to say is, success is not how we imagine it when you actually find something.

Walter: Yeah, I think I get where you are going. I used to be big into Gann. Again, basically, I claimed to have the secrets to the universe and so he would never have losers or rarely would have losers.

A lot of people have gone down to this rabbit hole where if you can just see the universe like Gann did then, you'll know exactly where the Euro is going to go and you'll make all this money in trades.

The New York Times reporter that followed Gan around noted that he had 22 out of 23 trades that month were all successful and this and that. I am not sure about this but I do believe that if you dig close to some of the algorithms that some of these high frequency algorithms, that some of the banks in the well heeled funds have -- and a really good book for people who haven't read is there's one called "The Predictors".

About a bunch of physicists who got into the trading game and had to learn some obvious lessons the hard way but, in the end, they made it work. If you look at things like that, it can be kind of what you are talking about, Darren.

If you have a fund and you built this algorithm and it's got all these complicated equations and you are using Non-linear Chaos Theory and stuff like that and you've got to have your server right next to the exchange and see cut down on latency and all that, these sorts of things can be maybe what we think trading is all about, perhaps.

I am not sure about that but I think so and then what you are talking about is, basically, where do we find our edge? I think you are absolutely right. Generally speaking, because we do not have all of those advantages or resources to hire a bunch of PhDs from Harvard to write our non-linear equations for scalping the GBP or whatever.

We end up trading quite simple, robusts strategies which aren't probably what you thought you would be doing in the first place. You thought you'd be lining up Venus with Gann's theory and so you didn't have a loser this year, that sort of thing.

I think that is true but it's just out of necessity that we have to trade the simple robust systems. I do think that part of the frustrations that comes when you are trading the simple robusts system is that they tend to work in specific types of markets.

You might have a system that works really, really well. For example, if the market is not trending, if it is not in a strong trend. You might have a system that works really, really well if the market's quite volatile but does not work if the market's quiet and not really moving around much.

These things come up and if you understand your system well, you will know in what type of market it will work well and what type of market it won't work well. The problem is you don't really know what type of market you are in until you're in it.

So, you can look back and say "Yeah, I can see why I lost all that money last week", that sort of thing. The market never stayed on the same fate, do they? They'd go for trending to direction list and then back to trending again. They go from volatile to quiet then back to volatile again. They flip flop.

I think that is how I see it. It probably is what we think of trading in the beginning if you get into these algorithms that are created and these magic things that the funds and the Physicist come up with and that sort of thing.

You are right. We end up trading simple things and then we have to deal with the consequences which, of course, is that not every trading system works in the same market and, in fact, different trading systems like different types of markets.

Darren: Can I ask you about your thoughts on discretion when it comes to rule breaking? Is this sort of seemingly popularity of discretion because people cannot stick to rules and they want to be able to have that ability to leave certain things undecided or that ability to pick a rule at a particular time they do not want to follow?

Is it because of that or is there a real advantage in discretion? I like discretion but I like the choices to be clearly defined and I think if you believe that discretion is helpful and valuable then, you should be able to wrap some rules around when and why you are using that discretion.

That is my opinion on it but I see they just instantly believe that discretion is a good thing. I don't know whether that is because everyone else -- or not everyone. A lot of people already think it is a good thing or whether, really, it's just nice to be able to have that option to break rules and then have a reason to explain why you break the rules.

Walter: Yeah, I think you are right. If you've got a really good discretionary idea, that should translate into a rule but there's two things going on with discretion. Number one is that when you get the point where you know what you are doing as a trader that comes with experience, then your discretion becomes more important.

In the beginning, your discretion is working against you, that is what I believe. I believe that that gut instinct that you have as a trader when you first start trading is working against you.

That is why they told the Turtles if you have two trades and you do not know which trade to take, take the one that you like the least. That is why they told them that because that tends to be true.

Now, that was my experience and I do not know if everyone listening to this had that experience but when you first start trading, you often have the wrong instincts. The other side of that coin is that as you become more experienced, what happens is it is difficult to access conscious knowledge of what you are doing.

It is better to make sure that as you grow as a trader, you create your rules as you go because sometimes, what happens is you'll talk to a trader and you'll say "Why did you do that? Why did you get out of the trade there? That does not fit your rules. That does not really make sense why you get out at that point".

The trader cannot really tell you and just say "Look, it's obvious. Can't you see that?" You knew that it is going to go down so you need to get out there or whatever it is. That thing comes up again.

So what's happening is some traders, when we get to that area, that level of you've had so much experience, you kind of know what you want to do and what you are doing but you cannot really articulate it.

It is difficult. It is really good if you can write those rules down as you were going through that intermediate phase. The other side, the thing about this discretion and this is the real danger we all, I believe -- and there is really good evidence for this -- that we all have this self-sabotage ingrained in us, for whatever reasons. From wherever it came from in previous years and things that are basically attacking us and those are in our subconscious, those are allowed to babble up and affect our trading and affect our account balance when we say "Well, I am a discretionary trader".

It is just an open door for these suckers to flood out and kill your account. That is the other piece here and why I think you are right, Darren. It is so critical to have these rules, these discretionary rules sort of encapsulated as a real rule.

As a written rule that you can look at and say "Am I doing this or not?" and I think the very best ones are that way. The problem is that these distractive tendencies that we have can come masquerading as discretionary trading decisions.

I think that is a difficult piece here. Any serious trader knows that there are some deep subconscious, whether they call it subconscious thoughts does not really matter. The point is, all the serious traders are working on themselves.

They are working on their psychology and they are trying different techniques, different things. It does not have to be all the same thing but doing different things to try and work through these.

Whether it means seeing a hypnotist or seeing a shrink or journaling or whatever your chosen tool is, you are doing something that is meant to help you reign these in, so to speak.

That is how I see it. The major point is what you've hit on here is that, if you have discretionary rules then you should be able to encapsulate these as a written rule. It should be something that you can write down and point to and say "That is my rule".

It cannot really be one of those things and say "I just have to go with my gut here." I do not think that, in the end, it's going to work because again, like I said, I think you have some of these other issues that are going to come up and impossibly, drastically affect your account balance.

Darren: Cool. Are we kind of agree then really that in general, rule breaking is a bad idea and you should really stick to your rules over the long run and if you are going to change them then that really should be not in the moment. It should be based on something that you've seen to be true over a longer period of time.

Walter: Yeah, that makes sense to me. What would suggest in terms of a process? It sounds like what I hear is there is a process that you might go through to change the rules. You cannot just go one day "Alright, I am going to change my rule. I am going to do this now because the last three trades that happens, so I needed to create a new rule."

There's probably some process that you'd have to go through to vet that rule to and to justify it into. Maybe look at some data and say "Well, okay this seems to make sense now so will add this rule or will change this rule"

Darren: It is a difficult one, really. I think you have to do a large sample size so you have to do a lot of backtesting. When you do that, compare maybe two or three different versions of that rule especially, the ones that you are using at the moment because it's really so easy to see a small period of time where almost the opposite of your rule just works absolutely beautifully.

Usually, when the rule you are using at the time is working really badly and it is very easy to think that you've actually found a better rule but all you've done is curve fit something into that small piece of data.

I suffer from that myself. Generally, what I do is I go over as larger period as I can and compare three or four different rules. Often ,what I find is all four of the rules are actually good and the one that really does well in a certain period does not necessarily mean the best rule to use over the long period.

It's a lot of getting your hands dirty and looking at much larger data samples. That is how much far I can go. I know there's people who have gone really deep on how to backtest and define rules well.

That is beyond me but that is the process that I have used and seemed to work fairly well for me.

Walter: It makes a lot of sense, absolutely. One concrete example for people would be of what you have just said which is sometimes, it is very easy to find situation where your rule doesn't work well so the opposite of your rule would actually work quite well on that set of trades.

For example, let's say that you had a system where you were using a trailing stop where you might find a situation where you have several trades in a row. Many trades, in fact, where you would've been much better off not using the trailing stop but using some profit target.

The problem is if you look at long -- and you know I'm just like anyone else, I love to take profit -- but one of the things that happen is you miss out if you give up on using that trailing exit. You miss out on the huge winners that will occasionally happen.

That adds a big chunk of profit to your account that you would otherwise miss out on if you were simply using profit targets because the market would hit your profit target and keep going for hundreds and hundreds of pips.

You would miss the boat on that. So, that is one thing that you can point to and say "concrete example". This is the example of what you are talking about, Darren. Sometimes, it seems like your rule is not a good rule and all these trades show you the rule does not work that well.

It needs to be changed but the big picture, of course, is "No, the rule's fine". It just happens to be a situation where the recent history does not really show you the value or the importance of the rules.

This has been a really interesting session. Just to sum up, I would say you really want to save yourself up in a situation where you can maintain your efficiency by trading your rules as often as well as possible. And that you wanted to make sure that you're taking records as you are building your trading system so that you'll realize what you are doing because when you get to a certain point, it is not consciously accessible.

It is one of those things that becomes like, if you are trying to teach someone how to drive, it is difficult. If you've been driving for a long time, it's difficult. But, if you have

just learned how to drive, it's probably not as difficult for you to realize what you are doing and how you are interpreting the data on the road. The same thing with trading.

The other thing I would say is that if you are using any kind of discretion, I agree with Darren that it should be able to be written out as a rule. I think that is the best discretionary rules are, in that form.

You can write them down and look at them and that you should be wary of adding new rules or adjusting and changing your rules because that could simply be some sort of subconscious distractive thing trying to work it's way into your trading.

Of course, as a trader, we want to maintain a vigilant outlook for those things because they can easily creep into our trading and really wreck a system and wreck an account. It is something we need to be aware of. That is basically how I would sum it up.

Darren: For me, it is something that is really obvious to me is I can pretty much get away with making one mistake rule-break a week and not really affect my profit. If I do two or three or any more than that, I find the chances of me coming away of a profitable week when my strategy-made profit get reduced dramatically.

For me, get some good rules, understand why those rules make profit over the long run and then just stick to them.

Walter: That is a great advice, Darren. Thanks so much for your time. We will see you next time when we talk about ways to improve your trading.

Darren: Thanks, Walter.