2 TRADERS

EP142: Trading Edges (Part 2 of 2)

**Walter:** It's quite easy to manipulate someone's perception.

**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 this Episode of Two Traders, we are going to see about the magician in the markets and what this means for your trading. Also, how to know if your strategy will work over the long term. What does the Shakespeare monkey mean for your trading.

You will also hear about the Turtle bummer and how to test for luck in your trading system. Also, how to know if you actually have an edge or not and finally, the story of the nervous Las Vegas gambler. All these and more in this Episode of Two Traders.

What you just said is perfect. That's just exactly right. If you want to make more, you've got to risk more. But here's the thing, what do you do? How do you risk more? What you've come up with is, I take more trades. That's how you're risking more. Am I right?

**Darren:** Take more trades and take trades that stop out more.

**Walter:** So in other words, you're taking a lot of trades and you're getting stopped out a lot because you know occasionally you're going to get the big winner.

**Darren:** Yeah.

**Walter:** But some traders don't do that. What they do, when you say, If you want to make it work --whether I'm paraphrasing -- you've got to risk more. Some traders actually what they'll do is they'll run like the Ryan Jones Fixed Ratio Method or something. Where they're actually literally risking more per trade. Right? That's another way to risk more.

**Darren:** I saw some really good research. This is more of people doing really in-depth scientific stuff with figures and that I don't 100% get. But I'd like to study this stuff because these people, they're equipped to do these sort stuff than me.

They said basically, if you've got a sharpe ratio on as much data you can find or as far back it's going. It says you're sharpe ratio is 3, then the actual sharpe ratio is going to have variants of 3. So it could actually be 6 or it could be 0. You could do it for the next 20 years and make nothing. Even though in the last 20 years you had a consistent sharpe ratio of 3.

**Walter:** I think that happened with the Turtles. Like the Turtles are using that trend falling strategy. I think that actually happened. It went really well until the mid-90's or something and then it just stopped working. But then it started again like in 2010, it fired back up again or something.

**Darren:** Yeah. When it comes to position sizing, does that mean that really you've got to have to be a bit conservative with position sizing and really pushing your position sizing is basically saying, "Okay, I've done my testing. I'm just going to hope that my testing was at the lower performance levels and it's only going to be uphill from here." I think that's probably a dangerous way to go by it. But for sure you could make a lot of money quickly. I suppose if you got a bit lucky. Maybe that has happened to a lot of people, a lot of blowing up.

**Walter:** Some of those people would say, like the academics would say, "Well, you know, for every Warren Buffet there's 20 million people that just had made a dime or whatever." Something like that. You'll hear things like that. They've all kind of evens out. It's the old Shakespeare monkey. You've got a million monkeys typing on a keyboard and one of them is going to start pounding at Shakespeare. Right? Something like that.

I mean, I just find it fascinating. If that were true, then you wouldn't think that it would be possible to teach trading skills. Like if that were truly the case that the people who make money just happen to luck into it, then how is it that this person is making money trading and then somebody talks to them and learns and then they'll go off and start making money trading. To me that's evidence that this is not true. That this idea that randomly the market chooses the lucky winners and everyone else gets to pay their lost money to the lucky winners sort of thing.

**Darren:** I think luck is a really important part that's not considered carefully enough. Especially in something like trading. I've been watching about **[04:36,inaudible ]** recently. Football or sports as well. I think where their skill levels have got to a point that they're all really high across the board. Then I think luck does become the defining element. But I don't think luck just kind of happens. It's you're in a situation where the things that you've determined, the decisions you've made mean that luck is more likely to play out for you than somebody else. Do you see what I mean?

**Walter:** I don't see why would luck play out for you because you're more well prepared.

**Darren:** Well it's because the decisions you've made prior to the good and the bad luck playing out. Let's say for instance, you decided that you are going to be a trend trader and you're going to trail your stop. Okay, and then it just so happened that year there was a lot of trends and that generated you a lot of profit. You had no way of determining there was going to be a lot of trends. But your decisions to let your winners run and cut your losers short always get the other way around. I have to check myself now. It meant that you were able to profit from that good luck.

Now, if it just so happens that markets do trend a lot. You know that's what markets do as a result of human behavior. Then your prior decisions to go down that route have meant that you would make money from that luck. Someone could be just as skillful but be basing their approach on something that's not going to deliver that luck. Not as likely to.

**Walter:** That's like the distribution of wins and losses then, I guess. Right? Is that the same kind of idea? That's like the luck element. When you do your back testing, you run your Monte Carlo test and you go, "Okay, this is kind of the distribution of R that I might get when I ran this strategy. It's somewhere probably going to be between here and here. So worst case scenario, I lose 12R. Best case scenario, I end up plus 60R or whatever it is."

If that's the case, and then you go and trade. You're probably going to end up somewhere in the middle. You're probably not going to end up down 12R and probably not going to end up, up 60R. But somewhere in the dark middle of that distribution. And so to me, luck is the distribution. It's your distribution of wins and losses.

I think it sounds like, you're talking about something a little bit different. In other words if you have a down year, and you think you're going to win 51% at the time and you have a down year and you only win 46% at the time. It doesn't mean that you won't get to that 51% over the next 10 years, let's say. Maybe you'll get back to that expected level but you just happen to start trading on a year that's just wasn't ideal for your trend following system or whatever.

**Darren:** Yeah. I probably made the point really badly. I suppose a simple way to say it is, if you have a really good process then you can be unlucky and have some bad years for sure. But, over the long run then, you're more likely to get good luck. It's like if you went all in on a 50-50 and you won then that's a bad process. But you got really lucky.

**Walter:** What's the 50-50, is that where you'll bet half of your account?

**Darren:** Like a coin toss. If you've got it all in a coin toss then you win, then that's really pure luck and it's a bad process. Sooner or later you're going to wipe yourself out. Do you see what I mean?

**Walter:** I saw that happen once in Las Vegas.

**Darren:** If you have a good process, you're more likely to reap the rewards of good luck.

**Walter:** Yeah, sure. I have this process in playing roulette. It has a negative expectancy and I understand that. But, what happens is that you get to play for a long time. So, even though it has a negative expectancy, basically you bet like 2 units on a color like Black.

And then, you bet on one unit on a third of the board or whatever. So that one unit on a third of a board pays 3 to 1 and the color pays 1 to 1 right. What happens is you end up covering most of the numbers. Chances are you're going to hit it. Right? But, you're not going to make money over the long run because of the 0 and double 0 and that sort of thing. So, you have a slight negative expectancy.

And what happened was this couple came up and you could tell they were not gamblers and they are not into this or anything. They took all their money and just slapped it down on Red. And "Bam!" they hit it and they're like "Woohoo, party on!" And that was their money for the weekend or whatever, do you know what I mean? That was basically like a 49% chance of hitting their pay-off. They were so nervous, Darren. They're saying they couldn't bear to look. They just didn't want to do it. But I'm happy for them that it paid off.

The thing is they didn't really do any preparation for that. They just said, "Okay, we are going to get all the money that we have, and we're going to put it on Red. We're maybe going to hit it or maybe not. Either way, we're going to be happy that we did what we did and we're going to walk away."

**Darren:** Yeah. I think maybe that is what an edge is. An edge is just having a really good process and then the outcome of that edge is really down to good and bad luck. I see that with a lot of their funds, who are like these are the funds who make it big. You go and look at their track record over 10, 15, 20 years and you see these guys will go like a whole year and not make anything. And they will go 4 or 5 months with making nothing and just losing. And these are the guys who are really making it big.

You think well, they have got a really solid process and they know that sooner or later, luck is going to turn in their favor. That's where they make so much money that when it wasn't running well in their way, they cover all their losses. That really incorporates the whole process together. It is their edge.

I think sometimes when we talk about edges, we look for them, we try and sort of say, "Well, it's 3 bullish bars with a 36-period moving average on the USD/JPY between 8 and 9 AM in the morning." I think, they are like the 2 extremes. When you look at those guys with really long successful track records, it's a much broader view of what an edge is. Would you agree with that?

**Walter:** I think so. It does make sense. I guess I don't think that edges are nearly as magical as I did when I first started trading. When you realise that, when you hear about Santa Claus, when you're about 7 or 8 years old. It's kind of like that. I think of it like back to when I first started trading and how it was all about, it was the search. It was more of the search. I got to find it. Where is it? And that has changed.

**Darren:** Yeah, but I think it was a search for something precise, wasn't it? It was like a precise, clean equation that everything was spelled out and the future was known. Once you're there then you're completely in control of outcomes. And I think, "Well, I don't think like that anymore." It revert. I think, I'm thinking more rationally by now but I could be wrong.

**Walter:** The good news is most of us think that we are completely rational, that's funny. To me, definitely in the market there are some inefficiencies, there are some weird things that happen and that's because people are in the market.

In some ways it's like what the magician does. You know, I grew up sort of performing as a child magician and really what we are doing is taking advantage of the inefficiencies in human perception. It's quite easy to manipulate someone's perception. That's really all what the magician does. It's just manipulate you know, look over here and they do something over there and that's the whole trick.

I think it's kind of like that with the markets. Where everybody's looking over here when the real move is over there. I guess to me, that's what an edge is. It's knowing when that's going on. So that's why I pay attention to things like the open position ratios for the retail traders.

If it seems like everybody and their brother is talking about something you know, then it's probably like think cryptocurrencies in December 2017. That sort of thing. When everyone's prowled in, that sort of thing. It becomes clear that to me, that's where the edge is most obvious. When people sort to get a little bit silly. To me, it's very similar to what magicians do. They just deliberately move the attention away. That's how I see it anyway.

**Darren:** I agree with you on that, Walter. It's essentially saying that edge is behavioral and come from human behavior. You could definitely attribute trends to that theory.

**Walter:** Exactly. That's a great way of saying it. That's where the inefficiencies pop up on things like that. Like, trends. That's a great way of saying it. Trends and bubbles and manias and when the market gets really stretched.

Well thanks for your time, Darren.

**Darren:** Okay, Walter. I will catch up on you next week.

**Walter:** See you next time. Okay, bye.