2 TRADERS

[EP132: Resiliency (Part 2 of 2)]

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Darren: Markets are made by human behavior and human decision.

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 Part Two. In today's episode, we're going to talk about the best way for you to look at your trades. Once you've looked at your trades this way, you'll be able to analyze them much better.

Also, Darren talks about the FOBO - the Fear Of a Better Option. What this means for traders. We'll talk about a poker player and what she can teach you about trading and a specific recommendation from her as well.

And, the reality of big returns. What you must mentally prepare to do if you are looking to make huge trading returns. Why money managers have a job and that job is not to make the most money for their clients. We'll talk about this.

And finally, we'll talk about the one skill that predicts your longevity as a trader. As what I believe to be one of the probably, the most important trading skill and it has nothing to do with picking tops or bottoms. All of these and more in Part Two today.

Yeah, I agree. Especially that first part that you said about how sometimes you get these psychological edges in what you're doing. I've become more and more aware of that over the last 6 years. It's like, I'm doing something. I know it's not the most efficient way to trade in terms of bottomline and profits but, I know that it blunts the psychological pain.

One example would be to split your trade up so that you have one really easy way to achieve target and then one trailing exit or really difficult position to hit. It's a really aggressive target.

If you run the numbers, that's not the best way. You're never going to come out ahead doing that but it just feels right. It just feels good to have those little baby winners in there. It's more of a longevity thing. It's more of a psychological play than anything else.

Darren: Yeah. I saw someone call this "FOBO" the other day - Fear Of a Better Option. I notice some people get really caught in this. They can work out all the elements of their trading strategy.

All looks great on paper and they go and start trading it and they'll see that there is a better entry option so they kind of need to change the entry option and they see that on the last trade, there could be a better trailing exit option.

They tweak and they just never really settle on a process because they are always seeing that on a small sample there could have been a better option. I think, at some point, you have to say, "Look, the entry is important but I can probably draw 10 different entries that are sufficiently good."

And in the environment that we are working in, sometimes that is the best option. You'll say, "Look, this probably isn't the optimum entry pattern but it performs well enough. I'm comfortable with it and I personally like it, so this is what I'm going to do."
That's really hard for some people to do because at the back of their mind, it's always more in a way, "Is this entry good enough? Is it the best?" and that becomes an issue for some people. For a lot of people.

Walter: Yeah, no doubt.

Darren: I mean, I'll run it through my head all the time but I've learned not to act on it now. I think it's probably always there but it's whether you act on that feeling or not.

Walter: Do you look at your trade in big chunks? Do you analyze them in chunks of 30, 50 trades rather than… Like you say there's that trap of, "Oh, the last 2 trades, if I use the trailing exit, this would have happened!" or "Okay, the next one I'm using the trailing exit." If you are analyzing trades, do you look at them in big chunks like that?

Darren: Yeah, as big as possible. I've got a lot of data sets running at different variations of exits and entries and trailing stops over 10 years and that's really what I always refer back to because, for me, that's the most robust data I've got. I use that and I tend to use like the worst variants from that set as well. I tend to air on the pessimistic side.

Walter: Absolutely, yeah. The reality is you can end up on the pessimistic side, as you say, for a long time. You could trade a trading system that has a 52% win rate but end up trading it live for months or years where the win rate is below that and it's still is the true win rate 52%. You just end up down at 49 or 50 for a long, long, long time.

Darren: Yeah, because of variants.

Walter: Absolutely. In the market, we have a whole bunch of that variants way more than what we think. So, Darren, before we hit the recording button today, you were talking about the Annie book. Can you explain to the listeners about the gambling book? What's going on there?

Darren: Yeah. **Annie Duke [04:49]** was a professional poker player, won a lot of money, a lot of tournaments. She's written a book called "**Thinking in Bets:** How to Make Better Decisions with Uncertainty". She coaches traders now and she's an author.

It's a really good book. It highlights the similarities between poker and trading and how to really approach these uncertain environments better. It's a really good book. There are great ideas in there and it's one that people should read for sure.

Walter: **We'll put it in the show notes**. Its **Annie Duke**, right? We'll put it in the **show notes** so people can read that. It is interesting you say this because I ran into a psychologist guy -- last week, in fact -- who had been working with poker players.

He's been working on the psychology of basically these professional poker players. Then he said that he was going to start working with traders. I said, "Ah, that's interesting." So I wonder if its a similar thing. I don't really know enough about poker to know what the main issues are.

My understanding is that in poker, there's also some reading of people, right? Like, so and so could be bluffing. So, there's some of that involved too. It's not just the odds. The odds obviously are shifting, changing every time you get a new hand. I get that, but there's also that element of the human reading other people and stuff like that too. Right?

Darren: Yeah. This sort of Game Theory is a big part of it. Like trading, that's something we have to do. Some of the problems I see with trading is that, people believe that, that needs to be in the moment.

I think one of the big ideas people need to grasp is that, markets are made by human behavior and human decisions. That doesn't necessarily mean you have to look at the last 3 bars, and from that decide what people are going to do next.

You can look at the movement of markets and decipher from that. You can look at the history of the S&P 500, from that you can assume that people are going to generate trends. Trends become, because of human behavior. Unless you think human behavior is going to change, then trends are going to occur.

So you can look at the big picture and say, "Well, I'll use trends as my edge because trends are the results of human behavior. That's not going to change. Trends are going to occur." I think we get too microscopic. Like, "I need to know what's going to happen next." That's not necessarily the only way to go about it. You can know that trends are going to occur. You don't necessarily have to time these things.

Walter: I'm with you on this. I have two questions for you. From your point of view, lets say, you look at a chart from the 1880's. So, that's a while ago from today. Would you say that you might look at that chart from the 1880's and see some of the same things going on back then that would translate today?

In other words, another way of asking the question is: Could you trade a system that was working, made positive expectancy in the 1880's and today would work as well? That's number one, let's just go with that. What are your thoughts on that?

Darren: If the system was based on something that is generated by human behavior, yes. If it was a system based on a market opened at a certain time and it didn't do it then, then no.

Walter: Right. To me, this is so interesting. I agree. In the same way that you can take a child and you can do things to that child, and pretty much know that there's a range of behavior. That child's probably going to end up at a certain range.

Or like you can take a poor chicken. You get this chicken and you don't feed it very much and so, you know the chicken's going to end up looking something between this and that. And I think the same thing can be said about the markets.

When there's a certain emotion that permeates the markets, you probably are going to see, this sort of chart. And that doesn't matter if that was because of the Industrial Revolution or whatever, or because of bitcoin.

It doesn't really matter what the "reason" is behind it, but these emotions pop up in the pattern over and over again. So things like double tops, things like trends, all these things I think, you're going to see over and over again because people are the ones that are involved.

Even the computers, people are the ones who program these computers. Although, we're getting away from that, aren't we? Like, there are machine learning and things like that. We're at this point now where we are actually programming the computers to teach themselves, so to speak.

So, that can maybe perhaps change things. I think that the interesting point they are making here is that humans are the ones that are operating in the markets. They are the ones that are taking on risks in the markets. Therefore, you see kind of similar things over time. I agree with that.

But to me, someone could listen to you Darren and they could say, "You know what?" he doesn't really believe in repeatable patterns. He thinks there's a lot of noise going on in the markets and you just kind of have to hook into a trend basically, and lock into a trend. I don't know if that's a fair assessment or a fair characterization, but I can see where someone might listen to you a few times and think that.

Darren: Yeah. I mean, when you sit on a plane, do you think about the plane crashing?

Walter: Unfortunately, yeah.

Darren: But, is it the thing that is on your mind for the whole journey?

Walter: Yeah! No, I'm joking. Of course, not. I need another Vodka. But, sure. I got it.

Darren: I mean, what are you going to focus on? Are you going to focus on the things that are the most important or the things that you can argue have some importance but you know are not.

If you had to rely on one thing, then you want that to be, the thing that has the most importance. So you need to push that to the front of your thought process and your ideas. Now we naturally, when it comes to trading, focus on the things with the least importance and we put those to the front of our thought process and they take precedence. If you do that, you're just making it harder for yourself to make profit.

So how can you simplify the whole process? All you can do is gather information. Gather as much information as you possibly can. Try and pinpoint the elements that are most important for achieving your goal. Then you have to build a belief system around those things and put them to the front of your thinking.

That's what I try to do. Now, in all of my tests, I've never come up with a result where the other elements are the most important because I change them and it doesn't make a great deal of difference to the results. The bits that I consider the most important, when I change them, it makes dramatic differences to the results on the same sets of data.

So, what am I going to do? Am I going to go with my gut feel? Or you know, "I love studying the charts, I'm trying to work out and forecast what's going to happen next. Feels good to me, feels right." But my information does not agree with that.

So I try and reinforce those beliefs because it's hard to operate against what your gut instincts and your biases tells you is right. The only way you can build resilience to that is by slightly dismissing them and perhaps taking them down. But you still need to be open-minded to them, like we were saying before. That's why I might come across sounding like that is because my data suggests that other things are more important.

Walter: Right. So, things like what's the reward to risk ratio of your profit targets?

Darren: Risk/reward ratio is the one element that I see makes the most dramatic difference to a system over long term tests. Confident thinking, you know I'm smarter than that. A lot of people do. But after a while of losing, a couple of years of going nowhere, you either bug out or you rise up to the fact that, “Look, listen to what the data is telling you.”

At the same time you have to accept that it is possible to find alternatives to that because it is uncertain. There’s randomness involved but, I find something good. My data suggests it’s something good. I’m comfortable with that so I should reinforce those beliefs and use that as my strategy.

Walter: We were talking earlier about the process. Focusing on the process and not the results of your trading. That’s really kind of where the gold is. If you have that discipline, you keep pulling back and focusing on the process.

Do you think that when traders look at things like, “Oh, this pattern is very reliable or whatever.” Do you think that it’s just because they want to feel like they’re clever and that they have control over their trading? And that in the end, what’s making them money is the reward to risk ratio essentially for that trade? It has nothing to do really with the pattern obviously.

Darren: Yeah. I think, it’s fairly uncommon to find people like that. Let’s say, they’re using high risk/reward but they think the result are all down to their pattern. I think that they’re probably -- the people, like you were saying earlier -- they are at some points can really have a big blow up. Then perhaps come back and say, “Look, probably the pattern is a good pattern. It has some good probabilities.” But really, the reason I was making money was because my winners were much bigger than my losers.

Perhaps there are one time they thought, “This is such a perfect pattern. I'm going all in” was the time they all blew up.Because like I was saying earlier, they’ve given importance to the elements that really aren’t that important and aren’t as robust. So you have to get good information and you have to base your trading on that information regardless of what your gut feel and you instincts might be telling you.

Walter: It’s interesting because I think, you look at the markets and you can see, for example like the markets really moving in one direction and the Pound is really falling for example. And then you say, there are going to be people out there that are thinking, “Okay, the Pound is on a downtrend, I need to get in on this.” And, there are other people who are thinking, “Yeah, it’s out of whack! It’s out of whack! It’s going to come back. It’s going to snap back like a rubber band or whatever.” You know that’s what makes up the market.

It’s so interesting to me. It doesn’t really matter, does it? Like you're going to have these people and they are going to see it in a totally different way, and when you take a trade and think it’s useful to think about the people on the other side. So you say, “Okay, I’m taking this trade because I think the Pound trend is going to continue.” Who’s on the other side of it? Well, it's the reversion to the mean, the bollinger band traders.

Darren: The different time frames.

Walter: Exactly. The H1 trade chart traders and all that. The interesting thing about it Darren is, there's actually room for both of them to be right. The D1 chart trader that's selling the Pound in the downtrend and there's the H1 reversion to the mean trader who's pulling out 30 pips on the pull back. They could both make money. It's just so interesting.

I also find it interesting that, when you see the really strong trends that the retail traders typically are going against it, that's when you see the numbers get out of whack in terms of the open positions. When the market's really trending, that's when you'll typically see a lot of the retail traders trying to pick the tops or pick the bottoms of the uptrend or the downtrend, respectively. That's another interesting thing.

I remember, you posted that great study in the forum, about how the real issue with retail traders looking over millions of trades is that, they're typically right more often than they're wrong. So they have a higher, better than 50% win rate but their losers are so big and their winners are so small, they end up losing overall.

That makes sense if you look at it from that point of view. Like I just said, where so many retail traders, forex traders are looking to buy when the market's trending down and looking to sell when the market's trending up.

So there's room for this little tiny profit. These little tiny retracements that they can capture, but otherwise they're just going to get stopped out. If they keep moving their stop or whatever - what do you call when you add to a loser, Martingale or whatever? -- you're averaging down.

All those fancy terms for you keep making your losers bigger. That's when they run into trouble. It's just crazy, but we're built to be attracted to the Martingale stuff or the end of the trend sort of thing. We're built that way.

Darren: Yeah, we all think we're all too good as well. I think a really good mindset to accept were, I'm pretty horribly average in most things.

Walter: Yeah and so where do you get your edge? Where do you get your edge, exactly?

Darren: Exactly. I mean, in like a super competitive industry where there's a lot of people chasing the money. Smart, clever people with a lot of money behind them, how can you have an edge?

I think a lot of people seem to think that, "Well, I'm going to be the edge. I'm going to read the market better than anybody." I'm at the point now where I'm quite happy to be average. I'm just going to use the market movement as the edge because that's always been true.

Is the market true for me? So, that's going to be my edge. I'm just going to be horribly average and just follow the process. I'm going to wake up everyday and that's a setup. I'm going to bound my trading in there. I'm going to take profit in my target, and I'm just going to repeat. If I get to the end of the year and I haven't made any money, then so be it.

I saw an interesting report. The top 30 money managers of all time, have had a greater than 50% drawdown. Who would have thought that? I'm not advocating big drawdowns. I'm just saying, if you want massive returns then that's probably going to come along with it.

Walter: That's interesting, isn't it? Imagine Darren, you're trading 800 million or something. Just imagine how difficult it would be to move that money around. You've got all these assets and things like that. I often think about that and how difficult it would be. If you got caught in a market crash and how do you get out of that. It's just really a tricky thing, isn't it? I don't envy them at all, really. I don't.

Darren: They're not trading for themselves as well. I think a lot of people look at funds that make 7% a year but have a maximum drawdown of 2%. And then them, as a single retail trader think that, that's the way that they should trade.

I'm not saying that is not a bad way to trade. But you have to remember that half of these people, their job is to keep their clients happy. It's not to trade in an optimum style. It's not to get absolute returns. It's about the people are giving us the money. What do they want in return? Let's give them what they want.

I think you've kind of need to do that on a personal basis as well. That's not like, that's a good way to trade, and big returns or big drawdown is a bad way to trade. They're different options but they're meeting clients' needs.

Walter: Yeah, that's right.

Darren: There's no black and whites in this. There's hardly any black and white. It's just a lot of gray area. Same with poker. If you go into poker saying, "Have I got the best hand all the time?" Then, you're not going to win because it's not about having the best hand. It's about how often can this hand win.

Walter: Yes. To bring it back to the idea of reward to risk. I mean, that's why having the high reward to risk trading strategy, it just makes it easier. You can be really bad and it can still work.

So in other words, you can just totally stuff up the entry. You can get slipped out of your mind. You can have a horrible broker that's re-quoting you and all these stuff but if you've really got these good fat winners, when they do pop up eventually, it just kind of erases all that. Doesn't it?

You are able to sort of withstand all those worst**.** If I'm scalping and my losers are 11 pips and my winners are 6 pips, I've really got to be on my game or it's just not going to work. It's just really not going to work.

Darren: Yeah. Again, that's what my big data suggests to me. A 2 to 1 risk/reward in my data, is as good as a solid strategy. 4 to 1 has more negative elements in it but it makes much bigger returns.

When you've got to that point where you've made those returns, you have to understand that. If the next year you have a particularly bad market and you've got some buffer there, with a much tighter risk/reward, then those returns can disappear much quicker. But that only becomes evident over a long time.

It brings us back to the resilience thing. If you really want to make good returns, you have to have more resilience because you need to go for more negative experiences to get there. People aren't happy with that.

Walter: Wrong answer. Yeah, no doubt. Well Darren, thanks a lot for your time. I really appreciate it and we'll catch you on the next episode. Thanks so much.

Darren: Yeah. Great talking to you again, Walter. I'll see you next week.

Walter: Okay. Bye.