EP95: Risk/Reward and Trade Frequency

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

Darren: Very good, Walter.

Walter: So Darren, the idea we have for this podcast is how your risk/reward for your system, how that relates to trade frequency. What are your thoughts on this? I know you have some thoughts on trade frequency and risk/reward.

Darren: We all know about risk to reward and we all know how important it is to trading but my idea is... I want to talk about this idea of having a blended risk/reward because I think when we talk about, the one that always taught it is the "if you get a 3:1 risk to reward, you'll be okay", and that sort of minimum is what you should aim for.

I think what people take from that is that every trade you should enter, set your target at 3 to 1 risk/reward. You should see if it's available based on how you trade and then you'll go and that's how you should trade.

I think that is just a way to blunt a way of using it and, for me, when someone says you should be aiming for 3 to 1 risk/reward, I'm thinking about my average risk/reward over a series of trades.

I think it's a mistake to just aim for 3 to 1 on every trade. At the same time, I don't think that you should discount trades where there's less than 3 to 1 risk/reward in the final result. They can still be part of a really powerful system.

Something I am doing at the moment with my trading is using what I'm describing as "blended risk/reward". Let's say, I take my first trade and price goes in my direction and then I take my second trade and it continues to go my way and, so on and so forth.

Let's say, I end up with 3 trades long and prices going in my direction. What I've been doing is on the first trade, which is the furbish from price now, with that one I'm looking for the higher risk/reward.

So, I want 3 to 1; 4 to 1; 5 to 1. But,with the other trades, when my first trade gets to TP, I'm happy to close them at a lower risk/reward because the way I see it, the way price

moves in this up and down, zig zaggy pattern, the trades closest to price are the ones most likely to get taken out by a retrace or a reversal even if price does continue in your direction.

That's just one way that I look at risk/reward and I don't see people often doing that. I think people try and nail it down that every trade needs to go a specific command. That's slightly unrealistic based on the way that a lot of people trade and the way that the market moves.

So, that is my risk/reward thing and the other idea with trade frequency. I see too many people trying to make a system that has a particularly low frequency work. I am not going to say that that cannot work but I think often, it can be detrimental to the system you use.

Not only that. I think they then tend to look at too fewer trades to get an idea of where the less system has a positive edge or not. So, they might say test a year and only have say 80 trades and then try and make assumptions about the entry based on the fact that it only generates 80 trades.

Whereas, what I would do is if I'll look at the 80 trades and the risk/reward was good at those other elements of the strategy then I'll perhaps say, "Okay, perhaps I need to relax my entry rules and allow for more entries."

What I find they tend to do is they go back to the entry and make it even stricter because they think,"Okay, if I can remove some of those losses then my overall result will be better on that small sample."

That's sort of two ideas that I'm bouncing around with at the moment and I wonder what you thought about that. I know you're doing something with a bit of a blended risk to reward at the moment where you add to your winners with an overall target and that's kind of similar thing.

Walter: Yeah. I've seen the light and I don't think that's a big of a deal if you split it up. I know a lot of traders, they feel kind of multiple personality if they have a target and a trailing exit and a pyramiding.

It's lot to take in because I think in the beginning, you almost feel like as a beginning trader, as a novice you feel like, "Well, I have to choose. Am I going to use a trailing exit or may I going to go for a target?" And, I don't think you necessarily have to.

This is one of the things I've learned from working with traders. I learned this idea of splitting it up and I think it's a powerful one. I also wonder though like listening to what

you're saying about having targets, I wonder if you could just, like if you're using a trailing exit only and not targets.

Let's just say, you're a trailing-exit-only trader. Would that eliminate some of those issues or not quite all of them? Do you know what I mean? When you're saying, "Well, the markets tends to go up and down." Let's say you're in a buy trade. You bought the GBP and it's going up but it goes up and it goes down a little bit and it goes up farther and it goes down a little bit.

If you had a trailing exit, wouldn't that help sort of solve the issue of how far though if I let this go before I take profit?

Darren: Yeah. I think that's another really good way of doing it. It doesn't seem very popular as well. People tend to find it quite difficult to do and so that would spike my interest in it as well.

I like that idea that one of the worst things about having a fixed target -- say 3 to 1 -- is those trades that blast straight through it, you'll never going to get those. You'll never going to get anything above your 3 to 1 risk/ reward.

If going back to that 80, 100 trades test, if 10 of those trades blasted through to double your target, what sort of difference can those sort of things make over the long run? I just think that a very strict "that's my target, that's where I think price is going to go" is perhaps not the best way to approach it.

Walter: Yeah, I have a theory about why people have a difficult time with trailing exits. Let's say that you have a 2 to 1 target and you have a trailing exit so, you split your position in 2. Most of the time, your trailing exit will probably make less than the 2 to 1.

Most of the time, the 2 to 1 is the winner so people look at that and they go, "My trailing exit is just ruining my trades. I'm leaving all these money on the table so I'll just move to straight targets." And then of course, that's when the big ones happens. And then, it's like, "Oh no! I missed out on that one."

Like you say, whenever the market really moves strong, it makes a strong move in one direction. If you have a target, your broker is always going to hit your target. Doesn't matter if it gaps a 100 pips over your target, you'll always going to hit your target. You'll never get slipped on the other way.

So, what happens is, traders look at that and they go "Ohh!" then they see "Well, trailing exit might have helped here." But, it doesn't happen frequently enough for traders to see it.

I think that's the issue, really. It's that people look back -- and like you were saying before -- people will look back and say, "How do I make this system better? How do I eliminate some of the losers?" and all that curve fitting stuff. That can be, I think, really slippery slow where you get into trouble because you're basically creating the best system for the last 80 trades and it's not necessarily the best system for the next 80 trades.

It's a tricky thing to get into but I want to get into this idea that you're talking about before about the low frequency system because some of the best system I've seen don't trade that often.

Now, there's a couple of different ways to see that. You could say, you could argue -- and maybe you would argue, Darren "Well, that's because it hasn't had the reversion to the mean yet." It's had. You've seen over the last 10 years, you've seen a trade with this system over the last 10 years.

The reason why it's so good is because now we're going to run into a rough period for the system and it's going to revert back down to the mean and it's not really that good of a system. That's one way of looking at it.

The other way to look at it is say, "Well, if I've got this system and it works really good but doesn't trade that often, can I extend it to other markets?" I don't know why. I know it's the obvious thing but I don't know why. It seems like a lot of times, people don't necessarily do that.

They feel like they have to trade the GBP and the Euro, they can't trade the EUR/GBP or whatever so that is another thing that I wonder about. What are your thoughts on those ideas?

Darren: I didn't want to come across like all the frequencies systems are necessarily going to be bad. No doubt, there's ways to make that sort of trading successful but, a lot of the time, people missed out on a lot of opportunities because of how they're thinking about trading.

For instance, let's say you trade a particular pattern at particular levels in the market. I think you have to go through and say, "How many times was price in the areas I want to trade but it didn't generate the pattern? How many of those were successful, as well?"

I think what people revert to is trying to improve the details of the pattern and that's not always the answer.

Walter: So they're missing the big picture, basically. They're missing the big picture?

Darren: Yeah. I think because they're focused on the accuracy of their pattern. They're perhaps missing a lot of occasions where maybe a few last rules on the entry would have got them winning trades as well. So, it'll be too picky on entry if you like.

Walter: Yeah, I got you.

Darren: It comes back to this whole thing of adding to winners that we've been talking about a lot recently. I think if your system is based on waiting for, let's say, you're waiting for a reversal in a trend and you're looking for a particular pattern, a particular level for that to occur. One sets up and you get in and it goes in your direction and it's running well.

You've read the market. Well, your analysis is spot on, you're in with a good amount of risk and price is moving your way. It's really hard to add to that because you're not going to see what you normally look for to enter. It's not going to happen again because that price is running.

It's not doing a reversal and so you then have to have a different mindset for entry if you want to add to that. Do you understand what I'm trying to say?

Walter: Oh, yeah. Absolutely! That is why I moved away from it, I get it. The way I deal with it now -- and I learned this from one of our forum members. He really showed me this from his point of view which was different to the way I've seen it because I've seen it like what you were just saying.

Now, the way he looks at it is he'll just have the trade setup and he doesn't care if the target -- the easy to achieve target level, the 1 to 1 or the 2 to 1 or the trailing exit -- makes the most money or the pyramid position.

So, you've got these 4 positions. You have one trade idea and you've got to split into 4 positions. He doesn't really care which one ends up being the winner. In other words, what I'm saying is I think you're going into it thinking, "Look, I'm going to pyramid in this one if it works."

Now, a lot of times, what will happen is you will get stopped out at breakeven because it's a breakeven pyramid. Assuming the trade doesn't stop you out, assuming it's not a loser. It could be a loser of all 4 positions, they're done.

Fine. But, if it goes in your favor and let's say it goes in your favor, it hits the 1 to 1 target and then it retraces and your trailing exit gets popped out at less than 1 to 1 and then your pyramid position also now gets stopped out at breakeven, basically, and then now your 2 to 1 target is still open.

So, let's say that it doesn't go to 2 to 1. It comes back, maybe that gets stopped out at breakeven because once you hit 1 to 1. You move your 2 to 1 position to breakeven, for example, right?

So maybe, what you end up so you've got these 4 positions on the trade, the pyramid position is a breakeven trade. That's nothing. The 1 to1 on a quarter of your position and then the trailing exit made .7 to 1 on a quarter of your position and then your 2 to 1 made nothing.

So that happens enough for you to get frustrated and throw it into the toilet and say, this sucks. But, it's that winner where it really goes and then your pyramid -- now let's say, you're risking half percent on each of these 4 positions. Now, your pyramids made you 10% on half percent risk. Where do you get that? You know what I mean? That doesn't just happen.

So, it's like playing a game. You'll never know when you're going to get snake eyes, I guess, or whatever. You just have to take that game approach, I think, which has really helped me because what you're saying is exactly that's what I run into too when I was doing this back in 2010.

I found that adding to my positions was really stressful and I would do the same thing. I would go even though I have them locked in. So, I have them locked in when I took the trade, I'd say "Well, if it goes 50% to my target, I'll add another position and if it goes 65, 75, 85% to my target, I keep adding these positions but I didn't have the breakeven."

I hadn't managed these trades and it was so stressful. That is why I like the breakeven pyramiding because, look, obviously most of the time it's going to hit breakeven. You're going to hit stopped out because it's going to retrace against you enough so that your positions get stopped out at breakeven. That is okay because that 1 in 10 or that 1 and a half in 10 trades that do are totally worth it.

Darren: There is this Psychology Theory about this where the perceived effect from the process takes over and becomes more important than the actual end outcome. So, the amount of pain and pressure that we feel during the process becomes way more important than the the actual end outcome.

I really think this is like the key with trading, is all those things that feel the most uncomfortable and the hardest to do, that is where the good stuff is. You need to get into those areas. That's where you're going to find your system, your consistency and your profits.

Walter: At the minute there I thought you're talking about marriage, Darren.

Darren: Let's not bring that subject up.

Walter: Yeah, let's not bring it up. Listening to the way that you approach this, do you think that's an over-riding principle of -- for trading, in general -- which is, it's the painful areas that you should be probing into?

Darren: I think so. I'm not smart enough or educated enough to bring it all together but my gut feeling tells me that all of those things that feel the most painful and the hardest to do are where the edges lie.

You see this with the way traders gravitate to what is most competent when you're trading and they very rarely make it into a long term success. Again, I'm not saying that you cannot make them profitable but it's the things that the most popular also, say 1 to 1 risk/reward trading is very popular.

It seems so painless. You know you have a pretty good win rate, you're not going to have to sit in your trades too long. Your losses don't feel that big because you're getting these regular winners and it all feels good and achievable.

When you look at the chart you see, "Oh, so many of these are winners" and that is appealing and I think that is where the dangers lie. When something feels good and appealing with trading, it just doesn't seem to work for the majority of people.

Walter: Yeah, I think you are absolutely right. That is why if you are looking at a chart, I like to do the one-minute chart. You do the one-minute chart and you say, "Okay, when am I certain that I know where the market is going to go?" And that is a great way to find a turning point.

On one-minute chart, in other words, you're wrong. You go, "Okay, it's definitely going up now. I would buy here" and then that's when it reverses. Now, I think that's essentially what you're talking about here.

It's this idea of the reason why trading is so difficult is because the easy roads lead to losing and the difficult roads that no one wants to travel down, those are the ones that are actually most fruitful. I think that is part of the deal.

I think that is why scalping, listening to what you were just saying, scalping fits that. What do you mean? I could get in and get out real quick and make a profit? Ooh! Awesome, let's do it.

Darren: Yeah, I could trade London Open. I could make 3% in the first hour, do that 2 or 3 times a week. I am going to be rich, easy.

Walter: Yeah, I think that's exactly what it is.

Darren: I am not saying people don't do that as well. I've got to stress I am not sort of saying any of these things don't work but you've got to look at the big facts. The majority don't make money and so if the majority are doing something or something is really popular, there's probably some psychological element in there that's making it popular.

It's not necessarily that it's going to work and make you rich. Probably just a comforting way to trade.

Walter: Yeah, that's it. I think that's it. For the listeners here, what I would do is I would say, "What are the magnets for me in trading? What are these things that I get really attracted to?" Question that.

"Why is it that I think that scalping is a way to go taking quick profit, getting in and out. Why is that the case? Because if that's the case, why don't more traders make it work?" That sort of thing.

I remember I was talking about pyramiding yesterday with some traders and one of the traders said, "That sounds just like Martingale". Actually, it's the exact opposite of Martingale. You know what I mean?

If you look at an equity curve, other systems were just straight pyramiding. It will go down, down, down, down and then one time it'll just go whoosh! It makes a huge move up which is exactly the opposite of Martingale. Martingale will go up, up, up, up and then one day the account is at zero.

Darren: Yeah, and look at how popular Martingale is and look how unpopular adding to winners.

Walter: Yes, exactly. That's it. I've rest my case, Darren. That's it. I'm going to leave this to the jury. No, but that's exactly it. All I am trying to say guys is this is probably what we should be looking at.

We should be postponing those, it's taking the other point of view. Why is it I am really attracted to this scalping? Why is that the case? I really like this idea of Martingale, maybe it can work. Why am I attracted to Martingale?

Try to flip it around. I like doing that too when I take a trade, I'll go, "Okay, I'm going long the EUR/NZD today. Who would be selling the EUR/NZD today? What are they seeing on the chart?"

I like to do that in order to just get my mindset right and try to make sure that I am convinced that this is my trade and what are the people looking at. Oftentimes, you can get good at this after some practice.

You can say, "Okay, they are looking at this. I understand why they might do this," that sort of thing. It's not perfect but I think looking at your assumptions, looking at what you're attracted to trading-wise, trying to figure out if maybe the opposite of that might be something that you should look at because so few traders were doing it.

I think that is one thing that I really agree with you on that. That can be really a fruitful area. I guess, though, you have to have enough mental flexibility to do that. You can't be stock in the confirmation bias which is just seeking out information that's support your theory.

You just really have to break out of that and that's a difficult thing to do. Even saying that you should be looking at unpopular things in trading that's it's own. At least, you can use confirmation bias to just look at that as well, you know what I mean?

You can never get out of it but, yeah, I think this had been a really good episode, Darren. I think we've laid out some fairly practical ways to approaching it. Do you have any final thoughts?

Darren: No. I think we've covered it all, Walter. I can't even remember what the original topic of this podcast was but I'm convinced there's some good stuff in there.

Walter: Yeah. I mean, we're talking about frequency of trading and risk/reward and that sort of thing.

Darren: Yeah, just looking at them differently.

Walter: Yeah, looking at them differently. Okay, cool! Thanks for your time, Darren. We'll see you next time.

Darren: Cheers, Walter.