EP04: What Goes Into Setting Your Stop Loss?

2traderspodcast.com

Walter: I call that casino thinking. You think in terms of the casino. The casino knows that so-and-so took five million out of the casino this weekend, but they're not going to go and slit his throat, right? They just understand that's cost of doing business. So-and-so won. He's a lucky winner. That's fine.

Recording: 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 show. It's Walter here and I've got Darren. Darren, how are you feeling today?

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

Walter: Great. Well, we were going to talk about stop losses today and I think that what will be interesting today is perhaps we'll have some different ideas, so that always makes for an interesting session. In general, I can just say that for me, stop losses for me, I use the market. Based on what the market's done, that sort of dictates where my stop loss is going to be. That's kind of how I approach it, so what that means, of course, is that my position sizing is going to depend on the stop loss as well, so I might have a trade where I've got a rather large position on, and then I've got another one where the stop's further away so it's a much smaller position. That happens all the time for me and it's not just because I trade the weekly and the daily charts, but also because I use support resistance and candle formations, naked training to set up my profits and my stop. Tell me more about how you use stops and how you approach it.

Darren: Well, yeah. This is the interesting conundrum for me, is that we know that you have this approach where you adjust your position size to fit with your stop loss so you're always risking the same amount on your trades. I go the other way, where I treat each trade as equal and always use the same position size regardless of the stop loss because I see the trades with the bigger stop loss less likely to be hit than the ones with the small stop losses. I'm not sure where I've got this from because usually I take ideas and then I play with them and I make them my own. This one, I don't know where it's come from. Deep down inside me, I believe in it massively and it's like I see this elastic band and on one side is your profit and then on the other side is your actual risk. If you stretch it and risk more, then your potential profit is also more and if you reduce your risk, then you're automatically reducing your profit as well.

It's very odd with what everyone teaches, but it works for me. The question is, Am I right, or is it just because it suits my personality that makes it work? I think about this when people ask me if I'm perhaps explaining a trading system. When someone asks me this, I'm very wary of saying to them, "Well look, this is what I do," because there was a market wizard called Jimmy Balodimas, I think, who's quite famous for doing the complete opposite to everyone. He started with a massive position and this price went in his way. He kept taking small bits off. Then when he got to his eventual target he had hardly any position left, and then he'd kind of reverse and go over massive position in the other direction. Some completely out there ideas. He said that it just felt right to him so he did it, but he said if anyone else did it they'd probably blow up their account. He wasn't trading his own money, he was working for a trading firm. He was a prop trader. Other people were letting him do this.

The question is, Is there technically one technique that is proven to be better than the other, or is something a bit more unusual that suits you personally the way to go?

Walter: Well this is fascinating. Let me get this straight. First of all, you placed your stops based on what the chart tells you. Is that fair to say?

Darren: Yes. I have like a technical place for placing my stop, yeah.

Walter: Got it. Then if that place happens to be, say, 30 pips away and then in another trade it happens to be 150 pips away, you would have a larger position on the trade that has the 150-pip stop, right?

Darren: Yeah. By five times.

Walter: Right. By five times. Right. There's actually a method to the madness. That's awesome. Because it's five times further away.

Darren: Yeah.

Walter: Technically, if you were to asks a statistician, I'm no statistician, but I studied a lot in graduate school. I've got a graduate minor and blah blah blah, was kind of known as being the stats guy among the psychology students and everyone came to me with their stats questions when they didn't want to ask a professor. Having said that, I think that the basic idea here makes sense, right? I don't think that normal distribution statistics apply to markets in general, but a lot of people do and what they would tell you is that you are correct. In other words, if your stop loss is 150 pips away in Trade A and in Trade B it's 30 pips away, well it's much more likely to be stopped out on the 30-pip stop because it's much closer and price fluctuates closer to on an average day it fluctuates 100 pips, of course it's more likely to hit the 30-pip stop than the 150-pip stop.

It's exactly the opposite because most traders I know are always looking for that little tiny kangaroo tail because that little tiny kangaroo tail, they all seem to put the stop on the other side of the kangaroo tail and it allows them to have a larger position. I'm always telling people that's the wrong way to look at it because those little tiny kangaroo tails are much more often, in my testing, to be losers than to be winners. From a purely statistical point of view, I would say yeah. You'd have to be right. What do you find? You find that, in general, your trades that have a larger position and a further stop placement tend to be winners or make money, at least, more often than the ones that have a tighter stop placement.

Darren: Yeah, definitely. The wider stops work better. It doesn't have to remain wide, either. It can just be initially wide and then when prices move so far in your way, then it can be tightened up. I think what people generally like to do, like you say, is because deep down they want to get rid of all of the risk really quickly. I think what really good traders do is they remove some risk rather than removing all of it. What people tend to do is, yeah, they jump the stop right up to break even. In fact, they even go and grab two pips into profit, like those two pips are going to make any difference in the long run. Then they like to trail stops, which is the other thing which is really bad.

The interesting thing is, talking about statistics, is it's not linear, so a 10-pip stop compared to a 100-pip stop is more than ten time worse, if that makes any sense. It's not a linear curve, so up to a certain amount all your stops are pretty bad, actually, and then after a certain amount they start getting better and better. Then, obviously, that tails off as well. Do you know Linda Raschke, who she did a lot of-

Walter: Yeah.

Darren: Yeah. According to her, it's 3ATR is kind of the optimum. I don't know about that, but in general she did a lot of testing: If you had a wide enough stop could you use random entries? She kind of proved that you could make a lot of techniques profitable just by using a wider stop. Even time stops she found could be very successful. Going on from that, the most successful version of stops she found was wider stops combined with use of trend. If you've got those two, then that's as close as she could find of you having like a real statistical edge in your trading. Yeah, it's really interesting. I think a lot of people are very single-minded about stops and they don't look outside the box on it, and it might be one of those. If you're interested in the technical side of trading, it might be one of the most important parts.

Walter: It's fascinating, really. You're basically say that Linda Raschke was saying that she found if you take the trend into consideration and if you use a 3ATR stop, that was really the way to go. Is that right?

Darren: Yeah, that was most successful.

Walter: Right. Let me ask you this, because devil's advocate here would say, "Well, Darren, is that really your stop?" In other words, is there a point? Let's say you've got that 150-pip stop loss on you position but the market goes 115 pips against you. Is there a point where you actually pull the plug, or do you steadfastly hold onto that stop loss and you don't take a smaller loss, you literally will either take the full loss or you take no loss?

Darren: Definitely never close it early. Never, ever close it. If you've watched it go against you 115 pips and then close it and see it turn around, it's just going to be absolutely devastated. Going on from that, your next three trades, you're going to caugh them up definitely. If you veer off plan there, then that's going to have repercussions on your trading. It's scientifically proven that you will, if you start making those sort of mistakes, basically using your emotions and turn them into actions, then there is payback down the line from that. Having said that, if you watch a 150-pip stop go within 10 pips of stopping out and then it turn around and go into profit, then you feel so good from that you can't describe. That's better than it just going straight in your direction from entry and hitting your TP. So, no, I leave them as they are and I trade stop loss to TP because that's the only way that's ever worked for me. Whenever I've tried anything else, making decisions as we go along, my systems always fall apart when I do that, or I fall apart, should I say.

Walter: Right. Well, that's fascinating. Yeah, no. It's sort of like being down three goals in a football match, right? Then all of a sudden you come back and win. How many minutes? Is it 80 minutes in the soccer match or is it more than that? How many-

Darren: 90.

Walter: 90, yeah, right. Okay, of course. Leave it to the American to talk about soccer. That's a big mistake. I can understand where, psychologically, having that trade go against you 145 pips and not stopping you out and then you end up actually making profit would be a big win. Also, is there this temptation to change your position size? Because I know you are literally changing your position size based on the trade, but let's say that you have that 150-pip stop and it's stopped out, right? However unlikely it is, it happens.

Do you find yourself looking for a trade that would fit the characteristics of a trade that has a further stop so you can actually trade more lots? I guess it doesn't really work that way, does it? Because your take-profit is directly related to your stop loss, isn't it? In terms of if you have a 150-pip stop, you're probably going to have, I don't know, 300, 350-pip target or something like that. It means that you're not necessarily likely to make more money on the trades that have more positions. Do you know what I mean? Does that make sense, or am I speaking out of turn here?

Darren: I think you're right. I think the way I've dealt with it, and this is just something that's worked for me personally, is I've removed any discretion from the entry, so my entry is an entry and there's no ifs or buts about it. Okay? There's no subjectivity or anything. It's a straightforward, simple entry. I've removed that decision process from the entry. The same with my stop loss, there's no discretion on it. It's the same technical point every time. That's helped massively. The other thing that's helped is I have high frequency of entries as well so I'm not waiting a long time for the next opportunity. I'm getting a regular supply of entries that are coming along.

The last thing I've done is I reframe it and I don't look at the individual trade. I've done lots of back testing, so I think of the bigger picture. How does it perform over 200 trades rivaling this trade that I've just taken? I just reframe the whole process into a much, much bigger picture. All those elements of focusing on the individual trade and the individual stop melt away. The only way I can do that, really, is by back testing. I do lots of back testing, even when I know a strategy deeply. If I get a spare hour on the weekend I'll just pull up something I don't usually trade, jump to a random month, and just start running the strategy through my head and seeing how it performs, seeing if there's just kind of like some sort of routine to build a good habit.

When it comes to live trading, it just ... In effect, I'm trying to sort of stop me from messing the strategy up, and I've almost changed the strategy to literally lock in with me and the technical elements are kind of secondary, really. As long as it's a wide stop, then how wide doesn't massively matter. Obviously, there are limits on that. It'd have to be some sort of insane market event for it to go out of the usual market movements. I know it sounds pretty crazy. I think, really, what I'm trying to say on this is there are some really good statistical reasons for using certain types of stop, but then you can kind of model it to suit yourself as well.

You can make that work, so you don't have to follow the rule book as it's given to you, or as you've read. You can play with the idea.

Walter: Absolutely. I think what you've just said, Darren, I really think that's the key to trading and if you had to take one rule away, I would say that's it for trading, is to mold that into something that, one, makes sense to you and, two, you can trade over the long haul because anything else, it's just a transitory system that you're trading for a couple of months or years or whatever before you're onto the next best thing. That's really the key, I think. What's fascinating to me, though, is that you have this, you talked about it earlier, where you kind of have the big picture, thinking about all of the trades and you have so much back testing experience with the system and live trading experience with the system that you see it.

I call that casino thinking. You think in terms of the casino. The casino knows that so-and-so took five million out of the casino this weekend, but they're not going to go and slit his throat, right? They just understand that's cost of doing business. So-and-so won. He's a lucky winner. That's fine. You don't have to change you're rules or change the settings on the slot machines or fire the dealer that allowed so-and-so to win five million at the blackjack table or whatever.

As traders, we often do do that, don't we? We often change it up. I think that's really cool, the way you're approaching this. What's fascinating to me is that I can see how, mathematically, you could make the argument that that's really the best way to trade, isn't it? I can see where you would come to this point. Like you say, you don't have to follow the rule book, and a lot of times traders come to me and say, "Well, the trend is your friend and I'm a trend trader," but I often ask them to double check that. Are you really a trend trader? Do you really believe that when you see this chart that goes straight up? Do you think it's going to keep going straight up? Because most traders don't think that way, so I find this really interesting. Certainly, it's an interesting thing to test.

Do you have a way of actually assigning a probability to a trade based on the stop loss, or do you not go that far? In other words, you say, "Look. This stop loss is 205 pips away. I know that with a certain amount of confidence that this is 85% likely to work out," whereas if you have a trade that has a 39-pip stop, you say, "Well, eh, this is a 50-50 proposition." Do you not think of it that way?

Darren: No, I've completely done away with all of those figures. Win rate, probabilities, I've just dumped them out of my mind and said, "Right, I'm not going to deal with those anymore. I'm just going to look at the profit at the end of the week." Some people think it's kind of mad, insanely risky way of dealing with it, but really I think the only reason people want the numbers, is they want just that little bit of security saying, "Well, it's okay. You're never going to blow up. Just keep doing what you're doing," but the numbers don't give you that.

They might give you a sense of that, but what I find was the numbers actually worked the opposite way for me, because when I pored over my numbers of live trading and they didn't match the numbers that I'd already predetermined, then I started… "Well, why hasn't it matched up? What have I done wrong? Maybe I need to add this indicator. Maybe I need to move my ..." Do you see what I mean? I was kind of basically trying to use the numbers to get rid of the uncertainty at the market, whereas now I'm just saying, "Right. Well, it is what it is. Logically, if I keep doing this, I'm going to make money, but there's always a chance that I'm going to blow up." I think that's the same whether you've got those numbers or not.

I know, we spoke about it before, we as human beings find a lot of comfort in numbers. Numbers are authoritarian and they've got real meaning because maths is numbers and banks use numbers and money is in numbers. Not only that, our whole lives now, how many followers on Facebook have you got? How many hits have you got on your website? How many ... You know, it's all number-based now. I just think, for me personally, they do more damage than good. I'm just kind of thinking big picture. Have I made profit this week or have I not?

Walter: I think that's fascinating, Darren. We should do a whole session on that actually, on what your numbers tell you or back testing or the idea of numbers as a false security blanket or whatever. I think that should be something that we definitely talk about in the near future because I think there's a whole lot there. I think what you're talking about right now is super fascinating to me because we know that the past doesn't really tell us what's going to happen in the future, and yet everyone uses past back testing past numbers to project. Like you say, it's a great point, which is if your numbers in the future or in the present, so to say, don't match up with your back testing, you ask yourself Why? What's going on here? What do I need to change? What do I need to optimize? What's the dif ... Yeah, I think that yeah that's a really interesting path that we could follow and we probably should in a future session. I think that would be really good to take a look at that, just a podcast just on that in and of itself.

I guess just to wrap up here, Darren, I think your system of money management is fascinating and I like the idea that you use profit to determine how well you're doing. It's one of the great things about trading, isn't it? That you don't have some boss telling you that you've done a good just or not based on his subjective interpretation of your work over the last 12 months. You actually have a bottom line, don't you? As traders we can all pull it up and say, "Okay, well how did we do?" If that's really all you're basing your trading system on, that's a pretty good place to start, isn't it? To just look at, look. What am I doing? How am I? Am I making money? Am I not making money? What's going on here? Can I keep this going?

Darren: Yeah. I think that's how, if you are a trader for a bank, they wouldn't be particularly interested in what your win rate was or how much risk you would be taking on. If you were making profit at the end of each month, they'd say, "Brilliant. You're doing well. Continue doing that." I'm just trying to basically question everything, really, and look a little bit deeper in it rivaling just opening the book and saying, "Well, that's what I'm being told. I'm going to go along with it." I just don't think trading is as much an exact science as people like to think. I do want to stress that maybe my style of money management is not the best route for everyone to go down. The two things I would say is definitely look at slightly wider stops, especially if you use tight stops. The second thing is if you like to use trailing stops or move the risk off quickly, look at somehow slowing that process down, and perhaps rerun some back tests and compare the two.

Walter: Yeah. That's great advice. I know a trader who basically adjusted his system to account for essentially a pullback after he had moved into profit. He was really slow to move his stop loss to break even, much slower than he used to be, and that made all the difference for his system. I think that's excellent advice. It certainly worked for him. As you say, it's not for everyone. You need to trade how you view the markets and that's really, I think, to me it's the key to trading, is to trade how you see the markets and not allow ...

We get into trading and we think, "Oh, I'll just do what so-and-so does. He's really successful. I'll just copy what he does." We quickly find out that that doesn't work. If someone's listening to this, thinking, "Wow, that works for Darren. I'll do that." Well, maybe. Maybe. If it works for you, maybe, but maybe it won't. I think there are a lot of traders that would be really tempted to pull the plug on a trade if they've got 150-pip stop loss and it goes 140 pips against you, but certainly that's not the way you trade and it's been working for you.

I find it fascinating and I really appreciate your time, Darren. This was an excellent examination of stops. I think that, if anything, it allows people to just sort of question what they've been told and what they've been doing and allows them to look at it from a different angle and perhaps that's a fruitful path for them to test.

Darren: Yeah. Totally. I agree, Walter. Be more of a free thinker with your own strategy and find something that works for you as well as a technical side of your strategy.

Walter: Great. Thanks for your time, Darren. We'll see you in the next session. Take care.

Darren: Cheers, Walter.