EP90: Emotional Gut Response (Part 1 of 2)

Darren: I am not a 100% convinced that a rule-based way is best...

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 and I've got Darren. Hello, Darren.

Darren: Hello, Walter.

Walter: You've got an interesting idea, Darren, that I saw you posted in the forum about -- I'll let you explain but it comes -- I suppose from the gambling world so, for a lot of traders, that is an emotional gut response, just for that fact. But, can you explain sort of where you're going with this and what intrigued you about this idea from the gambling world?

Darren: Yeah. Actually, you probably already know I quite like the association of trading and gambling. In particular, poker. All forms of gambling, really, and I know that's really contentious topic for a lot of people.

A lot of people are really anti, making an association between gambling and trading but for me, there's a lot of parallels there and I think we can learn stuff from that world, if you like.

The idea that I posted was this: it was a female professional poker player, particularly good. She has an amazing track record and she was discussing this idea of using gut and already we know this is something that has been talked about a lot in trading.

This ability to use discretion and this ability to have sort of sixth sense about what is the right thing to do in a certain situation. What she said really hit home with me and I completely agree with her. Her take on it is that saying that you are using your gut, your intuition or discretion, can often be a bit of cop out and a bit of lazy way of dealing with uncertain situation.

Her sort of main idea was that using your gut or your instinct can be really powerful but whenever she does it, she always look at the facts first. She looks at the math, she assesses the situation on the facts first and then she applies the gut.

I think in trading, this sort of connecting the two is often missed and if someone says to me, "I just didn't like the look of it", that is not good enough for me. "Okay, I didn't like the look of it. I didn't like how I was feeling but also..." Then, you let your facts in.

"Also, I've got 4-hour profit on the table and it makes sense to cover some of that." You're adding the facts of what you know for sure into the uncertain situation before you're using your gut.

I think that is really an important lesson to learn and this idea of using discretion to be a better trader is not something that... It's about combining those two together really hit home with me. I'll be interested to see whether you agree or not.

Walter: I don't think it's easy. I see where she's going but here is what I think. We know that confirmation bias is a big deal, specifically for traders. What I would say, if somebody is new to trading and they start using this, "Okay, I'm using my guts and I'm going to look at the facts", I would be concerned that they may be using confirmation bias to weed out the so-called facts that go against their hypotheses and just pay attention to the ones that support it. Do you know what I mean?

Darren: Yeah. I see where you're coming from.

Walter: Yeah. I mean, that is a tricky thing. How do you know that what you are doing is actually objective? Are these objective facts you're looking at? Are you just sort of filtering it through your hypotheses to try and get to the point that you want to be, whatever that is? -- whether taking a trade or dumping a trade, reducing your size, increasing your lot size, whatever it is.

I think, one of the best things I've ever learned in trading in terms of this -- from this sort of point of view, the intuition thing is -- is to watch a one-minute chart. What you'll do is watch a one-minute chart and you decide when you're convinced that you know where the market is going to go, then you take a trade.

I would say -- this is not a trading advice -- definitely do it on demo, whatever. But, what's cool about this is it's almost magic how often... Like when you see a one-minute trend and you'll say, "Okay, I am going get on the trend." That is the end of the trend.

Or, when you see the one-minute going, "Okay, it's going to bounce and reverse here" and it just keeps going. It is just magic how easy it is to be wrong consistently on the one-minute chart.

There actually used to be -- I don't know if you've ever seen this, Darren -- but there used to be this website. It would have like the Euro, it was like a game -- it does not exist anymore, I don't know if they've gotten into trouble with the law or what happen -- but the game was like this, if you could get something like 11, 12,or 13 -- I cannot remember what the number was, -- in a row, you would win this big pile of money.

It was like a gambling game. The game was you were to predict where the Euro would be in the next 30 seconds -- or maybe it was 60 seconds, or something like that. What you would do is you -- there will be a line and Euro is right here -- and all you had to do is to predict whether the Euro would be above that line or below that line, 60 seconds from now.

You had all these people trying to do it. Of course, they'll get to 5, 6 or 7 in a row then they'd lose. You can bank, you can stop, you can do it today and if you've got it right and then come on tomorrow and see if you can get it right again. Or, you can try and do them all at once, that sort of thing.

What was fascinating about that was how difficult it was for anybody to hit the jackpot, so to speak, by getting 11 in a row. I think it was 11 in a row that you had to get to to win the deal.

It reminds me of this because I think the Turtles, Richard Dennis and William Eckhardt, were right when they instructed the Turtles that when you have two trades to take and you can only take one of them because you have too many positions in the market, always go with the one that you think is the least likely to work out.

The reason why is because our gut is so wrong in the beginning. I am not saying that you cannot make it better and get to the point where it's useful. I think you can but in the beginning, it's almost uncanny how bad we are with it.

What's interesting is that when you get really good at this stuff and it doesn't matter if it's trading or juggling or whatever, it's really difficult for you to explain what you're doing. It's not natural because so much of it is automatic.

We know that from the Cognitive Psychology research -- and I know that psychologist definitely don't have it figured out at all, not even close but... And, I know I keep referring back to Psychology studies and things like that but really -- it's just kind of glimpse.

Our best guess that we have right now, and one of the best guesses we have about expertise and some pretty good research along those lines -- Diana Coon is one who's done some work on this. Its that when you are an expert at something, it's really, really difficult for you to explain it especially if you haven't been explaining it along the way throughout your journey when you were a novice and start getting your bearings.

If you haven't been explaining it along the whole way of your journey, then if you just all of a sudden ask an expert to explain what they are doing, you'll often find that sometimes it's really difficult for people to understand exactly what the experts do. That is because you do not know what you're doing.

I think this intuition thing is really tricky and I don't know that it's as easy as the gambler points out. Maybe it's because she's a woman and it's funny to say but they have a much stronger connection between both sides of their brain. This is well documented.

What that means is their logical side and their emotional side of their brain, there is a stronger connection there. For men, it is just not. Physiologically, we do not have that connection. We often find ourselves one side or the other sort of dominates depending on what we're doing or what kind of mood we're in or whatever.

Whereas women, it's easier for them to switch back and forth there. Maybe that's part of it. I don't know but I would have to fall down to the side of thinking, this is probably not easy to do, if this is what you are trying to do because of confirmation bias.

I would say it certainly would be really difficult to do if you are new to trading. To me, that just would not work but those are my general thoughts.

Darren: It sounds like you're saying, basically, intuition or this gut is a good thing to use but it takes a lot of experience to get good at it.

Walter: Yeah, I would agree to that. I would say that your intuition reversing it and fading your intuition is really a good thing to look at when you are starting out as a trader.

Darren: It's really hard to go against your intuition as well, your gut feel, isn't it?

Walter: Yeah, unless you've been wrong a lot of times. I mean, I remember when I first open the live account with my friend and he tripled it the first night. We have this like $2,000 trading account and I think it was FXCM. That was when FXCM just started because we couldn't figure out how to wire money to Saxo Bank in Denmark, or something like that, we just couldn't do that and FXCM came on board and we -- which is of course no longer in the US. They've been booted.

So, yeah, we tripled it the first night and after that it was all downhill. At one point, we looked at each other, I think it was a week later. So, he tripled it the first time, I didn't do that and then we looked at each other and said, -- it was like a lightbulb moment -- "Why don't we just reverse all of our trades because we are so consistently wrong?"

He was, "We've got to do something like that, man." I think it's really hard to get it right, intuitively, as a new trader. Most traders I know, they say that. I don't know. I think you are talking about something different.

You are talking about someone who's been around the block, just cut their teeth, kind of knows what they are doing in terms of operating their systems and sees it how it works

in different types of market and all that and you are talking about a different sort of deal.

Darren: Yeah. One of the examples she gave was, let's say, she has a system for what hands she plays and what hands she'll fold. Let's say for instance, in this example, she's got a hand that she would normally play but seeing opposite her, there's a guy who she has worked out only at a place very strong hands.

So, she sat there with a hand that she would not normally play but this guy is not folding and she knows it that he always play strong hands. In this instance, she breaks her system and folds a hand that she would normally play.

I suppose the parallel in trading would be that you have a system. Let's say that you have a system where you take profit and your experience is telling you that the market is just not moving in that way that it should be for your system to work out.

So, perhaps you might move out of your usual trade management rules to do something differently. It's where I try to get to with my trading. I did try and go against it last year and say, "Okay, let's just be completely rule-based systematic" and it didn't work out for me last year because there was some sort of major political events.

The market condition changed quite dramatically and I didn't react to that because I was working on the premise that, long term, my system will be okay. It is but I took more losses last year than I needed to because I didn't have that extra element of my sort of my gut saying, "Okay the system works long term but something different is happening, here maybe I needed to adjust the risk side of my trading".

Walter: What if, instead of looking at, from that point of view -- say because your gut wasn't part of the equation or wasn't a strong part of the equation last year -- what if you simply said, "You had a rule where if you hit an x number of trades. That a losers in a row or x% as drawdown or something that you would just kick in some sort of rules about changing markets or stop trading or something"?

I mean, I don't know. Maybe you do have those rules but, in other words, is there a way to get around that same issue like you said because the market did get -- especially the market that you trade or were trading last year. It was pretty crazy.

I guess, my question is, is there a way to get around that without pulling the gut or the intuition into it?

Darren: That is the other route and there are some kind of flaws in both ways. I mean, it's a question which one can you do and perform the best? Are you best to leave it open to

your gut instinct then make the decision when you know or are you better to work out the optimum level of drawdown?

In the past where I've tried to sort of work out, something I would do with my trades is that I place some above the high and the low of a previous close bar. I went down this wormhole before and trying to work out what is the optimum number of pips above and below so you don't get caught, take in a trade that could put you in 2 pips or 3 pips above and avoid enough of those breakouts for that to be in an advantage.

I just found that I was going round in circles with that so I am not a 100% convinced that a rule-based way is best but, at the same time, I can't guarantee it's not. It's very difficult because just a minor change in the market conditions can sort of throw those things way off.

The popularity of using discretion from experienced traders as opposed to very systematic rule-based way of trading. I don't know the answer, really, whether you're better to define a rule.

You'll end up with so many rules that you'll start affecting the upsize of the system, as well. What is your take on it?

Walter: Yeah. I am with you on that, no doubt. I mean if you read or listen to what systematic traders have to say, it's exactly what you have just said, Darren, which is the big no, no. If there's one takeaway from any of the systematic traders, that take away is be aware of the systems that has too many rules.

They're all pretty much in agreement and that's about the only thing they're in agreement with which is too many rules, too many degrees of freedom and you're really ruining the system. You'll run the risk of curve-fitting.

Darren: Yeah. Also, with the certain amounts of drawdowns, one of the issues I have with it is that the market can be moving nicely for me and I can just have a little bad run and have quite a bad drawdown. But, if the market is moving in a right sort of way, I'll know sooner or later I am going to catch that move and I'll clear most of that loss and probably make some profit as well.

Whereas, for example we take the GBP/USD at the moment. We have this big shock announcement the other week where we are going to have an early election. Straight after that, GBP/USD are really flat.

It is really quickly obvious that it's not going to move now unless some more news or something changes. The market is moved to where it's end. Trying to find a rule to avoid what is happening with the GBP/USD now but not avoid those periods where the

market conditions are actually alright. Just having a bit of a bad run. That's the difficult bit.

You can end up by, if you think, "I'll just put in this rule of drawdown on there". Then, you can find that you are also taking your edge where in other condition. That might not be true for all types of trading but I feel for the way I trade, the rule-based way sometimes has that effect.

Walter: To me, that reminds me of few things or bring up a couple of issues what you are saying. One thing I've noticed -- and I am sure you've noticed -- is that to me, when I look at the market -- maybe not, maybe you don't see this, this isn't a swipe or anything, your style -- what I see when I look at the market is I see strong trends followed by trendless moves, sort of directionless chop and then another strong trend.

Even during a trend you'll see that high tide, low tide sort of a look. So, when I look at the GBP chart, as we record this, it's like, "Yeah, that makes sense. It made a strong move and now just resting and it'll probably bump up again." Or, it can turn around and fall down, either way it's just in a resting phase.

As a discretionary trade, I'll look at that and say, "Well, I'll just wait for it to decide that it is going to break out that little consolidation before I get in". That doesn't necessarily come into your approach.

I guess, it could. I mean, apparently it has where you'll want to say, "Maybe, I'll step aside here and just wait for it to break out again." But, typically, you're just looking for any little turn because that turn can be the big move. That could be the big move.

Darren: What I like is for a systematic way of trading, to have long term positive expectancy. Over a very large number of trades, you're going to have bad periods, good periods, brilliant periods and really terrible periods.

My approach was if you've got that positive expectancy, surely the best thing to do is to remove as many decisions as possible and just trade the system and that is all well and good but I think it's doing intelligence -- is that the right word?

The abilities about brains, a bit of it is service and sometimes it can just be obvious. Like you say with the GBP/USD now, it's just obvious. Step out and wait till it stops moving and then go back to just applying the system.

It's just that slight element of discretion that you can put in there. I think if you can master both of those, have a good long term expectancy for your system and then just have the ability to just decide when to step out when things are really bad and avoid

some of those, I think that should make a big difference on your bottom line at the end of the year.

Walter: Yeah. I mean, it makes sense. It reminds me of the trader interview I've read where he was a systematic trader. He has thousands of thousands trading system. You know what he does every week?

Every week he just looks at all of his systems that are I suppose trading demo accounts -- they're not really trading live -- and then he looks at each week and he says, "Okay, these are 3 systems that are performing the best right now so I am going to turn those on and make those live this week." That's his entire thing.

First of all, it's like what you're saying. It's like, "I've got this system where it basically takes every turn in the market then my job is to maximize my profit out of those turns." And because you'll never know when the next turn in the market is going to the big turn and really, really move but you have this element of discretion which is, "Look, if it's obviously just chopping around, I am going to wait until it stretches out of that and starts moving again so I'm just going to hold back and switch market or just not trade or whatever."

It's fascinating because it's the same idea as this guy, isn't it? Where he says he's a systematic trader, right? But I would argue that he's not. I would argue that he's not because it's almost like putting your finger in the guys or the dam that is starting to break, trying to unplug the hole with all your fingers in the dam that's going starting to break.

As humans, it is amazing to me how good we are at allowing our decision making, our own discretion to seep into things even if we say, "No, no. We'll just let the computer do it. We're just going to make it really mechanical." It's almost like we just can't help ourselves. You know what I mean?

Darren: Yeah. Some of the ways I trade, it literally is. Place a trade at every close of the bar but every time I do that, my brain is yelling out, "Are you sure you want to take this one? It doesn't feel right." Even when without a doubt, the right thing to do is place a trade.

There's always that nagging thing at the back of your mind saying, "This is not feeling right." That slips in there. I am not sure if I could ever get rid of it. I don't know if that is true for everyone.

Walter: That's all the time we have for this episode but in Part Two, you will hear the following: the counterproductive thing that every trader thinks about when entering a trade and why this is counterproductive.

Why Darren is uncomfortable when I am most comfortable during a trade and vice versa and when following your rules can be absolutely devastating to your bottomline. Darren does a really good job explaining this. How to build up a profitable trader's gut and what this means.

Finally, the best place to start for new traders who are trying to create their own trading system. All of these and more in the next episode, Episode 91 of The Two Traders Podcast. See you then.