

2 TRADERS

[EP20: Seeing Chart Patterns](#)

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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 2 Traders Podcast.

Walter: Hey, there. It's Walter. Welcome back to the 2 Traders Podcast. I've got Darren on the line. Darren and I, today we're going to talk about pattern recognition, Darren, and how this applies to traders. First of all, let me ask you, Darren, what does it mean when we say pattern recognition? Why is that even a skill or something that's important to traders?

Darren: Apparently, we've got this ability to see patterns in everything we do. We use pattern as our way of learning. We learn by association of patterns and rewards and achieving some sort of goal. If you think about everything from learning to drive a car or how to cook a meal, it's all about patterns, and we repeat these and we learn by them. The story goes that we were in Africa, and you're walking through the woods and you hear a rustle in the grass. It could just be the wind, but it could also be a lion about to eat you. We've evolved from that in dangerous scenarios or risky situations to have this default where we believe in all patterns.

Although having this ability to learn from patterns is really good, because we've developed this kind of bias where in dangerous situations we default to believing all of the patterns, this obviously has some issues for trading. When we're thinking about exiting, we basically, if we're feeling fearful or we're feeling the uncertainty of the situation, we just see a pattern, a price action pattern, and we instantly believe, "Oh, it's definitely reversing." We close out our trade, and then price continues to our target.

That's one of the really key parts about pattern recognition. Have you got any thoughts on it?

Walter: One of my favorite studies in psychology is the study where they give people a sheet of numbers and then they ask them to ... I apologize if you've heard this before, but I love this study because it just illustrates exactly what you're talking about, Darren, which is that we have this ability, almost this default setting which allows us to see patterns everywhere. They give people a sheet of numbers, and they say, "Explain to me what's going on here with these numbers." People of course come back with many different theories and ideas about how these numbers are related. What they are given are random number tables, which by definition have no pattern.

It just underlines the fact that as humans we're so good at seeing patterns. In fact, it's sort of what we do. If you think about it, like you say, when you're driving you're

looking for patterns, patterns in drivers' behaviors around you, patterns in stop lights and what they do and anticipating what's going to happen.

A lot of this stuff, even, as you say, patterns for survival, it's sort of related to heuristics, as I see it. Heuristics are mental shortcuts. If you're in the queue and you're the grocer and you have your basket of food and you're there and you see a person look at you and say to you, "Hi, how are you today?" and then you just say, "Fine, thanks," or whatever, you know that this person that you see is probably going to take your shopping and charge you money for it, and you also know that he or she probably doesn't really care about what your day's like, so you just fall into these default patterns. You say, "Hello," and "Hey."

I've heard that a lot of people think that in life what we do is we kind of go through life on autopilot and we're relying on these mental shortcuts, we're relying on these patterns to understand what's going on. If you think about it, it makes sense, because if we had to analyze everything bit by bit, every time we woke up out of bed and rolled out of bed we had to decide, "Okay, now where am I? Where is this place? What's going on here? Why am I here?" if we had to do things like that, if we didn't have these mental shortcuts, if we didn't have patterns to interpret, we would have a lot of difficulty just functioning in day-to-day life.

The problem, though, I think comes in when we start to apply patterns in our trading when we see patterns, and we start to apply rules based on those patterns. The temptation in trading, because we see these patterns, is to apply too many rules, if that makes any sense. It's sort of counter-intuitive, but I do believe that the most powerful, robust trading systems have very few moving parts, and they also don't rely on new rules popping up along the way just because you seem to have noticed a new pattern, if that makes any sense, Darren.

I don't know if that's something that you've seen or if that's something that you apply in your trading, but to me I think although patterns are quite useful for traders, they can lead to too many rules and the death of a trading system by rules. I think that's something that we have to guard against.

Darren:

Yeah, like a sort of over-optimizing, where you have a system that's working, and then it has a bad day and you tweak the rules to allow for days like the bad day, and you go on and on like that until you basically lose the original gist of the system. I think at the other end as well is knowing that we react like this when we're making decisions in stressful scenarios, I sometimes wonder about, I know we all like to use a certain amount of discretion in trading, but I wonder whether really us human beings, we're built to be able to trade with discretion, especially discretion with no boundaries.

You say, "Okay, these are my rules for entry, but the exit is discretionary," just you'll decide when is the right time. I wonder whether, okay, maybe when you're on the top

of your game and you're going really well and you're winning, then you'll make some good judgment calls, but when you've had a bad week or you've just had three losing trades on the top, can you make good discretionary calls then, or are you just going to then fall into the trap of just seeing patterns all the time?

I question this ability. Everyone seems to think that the way to trade ... Well, not everyone. I'll rephrase that. A lot of people think that the only way to trade successfully is discretionary trading. I question that. I think really we always need, even if you have options for exits based on certain environments, I think you still need to have that framework. What's your view on discretionary trading?

Walter: The theory goes, at least if this is what you're talking about, what I've heard is that it's true that a discretionary trader will do much better than a systems or EA or computerized trading robot. This is what people come to me and say. In fact, a lot of people come to me and say, "Hey, I'd like to learn how to trade basically in some of the ways that you do, because I've got this system running and it's doing quite well, but I know I can make more money as a discretionary trader."

I wasn't really aware of this wives' tale or trading myth or whatever, and I thought it was kind of interesting. I think that's what you're talking about. Is that right?

Darren: Yeah, exactly, this idea that you should make the decision at the moment, and basically setting up rules will never work in the market, basically.

Walter: I disagree. I don't think that that's true. I think that there are very simple mechanical systems that don't really need any human intervention. In fact, that's kind of all the rage now in trading. You talk about how these violent moves in the markets are being blamed on these algos or whatever they call them now. There's always the boogeyman in the markets, and at the current moment it seems to be the algorithmic trading. The funds are being blamed for these sorts of things in the markets.

I don't think that discretionary trading is necessarily the best way to trade. I think that in the end most traders are discretionary whether or not they're using an algorithm. We've talked about that I think before. It's kind of a "How much do you give your system, how much do you allow your system to trade, and how much intervention do you have when you step in?"

I think that, to me, what's interesting about about patterns and using patterns in your trading is that it enables you to see the crowd. The way I see my trading is I get in when the crowd is getting really, really emotional. What I try and trade are these hyper-emotional patterns on the chart. Now, this could just be myself applying a logical reason and explanation for the patterns that I trade. However, I think that there's enough reliability in the patterns, at least from what I've seen in my testing and in my trading, that there's something going on here.

Whether or not everyone else in the markets, whether or not the market is really doing what I think it's doing, it doesn't really matter the reason why. To me, it's just if the pattern tends to work in general, then why not apply it? I guess that's how I see it. I'm not sure that I agree with the idea that everyone should trade discretionary and that discretionary trading is superior to algorithmic trading or mechanical trading or running an EA or whatever, but I would argue that most people, in the end, even if they're running an EA, even if they're running an algo, there probably is an element of discretionary trading in there that they're maybe not admitting or aware of.

I guess to me the important thing about patterns is just knowing that this is a pattern that you've tested, that you've used over and over again in your back testing and in your forward testing and in your live trading, and you believe in it. I guess it's like anything. If you're a 5-year-old kid, Santa Claus is real because you believe in Santa Claus. He's real. He exists. It's the same thing with patterns. If it's something that you've convinced yourself is true and reliable, I say why not use it? Because you're leveraging your human way of thinking anyway, aren't you? You're using what we do all day long anyway, so you might as well do that in your trading.

I think there are pitfalls in patterns, too, that we fall into, but I don't know if that's really ... I don't know, maybe we can get into that. I guess my answer is I'm with you, Darren. I'm not sure that discretionary trading or pattern-based trading, as we say, is better or superior to mechanical trading. In fact, some traders probably aren't even really cut out for it really. That may also be the case. They're more likely to do better with more very rigid rules and maybe even automated or semi-automated trading.

Darren:

Yeah. Patterns are good, we need to use patterns, but we need to decide on the patterns to use carefully, basically, because if we make those decisions in the heat of the moment, then we're likely to make mistakes. There was an interesting thing you said about algos as well, and that we always need to have a boogeyman and some sort of higher being that's trying to get us or control us. Apparently, this comes from pattern recognition as well, because if you go back to the story about when we were in Africa and we thought we were being chased by a lion, we associated pattern recognition and the decisions we make in those environments with this lion that was trying to get us.

They reckon that explains why we believe in UFOs and believe in a God and these kind of higher beings, and they're always super-intelligent. That's why we believe that the brokers are out to get us and the algos are there to trip us up and take our money. There's always this underhand thing. Apparently that comes from this pattern recognition thing as well. It's really powerful.

I use patterns in my trading, and I try and keep them simple. I just try and avoid deciding on patterns in the moment. Like if we get to point A and B happens, then I'll

exit, and if B doesn't happen, I'll move on to point C, and so on and so forth. That is all decided there. I still need to make judgment calls along the way, but they're within a predetermined structure so I don't go completely off the thing and just suddenly price starts spiking around and I make a key decision based on that.

Yes, it's really important. Again, it's something that we all do and we need to understand it.

Walter: Yeah. I think it was interesting what you were saying about having to have this force that's going against us, like the brokers or the algos or the private funds or whatever it is, the banks. Especially in trading currencies there's these few things that are always in the way of success. One thing that I found really interesting when I was studying psychology in graduate school was that it seemed to be in the '60s everything was about the environment. The reason why we did things was reward and punishment. In fact, I think the quote was something like some famous behaviorist said, "If you give me a child, I can create a scientist, preacher, or a baker," or whatever, something like that. I'm probably butchering the quote.

The idea was that you could mold somebody with rewards and punishment and create them, and that the environment creates the person. Today we've swung the other way. There are actually studies where they have shown that whether or not you're conservative politically or not or whether or not you believe in God or not is down to your genes. We've actually gone the other way from your environment molds your self and your beliefs and who you are to your genes are mostly ... I think most people would agree that that's kind of the default setting for science today, which is "If we can just unlock the genes, we can figure this out." That's the whole thing. In a way, I guess, the genes are the boogeyman.

What does that mean for traders? If your patterns, your genes, your makeup, your recipe inside of you does not allow you to trade profitably or makes it difficult, does that mean you're not cut out to be a trader? What do you think about that?

Darren: I'm not 100% sure on that. It's possible. It's definitely possible. Maybe it's true. It'd be terrible to think that some people trying to learn to trade and spending a lot of time and money and heartache, and it's not possible to do it. I don't know. I still lean towards this thing that if you put your mind to it and you've got the right mindset, that anybody can do it, but maybe certain people carry more of a genetic advantage. I don't know. I really don't know enough about it.

I'm a strong believer in this great mindset, and that if you have some determination and you have the right mindset and you learn the right skills, that your brain can improve nearly everything you try. I lean that way.

Walter:

Yeah. I think that the turtles experiment was a pretty good one to show that. That was basically the crux of the deal, wasn't it? where William Eckhardt said, "You've got to be born with the ability to trade," and Richard Dennis said, "No, no. I can take anyone and teach them how to trade and make profits." Dennis clearly won the bet there. There was some discussion about one of the turtles didn't do very well or something like that, he wasn't following the rules. I don't know if that's a rumor or if that's true or whatever, but I guess at least in that example you could point to that and say that's evidence that you can learn to trade.

What was interesting about that experiment to me was that I believe that there's a trading system that fits your personality, and so it's up to you to discover what your beliefs and the undercurrent beliefs about the market, what is your default belief about the markets? and then apply that to your trading, find a trading system that fits that. What was interesting about what Dennis and Eckhardt did was they actually gave everyone the same trading system. They had a little bit of leeway and they had a little bit of ability to change their approach, but by and large they were all basically doing trend-following trading, which from what I've seen is not the type of trading that most traders want to do.

I think there was a lot of breaking down beliefs and there was a lot of education involved with the turtles in terms of teaching them, "Look, this is what you think you should do in the market, but really you should do this instead." The idea is that most people see a runaway market and they say, "It's going to turn around right? It's got to turn around," whereas they were teaching them that when it starts to go you just assume that it's going to keep going. From what I've seen in the traders that I've tested, that's not a normal way of seeing the markets. Most traders are much more inclined to look for turning points than to jump on strong trends.

The other interesting thing about patterns I think is we're saying, is there a genetic predisposition to profitable trading? Some of the things that I like to do with this is to have a mind experiment. All right, so let's take somebody. Let's say that you believe that there isn't a genetic predisposition to profitable trading. All right. What if somebody has an IQ of 60, which is pretty low. Will they be able to trade profitably? What if somebody has brain damage in their frontal lobes and they can't control their impulses? Are they able to trade profitably? Those sorts of things.

It's like take it to the extreme. What if somebody is really anxious? Would they be able to trade profitably knowing that every time they take a trade they're putting money at risk if they're really, really risk averse? I guess there's characteristics and personality characteristics, and even intelligence may come into play.

I tend to believe, and this goes back to a story that I ... When I first learned how to trade currencies, I went through a week-long course, and the guys were ... The whole

thing was shut down by the feds later, but that's a different story. One of the things that I noticed was one of the best traders in our group was a guy who I wouldn't characterize as necessarily very intelligent. All he really did was just follow what the instructor said.

I think there's a lot to be said for that in terms of "Is your pattern of belief to simply take what someone says and teaches you and just apply it, without ... " It's almost like you can be too intelligent, because you get too tricky and you can find too many patterns in your trading and keep applying those rules over and over again until now you have something really complex and sticky that doesn't really work all the time. I don't know if that's something that's true, but I've thought about that ever since I ran into that trader.

Darren: Yeah, I've heard that story. You either need to be really stupid or really clever, and if you're anywhere in between then you're going to struggle.

Walter: Which is the lot of us, isn't it? It's like the 86% of us that are right in the middle.

Darren: Yeah, the 95% sit in the middle, and then you have the really smart and the really stupid traders who are doing really well.

Walter: Yeah, exactly. I think the other thing about patterns that I was thinking of, Darren, was this idea that we have these negative patterns. I know this touches on the psychology which we've talked before about ... Which we talk a lot about in fact because I guess we probably, but without putting words in your mouth, we probably both believe that there's way too much focus on the system for most traders and a lot of what determines your results is more geared to your psychology.

That's another thing where patterns come in. Let's say that you have this pattern of in your life you always have a situation where you're just about to make the big win or get the big result that you're looking for, and then you fail for whatever reason. You pull back or you don't do well or you have performance anxiety or something like that. If you have something like that going on, that could also crop up in your trading and really hold you back. There are those patterns as well, patterns of behavior in terms of your role in life.

Some of these things could be, perhaps, depending on who you talk to, could be written into your behavior, into your beliefs, into your subconscious, even, at an early age, and those sorts of things keep cropping up over and over again. Those patterns are also something that we have to be aware of if you believe in that, if that's something that you've noticed with yourself where things tend to keep happening in a similar way.

Sometimes it's hard to see, you have to take a step back, but I think that also is a fruitful area for you to examine if that's your belief, if you do believe that we fall into particular patterns in our lives.

Darren: Yeah, definitely, Walter. Bringing it back to the emotional aspect of dealing with these patterns, like you're saying there, is even the strategy side, the patterns in our strategy, they need to allow for that as well. As an example, you like to trade the kangaroo tail, don't you? In your mind, not all kangaroo tails are created equal. Although it's a specific technical pattern that you like to use, you're using that to gauge the emotion of the other market participants and how they're feeling.

That is kind of like something that you have to learn over a lot of time, which is I think a problem people have, is you teach them a simple technical strategy that has some simple patterns in there, but then to reinforce that you kind of need the experience of... They want to know like a precise, "when x equals y, then you're good to go," and it's not quite as clear cut as that. I think this is where the bit of discretion comes in with the pattern recognition, is you then need to use that pattern to judge the overall emotion and feeling of the other market participants.

That is something that I suppose cannot really be taught like you can with the simple patterns. That takes a lot of time to learn.

Walter: That's interesting, but let me play devil's advocate. I really like that point that you made. I'm wondering, though, if you could argue, someone who was a pattern protagonist, say, that basically what you're talking about, Darren, that last bit that you need learn, why couldn't that be more subtle patterns that you've been exposed to? In other words, there's another pattern within the pattern, or something like that, and that that's what happens with experience in the markets, is you start to learn those sub-patterns or something like that, so why not every kangaroo tail is the same, for example, and what makes a more profitable one than one less likely to work out, or something like that.

What do you think about that?

Darren: I think that's where you need to decide how you want to trade, the pattern. You might say, "Well, not all kangaroo tails are created equally, but can I trade them all and still be profitable?" Then you say, "Well, okay, I can, but x amount are going to lose, so how do I still make profit?" You do that by letting your trades run longer so hopefully you'll get some big wins to cover the losses. Rather than trying to find the answer and find, "This is the exact kangaroo tail that works," you use some other techniques, which means that you don't have to be right.

I think you still then need to have that kind of empathy with the market to have the confidence to keep going along with it. You have to, "Well, this looks like a down trend, it fits the pattern for a down trend, this is a down trend signal to sell here, I'm going to go along with it, knowing that it might lose, but I'm believing it enough to be able to make this risky decision." It's a tricky one to do.

I tend to lean to the side of like, this is a set up, take the set up, but you need to make sure that either you're going to give it enough space that you always win even if you're wrong on the direction, or you need to let your trades run further enough when you do get one right that your wins cover your losses.

Walter: Yeah, yeah, exactly right. That's an interesting way of ... What I hear that, what I interpret that as, and maybe I'm wrong, but I interpret that as, yeah, you're saying basically either you need to decide as a trader you're going to have really wide stops, which means potentially low reward-to-risk ratio ... and every trading book you read they say you've got to have x reward-to-risk ratio and it's so important to have your high reward-to-risk ratio and all that ... or the other thing you were saying is you could simply decide to use basically a trailing exit or an exit that allows really, really big profits occasionally, so that wipes out all of your other little losers and sub-par trades.

Darren: Yeah, completely. Use patterns, but I think you have to use them wisely and you need to think not just of the technical patterns but the emotional patterns of the other traders as well. It's very complex, and I think the key thing to take from it is to study these patterns and decide on which ones you're going to use when you're away from the charts and you're thinking rationally.

Don't make decisions on patterns in the fly. If the news comes out and it's spiking upwards and you suddenly decide that this pattern says it's going long and it's nothing to do with any of your rules, then don't act out that feeling.

Walter: That makes perfect sense. We want to be aware of our own emotional patterns that could be sabotaging our trading or at least holding us back. We want to understand that we are using patterns in our everyday life and probably in our trading. I guess one of the things that I take away from our discussions is really question it, question what these patterns are that are sometimes implied in your trading. Sometimes they're not even those things that are particularly overt, but they're underlying your beliefs. It's almost like you don't even question those things.

Really question those as well to make sure that what you're doing you really believe in and that you're going to stick with over the long haul. That's what I would say about patterns. That would be my takeaway for today.

Darren: Yeah. Really good, Walter. I'll see you next time.

Walter: Great. We'll see you next time, Darren. Take care.