2 TRADERS

EP121: The Idea of Prediction (Part 1 of 2)

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Walter: One of the things that make us so difficult is we're not really built to withstand the 77R losing streak. That's not the way we operate...

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 Podcast. Hello, Darren.

Darren: Good morning, Walter.

Walter: The topic we had discussed for today was this idea of prediction, whether or not as a trader -- a trader who's looking to pull profits out of the market -- whether or not you have to have some way of predicting the market.

I think this is a really interesting topic. I think I know what you're going to say but, what are your thoughts on this issue? I think it's kind of assumed. Like, people who are new to trading or don't know much about trading assume that what you do as a trader is you predict where the market is going to go. What do you have to say about that?

Darren: I think that is definitely the approach that I've got to say the majority use. The majority that I come into contact with definitely have that sort of approach. I don't think you -- I mean, obviously -- you don't need to be able to predict the market.

But, maybe as human beings, we have to have that belief that that's what you're doing even if you're not. If that makes any sense because the opportunity lies in the movement of price.

You don't necessarily have to be right about where the direction's going to go to make a profit. I saw that recently. Just yesterday, one of the members of the forum ran a test on a really simple trend trading idea that I posted a few months back.

He did ten years of testing on this strategy. He found out that it had a positive expectancy. I am always saying that you don't really need to predict the market. You just need to participate and maximize your profits when you're right and minimize your losses when you're wrong.

What he did was he -- rather than using the simple rule I had for determining the trend -- he just determined the trend for the day by using essentially a coin flip but he obviously programmed it so it's either long or short. A decision was made randomly everyday and he actually made more profit. So, quite a bit more profit.

You have to start to sort of question why did it make a profit. In this instance, you can't prove why it did make profit. There's a few elements working together but the core of the strategy idea is that you hold your winners for a long time. In his test, he was using the risk/reward of 5 to 1 so he's winning five times more on his winners than he was on his losers.

The obvious assumption to make is that predicting the market direction isn't essential. It's the fact that the market does actually move because for 5 to 1 you need the market to move in one direction for quite a sustained period.

Walter: Or, you can have a really tight stop. You can have a V winner if you have 6 pips stop and you just get 30 pips out of the market. I think that's potentially, yeah...

Darren: Essentially, yeah. It's that drift. It's that movement from A to B and B being not where A was essentially. You don't have to be able to predict the market. But, if you go a little bit deeper into the psychology of it I think there is a subtle advantage for us to believe we are.

Even if you know deep down it's not essential for you to do it, I think sometimes it's quite helpful to put those things in there where you believe you're kind of having some effect on the outcome.

It's a difficult one to say and there might be people out there that can. By their sort of got in years of experience of looking at charts, have like a good hit rate of predicting where the market will go. As the test has shown, it's not essential.

Walter: Just playing devil's advocate here, did he ran just one test of the random long short? He had the computer determine whether it was a long day to buy or a short day to sell. But, he only ran one test so someone could argue that he just got lucky. He kind of locked in to a sequence of long and short days with the random generator. You know what I mean?

Darren: No, he ran the test for 10 years and then he ran it 10x.

Walter: So, 10 sequences. Ten sequences of buy and sell days.

Darren: Yes. His lowest return was 215R for the ten year period and his highest return was 614R. It won in every year. Now, that could still just being pure luck.

Walter: Yeah because some people will say, "You've got to run a Monte Carlo with 10,000 sequences" or whatever, blah, blah, blah...

Darren: Yeah. But, when you backup with the trend row in place also being profitable, then you've got to start telling you that the probabilities are it's the high risk/reward and the market condition that existed during those ten years.

Walter: Yeah, absolutely.

Darren: And, you have to say, "Well, was there something specifically unusual in those 10 years of market movement? Or, are they generally what the market always has done?" You have to kind of dig a little bit deeper.

Walter: Absolutely! That's interesting. Did you think that's what it is? Do you think that the reason why those 10 tests over 10 years made money was because the market was basically moving? If the market was pretty, if the market had consolidated... Which market did he traded on?

Darren: It was the EUR/JPY and he was trading the H1 chart. He did do tests with different risk/reward as well but that was only with predetermined direction indicated whatever the trend indicator all in place.

From 2R all the way up to 10R and all of those are profitable. For me, it's about the drift of the market. For me, it's about the fact that the market…

Walter: Wiggles. It wiggles around.

Darren: Yeah. It wiggles and it has this kind of drift. It will stay in a range but then it will move on to a different range and so there's opportunity there in that movement.

Walter: Yeah, absolutely.

Darren: I mean, obviously, if price just stayed in a range forever then it would be simple, wouldn't it? Likewise, it would just have trended forever it would be simple.

Walter: Yeah, absolutely. It reminds me of -- the concept that you're talking right now -- reminds me of what Goncalo said at the conference. He was talking about this strategy of... Like, he looks at drawdowns in a completely different way. The way that he trades.

He was saying that the idea is that if you look at the coastline of, say Massachusetts, you could measure it one way and say, "Well, it's a 300 mile coastline," or something like that.

But if you look, if you zoom in at it, you zoom in and see all the zigs and zags, it approaches infinity with all the little moves. The question is do you want to take advantage of those little tiny zigs?

How much do you want to zoom in and zoom out? Isn't it that kind of the way? Like, if you're trading the H1 chart and you're trading the zigs and the zags in the H1 chart. That's a completely different experience to trading, the daily zigs and zags.

Darren: In time, definitely.

Walter: Absolutely. You remind me when you were talking about the way that you'll approach this strategy originally before he use the random entry or the random determination of bullish days and bearish days. How did you determine whether the day was bullish or bearish? What was your indicator for that or whatever? What was your approach?

Darren: Just really simple. It was if the previous day closed bearish -- so it was down -- the close was down on the open then the next day you trade only short. If the previous day closed bullish then the next day you just, you only trade it long.

The whole point of putting the strategy forward was to say, "We're debating too much about how to determine the direction. We're given too much emphasis on picking the direction because we're being led to want to be right and to be right because of how clever we were. 'Look how learned I am. I could predict which way that the market is going to go.'"

And I was just trying to say, "Well, look it's actually really difficult to do that and moreover you don't actually have to be able to do that." Simplify that and when you adapt that mindset, then you'll find it easier to stick the strategy over a long period.

In all of these tests that you did, if you just took one month of the trading, you probably wouldn't have made any money in any of them. But, because he stacked it for a long time, the numbers would like to play out and that's where he made really good returns. I mean, people will argue that 200 R over 10 years is not enough but 20% a year compounded is amazing result.

Walter: Especially if you don't pull money out of your account. Exactly, if you compound it. And also remember that the R that you had. The R that you returned on your one is obviously completely different than the R that you returned on year nine. It's completely different.

It's a completely different result because the account has grown. That's compounding. I think a lot of traders miss that. Let me ask you this: Do you think that the reason why -- because you've sort of just touched on this. Do you think that the reason why this five R strategy with the random assignment of bullish and bearish days, do you think that the reason why it makes money is because it was given such a long period of time?

Because in other words, if he had traded this even if it was the H1 chart for only 30 days, 30 trading days, he could have probably and there's likely or perhaps he could have just thrown it away and said this is no good after looking at those results.

Darren: I don't think the reason it made profit is because it was traded for a long period of time. But it is quite likely that the wins and the losses are pretty randomly distributed and it is quite likely you could start and just lose all month.

There was very long sequences of losses. I think the 10R strategy had 77 consecutive losses but it made 600 odd R at the end of the trading period. I think again that's what draws people to say, "No I've got to improve at predicting because this cannot be right." This isn't right but that's the nature of trading. If you don't learn to deal with those elements of pain, then I don't think you can make it.

Walter: That's great. I think it's great advice. It kind of boils down so when you look at trading, the trader who's able to somehow come to a place where he or she can deal with 77 losers, 77 R loss can live to see the day of the $600 R win. I mean a cumulative win.

But the trader who cannot do that, the trader who completely scraps the system after three losing trades in a row, never lives to see the day of the 600 R payoff. And I would even say, one of the things that make it difficult is we're not really built to withstand the 77 R losing streak. That's not the way we operate.

Darren: And that's why experienced traders always saying psychology, psychology, psychology. Because they know that you're going to have to deal with this hurdle at some point. If you're going to make it at some point, this is a barrier you're going to have to cross.

Even the 2R test had 19 consecutive losers. Even the 2 R and it made a 193R at the end of the test period. Your mind is going to say to you, "Okay, I need to improve this strategy to get rid of this element consecutive losers" drawdown or whatever and it's almost impossible to do.

A better approach is to accept it and say, "I've accepted this now." And then when the moment comes that you hit this losing streak, then you've least got the chance of sticking with your strategy. I presume that the majority don't do that and that's why the majority don't make profit.

Walter: That's right because they take quick profit, basically. They like really quick short in and out sort of profits. We know that from the data. I think you posted one of those things in the forum.

The article about where they look at millions of trades and that's basically what they found, that most traders take quick profits. They're right more often than they're wrong but their losers are so big it wipes out their profits.

Let me ask you this, Darren, if someone's listening to this and say that sounds really cool. I want to do something like that. First of all, we've given you everything you need to know. It's not very difficult.

You can create a strategy based on what we said. You could test a strategy where it was 5R and you're basically flipping a coin whether you're going to go long or short. Now, you're probably going to mess around with your stop loss placements and all that because that's -- I don't know what kind of stop loss that he use. Did you use a 60 pips stop or something like that?

Darren: No.

Walter: Also H1 chart.

Darren: It's a H1 chart. If the direction for the day was short to sell then, if you had a bearish close on the H1 timeframe, you took a sell at a low and put your stop loss at the high.

Walter: Of the one hour candle, right?

Darren: Yeah. And that was it. There was no particular candle pattern. There was no moving averages. If the bar close down, that was the sell signal. You put a sell up.

Walter: And, he didn't care if it was a 70 pip candle or a 15 pip candle. It was just...

Darren: No difference.

Walter: That's interesting.

Darren: So, it's really simple. It has literally taken away all of the analysis. It is essentially just a risk/reward strategy, basically.

Walter: I think a lot of the way that the Turtles originally traded was kind of like that. It makes a 55 period high you go along or whatever. You just wait until it makes the 10N period low and then you sell out. That's your trailing exit. There's really no guessing involved. You don't have to know whether sugar's going to go up or sugar's going to go down. That sort of thing.

Darren: And Dunn Capital guy has traded a system like this for decades.

Walter: I had this running bet in my head whether or not Dunn Capital would come up. I knew they would come up because it's a great example of this. It's a great example of this.

Darren: Because he does no analysis at all. He doesn't look at sugar and look at the fundamentals and look at a chart pattern. If the moving average crosses over, he goes long and he holds it. If it crosses back again, he goes short and he holds it.

Walter: And he's always in the market.

Darren: Always in. He has long periods of losing but then he gets a massive winner and that's an extreme example. And, there's Basso who did a completely random entry.

Walter: Tom?

Darren: Tom Basso, yeah. Completely random entry and used a wide stop and then a trailing system. Again, he had lots of losers and eventually he's going to get the trades that run. It's one approach. I'm not saying you have to trade this way. If you want to still trade in an analytical way, just take these elements on board because they can also improve that style of trading.

Walter: It just opens up your mind and it can give you a relief. Like, I have a lot of friends. I have some friends who are retired and they're really more investors than traders. We talk about the way that they trade or invest and they ask me questions as well.

What's interesting is they'll look at me and say, "Wow. I can't believe you do what you do because you must have to read all the newspapers". I explain to them, "No. Actually, no." Reading the newspaper is the last thing I want to do. It gets on the way but people assume that. They think that that's the way that you know what's going on. That's the way that you'll know whether to go long or short, is by reading the newspapers. Well, it gets in the way.

I think a lot of people listening to this. Even if you don't want to trade this way, what you can take away from this is... Obviously, the key things I need to be looking at here are dealing with my emotions and how am I able to withstand huge drawdowns, huge losing periods.

And two, how can I setup my trading so that I'm going for large reward to risk because if I'm going for larger reward to risk, I can really become sloppy with my trading and still make money. I know that that may not sound right, it may not be taken the right way but you can kind of mess it up. You can mess your trades up and still make money **if** you have large reward to risk ratio.

Darren: I think that the further you go down this idea of being able to predict or wanting to predict everything, you'll get into such minute detail about exactly the right setup and exactly where to place the entry and then stop.

Before you know it, you can't take any trades at all because you've basically bought so many criteria that you're actually never in the market. I know overtrading is a problem but if you've never entered, you're not going to win anything, can you?

Walter: Yeah. That's right.

Darren: I think also a friend of mine recently sort of reminded me about... Over Christmas, he said he re-read some books and re-read Nassim Taleb's "Fooled by Randomness". If people have never read that book, it's really good book for just making you think about things slightly differently -- in terms of trading, anyway.

Walter: Yeah, absolutely. I think he consults for private funds or something like that. The interesting thing about the way that he trades is that it's completely different from the way he's mentor trade. He's mentor just sort of just took short quick profits and he trades the exact opposite of that.

Darren: That can be a really good edge as well. Having a high win rate can be a good edge. The psychological pressure is slightly different with that in a such that you tend to stay around break even for a long time and increasing your account is very slow. You can use that approach as well.

Walter: Absolutely.

That's all the time we have for this episode. In the next episode, we are going to dig into palm readers, the trader who could never lose. What it means to predict the future and be human at the same time.

All these and more, including the hive mind in the next Episode of the Two Traders Podcast. I'll see you there.