

2 TRADERS

[EP23: Confidence](#)

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Darren: If you have a bad method and you trade inconsistently, even if you believe you're doing brilliantly, then you are going to keep blowing up your account.

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 to the Two Traders Podcast. I'm Walter Peters. I've got Darren on the line. Hey there Darren.

Darren: Evening, Walter.

Walter: Today, Darren, you've come up with a beauty and I'm very excited to jump into this one. This is the Dunning–Kruger effect. For those that are unaware of what this term is, please explain to our audience what the Dunning–Kruger effect is so we can dig into how this possibly relates to our trading.

Darren: This is a new one on me. I keep finding out these knew cognitive biases, they're called. They're pretty scary as well as enlightening. Basically Dunning and Kruger were two professors at Cornell University. They wrote a paper called Unskilled and Unaware of It. They discovered that there was this gap between people's self-assessed competence and their real abilities. They argued that incompetent people suffer from two consequences. One of them is that their incompetence leads them to make really bad decisions. The more important one is that they don't have the ability to realize that their making these poor choices. Instead they blame their failings on outside factors, not on themselves. No matter how bad they do, they always think that they're really good, really skilled and they're doing really well, so they never actually improve.

The flip side of this, they found that the people that were really skilled and competent, they thought that everyone else must have these skills and abilities too. They thought they weren't as good as they were and devalued their own abilities, and were then a little less competent, and they weren't as go-get it as they should be because they were really competent, skilled people.

They got a load of students in to test this. What they found was that the most incompetent got their self-assessment massively wrong and the most competent devalued their own abilities by the largest amount. We all suffer from one side of this or the other. It's quite terrible to find this out when we know that as traders we have to assess our own performance all the time, especially as retail traders, where most of us sat at home, we're trading, and we have to make some sort of assessment about how good we're doing and whether we're able, "Can I give up my job to do this for a living?" You have to make those decisions on your own. What they found was that the

skills to be competent are the same as the skills to assess that competence. Essentially, even if you think you're really good, you might actually be the worst out there. It's a pretty scary thing for a trader to find this out. What are your thoughts on that?

Walter: It sure is. It reminds me of two related, but slightly different things I learned in psychology. One was where we would take a class and we would say, "Estimate your intelligence. Estimate all these things," and they'd give everyone the test and of course they say, "There's a hundred and fifty people in this room, here's what it's going to look like in terms of your intelligence," or whatever. We'll just use intelligence. We know that there's going to be some sort of a normal curve here, and yet when you actually tabulate the results everyone was above average. Everyone considered themselves above average. That's a different thing to what you're talking about because you're saying that they actually separated the incompetent for the competent, or very competent, and they found different ratings based on whether they were incompetent or competent.

To me, what makes sense ... That sort of makes sense because you would think that somebody who, and we're talked about this before in a different podcast where, those individuals who feel like they need to work on themselves, they've always got something to work on, those people tend to do better than the people who think that they've got it all figured out. We've talked about that before, haven't we?

Darren: Yeah, indeed. That is key. It's that, can you take in information that's different to what you believe to be right and can you accept new ideas, or are you always right? Are you always stuck in the mindset that everyone else is wrong and only your ideas are right, only your trading strategy's right? If you are, then you're probably leaning to the more incompetent side. The people who are very skilled, like you say, can take on those ideas.

Walter: Yeah, and they're constantly working on themselves and working at it. This is one thing that I learned about four years ago, which was you get that idea in your head where someone tells you something or maybe you're learning from a teacher, or a book, or whatever it is, in some sort of situation where you're learning, and then you hear that voice in your head, "Well, I knew that," or "Anyone knew that," or "That's easy to know." I've learned to try and stamp that out as best I can because I believe that's a really dangerous line of thinking, which is whenever you hear something you say, "Well I knew that. Oh yeah, of course," or you discount that information that's being presented and cheapen it. I really do think that's a dangerous way of thinking.

The other thing that this reminds me of in psychology is, I used to work as a jury consultant, as some of you know, which is a profession that only exists in the United States because of the legal system, the way it's set up. What we would do is we would help our clients who were in bad situations, usually you're talking about big

companies like insurance companies. We would help them when someone was going to sue them for a lot of money. We'd try and figure out, how are you going to set up your argument? What kind of juror do you want to kick off the jury? In the United States you can say, "Okay, this person has got to go. We can't have them on the jury because they're biased for this reason."

My mentor, and the owner of the company, he has been doing this for decades. I think he actually really liked me. He started giving me his ties and things like that. He actually used one theory in psychology, one. He used that his whole career. He even told me this. He said, "Look, see how far you can go with one idea in psychology?"

He used to teach psychology at a university, but his entire jury consulting career was based on the fundamental attribution error, which is this idea that, let's say I don't know you Darren and someone's talking about how, "Oh, Darren always does this when he's drinking." I might say, "Darren sounds like an alcoholic." I'm going to blame your behavior on yourself. It's a characteristic of you, that's why you do that behavior. When it comes to me, when I do the exact same behavior, me or it could extend to someone who's close to me like a wife or a close friend, a family member. You would say, "I didn't do that because I'm a jerk, I did that because I was drunk at the time." It's the situation. When it comes to you the reason why you do things poorly or you're incompetent, it's the situation, and yet, when someone else does it it's because of something internally.

That's the fundamental attribution error. You can relate that to jury members. For traders it's the same thing here that's going on which is these people who are really, really competent, they are trying to figure out what's going on and they're not really sure if the people around them are as good as they are. Maybe the people around them are better. Whereas someone who is really, really low on the totem pole believes that they're great. The example that we have here, did you see the lemon juice example, Darren?

Darren: I did see the lemon juice example, yeah.

Walter: Explain that on me because I think that's a great example of the effect.

Darren: There was a bank robber and he'd read somewhere that if you put lemon juice on your face, then CCTV wouldn't pick you up, CCTV cameras wouldn't work.

Yeah he just put lemon juice, and then robbed a bank and thought he was going to get away with it.

Walter: Lemon juice is used for invisible ink, so of course, if I put lemon juice on my face they won't see. These things are crazy. This shows you exactly what's possible. If I'm a trader and I think, "Okay, I'm going to be really, really good at picking tops and

bottoms. That's my thing." You can think of some of the things that might be an outgrowth of this, maybe that means, "Because I'm such a competent trader and I can pick the tops and pick the bottoms, I might as well really load up on this position. Why take a normal, two percent risk when I know I'm going to be right. I'll go ahead and slap twenty-five percent on my account on this trade." You can see where that can really fall apart.

Darren: Yeah, definitely. I read some more examples where this Dunning–Kruger effect can be advantageous. Sometimes incompetent people get into really powerful positions because they believe so strongly that they're excellent at everything they do and all their ideas are brilliant, that people get sucked into it. Before you know it you end up with a complete lunatic who's president of the United States. God forbid. That's never happened. In trading I don't think that's the case because if you have a bad method and you trade inconsistently, even if you believe you're doing brilliantly, you are going to keep blowing up your account. You do need to be aware of this. If you go back to the trading basics which are that you should keep a journal of your results, then even if you believe that you're a brilliant traders, and you're so smart and intelligent, that that's going see you through, there should paper record sitting there in front of you that's saying, "Hang on mate, maybe you need to get some outside advice there."

In their testing they found that even if you were incompetent, that this could be changed with good training. First off you need to get to the point where you at least accept that you're suffering from this condition. That's the paradox of it is when you're suffering from it the worst, when you are the most incompetent, you believe you're the most skilled. It's a trap.

Walter: That's interesting. What I did when I did my PhD in psychology, I did a study where we were teaching little kids to think about if they understood a question. I know this is going to really boring for lot of people, basically what I spent a lot of my time in school doing was trying to come up with program to teach little kids meta-cognition. Meta-cognition, which is what the Dunning–Kruger effect taps into, which is a meta-cognitive skill which is thinking about your thinking. What we were teaching little kids was this ability to recognize when you don't understand a question. The reason why that's so critical in the legal setting is because lawyers are famous for using questions that are, shall we say, difficult to comprehend. In fact, they've categorized them and all that. We used the different lawyer categories of questions called lawyerese.

What we did was we were able, and a lot of people thought that this was not going to be possible, were able to teach even little kids this ability to say, "Hang on, stop. I don't understand that question." As we talked about in the last podcast, kids are really good at taking a stab at things. They're just okay with being wrong because if they're wrong with one answer then they're just go ahead and blurt out another. This is really dangerous in a legal setting where you really should be thinking about whether or not

you understand the question, this goes for adults as well, if you don't precisely understand what the lawyer's asking you, for example when you're on the stand, you can give testimony that isn't quite what you want to say, and is more along the lines of what the opposing attorney wants you to say.

You can see the application here, but what I found fascinating was it was possible to teach even little kids this ability to stop and consider whether or not you are confused, whether or not you understand what's going on. I think what you're talking about, Darren, is probably the process that I would recommend, something where you would say, "All right," there's two ways you can do it, you could have someone else, like another pair of eyes, look at your results and look at your trades and see what's going on and actually tell you, which is probably the best thing. The other way to do it is to have something black and white and you plug in your trades, say, into a spreadsheet and they would pop out numbers. Someone who's really analytical and quantitative would do this, you'd have pop out numbers and say, "Okay, this is what this says about you. This is telling me that you're having more losers than winners and your losers are about the same size as your winners, so you're losing here. You need to change something. Something is going wrong here."

That would be one way that you could try and dig this out if it were happening. The other way is to just step back and ask yourself, "Do I feel like I'm superior to the others around me when it comes to the trading environment?" If that's the case, I know everyone's listening now saying, "No, no, not me. I'm not. I'm very incompetent." We should've asked that question earlier on and said, "What do you think in general? Are you better than most traders? Are you about the same or are you worse than most traders when it comes to your trading skill?"

Darren: Yeah. When you start thinking deeper about it you think, which element of trade are we talking about? Are we talking about coming up with good strategies? Are we talking about actually sitting at the charts, pressing the button? Are we talking about all of the keeping data and that element of it? Personally, I'm probably competent in certain areas and incompetent in others. Who knows? I'm self-assessing myself, I could be way out.

Walter: Right. Exactly.

Darren: It's a difficult one to do. The important thing, as with all of these stuff going on in your head, it's about being aware of them and being aware how important they are, and don't just blindly plow on believing that you're brilliant, or even plow on thinking that your not any good. I always come back to this thing, you have to do some bookkeeping. You have to, it's like any good business. You can throw the doors open and be busy in your hotel, restaurant, car workshop, but at the end of the day if you're not doing the paperwork and you're spending more than you're taking in, you might just be busy fools. With my it always comes back to, what I'm probably incompetent

at, and that is probably why I fix on it, is this idea of bookkeeping and record keeping and putting down stuff on paper so you can then make that assessment rationally rather than in the moment assessing where to exit or when to pull the trigger. All that decision making should be done outside of that, in a moment of calm, rational thinking.

Walter: Yeah, I think some of that could be done by putting yourself in the right mindset. You could do some meditation or you could just sit quietly for a while to get to that mindset before you do that. Does that make sense?

Darren: Yeah, definitely. I'm going on holiday in a couple of weeks time, and I'm taking your advice. The hotel I'm staying at, got a yoga teacher. I'm going to try and start doing a bit of yoga. Yeah, you've got to be open minded about looking at yourself and you as the trader, and not just your strategy.

Walter: That makes sense. Exactly. There's so much focus, your body can conform to your seat at your desk and you can grow a beard if you're sitting there focusing so much on your trading system. You're sitting there hours on end back testing and Forex Tester. Meanwhile, the actual trading machine, you, is deteriorating physically and mentally because all you're doing is bleary-eyed staring at the computer. Your body's starting to conform to that seat. I think we've all been in that situation where you feel like, "What am I doing here? I spend so much time working at this." What I've found is that the more time I spend away from the charts, the better my trading gets, perhaps partially because it's daily and weekly charts. It's also that idea of getting away, refreshing the batteries, taking care of yourself. These sorts of things are really important.

If you want to be a competent trader you've got to take care of your mind, your brain, your body. You've got to do something to refresh yourself so that you're not in front of the computer all day. Then you come back to the charts with a really good mindset. One of the things I've learned from going through draw downs is that having that break, and then when you come back to the charts it's almost like they've been reset. If you go away from the charts long enough, it's almost like the charts have been reset and now you have this wonderful opportunity in front of you that's completely different to the last opportunities that you had on the charts. It's a really good way to reset and get going again.

Okay, Darren. We've summed it up here. We've said, as far as the Dunning-Kruger, there's a couple of things you could do. You can take really good records of your trades and of your results. You could pipe those into a spreadsheet and get some objective numbers. What I'd like to do in the next podcast is look at a specific number that I think is a really good one for telling you, it's a simple one to calculate, anyone can do it, and it's a really good one for telling you how is your trading going. Maybe we can talk about that in the next episode. Keeping a good journal and writing down what you're doing, why your doing it. What else, Darren? Is there anything else? We

can mediate or just be really quiet before we sit down and objectively look at our records. What else can we do?

Darren: The idea of a sabbatical is a good one. That's probably something for a future podcast, actually, because I've got some really good examples of that, where taking breaks really helps creative people. With the Dunning-Kruger thing, just do a little bit of self-examination. See if you're the sort of person that thinks you're always right and you always want to win an argument, and you think that your system is somehow got some market edge that other system don't have. If you find yourself thinking that way then you're probably suffering from overvaluing your own abilities.

Walter: Absolutely, that's great advice. Thanks Darren. We will see you in the next podcast.

Darren: Cheers, Walter.