EP124: Market Patterns: Random or Not? (Part 2 of 2)

Darren: Most of my rules in my trading systems now are just to stop me from being stupid...

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 you're here at Part Two. If you didn't hear Part One, you can go back and listen to Two Traders Episode 123 to get Part One of this Episode. But, in Part Two now, today, you're going to hear all about the hedge fund indicator man; why trading systems make you uncomfortable and what you should do about this; the really surprising result that was posted in a private forum about ten years of data. Ten years of testing big profit targets and what he found.

Also, why automated trading and discretionary trading systems are both subject to the same problem and the need for understanding your uncle point. Why is this so critical for your trading. Finally, we're going to reveal the secret of old traders, what they all have in common.

All these and more in this Episode. Episode 124 of Two Traders.

Walter: Yeah, it's amazing to me. There's a guy I know -- and I can **put it in the show notes** for you guys who are interested. He sells information or indicators and stuff in systems. I think they are more like indicators and he's pretty well known. They're so expensive they just sell in the funds.

Most private traders wouldn't even consider buying them. It's crazy, right? There's several of these guys actually that do this stuff. They really have these magic things that funds are happy to pay for because that's the magic thing. It's crazy but I guess it's what people want. We've talked about this in the last episode.

I've said to traders who fight me on the exit thing. I say, "Look, don't worry about the entry. Keep your entry the same. What you need to do here is you need to workout a better exit." And they'll say, "Why? This and that".

I say, "Here's what you do. Flip a coin, take 200 trades in Forex tester. Flip a coin heads or tails by yourself and just put a 5 to 1 or 3 to 1 or whatever like a 5 to 1 target. Risk 60 pips to make 300 or whatever it is and come back to me after 200 trades." Without a doubt, they all come back and they all say, "Wow, this is amazing. It makes money! I can't believe it. How does this make money? It doesn't make sense."

Darren: Yeah. I think the difficult thing then is that's essentially finding an edge in the market. The difficulty then is executing those systems. I think people see stuff like that and they try trading the system. When it acts as you'd expect it to act, they then sort of drop out because they're going to feel uncomfortable trading a system.

Any system, at some point, is going to make you feel uncomfortable. That's I think in those times is when the mind is really searching for new patterns. The mind is saying he's not liking this, how can we make him feel better, and you search for new patterns. That's why people struggle. Because the psychological hurdles aren't just at stage 1, they are all the way through the trading.

When you talk about a magic moving average, I use a moving average in one of my trading strategies that actually makes the strategy perform worse. If I removed it, my test results are much better. But, without that moving average there, I have to make more decisions and there's these periods where I have to make these really tricky decisions and I make mistakes in those periods although, if I traded it more mechanically, I'd get better figures.

I put this moving average in there to make the whole process easier because I know over 10 years, I would perform better in the system, would perform better because of that. Most of my rules in my trading systems now are just to stop me being stupid. If I can make 3 to 5R every month and I'm not likely to make many mistakes, that is worth more to me than a system that could make 20R in a month or lose 20R if I execute badly.

Walter: Exactly. I'm with you in that one. I think as you grow as a trader a lot of what you're doing is putting up guard rails to make sure you don't swerve off the road and stuff like that. It sounds like that's what you're doing.

I think one of the big mistakes is that traders think they can just simply hook-in to a strategy, basically an entry, and just ride it for all it's worth. It's just not that easy, is it? Even if you don't believe that a pattern is going to help you find good trades, right?

What you might do is you might decide that, "You know what? I'm just going to trade." For example, you might trade in a similar fashion in a way that you trade where you just say, "Okay. Every time the market makes a wiggle, I'm just going to assume that it's going to really go".

Sometimes it will go and sometimes it won't everytime it makes a wiggle. But we do know that it's going to make a wiggle first before it's going to go. It always makes a wiggle before it goes. It has to. That's basically your edge in a nutshell, if I understand it right. You're just trying to milk those big moves for all you can.

If I do that -- and I decide that's what I'm going to do -- but what happens in those times when the market does really tiny wiggles. You know, wiggle up, wiggle down, wiggle up, wiggle down. It doesn't really go anywhere.

You're getting chopped up, obviously. It's the weakness of the strategy. You think the next one could be the big one and then eventually you have decide, “Am I going to take a break here or am I going to keep doing it?” I mean, really what you should do is you should keep trading it. But, boy it’s that hard, isn't ? Isn’t that hard to keep doing it?

Darren: That’s it. And I think the problem is that strategies that have edges have -- and I posted on this before -- drawdowns are much deeper and much longer than anyone can accept. We just don't accept it. Even if we know it, it is almost impossible to accept.

Saw that recently on Reima who did 10 years of testing with different R-targets. Even the 2R target had something like 22 consecutive losses and that’s what happened in his period of testing. You could have 30 consecutive losses but it made really good money.

I think people believe that they can find a system that doesn't have that element in it. Whereas, I believe if you’ve found a test period that doesn't have that in there then you probably just got really lucky.

I just don’t think people can take that one on board. When the moment comes then they change because if we think about it, if what we’re saying is true then you should be able to build EA’s that make money. And people’s argument would be, “Well, why aren’t people with EA’s all making money?”

I believe it's because they all change it. Whenever I follow people with EA threads, as soon as something bad starts happening, they go in there and have some “Aha!” moment and they make changes. That's what I see always happening but we don't seem to remember that fact that we gloss over it because it's uncomfortable to deal with.

Walter: Absolutely. And I've had this discussion with Mark Fletcher in the forum. He’s big in the Automated Strategies and I've argued that we’re all discretionary traders. Even the EA traders are discretionary traders because they decide when to turn it off.

He used to argue that and I think he has come around. Basically, said “Yeah, I agree with that now.” Because he has ran through that cycle where you end up modifying, turning them of, saying “Oh, it's not working anymore.”

It's interesting because Adam Hartley, who’s another trader -- I think he’s discretionary now. As a job, he used to build these automated strategies for funds and stuff. Repeatedly, he said that it's easiest for us to make the trending strategies work.

The automated strategies that capitalize on the trend and just about everything else is really hard to make it work. But these trending strategies seem to be the easiest ones to automate, which I found fascinating as well.

But, I think you're right. I think it's so true. That's the next step in our discussion. You were talking about this stuff -- 22 losers in a row, why don't you just automate it? Well the problem is 22 losers in a row, you're watching this, you're not actually physically taking the trades but you watch your robot taking the 22 losing trades in a row. It's really hard to let it keep going. You're probably going to flip the kill switch and turn it off.

Darren: Yeah, I know. It's the drawdown that's why you're going to look at you balance. At some point, you're going to monitor it.

Walter: Absolutely.

Darren: At some point, it's going to be uncomfortable. Let's say you tested 20 years and the worst possible scenario you've found was 22 losers in a row. When it gets to 23, are you really going to believe that my system doesn't work anymore? If that's what's not going on, are going to be able to do that?

We've talked about it ourselves. When do you decide a system is not working anymore? You have to have the mentality that it's going to work forever but there is a possibility that it does stop working. How do you deal with that?

Do you just keep letting it drawdown until it hits zero? And, really, that's what you should be doing but you should have some sort of diversification in there so if the strategy that has always worked, does go to zero, you haven't lost all your money. Really, all of these comes down to risking the right amount on each trade, on each strategy. Doesn't it?

Walter: Yes, exactly. And that's exactly it. I think what you've highlighted is absolutely true. We all have the "uncle point" -- to use the American term. I think it's an American term which is basically, "That's it, I'm throwing-in the towel. I'm done." We all have that.

Even if you say you don't have one, you have one. And I've run into traders that can completely pull a drawdown of more than 50% and they will keep chugging along. Actually, I didn't notice but I've known a trader for a while and a couple of months ago I met him and we were talking about this and his point is 5%. If he hits a 5% drawdown, he scraps the system and it's all done.

We all have different uncle points where we're going to throw-in the towel. The key is exactly what you say -- I believe, Darren -- which is you've got to backwards engineer it. You've got to understand, where is my uncle point? And understand that we usually are faster to shut it down than we think we would be.

In other words, if you say your uncle point is 20%, it might actually be like 15%. It's easy to say that you'll sit through a 30% drawdown but when you see that Dollar amount, then it's different. "Ah, man! That's a car!" or whatever. That's hard to sit through losing a car with your trading account. You just need to backwards engineer. Figure out what is your max drawdown that you don't want to hit, and then from there, you can work out your risk.

Also, diversification strategies that are complementary that kind of one usually does better, when the other ones not usually doing so hot. That sort of thing. Both of those things can help. It really comes down to math in that sense.

Like, Darren, you run your strategy through 800 trades in Forex Tester or whatever but you don't know your max drawdown was 22 losing trades in a row. You don't know if in the future you might have 40 losing trades in a row and really, the only way to get around is to reduce your risk.

If you reduce your risk to such a point where it doesn't really matter to you, it's not going to keep you up at night. You're okay letting it hit the stop loss or whatever. It's so much easier to do that.

Alex Upton is really good at this and he talks about this. You know how much he risks? He risks, I think he said a quarter of 1% is what he risks in his trade. But ,guess what? He's making money. He's following a strategy. He's not changing anything because it's so easy for him to fall asleep at night knowing that he's risking a quarter of 1% on any given trade.

Darren: He's probably also accepted that he is going to make slightly more modest returns as well. I think people, they think "Well yeah, I can reduce my risk. I can be smart about risk." But, can you also accept that you are not going to make a hundred percent a month? Everyone wants to make amazing returns but for no risk and you've got to have to marry these two up.

Nick Ranch did a thing about his clients and his fund and he says to them, "What is the most you're prepared to lose? Work out the risk, how much you want to risk based on your testing for that." And he said then, "Half it because whenever you're sitting here now thinking you're prepared to lose, when you're halfway there is when the pain is going to be hitting you."

Walter: Yeah, that's so true.

Darren: It's about getting through those drawdowns.

Walter: That's it. That's when the Psychology comes in. The longer you trade, the more you realize that the traders are able to withstand the drawdowns are the ones that keep trading. Everybody else is changing their strategy or giving up or whatever.

It's crazy but some traders, when you look back historically -- **Jesse Livermore. I**f you don't know who he is, **I'll post in the show notes**. I'll post his biography. He was able to withstand drawdowns. He had crazy drawdowns. Actually, you could argue that he didn't, because he ended up committing suicide so maybe he didn't.

Actually, he wasn't actually able to do that, sadly. But, he would have these "boom and bust periods" where he would make tons of money and then he'd lose it all. But, he would go back and do it again, make tons of money and he'd lose it all. He had these wild swings with his trading.

But now, the polar opposite of that is Alex Upton who has this really defined small amount of risk. He understands that he's not going to have the Jesse-Livermore-highs, but he's not going to have the Jesse- Livermore-lows either.

He's going to be pretty steady and he's probably going to be much better off over the long run. Yes, he's going to take longer to compound it but who cares? If he's making money, he's making money. He's not going to go through the psychological torment of the boom and bust of the "Boy Plunger", Jesse Livermore.

I love that name. I love that nickname, the "Boy Plunger". That's what they call him. It's so crazy. Have you read his book? He's from like the 20's and stuff. They call him the "Boy Plunger". I think he really loved to short the stock market so he made a big pile of money during the depression and all that sort of thing.

Anyway, so patterns, I know we've kind of wandered around here in this episode but if I'll sort of wrap it up from my point of view I would say test your patterns and see if they work for you. They could be something very useful.

Like you say, you're using a moving average that maybe it's not really going to improve your strategy but it just helps you keep things in a box, helps you stay on the road, so to speak, with your system.

Even if you're wondering about the patterns, if you test them and they work for you and you realize it helps me keep my strategy in alignment and it helps me stick to my rules. I can use them but, no.

The big deals in trading are working on you, on your psychology, withstanding your emotional highs and lows, and really trying to figure out your risk, and backwards engineering the horrible drawdowns that you may or may not have. And based on that, that's really where you are going to make your gains.

It's figuring out, "Okay, how do I avoid the catastrophic drawdown?" **I'll link up in the show notes the calculator** so you guys can go and type in your numbers and figure out a lot of that stuff because that comes down to probabilities. That's my overview of patterns. I think they're pretty useful. What say you, Darren?

Darren: Yeah. I think if you're still looking for patterns in Forex charts, I think the important thing is to ask yourself: why you're still looking for patterns? Because if you can answer that honestly and accurately you're probably going to find stuff of more use than looking at the charts for patterns. If that makes sense.

Walter: Well, thanks for your time, Darren. Will see you next time. We'll talk about the subconscious next time. That sounds interesting.

Darren: Cool, Walter. Nice chatting with you again.

Walter: Thanks.