EP99: Comfort in Trading

Walter: That's the mistake. The mistake is thinking that you can make money at this by having a high win rate, high frequency, low reward to risk strategy. That's the whole deal. I mean, that is how I see it anyway...

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 back to the Two Traders. It's Walter Peters here. I've got Darren on the line. Hello, Darren.

Darren: Good evening, Walter.

Walter: Yes, Darren, so we're going to talk about comfort in trading and why it is that we tend to be attracted to comfortable things. Why we probably shouldn't do everything that's-- and I am guilty of this. I talk a lot about how you need to trade your belief as a trader but one of the things that you brought up in our last episode was how important also to give yourself a little bit of a push.

There are some elements of your system that should really be uncomfortable and I think this is really a good idea so, let's dig into this. What do you mean when you say, "Yeah, you need to know what kind of a trader you are and how you should trade"? What's attractive to you as a trader but also having elements that are uncomfortable. What does that mean to you?

Darren: Yeah, I think the first one you need to consider are biases, our cognitive biases. The way we react to certain things, not just in trading but in life in general. These biases, we all have them, some to a lesser degrees, some more extreme.

When you look at the mistakes that traders make and the reason that most traders lose money over time, you can see that these biases that we have, they come into play in a big way.

The danger when trying to fit a trading strategy to your personality is, over time, you tend to change the elements of the strategy so they'll feel comfortable in the belief that what you're doing is trading your personality.

So, for instance, you could say "I don't like scalping" and then you would adjust your strategy based on that but I feel that whatever style of trading you pick, there's going to be elements that feel uncomfortable. An ability to deal with those uncomfortable elements, I think is really where the difference between winning and losing as a trader lies.

I think in sports, it's where you kind of get this. When you listen to people who were successful in sports, they've developed this ability to just go through the pain level at the points where maybe some of us would give up.

Just like football teams, even when they're all it seems like everything's lost, they have this ability to stay calm and go through the processes and they always seem to come back and win.

I think that's why we always lose to Germany in the World Cup. They just got better psychologically as a team. They've got this ability to deal with those uncomfortable moments.

I think if you always tweak a strategy so it feels comfortable to you, essentially, what you're doing is you're just making it... You're making trading more human, if you like. I think it's those abilities to deal with those uncomfortable elements that really makes a difference.

Walter: Yeah, and if you think about it -- here's the reality. The reality is that most traders would like trading to be like their personal ATM. They flip open their laptop, they sit down and they punch a few buttons and then, boom! The cash spits out.

I mean, that's the reality. That's what the traders want and then they want to tell their boss to screw off or they want to buy a nice car, they want to travel or whatever but it's because they can flip open a laptop, make a couple of decisions and pull out some money. That's kind of like the dream scenario for trading.

So, if you'll look at -- and I think most traders are drawn to trading with that at the back of their mind, whether they admit it or not, right? I could be wrong but that's what I think. Now, the interesting thing about that is if you'll try to map that unto a trading style, scalping would most closely be associated with that style of trading.

Because you sit down, you pump out some trades, you're flat, you'll get your winners and all that and you bank it and then you close your computer down and you're flat. You have any open position, you have to worry about until the next day when you wake up and you do the same thing all over again.

I can see why high frequency, lower timeframe trading, is attractive to people because it's a great way to just sit there and make it your own personal ATM, so to speak. But, here is the thing, that is what everyone is thinking. You know what I mean? That's kind of your point, isn't it?

That everyone is thinking the same thing which is, "I'd love to get into trading because then I could just sit down and make money whenever I wanted to." And, what I found is that, trading is actually more like a job, like a lot of other jobs.

In that, yes, you can get paid for making decisions like you can get paid on the decisions you make and you can lose money. You can pay for those decisions you make as a trader but there still is work involved.

So, like, if I were an algorithmic trader, there would be a whole lot of work in developing and validating my system and running three different data sets and all that sort of stuff. Same thing as a discretionary trader. There's a whole bunch of work that goes into coming up with an idea, testing it, taking a look at the numbers, seeing if you can tweak the exit, doing all those work so that you'll have some numbers so that it feels comfortable,. Whether or not you believe in those numbers are going to project in the future or not, that's irrelevant.

You just want to get good at trading the system and feel like, "Okay, I know what I'm doing here" and hopefully things will hold up in the future, doesn't totally collapse. I can see why traders are drawn to a certain style of trading.

They want to win, they want to take a lot of trades, and they don't necessarily want to have a trade that they're hanging on to when they go to sleep. To me, those are the three big ones. Would you agree with that or are there other something that I'm missing here?

Darren: Yeah, I agree completely.

Walter: Yeah, it seems like that's the thing. Like, that's the whole draw to trading, at least in the beginning, but the reality is for me -- and I know this isn't the case for everyone and I don't think it's the case, could be the case for you where sometimes, or almost all the time, I've got a trade that I've been sitting on for days or weeks.

And so, it's something that I do go to sleep with and I do have to wake up on Monday morning here or in Asia and check to see if the market gapped against me and all these sorts of things that I have to deal with as a trader who trades say, the daily charts.

These are the sort of things that I have to deal with. I have to deal with the weekend gaps, deal with being always in a trade and not knowing what happened while I was sleeping and all that.

There are strategies to deal with that. So, how do you deal with that? Will you take small position sizes so you're not worried about it? Gapping, you try to avoid in getting

in on a Friday so that if it does gap, ideally, it's not going to gap over your stop loss because you took the trade on a Wednesday instead of a Friday, all those sorts of things.

But, beyond that, I think it's interesting that by moving to the weekly and the daily charts, it's like you're playing with the unpopular kids. No one wants to play with those kids.

They all want to play with the five-minute charts, they all want to do scalping stuff, they all want to have high win rate, quick profits sort of thing. It sort of speak to what we're talking about and that's where the mistakes are made.

That's the mistake. The mistake is thinking that you can make money at this by winning, by having a high win rate, high frequency, low reward to risk strategy. That's the whole deal. That is how I see it anyway.

Darren: Yeah, and I think also it appears to be a less painful way to trade as well because the reality of holding trades longer is that you've got longer periods of drawdowns. You have to wait longer for those wins and they're not evenly distributed wins and losses.

Regardless of what your win rate is, the wins and the losses will crop together and all those elements will be uncomfortable to work through. Your gut instinct is that because you are having those feelings of, say being in a drawdown or consecutive losses, that is more than your gut feeling tells you is right then you tend to move away from the strategies that have those elements in.

I think those strategies are where the money is to be made and I've opposed recently with funds that trade longer term trend trading. If you'll look at the results over, we are talking about 10, 15 some of them maybe even 40 years of result. They go through long periods of losing.

It's hard to say to someone, "Look, you're going to take 15, 20 consecutive losses." It's really difficult then to go on and persevere with your system when you're in those drawdowns, you're in those periods of losing.

Generally, what we're doing is we'll say, "Well, there's probably something wrong with the strategy" so you'll find some way of reducing those losses in a strategy. Usually, it's moving your take profit closer to your entry. That's one simple way of doing it.

You are in the belief that by removing that pain, you're improving your trading and that is rarely the case. What you are generally doing is you're reducing the amount of profit that you're going to make.

Walter: Yeah and you bring up a good point. I think you can tell, just as you can look at what retail traders are doing, I'll put that **link in the shownotes for people who want to see** that link. You know what or how many percentage are long or short or whatever.

I think you can see the same thing. Like the fund managers, they see when they're in a drawdown and everyone is withdrawing their money from the fund and the fund shrinks because they're in an 18-months drawdown or whatever.

To me, it's like a sentiment indicator like the same thing that you see with the retail trader open position ratios. We can see how many people are long or short the GBP or whatever. I think it's the same thing and it's usually when it reaches that apex point where you have the maximum number of withdrawals from your fund. That's when it is going to kick in and it's really going to turn around.

The same thing with the media. Financial press will start talking about the death of the trend following like you're saying like these one's are done or whatever. Dunn Capital in Florida, these guys will often take the broad of these articles that are written when the funds of these trend following funds, in particular when they have a down period, all of these articles will come out.

They'll talk about how trend following doesn't work anymore, the markets have changed, blah, blah, blah. It's usually around that point when there's another massive trend and it takes off and then they all make money. It's so funny.

Darren: This is what they call "the dumb-money effect", isn't it? Where, when something is doing really well, everyone piles in just at the time that it stops doing well because obviously, it's already unrestricted it's normal performance.

Likewise, when a fund is in a period of a drawdown, everyone pulls their money out. Just at the point that the market conditions sync up again and the big money was there to be made.

Walter: Yeah, exactly. That's exactly it. There's a really good short that I'll post to for...

Darren: We do that in our own trading all the time, don't we?

Walter: Of course, yeah.

Darren: Just at that point where the drawdown becomes unbearable that we make the changes and then the chart conditions improve, there's your big winners that would have covered your losses and put you into profit.

This isn't only for long term trading as well, holding trades for long time. You trade a simple support and resistance strategy on 15-minute timeframe with a 3 to 1, or 4 to 1 risk/reward.

The elements are the same, just the frequency of your trading is changing. So, you might see taking ten losses in a week as being catastrophic but those long stretches of losing are always going to recur.

I think the danger is people look at short term results of people where they appear to not have those periods of drawdowns and consecutive losses. They jump to that different systems only for the next week for it to fall apart.

Walter: Yeah, it's so true. I remember I did a webinar once and we were looking at the one-minute EUR chart -- I wish I could find this webinar, it was so great. It's exactly what you're talking about, Darren. I said, "Okay, now we're going to watch this one-minute chart, guys, and when everyone is convinced, let me know when you're convinced that you know where the market is going to go".

So, we watched this one-minute candles and I was yabbering on about some other thing and whatever and then everyone piped up and they started typing in the comments, "Okay, EUR is going up. Let's get in," "Uptrend, let's do it," blah, blah, blah.

Damned if that wasn't the turning point, you know what I mean? That's when it fell. It fell for the rest of the webinar. The next 15-minutes, the one-minute chart went straight down and it was everyone had said, "Okay, let's buy the EUR now".

It just goes to show that we are -- and you can use that as barometer. Like you say, you can even use it as a barometer with the system, a barometer with the individual trade. You can definitely use that to your advantage.

Darren: Yeah. I think one of the easiest ways to find how to improve your trading is to look at those elements that feel uncomfortable to you. Let's say your profit target is 3 to 1 risk/reward and if you always find a reason to take profit to 2 to 1 when you should have held, then that's going to feel uncomfortable to you.

It's that element is there, that's where you're most likely to make the biggest improvements to your trading and not sort of adding on with the criteria to the entry or another indicator. That's not where you're going to find the added alpha, if you like.

It's going to be in those elements that feel uncomfortable so you should search them out and make a list of which elements feel the worst to you, the hardest to do and that's where you're going to find your added edge.

Walter: That's a great point. Here's an idea because this is something that comes up a lot. I'm one of those traders who likes to move to breakeven and I'll probably move to breakeven fairly quickly like a lot of traders don't like.

What that means is I'll have a whole bunch of trades where if I had just left my stop where it was then -- farther away from entry -- that trade would've been a profitable trade. But, because I moved to breakeven and I pulled up, pulled back to stop that at breakeven, it was a missed opportunity so to speak. Right?Because it went to the target at night when I wasn't on the trade.

Now, that is something that a lot of traders find uncomfortable. If you are a trader, let's say you trade the four-hour charts and let's say that you use 60 pip trailing exit, so as soon as the market goes let's say 50 pips in your favor, you move to breakeven and you kick in that trailing exit stop. So, as soon as it goes 60+ pips in your favor, that trailing pip stop just kicks in and starts trailing your trade until you get eventually stopped out.

Now, there's going to be a lot of times when you're getting stopped out at a very, very small winner or get stopped out at a breakeven and that's going to be really painful for a lot of traders and they're going to want to fight that. I think it's because of what you're talking about.

Darren: Yeah, definitely. I find that to be seems like the problem with trailing stops. The whole idea is that when the market goes and goes and goes, you're going to get those massive wins. But, what you'll find people do is they trail their stop until it does a little bit of exciting move up and then they think, "Well, in this instance, I'll just take the profit there because I do not want it to trail back". They don't like that push of giving back.

That's the problem, They're picking what's comfortable and feels warm and fuzzy in the moment but they're missing the whole point of their edge which is when price goes and goes and goes, then they'll get a massive winner.

What they'll find they're doing is that cutting off those massive winners and the whole balance of their edge in their profitable way of trading is disrupted then because they couldn't deal with that bit of pain.

Walter: Yeah, absolutely. I think it's a good test. What we're saying here is, essentially, if you feel like something is uncomfortable and you want to fight against it whether it's moving to breakeven early or whatever it is -- using a tight trailing stop, which by the way I think the data is pretty clear for what I've seen most traders. They give their trailing stop too much wiggle room and they often have their stop losses too close in the beginning.

They do the opposite. What they should do is the stop loss should be farther away from the entry in the beginning and then as the trade goes in your favor, you have tighter trailing stop.

I think from what I've seen, the data suggest that that's reverse of what most traders do. They really want to get in a really tight stop and then once it goes, they want to give it all this wiggle room because they want to be able to survive that pull back and see if it keeps going in their direction when instead, they should just let it pop themselves out.

Any other closing thoughts on this, Darren? I think it's a good point that you can make the largest gains when you're uncomfortable. It doesn't mean that if you're a trend follower that you should be trading reversal trades or whatever or picking, following a -- what is it called? -- catching the falling knife or whatever.

Doesn't mean you should be doing that. It just means that you should be paying attention to what's uncomfortable because that's probably where you're going to make the largest gains.

Darren: Yup, definitely. Just because something feels right and you're told to trade your personality, that doesn't mean that your every element of your trading strategy should feel warm and fuzzy.

It's natural for elements of trading for us, for human beings, to feel uncomfortable and you just need to learn the processes to deal with that rather than removing them from your trading completely.

Walter: Great! Well said. Thanks for your time, Darren. We'll see you next time.

Darren: Okay, cheers!