2 TRADERS

EP126: Overconfidence

Walter: But this is probably one of the best exercise anyone can do listening to this. You can just flip a coin. Literally flip a coin and take a 5R exit, see what happens. See if that trading strategy works...

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: Hello, Walter.

Walter: Welcome back. We're going to talk about do too many indicators lead to overconfidence or do indicators in general lead to overconfidence? Building off of that, what about having too many rules in your strategy? What that could mean to your trading? What do you think about this?

Darren: I think overconfidence is a problem. I'm not sure about too many indicators leading to overconfidence.

Walter: What about -- sorry I guess, I kind of constructed this. What about if I reconstruct the question as this: If you have too many elements in your strategy, does that lead to overconfidence?

What I'm thinking about here is when you have the strategy and then you have all these contingencies -- well, if this then we do this and if that then we do that. What you're doing is you've kind of… You're making a very complex strategy because what you're trying to do has account for everything. What about that? That's what I'm getting at.

Darren: I think that is a major problem and that is kind of looking at the problem. It's misinterpreting the problem because I don't think it's a complex problem. I've done a lot of testing on this myself where I used a secondary moving average for, say, the trend and then a fast moving average for the entry.

Completely buying to the fact that this other moving average makes big difference. It may make a difference but it's a lot less than you think. That's what I found. Even if in cases, in certain cases, where the additional filters actually make the system much worse.

Walter: Right, that's awesome. I mean that's the thing. I feel like the big issue here is that traders are trading their last trades. They're letting their last trade beat them because the last trade, whatever happened, so now we have to create this rule so that it doesn't happen again.

This is like a normal thing in life. Big businesses are -- or actually governments -- are the best example of this where something happens. Like take an example, September 11th in the United States. That was awful.

It was really interesting living there at the time, where, how after it happened people were so different. Everyone basically become really nice to each other which, just setting it aside, I thought it was kind of a really nice thing.

A nice result of that but the interesting thing that occured after September 11 is essentially, these doors now to the cockpit of the planes are basically bullet-proof. There's no way everyone, anyone, can ever storm into a cockpit of an airplane again.

That's not going to happen. The next tragedy will be something else. They'll do something else. It's the same thing with trading. We come up with these rules to try and bandaid, put a bandaid on something that happened in the past.

Now, what you end up with is all of these extra rules and it's just going to make you feel better. You're going to feel more confident, "Well, that won't happen to me again" or whatever but you've totally changed your strategy.

You're trading something else and you're adding degrees of freedom which is a terrible thing. I believe like you, Darren, that one of the most powerful ideas in trading is to have a very simple idea that doesn't have a lot of moving parts. Those are ones that are usually going to be robust and last the longest.

Darren: Yeah. This desire to remove all of the unpleasant elements possible. It's kind of this deep belief that if there's a bad feeling associated with your trading strategy then there's a problem with your trading strategy. Not that you've just got a problem dealing with any downsides.

Walter: Yeah, exactly. It's really you, isn't it? It's not the strategy, it's you and you're upset that the trading strategy didn't pull a profit or whatever.

Darren: Yeah. And I think there must be parts of life where we are much better at dealing with those downsides. I suspect it's where we are more in control of the outcome. Is it particularly trading or is it just things with a lot of uncertainty and risk? Is it the money? Is it the money being involved?

Walter: Yeah. I think people who play trading like it's a game do better than people who think about, "Oh, wow! I can take that money and go on holiday" or whatever go buy a motorcycle or something. I think people who look at it that way as if they're playing a video game, they tend to do better.

Darren: We see with traders that have been around a lot longer that have already made consistent money, they seem to get better dealing with the negative effects of a strategy. As an example, I always mention Dunn Capital. He can have losing years but when trying, change his strategy. Whereas a new trader who's been trading for one year, if he has a losing month or even a week, that might make him change his strategy.

When there's this kind of a bit of a long term memory thing here and if you can just say, "Okay, my aim for the next three months is just to grind out a losing spell or a drawdown. I'm going to just go wait for the next drawdown and I'm just not going to change anything. I'm not even going to debate change. I'm not going to go look for different entries. I'm just going to see if I can get to the point where I would recover that drawdown and get comfortable with that uncertainty and those bad feelings." I think it's a major hurdle. If you can do that then maybe that is one of the keys.

Walter: Yeah, I agree. But, it's just so much easier to add another indicator to your chart.

Darren: Yeah, definitely.

Walter: It is. It's like it's setup. There's certain things when you have kids around the house, you'll look at those in a totally different light. You'll say, "That could be turn into a step and then they could dive into an aquarium" or whatever.

You'll look at these things and you'll think that can be used as this. I look at the same thing with these charts and I see these advertisements for... You get all these advertisements for brokers.

They talk about how they've got all these indicators of these flashy charts and everything. It's like the charts is just beckoning you to add as many flashing indicators as possible. It's just insane, really. It's crazy to me. It feeds into this. It feeds into this idea of adding complexity to make it better

Darren: Yeah. You could argue, really, that people with certain -- I know we've talked before about this idea of certain personalities are better suited to trading and I've kind of being a bit where I'm not completely sure about that -- but maybe people who are just really good at looking at both sides of the argument or accepting that they're maybe on the wrong or being about to have a debate on something and see both sides of the debate.

These personality traits which are not common in a lot of people, to be honest, are probably best suited to being a trader. I didn't want to vote for Brexit. I wanted it to remain in the EU but I can see some of the points for people who voted out.

It doesn't mean I necessarily believe they're right but there's elements in both arguments that could possibly be true. It's really hard to do, isn't it? Because, it's just not about you. It's about your cultural group and groups you're associated with.

I saw a talk recently about global warming and why with so much evidence that global warming is happening and that humans are pretty likely affecting that. Why so many people are still kind of resist those arguments.

I think all of these things are playing to be becoming a better trader and I think if you can just stop and say something like Brexit that you are really strongly on one side or the other, if you can start to just say, "Okay, let's reassess this. Let's have a look at the other side of the argument." If you can have a bit more of humility, I suppose, or empathy.

Walter: Yeah, absolutely. Humility I think is a big one for traders. In my opinion, I think that's why female traders often do better as a whole than men because men hold on to their ideas of wanting to be right and, "I did this. I would want to make back that money so if I lost 5% of my account, I would want to make back that 5% the next day" or whatever.

You kind of getting into this tug or war with the markets. But, your idea of personality I think is interesting because one of the things I always laugh at is that traders think that they can just copy another trader and everything will be fine. That doesn't necessarily work another thing.

I can watch all of the videos of Tiger Woods swinging his golf club or Rafael Nadal swinging his tennis racket and I could try and make everything the exact, do the exact same thing that these experts are doing. It doesn't necessarily mean I want to play tennis as well but I can take elements of that and I can leverage of my strength.

For example, your strength might be different than one of the listener. You might have the strength of essentially self-reflection. Being really good at looking at, "Why am I doing this? Is this going to be helpful? Am I following into a trap here?" Just thinking about your trading in that point of view.

It's something that keeps coming up. Is this going to be helpful or should I be working on this? And, another trader might be exceptionally good at keeping records so that trader might be able to take very good, have a very good journal of why they took a trade and what they're feeling. Have a screenshot of before, during, and after the trade and have this wonderful records of all of their trades.

They may not be as self-reflective as you but they can leverage their strength with just to be conscientious with their records and they can learn about themselves through the records. You see what I'm saying?

To me, that's the great thing about trading. It's that even though we can all sit here and say, "Everyone needs to do this" or "If you do this, you're going to shortcut your way to success." It's not the case that we can all swing the racket like Rafael Nadal and we can't also reflect like, Darren.

We can leverage our strengths. We can still leverage our strengths and we can still find something there. I think that's the big story here with trading. Is that there's so many different ways to make it work. It's not that you have to follow Darren's way or my way or whoever. You don't have to do that but what you do have to do, I believe, is figure what you're good at.

Darren: Yeah. All the kind of proven ways of, you say, you need to kind of find things that you need to work on. Parts of your psychology you need to work on and that kind of proven ways and techniques of improving. You're too impulsive or you're too impatient or other good ways of getting better at these.

Walter: Yeah. Well, it depends on who you ask. If you ask Freud, he would say "Yes, of course. Lie down on my couch, we'll talk about your dreams." Freud actually moved away from dreams, initially thinking that was where you're going to get the gold. And then, he moved later on to free association where he says a word and whatever pops into your head - the first thing in your mind.

If you'll ask Skinner, the Behaviorist, he would say, "Yes, of course you can. All you have to do is reward yourself for doing the right thing and setup a reward system." It depends on the theoretical orientation or whatever.

But to me, the subconscious has been the key, and I know some people are going to laugh. This is crazy but that's the great thing about life. Everyone can take a different approach but for me, the data and the results that I've seen with traders who used simple subliminals has been exceptional.

There are **subliminals** that you could use. **I'll put them in the show note**s for things like over trading so impulse control. If you have this problem where you know you should seek your system but you don't and you take trades just based on some tip that you saw CNBC or whatever, Fox, or Sky news. That sort of thing.

If you have that issue, if that is your issue -- impulse control -- there's a subliminals for that. There's a subliminals for people who have this idea that money is evil and deep inside they know that they shouldn't be making money as easily as clicking a button on a laptop.

For trading, you make a decision. You get paid for taking a risk and making a decision, that's basically what we get paid for. Those sorts of things, those subliminals are quite good and there's a pretty good body of research that shows that these subliminal tracks actually do affect behavior. For me, that's the simplest way because you don't have to do much. You just kinda have these playing in the background when you're working or sleeping or whatever.

Darren: Alright. Going back to the indicator thing then what's the rule of thumb with indicators? How do we know if we are using too many and how do we know if we are using them right or whether we should use them at all or have none?

Walter: Well, one of the fascinating things I've learned from the guys that do the automated backtesting where they're looking to make algos and stuff, one interesting way that they do it is... Let's say for example, you, Darren, you have a system that uses the 6-period moving average and that is one of the critical component of the system. What happens if you use the 7 moving average or the 9 or the 4?

What these guys will do, they'll run that through and see does the edge still hold up or does it break down? That's a logical thing. If you're purely a discretionary trader, you might think there's something magic about the 21 moving average or whatever it is so they do that.

They'll just slightly shift it up and down and then they'll say, "Okay, is this still going to work?" Let's say you're using an exit which is at 3R exit so you're looking to make 300% of your risk on the trade and you just let it go. See if it's going to hit your 3R exit or it's going to stop out at -1R so all of your risk money is gone.

Now, what happens if you test a 2.8R or 3.3R or whatever? Does that really change it? I think that's a useful way to see. I think that if you have too many indicators on your chart, there is a likelihood that you could lock into something that works really, really well over a short period of time and then outside of that little time window, it completely breaks down but that's just my belief.

I could be wrong on that. I just believe that in other words you can almost like curve fit where you have everything set up perfectly for the 6-month window. Outside of that, you're just totally throwing your account into the fireplace.

Darren: The problem with too much backtesting like curve fit. I think what you're saying about testing in different indicators and variations on moving average is really important to get that data and then actually use that data as well.

I see often people will pick the data that confirms what they already believe and then just gloss over all in that. What's really important is to get that comparison and then actually take on board what the data is telling you. That's something that we seem to really have big problem with.

Walter: Yeah. And if you're a discretionary trader, you could just pull off indicators. Let's say you have five indicators, you could backtest 4 out of 5 just keep testing 4 out of 5 and keep pulling off each of the 5, seeing what happens when I do that, what happens if I take off 2 and just test 3 out of the 5. That sort of thing.

You could do that if you're statistically inclined or using some sort of algorithm. You can also do a regression. Multiple regression is basically where you're trying to predict a curve based on a bunch of variables.

Now, statistically the program can spit out and tell you how much each of those indicators contributes to that. You could statistically go, "Well, the MACD is only really just giving me 5% of the overall power. It's really kind of a prediction of the curve so maybe I can just delete that."

If you're really mathematically inclined, that's another way to see it quite obviously and just go, "Yeah, okay." If you're a discretionary trader, you can do the same thing like I said with the pulling them off the chart.

You can just also flip a coin. You and I, we've talked about this before but this is probably one of the best exercises anyone can do listening to this. You can just flip a coin, literally flip a coin and take a 5R exit, see what happens. See if that trading strategy works.

Darren: Yeah. So many of those random test or a random selection of direction or just super simplifying strategies, think you can kind of need to do this research to make it clear what's really going on. What sort of game you're playing and I think we don't do it. We go for complex solutions.

Walter: Why do you think that? You and I both know logically that I could flip a coin and I could place a 5 to 1 reward to risk. I'm risking 40 pips to make 200 pips, I could do that and that's probably going to make money. I've tested that and it does make money.

I tell and say to people when they're worried about a strategy, "Well, just look at the exit. The exit is probably going to help you here if you'll just make that a little bit tighter. Make it a higher reward to risk ratio."

Yet, you don't trade. Do you trade that system? Do you trade a system where you flip a coin, literally flip a coin? Take a trade and just walk away?

Darren: I don't know but I've tried to get as close to it as possible.

Walter: I don't either. That's awesome. Let's talk about this next time. I want to talk about Darren's almost flipping a coin strategy next time we get together because I really want the listeners to hear this. This is going to be a good stuff. Let's talk about that next time. Are you keen?

Darren: Yeah, definitely.

Walter: Okay, next week. Next podcast guys, we are going to talk about Darren's almost flipping a coin strategy. It's going to be awesome I can't wait. So, any final thoughts about having too many rules for this episode?

Darren: No. I think we've covered everything really, Walter. As always, Psychology is the one.

Walter: Everytime we set sail and run the boat, we think we're going to this and then the winds come up and we end up back but that's alright.

Darren: Yeah. It's difficult to get away from it though. Where are we going to go? Unless we come back next week and we both completely change our beliefs.

Walter: Exactly. Cool! Alright, Darren, we will see you next week. I can't wait to talk about the almost random flipping a coin entry strategy. Let's do it.

Darren: Yes, Walter. See you next week.