2 TRADERS

EP127: A Tweak To An Old Strategy

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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 here and I've got Darren on the line. Hi, Darren.

Darren: Hi, Walter.

Walter: So, Darren, just before we hit the record button here, we were talking about a potential risk management strategy that I've been testing -- and it's really nothing new. It's just a tweak to an old strategy. The way it works for the listener is this. Essentially, if you have a winning trade, on your next trade what you do is you'll risk that money that you won and you'll risk your normal percentage risk that you would have.

If you're a trader that risks say 1% on every trade, a winning trade might return you 1%. It might return you 3%. I mean, who knows? It depends but that's not important. What you do on your next trade is you risk all of the winnings that you had on your previous win plus your normal 1%.

And then that way, if you get another winner -- it's accentuated quite a bit but, really -- you're only risking your winnings. Some traders do this. In fact, they'll take their account, they'll grow their account and they'll take all of the winnings out of the account. Reset the account to zero and get really aggressive with that little tiny account that they now have of winnings.

And it's this kind of like doing that, but it's doing it a different way. What I found in my testing is that, your drawdowns aren't that bad. But, obviously, you really accentuate your winners because you get 2 or 3 winning trades and you're really on a roll. So we were just talking about this and I was just getting some of your thoughts about this and how it related to like gambling theory and things like that.

Darren: Yeah. When you think about it rationally, it makes complete sense because if you've ever done a lot of testing on systems or you've traded a lot of systems, they all seem to have the distribution of wins and losses. It's not linear so you get clumps of your wins together and clumps of your losses together.

Obviously, that's because trading strategies work on exploiting particular market conditions and those conditions don't change everyday so when a market's in strong movement, it tends to go on longer than you'd expect and the same for consolidation. You get this clumping of wins.

It makes complete sense. We're obsessed with trying to play with the elements that make small amounts. The difference are hard to control and ignore some elements which really could make a big difference to your profits and money management strategies can.

And I was saying, it's similar. If you ever look at gambling websites and strategies, their approach, it tends to be more in these areas. I think it's an area as traders, we tend to overlook or there's something psychological that goes on that says to us, "No, this isn't the answer." We're kind of trapped in this loop of looking for the magic equation and sometimes missing really obvious things.

The interesting thing is one of my trading strategies has a very high risk reward so it has very low win rates in the 20% area. But even there, there is a clumping of wins. You notice you'll get 2 or 3 wins together and then a long period of just losing and single wins, but they still clump together.

I think with this particular idea, if you have something -- lets say 40% win rate -- 2 to 1 risk/reward in those kind of areas, that's a distinctive clumping of winners in those sort of strategies. It could be a sign that it really works well.

Walter: Yeah. I mean, basically, you're just growing your winners by… It's like an exponential growth kick to your winners.

Darren: It's like the whole hand thing, isn't it?

Walter: Yeah, exactly.

Darren: Although because you've had a winner, there's no guarantee that the probabilities change for the next. When you look at your data, the wins do clump together.

Walter: Yeah and obviously as your win rate increases, you get longer streaks of winners. And as your win rate decreases, you get longer streaks of losers. But like you say, you're always going to get some clump together even with a 20% win rate, you're still going to get clumps of winners.

I was thinking about what you were saying about gamblers. I think that gamblers have kind of come to the conclusion that they're working inside of a closed system. In other words, the odds are set for certain games and they understand that. That's why they're sort of feeling around those areas that they have control over which is essentially their bet size.

The way that they use risk management and position sizing but traders have this illusion of control. We feel like we have control if we tweak the way that we decide to get into a trade.

Gamblers have kind of given up on that, haven't they? They say, “Look, we understand that were looking within a closed system here, there isn't really much we can do to change the odds.”

We can monitor them, like for example in blackjack, we can monitor them and say, “Okay, at this point I have a slight edge. With this other point, the house or the dealer has a slight edge or whatever.” They can certainly do that but they have resigned themselves to just focusing on risk management.

I think that's kind of a key point you’re making. As traders perhaps were just too focused on feeling like we’re in control and doing things to make us feel like we’re in control. When really, we can exert a lot of control.

I mean, what I’ve found with this sort of risk management, it makes a huge difference in your system. I’m talking about systems that aren't even necessarily very good. You have trading systems that aren't necessarily that good and they’re making 7 times than what they would normally make over the same sequence of trades. To me, this is really powerful stuff.

Darren: Yeah. It is quite fascinating, isn't it? I mean, strategies like these can make a huge difference to the performance of a system but it's almost like we don't want to accept it so we’ll scratch around in the areas where you can maybe eke out a few more percent a year.

Like tweaking the entry slightly or tweaking the moving average slightly. We’re like rabbits in the headlights with that. We can't break away from that when there's obvious simple ways. You just don’t seem interested in that.

Walter: It’s true. It's definitely not the sexy stuff. We want the 85% win rate indicator or whatever. That’s the important thing, isn't it? It’s not in the way that you risk. It’s funny when you think about the companies that have the biggest buildings. The insurance companies, things like that, that’s really all they’re doing.

They’re just like casinos, really. I mean, insurance companies to me, they’re no different from casinos. They take the bets from their clients that pay their premiums then they look at the odds and work out how they’re going to make money out of the deal even though they have to keep paying out.

Casino has to keep paying out. The insurance company has to keep paying out but they have just enough edge that they make money overall. They do so much volume. So many gamblers, so many people paying premiums to the insurance company. They make this huge sums of money and trading is the same way. The way I see it, it's the same way. We're just doing it on a much smaller scale. At least most of us are.

Darren: You've got to argue that those companies -- like insurance companies -- clearly understand the edge of their strategy because if they've got it wrong, they'd be losing money. They clearly understand what makes it work.

I think half the problem with trading is our psychology is constantly urging us to get it wrong. Everything that it urges you to do is in the areas that aren't important and we tend to gloss over in the areas that are important.

Have you actually been sort of live testing this idea? Because, the interesting thing that jumps to my mind is how this sort of a loss aversion, fear would creep in taking that winning trade. All of that good feeling about that winning trade, the next trade sets up then you've got to put that all on the line again. You step in back into the trade. How's that executing?

Walter: No, I've only tested it in Forex Tester. I haven't gone live yet but will go live and I'**ll post it in the forum so people can see**. I think the interesting thing about this is that I'm not going to focus on the strategy. I'm just going to focus on what I attribute the results to. The strategy is not that important at all, it's just the risk management but I think you're right. I think it's really difficult, isn't it? To give back even if it is "the market's money".

Darren: Yeah, sure. I mean, this would be similar to say you risk a fractional proportion of your account. So that's 1% of your balance and obviously if you have a winner, 1% of the new balance. So your next trade would be larger than your previous trade.

Walter: Yeah it would be. You're right. Lets say, your next trade might be risking 1.1%. If you compare it to the previous balance but this is so much more. This is so much more now. isn't it?

Darren: Yeah. Bit, if your balance goes down you'd have to still be risking the original 1% to basically get the same effect but not as pronounced.

Walter: Yeah. That's right.

Darren: I've always wondered about that. The fixed percentage of your current balance strategy always just doesn't feel quite right to me.

Walter: So, what do you risk the fix percentage of the previous balance? Like before the trade?

Darren: I feel much more comfortable saying, “Okay, my account is $20,000. So I’m going to risk 200.”

Walter: 200 or whatever.

Darren: You know, 1%. Yeah, $200 and that’s what I'm going to continue risking. When I reach a next goal post say $30,000 or $25,000 then, I will increase. Do you see what I mean?

Walter: Yeah. So if you look at it from a fixed fractional, your last trades in that sequence are much like 0.7% rather than the full 1%, basically.

Darren: Yeah because if you have a high risk/reward, low win rate strategy, it’s quite likely you're going to start with 8 losses. Then when your 1 win comes, trading off a much smaller size will actually reduces the effect. I don’t think the idea of risking 1% of your current balance is ideal for all strategies. Again, it kind of highlights this point that money management is important as a part of your strategy.

Walter: Yeah, its funny that it's one of the last things we look at typically. It's just not the focus. I think you almost have to go through so many different strategies and go down so many different dead ends before you finally come to the conclusion. It doesn't really matter why I get into the trade. What matters is what I do after I’m in it.

Darren: Yeah and that part we tend to read someone’s trading strategy where they say, “Risk this much.” We’ll take and say, “Ah okay, that will do.” We don't really dig into it any deeper and say, “Okay, how about if I play around with this.” It’s interesting that it doesn't grab our attention.

Walter: Absolutely. Another thing that comes in mind when we’re talking about the insurance company is even insurance companies are always trying to look for a different angle. I notice the typical things that they’ll look at. Let's say, if you're insuring your car, they'll look at which postcode do you live in. How likely is that your car is going to be stolen or something like that given where you live.

There are other things too. Like, I've noticed in Sydney, a lot of people who will take the ferry to work because the harbour is everywhere. You’ll see advertisements on the ferry -- at least they used to have them -- that would say, “If you take the ferry to work, go with us. Insure your car with us because you’ll get a much better rate” because they basically know you’re not driving your car that much.

You're basically just driving your car on the weekend. Essentially, if you commute into the city into work on the ferry so they should give you a break because you are a lower risk. You know what I mean? They're always looking for things like that. There are different angles and different ways to approach it. In a sense, it's just looking at the odds from a different angle.

It's the same way with trading. You can take the same trading strategy. Insurance is all the same strategy. They take money from people who are worried about something bad happening. Right? And they know that it's unlikely going to happen but for a small percentage of people, something bad will happen and then will have to pay.

It's the same with trading, isn't it? Where you risk a little bit of money hoping that something really good is going to happen. The key to your trading success is basically how good are you at making something really good happen.

When you have a winning trade do you capitalize on it by using some sort of risk management strategy or are you so bad at it that you just don't capitalize enough? You keep taking these 1R winners when you should be taking 5R winners or whatever, that sort of thing.

Darren: Definitely. I notice this as well in insurance companies. They do listening now, don't they? Where you can pay a lower premium if you put this app in your phone and you take it in your car and you stay below a certain speed. They monitor the speed you've got and for 3 months if you drive a lower average speed, then you get a lower premium.

They've clearly looked at accident rates and the speeds. They've worked out, "If we give people this much money back, we'll save this much money there." They've looked at the whole risk/reward thing really carefully. That's how they make their money. Like you say, trading should be the same. We're sort of our own insurance company, if you like.

Walter: I'm thinking now that you said that, Darren, maybe I should download that app on my phone and just ride around in my bike for a while. Then I'm guaranteed the best rate, right?

Darren: There's a really good quote from a comedian. He said that when you're in a car, everyone going slower than you is an idiot; everyone going faster than you is a maniac.

Walter: Yeah, that's so true. So what are some of the other strategies? We've talked in the past about the fixed ratio. Which is basically, once you make a certain amount in you account, your risk goes up. I think that was the Ryan Jones one where, basically, trying to build a small account rather quickly.

Then we've talked about this method that I'm calling the brick method where you add a winning brick to your normal percentage of risk everytime you win. What are the other ones? You've talked about the one where you actually risked the same dollar amount until you reach a certain goal and then you move it up which is kind of similar to the fixed ratio.

It's a bit similar to that but there are other ones too that you can just add to a winner, right? If you have a winning trade and let's say you're looking for 4R target. If the market goes 2R on your favor, you could move to breakeven and then just take another position on the way to the target. I mean, things like that.

Darren: Definitely. It's something I looked at when I've been playing around with my system recently with regards to risk/rewards. On the high risk/reward trades, I tend not to re-enter, add another trade, until a certain point has been reached but I find that, you can generate a similar effect by taking profit quickly and re-entering. Essentially, a lower risk/reward trade that has a higher frequency of entries.

Although the returns are different, the drawdowns are different as well. Then you can adjust for that just by changing your position sizing so getting the correct position size for the different risk/reward targets then becomes the key to how much you make.

One might have 40R return over a period and another one might have a 10. Because of the lower drawdowns, you can risk much more on the 10R return. You essentially end up with very similar strategies that are just played out differently psychologically.

Walter: When you're in a trade like that, like a 10R trade, what do you do if you're in a trade on a Friday? Do you close it out and then re-enter the following Sunday evening? Or, what would you do?

Darren: No. I just leave the trade unless my entry is very close to the close price and then there's a risk from a large gap. When you're on a high risk/reward trade, a large gap can be a large loss so you have to use a little bit of discretion there.

But, this is a problem with really bad events, catastrophic events we tend to overemphasize how often they can happen. And I think when I've done testing over this year, over 2017 on E-J there was one occurence where it would happen with the gap.

I think instead of losing 1R, I would have lost about 5 or 6R. When you look at it on the charts, that one event that looks really catastrophic over the big picture of the year. It didn't really make much difference.

Walter: Still hurts though when you get gapped. It's one of the reasons why I like Forex charts actually because they're not so gappy. They're quite smooth. I feel sorry for the traders that trade those charts that are really, everyday is a gap. I don't know how they do it, really.

Darren: Yeah. I suppose you have to have the right system and maybe you trade it with wider stops.

Walter: Yeah. I think they must. I mean, these share traders and things like that. Like the Australian stocks are very gappy and a lot of the crypto-currencies are quite gappy. These markets, I'm sure they're great for some people but I wouldn't want anything to do with them.

Then you have like laws and things like stories about people in the futures market where the market goes lock limits so they can't get out. They're actually in a trade and soon as the market open, it goes lock limit and they cant get out. It just sounds crazy. Any other thoughts on this?

Darren: Well, my initial thought was Van Tharp. Is it Van Tharp

Walter: Yeah, Van Tharp.

Darren: He does a lot of work on this side of it, on the money management.

Walter: Yeah, money management and Psychology. He's done a lot of great stuff. I think his stuff is mostly focused on share traders or future traders but definitely, he's done lot of really cool stuff here.

Darren: And your current research explorations on this is leading you to think that to risk all of your previous win and just kind of get that compound and stack of trades.

Walter: Yeah. The idea is just disregard that win and use it. For example, you have a 3R so your system is either a 1R loser or a 3R winner. If I have a winner, I've now made 3R and I'm going to risk 1R anyway. So on my very next trade, I'm going to risk 4. Essentially, 4R instead of the 1R. Now if that wins, of course now that's made 12R. Right? I've made 12R in 2 trades. Normally I would have made 6R in 2 trades.

Now, let's talk about the losing. If I take a trade and I lose, then I lose 1R and then I take another trade, I lose. I lose another R. I've lost 2R. But if I take a trade and I win, I've made 3R and then I'll risk that 3R, plus another R -- that I'm normally going to risk anyway -- so that's 4R. And if I lose that trade, now I've lost 4R. Right? Then I'm back to risking 1R again. You only really add the markets money when you have that winning trade.

The variable I'm testing now is this idea of should I reset after 1 win? So if I have 1 win and I risk that winnings plus the normal risk percentage that I normally would risk. Do I just do that once? Then if I win, "Woohoo! I made 12R." Then that's it, or do I do it again? How many of these winning bricks do you add up and where is the point of diminishing returns?

That's one of what I'm working on right now. Once I figure out what I want to do, I'll go ahead and live test it. It's really cool when you think about it. To get to 12R, normally, I've had essentially, had to have 4 winning trades in a row. Four winnings in a row would give me 12R but with this strategy, really you just need 2 winning trades in a row to get to 12R. Right? So, it's kind of cool.

Darren: Yeah. You just need to look over your testing and see how often you get those clumps of 2 consecutive trades, isn't it?

Walter: Yeah and that will go up depending on the win rate. But like what you say, if you have a 25% of the win rate, you're still going to get a few clumps of trades. In a normal pyramiding situation, you're scaling into the position as the market goes in your favor, which a lot of trend traders will do. But this is not really looking at it at the trade perspective, it's more of a sequence perspective. Like you say, you're looking at to get a run of winners, which you normally will.

If you have a win rate around 50%, it's easy to have a string of winners or losers. That's definitely going to happen. **I'll put the risk calculator in for people -- I always like to put that in the show notes.** The risk calculators kind of cool because you can see what's the likelihood of having for example having a 50% win rate.

Let's say that my reward to risk is 2 to 1 so I'm risking 1% of my 2%. If I risk 1% over the next thousand trades, what's the likelihood that I'm going to have basically 7 losing trades in a row?

I have a 50% win rate, a 2 to 1 reward to risk ratio, I'm risking 1%. The question is can I get 7 losers in a row over the next thousand trades? And yes, the answer is absolutely 98% likely that I'll get 7 losers in a row over the next thousand trades.

These are the sorts of things that, obviously, if it's a 50% win rate, it's likely that I'm going to have 7 winners is a row too. In fact, it's just as likely the payout will be different because it's 2 to 1.

These are the sorts of things that traders would probably find more useful over the long haul. You can literally take a strategy. It's okay that its not that good. But if you pair it up with a good money management and you get your mind right, you know what you're dealing with here, then I think it's a pretty powerful thing.

Darren: Yeah, definitely. It's what we've always been talking about here. With psychology being more important and the strategy being important but because of psychology, you'll tend to be focusing on the wrong things. A really good tip is to list the things that you think are most important and then go and look at the other things because that's probably where the real chunks of gold are lying.

Walter: Absolutely. Well, thanks for your time, Darren. I look forward to seeing you next time. Thanks a lot for your time.

Darren: Cheers, Walter! Thank you.