EP136: The Effects of Optimism

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Darren: Or maybe it's like, think positive but don't be surprised if it all works out horribly. That's probably a good mantra, isn't it?

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. Walter here. Hi, Darren!

Darren: Hello, Walter.

Walter: So today's episode Darren, we are going to talk about the effect of positive thinking ON your trading. Do you want me to go first or what do you think?

Darren: I think, I need you to go first on this one.

Walter: Okay. This is the thing I've been thinking about. Here's my theory and I could be wrong. I think, most traders, they get into trading and the reason they get into trading is because they get really excited about the possibilities.

I think that we gloss over the risk and the negative. I think that hindsight bias has a lot to do with that. I mean, I recall myself scrolling back on the charts looking at different indicators like Stochastic or whatever and going, "Yeah, I would've taken the trade here. I would've exited here."

It's almost like, it was totally a mess. It never worked out in real time. That sort of scrolling back and eyeballing it. That was before I even knew forex tester or I didn't know it was around but I didn't know about it.

I think that it's common. I don't know maybe I just assume that I'm like the average case where we look at things and we think, "Okay, this is a great way to make money. I want to make money. I'll do this great thing and I will make money" and you forget about the risk.

The other side of it, is I think that some of the best investors think a lot about risk. So, that's thinking a lot about the negatives when you think about trading. Because the negatives are that, we risk money in exchange, we are getting paid for taking on risk in the times of uncertainty. We're putting up money in things that are totally uncertain.

We don't know if we're going to get that money back and the payoff is we might get more with our money back. So, that's basically what the trader does. Now I wonder if, people say, "Oh you need to think positive. Being positive is the way to do it. You've got to think positive.

And there are all these great correlates that go along with positive thinking and approaching things that way. I think in trading, if you don't have the yin to the yang, so to speak, you don't have the risk thing, you don't have risk in mind, you can really get into trouble.

And the other part of that is, when you see what you don't want, when you see the negative, it helps you to find what you do want. So that's why I think we can learn. We make mistakes about looking at things in trading such as forgetting to look at risk or maybe correlated risk or risk of holding a position over the weekend or whatever it is.

We kind of gloss over this risk and then boom! When we learn that is really something important that you need to pay attention to, it helps us to refine what we do want and helps us focus in what we want.

In that sense, it's not all about positive thinking. I think you still need to have some of the risk thinking. And I know all pessimist will say, "I'm a realist." I get it. I know that's true, right? Every single pessimist you'll ever meet...

Darren: That is true.

Walter: It's true. You'll never meet a pessimist who'll say, "I'm a pessimist". Every pessimist is a realist. I think that it's not all about positive thinking. Positive thinking helps in terms of setting goals and expanding your limitations a little bit farther out and that's great. But, I think that if you don't have the focus on risk as a trader, you'll get into big trouble.

I believe that's why most traders get into trouble. It's because they don't understand that what they're doing will eventually send them to a place where they'll get really stressed out and they'll feel helpless. It was actually just, they were already on that road. They were already headed to where they ended up. They just didn't know that the road they were on was going to go there.

And, if they had figured out the risk side of it, they would've known long before they reach their destination of pain that, that is where they're headed. It is all about understanding that risk part. So, I don't think that you could just say, "Yey, let's all think positive and we'll make tons of money" I don't think that's true.

Darren: Yeah. When you say positive thinking, it reminds me those books in the '80's. Think Yourself Rich. It's just the case of like, if you're thinking positively then everything is going to go your way and you're going to be rich. I think that's a really bad way to approach trading.

I think the problem is, like you say, it's the information that we discount that is the important fit. Generally, we've got all of the information but we tend to focus on the bits we like. The nice fluffy, comfortable bits and the bits we don't like are the bits that we're kind of try to block out and discount.

You need to see the real probabilities rather than just the stuff that backs up the outcome you want. I think that is the problem. So in my eyes, positive thinking is probably a really bad phrase to use to your trading.

Walter: What will be better then? What is the better way to look at it?

Darren: Is it bayesian?

Walter: Bayesian probability, yeah.

Darren: Where you kind of really, you have to look at just because something is highly likely, it's not guaranteed. Whereas generally, 75% would kind of, that's a guarantee. I think we fall into that trap a lot in trading.

Walter: Absolutely. To me, I'm not against like when you're in a trade, I don't think it's necessarily a bad idea to think that, that trade is going to work out. I don't think it's a bad idea.

What I think is a bad idea is looking at a trade and thinking, that is such a no-brainer that I should risk a third of my account on it. That's what I think is a bad idea. You know what I mean?

I think there's a difference between hoping and cheering on a trade. Envisioning, "I see it on my head. It's going to hit the profit." All that is cool. Totally cool but I think the issue comes in when we let that cloud or judgement, which should be based more on probabilities than on sort of feelings.

I always remember, Darren. This was a long time ago and there was a couple of guys, a friend of mine who wanted to get into trading and then at this stage, I just basically moved beyond breakeven. And I was like super excited.

So, everything that had to do with trading I would tell them about. I'm like, "I think, this is going to work" I was really excited. Anyway, so this guy he was like, "Hey, my brother and I want to come over to your house. We just want to talk and see if you can teach us some trading stuff" And I'm like, "Okay. Alright, sure"

You know what was interesting about this -- and I'll never forget this -- I said to them, "Can you tell me what's some great, what are the best methods for a risk?" "What are the best methods you know of for managing a risk?" You know what they both said?

They both said, independently mind you, they both said, "Obviously, just risking more on the trades where you know it's going to work out." You know what I mean? That is exactly what we were talking about here, isn't it?

Darren: That's a good plan.

Walter: Exactly.

Darren: Exactly if you know it's going to work out.

Walter: Exactly, yeah.

Darren: In trading, it is about knowing what you don't know. If you truly know what you don't know then you are in a much better place.

Walter: Yeah but you see, the problem is there are known unknowns and then there are unknown unknowns. To quote a certain former Secretary Of Defense in the U.S. So that's the problem, right?

There are things that we now, we don't know which is like for example, what is going to happen on the next trade. We don't know that. But then there are also things that we don't know, we don't know. How do you deal with those? Those are just like black swans, it's just like out of the blue. What is the contingency for that?

Darren: Nassim Taleb would say, be antifragile. He'd say, "Have something that prospers from that possibility, that probability rather than in something that blows up". So, perhaps, you could, let's say, you work out that risking 3% of your account means you're never going to blow up based on your data then perhaps risk 1% of your account.

It gives you a greater chance of not succumbing to that but I think there's a lot of people that don't agree with that. They think they do know all of it. I think that's where the danger is. As long as you accept that you don't know everything and you've got a pretty good idea of the things you don't know then you stand a better probability of making money in this game.

Walter: Some people also just, it's so sexy to be able to just pick up and make money every single day not knowing that the one day is coming that is going to completely wipe you out.

Whereas, Nassim Taleb, he's comfortable losing money everyday and then the big payoff comes some years down the road. He takes the opposite side of it. I think, human nature is, we are not really built for that.

We are not really built to the point where we can say, "Yeah, I'm happy losing money between today and the nex 5 or 6 years" knowing that one day between now and whenever, 5 or 6 years from now, I'm just going to get this huge payoff.

Darren: Yeah. I don't think we are setup to think like that and I think most of the things we do in life don't necessarily adhere to that rule.

Walter: That's right.

Darren: Most of the things we do, we can pretty much guarantee the outcome in our daily life. I think that is the big, not known that is a good idea to take onboard. It's what the outcome is going to be and not just the outcome today. The outcome in a years time and you can practice and test and have live trading data as long as you want but you don't know how much money you're going to make this year.

When you start believing you're in control of that outcome, I think that's when you're in a danger zone. You really kind of have to let the whole outcome thing go and just focus on the process. That is something that we don't do well naturally as human beings.

Walter: No because we look at the outcome and then we adjust on off of that, absolutely. I would argue that most of what we do as humans is we just draw the straight line like you're saying.

To me, everytime I look at some sort of article in a business or economics magazine or something, they're always saying basically like, "This is what happened". All the banks and all the experts they're all saying, "Yeah, we kind of expect to keep going." It's so funny. It's like nobody ever learns.

Everyone thinks that, today is sunny. Tomorrow is probably going to be sunny. Last quarter, the market went up. Next quarter is probably going to go up. It's crazy to me that, that is the case but sometimes you wake up and then the next day, there's a tsunami. Or sometimes, you wake up and then boom! There's a nuclear power plant meltdown or you wake up and there's a revolution or a coup or whatever.

These things happen and yet they're just not even on the radar. They just come in as these big surprises. I suppose, you'll go crazy if you had all these anxieties. Worrying about tomorrow there could be a tsunami or whatever.

It's just crazy to me that the so-called experts, the guys that's telling us what's going to happen tomorrow, they just draw a straight line based on what has happened the last week, or the month or the last quarter. It never seemed to be the case where they'll say, "It's been going up for five years but we think it's going to be tank this year." It's crazy. It's just crazy.

Darren: You know weather apps always give you a 10-day forecast and it's known without any doubt that their 10-day forecast is basically worth nothing. But they all have 10-day forecast and we all believe them and we buy into them.

Amount of people have come up to me ad say, "Look, in 10 days time, it's going to be 25 degrees and blaze in sunshine." You can show them the statistics and say, "look, it's really, really inaccurate" past ten days. In fact, weather reports have only really accurate for sort of 24-hours. Still can't believe it, you still can't buy into it and then that's how we think.

Walter: Yeah, I totally do. I totally fall victim to that. I'm like, "Oh yeah, 8 days from now it's going to be raining so I won't do this. I'll do that" and then it'll come up and I'll be like, "Are you kidding me? It's supposed to be raining today. What?"

Darren: Usually it's because there's some sort of an event going on in their life that they want to have a good outcome. Maybe they're going camping or something and they're attached to that one particular outcome.

So when you're in that kind of mindset, any data that comes at you just bounces off. You're not going to take that. Your mind's made up, it's going to be sunny when I go camping. It's says on my weather apps. So whatever you tell me now, fact or otherwise, is just going to bounce off me.

I think that's the key system that you have to build into your trading is, some way to rationalize that. A different way of thinking about outcomes. If you can do that and you can get good at that then it will improve your trading ten-fold.

Walter: So how do you do that? How do you think about outcomes?

Darren: Let's say, I'll cast my trading strategy that has a 50% win rate. When I enter a trade, it's no good than instantly thinking that it's going to be a winner and acting based on that emotion. You have to be realistic with your expectations.

So, you have to say, "This has got much chance of being a loser as being a winner " and there's going to be variants in there as well. If I have 3 winners on the trough, that doesn't mean that my win rate is now suddenly a 100%. It's still 50% but you just happen to have about 3 on the trough.

It's kind of this idea of thinking in bets and looking at all the information and being realistic with your expectation. I don't think you have to be particularly clever to do this. It's just kind of a personal choice. I'm going to be a little bit more rational about what I'm expecting and what the possibilities are.

That can go a long term data as well. You can have ten years of data that says that your returns are going to be an x amount. There could be a massive variants in the next ten years.

Walter: Yeah.

Darren: You have to accept that.

Walter: William Eckhart talks about that in the New Market Wizards. Actually, I've tested what he was saying. It was exactly what you are saying, Darren. He says that, for example, you have a 50% win rate.Sometimes what you'll notice is that the actual data, the actual trade results will get away from that 50% mark and they will stay away from that 50% mark for a long, long, long time.

So you've tested your system. You have a 50% win rate and then here you are, 3 years into trading it live and your win rate is at 48%. It could stay at 48% for years. It may not get to 50%. You may die before it gets to 50%.

So if you'll get really aggressive with your risk or if you make any sort of mistakes based on assuming that 50% win rate, you can get into big trouble and I've done this with random numbers.

I'll dump them into the spreadsheet and just see like, if you dump a 1 through a 100 into a spreadsheet, you can just make it randomly assign 50 to 100 as a winner, or whatever 51 to a 100 as a winner and 1- 50 as a loser. You just do that and see how far away can it get from the true mean, which is assumed to be 50% and what happens. And then it happens. It does happen exactly like you said.

And so, what he says, is that we have in the markets, we have infinite variants and everything in statistics is not assuming that. Every normal curve you've ever seen, every statistical test you've ever seen in your life, all that stuff, assumes a normal curve distribution. Which means that only occasionally do we get those outliers on the tail.

We don't have fat tails and what he's saying is that not only do we have fat tails but we have really fat tails. I believe it. I've tested it. I think I've mentioned this before, probably in an episode a long time ago where I look at Swiss Franc and I said, "Okay, let's look at Swiss Franc. Let's see the distribution of the prices and is it true that we would have, the distribution of the Swiss Franc prices fit the normal curve" and the answer was no.

It was 300% more variants in that distribution. And that was over like 3 years or something like that. It wasn't even a big sample. I think that you can make the case quite easily that we have such variants in the markets. Even if you don't want to say that it's infinite variants.

There such variants in the markets, that means the market can move really fast, really quick and you have to decide what you're going to do to counteract that. What are you going to do because that means you can get literally wiped out.

It's just crazy. That's one of the things I guess. Thinking about our main topic I suppose. We don't think of that. As a trader, you think positive, "Okay, it's going to be a win or a loss" you don't think in terms of this huge variants that's out there so you can decide to take advantage of it like Taleb does. Or you can decide to try and negate it or guard against it.

Be aware that it's going to happen but that is why I think it's crazy to give all your money to one broker or it's crazy to put, let's say, you have x dollars for trading, you don't want to put all of that money in with your brokers. That's crazy too. There's risk everywhere and it's just not, to me, we just forget it. It' too easily forgotten.

Darren: Yeah so really the message isn't think positive, is it?

Walter: No. I guess not.

Darren: Well maybe it's like, think positive but don't be surprised if it all works out horribly. That's probably a good mantra, isn't it? It's basically saying, the one thing you don't know and you need to forget about is the outcome. You need to focus on other areas.

Walter: What can we control? We can control process and execution, right?

Darren: Yeah, those two. And there has to be sound reasoning behind your process and really kind of get into the area of edge. What is your edge and how sound is the reasoning for your edge?

Walter: Are you focused on making sure that the way that you interact with the markets will pull out that edge? In other words, are you executing a sound manner so that your edge will show itself? Because we get in the way, I guess.

Darren: Definitely.

Walter: Cool stuff.

Darren: I did it last week. I started trading my stop earlier than I normally would and I've convinced myself there was a sound reasoning for this. It end up causing me a lot of profit. I didn't lose any money but it caused me a lot of profit. I basically took my edge away.

Walter: Which is more painful: to lose out on a potential profit that you should have had -- the missed opportunity -- or is it to lose money? To actually lose money because of a mistake. So the mistake causes you to lose out on more profit or missed opportunity or the mistake causes you to actually just lose money.

Darren: I run a very low win rate system so for me, it was missing out on the winners because I don't get many winners. And, execution mistake that takes one of those away can really damage my outcome in the long run.

Whereas, loses happen a lot and I should've set my position size correctly that they are not going to matter so much. So, for me, it was missing out on the winners. That was the painful thing.

Moreover, the fact that the failure was in me. The system was clear. I know what I needed to do and I break the rules. That's the most painful. I can't blame it on anyone else. I can't blame it on the markets. I'd like to blame it on the markets but it was me.

Walter: Let's say, you're in a trade and you calculate, because what I do is, if I'm in a trade and then I'd take another one, I calculate my risk assuming that the trades I'm in currently are going to be lost. They're counted as a losers. Do you do that or how do you manage your risk? So, when you're calculating your risk, what do you do with the open positions?

Darren: My risk is based around I take on every setup.

Walter: Right. For example, let's say, you have 5 positions on and you're taking a 6th position, would you assume that those 5 previous positions are like, let's say, you're risking 1% per trade, do you just assume that those previous 5 positions were all 5 percentage lost or how do you do that? Or do you just keep the risk the same or do you adjust it every week or something? Is that what you do, you adjust the risk every week?

Darren: Only up. If I'd make profit then I'd compound it but if I made loses I don't.

Walter: Right, you keep the same risk.

Darren: Yes, I keep the same risk. So, if I have 5 trades open as far as I'm concerned, they're gone. To be fair, I've never gotten to the point where I got 6 trades open with these strategies.

Walter: So you would go like, We're up 10% off of last week, -- so you go -- "Okay, now this is our new risk amount" and then all week long, you're using that amount. And, let's say you're down 2% on the week, the following week, you'll keep the same dollar amount or pound per trade risk.

Darren: I'm not an expert on risk and I need to do a lot more studying on it and I wouldn't advise anyone to take my advice. I may well be doing it right based on the data I've got then it works good enough. I try to stop trying to optimize. Stop trying to be at the maximum all the time and try to find a place that the works good enough and be comfortable with that.

Walter: Gotcha, cool.

Darren: Again, whether that's the right thing to do or not. I don't know but I think you can. Optimizing can help but again, you don't know what the outcome is going to be. So you test 3 years and workout you can risk 5% and risk 5%. It could be too much. You could just have 3 really good years.

If you'll look at some like Dunn Capital who go a whole year and make a loss and then the next year makes 30%. He makes massive returns but there's a lot of volatility in his returns. He's probably not best to optimize on one good year of data. Optimizing is a double-edged sword and you need to be careful with it.

Walter: Absolutely. The systematic traders are very aware of this but even discretionary traders need to be wary of this. It's a common thing. The best example I've seen of this is the book -- and I'll put in the show notes, I mentioned it before I think. -- The Holy Grail or something like that.

It's like some books on Kindle and these guys got together and there was like this A-team of traders. They all met in the forum. They're on some forum on the internet and they basically came up, they concocted this strategy and they really build up their account really quickly.

They've got really aggressive with risk and everything. What they didn't realize though is, they basically optimize everything on the Euro during the first 6 years of the Euro. So, it was just an uptrend more or less.

So, when the Euro first came out, it was in a straight downtrend and then it immediately reversed of that. Basically went roaring essentially in an uptrend and so, what they didn't realize is that everything that they had come up with was based on these data. On the Euro because they were just trading the Euro which is basically just trending in one direction. They've got into big trouble and essentially they've lost it all.

But, that was based on what you're saying. In this instance they took all of the data available. They were trading the Euro, they've took all of the data they had in the first 6 or 7 years of the Euro or whatever it was. '99 to 2006 or something like that and they still made a mistake.

Darren: Again, they've bought into the outcome and even if you have all the data available, it doesn't mean that you've got all the data. I think that is the take away from this. Be positive but accept that you don't have all the data.

Walter: There are definitely unknown unknowns. Thanks so much, Darren. This has been a great episode and I can't wait to see you next time.

Darren: Okay. I'll see you next week, Walter.

Walter: Bye.