

2 TRADERS

[EP125: The Causality Bias](#)

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Darren: Until you accept what we know, what we can prove and what we can't prove, then you're going to make cognitive errors all the time...

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 Two traders. Walter here, hello Darren.

Darren: Hi, Walter.

Walter: How are you going today?

Darren: Really good. Just came back from a few days from the beach.

Walter: Awesome! Excellent stuff. The question we have today is do we “need” to explain what’s happening? In other words, “Why we’re having a losing streak or whatever?” or “Should we have to explain things when we’re trading?” or “Is there a better way?”

Darren: Yeah. This is the causality bias, isn't it? That's what we're talking about?

Walter: Yup.

Darren: Yeah. It's one thing in trading that really annoys me. I dislike it but it does seem like something that’s ingrained in us as humans -- this need to have a reason for everything and we particularly like doing it with trading.

I think that's because of the nature of trading itself. There's a lot of uncertainty there. We know that but we’re never particularly happy with it. We are much happier if we can give a reason for every twist and turn in the market for everytime we lose or even everytime we win.

I'm guessing at some point in the past, when life was there’s sort of things we dealt with were much more simple, that was probably really very beneficial for us to be able to do that because you could learn from that.

But, I think the problem with trading is trading isn't simple and you can't even say it's complex. It's chaotic. There's masses of uncertainty. I think trying to use causality, trying to explain why everything is probably detrimental to us.

I really try and avoid it at all costs but it's a big part of trading. We do like it. We like to tune in to people that's explaining why the markets going to do this today or why the

market did that yesterday. We really like that and we hook on to it very quickly without really questioning it.

If it fits what we want to hear, then we're unlikely to do it anymore. Sort of digging around to find out if it's true or not. If you had a line, \$1.30 and that's being explained as the reason and the explanation agrees with that, we're going to lap it up. I think it's a kind of dangerous bias to have.

Walter: Yeah, it's interesting. I wonder what trading would be like for people who just decided, "You know what? I am not going to try to explain why I have a winner or a loser. I'm just going to take these trades. I'm just going to go for say 5 to 1 on all the trades and I'm just going to concentrate on myself, in trying to calm myself down, and keep myself on track with this 5 to 1 strategy." I wonder how a lot of traders would do if they just did that.

Darren: They'd probably be profitable.

Walter: Exactly. Yeah.

Darren: There's data to back that up as well. There is data to back that up and you can get your own data to back that up as well. It's called back testing.

Walter: Of course. But the thing is, Darren, here's the thing, we know as humans we have horoscopes and star signs. Some people would say, "I didn't really have control over that. I see now, looking back, that was God's will. God's will made that happen. That's why that happened it was God's will." Or, "the reason why I'm doing this is because I'm an Aquarius." It's like almost part of being human.

Even one of our heroes, the Taleb book. Nassim Taleb's book, "The Black Swan", he talks about how as humans, we need to explain things. We piece it all together after the fact, sort of hindsight bias.

We have this need, this yearning, to explain things whether or not the explanation is true or not. I'm not arguing that it is or it isn't God's will, or it is, or isn't the fact that you're an Aquarius and why you do this or that or the other.

All I'm saying is for trading, just looking at trading, is it possible that we're going to give ourselves a handicap if we rely on this? Are we better off trying to fight this and trying to work on our own thinking rather than succumbing to this?

Darren: Definitely. And, I think when the key things is to get past in trading, to get past what you need and think more about what you want. If you want to feel comfortable all the time and assured and remove uncertainty, that's good. That's naturally how you're going to

feel. But, if you want to make profit then you have to approach it differently and that I think is the battle. That is why trading is so difficult because what we want and what we need don't match up.

Walter: Yeah, exactly. Two things that come to mind when I'm look at I'm losing trades. I'll ask traders, "Why is it that we have this streak of losing trades?" We have 7 losing trades in a row, why is it? And traders will come up with all of ideas, anything under the sun and yet I believe that there should only be one reason in this. It's just bad luck. That should really be the only reason.

There should be no other reasons. It shouldn't be because my broker's screwing me or it shouldn't be because Donald Trump sent another Tweet. It shouldn't be because the markets have changed and my strategy no longer works. It really should be because of one thing and it's just bad luck. I mean, that's true. What say you about that?

Darren: Yeah, a hundred percent. But, luck again is one of these things that people really have an issue with because it is challenging those biases to accept that there's luck involved. I'm always bringing up this point about how much of an effect good and bad luck has on your trading result and you get responses like, "Well you know, it depends on the strategy. My strategy doesn't have any luck involved."

I think one of the other important biases is in all this is this complexity bias. We like to see problems have a lot of uncertainty where you have to use a lot of assumptions. We like to label them as complex so we go searching for complex solutions for these problems.

Whereas, when there's a lot of uncertainty, you really don't know or you can't plan what's going to happen next. The problem is chaos. It's a chaotic situation. In those scenarios, it's much better to go for a simple solution. There's a really good rule of thumb and that is if you're making a lot of assumptions then the solution is probably the simplest.

Recently, I've been having an argument with people about, "Has entry got an edge?" The problem with that debate is there is no answer because you can't prove it. I mean you could say, "Well, here's my proof that entry has an edge" but the problem is you can't prove that it was the entry that generated the edge.

It might have just been good luck. It might have just been the market condition at that time. It might have actually been how you've managed the trades and you can't really pinpoint where the edge is coming from. All you know is that you used a series of things and it generated an edge so that makes it. Is it a problem of chaos and not complexity because there is no answer? You don't know.

Walter: Yeah. Well, you can always argue like I'd say, "Darren, I've got this great thing. This moving average gives me a great edge." Then you could argue, "How many trades do you have?" And I say, "I've got 700." And you could say, "Well over the next 14,000 trades or next 2,000 trades, that edge will probably erode or get back. Like, it will give back or regress to the mean or whatever." You could argue that as well.

Darren: Definitely. And, that really is my point. You don't really know and you'll never know. Rather than trying to getting an answer to that, you're much better just say, "Okay, well, you never really know. So, what's the simplest way to go about this problem?"

You look for a simple solution, some simple rules of thumb. That's the best way to kind of go about it, I believe. That's why Psychology, I think, is the most important thing because until you kind of accept what we know, what we can prove and what we can't prove, then you're going to make cognitive errors all the time.

Walter: Right. The questions comes out something like this: "I have this strategy but it's not good enough. It doesn't have a high enough win rate." Or they say, "I really want to have a strategy that has a win rate of X, 70% or whatever it is."

Sometimes, you can ask yourself this question: "If I had to choose between making money and being right, what would I choose? Which one would I choose?" I think if the answer is you'd really rather make money than just being right, why not choose a strategy where you don't have to be right 70% of the time. Instead, you can be right 40% of the time or 35% of the time but you're going to make a lot more money.

The reason why, of course, is people don't like that. It's uncomfortable, it's difficult. It's very difficult through losing streaks which happen all the time blah, blah, blah. It's a difficult way to trade. That's the main reason. But then, we come back to then you need to work on **YOU**. That's really the key here. You work on you, not the trading system. You shouldn't fix the trading system. You should fix you.

Darren: Yeah, definitely. And it's one of the hardest things to do. I've recently been chatting with traders about this idea of where edges lie and do really simple ideas have edges. We've run tests. To be fair, I haven't run the tests.

One of the members of the group has been testing this over years and years. Just running test on really, really simple ideas. As simple as you can make strategies. The interesting thing is that all of these end up with positive expectancies. All of them.

You start having to question, "Well if this is true then how come it's so hard to make money trading?" You know the big conclusion that we have come to is that people just don't stick to it because all of these systems have periods where they perform badly. But, at the same time, over a long sample they all make profit. The simple rule of thumb

is like you say, the problem is with the trader because they're failing to deal with the bad sides of the strategies.

Walter: So basically, the solution is to work on yourself and to be able to teach yourself to execute the strategy, essentially. The other side of that coin is understand probabilities and understand the math behind the way you're trading it because you might be trading that strategy in a manner that guarantees you'll have a 37% drawdown and you freak out when you have a 22% drawdown. That's what I'm hearing. You can have strategy that potentially with compounding and such you can reach all of your life goals within 5 or 6 years but the real problem is how do you teach yourself to keep trading it.

Darren: Definitely. The interesting thing when you mentioned the math is actually really simple maths as well. It's not really super complex. I think people see hedge firms and big firms using this really complex algos. They're just trying to squeeze a little bit more blood out of a stone. You don't need to be that complex. It's highschool math.

So, again, simple things work with that as well. When you talk about being able to manage yourself in that when it comes to forex education, this is kind of one area where it is worthwhile spending your money on a coach because even expert traders will benefit from having a coach who basically monitors their actions and their behaviors.

Walter: Yeah. And, if you want to do it on the cheap you can get an accountability partner. You can get somebody. Essentially, like a performance coach or someone that you're going to be accountable to. You can also find a trading buddy that you're going to Skype every week and you're going to lay everything out just as he or she will do for you. That's another way to do it on the cheap.

Looking back, if I had figured out how to backtest in Forex Tester and if I had someone that I was accountable to every week, that would have made the biggest difference. I kind of did for about 6 months or so but the problem was we didn't really treat it the way we should have.

We should've have like these meetings where we talk about what we did this week, whether or not we stuck to our rules and instead, we were just talking about trades and trading war stories and crap like that, which doesn't really help.

Which is another thing, I believe, sort of along the lines of the Ed Seykota. Ed Seykota said everyone gets what they want out of the markets. People can win by losing -- I'm just paraphrasing or something like that.

Sometimes, what people want as traders, even if they won't necessarily admit to this, they may not necessarily even know that this is the case because it's kind of a subconscious thing but they want to be able to tell the war stories about this great

battles they had with their trades and that's how they win. What they're getting out of trading is having all these stories so that they can tell other traders about them which is a fascinating thing when you think about it.

Darren: Yeah. It's amazing how the ability we have of being able to lie to ourselves and completely cover up that fact that is going on. It's amazing that we don't just say, "Hang on a minute, that isn't really what happened." That comes from a subconscious thing, doesn't it?

It's an emotion, I suppose, where we're afraid to say, "Look, I just didn't stick to my system." We naturally get into this defense response of saying, "Ah, well yeah but the ECB release came out and we're just some bizarre thing where quite simply what we did was we know we broke our rules. We closed our trades early."

Walter: It's so true. It's interesting because as traders, we feel like we're in control because we've read the news or we're aware of the news or we understand how this indicator works or whatever and yet it's just a crapshoot. You can literally flip a coin.

Darren: Definitely. And it's why I strongly argue with this "the entry doesn't matter." When I'm making those arguments, it's not really that the entry doesn't matter. It's that because it's so significant to you. It's more likely to be a lot less significant. I kind of accepted really that we try and fool ourselves with this very uncertain risky situations so more significant stuff fills. I try and reverse that one instead.

I noticed, I used to do this when I was a kid as well. If someone advertise something on tv, say an ice cream -- this is like the new super chocolatey ice cream -- I deliberately not buy that ice cream because I felt like they were trying to lure me into buying it.

And the way to win the argument really was just to deliberately not to buy it even if I fancied one of those ice creams. You know when someone's marketing something to you with an advert, they're trying to lure you into doing something. I would deliberately fight against that.

Walter: Yeah, definitely.

Darren: I'm definitely not going to buy that ice cream even though I quite fancy one because you've laid a plan that's going to make me buy it so I'm deliberately not going to buy it. I try and do that with my own psychology now.

As soon as I get that urge or it's not quite reach my TP, I think I'm going to close it now. Then I have that instant response, "Okay, this is what I'm feeling I should be doing so I'm definitely not going to do it." I use that as my way of dealing with these urges and these biases.

Walter: Yeah and I think a lot of traders are probably like I always sort of fight trends with people who are always wearing a certain thing or whatever. I was just like trying to go against it. It's just in my nature. I think it's more fun to try and fight it.

It is crazy when you think about it, how you look at people and we're all the same. It's like looking at animals in the zoo. Like, everyone's doing the same thing. That's just crazy but I think that's what makes us as traders too. It's the fact that we're like a contrarian. A lot of traders are sort of contrarian by nature.

I think investors tend to be more herd followers, in my opinion. To me, an investor is just a trader who doesn't have a stop loss and just kind of only buys things. Like, the bitcoin right now. As we're recording this, bitcoin is a big one.

So, you have all these "bitcoin traders" but really, what they're doing is buying bitcoin hoping it goes up and not really having any sort of stop loss or any way of mitigating a risk. I could be wrong but I think most trades tend to be sort of contrarian by nature. Yet, we don't apply that to the psychology side of things as we should.

It's basically your point. We need to shift our focus from contrarian in our approach to other things and look at it. That's why I think it's helpful when you look at a trade you're saying, "Who's the other person at the other side of this? I see a bullish market here, I see an opportunity to buy. Who is the person that's selling here? Who would that be? What would they be looking at?" I think that's a really useful exercise.

Darren: Yeah. Well if we go back to the original question, this "need" to explain what is happening, it is actually something really good to do but you should be doing that on your psychology and your decision making. Like you say, the psychology in decision making of the other participants in the market, not the actual what happened on the charts.

That's what we really need to be explaining and if we made notes on that, what we're feeling when we closed that trade and how much of that feeling did we have, were we anxious or scared? Assessing that, that could lead to much better decision making. That's been tested and proven.

Walter: Yeah, exactly.

Darren: There is a really good book on this, the "Storytelling Beast" or something. I think it's called the "Storytelling Beast". It's about the psychology of using stories and where it comes from and where it's beneficial to us and when it's clearly not. I'll find the link for you.

Walter: It's not "Beauty and the Beast" storytellers?

Darren: No.

Walter: Okay, we'll put it in the show notes. Okay, cool. So, Darren, what about journaling? I know you're a big fan of the journaling. I think that for traders who realized that they had this need to explain things and potentially could be an issue, what is the antidote?

I suspected one useful antidote would be just journaling. There's two parts to this. One is journaling about your trades; and the other one is actually go back and look, read at what you've written in the past because you'll notice your growth. You'll see your growth overtime.

Darren: Yeah. Actually, I think there's two benefits of journaling. One is the obvious that when you look back over the previous week, you'll basically add lots of biases to what really went on. To make you seem really smart. Why you didn't make any mistakes or your losses were bad luck and all your wins were pure skill.

So for that reason, it's really good to keep a note of all your trades. But, it's also a good way of breaking the link between emotions, decision making and actions. For instance, when you're about to make an important decision in your trading, if you write down at that point what you're feeling and what your actions going to be -- basically write down what you're planning to do -- you're less likely to make bad decisions.

This is some research that comes from Denise Shull about emotions and decision making. It acts as a blocker from making mistakes, particularly ones that you make repetitively and often.

I always use this as an example. If you're always closing your trades early when you get that feeling that you're about to close a trade, if you stop and write down why you're closing it and what you're feeling at the time, you can reduce your errors.

Walter: Yeah. To me, the value in that is bringing up to your forebrain to your planning area of your brain. It's out of the emotions center, that makes perfect sense. This is a really difficult thing for traders who are trading the lower time frames because they're at the heat of the moment and they feel like they need to make snap decisions and they're under the gun.

It's a little bit easier, I believe, if you're trading time frames that take awhile to unfold so it's a little bit easier to plan things out and think it over. But, if you keep taking profit early, first of all you're not alone. It's probably the most common mistake that we've seen. We've seen the data, right? The 43 million trades that you've posted. That article

in the forum which was awesome and that just highlights the big problem. It's that it's not being right.

These retail traders are right, but they largely lose because they take profit too early. It's a very common thing. So, just by writing it down can help. Any other thoughts?

One of the things that comes into mind -- I know I keep using this example -- but the woman who keeps getting attracted to the wrong types of guys. She keeps falling into these relationships where the guy is abusive or whatever. Yet, every time she gets out of the relationship, she goes and finds another abusive relationship. She just is magically drawn to these.

Some of these mistakes, you'll notice, are recurring and you keep doing the same things with your trading over and over again. To me, there's a deeper issue there that you might have to deal with. Working on your subconscious, things like that. I think those things can help as well.

It makes sense to write it down and journaling can definitely help by bringing it up and getting logic involved instead of just pure emotions. But, at the same time, if you keep doing the same thing over and over again, at a certain point you have to decide where is this coming from. What's going on here? How do I deal with that? To me, that's a subconscious thing.

Hypnosis can work for many people. Hypnotherapists are really good at figuring out how to change habits. The bread and butter for a hypnotherapist is someone who comes in, they want to quit smoking; and someone who comes in, they want to lose weight. Those are habit-based things. They can work with traders as well. They're not used to doing it typically but they can certainly help you.

I would also encourage people to look at the subconscious side. If they feel like they keep doing it over and over again and they just feel like they're out of control, get a trading accountability partner, write it out before you execute and maybe look at some subconscious tools such as hypnotherapy. That would be my sort of list there. What about you? Do you have any other ideas for traders?

Darren: Well I think all of the things we've talked about today are the important things. Perhaps, rather than focusing so much on the technical side of your strategy -- which is what we like to believe is the most important part -- I think really doing some work on a psychological strategy. A strategy that deals with psychology rather than particularly technical.

Like you were saying about one of the issues with trading on a short time frame is disability to have time on your decisions and perhaps break chain of errors that you're making. That is changing to a strategy that, technically, the shorter time frame is going

to offer more opportunities. The potential to make more money is on the shorter time frame but that is basically disregarding psychology completely.

So sometimes, the technical elements of your strategy should be there for psychological reasons. I'd argue actually that that's probably more important in the long run than whether it's the best entry on paper. What you should do, there's rational behavior and is what you actually do. You're much better to build your strategy on you actually do rather than just the numbers. You have to include the psychology.

Walter: Yeah. And I think you've kind of build it from your beliefs up. The big mistake that traders make is they go out and they say, "Wow, Darren is an amazing trader. You know what, I'm just going to do what he does." That works or can work if you totally lock in and agree with Darren's beliefs but if you don't, I strongly believe that you will always end up trading something else. It is because you get pulled back into your beliefs.

You can find somebody who is an awesome trend trader and you can swear up and down that your going to trade exactly like your awesome trend trader buddy. But you know what, if you're a counter-trend trader it's not going to work. It's just not going to work.

You're going to have to tweak his strategy and turn it to a counter-trend strategy that will work for you. That's the other thing to keep in mind. Build on your beliefs and build up from there. Don't go look for the best trading system that you can find in the internet and go, "Well, I'm going to do that." That doesn't work. You need to start with your beliefs and work off from that.

Darren: Totally agree, Walter.

Walter: Alright, thanks for your time, Darren. I really appreciate it and will catch you next time. Thanks.

Darren: Cheers, Walter. Bye.