2 TRADERS

EP84: Reversion to the Mean

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Darren: It's not intuitive to trader, it's just so difficult to do the right thing...

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

Darren: Hello, Walter.

Walter: Darren, we've got this interesting idea about reversion to the mean trading systems and I was thinking that as traders, you can go and find on the internet, there'll be forums where people are talking about some sort of a Martingale system.

We all know that while they make really nice equity curves or can make a really nice equity curves for a long time, eventually they completely crash into a fiery ball of flames and swallow your account.

My question is, the reversion to the mean trader -- reversion to the mean is actually a pretty popular style of trading. For those of you that do not know -- I know most of you know listening to this but -- some of you might be "What are you talking about?"

An example of the reversion to the mean, let's say that you have 34 exponential moving average and you basically trade the market back to that moving average. If it gets really far away, maybe it spends, I do not know, 25 candles away from touching that 34 moving average.

For example, it fell below it and the moving average is above it, you might buy. Buy up to that 34 moving average but let's say that you did that and then the market move farther away from that moving average, you might have another signal to buy.

So, what happens with this reversion to the mean trader is, some of them -- not all of them -- some of them will have signals and then the trades goes against them and then, they'll get another signal and then it'll go against them. They'll get another signal so, my question is, for you Darren, with this style of trading, is it really that far removed from Martingale trading? Is it possible that they might blow up your account just as a Martingale strategy might? I am curious about your thoughts on these.

Darren: I think the similarity is to Martingale -- and this style of trading is really popular. I know a few people who are pretty consistently successful over a long period of time trading this way.

I can see the appeal of it because, really, what you're doing is you are never really accepting a loss because the chances are sooner or later that move has got to retrace. That is where you recoup this trades that occur in drawdown.

Whenever there is a positive side to a particular approach to trading, I think what we often do is we cross over to the sort of negative side. For instance, in your example, you would see a high number of sort of net winning positions but what tends to happen is your winning trades are recovering from the ones that were in the most drawdown.

You tend to have, your actual real profit is fairly small. Obviously, sooner or later, it's going to keep moving against you. You've got to have a cut off point at some point and that is where you have a very large win.

Basically, what you are doing is you're saying...

Walter: Large loss.

Darren: Yeah, large loss. Exactly. And that's glossing over the negatives again if you tend to just see the positives. You've got to accept, I think however you trade that if your strategy has a very high win rate, then there's going to be some sort of element of that that means that your losses are relatively large compared to your wins.

I think what people want to do is they want to break that equation and, for me, the parts rule into waiver. You cannot stretch alpha so far out and remain there. Do you get what I mean? The edge tends to be much closer to the mean.

Walter: Right.

Darren: Really. If you are a good consistent trader, it's unlikely you are going to hit bull out of the park year after year, after year. You're probably going to see your average winning year is probably not that impressive.

If it is then you're probably be doing something like Martingale where you're open at the inevitable, it never happens really. I can see the appeal in that, I really can, and in some respects it feels like a much easier way to trade but to do it successfully over the long period of time. I know one trader who lives in Thailand. He's got a couple of houses there. He just trades gold and he trades something very similar to this. He does very well and consistently makes gains until the market starts to trend.

Just recently, he has taken a very large loss to the point that he completely stops trading for a bit and just refocus and he's getting back into it now. That element is always going to be there and I do not think you can avoid it.

I think a lot of people seem to think that their version is going to somehow avoid that. That is my thought.

Walter: Yeah, it's interesting. I think you are right. That is what that style of trading does. It attracts people who do not want to take the loss or like the idea of slowly building up their account.

Occasionally, what you'll see is -- listeners can go back on the charts and see this. Occasionally, what you'll see is that the price will get away from the moving average for a long time and when it comes back to it you have to ask yourself where were those original positions? They're all into the water. You know what I mean?

So, you take those buy trade because price has fallen away from the moving average and then it keeps falling lower and lower, finally. What happens is the moving average is catches up the price and so it is not really that you are making a lot of money on the trade because all of your original positions you first started taking, they're all up much higher.

Now, you've got the signal to close the trade, like you say, you are closing them at a loss. What do you think you can do if you want to trade this way? What is the solution? How do you deal with this style of trading if you want to make it work?

Darren: I think you need to focus on that fact that trying to avoid too many loses is going to give you that scenario where your wins are too small and your losses are too large. You have to decide where the cut off point is and you need to be really strict on that. You have to say, "Okay, how many positions am I going to let it go against me before I just cut the lot?"

The danger is as you say, "Okay. Well, let's say, every 50 pips after my first trade, it goes against me, all other trade and I'll do at maximum of 3 and once that third trade triggers then I'm going to put the stop losses in and if it goes anymore then I am out of the position."

Obviously, the difficult thing then is going to be "Okay, how many positions and where am I going to place the stop loss?" And then, you have to follow through on that. It's really going to be difficult to pick that level because you could test it on one year and say 4 positions was brilliant.

You could test it on the next year and it's 4 positions and is terrible. It would be very difficult to find something that always is optimum, if you like. The other side of the equation, you've got the problem "Well, when I've got to that maximum 4 positions that under water, when am I going to get out?"

"Am I going to get out at breakeven? Am I going to get out at a small loss?" or, "Am I going to hold down and try to generate a large winner?" You've kind of start with the same dilemma in any approach to trading but you have that risk at one that never lose and then trading for a very long time and not getting anywhere.

Walter: Yeah, exactly. I mean, it's so tempting to embrace a trading system where you keep getting all these winners, winners, winners and then don't want to think about the big losses looming.

It reminds me of Victor Niederhoffer who basically did that. He's done it a few times. He trades that way where he writes options, naked options, so he doesn't actually own the underlying asset. He'll write options for these and every day, every week, every month he is making a little bit of money then, all of a sudden, the market has a huge crash and all these options have come good. He's going to pay up.

It's the same thing. My thinking on this, Darren, is that there are traders on the other side of this. I find this fascinating because if we talk about the traders who are reversion to the mean and they're in a situation where the markets moving strongly and so they are hoping that the market turns around and goes back to the mean or to the homeostasis part of the chart.

There are other traders who are actually waiting for these opportunities when the market takes off and gets to the edge of the Bollinger Band or far away from the moving average or has a 54 day break out or whatever it is. There are these trend followers and there are also traders who will add to a position as it becomes more and more in profit.

It's the opposite because these reversion to the mean traders, they're adding to their positions that is in drawdown and it's a losing positions, they are adding to that. Whereas, there are traders that do the opposite, they add to winners, they look for a trends, they try and capitalize on that.

So, my thoughts are we've identified some of the problems with the reversion of the mean system where you keep adding positions and maybe some ways that are out of that. Like you say, like maximum never positions, maximum level of pips that the market goes against you.

You decide, "Okay, that's it. I am going to cut it." Or, maybe you can use a time exit and you go, "Look, I've been in this position for 10 candles, it's time to get out" or whatever you choose.

These other traders on the other side -- this is what's fascinating to me about the market because we'll always have somebody on the other side. So, what do you think about these traders who trade at the edges? They look for these opportunities where

the market gets far away from that midpoint and they look for opportunities to add to their positions when it goes in profit. What do you say about that?

Darren: I definitely think trading at extremes is a really good approach to take. When price is stretched, it is a great time to trade but the thing I would say would be, do you know more traders that add to a winning position or do you know more traders that add to a losing position?

By far, in my experience, adding to a losing position is way more popular and that is always a red flag for me because if it's popular, it's that what the 5% are doing well. It's unlikely, isn't it?

The 5% is doing something different and so I'd be much keener to explore approaches where you add to winning positions than adding to losing positions because I do not see many people doing that. If we assume that the majority of people are losing and the majority of people adding to losing positions, then you could take a part shot that that was probably not a great way to approach trading.

I am not saying you can't win that way but there's obviously pitfalls in that. I do not know if you do that. I do that all the time. I'd say, "Does everyone agree with this?" and if so then I tend to question it.

Walter: Yeah, absolutely. I think it's a great way to go. In fact, I just drop off my son, kindie and the teacher said to me, she says, "You and your wife are doing a really good job with your son. He doesn't give into peer pressure. The other kids would say let's do this and let's do that and if he doesn't want to do it, he'll just say no.

I thought that is the principle we're talking about here. You know what I mean? Where you just, you look at what everyone else is doing. "Everyone else is doing that?" and you, "Nahh!" I think that is good if you are seeking profits, anyway. If you want to be like everyone else, that is cool but, a lot of people are having problems trying to extract profit consistently.

One of the things I've been working on a lot lately is just this idea of adding to the winner. It's been interesting because depending on how you do it, I used to do this a lot about 9 years ago as we're recording this so I used to do this a lot but I did it in a different way.

It's a little bit more risk-involved and the way I am doing it now is just really adding to the positions but it is super frustrating because a lot of the time when you do that and you set it up so that if the market goes where you think it's going to go and it goes far enough and fast enough then it's brilliant, right?

If it meanders, it doesn't really get there quick enough then you end up, essentially, with a breakeven result. It's an all or none, the way that I am doing it. That style of trading that I've learned from some of our forum members and from people who are doing this.

I think it is probably not for everyone and there are different ways to do it. Let's say that you are buying the EUR. You think that the EUR is going to go up, you might split your positions so that you have one position where you are going to add to it as it keeps going higher and higher.

The other one, you just leave it as a normal trade where it has a normal trailing exit or a normal target or something like that because, that way at least, if the pyramided position, if that one gets stopped out at breakeven or even it can get tantalizingly close and still leave you with nothing. It's good to have that other position I suppose to at least say, "Well, at least I made something out of this."

It's frustrating. That is why a lot of traders don't do it. It's frustrating, it is not natural. People do not like to do that, you say, "I bought it 50 pips a Gp. Why do I want to buy it now?" I'm going to add risk to my trade now. I could end up with a breakeven result or something like that.

So, I see why traders don't want to do it. That's why exactly, Darren. That is why it works. That is why it's such a profitable thing to do if you think you've captured a strong move in the market then by adding to that position. It's brilliant. I mean, I know you used to do a lot of these trading around the 4-hours where you were doing sort of stacking positions and that sort of thing.

Darren: Yeah. And it's something I'm looking again at the moment and in tandem with letting some trades run a bit more. I think it really is one of the hardest things to do and if you imagine a trade that was, say in 50 pips drawdown, and came back and you've got out at break even.

That tends to feel more of like a victory than a trade that was in profit and came back to breakeven. Essentially, the outcome and the result is the same but that sort of initial euphoria of having a winning position tends to mean that we tighten things up too quickly.

I think you really need to have this exponential curve of how you take risk off of your trade and it's something I'm trying to look at the moment. To paint a picture, your initial stop is quite wide so you give the position a chance to go in your favor. Unless it goes in your favor, you tighten a little bit and then if it moves to the next level, you tighten slightly more aggressively and to the next level even more aggressively.

You take the risk off gradually and I think there's always this element of we want to get out right at the top and we want to get out right at the peak of our trade. I think it's one of the hardest thing to learn is to let trades run but it's one of the things that, if you master, can make the most dramatic difference to your trading.

That only makes clear over a long period of trades and that approach of letting your trades run does mean you are going to have a lot more disappointing trades. They'll look like they're really good and came back, essentially ends up as nothing or even as losers. It's really difficult and it's something I'm really pushing myself to improve on at the moment.

Walter: Yeah, I agree. The point of view, the undertake is sort of like, next 30 trades, next 50 trades instead of I can't believe that last 2 trades did that to me. You just have to adapt sort of a longer term point of view, I suppose with your data.

That is why a lot of traders have difficulties because they are always looking to adjust on the fly or looking for reason why that last one missed the profit target by 3 pips or what have you.

Darren: Yeah, we kind of om one end determined and we seem to think as well that our strategies should be better than they are. I just don't think that trading is that clear cut and you can have so many near misses in both directions.

You can't necessarily always make a change to a simple trading strategy that's going to remove that but that desires is always there to try and remove it. It's not intuitive to trader. It's just very difficult to do the right thing.

Walter: Yeah. I think we should talk about that idea right there in a whole episode on it's own because I think it deserves that. The truth there that it is not natural, it is not easy, it's a difficult thing to get right.

If I were to ask you, Darren, you are not interested in trading these reversion to the mean systems where if the market goes against you, you keep adding it. That is not something that is on your radar?

Darren: I have recently been looking at something similar. It wasn't really adding to losing positions but it was trying to deal with ranging markets. But, like I said before, what I found was in the range, you had a quite high win rate but your wins are relatively small.

When it broke out and trended, you took these big losses and in the end you didn't make much profit at all. It's not really for me. I certainly see people who can make it work but they still cannot avoid the fact that when the market conditions aren't right, they're going to take some pretty large, painful losses.

Walter: Yeah. And, it can get tricky in trying to decide, "Well, I'll turn it off when there's a trending market" or whatever but sometimes it's too late. Sometimes you'll say, "Well, when it's a trending market, I'll just turn off my mean reversion system." Sometimes there's a trending market and you're ready to trade on your mean reversion system. It's little bit too late, oops!

Darren: Yeah, that whole picking in the market condition and put it in 2 or 3 simple boxes. I can appreciate using that in your trading but it's accuracy and ability to get me consistent profit so I think the movement in the market is way more complex than that. Just to say trending or ranging, I don't think that's really the answer.

Walter: Yeah, absolutely. Well said. I appreciate your time. Darren. Thanks for spending time here and I look forward to seeing you next time. I think next time, maybe we can talk about this idea of why is trading unnatural. What is it about trading that is so unnatural and how can traders deal with that? If you are up for that?

Darren: Cool, Walter. I'll look forward to that.

Walter: Okay, see you.