

2 TRADERS

[EP134: Perception Reality](#)

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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 back to the Two Traders. It's Walter here and I've got Darren on the line. Hello, Darren!

Darren: Hello, Walter.

Walter: Welcome back, Darren. So, we're talking today about perception reality. The question is this: Is perception reality for traders? If so, why this matter? Any thoughts on that? What are your thoughts?

Darren: I don't know. What's your thoughts on this?

Walter: Okay, I'm happy to go first. I think really what's going on here, my thinking of this when I think about this is traders basically have a really difficult time. And this is not an indictment of a trader but all people really, have a difficult time stepping out of our theory or the way that we see things. This is kind of the root of the confirmation bias.

And so, it's really hard for us. Like, if you think the economy is going to collapse then every chart you look at basically says, the economy is going to collapse. Likewise, if you think that gold is going to go to the roof, then everything you look at sort of, is tainted to that way. So in that way, our perception becomes reality.

The real concern here I think, there's two things that are important here. One is, when you take a trade, can you step out of your suit of armor so to speak and say, "Alright, who's the other guy on the other side of this trade? What is he thinking? What does he see?" Or, "What does she see? Why would she take the opposite side of my trade?"

And then, the other bit of it is I think that is really a useful exercise to look at it from the other point of view and come up with a case for why someone would want to take the opposite trade.

The other part to this that I like is that it's so much nicer to get out of a trade and then analyze the chart. It's so difficult I think for traders when they're in a position like, if you long the EUR/USD and you're trying to figure out if it's double top or whatever, or there's a reason to get out of the trade, it's difficult. It's much easier if you'll just drop your position and then decide.

In other words, clarity comes by not having skin in the game I guess, is one way to look at it. So, what are your thoughts?

Darren: I think I like Annie Duke's way of approaching these things where she says, to think in terms of probabilities all the time and to sort of understand them rather than looking at a chart and saying, "Right, it's definitely going to go up here and it's going to hit 1.3" or whatever.

Rather than doing that, you think in terms of what the probabilities of it going there and then being kind of realistic about them. Even if you think it's a 70% chance that I'm right, you're allowing the notion that you're going to be wrong as well. Rather than seeing it as black and white.

Walter: Yeah.

Darren: So this is my analysis and this is definitely what's going to happen. Even if something should you know, 90% then it's not going to happen all the time. I think that is a better way to approach it.

Certainly, the element of it that always fascinates me is the way that what we visually see plays tricks. I'm really a bit fan of visual illusions and I'm always searching out for those. That always just kind of sits in the back of my head.

I realized that when I look at the chart, my eyes are just picking out the patterns that I've predetermined I like. The rest of it kind of hazy in the background and you're not considering that. So, I particularly like the visual upside of that idea.

Walter: I think, it's really useful to like, when I'll look at the chart, I usually and I'll even say this in my videos. I'll say, "If this happens" -- that I think this scenario is more likely -- "if this happens in this scenario" you know what I mean? The next piece of data that comes through, it points to which path we're on, so to speak.

Darren: Yeah, definitely. I think that's why, like we were talking about earlier, why systematic wins over discretion.

Walter: Right.

Darren: Because you should be able to build systematic rules around that and if you can't then it means that you haven't either, haven't got enough data or you're just falling to confirmation bias. You're just looking for the stuff that agrees with what you believe is going to happen

Walter: What do you think about -- I know this is kind of tangential but what do you think about -- those guys who build these automated systems that say, they kind of let the machine come up with the rules. They're not really in control. They'll just throw a bunch of data in there and then the machine comes up with, "Okay, this is a pattern that we find." The machine find the patterns that you know, you bought 330 on a Tuesday. Chances are, it is going to work out.

They come up with these things that you can't look over the reasons why would it be the case but it just happens to be the case. What do you think about that? Is that acceptable as a system building? Or does it have to be logical except that it has to make sense to you as a trader?

Darren: No. I think the approach is the same really. It's looking at data and working out probabilities and working out a mathematical edge. If that appears to be there over a large set of data then really that is the sort of basis of what trading should be. Unless, you believe in forecasting and it's a case of you being able to decide where prices are going and you're being right.

Walter: Some traders will just say exactly what you've said which is, "Look, if the Euro makes a new low every time the new moon comes up then, I'm just going to trade at the new moon." Other traders are going to say, "That makes no sense whatsoever. There's no way a new moon ever do that. Doesn't make sense." That makes up the market, I guess.

Darren: Yeah. I suppose as human beings, we kind of want to be able to find a reason, a narrative for how it happened.

Walter: Yes.

Darren: We want to find that but it's quite possible that computers can find that there's reasons as well. It's quite reasonable to accept that.

Walter: Yeah, they'll find the patterns and they'll find the solutions probably way better obviously than we could possibly do so or it's approaching that any way. Here's the similar thing. So the United States, in the football league, they have 16 weeks of games.

And so, the opponents are set but the schedulers have to come up with a way where everything fits. Some of these stadiums, they're sharing them with baseball teams or there's concert or whatever they were booked in advance. So, they've got to work it out so that all of these teams play a schedule in a fair way. Where they don't have to play 5 away games in a row or whatever.

Basically, what they do is they have the computers spit out all of these different versions of the potential schedule and then they've kind of whittle it down. If the computer does the hard work, the humans just in the end sort of end up making the final decision.

I think, that is how a lot of traders who use these automated strategies, you put all the data on to the computer and the computer spits out and say, "Here's a profitable system."

I think a lot of traders they'll just look at it and think, "Well, buying EUR/USD every Tuesday at 3:30, I don't know. It doesn't make sense. Why would I buy the EUR/USD?" "Buy the EUR/USD everyday at 6 pm, why would I do that? It doesn't make sense. What's going on in there?"

But, if they can come up with a story, if they can come up with a narrative like you say, then all of a sudden, everything is fine.

Darren: I think you've kind of got to have an idea of which stories are worth basing your evidence on which are not. I think in markets now, we understand that really the good evidence stems from human behavior. We are much more switched on to that now.

Although, these books from the '30's which were all written about human behavior and markets but I think we're giving it more precedence now. I think for awhile, technical analysis took over but now it's more about human behavior. That is what I believe anyway.

Walter: Do you think technical analysis is a way of looking at human behavior?

Darren: I think it is but that doesn't mean that all of it is.

Walter: I agree.

Darren: I mean, there's technical analysis that works because of human behavior and then there's stuff that's really out there and it's very hard to tie it to that. Trends for example. A trendline or a moving average or retraces in trends. Elements like that can be tied to human behavior.

The two actually work together really well. I know it seems like sometimes I'm negative on technical analysis but it's more a case of being realistic of how important it is or how precise it can be. I think this notion that ultimate technical analysis will give you precision. I don't think that is possible to achieve and that's really what I argue against.

Walter: Right but if technical analysis enables the trader to feel like he has precision, there's a value in that.

Darren: Possibly. I think it's probably a bad mindset to take to trading because when you're having inevitable losing run, you are likely to react badly to it. Rather than just accepting that it's not a precursor and sometimes it's not going to work out. You need to remain steadfast and systematic and continue to trade.

Walter: My daughter when she's convinced that she's hurt, if I gave her a bandaid it makes everything better. I don't think it really does anything medically for. It's just psychological. I guess, it's the same idea with technical analysis.

It's like, "Okay, let's do this and we'll be precise about our positions" maybe it's not true. Maybe it doesn't actually do that for us but it gives us the illusion of control. I think you can see that there are many different technical systems that will enable you to see. For example, exuberance in the markets or fear or something like that. I think that's quite valuable that you can see that.

That emotion will pop on the chart when you use certain types of technical analysis. So, it'll become quite obvious that, "Look, there's exuberance here. This market is really stretched." Same with fear. You could see that and it's quite obvious and so that becomes useful.

Even if you're just to use it, just for that for example. If you'll just to use that for that. I think, it's interesting. If I were to just and I know traders that do this or at least I know one trader that does this.

If you were just to read for example, the newspaper. Like if somebody just said, "You know what? I'm going to start investing in the markets and you know what I'm going to do? I'm just going to read the newspaper. Whatever the newspaper suggest I do, I'm basically going to put my money in it." I think that would be pretty much the fastest way to lose money.

I can't think of a better way to lose money than just to like read the business paper or the Economist or something like that. It just seems like that would be the perfect recipe for losing money.

The reason I bring this up in regards to technical analysis is because that is essentially the opposite of looking for fear and exuberance in the markets which you can see with technical analysis.

If you'll just go by what the financial writers are writing about, I think you'd be much more likely to follow the crowd. That sort of reporting is largely, not completely but largely about what the trend is doing. What is the crowd doing right now.

It's only later on after the peak that they'll ride about it. It's kind of that. I have friends who write and they're telling me that their Editors tell them now that you've got to talk about what's happening next. It's not enough to just report on what is happening but you've got to also talk about what's going to happen next.

Which is interesting because I think that when you look at research along these lines, you'll see these too in Psychology. Most people think that whatever is happening today is going to continue to happen in the future.

If you're asking a reporter, a finance reporter with an Economics degree or whatever, to report on what's going on in the Economy or in the markets. And then, you're also asking that same person to project into the future, which is apparently what the Editors are doing. It's not enough to report.

So, what they're doing is they're just saying, "Well, this is what's going on" and basically we expect it. They're most likely to say, "and we expect it to keep going" and it just seems a recipe for failure.

Darren: Yeah, everyone who bought Bitcoin at 18,000 would in that boat.

Walter: It's crazy, isn't it? Absolutely crazy.

Darren: How do we go about a good perception of markets and having a reality? What are the simple steps to take to having a reality that gives us an edge?

Walter: I agree with you in terms of the data. I think the first piece is you've got to convince yourself. That means collecting a lot of data. Once you've done that, you've convinced yourself, "Yeah, there's an edge here. These series of rules or this way of interacting with the markets works. I have enough data here that support this theory and I believe this to be true."

I think it is also important that it matches up with what you believe about the markets in general but some people just look for what works. I don't think that's the long term path to success as a trader.

I don't think you should be looking for what works. I think you should be looking for what you believe will work. You find that data then you go, "Okay, this seems to work" and then it comes down to basically having a setup.

Have you ever seen when you go to a bowling alley and they put those big balloons in the bowling gutters. So that when you roll a ball, it won't go to the gutter and it just keeps bouncing off. It's really hard not to hit the pins? I think that is kind of what you have to do.

Once you've decided, "This is the path I'm going to go down with this strategy" I think then you've got to setup those little balloon things in the gutter to make sure that you don't go off the rails.

So, that means coming up with rules, that means writing down your results before and after having good records. That means having somebody else to talk to about your trading, all of that stuff. It can even be working on with your mindset and your beliefs is the next step for that. But really, the focus has to be on execution.

You need to move away from what did the markets do, that's in the testing phase and how can I make money here. You've got to get away from that. Those questions are answered once you've decided that this strategy is something you want to employ and then it comes down to execution. I think, that's the key. What do you think?

Darren: I think so. The difficult is the point you said about, you have to do something that you believe in. If it's true that we've all come to trading with the wrong beliefs and I think most of us do. Naturally, our beliefs about what sort of the game is a wrong then you're a disadvantage already.

Walter: Absolutely, yes.

Darren: And it's very hard to start and say, "What I believe about this is wrong" because you believe it and that's the difficult thing.

Walter: And you are going to seek out evidence that supports your belief.

Darren: And it's easy to find in the way that the markets move.

Walter: Yes, absolutely. So, that gets back to your point about the big data. You've got to have a lot of data. You just can't sit down at Forex Tester pound out 25 trades and go, "Look, it works."

It's got to be repeatable. Ideally, I think it would work on multiple markets, not just one market. It seems to me, I don't know if it's true but to me, something that works on just one market or one time frame, it seems a little gimmicky or kind of lucky.

Darren: Yeah, definitely.

Walter: Yea. It should work on more markets and then you've got to have enough of them where you'll go, "Okay look, I think there is something going on here" and then it's all about, so you've convinced yourself, now it all comes down to what do I do for myself so

that when it goes bad and it will go bad that I don't quit. And that I don't say, "Ah, this doesn't work anymore".

How do I make sure that I don't do that because that's the big thing. If you go to these trading forums, everybody is talking about, "Look, this works"; "I need a system that works" or "This system works".

Basically, there are two groups of traders on the forums. One is, "Hey, look at me. I've got a system that works" and the other group is, "Hey, I need a system that works". Everyone is looking for something that works and then the problem is, once you've find that you quit because you've decided it doesn't work anymore.

Usually, that's is due to either a risk problem, risking too much when you get really confident. Or it's simply, it does not much up to your beliefs. So, you've been looking for reasons to throw it away.

You were looking for something that worked rather than looking for something that made sense to you. Some traders wrote in this week and said basically like, "Hey man, convince me that price action works."

And so my response is no and he talked about all these reasons why all these famous traders who've never use price action. So, I'm not going to convince him that price action works.

What I said was, "You don't trade price action. You are talking about fundamentals, that is what you need to do. You need to marry your thoughts" -- which was quite clear in his email. -- His thoughts were that all of the really great traders used fundamental analysis to make money. So why would I send him down the wrong path? He needs to do that, right?

Darren: Yeah, possibly. But, is trading about changing beliefs? Is the key being able to change your beliefs? Because, if we naturally come to trading with the wrong beliefs on some key elements, be in short-term, not sticking to a system, having to run systems over a long series of trades to really see the benefit. Is it really more about changing beliefs rather than to make it fit your beliefs, if we come to trading naturally with wrong beliefs?

Walter: I hear what you're saying. I think you are definitely right. Here's what I think. I think that most people have sort of general beliefs about the market. It could be like you've got to understand the news in order to make money out of the markets, so it's like a fundamental belief. You've got to understand politics or economic policy or whatever to make money in the market.

So that's one kind of core beliefs, the fundamental traders. Then there's the other belief which is like, the trend is your friend. You need to trade trends and then the most common one or some people think the real trade setup when the market gets really quiet.

Markets really quiet right now. It's getting ready to get really volatile so I want to be in on that, so they are the breakout traders. Or, there's a trader that say, "Look, this has been going up too far, too fast, too long. I'm going to get in when it all collapses and I want to make a pile of money quickly because I'm going to get in on the turning point." the swing traders, the counter-trend traders which is probably the most common style of trading.

If you'll look at the numbers, most people are trying to do that. So, you need to determine where you are in one of those buckets but then what you're talking about, my belief is that, my belief about what you said is that, that comes down to kind of the fine tuning like you say.

First of all, if we'll just scroll back on the chart and say, "This is what I would do." That's all hindsight bias, that's total crap. That is not going to help and the other thing is, we know that we take profits too quickly. We all know that, don't we? I know that the average trader takes, I did.

When I first start trading, I took profits way too quickly and we all know that most traders want to win more often than they lose. The easiest way to do that is to take profits too quickly. I think those are the core beliefs that the majority of us hold that we have to beat out of us over time.

Darren: It's like you can have an array of beliefs that are profitable but other beliefs are essential to get right.

Walter: Yes.

Darren: Like you say, if you've got a leaning towards being more fundamental, you can make that work if your other beliefs are correct. Likewise, if you've got a leaning towards to being very technical, you can make that work. I think the key is knowing which elements are really important and which elements are really down to our personality choice.

Walter: I'm totally with you on that one. Hey Darren, thanks so much for your time today. I really appreciate it and we'll catch you in the next episode.

Darren: Thanks, Walter. I will see you next week.

Walter: Okay, bye.