2 TRADERS

EP146: The Mathematics of Trading (Part 2 of 2)

Darren: Are you going to take that as being more important from guys who've been around 40 years and make an average 20% a year and have never blown up and are managing millions of money and there is a huge group of them? Which one do you want to believe? Which group of people do you want to believe?

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 the Two Traders Podcast, you're going to hear about trading discretion, intuition and large winning trades. What do they all have in common? Also, we'll talk about Richard Donchian. A Community College Instructor and probably one of the most influential traders of the last hundred years.

People such as Ed Seykota from the Market Wizards and Richard Denis of the Turtles fame have all been very influenced by the Donchian. Which instincts traders must overcome to make consistent profits. Find out in this Episode.

Also, Darren offers his simple hack for how to tell if the system works or not. You will hear about the weirdest currency trader down under. You'll be laughed off the free factory forums if you'll explain how he traded and he manages money. He's been doing it for a long time.

What winning traders do differently from the crowd. Blink and you'll miss it. The trader with thousands of trading systems and why he rarely trades them. Also, a simple forex system, Darren will all lay out for you. The antidote for trading mistakes. These are too common amongst traders but you don't have to make them.

Finally, why most trading systems don't need to be fixed and how fixing them can be dangerous. All these and more in this Episode of the Two Traders Podcast.

So if I tell a story to you and then I tell a story to my daughter for example. And the story that I tell you, is all about how this man searched high and low and collected the data then figured out this is the way that you can make money in the markets. You might think that's really great because that's your approach, that's your orientation.

If I tell that story to my daughter, she's going to be like, "Whatever, I want to hear about butterflies and unicorns. I want to hear about their friends and how they play." Some people are more on the right brain side and some people are more on the left brain side. Some people lean towards Science and others kind of lean towards creativity and mixing things up. I wonder if that doesn't sort of direct the style of trading that you'd be able to adapt.

I guess, for traders out there maybe asking the question: are you saying that if you're going to trade, you've got to go based on data? Or, is it possible for some people to simply look at the charts and notice something and go like, "You know what? It seems like this is happening. This is what I see and it usually does this. Should I test that out and see if that is true or not?"

Darren: It's kind of a deep pattern recognition skills that we have.

Walter: Sure, yeah. Something like that as an example.

Darren: I think so to a point. I like the **Interviews with Poetry to Jones. 217** When he's used a lot of kind of intuition, if you want to call it that and discretion in some of his biggest trades. And when the interviewer asked him why he's being so successful, he tends to kind of think about it for a bit and he's not a 100% sure.

He's had some gut feeling and it worked out for him but at the same time he also says, "If I wanted to give advice to anyone I'd say, just use a 200 period moving average and have a 5 to 1 risk/reward."

There's somebody that's kind of playing both sides of the game. They understand that both sides of the game, just the data and this kind of gut pattern recognition, intuition side can both be useful.

I think really perhaps it comes down to doing that. Having an open mind that both of these things can be useful. So really, if I want to give myself the best advantage, I really need to understand both of these factors that are at play. And then, perhaps develop my trading strategy around that.

So, you might take all these information in and think, "You know what? I am just actually really good at picking when the trends are right and the right entry. So I want to build my trading strategy around that but I am not going to discount the fact that data are important as well. So I am going to take that and use elements of data and see if I can make my strategy a bit more robust."

You have to be open minded. I think the best traders are able to push themselves into the field that they are not comfortable in or where they are not an expert and use that data as well.

Walter: Yeah.

Darren: I don't know if you agree. Don't you agree with that?

Walter: This is what I think. Let's just start with somebody who is new to trading. It gets a little bit complex as you do this longer but when you first start out, I think the best thing that you can do is figure out what makes sense to you and then start there. The next thing you need to do is convince yourself that it works.

Do you know the story about Richard Donchian. Obviously the Turtles, traded the Donchian channels and all that, I think Emmanuel in our forum did a Donchian presentation for everyone, which is interesting. He uses them totally different to the way that the Turtles do.

What's interesting about Richard Donchian is this: reportedly he taught this class like in some community college or something. And the whole class is about trading the markets. I think this must have been back in the '60´s or something.

It was a 12-week class. He spent the first two weeks explaining to the students what the trading system was and the remaining 10 weeks, convincing them that they should take every single signal.

When you're thinking about trading I think, that is a pretty smart approach because he understood that a lot of people would just give up after so many losses. When you determine as a trader, you´re new, you´re trying to figure out, how am I going to quit this first system.

I think, once you figure out what you believe in and what makes sense to you then what you needed to do is convince yourself that it works. I think that you are right that data is one way to do it. I think that data in a simulator is one way to do it.

I think that you can have the computer spit out some numbers. Have someone code i in for you if you don't´t do that or use a software that makes it easy to do that, just spit out some numbers. I think that, that´s a distant second to actually getting your hands dirty and trading the system and taking the trade yourself. Because I think you get more out of that but that's just my personal opinion. Some people like to code it in and I think there's a whole bunch of pitfalls there when you do that

Darren: Here's where I have a slight problem with that idea. Are we naturally hard wired to be attracted to the things that do not work when it comes to trading? Aren't most traders going to come in and what they feel works is hard wired to be wrong and then what we do is we use biases to find information to back up that belief.

Then we get kind of fenced in with this kind of belief system where everyone on the forum is saying this works, this is what I believe. This is what my gut tells me works and so I´m just going to keep tweaking this and eventually I'll get there. Is it our natural intuition to look for the wrong things?

Walter: Yes, it is. I think that when you do your testing, when you go to your simulator that is when you learn how to tweak it. What I ´ve noticed is that the easiest way tweak to make, to make something better is to basically change the way that you get out of your trades. That is usually the easiest way to do that.

If you are trading a system and you want to trade the 5-minute charts and you want to get a one-to-one reward to risk ratio or whatever or even less. A .8 to 1 or something like that. We have these 15 pip losses and these 11 pips winners or whatever it is on average.

You can do that and then when you go through the simulator and you start taking the trades, the idea here is you say, "You know what? Maybe I should give it a little bit more" I mean, I've just recently talked to a trader in England about this exact thing. He was saying that he was really trying to get to the point where he could push his targets up further because he understood that it would take the pressure off. It would make it easier for him to, it is a little bit of a cushion if he'll do that. If you change your system from one-to-one reward to risk ratio to two-to-one, it changes the whole dynamics of how important the execution basically is.

Darren: I pretty much benchmark traders and strategies that I look at now by how much emphasis they put on how the trades are managed.

Walter: Right.

Darren: So, if this is really a great, if I'm reading a strategy like a thread about strategy and there's all these information about how they are picking out the charts and how they are timing their entry and then at the end, it's just one sentence that says, "Exit when you want. Pick what you fancy" at the end.

This is just one line after sort of 12-pages talking about the entry. Then I can pretty much, my gut feeling is that's probably missing the point because that's the one consistent thing I find when I build this evidence of traders who've been successful. They all bang on a lot about how they manage their trades.

Walter: So let me ask you a question because this is something that I still don't know. I know the easy way out but this is one thing I've been thinking about ever since I read the **Scott Barlow** 0952 interview in the — **I'll put the book in the show notes** for you guys if you want to read it. — the **Nick Radge book <u>Every-day Traders</u>** where he interviews a bunch of traders.

Scott Barlow is the only forex trader in there and I mentioned him before. Basically he gets a subscription to this bank's currency recommendations. The bank tells him which currency to buy and when to buy them and all that. He just manages the exits and he just goes for 3 to 1 target.

And so all of his trades basically have either it hit a 3 to 1 target or they get stopped out and they lose 1R and that's it. In the bank signals that he subscribes to, he doesn't listen to their exit. He hasn't care why they say to buy the Euro and sell the Aussie or whatever. He doesn't care about any of that stuff. All he wants to do is outsource the signals.

Now, here is the question Darren. If you have a trade that goes 2.9R in your favor but never hits the 3R target and then comes back and reverses and stops you out at negative 1R, are you a good trader if you allow that to happen?

Darren: Are you a good trader if you allow that to happen?

Walter: I think he is a good trader because he is sticking to his rules. His rules are: this trade will be a 3R trade or it'll be a negative 1R trade and that's it.

Darren: Yeah. I mean, if he is sticking to his rules and he's got evidence to back up that management, over a long period, his work did in the past and he's got belief that it will take a radical change in the way that market moves for it to stop working and has set his position size correctly then certainly, yes.

Walter: If he goes to one of the forums, the free forex forums out there and he posted that and this guy manages his own money. He's been doing it for a long time. So, if he goes out there and he posted this in the forum, he'll be laughed off in the internet.

People will laugh because as you say and you're right, our instincts are wrong. So people will look at that and go, "Dude, what are you doing? You're taking these signals from some bank? Are you kidding me? Maybe they're good but you are not even listening to their exits, their targets and you are letting these trades go 280 pips in your favor and then reverse and stop you out at a 100 pips. That's crazy. What are you doing?"

I can tell you like people will look at that and say, "You are making a mistake. At least move to breakeven or at least take profit when it goes 2.9R." All these sorts of things, that is what people will say and they will say that he is the village idiot. But he is following his system and the system works.

Darren: Yeah and you have to ask yourself: Are a group of people who are saying it is wrong profitable and are making a lot of money from trading? Is the majority winning? Are most people winning?

No. It’s the people that are behaving slightly differently that are winning. It's the small percentage and they are doing something different to the majority. That's their edge. If everyone is jumping out of their trades early, then that is probably giving him his edge because they’re adding liquidity to the people who are still holding their trades.

Walter: Yeah. It’s crazy to me that people will overlook a profitable approach because it does not make sense. But, it is true. That’s pretty normal. It’s pretty normal that people look at something that is profitable and they’ll talk themselves out of it because they’ll say, “That’s wrong. It doesn’t make sense”.

Darren: I think a lot of the time, it does make sense to them but it doesn’t feel right.

Walter: Yes. There’s another guy who runs these thousands, he uses a machine learning and so he’ll run through the data and every week he’ll get thousands and thousands of trading system and he´ll rank them. He’ll be like, “Okay, this ones are performing well right now. So on Monday, those are the ones that I am going to fire up and start using on my live accounts.”

What’s interesting about that is the machine learning is like, you would think the sort of systems that it spits out are these really complex moving averages and bollinger bands and all these things like ADX or whatever. All of these sorts of indicators would be the backbone of the strategies but they are not. What ends up happening is, it says things like, “Buy the Euro on Wednesday at 4 pm”. That is the strategy. That’s what it gets like these are the things that come out.

To me, I think, if we’re relying on these computers, on machine learning and neural networks and all these advanced tools to tell us what to do. Because the markets are so complex and they’re so efficient we really need to rely on computers. If we don’t do that, we’ll never make it work. And then the computers are turning around and giving us these answers. To me, what is that telling you?

Darren: It’s telling you that what you feel shouldn’t necessarily be what you believe.

Walter: Yeah, it doesn’t have to be that complex. You think it should be complex. You think you need a computer to tell you what to do. These are all the assumptions but really it doesn’t have to be that complex. You can literally have a strategy where you buy at 4pm on Wednesday.

Darren: And what you’ll find is when that rule becomes more extreme when uncertainty becomes more extreme.

Walter: What do you mean by that?

Darren: If you'll compare say, the EUR/USD and the S&P 500. Over the last sort of 30 years, the S&P 500 is generally being one direction. It is generally being going up. So, if you are trading like a simple trend trading strategy with the S&P 500, let's say you have a strategy where if the previous day close up, you bought. If the previous day close down, you sold.

And then you had a second strategy where you said, if it's above the 200 period moving average and the previous day is up, you are going to buy and if it is below the 200 period and the precious day is down, you are going to sell.

Now because there's less uncertainty in the movement of S&P 500, it's generally going in one direction. Whereas, the EUR/USD as being much more up and down, the more complex entry is more likely to work well in the S&P 500.

Whereas, the very simple just the previous days direction is more likely to work well on the EUR/USD because there's more uncertainty in the actual overall direction. Does that make sense?

Walter: I hear what you're saying.

Darren: So basically, I have a very simple trend trading system that I trade in forex. One of the rules I use is, if I'm trading intraday, I use the previous days close for my direction to trade the next day.

So if yesterday closed down, I'm just going to look to short today. Now, you'd think, "That's pretty good. That works." So I'd do a backtest on my system and that works. That is a pretty solid way of trading. Sooner or later you're going to get 4 or 5 days in a row and you're just going to be trading long. You're going to be in line with the market movement.

If direction changes one day, my strategy changes direction fairly quickly. Now you're going to think, "What if I add a long term trend to that as well" is definitely going to make it more accurate. That is your natural belief is but the data does not back that up.

It might have a slightly higher win rate but I missed out on more opportunities because of so much uncertainty in the direction and the movement that adding that extra layer. Just that one little extra bit of complexity to the entry actually reduces the performance.

The important thing is, that is the odds of what you believe. You naturally believe that adding that 200 period moving average is what everyone uses. I'll add an extra layer to it is definitely going to improve it but I've tried a gazillion of these added layers and none of them actually improve the performance, quite the opposite.

Walter: Yes you are right, in the bulk. If you'll look at the whole of the data but the sexiness to it is this, is that people will go, "Ohh! I just had a second loser, if I had used the 200 moving average on these last two trades, that would have saved me and I wouldn't have these losers." That to me, that is the big trap in trading.

Darren: Yeah, definitely. Or you have a really good strategy and you backtest it for a year and it's brilliant. And you back tested the year before that and it's brilliant and the year before that, it was brilliant as well. And then the fourth year back, it made a drawdown over the whole year.

So then they'll go back and find the tweak that made that year profitable and then they'll realize that they've just reduced all of the other years in their profit. Rather than just saying, "Okay, that's fine. If I have one losing year out of every four years, that is a pretty good ratio. I can compound that up".

Walter: Yes.

Darren: But, it's the obsession with the short term results. You want everyday to be a winner. You want every week to be a winner and every month to be a winner. Whereas, actually a really good approach is just to say, "You know what? If I trade a whole year, what is the likelihood of that year being profitable? And if I could do, if there is a high probability of that, I could just compound that reasonable return over five, ten years and it's really robust, I could be really successful doing this".

But that requires you to have really horrible periods where my last three weeks had been losing weeks and I posted it on my Facebook group and some were saying, "How you're coping with three losing weeks on the trough?" I said, "Well, if you'll look at my results based on weeks, my weekly win rate is only 50%. So having three on the trough is not unusual."

Walter: But the antidote for that is just building up your resilience. And so for you that might be data. You might like data is what, well actually you just cited the data, didn't you? When you said 50%.

I believe that, that is the key. How do we deal with those losing periods? How do we wait through those? If the more resilient traders are the ones that stick around long enough to see the next lucky streak or winning streak. And, the less resilient of us are the ones that kind of fall by the wayside.

There are many ways to do that. You can quit trading altogether or you can go and find a new system or you can tweak your existing system or whatever but you still kind of starting over again no matter what you do.

Darren: Yeah. I know you're much more into this idea of people's personality. I completely believe this that people's personality should decide where they'll go to trading but maybe it's that personality trait to be able to kind of notice when your beliefs are wrong or you need to question them.

That ability to do some analysis on yourself on how you are behaving and step back and say, "Look, you're being a bit overconfident here". You've got this really strong belief in this approach but what are your results saying?" You're not doing that well at all.

In fact, you are pretty much breaking even for the last three years but you still got this belief that this is going to make insane returns. The two aren't matching up here. Maybe I need to step back and say, "Okay, let's reexamine this and be a bit more honest with myself."

Walter: Yes, and the opposite of that also holds which is we're catastrophize and we say, "Oh my God! I had three losing weeks in a row. This is it. My trading is going to fall apart. I'm never going to make this work. I can't believe this is happening to me. What am I going to do?" It works both ways, doesn't it?

Darren: It does. There's data out there even in retail forums. Everybody is saying the right thing.

Walter: What do you mean, saying the right thing? What do you mean?

Darren: Well, everyone is saying you're going to have to accept losers. Everyone is saying that you need to stick to it in the long run. This aren't unique or new ideas. This idea is everywhere about how to trade the right approach but clearly people aren't, they're saying it but they're not doing it.

Walter: Right of course because people want to be right. People want to fix things. Like, Darren if you are driving your car and you hear some weird noise, that doesn't seem right to you and the car doesn't seem to have as much get up and go that it used to, I think that is an American term. What would you do? What will you do if that happens?

Darren: I'm terrible with that. If anything is broken or looks like a little leak, I need to fix it right straight away and I need to fix it myself as well.

Walter: Exactly. It's the same thing with trading. We do the same thing, don't we? When really the deal with the trading, a lot of time is nothing is broken. It is just bad luck. You have three weeks of bad luck, that's all it is.

In fact, it's not really bad luck. It's actually a normal luck. It is a normal result of wins and losses. There's really nothing here to see. There's nothing to fix. The engine is not broken.

Darren: It is also important to appreciate that an engine in a car is not trading. An engine in a car is kind of a closed circuit and if something is not right then it is quite easy to work down the line. Pick the element that is not right and replace it.

When it comes to trading, you need to see yourself as the engine, the market and the trading as being the environment that it is working in. So you are much better off to look at how you are performing in accounts by journaling and saying, “Am I following my system? Am I doing it correctly? Am I risking the right amount or sum planned out?”

That is the engine that you need to fix for trading and the bit that you don’t have control over, which is basically your results or your system performance, that is the bit that you have to see in a different light.

Walter: Yes, exactly. The key really is this I think as you’re saying is, is to be self-aware. You can become self-aware when you write. When you write down your thoughts especially if you write them out long hand and not type them into a computer.

So if you write out your thoughts, you can become more self-aware. Really what you want to do here is you want to be aware of when you are becoming overconfident or when you are catastrophizing, when you are doing these things. That is the key here.

People talked about personality as if it is set in stone, that is not true. If you are not very self-aware, you can teach yourself to be self-aware. Just as if, if you’re an introvert today, you can learn to be more extroverted. All of these are true.

Those old ideas in Psychology that came from Freud were wrong. We know that. I think that people shouldn’t feel like you’re destined to you know, your genes aren’t your destiny. This whole thing in Science is swinging back the other way with Epigenetics.

It is not true that your genes determine who you are and what you are going to do. As a trader, if you find yourself feeling like you are not very self-aware, you might feel like you are fooling yourself or you are catastrophizing or making any of these sorts pf mistakes that we all make, depending on our circumstances and where we are in the equity curve, you can change that. It is possible.

I just want people to know that because this trading thing is not necessarily easy. It can be very simple but you’ve got to let it be simple. You do not have to overcomplicate it. I strongly believe in 80/20 in trading.

I think that most of the time, you can get 80% of your results. 80% of your profits from a very few number of things. One of those things is definitely being self-aware as Darren has highlighted today.

I just want to make sure that, that is really clear. Anything that you want to sort of conclude with, Darren?

Darren: No. I think we've covered a lot of stuff there. Definitely have a look at this trader because he's a really interesting guy to listened to. I love how kind of relaxed he is about it all, this very, "Yeah, you know we've done alright."

Like I said, at the start of the interview, if you have this strong belief about how things are with trading, do not ignore or blank out stuff that disagrees with your approach because that is being, looking outside of your circle of competence, is where you are really going to learn the good stuff.

Walter: Right. Thanks so much Darren for your time. See you next time.

Darren: Thanks, Walter. I will see you next week.

Walter: Thanks.