

2 TRADERS

[EP144: Broken Systems \(Part 2 of 2\)](#)

Darren: If you're quitting a system that you've tested over 10 years, after 6 months of live trading then based on that 6 months, you're more likely to be wrong than right...

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. You're in the right place at the right time. It's the Two Traders Podcast and in this Episode, this is Part Two. This is Episode 144. If you haven't listened to Episode 143, go back and listen to Episode 143. The first half of this conversation.

In this Part Two, Darren and I talked about the rule of thumb for determining the optimal risk amount for growing account and why no one trades this way. You'll also hear about the trader who lost 45% of his account and is considered as one of the best traders in history.

You'll also see why the optimum trading system settings are avoided by most traders. How to keep trading even when it seems like everything is working against you; Darren's hack for outperforming other traders and it does not involve watching Sky news or CNBC or reading the Wall Street Journal or the business pages of the newspaper.

Also, we get into is this why most traders use the same profit target and what does it say about consistently profitable trading. We talked about how to adapt profitable trading habits that crush the confidence of some traders, actually most traders but could work wonders for you and what you should probably write down before you trade any trading system and keep this handy.

Finally, Darren and I talked about the number one skill for successful traders and why this helps some traders achieve great things and others simply quit. This is a key and I hope this helps your trading. All these and more in this episode, Episode 144 of the Two Traders.

Darren: Yes. I mean, in other words, just because you've got a backtest over a very long period of time, it still doesn't mean that there's no uncertainty anymore.

Walter: Yeah, because what you could be looking at is an edge that has an expectancy of 0.1 or 0.01 or something. So for every dollar you feed to the system, you make 1 cent. That's the kind of power you'll get if you've got 6,000 trades under your belt but if you've got 30 trades under your belt, you won't find that.

You're very unlikely to say, "Yeah, this works" if you've got 30 or 40 trades but if you have a lot of trades, because the power goes up, you could see the really small effects. That's the only thing I'm trying to get across because I know people understand quite

easily this idea that you need more data and that's true but the other side of it of course is you'll get a great result.

Darren: What do you think of this idea of setting boundaries on your system? I like the concept that, the thing that springs to my mind is that people will set these boundaries wrong.

Walter: Why don't you allow yourself to do like, it could just be based on what you can stomach?

Darren: Yeah but I just think, a natural reaction to that is to lean too much towards comfort rather than leaning towards optimum.

Walter: I think you're absolutely right. That's why most traders don't trade anything near Optimal F. The Optimal F of course which is the best way to grow, it's the geometric growth rate of your account. Optimal F is the way to go.

Most people can find that. The easiest way to find that is to just divide your win rate. So if your win rate is 60%, divide it by 2. Divide it in half, so if you have a 60% win rate then you should be betting 30% of our account. Which is crazy.

I think you're right and that's why, Darren, like you say, you'd talked about these trend followers around this 25-year records and all that and then they'll have down years. They'll have 2 down years and then they'll have an amazing year next year. But if you ask them they'll tell you that most of their withdrawdownsals come right before the big 135% year.

Darren: Yeah.

Walter: Because people are uncomfortable with the 2 years of drawdown.

Darren: It's kind of like this idea of you can only really profit big by taking on more risk and what we really want is more profit with less risk. So what that leads us to do is actually make less profit in the end because we're not prepared to take on enough risk.

It is difficult because risk is bad, isn't it? Risking too much is bad. We're always told that risk is bad. It's tied to the profit so you can't have your cake and eat it.

Walter: Yeah, absolutely. The classic example of that is Larry Williams who won the trading competition. He was basically trading Optimal F and he asked Ralph Vince. Here's the point. Everyone says, "Oh, Larry Williams is so great." He took \$10,000 to 1.1 Million or whatever it was. It was something like that right back in the 80's but what people forget is this, Larry Williams was like in a \$900,000 drawdown when he won that contest.

So, he literally had peaked out at 2 Million and he won the contest at 1.1 or whatever, it was something like that. Over 12 months, he took the \$10,000 account to 1.1 Million but he was like in a, it was essentially like a 45% drawdown but he kept trading. He kept going. He kept pushing on and that was the whole point.

You're absolutely right. The reason why risk is bad, I think is because most people forget that yes, you make more money when you risk more but then the other side of that is your drawdowns are that much more painful. That's what kicks us out of the game, it's the drawdown. It's always the drawdowns.

Drawdown is the thing. I believe that if you've kind of 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 can set yourself up to cushion yourself and that means basically being a very resilient person, if you can do that then you can make it. You can keep playing the game but soon as drawdown breaks you, then boom! You're out of the game.

Darren: Yeah, definitely. I think that is why this question of when is the system broken is really important. It's what trading is all about. Can you just stomach a little bit more pain than everyone else.

I think really that is the easiest way to have an edge over everybody else. I mean, everybody else is looking for the informational edge, aren't they? They're looking for their little tweak on reading price action that's going to make them better than everyone else. Let's be realistic, everyone has got the same information that you've got. The information is all out there.

It's a little bit arrogant really to say, "You know what? I'm just a little bit better than everyone else. I can see it when nobody else can. " That's a little bit, I don't know if arrogant is the right word but it's a little bit hurtful should we say.

Walter: Overconfident.

Darren: Overconfident, yeah. At the same time, if you'll look at it from the pain side of things, if I can just hold on to my trades a little bit longer, I'll know. If I'm feeling this pain then everyone else is feeling it and it doesn't really take much. I can actually just write a very simple set of rules to follow that would push me to the other side of the pain.

If I could just do that and I can do it repetitively day in, day out actually that could be a really easy way to have an edge over everybody. That is how I try and look at it. I just want to be more uncomfortable than everyone and not do anything about it.

Walter: So, when you say more uncomfortable, you mean sitting through more difficult time as a trader?

Darren: I mean, looking at where does everyone getting uncomfortable. I'm going to set my boundary on the other side of that. If you can go troll the retail trader forums, you'll see that if you'll look at the profit targets of every system and then find the average then you'll find it's pretty much everybody is repeating the same thing. They're either 3:1, 2:1 or 1:1. The majority are in that zone.

You could take it two ways: That's the right answer or that's where most people feel comfortable. To me, that's where everyone feels comfortable. Where do you see the threat where they'll say, "Set your profit targets at 5:1 or 10:1 or 20:1?" You don't see them.

I'm not saying that, that's the right answer but the fact that there's so little interest there suggests that it's an uncomfortable place to be. So how about going and testing those notions of trading the uncomfortable places to be and see what the results are. You'll find that if we'll go back to that group of traders who have been successful over the long period of time, they haven't even got a target.

They're just saying, I mean, I'm generalizing, not all of them but, you'll find that a lot of them are saying, "As long as it keeps going, I'll stay in and when it turns around then it'll take me out". They have not even decided where their comfort zones is. They're letting the markets decide for them.

It's an idea, isn't it? I mean, maybe you can find the easy way to get an informational edge over everyone. Maybe, you have a special skill or a higher level of intelligence than the majority. I think the majority of us are average, that's how the numbers work, isn't it?

Walter: Yeah, at least 68% of us. It's true, technically. 68% of us are all clamped together and what's the next level, 86% or something percent is pretty close to the 68% largely.

Darren: It would be interesting to find out how many consecutive losers people can take before they'll feel uncomfortable.

Walter: It's really interesting to say that, Darren because I've met with a trader, talked to a trader, a group of traders in London and one of them, he trades 20:1. His winners make 20R and his loser lose 1. What he was saying was, he's talking obviously a lot about, he automated it. He basically trades and abandon the charts, kind of like you do.

He was saying that it's amazing. It's so tough when you're up 16R to not, either you'll go in there. He'll go and check the EA, have a look. He's like, it's so hard for him to let it go

because it's up 16R so I'll just close this one out or you know, sometimes it'll go up 10R and it'll go back down to the entry price and then it'll go back up to 20R. But the good news is, it doesn't have to happen all that often.

He doesn't really have to have a really high win rate and the fact that it's all automated, it means, he doesn't actually in theory, all he really has to do is just babysit the EA and make sure that it is running on the server and everything is fine there. He doesn't have to actually feel like he's the one making these decisions when 92% of the trades are losing trades.

I thought it's fascinating because if you'll work out the numbers on that, if you're making 8% winners and your winners are making 20R and so, 92% of the time you're losing 1R. It's a pretty good system. A really good system.

Darren: Yeah, and the thing is that when you step into those uncomfortable areas, they don't stay uncomfortable for long, that's the surprising thing. If you can just kind of force yourself to do it then before you know it, you'll start finding it easier and easier and less and less uncomfortable.

The illusion is as well, is that if you stay in the comfort zone then you're going to avoid ever feeling uncomfortable but that's wrong because it's always going to come, there's always going to be a payoff for that.

If you'll sit on that high win rate, you're taking your profits quickly zone then it's going to feel comfortable for a long time but sooner or later you're going to have a bad period and you're going to have a bad week that wipes out 3 months of feeling comfortable. There will always be a payoff for that.

Walter: I think here you're describing, it kind of reminds me of the people who sell all of their possessions and move off in the mountains, move off to Tibet or whatever, you're just kind of you want to go all in now. Actually, I had a girlfriend who did that. Before I met her, she basically left everything and move into a monastery with the monks and stuff.

It seems like it's such a big step to do that and leave your everyday life and do that but after a while, it's not that bad. It's actually quite nice to have that different perspective and I think it's the same thing that you're talking about trading.

It's going to be tough in the beginning. If you're going 2:1 on your trade to move to 20:1, that's a big jump. All of those losers that you have to deal with and dealing with the risk management side of things knowing that you're going to lose 92% at the time or whatever it is, it's a tough thing to handle.

But I think it's like everything, you've built up those calluses and then after awhile, it's a little bit easier. It's almost like building up a tolerance to a drug or something. It takes a little bit more for it to affect you.

Darren: Yeah because you're learning a new scale. It's like say, you're trying to learn languages. Say you find learning languages difficult. When you first start out, it just feels like, you're never going to get it but if you keep trying then it does sink in.

It becomes like a behavior that you'll learn. Maybe that is the secret, whether you actually ever push yourself into those uncomfortable areas and I think if you never do, then the chances of becoming successful in trading are probably diminished. The last 6 months, I had a 43R drawdown.

Walter: 43R, wow!

Darren: 43R which sounds unbelievable but in the last 6 months, I made 80R back and that's the only reason I sat through the 43R drawdown. Obviously, if you get your position size wrong then you bug it.

Walter: Yeah, you won't survive that 43R, that's right. It's so funny.

Darren: The upside is that taking setups that fit my model, that meet my rules are easier now because that individual trade is not going to make a difference. It's not going to get me to my goal. It's not going to blow me up. It's not significant anymore. It's the last 200, 300 trades that are significant. Which means you have to be patient and that is the case however you trade.

You've got to have that stickability, that resilience. I listened to a really good podcast the other day about a fund that set up rather than having interviews in trying to find traders to teach to trade their strategy, they were looking for traders and test their resilience.

For the interview, they've got them to come in for the day and trade and they've just set up all of these scenarios where they could test their resilience. They were messing with their data feed and they'd sit a trader opposite them that was constantly badgering them because they were looking for how much of this quality does this trader already got. If they have got this quality then we can build on that and they can become really good traders.

Walter: I agree. There was this Psychologist who came up from the States to Sydney recently and went to where he'll speak and he's kind of what they call the Father of Positive Psychology.

Part of the deal is you'll go in the afternoon, listen to him talk and then you can go and ask him a question, have your book signed or whatever. He's always got books and stuff. Anyway, I asked him. I said, "What is the number one skill? What's the one thing?" and he says, it's resiliency. It's resilience.

I asked it kind of like from the point of view of a parent. What should you teach your kids? "Have no limits. You can do whatever you want. You can do anything you put your mind to." I agree, I think he's right. He says it's resiliency.

If somebody has resiliency, they can pull out of anything. I think it's so important to trading. Resiliency is the key. He said, they had this study, these guys contacted them from the Pentagon and they said, "We've got all these soldiers coming back from Iraq and they're all messed up. What can we do about it? Basically, fix our soldiers. You talked about resiliency and how people are so able to rebound on this and that but we've got all these soldiers. We can't reintegrate them into society and blah, blah, blah."

You know what he said? He told the General or whatever, he said, "Look, if you'll look at the soldiers coming back from war, most soldiers within about 3 to 6 months are able to reintegrate into society.

It's only like, 9% really have difficulties after about 6 months. 3 to 6 month into it, most people are so resilient that they're able to get it back together. It's only the much smaller percentage that aren't able. So basically, the Pentagon hired his team to help these people and give them skills as they come back into society from war.

I thought it was really interesting that it's easy to take the pessimistic point of view and say that this doesn't work or this is so horrible or whatever, his point was, "Well, actually most people were able to do it. It's the few that you're concentrating on" I thought that was interesting.

Darren: What's the broad drawdown about deciding whether your system is broken or not?

Walter: To me, I think you've got to go into it with expectations set. If you're listening to this, if you're like me, I enter into trading thinking all I want to do is get a good system and I'm set. I didn't consider drawdowns. I didn't consider risk of ruin. I didn't consider any of that stuff. I didn't understand that.

To me, what you need to do is based on your testing, before you go into trading live, you have to decide going in. "Look, these are the ground rules. If it happens like this, I'll keep going. If it happens like that, something is a bit weird then I've got to reassess. Figure out if I still want to do this." That point can be when you're accounts are out of money.

Maybe you have that ability to keep trading your account until you literally don't have enough money for another trade. Maybe that's what it is but it might be a different level. For a lot of traders, it's probably a different level.

I think if you'll go, "Look, if I hit 25% drawdown I'm going to be in trouble. I'm going to freak out" You have to manufacture your risk and set it up in a way so that you'll think that's very, very unlikely that you'll hit that number. To me that's the smart way to do it.

Like you say, Darren, as you collect more data, you put that data into your, basically add that data to your file and say, "Okay, where we at here? Where we at in terms of, is everything about horse or it's totally off?" That's how I would do it.

I think collecting your data as you go through it and setting the uncle point for you to get into trading that system, to me that's the smart way to do it. So you've got your rules going into it because it's so hard to figure out what to do when you're under the stress of a drawdown. To me, that's not the time to make those important decisions.

Darren: Yeah, I agree. I think, it would be a good idea when you start out with a system. Write down why you're trading the system. Why have you decided to start trading the system? What information have you got and what expectations has that led you to?

As long as when you decide your system is broken, it's referring back to those notes you've made then you're more likely to be making the right decision. In other words, don't jump to conclusions so quickly. I think that's what people do.

Walter: Thanks so much for your time, Darren. I look forward to seeing you next time.

Darren: Yes. It's good to be back, Walter. I'll see you next week.