EP143: Broken Systems (Part 1 of 2)

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Walter: I believe if you set yourself up to survive the drawdown, if everything you do psychologically, mathematically, everything that you do in terms of the risk side of things and the psychological side of trading, if you could set yourself up to cushion yourself and that means basically being a very resilient person. If you could do that, then you can make it like you can keep playing the game...

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 Podcast. It's Walter here. I've got Darren on the line. Hello, Darren.

Darren: Good morning, Walter.

Walter: So Darren, we've got this idea, this topic today which is about broken systems. The question is: When is a trading system broken or just are not viable anymore? What are your thoughts on that?

Darren: I think this is one of those questions that you cannot answer because you never know. You never know when a system is broken. It's very difficult to assume a system is broken because all of you'll ever know is when people say that a system works, they're just guessing. All you'll ever know really is that it worked and you know that in the past, your system may have had a positive expectancy but you can never carry that going forward.

So, you can say, "Well, I'm going to get a lot of data and that's going to make it more robust. I'm going to know with more confidence that this system works." But, whatever your data has said in the past, you've got to expect that to very going forward.

If that's the first point, I mean, let's say you've tested the last 3 years and your maximum drawdown is 20%. If your drawdown hits 21%, do you stop trading? And, you shouldn't. You should keep trading.

A lot depends on your outlook of how trading works. Some people will do their backtesting say, "Right, that is a fact and going forward, that will be my maximum drawdown" but I have not seen that to be the case.

When you start trading a system, you should trade it based on the fact that, "Okay, as much as I can tell, this is a profitable system and these are my expected returns. This is what I expect my drawdown to be" and then you should base your trading on that. And give yourself a certain amount of leeway.

So, if you work out that your maximum drawdown is 40%, then you should expect the drawdown to be bigger than that because that gives you a bit of leeway for mistakes or changes in market conditions.

But then really, once you start trading that system, you should just keep trading that system. You should never get to a point where you'll say, "This system is broken." That point really should be when your account is gone. Obviously, people are not going to that. They're not going to do that.

I mean, if your maximum drawdown in a 3-year period was 30% and then you get to year 4 and you're at 60%, it's quite feasible that the way your drawdowns came, was as you know, in the first 3 years it was expected and the next 3 years it was in the first year.

And you could stop trading that system right at the point where you hit the good period where you would have made direct drawdown back and going to profit. So I don't think you can say. I mean, when your account blows up then I suppose you can say, your system is broken.

Walter: I think you're basically saying this. I think there's two sort of pillars here. The first pillar is, does the system still have a positive expectancy and the second one is, am I comfortable trading the system where it's at right now in the equity curve?

Like you say, the system is broken when it blows up your account. You know for sure but the other side of it, what if it's actually user error. You hear things like, "Sometimes for whatever reasons, somehow my mother has this really terrible issues with her email." Sometimes, I just think, "I think it might be user error" this case.

I think it's the same thing with the trading system. Like you could be trading a system and you're doing really well with it and I'm trading the exact same system but because I tweaked something, like I take on a little bit more risk or I'm not as aggressive taking my profit as you are or something like that, I might end up coming to the conclusion that it's broken.

As I see it, there's these two sorts of questions. One is, the mechanical side of it. Is the system still in positive territory? Does it still have positive expectancy? And the other side of it is, am I still comfortable trading this system?

Darren: Definitely. You can make a lot of mistakes when you initially make the assumptions about your trading system. I imagine that happens a lot. I've read a really good quite the other day that the biggest risk is thinking you've got a winning system that is not a winning system. That is the biggest risk and that kind of really what you should be more concerned with. It's how sure are you that your system has positive expectancy? I think that you can guard against that slightly by the system that you trade.

If your system is based on some weird anomaly that you've discovered like, friday on EUR/USD, 4 pm, price always retraces by 4 pips or kind of really out there bizarre, a very precise edge that you're trying to exploit. I think those sort of systems are probably more prone to those mistakes because they could just be anomalies.

Walter: I know a trader who trades something very, very similar to what you've just said. I agree.

Darren: I think, those edges tend to go away. The way I look at it is this, there's a group of traders that have been around for a very long time and have consistently made money. What is their approach to trading? Because obviously, if these similarities between them in their trading strategies, their styles then there must be something fairly robust.

Walter: Yeah.

Darren: So, I'm kind of looking for something that's always true rather than, right now this looks like a really good edge. What has always been true?

Walter: It's interesting because there a lot of new players in the market, private and institutional who are doing exactly what you say. They're looking for these weird edges when they use machine learning or whatever and they find these really weird things where it's like, "Yeah, over the last two weeks, if you keep selling the Euro at 3 pm on Thursdays, it's always good for 20 pips."

But these things come up and there all these people who trade it. They might have a 10,000 systems that the computer has determined and they'll just trade like the top 50 that week. Just assume that, "Yeah, it's been going really well so we'll just trade it this week then the next week they might trade another 50. They're just kind of keep rotating through until they find these weird little edges that don't really make any sense to a more traditional discretionary traders but to them it's like, "Hey, it doesn't matter. It's in there. It's happening. I'm just going to take advantage of it".

I think you're right. Those sort of things kind of go away. They would probably agree with that. Those things kind of fleeting edges that disappear but one thing that you've said maybe, think about just the markets in general which you said, you can make a lot of mistakes, when you're first validating your strategy and I think I believe, those mistakes are what makes up the market. Do you know what I mean?

If you think in terms of, let's say, I'm looking at support and resistance. I see that the Pound is at a certain level and I go, "Wow, there's going to be some serious resistance there. I'm ready to sell. In fact, I'm going to sell."

Somebody else is looking at it and going, "Look, the RSI is down and it's coming back up so I'm just going to buy." Somebody else is looking at it say, "Well, the Pound is in the cycles. In every 25 days it does this and then it cycles down then another 25 days or whatever, so they're going to buy." And then, somebody else is saying, "It went down over the last 4 hours. I'm going to sell"

So, they're all looking at different things and some of us, we got paid, it turns out, we're "right" because we make money or whatever. Others of us, we make mistakes and we're "wrong" when we lose money. To me, that is what the market is. That's the whole market.

Darren: I think one of the big problems with this idea of, is my system broken? What I know is the most successful traders do is, they don't jump to that conclusion too quickly. I think that, that is the main problem. It's we label something as broken too quickly so we'll take a week's worth of data and decide that the system is broken that we've built on ten years worth of data.

I think you need to have that patience with your system. The guys who've been around the longest seem to have that patience with their system. They've just stuck with it a little bit longer than everyone else. They have like a behavioral edge rather than systematic edge.

I think most people trades system that on a skill level are really similar. Most systems that people trade are like, can you a system is skilled? They're kind of like, equal merit if you like, most system but it's how people behave within that system that makes the difference.

Walter: Definitely. Do you think that really the differentiating factor is the confidence they have and sort of the underlying theory that their system is based on. It's almost like, you have this unshakeable confidence, that's really what's going on. I know that's what is going on. So, it's like, "There's no way I'm going to let go of this".

Darren: Yeah, I think so. What they based that confidence on and I think the best traders they think in different patterns. They have different patterns of thinking about problems and you'll notice that traders that struggle, a large group of traders that struggle tend to go around in circles. They think of the problem in a very similar pattern and you kind of have to change that pattern, I think. Does that make sense to you?

Walter: Yeah. The way I talked about it is, what I call the cycle of doom and I'm sure people have heard this. You find a new system, you get really excited, you trade it for a while and then boom! You hit that losing streak, that drawdown and then you get really upset. You'll throw it away or just change it beyond belief. Just completely change it, add some filters from whatever or you just throw it away. So then you've got this new system, you start trading it again.

We go through this cycle and I understand. I know that cycle really well. I think part of the antidote for that or the main sort of inoculation for that is to base the way you trade on what you clearly "know" about the markets.

If you can base your trading system on what you "know" about the markets, why would you ever throw it away? You'd literally have to throw your beliefs away. To me, that's what makes the most sense.

You can guard against making mistakes in your trading by trading a system that you know that is what's true about the markets. If you believe that the market will just kind of chop around sometimes and occasionally run into a really strong trend and you know that the way to take advantage of those trends is to just follow those trends and add more positions when it's trending and take as much profit as you can for those trends. Then you're just going to wait around for those trends. You're not going to see the market, you'll get frustrated when there are no trends of course but you'll know that eventually those trends will come up again.

Darren: Do you think that our expectation of system that is not broken and a system that's broken is that kind of, I think it's kind of a way, it's way off.

Walter: I agree.

Darren: We only need a little bit of downside or bad feeling to feel that system is broken and that can come up so quickly. I mean, it can literally be a single trade. It can completely knock your confidence in a system. I think, we expect edges and profitable systems to be completely, our expectation is just way off the mark with the reality.

I keep on banging on about this but I said to myself a few years ago, I said, "Look, who is really doing this? Who has shown and proven that beyond that, a lot of data that they can do this? What is their experience? Why do I believe that my experience is going to be so far above from what they're experiencing."

If these people are saying, "We all have losing years" or, "I have multiple losers" or, "Yeah, I have periods where my system just doesn't work but I stick to it." Why should I believe that I'm kind of a super human and I'm going to elevate way above them?

Walter: Yeah, it's true. It's kind of well-known in Psychology. In fact, some of my Psychology friends who are Professors at schools and universities now, I just saw them talking about this on Facebook. They're talking about how all their students, you know when they do their ratings, they'd say, "Write how good you are or how intelligent you are, your IQ" or whatever, and 70% of the room says they're above average. That's the same thing in trading, isn't it? Where we all just assume that we're going to make it.

I think, the other part of it what you've touched on is, it's important too to remember. It's that we often get into trading because it makes so much sense why not get paid for each decision you make rather than getting paid for the amount of time you've put in. The amount of time you've punched in at a job or whatever. Why not just make decisions and get paid based on your decisions rather than on the number of widgets you sell or the number of hours you've spent in an office or at a job site or whatever. That makes sense to people.

The problem though I think, is that people forget. The reason why traders burnt out and they quit and they throw systems away is often forgotten until it actually happens to you. Which is, that you essentially you feel like there's no hope. You feel like the system is broken. You feel like it's not working and that is basically drawdown. It is the drawdown blues that is why traders quit.

We get into it for a completely different reason. We get into it for freedom, to get out of the job life. To be able to make money based on decisions you make and kind of you can do it from anywhere in the world. It's great but the bad news is, unfortunately when those unlucky streaks pop up, that's when those darkest hours that really test us and that is why we give up.

So, you really need to make sure that your system like I said, is locked-in to your beliefs about the markets so that even though during those dark times, you're able to push through it.

Darren: It's a difficult one really. Like I said at the start, I don't think that if you've got to the point where you're putting your money on the line to trade a system then you should really just keep trading that system.

The only time you really should change that rule and stop trading a system is when you have more information to when you start it with. And that greater amount of information disagrees with the conclusion you've made when you start it.

So if you're quitting a system that you've tested over ten years after 6 months of live trading then based on that 6 months, then you are more likely to be wrong than right. If you add that 6 months to 10 years and so you're not basing it on ten and a half years and it's making the same conclusion as the purely just the 6 months then you might have a good reason to change your system.

I think, when I listen to experienced traders, that is what they do. They start off trading their system based on the information they've collected but then they update that as they go along.

Initially they've got 10 years of information and now they've got 15 years of information so they might adjust their position sizing or they might adjust their entry asx they get a greater body of evidence to support it. But they never based it on a smaller amount of information. I think that's the polar opposite of what a lot of us do.

Walter: A couple of things I think. I agree. I think, when I look at a possible trade, I always say, "If the market does this then, I'll do a trade like this. If it does this then I'll sell" if the markets starts to unfold as I expect. But then, it does something completely different and it doesn't fit the pattern then I'll say, "Now, we've got more information and it does no longer looks like it's a sell trade".

It's kind of the same thing that you're talking about but here are a couple of things I think traders get confused. It basically has to do with your trading results as they come in. So like you're saying, let's say, you've backtested a system for 10 years. You start trading it for 6 months.

I think that what traders do or should do is exactly the kind of what happens in the options market for example. I'll explain why. When you're trading a system that you've tested for 10 years. You think it's acceptable. It's going to make money. You're very excited and you trade it for 6 months.

Based on that 10-year window of testing, you should have an idea of what is expected to happen. Now, it doesn't mean it's going to do exactly what you think but you're kind of have upper and lower limits.

It's like, if you marry somebody, you might expect a certain range of behaviors from that person. And if they'd all of a sudden, start showing behaviors completely outside that range, boom! It's like, "Okay. This is not what I expected" sort of deal.

When you marry a system it's the same thing. You go, "Okay, I think this is what's going to happen here. I would expect in most cases a return of somewhere in between -5% a month and +9% a month or something like that."

Now, if you've come up on a month where you've lost 25%, something is going on there. Is it you or is it the system? Something is going on there. You can kind of lock in to this range.

I think that's what happens with the options markets. It's weird but it's true. If you look at these options, there were some rumours going back in late 2017, early 2018 of this guy who kept buying volatility in the options market. He kept buying more and more volatility and expecting the markets to completely, totally get really volatile. People were saying, “What’s going on?”

What happens I think, if I understand it correctly, when the markets don’t move a whole lot, then in the options market, they’re expected they’re not going to move very much in the future. So they’d go, “Well, the Aussie Dollar hasn’t really move that much. It’s been in a pretty tight range”. So in the future, they don’t expect it to go very far.

But here is the interesting thing about the markets, it’s exactly the opposite, isn’t it? In the markets, which market is the most likely market to actually breakout and go really violently in one direction? It’s almost always the quiet market.

It’s the quiet market that’s been sitting there for a long time, not really moving anywhere, that’s the market, that’s the likely one to breakout and start getting really volatile. And just like the really volatile markets are the ones most likely to quiet and tighten up in the future.

So I think that’s one of the things to keep in mind as a trader. You can’t expect the exact same thing to happen but you can set ranges. You can use statistics to set those ranges. I think it’s the same thing that we do in any social situation or relationship.

We kind of have it in the back of our heads like my friend, if he’s really my friend, he’s probably not going to crack me upside the head with a fist. That’s probably not unlikely thing to do and if he does, maybe he’s not my friend anymore. I think that’s one way to look at it as a trader.

The other thing I want to say, I hear a lot of us talk about that there’s not enough data. There’s not enough data. We don’t have enough data. You only have 35 trades, you don’t have enough data.

Now, that’s true but here’s the other side of the coin. Let’s say, you did an experiment and you have 30 people on one group and 30 on the other, you have 60 people. Well, if you did that test and you’ve found out that the placebo group didn’t do nearly as well as the group that got the real vitamin or whatever. The results were outstanding. Absolutely outstanding.

The people who got the vitamin, they lived 20 years longer than the group without the placebo. So this longevity vitamin we really think it’s great. Some people are going to look at that and they’re going to say, “Hey, that’s only 60 people. You can’t really say.” That’s true. That’s absolutely true. It could’ve been fluke result.

But the other side of the coin is this, if you get 6,000 people in both groups, do you know what's going to happen in almost every time? You'll find the difference, almost every time. Academics know this.

So when Scientists do their studies, they often get a huge sample size. The reason why they do so is because that means that the study has more power. It's like a microscope, it's really strong. It can zoom in and look at the smallest little things. You'll find the smallest little differences between those two 6,000-person groups.

Whereas, when you did the study with 30 people in each group, that study doesn't have much power. The only thing that, that study is going to find is a very strong result. In other words, a super powerful drug.

So that is another thing to keep in mind. I know people always say, "You don't have enough data" and that's true because you could be making the mistake of saying, "There's something going on here" when there really isn't. But the other side of it is, if you've found something with the small amount of data, it could be something really really strong because you don't have a lot of power when you're looking at something with the small amount of data.

That is the other thing I just want to point out because I don't hear enough people talking about the power of any investigation and the power that comes with a large sample size. Enables you to detect small results, small differences but if you have small sample size and you see a big result, a big difference it could be because you're dealing with something really really valuable and really really strong. So that is something to keep in mind.

Walter: That's all the time we have for Episode 143 of the Two Traders Podcast. In the next episode Part Two, we'll get into the rule of thumb for determining the optimum risk amount for growing an account. This is for any system, any trading account and you will see why no one trades this way.

You will also hear about the trader who lost 45% of his account and is considered as one of the best traders in history. You'll get why the optimum trading system settings are avoided by most traders.

You will see how to keep trading even when it seems like everything is working against you. You'll get Darren's hack for outperforming other traders and it doesn't involve watching Sky News or CNBC or reading FXStreet or the business pages of the newspaper.

Also, we'll get into this reason: is this the reason why most traders use the same profit target and what does it say about consistently profitable trading? Also, we talked about how to adapt profitable trading habits that crush the confidence of most traders but may work wonders for you.

What you should probably write down before you trade any trading system and keep this handy. Finally, we get into the number one skill for successful traders. This is pretty cool because Darren and I both agree on this and it’s really the reason why some traders achieve great things over decades and others simply give up. All these and more in the next episode, Episode 144 of the Two Traders Podcast. See you next time.