EP123: Market Patterns: Random or Not? (Part 1 of 2)

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

Darren: Good morning, Walter.

Walter: We're talking about this idea and I'd love to get your thoughts because I think we are going to have different approaches on this -- which is always interesting but... What do you think of this idea that there are these patterns in the markets that are repeatable, that you see them over and over again versus the idea that there's just looking at the patterns in the market its like watching cockroaches walk up and down the wall? It's just totally random. They both have their supporters.

My thought is when someone says to you, "This is a repeatable pattern. I see this happening all the time." What are your thoughts?

Darren: Well my initial thoughts, that's what we're built to see so you're going to see patterns. I would say if you're going to trade off patterns like that, I think that's fine but, you need to understand how much of an impact it's going to have on your trading results.

The fact that that's just a part of the bigger equation, if you like, that you need to work on and you're not going to find a pattern in its own that's going to make you a successful trader. It's quite difficult to talk about things like patterns with trading.

First, you have to just do some 5 minutes research on the internet about humans and patterns. There's a few biases that relate to us and seeing patterns. For instance, there's the one where you see faces and things where people have seen…

Walter: Apophenia.

Darren: Yeah, apophenia, and we have a few biases like that. When you look at the research into it and why that exists, then it makes sense. It's logical that we would see patterns. Whenever there's a deep rooted bias and then you believe you've found a pattern in something like a Forex chart, it's quite difficult to convince yourself that your pattern's not valid. But you just need to join the dots up here, don't you?

You need to say, "Well, let's have a look at the evidence here. Is there evidence that I might just be imagining this pattern or I might be making more out of it than it actually is?" -- and I think there's a lot of evidence to support that.

You have to be logical and step back a little bit and say, "Okay, this is a pattern I think exists. There is a possibility that that's just being created by random up and down movements. There's a possibility that I'm visualizing it because it's what I want to see."

If you still decide to trade based on that, then I know at least you're going into it with an open mind because I think most of these patterns don't really exist. For me personally, if I'm going to trade a pattern, its a much broader concept of a pattern rather than a very precise, this goes below the **61.8% retracement** and then it prints this color bar at this time. When you start getting that deep into it, then I think you're over rigging it a bit.

Walter: Right. But, what if that's not -- I see what you're saying -- but what if someone has a pattern and they've got it really detailed? Like it's got to be this 33% and whatever and blah, blah, blah. But, that might just also work as a method of restricting them to taking certain trades. It's just like a rule, basically. It's a system-rule. It could be helpful in that way, right?

Darren: Yeah, definitely. And, I think there's some logic behind it. Its saying this is a pattern that occurs. Presumably, they've gone on to test that they can use it as a tool for trading and its main purpose is it stops me from over trading, such as a pattern of waiting for a deep retrace after a strong momentum move. That makes sense to me.

I think the problem is that a lot of people say, "I've found the pattern that's always going to win." I think they see patterns like that, they somehow solve the problem. Then, other elements of the trading tends to be pushed to the background and not given the importance it requires.

Walter: Right. So reading between the lines here, listening between the lines, basically you might say… Okay, you see this pattern. I understand that and it looks like this is something you want to trade but you're really focusing on the wrong thing. What should be talking about or concentrating on is your reward risk ratio or how you manage your exit. It's not really about the pattern that gets you into the trade.

Darren: Yeah, andI think like you were suggesting patterns. If we are talking about a particular candlestick patterns and as such on charts, they're better used for -- like you say -- giving you some sort of order and guidelines to trade around and not really the elements that are going to make your profitable.

Walter: Yeah, right.

Darren: Some people would disagree with that, though. For me, it's always whenever something like this comes, I always look at the Psychology first and see if there's a compelling case that we might be making a judgement mistake on. I always look for that. If there's really strong evidence that that could be happening then you have to be much more open-minded about what you have discovered.

Walter: Yeah, absolutely. I find patterns very useful for me and I'll test them. I have tested the patterns that I don't like. For example, one of the ones I've seen or came across -- I think it was 2003, 2004 -- was this it's called the "3 Soldiers".

Anyone who's familiar with candlestick patterns has probably heard of the 3 Soldiers. I found it to be completely unreliable. In fact, I contemplated a trading system based on fading the 3 Soldiers. It was that unreliable. Whereas other patterns I've seen, such as the Big Shadow or Kangaroo Tails or whatever, I found to be quite reliable.

Now, I'm open to the idea that perhaps because I understand apophenia, I understand you give people random numbers and they can find the patterns inside there. I'm open to the idea that maybe there isn't anything going on there. But, what I don't understand is how is it that I can go and test the 3 Soldiers pattern over 12 years, let's say, and take 700 trades and it completely stinks.

And then I'll use the Kangaroo Tail, test that over 12 years, and it works even if I'm using the same exit strategy on both patterns. To me, there has to be some sort of edge there. There's got to be something going on. I realize I'm open to the idea that perhaps I'm seeing something that's not there but, at the same time, why do I see this disparaging statistics.

I mean, one theory would be that the reason why your Kangaroo Tail seems to work, or your Big Shadow seems to work, is just because you happen to live or test in a period where it is working, then later on it will stop working. Is that one thing you would maybe point to?

Darren: It could be just blind luck. It could be just randomness and you have to be open to that. That's why you have things. That's why you do backtesting and then you make sure you trade the right size. You make the best of your winners.

You have some sort of exit strategy that's got a positive expectancy. That is one possibility. It is a possibility like you say that there is a true edge in that. I think if I looked at Big Shadows and find a positive expectancy I'd say, "Well, what is actually going on here?"

Essentially, I'm presuming prices, say, are rising very strongly and then it peaks and reverses very strongly. That is a good indication to sell because there's clear evidence on the chart. The biases change and momentums increase with that bias change but then you have to say to yourself, “Well that's not the only pattern, candle pattern that represents that.” You really have to test the Big Shadow against a similar price movement that has a different pattern.

Walter: Yeah, absolutely.

Darren: I mean you could argue that people are looking for that particular pattern. If that was true that the majority of people are watching the instruments you trade, on the time frames that you trade, in the time slots that you trade -- and they're waiting for that -- then it would really have a high success rate, wouldn’t it? Because, majority of the people would be trading that signal.

Walter: Yes. But, here's why I think it gets so interesting -- I agree with that premise -- but here's why it really gets interesting. I get emails from traders around the world and they say, “Hey look at the EUR/JPY right now,” then save a screenshot or whatever. I’m sure you’ve seen the same thing and it’s like there's no way I would take that trade. Like, I can kind of see what they're talking about but it's completely different to what I would. When I look at a chart, it has to either hit me straight away and I go, “Yup that’s the trade!” or I just walk away like it’s got to be obvious.

Darren: You're basically taking in information that isn't really just a pattern.

Walter: I would have to say probably. But the fascinating thing is that I can give you the Big Shadow pattern. I can give it out to 25 different traders. We can all come back a month later and compare our trades and there's going to be some overlap. But, it's fascinating to me to see the difference and how people supposedly trading the same strategy, the same discretionary rules are taking completely different trades. I think that’s what makes the market.

Darren: Yeah. I think there is a broader concept going on, isn't there? Rather than just the pattern. Maybe that's what makes the difference between traders.

Walter: Yeah. The first time I really found this -- and **I’ll put this in the show notes** for people interested. There's a book by a guy named Daryl Guppy. Daryl Guppy is an Australian trader -- and I think I read this in 2003 in one of his books. I find his books kind of hard to go through and I haven't read one in years.

I’m sure he has more and I think he's in Singapore now. But, the interesting thing in the book is he actually demonstrated how here’s a strategy, you give this to some people and then they all take totally different trades even though officially we’re all trading the same strategy but it ends up with totally different results because everyone sees it a little bit different.

That's the fascinating thing about trading. It's that we can all be looking at "the same pattern". We're all trading the same system and yet, we're not really because we see things totally differently. It's just fascinating to me.

Darren: Yeah. And again, it comes back to -- I don't know. Can you put that down to psychology? Because how much are you being affected by what happened this morning before that Big Shadow and what happened when you were trading yesterday before that Big Shadow.

All of these things we don't think are being used in our decision process. We think we're being completely rational all the time but science has pretty much disproved that now. With the amount of rationality is probably the smallest percentage, the rest or all of it is coming from the subconscious.

Walter: Absolutely. And that would probably make an episode in itself. Maybe we can talk about that next time. There's a lot of going in there that we're not aware of and I think that sparks an idea or a thought in me when you say that, Daren. This idea of what's going on in our head. How maybe our experiences perhaps play into that. We see things slightly differently.

A good example of that is -- sad example -- is somebody who has been abused, physically abused as a child. They will see other people and interpret what's essentially a neutral expression or a neutral interaction with somebody as the other person's being aggressive. They see agression everywhere because they've been attuned to that.

To me, that's the same thing with the woman who keeps choosing the husband or the boyfriend who is abusive. You tell her you've got to leave this guy, you've got to find someone better. And then she leaves him and then she comes back with the exact same guy. It's a different guy but it's the same situation over and over again.

To me, that's kind of the psychology of the markets that is exposed when you're looking at patterns. If there are patterns that offer an edge, to me, the reason why they're there is because we humans are the ones that are making them appear over and over again.

The vacillation between fear and greed. We see these things pop up over and over again not because everyone's trading the same system but maybe because we're all predictable in a certain kind of way. You kind of know what someone's going to do in a given situation.

For example, maybe you know someone they've been in a trade for 2 days. The trade has been going against him the whole time. What are they thinking? A lot of times they are thinking, "If that trade can just get back to breakeven then, I'll dump it." Right? Well guess what, if you took that trade at a support or resistance level, my theory is that's why the support resistance level is there because everyone's ready to get out of breakeven or whatever. Everyone's thinking the same thing and that's where it pops up.

To me, I find it fascinating that as humans, all these people were taking this trade for all different reasons and yet it seems to me there are some glimpses of what we're thinking as a group and these are the patterns. I understand it could be wrong. It could be apophenia, it could be something else.

If the lady that keeps going for the wrong husband that's going to abuse her even though if she knows she shouldn't do that; and the kid who's been physically beat up keeps seeing aggression everywhere he goes; then, why isn't it that also traders keep seeing the same thing in the markets and keep doing the same thing around support resistance or whatever. To me, that's where it makes sense.

Maybe I'm just trying to construct a case so to help myself believe it. But when you can test it, when you can see it over historical data and you piece it together, why would it be these way? To me, that's one theory.

One theory would be a lot of people are kind of just like we make the same mistakes in life with our behaviors. We do the same things in the market, I don't know. It's a fascinating topic. I guess the other thing that you are highlighting to me is that it's not everything. When we first get into trading, we think that the pattern or the entry is everything but it really it isn't, is it? That's just one little, tiny, small piece of what it takes to pull profit out.

Darren: Yeah. And I'm often kind of beat up on people about obsessing about the entry and probably don't get my point across clearly. Like you say, there are reasons for these patterns but just relying on finding a pattern to become a successful trader is throwing a lot of really useful tools that we can utilize and are probably easier to be consistent with.

Psychologically, they are easier to use, I think. All I'm trying to do is to highlight to people that there's perhaps other methods that you can use that are easier to get good at than just perfecting the entry.

Walter: Exactly. It's like the focus is on the wrong thing. I think that if you look at most trading books or most trading courses, or what most people talk about on the trading websites around any form, anything you pick up. Like, if I go in the bookstore… There's a bookstore in Sydney that has a lot of trading books.

If I go in there and I just randomly pull one with my eyes closed off the shelf, it's a 9 out of 10 chance that that trading book is going to talk about trading systems. It's going to be about trading systems. How to trade this way and that way, why this way is the best.

But you know what? The longer you trade -- and maybe I'm wrong here, Daren, you let me know -- but the longer you trade it seems like the more emphasis you put on **YOU**, on understanding you and not really the system. You can understand a system in a weekend, you can figure out its weaknesses and all that. That's easy.

The difficult part is how do you follow it. How do make sure that you follow it? I mean, there are so many times I've run into traders and they just throw their hands up and they quit because it's a tough market for their strategy or they're risking too much. They can't sleep at night or their accounts are too deep at drawdown or whatever.

To me, it's like we've got it wrong. It's our own fault that we want to have dessert. We don't want to have our vegetables, do we? We don't want to work on the psychology of trading. We just want to eat that really nice chocolate ice cream, creme brulee, or whatever. The pattern, or the magic moving average, or whatever.

It's amazing to me that people pay for like… Did you know that there are moving averages that people pay for? I'm talking about like private funds. Private funds will pay to use moving averages that have secret formulas that create the moving average. Like, to me that's crazy. That's insane but it's true.

Darren: Yeah. I'm surprised funds are still making those mistakes...

Walter: That's all the time we have for Part One. In Part Two, you're going to learn about the hedge fund indicator man. Why trading systems are making you uncomfortable and what you need to do about this. The surprising result of a ten-year study, testing big profit targets. Why automated trading and discretionary trading systems both have the same problem and the need in understanding your uncle point.

As well as the secret of O traders and what they all have in common. All these and more in Part Two. We'll see you next time.