

2 TRADERS

[EP17: Random Charts](#)

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Announcer: 2 Traders, Darren and Walter, pull back the curtain on profitable trading systems, consistent money management, and profitable psychological triggers. Welcome to the 2 Traders Podcast.

Walter: In this episode of the 2 Traders Podcast Darren and I look at the randomness of the markets. Are the markets actually random and if so, what does that mean for your trading? Does that mean that you won't be able to consistently find profits from the market? Or is it something that doesn't really matter at all? Is there any evidence for the random movements in the market? Darren and I tackle this and more in this episode of the 2 Traders Podcast.

Welcome to the 2 Traders Podcast. I've got Darren on the line and Darren, it sounds like you want to talk today about something about the random nature of the markets. Is that on your mind?

Darren: Yeah. I sit in the random price movement ballpark of things and I know it's a really contentious topic with a lot of people. I've got a few opinions on this and I need to say that I'm no expert on this. I'm not like any great market scientist or mathematician. I've not got the answers to these, these are kind of, "This is my mindset on it that I take to my trading." The point I want to make this week is about ... I don't know if you've ever looked at random generated charts. Have you ever seen any?

Walter: Yeah, you can do that. You can create those.

Darren: You can create them and here's the thing. When we create random charts you find that those charts create all of the patterns that we see in our forex charts, like double tops, head and shoulder patterns, trends you see, support and resistance. You see it being respected and you see price spiking out the highest before reversing. Really, it's very difficult to be able to tell the difference between a random generated chart and the charts that we trade.

Here is the question is, if there's a possibility that the patterns we trade, if we're price action traders, are random and by the same thought process, really the outcome of

those patterns must have some randomness in them as well. If that is true then how do we make profit from trading?

I've seen a lot of debates on this topic and people seemed to be very black and white on it, they either believe they're random or they believe they're not, whereas I believe that it's impossible to determine really whether they are random or not. If it looks like a duck and it sounds like a duck then it's a duck, isn't? If we make random charts and they looked the same as forex charts then does that mean that really all of the outcome and all of the patterns are just random? What are your thoughts on it?

Walter: I think you opened up a really interesting line of thought. I've got lots of thoughts bubbling around in my head but one of the things I think about is let's draw an analogy. Let's say that you know that the ... Let's take Gucci for an example. We're going to talk about Gucci and Gucci makes a handbag and the handbag that Gucci makes comes from the same factory in Thailand as the bags that they sell at Kmart. I don't know, do they have Kmart in the UK? Is that even a ...

Darren: No, but everybody in the UK knows what Kmart is.

Walter: It's the Walmart before there was Walmart. The same factory makes both bags and one of them gets stamped Gucci and one of them gets stamped the Suzanne Somers Special Kmart Bag or whatever. The question is, "Why does Gucci get to charge so much more for their handbag?" The answer, of course is perception. If we believe it to be worth more money then there's a certain proportion of the market that's going to pay that even though it's in essence it's really the same handbag as the Kmart bag.

The reason why I bring this up is because I think about this in terms of, you're talking about random patterns in the market and there are lots of very smart people and one of them that comes to mind is Benoit Mandelbrot, who's of course associated with Chaos Theory and he's also written books on the market, *The Misbehaviour of Markets*. If you dive into this area you're going to find a lot of academics that are going to tell you that the market is random and that there's really no way to make profit from the markets because it's just a random jump around the charts.

Now, remember that these are also academics that aren't making any money from the markets. You've got to keep that in mind too. That's number one. Using that handbag analogy, my question is if the Gucci handbag is the same as the Kmart handbag but everybody thinks that the Gucci handbag is worth more money, it's dearer, if you have the money and you really want it you would spend it on that bag, does it really matter?

In other words, if the markets are bouncing around randomly and yet we humans tend to see these patterns in the market, does it really matter if the patterns are just randomly generated or if there's something behind them? It's like the Emperor's New

Clothes, right? The Emperor's not wearing any clothes but everybody says he's wearing clothes. Does it really matter that he's not wearing any clothes if we can all basically come to the agreement that that's going on?

I guess what I'm saying is ... because you're right, I believe that there are some really good studies, the classic is the give people the random number table and they say to them, and these are psychological studies, give people a random number table and say, "Tell me the story, what's going on with these numbers?" Everyone can come up with a great reason why these numbers are related even though in theory there's no reason for them to be related because they're random.

I guess my point is, if enough people see something in the charts and that affects their behavior then maybe it doesn't really matter. Do you know what I mean? If enough people see this as a certain thing then why can't we just use that? Why can't we go with that? We know we're really good at seeing patterns.

Darren: I think that's where I'm at with my thought processing. We seemed to be obsessed with, will it matter and whether it is random or not, whereas really we're kind of might be missing the point really. Really, we should be thinking, "Well, if it is random then how do we employ a strategy to make profit under those conditions?" If it's not random, the same question.

Really, I think people get so bogged down in thinking that they need to have an answer why that they miss the point and that probably affects their trading. I come from the point of view While it might be random, it might not but if it is random, have I got an approach that's still going to make profit under those conditions?

Walter: Really, I guess one of my thoughts is you can get sucked into a trap as a trader and typically the more intelligent or more ... intelligence is the wrong term because intelligence is probably, there's different areas of intelligence. It isn't just one thing but if you're really an inquisitive person you like to know how things work. As a trader sometimes you get confused what your overall goal is. Is your goal to understand the markets? Which means you might go down this rabbit hole of, "Is it random? Is it not random? Is there something, some sort of repeatable pattern going on here?" You can get sucked into that hole or is your goal really to make profit?

I think that sometimes what happens with some traders is they start to get into really understanding the markets and trying to figure out what's going on rather than trying to come up with a really robust process for extracting profits from the market. I think that's a danger. I think that, I'll hear from traders and they really want to know the why and they're trying to put together a story of why this make sense. I understand that because you're going to end up trading your beliefs in the end, whether you know that or not, in the end you're going to end up trading your beliefs.

I understand that but there's also this type of trader and you see these people in business too. They're generally pretty successful where they'll just figure something out really quickly and they'll just run with it and they don't necessarily have to question every little aspect of it. They're usually quite successful simply because they're the few, there's a minority of people who actually do things. You know what I mean? They just go, "Okay, what's going on here? All right, let's do it." They just run with it.

You can always fix your mistakes later and I think that's something that traders can get, at a certain point they diverge and they say, "Okay, am I going to just really focus on this system which seems to work for me or am I going to start going down this path of really trying to figure out why this is happening?" I'm not saying it's a bad thing to figure out why, it's just it can detract from your primary goal which is to profit, and that's why I think for some traders this can be a sticky situation to get into. I don't know. Do you know what I mean?

Darren:

I think people underestimate how complex it really is as well. I think finding a really clear edge that will be consistent over time from reading the market I think is so complex or would be so complex. Because although visually to our eyes the market seems to be repeating patterns, if you really went into it I think it would be really complex.

I think also you have to ... I have my feeling about the simplest way to make consistent profit, if I think on that too long I can find scenarios and reasons why I could question those beliefs. As an example, I like this idea that the simplest way to make profit from the market is either to ensure a high win rate with a wide stop in taking profit more often or with a relatively tight stop and letting everything run. You're essentially playing with the risk-reward relationship to make profit.

For me, that's the core of all of my trading ideas and I believe that 100%, without that I'd be lost, but someone could around to me and say, "Well, if that's the case then a simple EA should make profit," but I don't think I could make a simple EA to do that. I've tried in the past and to be honest, I don't know how to program MT4, I'm kind of having to always go to third parties and it's never really worked out for me but it's a valid point. If what I'm saying is true then surely we can just set-up a random entry, set it to use a high risk-reward.

There is an unknown element in my method as well which is essentially just those times when I seemed to know, "Okay, this trade I should let run a bit more and this one, it's time to get out." There's no way I can explain that, that's just something, a decision that I make and so far over a large period of trades I'm making profit on that.

I always get to a point where I do it myself. I try and think through, "Okay, what is my edge?" I think it through and I try and find the flaws in it. I do, I find these scenarios that I can't explain myself and that could be a problem for the traders but I think it's simple. You've just got to accept that human element of making good decisions in there as well.

Walter: I think you just touched on something really critical, Darren, which is this idea that it's tough to understand. You're trying to figure it out. I think this can be a barrier. I think it's an important thing to note that if you're, as a trader you're saying, "Well okay, there's all these big banks and funds and they've got all these Harvard PhD physicists and statisticians on board and they're all trying to figure out how to make money from the markets and they're all figuring it out and I don't know the first thing about Chaos Theory or whatever. So how am I, the little guy, ever going to do this? How am I ever going to make it work?"

It's like you're talking yourself out of your ability to do well because you don't have the resources that some of the other market participants have, especially nowadays when you hear the press keep hammering on about algorithmic trading and this sort of thing. It can get you to a point where you almost hate yourself in a corner psychologically and just think, "Well, just blame it on the market. I can't compete with these guys." That could be a barrier in itself for a lot of traders.

Darren: Do you think that luck plays ... This is another topic that will get everyone riled. Do you think that perhaps luck plays more of an important part than we give it value as well? I'm not saying just luck is going to make you win or not but I think if you perhaps got a good method and a good discipline when you trade and you stick it at then you make your own luck as well by being in the right place at the right time?

Walter: I think so. I think you can make your own luck if you've set yourself up so that you believe, that what you're going to do is working or is going to work for you. I think in some ways that what you're doing, because we get bombarded by messages all day long and a lot of them, most of them, we have no idea what's going on. We get fed information and ideas into our subconscious and we have no clue what these messages are.

If you can get to a point where you're really sure that what you're doing is going to work, it might be something as simple as you just follow your rules better than someone who is questioning whether it's going to work. It might be something as simple as that but I think the most important place for luck in trading is in something that people don't look at, at all and I'd spent a lot of time looking at this because I know there's nothing you can do about it but by looking at the scenarios there seems to be some comfort.

It's like a lot of things where if you don't really have any way to control it, if you anticipate it and see it and look at different possibilities you feel like you have some control even though you don't. That is in the sequence of trades. If you've been to a casino you've probably seen those display boards at the roulette table where it says the last, I don't know, 50 numbers or 30 numbers that have come up on the roulette table and some of them are black and some of them are red and occasionally one of them is green. If you look on there you'll see people say, "Wow, that table over there, they've had 15 black numbers in a row, so you know that a red number is going to pop up."

Actually, no, you don't. You don't and it's the same thing with your trading where you have a certain win rate and so long as the last trade is independent from your next trade, then really the only thing that's determining what the likelihood of the next trade being a winner is your win rate and that's it. That's the only thing that determines that and it has nothing to do with the fact that you've just reeled off seven winners in a row.

I look at sequence of winners and I ask myself, "Okay, given the parameters of this system, what are some of the likely scenarios that come up and say like the first 30 trades?" Because for me the first 30 trades is critical in terms of are you going to stick with it or are you going to throw it in the bin and say, "This doesn't work or it's not making enough money for me."

I look at that a lot where you basically ... and I have a spreadsheet and I'm happy to, I can post this in the Show Notes for this episode so people can download it but the spreadsheet just enables you to look at different possibilities. It doesn't mean that one of the ones that you see in the spreadsheet is going to be what happens for you in real life but at least it gives you an idea. Running through data like this is called Monte Carlo Simulations where you're not really using a formula to dictate what you think is going to happen but you're just running it. You're doing example runs, example run, example run after example run just to see how that works.

To me, I think that aspect of luck is probably, for me the most important aspect of trading for traders because they don't ... They forget, they look at reward to risk ratio, they look at win rate, they look at how much am I going to risk per trade but they don't, and they even tweak their exits. They don't consider that, "I could get really lucky in the beginning or I might be really unlucky, and maybe later on I get really unlucky. What's the likelihood or the extent of an unlucky or a lucky streak? What likelihood is that given my trading system parameters?" That's one thing I think it's really important to look at just to psychologically prepare yourself for what might happen.

Darren: To sum it up from my point of view, I'm going to make the statement because I think everyone wants to make the statement that they can read the market but for me I don't think I can read the market. I think it's random but at the same time I think and I believe that there's ways to make consistent profits within that and maybe I should write that down on the top of my trading plan just to remind me really. That's my thoughts on it.

Walter: Right. For those people that are just wondering, basically Darren, what you're saying is you hang your hat on the relationship between your stop loss and your take profit or your target or whatever you want to call your exit. That's really where you hang your hat on it's not ... you've sort of said you've put aside entries and you've said, "Look, really where my edge is, is the relationship between my stop loss and where I get out of the trade." Is that fair to say?

Darren: Yes, and I think the key element of, the key technical element that makes it work or fail is the movement of price. If price stays in a very tight range consistently then my particular method won't make any money but as long as price moves even if it's not consistently moving in one direction then that's an opportunity that my particular strategy will make a profit from.

Walter: Right, you need ...

Darren: I need that volatility, if you like.

Walter: Exactly, you need volatility. I'd like to leave with, I don't know if you remember this quote, Darren, but this is one of my favorite quotes from Ed Seykota in *The Market Wizards* where he says, "Common ... The question was, "How similar are the price patterns in different markets?" Ed says, "Common patterns transcend individual market behavior, for example bond prices have a lot in common with the way the cockroaches crawl up and down a wall. Unfortunately, for cockroach followers there is usually no one around to take the other side of the trade." I think it kind of fits with what we've been talking about here in terms of randomness, does it matter, can you still profit from a random market, I think it makes a lot of sense but I'll leave that to the listener to decide.

Thanks for your time Darren.

Darren: Great to talk to you again Walter.

Walter: We'll see you next time. Bye.