2 TRADERS

EP133: Trade Confirmation

Walter: I do not want to be skillful at making money and I know that sounds a bit weird. Really, what I want to do is find a strategy that has a positive expectancy and once I've convinced myself of that, then all I really care about is the execution of the strategy...

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. Hello, Darren!

Darren: Hello, Walter.

Walter: So today, we have a really interesting topic. We are going to talk about -- it makes a lot of sense to me and I'd like to get your take on this. The idea is something along the lines of this.

Actually what a lot of traders do -- including myself -- is we'll look for a certain thing to happen. Whatever that thing is, it could be a pattern or other traders might use indicators like there's going to be some sort of cross on the MACD or Stochastics or whatever it is. And then, when that happens it is like, "Okay, time to take a trade."

The idea is this, that you actually pay for that. So, if I'd wait for an engulfing candle to occur on the chart. The price that I pay for that is, by waiting for that candle actually form and print, that usually is going to mean that I'm going to have my stop loss pretty far away from my entry price because I waited for "confirmation" of the trade.

So the idea is it's like a price that you pay. How do you get rid of that or how can you trade without paying that price? And you collect a premium or you make more money if you are willing to take trades that do not have confirmation.

In other words, you kind of like trading saying, "Look, if price gets here, I expect it to turn around and so I am going to go ahead and just put my order in. Even though I do not know what the candles or what the indicators are going to look like when the market gets there."

And so, what you are able to do if you do that, in theory, is you are able to get in with probably a tighter stop loss than you normally would. In exchange for that obviously, you get a better reward to risk ratio in most cases because you don't have to wait for all these price movement to happen before you enter that trade. I am just wondering what your thoughts are on this.

Darren: We should trade in a systematic way because in trading it is not just skills exercise, there's skill and luck. When luck plays a factor in the outcome then you have to look at base rates and statistics.

The safest, most robust way to do that is to look at a lot of data. The more data you look at, the better. If you've got more data that backs up a systematic approach getting in before confirmation then it is fine to do that.

Likewise, if you've got data that backs up in approach way you wait for confirmation then that is a robust approach. But, if you are basing it on the fact that on the previous trade, you shouldn't have waited for confirmation because that would have got you into your target and waiting for confirmation didn't, then that is not good thinking. That is a bad process and we tend to be attracted to bad process.

We like the unexpected, the unusual and low probability stuff. Like, looking just at the previous last trade or maybe even just the last week. When you consider these things, it is really important to think about what you're given weight to here.

Are you giving weight for the unusual the Black Swan event, the lucky event? Are you giving weight to that? Or, are you looking at skill and luck? Are you looking at a lot of data to make these assumptions?

As humans, we are naturally drawn to saying, "You know what? That entry was better last week so I'm just going to buy into the fact that that entry is the best." And we'll discount the three previous months of trading because of what's just happened.

That's the problem with it and I think we like to believe that the reality is is that, generally - specially with entries - both will probably work but you need to apply them in a systematic way over a long period of time for either of them to really work.

Walter: I guess the way that I see this is it's kind of like a math question, right? Like, you can boil it down and say -- I know if I take a D1 chart trade that are GBP/JPY, typically my stop loss is going to be about 250 pips. And if I take a trade blindly of support and resistance where when I see the GBP/JPY approach, a support and resistance level, I might be able to get away with the 70 pips stop because I am saying, "Look, if it goes here i think it is going to bounce and go the other way."

And so, I don't have to be right that much, that often as long as I'm waiting out for the bigger target on these GBP/JPY trades. If I get in with the 80 pip stop or the 70 pip stop versus the 250 pip stop -- because 250 pip stop, I might going to get 2R or something like that let's say on average. And then with the 70 pip stop I might be able to get 7R. Basically, I'm getting 7R, 490 pips (7x70 is 490 pips) on the one trade and on the other trade, I am basically getting 2R which is 500 pips.

So, that's kind of the way that a lot traders see it, I suppose. On that way where they say, "Look, if I am trying to catch a falling knife here, I'm better off because I don't have to be that right that often. I can have a really tight stop and all that." You just have to deal with the pain of losing a lot.

I think there's two parts to it. First part is that you are getting in "early" because the market is not turning around and you are just expecting it to turn around. The second part is, you really have to wait for the target.

I think that is where -- we've talked about this before, this is where -- the traders go wrong. The big news and the big news flash for everyone who hasn't seen this is that, most retail traders, they get in front of a strong trend and they expect that where they get in the trade is the turning point of that trend.

We can see these over and over again with the open position ratio data. We see it. That the vast majority of retail traders are going against the trend and when they do so, they get out really quickly. So, they are basically trading the retracements, essentially.

I guess that is the way I see it. It is like a math question but the trap is that it is really hard to wait long enough to make the math pay off. If that makes any sense.

Darren: Definitely. The problem with the whole mathematical edge thing is, there is no right answer to it. There's essentially a lot of options that could be right and most likely are right. It is really difficult accepting that sometimes your option is not going to be the proven option and that's really, I talked about this last week, Fear Of A Better Option, is a really big problem for people.

It really comes down to getting good information and getting a lot of data and comparing them. I see a lot with entry patterns or indicators to indicate direction or trend. We're buying into these low probability thing that there is one moving average crossover that works and the others won't. There's one particular entry pattern and others won't.

Generally, there's a whole array of moving averages that you could use for the same particular system and likewise for entry signals. But, we are obsessed with this cause and effect thing.

We'll see one particular entry pattern working for short period of time and we'll kind of build a narrative around that. This is the cause and that is the effect. Unfortunately, because there's a lot of luck and skill involved in trading, that does not follow through. And so, the next week it will be the other entry pattern that was the best. We kind of get comfortable with that reality. I think, we always struggle as traders.

Walter: Yeah, absolutely. That is so true. You were mentioning earlier about luck and skill, and separating luck and skill. Can you talk a little more about because I have some ideas along those lines but I think they're different to yours.

Darren: Michael Mauboussin has written a brilliant book on this. He says, "When skill plays a role in determining what happens, you can rely on specific evidence. In activities where luck is more important, the base rate should give you the predictions."

It's because we focus on narratives. We put weight on a few bits of unusual evidence rather than in clarion way many different pieces. We ignore base rates and we ignore high similar one decision is to another. We don't naturally view it correctly.

An easy way to tell if luck is playing a role is can you repeat the same process and get a different outcome. If that is true then luck is involved. If it is not true then it is mainly skill. That is an easy way to judge.

So, you can quite easily see price above the 200 moving average retraced to a 50% pip, it goes to your target. Do you think it is going to happen every time? No, because there's luck involved in the outcome.

Walter: Yeah. But this is different to, for example, in most aspects of life. I think this might not be true but a lot of people look at say, business. They say the reason why so and so - like Jeff Bezos of Amazon or whatever - the reason why he's succeeded is because of his skill in creating a company and delivering what people want and now we've got Amazon.com.

But then you could also argue, "Well, hang on. Actually, it was just that Amazon -- His idea for Amazon came around at the right time and he was riding the wave of the internet so forth and so on and blah, blah, blah." There are ways that you could sort of, it's kind of hard to even separate that in normal life.

For people to say, "The reason why this person succeeded is because of their skill" and other people say, "I don't know. Might have been maybe there's kind of the rising tide that raises all boats" or whatever.

Darren: The recent scientific studies on this actually suggest that it is much more luck than skill. They found that people with the same advantages and the same education, you'd expect them all to be mega rich or a few of them mega rich. They found that actually luck is playing a massive role in those sort of things. Who is the head of Microsoft? I forgot his name.

Walter: Bill Gates.

Darren: Bill Gates. He famously said that the reason that Microsoft got so big was nearly all down to luck. They were just in the right place at the right time doing the right thing.

Walter: Yeah, copying Apple. Exactly.

Darren: Didn't Yahoo turn down buying Google for 5 Million or something?

Walter: Yeah. I don't know.

Darren: Then they turn them down about three times.

Walter: That's funny.

Darren: So, there's a lot of things in life where you can't rely on just skill. If you can see trading as falling in that category, I think you are better set to make profit in the long term. Certainly, when you listen to traders that have made profit over the long time, they will echo that sentiment.

Walter: Yeah, absolutely. For example, when I first started trading, we were trading stocks. My friends and I were trading shares. It was in the early 90's. This was the beginning of a pretty bullish market from 1992 through 1998 or so.

We all thought we were geniuses. We were buying Intel, all these stocks that were coming out. There was like the Netscape and all these. We were all geniuses because we were buying these stocks that were just powering through resistance after resistance; new high after new high.

That's one of the things I think I envy share traders because as currency traders, we have to decide if we are going to buy or sell where share traders nearly always just buy. It's just which is which to buy. They have fewer decisions to make.

Here's what I think that traders can differentiate luck from skill because I think you are right. I think there's two and they're confused, and this is common. I think that we needed to focus in on the right thing.

So, what do we want to be skillful at? What I would say my focus is I want to be skillful at executing my strategy. I don't want to be skillful at making money. I know that sounds a bit weird. Really, what I want to do is find a strategy that has a positive expectancy and once I've convinced myself of, of that then all I really care about is the execution of the strategy.

Now, because any given run of trades is basically due to luck, all I can concentrate is my execution. And so, what I should be rewarding is my execution. I shouldn't be rewarding whether or not that trade was a winner or a loser because it comes down to luck, as you say.

So really, what I should be doing is focusing on the execution and everything I do and again, this is once I've decided that I've got a positive edge, that I've got a positive expectancy strategy. It's only once I've decided that, that I move it to the phase where I don't care what happens.

I am going to reward myself for three losing trades in a row if they're executed properly. Does that make sense?

Darren: That makes complete sense because that's saying that you're going to run an algorithm. An algorithm doesn't get swayed by small, unusual events or bizarre events or luck. An algorithm is skillful because it is working on a lot of data.

The data is put in there and probabilities are all there and laid out and then it is systematic in it's approach. That is accepting an exercise in skill and luck. That is the smart way to go about it. Now, if you believe it is all skill then you would…

Walter: You change focus, right? You'll focus on results, wouldn't you?

Darren: Yeah. You'd be more discretionary because you're saying it's down to your skill of reading what is happening right now rather than the base rate, the statistics, and that is what we are attracted to as humans, unfortunately, which is why it's difficult for us to trade. Because we need to be systematic when working on a big set of data rather than like you say, reacting to what is happening right now.

Walter: Yeah and the big data thing also, that is interesting to me too but probably for a different reason. What's interesting to me about big data and you're mentioning big data backs up something and it helps you to accept something if you've got a lot of data. But here's one thing that I've learned going to school for so long about statistics and experiments and I find this fascinating because I think it's abused in Science.

It's basically this idea which is scientists know -- and Psychology is included in Science. Most people don't think of it as a Science but it is. It's a Social Science and I think the main reason why that is the case is because everybody has, we all have our pet theories about why people do things.

I really don't have any naive theories of Physics but everyone has their own naive theories of Psychology. Naive as in you know, just everyone has, "Oh, that's why she does that" or whatever. -- But, here is what's interesting, Scientists know that if you get enough data, you're almost assured to have a significant result.

Now, basically the way it works is like the rules of Science, I'm sure that people know that if you've done a research method course or whatever, you know that almost all of Science is basically asking the question: Are these two things different?

If you get enough data collective for the two groups -- and I know this is really simplistic but this is kind of the base -- so like, placebo group and then the group that has the real drug. If you get enough data collective, you are almost assure to find the significant result.

Which means, you can publish it. Which means you're on track to become tenured. Which means you get more money and then they can't fire you and so forth and so on. So it's like, they want grant money. Scientist want grant money so they can pay for enough people or subjects or rats or whatever they are using in their Science, to get a significant result.

The interesting thing about that is you don't have to have a very big result to find it if you enough data. I think that is kind of the same thing that you're talking about with trading. You don't have to have necessarily a very big edge but you'll find it if you have enough trade sample. If that makes any sense.

I'll round this up now and finish up. I've been long winded here because I want to get your reaction to it. So, what I am saying is this. If I have a small sample of data, in this case a small sample of trades and I find a very significant result.

In other words, it looks like there's a pretty strong edge here. It could be that I am making the error because I just happened to lock into some really good trades and then overall if I had more trades under my belt in this sample, I would know that the strategy is not that good.

But, it could also be this. It could be that the edge is so strong or the effect is so strong that it shows up rather quickly and that you don't need a lot of data to see it. That is called Effect Size.

You can measure that. If you have a big effect size for a drug or whatever, that will show up quickly. You don't need to have thousands, of thousand of data points. That's what is interesting to me about this is that, you can kind of abuse this and you can get a lot of data points.

And if you get a lot of data points, you're almost always going to find something but if you have a few or just a small, little sampling and you already see something really big, that could be because you have something really good. Do you know what I mean?

Darren: Yeah, definitely. I really can't add anything to the science of that but that is my approach to trading. That is why I try to be more systematic all the time. I really believe that the whole discretionary thing is a complete smoking mirror.

I was reading someone the other day and he said there's no forecasters in the Forbes rich list. Why is that? But, you know it's really difficult to do because we're not built to believe in that.

If you and I ask everyone if they think the roads would be safer if all cars were computer-driven, nice people would believe that it is safer when humans driving. BUt, computers will never take their eyes off the road. They won't be distracted. They won't answer a phone.

Walter: They won't be texting.

Darren: Yeah, they won't be texting.

Walter: They might not be drinking either. They probably not be drinking, right?

Darren: They're not. We give ourselves too much credit and I rather step back from that. Like I was saying last week, I'll just say, "I'm probably pretty average." Which is a good starting point. So, if I'm going to try and make a living out of this then, I really need something more to back it up rather than saying, "You know what? I was pretty much smart at school. I was in the top ten. Everything I try I'm good at." We all think everything we do, we're good at.

We are kind of have that built into us. I think probably more so in men than women, I'm not a hundred sure of that. I just think if that is not working for you then perhaps take a different approach. A systematic trading approach is a good alternative

Walter: And so, why wouldn't you just go for on like automated? Just have the robot do it for you then?

Darren: Like I said, because we're not good at it. We can't buy into it. We don't trust the system.

Walter: We don't want to let go of the steering wheel, do we?

Darren: We still want to feel we are in control. I think to an extent we need to hold onto that but I think if you get carried away with that, that is where you'll get into trouble. Also, sometimes it is acceptable to be not optimum.

Let's say, that we accept that it is difficult for us to do. Trading systematically is difficult. Even though we know over a long run that pros would be better, to be comfortable with the whole thing then maybe you should allow yourself a little bit of leeway.

So, if you want to include a little bit of discretion because it makes you feel bad then do that but do it in areas where it makes the least amount of difference. For me, that might be my entry signal.

I am not concerned with precision on entry signal. I put my stop at the bottom of the signal bar but sometimes I might not put it right at the bottom. That is kind of me having this feel of I've got a little bit of control but also I've got a data to suggest that over the long run, it's not going to make a huge amount of difference. Does that makes sense?

Walter: It does. I guess, when we talked about investors like George Soros or Warren Buffet, they're just kind of the lucky ones then, really. I mean, aren't they? I know how you say like, we're basically convincing ourselves that we're better than we are.

So, what that means is then that, there's always going to be some outliers. There's always going to be some that just happen to get lucky like Warren Buffet or George Soros.

Basically, these guys are fundamental traders. They trade their beliefs. They think they see the world in a certain way and they see it going in a certain way. So, they make investments accordingly.

These guys, I suppose you would say like, if you're going to take this very to the extremes you know, which I think there's a lot of data to support this by the way. We make a lot of mistakes in our decision making and one of them is overestimating our abilities.

You take a room of a 100 people, about 62% of them are basically average. And you ask them, "Are you above or below or about average in intelligence?" 85% of them are going to say above average. 85 out of 100 people are going to say, "I'm above average". When really 62 out of the 100 are basically average.

So I guess, taking this to the extreme, these guys like George Soros and Warren Buffet, it's just like a room of 10 Million monkeys. One of those monkeys is going to pun out Shakespeare. I mean, that's essentially what we're talking about?

Darren: Sort of but I think it's more a case of there will be other people out there who haven't done half as well but have as much skill.

Walter: Right, because of the luck.

Darren: I guess is what we are really saying. So, you're going to get those outliers whose process isn't necessarily much better than the people who are just doing well but they've just also had more good luck playing in their favor.

Walter: Gotcha.

Darren: So, you can have a great process and stick to it systematically and just do alright. That is something else you kind of have to accept.

Walter: I see where you're going with that, cool. Well Darren, thanks for your time today. I really appreciate it. This is interesting.

Darren: Cool, Walter. I'll speak to you next week.

Walter: Okay, bye.