EP37: Infinite Variance

www.2traderspodcast.com

Walter: If you believe in this idea of infinite variance, or a lot of variance, a lot of volatility in the markets and you hear a lot about, in the financial news and stuff like that, then maybe you want to take advantage of that. There are multiple ways to do that.

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. Walter here. Darren is on the line. How are you today, Darren?

Darren: Really good, Walter. Nice to see you again.

Walter: Guess what Darren, we're going to talk about this idea of infinite variance and what does infinite variance mean to traders? Any ideas? Do you want me to take crack of it or do you want to go first?

Darren: I'd like to hear your opinion on this first. Obviously, it's going to be slightly different to mine.

Walter: Sure. The idea, basically, comes from one of my trading heroes who's in the "New Market Wizards" book, William Eckhardt. I believe, during his mathematics degree, he bailed out because his buddy, Richard Dennis, got him into trend trading.

There's actually some really good experiments that you can run yourself in his interview in the "Market Wizards" and I've done them.

This is what he says, "These brings up two different ideas. There's variance from your win rate as a trader in your trading system and then there's a variance in the markets."

There's two different ideas here. The first idea, which he nails in his interview, is that let's say that you've got a 50% win rate for your trading system. One way to see that is, you could call on -- and this is just like a mind experiment or like a concrete way of seeing this, is to pull up this spreadsheet and you can have a random sequence of zeroes and ones, print in the spreadsheet. Zero is a loser. One is a winner. If the probability of 01 is .5, then it's a 50% win rate.

What you'll notice if you scroll down there and if you keep tabs on what the win rate is, how many ones are hitting the column? Sometimes, it'll get really far away from 50%. It'll come back to 50% or go above, it'll go below but sometimes it stays away from 50%. It stays away from 50% for a long, long time.

The question is, when you think about this, are you really trading the 50% win rate system or is it something else? After all, you only have so many trades in you as a trader before you're going to kill over and die. If you're trading this "50% win rate system" and over the last three, four or five years, it's been something other than 50%, for all practical purposes, you're not really trading a "50% win rate system".

The reason why is because there's so much variance in the markets. There's a lot of variance in what we perceive to be the true things. What we perceive to be the win rate as 50% for our system because our testing has shown that but we get away from that for a long time.

That's one thing that he talks about in there. The other thing that is critical and is something that trend followers, those people who are looking to make huge gains by their trades. Those people are aware of the fact that we have a few, hugely impactful events that happened and they affect the markets.

These events are hopping with much more frequency than will be expected if we were to believe that the markets have bell-curve shape of variance. So, in other words, most of the days are going to move about this much up or down.

Let's say, we're talking about the S&P 500. Most days in the S&P, 500 is going to move less than -- I don't know -- 150 points, let's say. That will be the middle of the bell curve and then at the far end of the bell curve, sometimes the S&P 500 moves 4, 3, 500 points. And, the other end of the bell curve, sometimes it moves only 5 or 6 points, doesn't move much at all. I don't know if those numbers are correct, I'm just using them as an example.

The fact is, if that were true, then if we were to look back over through time we would only see a handful of those days where the market moves a lot and goes really, really far. In most cases, when you're talking about stocks, it's where the market falls okay.

For example, looking back over the last decade we had things like the tsunami in Japan, we had things like the Franco getting Swiss National Bank, we've had things like -- what else? -- other kinds of major events like Greece going to exit the EUR, Chinese stock market's big fall, and then the Governor makes it illegal for the stock market to fall and free to sell your shares, and things like that.

All of these things had happened and, really, if you were to approach this from the bell curve, say "this is the bell curve fits". If the bell curve was to fit, we only have like one of these every five hundred years. We wouldn't have a handful of them over the last five years.

This is the idea that there's much more variance in the markets than we would expect. That's kind of the idea and I'd love to get your thoughts on these.

Darren: Yeah. I'm completely with this guy's opinions. That's why I don't like relying on figures, especially from backtesting and system testing. Like you say, whatever you tested in a previous period could vary dramatically in the next period for so many reasons.

The only figures that matter are the ones in your account balance. The trades you've actually taken, they're the ones that matter. That win rate is the one that matters.

You should always have this mindset: however well you've been trading with your system, it can vary. Even just slight variance in the movements of the market, completely out to your figures carrying forward.

You have to be flexible, I suppose, really. At the same time, you don't want to be so flexible that every time you're having a bit of a drawdown or a bit of a lucky run, that you vary your system. It's why I've tried to move away from patterns and move towards this sort of logic of what does the market do all of the time rather than specific key moments of entry and exit.

That's why I break it down to simplest form. The market is either moving down or it's moving up. It can only be doing one of those states. I'm trying to trade a system that over time will make profit based on just that real simple logic.

The variant is just such little things can throw your next day trade or your next hundred trades off. They're trying to account for all of that, you're just chasing your tail and getting nowhere. It's so complex that you have to stand back and view it from afar, if you like.

This is how I'm going to attack this thing and, at the same time, I'm not thinking my figures are going to repeat themselves. I hope that I've got a chance of it will be. I know my logic is sound but, at the same time, my every trade in every week I'm expecting the unexpected.

Walter: Yeah. As a trader, do you have something in your systems that takes advantage of infinite variance? If we really truly have infinite variance and the markets can really go much farther than we would expect, given a normal distribution of market moves then, how do you take advantage of that?

I know how the way that the trend followers do. They don't have profit target, so if you don't have a profit target, in theory your trade could go to the moon. As long as it keeps going, you're happy because you're not going to get out until you have some reversal signal or enough of a return against your trade to pop you out and get you out of that trailing exit.

I guess, that's my question as a trader, what do we do to take advantage of -- if we believe this to be true -- then what do we do for this?

Darren: Personally, I like the idea of not having an exit rules because as soon as you define exit rules then you can never capitalize on those movements that, like you say, just go on and on. I have very strict rules about entry and there's no discretion on them when it comes to exit. I'm just looking at it as: "is the profit there or is the risk on the table?" I'm just managing those two sides of the coin.

If, for example, I have three short positions and price is looking like it's ten in a round, well, I've got three exposed positions there and three lots of profit. Then, I'll say "it makes sense to rationally manage this either it makes me stop shop or takes them off the table".

But it's not in a predefined when one A, B, and C happens then you'll do move your stop or exit. I really like to have that and after a while, that becomes a comforting way to trade but initially, it's a very difficult concept for people to take onboard.

Walter: This is interesting. I have a trading friend. I worked with him. He was telling me how his wife really wanted a new kitchen. They wanted to build this dream kitchen in their house. He was sitting there one morning and he had this trade on, he trades sort of quickly, he's flat at the end of the day, in the lower time frames.

He was sitting in his trading and he looked at it and said "well, that's the new kitchen right there". And so he dumped the trade, of course, and said "there's my new kitchen." He dumped the trade, but the issue was he came back later in the day -- he trades in the morning where he lives. He came back later in the day and said "wow! I can't believe how much farther that trade went after I dumped it because I had enough for the new kitchen".

If you're using other dangers, if you're using sort of the-bottom-line-the-profit-is-sitting- there, if you're using that as the gauge is that a danger or is that just part of the game? You'll always going to have those trades where you were happy with the profit and the market keeps going without you. You just missed out on that. Or, is there something, some mind trick, something that you do for that?

Darren: Well, going back to your bell curve idea, people want to be at the extreme of the bell curve, so why not just sit in the middle? Be happy to perform all right rather than having to eat their absolute, maximum amount of pips or available out of your strategy.

It's much easier to say "What do I need to get out of trading?" Obviously, some people want to be excellent traders. They want to be always have excellent exits and maker as much as possible. Most of us, if we think about it we've got a clear defined goal and that could be expressed in money and in pips and percentage account group.

Why not just try and achieve that rather than thinking: "well, there'll be enough opportunity this week, I need to get the maximum amount of that opportunity". I approach it, I'm going into the week. I have a rough weekly target and I want to achieve that. I know sometimes I stop and I could've made twice as much. Other times, I continue trading and give later it all back.

That's always going to be the kind of regret where you've closed that trade and it continued. Perhaps, if you're a technical analysis type of trader, it's probably more difficult because you're obviously looking for particular things to happen that say that your trade is done right and you're reaching a strong support or perhaps some reversal signal.

I think that's probably more difficult if everything is saying that the price should go down to the next polar resistance. Just taking your profit off there would be very difficult for those sort of trades to do.

I use hedge a lot as well. I'm a big fan of hedge in a position. If I was to go back to support and resistance, if I pull on support and I've got to the next resistance where I should take profit and I thought it was going to continue, I just slap a hedge on then wait and see what happens.

You've locked in your profit anyway and that gives you a bit more of time to see what the market is going to do. That is not very popular and I know in some places you can't even do it but, I'm a big fan of hedge in positions.

Walter: That will make an interesting episode just going down on that road. I think that's an interesting one for some people who are interested in that idea or in that practice.

In some, what I would say is if you believe that there's a lot more variance, the market goes much farther and much more drastic in ups and downs than we will otherwise expect, given traditional statistics. Then the easiest way to take advantage of it is to use a trailing exit.

It doesn't really matter why you give into your trade. A trailing exit will eventually catch one of those really big moves when you're in a trade. The trade off is something you've just touched on this episode, Darren. Which is this idea that if you are using a pip target or percentage target every week, if it's in the middle of the bell curve and it's in the middle of the area that is achievable, you can make that a lot. You can achieve that a lot and feel good about your trading.

But, if you're using a trailing exit, what typically will happen is you'll have a lot of profit under your belt and then the market will come back to you. Give back a chunk of that. Sometimes the significant chunk of that before you get out of your trade. That's difficult to deal with.

If you have a target, and it's an achievable target, you can feel good about what you've done many, many, many weeks. Whereas, if you got a trailing exit and you're using that, sure, you're going to get the occasional really long runner from the tail end of the curve but you give back profit on every single trade. You're always going to have more profit on every single winning trade and then you're going to have less profit when the trade is closed by the nature of the trailing exit.

I'm not saying that the trailing exits are for everyone. It's one of those things where if you want to take advantage of a lot of variants in the markets and you see the markets and you think these are volatile markets, then it makes sense to use the trailing exits.

Who says that you have to do one or the other? Some traders are actually very comfortable having profit targets and then leaving some of their positions on with the trailing exit.

In fact, our good friend, Jorge, does a lot of that with his trading. He tries to capture trends and he has a target and he also has position and he has trailing exit. These are the things I think you needed to think about as a trader. If you believe in this idea of infinite variance or a lot of variance, a lot of volatility in the markets, and you hear a lot about on the financial news and stuff like that, then maybe you want to take advantage of that. There are multiple ways to do that.

Darren: Yeah. I don't think that a lot of retail traders think there is, that variance there, that it could be the problem. Probably a trick of the eye, sort of thing where you look at a chart and it looks like the same set up you've seen over and over again. You think you know what the outcome is going to be.

Obviously, it does something completely different this time. If you break it down, really, if there is a certain pattern you're always looking for, you to start to visualize just that on the chart. Certain people should take it on board that there is this infinite variance. There is no best exit and there is no best entry. This is just good enough.

Walter: Yes, exactly. Good enough. You're happy with what you've been able to pull out of the markets. You've got to be happy with that. That's it.

To me, thinking about exits, the big question is: which of these hurts more? Seeing a trade that you took go on and on without you and you only took little, small piece of that profit that was available on that trade. Does that hurt more or does it hurt more when you have a whole bunch of profit on trade and then you give some of that or a good chunk of that back and then you get out of your trade?

That's really going to define what type of a trader you are? Which of those hurts more? Because, if number one hurts more then you should apply trailing exits; if the second ones hurts more, you give back while on that profit then get out of the trade then you should have targets. You should use something other than the trailing exit because it's going to hurt too much every single time you take your trade.

Like most things in life, and in trading in general, it's a trade off. You've got to decide which side of the fence you want to be on. Any closing thoughts?

Darren: Yeah. Me personally, I definitely prefer taking a streaks of loses knowing that when price moves I'll get one or two positions in that long move and I get that big win. Clear my loses and make my profit.

When I've tried the other way, with the trailing stop like a stop or reverse strategy, my win rate goes up and I make lots of small wins but I find that less, less satisfying and that missing out on the bigger moves, so that's my personal idea.

Walter: Yeah. Great. Thanks for sharing, Darren. I'm looking forward to hearing more about your thoughts on the hedge. That'll be interesting.

Darren: Cool. Yes, see you next time, Walter.

Walter: See you.