EP138: Compounding Your Trades (Part 2 of 2)

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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: In Part Two, you're going to hear about what big market data tells us about the markets. Why we traders are obsessed about the wrong thing. The one magic fix for all trading system. I know it sounds a little bit crazy but it's true. You do this one thing and you're generally going to be alright with your trading.

Why traders are obsessed with the normal curve and here's a hint, it actually shows up anywhere even where it shouldn't be. And also, you're going to get the genius of the low IQ trader. What he did and what you can learn about his approach.

All these and more in this Episode of the Two Traders.

Alright, are you ready for the next question? Here's another one we've got: Why the trend is your friend? It seems to me the market always moves much further, much faster when the trade is over. What can you say to that?

Darren: The first part, why is the trend your friend. For me, it's because you can make a mathematical edge out of the fact that trend exist. What I mean by that is that if you have a system that uses some way of indicating the trend and let's say, you have a 3:1 target.

So you have a fixed target of 3:1 generally if you double your target to 6:1, then the decline in your win rate tends not to be half and that's when you've got a mathematical edge by using the trend.

If you can test the system on different targets and you find that you are seeing a similar decrease in your win rate when you increase your target then that is one way that the trend can be your friend.

In most of my systems, that holds true. It's not completely linear but you'll find that exactly the same entry criteria rules. If I double the target, I tend to make more profit than you'd expect from that.

Walter: Have you thought about why that would be the case? I have some ideas. In theory, people will say, "You take a trade 50-50 chance" in theory, you would say, "If I double my target from 3R to 6R, I should also half my win rate but it doesn't happen that way".

Darren: Obviously, I have not done my own research on this. I'm using other people's research but generally when you look at price distribution, it has fat tails. They're fatter than you thought they'd be.

So in other words when price gets moving in one direction, it tends to continue on in that direction longer than you'd expect. That seems to have been the rule for markets from day dot. I am using other people's research on this but there's a lot of research, there's a lot of data to say that's true. Though I cannot say they are a 100% true. I'd say that based on evidence the probabilities are pretty high that's true.

Walter: I've got the same theory that William Eckhardt talks about in the New Market Wizard Book. I tested one currency pair, the Swiss Franc and I found exactly what you've said that you could break down anything.

This is the interesting thing about statistics is that you can sample anything. If you do a random sample, you take a random sample what should happen is, any distribution should line up with the normal curve which is kind of a weird thing but that's the central limit theorem. So, you should take anything unless you get that.

What that means is, you should know exactly where everything should fall according to the standard deviation. That wasn't the case with this Swiss Franc. I looked at it and it was like almost 300x more volatile on the tail. On the fat end where there should be only a few data points. There were like almost 300% more. So to me, that's like I'm happy enough walking around with my confirmation bias if that's the case because I clearly haven't tested any other currency pairs.

It makes sense. I mean, you look around and you see these volatile periods that shouldn't happen that often but they do. They happen all the time so to me, that makes sense. Clearly, if you're using a trailing exit or you're using a system that takes advantage of that and there's a real edge there, isn't it?

Darren: I think, it's the strongest and the easiest edge to exploit. When you listen to the guys that have been around for 20 years, you'd find few of them disagreeing with that and that's a good thing to base your trading on. You can do your own testing. Your own testing of just a year or 2 or 3 years, it should show that edge.

Walter: What's interesting to me is that the traders who do the opposite. They have used the normal curve to set themselves up. So, they're depending on everything falling within the normal curve and if it does then they're going to make money. They don't want those tails to pop up and if they do, very rarely do they want it to. Those guys have all gone broke.

It's amazing to me. If you'll look at those traders in the market that do that they all go broke. You can look at all of them and all of them have. Some of them, multiple times. It's crazy to me. I mean, when I say, all of them, I'm talking about the famous ones.

Obviously, there were traders we've never heard of who's using that idea which is basically an idea that, basic idea is, the market can only go so far before it'll come back. They typically go broke when the market go so far. They expect it to come back and it keeps on going farther and farther and then they go broke. Meanwhile the guys who are taking advantage of that with the trailing exit or whatever, they are making money.

Darren: I think one of the problems with trend is we can be obsessed about forecasting them and finding the exact start and picking trends rather than a system of getting big gains when they do occur. We get obsessed a little bit too much about that.

If you look at great trend traders, they'll often have losing years and you'll say, "Well, if his success was based on these facts that he can predict the trends, how can he have a losing year?" Because he should in theory been able to say, "The signal was not right and so I'm not going to take a trade" but, they don't do that.

They like taking small little bites then when the big trend comes, they have a systematic way of getting the most out of their strengths and they pay for their small losses. You find that pretty much uniformly across the board. That's how they approach it which gives you a clue that obsessing about the right moving average crossover or combination of indicators to perfectly pick the right trends of the start of the trend is not really the way to go but it is the way that we are attracted to that approach. Most would use very simple ways of identifying the trend.

Walter: I was just going to say that. A lot of them where you can just say, "If price goes up, we buy. It goes up, we buy. If price goes down, we sell". My friend who got me into trading, he said, "You need to go take this course on how to trade currencies" so I went and took the course.

He took the same course and in his course he said, "You know who the best trader was?" When he did the course, it's like a week-long course and he said, "The best trader was this guy who was clearly not the sharpest tool in the toolshed." You know what he did? That's all he did. He just bought when it went up, bought when it went up and sold when it went down. He did really well. Whereas, everyone else was overthinking it. I just thought that was fascinating

Darren: Do you mind of entry systems I played around with? Eventually, you'll come to that conclusion. Buy when price is rising and sell when price is falling.

Walter: The hard part is getting out of that, deciding when are you done. Having a mechanical trailing exit is really your friend in that case.

Darren: I think so and also the mindset that there's no optimal because the optimal exit last year could possibly be really terrible this year. It's like when I run tests from 2R to 10R and then repeated it with various, different trailing exits. What I realized is that when my wins are much bigger than my losers then I'm generally going to be okay.

So what I need to do is I need to select one that's kind of a risk profile I'm happy with. I could live with that drawdown. I could live with those returns. I can work out how much I need to risk and I know that this is not always going to be the best but over the long run, I'll stand a good chance of making a really good returns.

You need to get comfortable with that idea that you're not at the optimum, not the optimal exit. You're always going to find trades that turn around just before they hit your target or you hit your target and then they continue they go. That's just the nature of the game and you need to get comfortable with that.

Walter: That brings us to the next question. I think you've kind of tackled it which is: Isn't it better to take quick profits than to wait for more profits as it can go against you and you can lose what you had? In other words, you can't go broke taking a profit. What do you think about that quote? They say, "You can't go broke taking a profit."

Darren: Well just the nature of the question suggests that the answer to that is not known because if you're asking that question then do the testing. So, if in your mind with your entry setup and how you trade, taking profits of 1:1 risk/reward is more profitable but go and test it.

Do exactly the same trades with te 2R and a 3R and a 4R and then with a trailing stop and see if it's better. If you find that it is better, then you found an edge to your system that it's better taking profits quickly but do the testing first and use all of the information.

Generally, when we ask question like that which is kind of going on in a gut-feel. Probably you've had some losses where they weren't profit and the emotion of those losses, it's weighing your opinion and you're discounting of a data there.

Walter: I think part of it is that's just what we do in everyday life. We learn something, think about like trying to ride a bike, you learn something. If I do this, I'll fall off the bike so maybe I'll do that.

I think in trading, we carry that with us where it's, "Okay, hang on. The last time I did that, this is what happened so maybe I'll do this. Do something different this time." that's our natural tendency but it works against you when it comes to trading.

Darren: Yeah and the difficult thing is, it's completely possible to make profit from exiting trades early but history has shown us that the people that make the most money generally don't trade that way. It's a question of how much information you've got that you're basing your trading on and how good that information is.

Walter: Absolutely.

Darren: I do know some people that trade that revert inverse risk/reward and they're kind of playing with the same edge there really. They're playing the edge of keeping their win rate high rather than the edge of having winners much bigger than losers. Both edge can be exploited.

It's very hard to say that one is better than the other but all you can do is you can look at your trading approach and how you want to trade. Get information on both of those approaches and see which one appears to be better based on data.

Walter: To me, the two big strikes that, that quick-profit-high-win-rates system has and I used to try and do this is that you may pay more commissions in theory and then if you're not really on top of your game, if you're not really executing well, like just a little bit of a poor approach in your execution can really hurt you.

So I feel like, for me anyway I'm better off and you know, I've always kind of toying around the idea of really going for it one time. Just really testing it out and see if I can do that again. When I mean again I mean, I used to trade D1 charts where I basically go for like 1.2R or something like that. I don't really do that anymore.

I'm just wondering the way that you see things, do you see it the same way because I just see those commissions as really taking a bigger buy out of my profits if I do that. And, I feel like I really need to be on top of it because it'll get a little sloppy that can really hurt as well.

Darren: I've never traded that style really but I think so, yeah. Things like getting gapped or slippage can make a huge difference if you're doing that inverse risk/reward thing because you tend to have to trade a much bigger size. Like you say, if you've got very big account, it's harder to manage that sort of strategy.

Psychologically, it's a different sort of pressure you get from that because you can't go like a whole, you can go instead of like having a long drawdown period that you might have with the high risk/reward system. You tend to have long periods of just grinding and going nowhere, just basically trading a breakeven, you can have periods like that as well. It's not my way to trade but you can make an edge out of it.

I think the danger is that it's appealing and that always turns me off solutions to trading properly because it just seems you see, you're really comfortable to just keeps locking those winning days.

Walter: It's a trap.

Darren: Yeah and I think whenever it feels kind of, "This is really easy", that's when the red lights are going off for me. With everybody losing money or large percentage of traders are losing money then, it's not going to come easy, it's not going to feel comfortable. It's going to feel difficult and hard work inside and that kept me safe the last few years.

Walter: I just imagined the mouse crawling, "Oh, look at that cheese. Wow! It's just sitting there. I'll just go in there" then slam! It was too easy, mouse. You've made a big mistake. Definitely.

If you'll look at all of the trading systems out there my guess is that, most of them would be related to sort of the quick-profit 1:1 or even less than 1:1 risk/reward. Seems like that is the sexy thing. I could be wrong but that's my guess. Most of what's out there is what people wanted, I suppose. I agree.

Darren: Most of the systems I read, they seem quite good until they get to the crunch part which is how to manage the trade once you're in it and when are you going to take profit. I see such a huge percentage that don't even talk about that.

They just talked about the setups and analysis in the entry. It's like their edge is clocking winners and they're not even considering how big those winners are going to be. All they're concerned about is how frequent they're going to be and it's kind of like, taking half of a trading strategy away, maybe even more.

So, if that is your approach to trading, I think you're going to come stuck at some point because without a clear plan, you're going to be swayed by emotions, by what happened in the last trade, by what sort of data you're having, by what's the weather is like outside. All those things are going to be pushing or pulling your results around because you haven't predefined where is the most important part of your trading strategy.

Walter: Absolutely. I remember seeing with a trader and he was like, "Oh, I'm going to get out of this trade. I can pay for my new kitchen. It's exactly what you were saying. He just completely switched off the strategy, the trading strategy and just said, "Hang on," he just realized, he was just looking at the trades and he's like "I've got enough in this trade to pay for a new kitchen that my wife has drawn up. I'm out of this trade". It's so true. It's so easy to switch out of execution mode and look at the what is available in terms of profit or loss.

Darren: I can go on weeks without looking of what my trading account balance is now. I don't look at it. I'm not interested. I need to get up and I'm looking at the correct entry. When it comes, I'm setting my target and how I'll run my trailing stop and then I'm on the next trade.

I'm not focusing on how much money I've made in the outcome because I think that is a bad habit to get into. It's focusing on outcomes rather than in process. You generally know how well you are doing.

Walter: One last question. The other issue I have with the inverse reward to risk or high-win rate strategies like that are that, if you were to throw a dart and let the dart decide whether or not you would take a trade or what currency pair or buy or sell or whatever, if you were to throw a dart with your 5:1 reward to risk ratio strategy, you're probably going to make money and you can test this on your own and see.

But if you were to throw a dart with the 1:1, I don't think you would. Although, I have to admit, I haven't tested it. So, I'm just wondering what are your thoughts on that? It just seems like, that piece of data, if that's true -- now, I'm interested -- if that's true, doesn't that tell you there's a fatter edge, so to speak in the low win rate, high reward to risk ratio strategy?

Darren: Yeah and that's what most of the studies into that have shown. So basically with the inverse, you're basically saying that your ability to forecast and predict the market is going to remain consistent. Again, that is a dangerous mindset to get into, I think. It's a flimsy edge to hang your hat to that thing.

Walter: To depend on, exactly.

Darren: Yes, to depend on.

Walter: There's another guy that I'd read about who, he had like this automated strategy. He would keep taking trades and it had like a 1 pip stop so he kept getting stopped out, and then occasionally he will just hook into one. If you'll think about it, if you're up like 100 pips, you're up a 100R. It was just crazy.

He would just keep taking these trades and then occasionally, -- I guess quite rarely -- he'd hook into a winning trade. It seems like to me, it would be really, really difficult to trade a strategy like that but it's kind of like the extreme of what we're talking about.

Darren: Yeah, definitely. He's taking it to the extreme and it's really good to do that with a strategy you trade. It really take the targets out to the extreme and look at the data you get back from that.

Take all the stages in between and you get a good math and you can clearly see them when you've got that amount of data in front of you where the edge lies. And then, it's just the case of making personal decision, where on this lie, am I going to feel comfortable. How far can I push this and feel comfortable.

That is my approach to trading and it's certainly not for everyone but it is a simple edge to exploit. It's technically simple to exploit. You really need to just get enough information and build up some sort of trust in a systematic way of exploiting that. I think as human beings, it's one of the easiest ways to make profit trading markets.

Walter: Well, thanks for your time, Darren. I really appreciate it and looking forward to the next episode.

Darren: Okay, Walter. Thanks, see you next week.

Walter: See you.