2 TRADERS

EP08: Is Complex Trading Right For You?

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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: All right, welcome back to the Two Traders podcast. It's Walter and I'm here with Darren. Hi, Darren.

Darren: Hi, Walter.

Walter: Darren, you have this idea and I thought, "Brilliant." It was sort of fortuitous because I had just read this book review by one of my favorite authors and then you had this idea about, diving deep into this topic, so would you like to explain to everyone listening exactly what's on your mind?

Darren: Yeah, this is Nassim Taleb's new book, "Antifragile," I think it's called. I saw him do a seminar on the internet about the book and basically part of the premise is this idea that we're obsessed in the world now with making stuff more complex. We've kind of got this notion that if you make it more complex that we are basically improving it. He's saying, "No, actually what you're doing when you're making things more prone to fail and you're actually making them more fragile. He made a really good analogy about a Kindle and a book. I was, "Everyone wants a Kindle because we think they're so much better than books," but he said, "Well, you try destroying a book and you try destroying a Kindle and you see which one's most fragile." They both essentially do the same job, but we as human beings now, we just seem focused on this idea of the complex thing being better.

We have these Kindles and we think it's great and we go on holiday and then you spill your drink on it and it's broken. When have you ever broken a book? It's nearly impossible.

Obviously, it was much more to this, but for me as a trader, I thought this was fascinating because now how many times have you seen people say, "Well, you know, the system failed today, perhaps we need to add another moving average, or we need to, you know, only take pin bars." We complicate our systems and how we trade, thinking we're making it better and in effect we could actually be making it much harder for ourselves. That's what I thought that was one of the ideas in there that I thought was fascinating. What do you think?

Walter: I agree. I think this is great. It kind of goes along the lines of my thinking in terms of keeping things simple and you're looking for ... At least my opinion is, as a trader, you're looking for really simple robust things that tend to work and you can use plenty of analogies. You know, you can do a lot of things with a crowbar. You can hammer a nail, you can open a door, you can lift something, you can crack something open, you can sort of use it as an ax, lots of things with a crowbar, but there are only a limited number of things that you can do with a power drill. Right?

Look, I've got a little bit experience in this area and I think that I fell into the same trap that a lot of traders do, which is, "Look, I'm trying to make this trading thing work and it's not working, so obviously it's very complex and difficult." Right? In our mind we have this idea that if it's difficult, it must also be complex, which I don't necessarily agree with when it comes to trading. Right? I mean, what do you think?

Darren: Yeah, definitely. We generally look in the wrong place for the solution and we think that it's the technical side because side is numbers and numbers is maths and maths is intelligent, so that's going to be the answer. Whereas, generally, the answer is you need to just stick at your system and be a bit more consistent in how you trade and not make any snap decisions about what's wrong. It's obviously a natural urge for humans nowadays to look down that route. As we say we trading, the majority usually wrongs, saying your gut instinct is usually wrong and you need to, again, step in the way of your decision making. When you're looking to improve your trading purely through the technical side, then you need to question whether you're just complicating it because you feel that's the right way to go.

Walter: Yeah, I definitely did. I've got a bit of a background in statistics, so what I decided when I was trading ... This was actually after I already discovered some simple naked trading patterns which are essentially my bread and butter now. I decided that I wanted to see if I could build an algorithm, so I got deep into what's called neural networks, which is a system that just loves data. What I was trying to do, when I found out over time, is what you need to do with the systems is you want to predict something kind of smooth. Right? Otherwise, it will get really choppy, so I built one for the dollar-yen. What I found out was you weren't supposed to try and predict where the dollar yen would be tomorrow in terms of a closing price or something like that. What you needed to do was predict the moving average. Okay?

To really make this work, you really need to predict two moving averages because you want to see the spread between them to see how fast it's going or if it's going to turn around and go up and down. What I did was I predicted the ten moving average and the twenty moving average of the dollar-yen. You can only imagine that I had tons and tons of data to put in, and these from the world markets, like Germany. Everything you could think of, I would dump in there, and some indicator data as well, just to top it off. What I found was exactly what Taleb's talking here was it was interesting because it would work for a while. It was pretty good at predicting what the moving average would be two days in advance, but then there would be things that would come up and it wouldn't make sense. Like something would happen where the twenty moving average was predicted to move faster and more violently than the ten moving average. Right?

Then I knew, "Okay, this isn't going to work." It was early days. The thing is I fell into the trap of thinking that this is something that's difficult to do, so it must be complex, and if I really want to gain an edge here, what I need to do is build this artificial intelligence style neuronetwork that's going to predict the future for me. That sort of thing. I really over-complicated it. I think you have done a really good job in terms of looking at charts and figuring out, "Okay, what do I need to do to take a bite out of the profit that's available to me in this market?"

Which is a different way of approaching it than what I was doing back then, which was, "Okay, how am I going to predict the future?" It's like a totally different question. You know what I mean? I would argue that it's much easier to answer, and I know I'm putting words in your mouth, but it's much easier to answer your question, which maybe that's not how you look at it, but that's how I see your trading, is what can I do to set myself up so that when the market moves, I'm going to take a big chunk of that profit. Right?

Darren: Yeah, definitely. The thing is is with those complex things, you can always make them work. That's the trap is because it's complex and it does work some of the time, you're more compelled to believe in it. We get back to this thing about what you believe in is really important, but the problem is is their more susceptible to the unusual event. Although it can, like you say, win for a while, it needs a small change in what the market's doing for it all to come crashing down. What I try and do is say, "Okay, what's doing to work in all market conditions? If the market stops trending, am I going to get wiped out?" I try and sort of build it around what's happening all of the time, rather than just specific patterns. That way, I think your system becomes more robust. I think a lot of the difficulty is is deciding how to simplify a system because it's very easy to say, "Well, you need to keep it simple," but which elements then do you lose and which do you keep in? Which elements are important?

For that, I think you have to look at the big context, which is my personal opinion and it is my approach to trading. Again, I'm not saying it works for everyone. I was chatting to a trader this morning and basically the point I was making to him was if you use trend and then you either use a wide stop so your win rate is high or you use a tight stop and let everything run so you always get the big wins, then essentially, that is all you need to do. He came back to me, "But I know two very successful traders that use tight stops and small wins and they do really well." Again, this is that little complex trap where there's a few exceptions and because it's the hard way to go and someone's achieving success with it, you're more likely to believe it than what's really obvious in front of your face.

Like I said, this is just my opinion on trading and it gets a lot of people's necks up because it is very different to what we usually hear from traders, but if you read any of the market wizard books, they've all got their own take on trading. Very few of them follow the same path. It's my opinion, it's a little bit out there, but for me, that's one way of simplifying it. I'd say use trend and think about stop placement and then how big your wins need to be to make that a profitable scenario. It's very simple. It's my opinion.

Walter: What's interesting about that is what you've just described, your approach, is exactly the opposite you would take when you have a really complex algo that you're working with because you've really whittled it down here. You said, "Okay, well what elements do I need to really focus on here to make this work?" Whereas when you've got something complex, and I think Taleb would agree with this, what you essentially have to do is you have to anticipate the weaknesses of it. You have to build in ... It's sort of like building a nuclear reactor. Right? You've got this really complex thing that harnesses energy and turns it into electricity, and what you're to do now is say, "Okay, now what are the things that can happen than can cause a meltdown here and how do we build safeguards in for that?"

That's what happens when you build something that's interdependent on itself and really complex is you've got to anticipate where it's going to fall apart and how to get around that, or how to avoid that. That's much different to something that's simple and robust because it has so few moving parts. It's sort in its very nature more robust, so all you're really saying there is, "What is the core thing that I need to focus on here to make it work?" It's almost the exact opposite. In one, you're looking, you're trying to anticipate the destruction of the system. What's going to make it come down because it's so fragile? Then the other one, it's trying to just pick the one thing that's going to make it chug along, the thing that's going to fuel it.

I find that fascinating and I think that for a lot of traders, it takes time to come to that point. I don't know what your experience was like Darren, but for me, it sort of really took time for me to come full circle around to the point to where I am today, which is making it really simple and not adding too many layers or filters over the way that I look at the market. It wasn't always that way. Before it was always, "Okay, well this works pretty good, so if I add this element, if I just add Bollinger Band here, then I'll be able to filter out these losers and that sort of thing. It can get out of hand rather quickly.

Darren: Yeah, definitely, Walter. I think what I did personally ... Well, a thing that fascinated me was how come we're all making the same mistakes? What is the solution to all those mistakes, really? Generally, you have the people who like the really accurate entries with tight stop blocks. Obviously, a lot of those get stopped out, and then when they do get a winner, they closed it early. They would do it in tight stop blocks, small win. Then, invariably, even if you were good at that, you were ending up break even. Then you had people using a wide stop and then trying to get long runs with that as well, so then not get in a high win rate.

For me, it was looking at what everyone's doing and surely that's going to be the answer. It goes back to this idea that ninety-five percent, or however many it is, lose. Surely, there's something that we're all doing in human nature that is making us lose. Then, okay, so I'm just going to reverse everything and do the opposite of what everyone's telling you to do and maybe ... That lead me down a path. I mean, essentially, I'm looking to start trading at point A and exit at point B and not ... As long as there's a difference between those prices, there's opportunity there.

It's the way I see it, rather than looking for a particular event to happen and decide, "Well, now is the time to get in because I know it's going to go to a certain place." I removed all of that trying to predict what's happening next out of my trading because that killed me, as well. I found it really, really frustrating. I'd get to the end of a day and my head would be pounding if I'd had a bad day and, "Where did I go wrong? What did I do wrong? The pattern was right and everything was lined up, why did I lose?" Then the next day, the pattern's not quite so not quite to your complex system you have.

Then you get out early because you built up fear because it's a perfect entry. Then that one goes on to where? You know, just get trapped in a circle of second guessing your own analysis. I just find it a lot easier to have no discretion at all on the entries, really, and take all of that. Consider them all to be a guess, if you'd like, really. Then it's how you manage those ones that survive and where you exit. That is the important bit. It, in a way, reducing the amount of involvement I have to have, so I'm just using my mind to get decisions to get good exits, rather than on the entry as well.

Yeah, slightly going off course there a little bit, as we normally do. Essentially it's trying to simplify the whole process, really, rather than making the entry, the management, and the exit all very complex. I think that's really near impossible for a lot of people to do and I'm not saying there won't be exceptions throughout and people who are particularly talented at doing it, but clearly for the majority of people it's a really hard skill to do.

Walter: I think you hit on one of the central keys to it. It's sort of like a zen-like attitude of it, just let it be, just let it go. It's not something you can get attached to because it'll do your head in, right?

Darren: Yeah.

Walter: It reminds me of this trader that I read about and I would like to meet him. I believe he is still in Australia, but there was a book called Every-day Traders by Nick Radge and the interview was mostly they were stock traders and systems traders, like automated systems traders and things like that, but basically there was one currency trader in the lot and his name was Scott Barlow.

I thought what he did was fascinating because it's very similar to what you just spoke about, Darren. He said that he subscribes ... Okay, he manages money and he subscribes to a signal service. Okay? All he does is he takes the signals as they come and he manages the trades with a three-to-one reward-to-risk ratio.

He doesn't actually pay attention to the exits that are suggested or anything like that. All he does is in the signal service, he just takes the trades as they are offered to subscribers and then he sets a three-to-one. That's all he does and those trades will either hit the stoploss, and he'll lose one, or they'll hit the take profit and they'll hit three. He said, "The reason why I do this, the reason why I outsource my decisions," he says, "Look, it's my job to manage the exits, so I just go three-to-one and I never moved to break even." He never does any of that, he just lets it go.

He says, "I don't want to beat myself up over the decisions, whether to get in or when to get in and which market and all that. That's why I've outsourced this." I thought that it was a really interesting way of sort of psychologically of releasing yourself from beating yourself up from that guilt or whatever you want to call it that comes with making the wrong decision.

Darren: Yeah, and why not? Why wouldn't it work? I imagine whoever is giving out the signals is using some sort of trend, you know, picking pairs that are trending to give the mostly winners. I've seen data before where random entries make profit as you increase service-to-reward ratio.

Walter: Yeah. That's right.

Darren: The difference is can you do it? Can you believe in it? Can you wake up everyday and do that and not start to want to think that you somehow are going to be able to pick a better entry. It's whether you can execute those simple strategies. That's quite a hard leap to make if you've been down this path where you somehow are going to have a really accurate system and I think that's kind of a major hurdle for people. Yeah, I find it much easier to believe in systems like that and many of the ones that I see people using like that.

Walter: Yeah, the seduction is in the win rate, isn't it? I mean, the seduction is in ... Let me ask you. You've got a simple way of approaching your trades, and how do you convince yourself that what you're doing is right and that it's going to work in the long run? What's the trick for you?

Darren: Well, I do a lot of back testing, even when I'm trading live, so on the weekend, perhaps, if I've had a bad week, I would just pull out some random data and run a back test and just really enforce in my mind, "No, okay, no. This system works, I just, you know, I've had a bad time, or I've executed it badly." I do that. Also, I've got my memories of losing as well. I don't know who it was, but I remember someone said, "Enjoy your losses because you're going to learn a lot more from them than you are from the winners." I completely agree with that.

I think you kind of get to the end of the line, as well, where you've tried a certain approach for a long time and you've beaten yourself up about it and you've gotten to the point where you think, "This just isn't going to work out for me," and you say, "To hell with it, I'm just going to do the opposite of what I was doing. I'm going to just put the trades on and walk away and forget about them." I think I got to that point, as well, many times in my trading. Yeah, I think perseverance as well. It's almost an alien thing to be able to trade, so you have to do a lot of looking within yourself to become a good trader, I think.

Walter: What do we do then? If we believe this is true, that we want to simplify our system and we don't want it to have too many moving parts, we don't want it to be fragile, we want it to be robust. How do we do that? Someone listening here saying, "Yeah, sounds good, but I don't know how to do this. What do I do? Where do I start? How do I create something that's anti-fragile?"

Darren: I think the only technical element that is going to give you a slight edge, in other words, give you a sort of guaranteed more than fifty percent win rate is a simple use of trend, so use something very simple to decide what your trend is. You know, a move in average, lower lows, lower swing lows, lower swing highs, something simple like that, but make it really simple and non-discretionally, so there's no questions that it's above or below the moving and then that tells you what the trend is. There's no ifs or buts to that, nothing else changes it. That's the first one.

The second one is I really believe this idea of even if you want to use a tight stop on your trades, I think unless you're wider stop is really beneficial and by all means move it up after price has moved away. I think what a lot of people like to do because they think no removing risks is they like to use a very tight stop behind the entry and then as soon as price moves, they like to move that into to secure some win too quickly. Okay? This is like a fear move, okay? "Excellent, I've got a winner. There's no way I'm going to let this become a loser or a break even, so I'm going to grab a bit straightaway."

All the data I've seen says that that's a really bad thing to do. By all means, start with a wider stop and when prices are moving away, reduce your stop. Okay? I think people are just a little bit too tight when they first enter and a little bit too quick to move the stop up, and that basically makes your job a lot harder. If you do want to use a tight stop, I think you need to then accept that your exit needs to be larger that, say, a one-to-one or a two-to-one risk-to-reward. To really give you an advantage on a money management side, you want to let your trades run and a few big wins will make up for all those stops that get hit.

My personal preference is to use a wider stop and then basically make my judgement when I see how price has moved away, so if I start with a wide stop and the price moves dramatically away and the trend continues strongly, then I'm going to let it run longer. I'm using a judgement call then. I'm looking at it, there is a trend, it's moving strongly in that direction, no news has come out to counteract that, so I'm going to let it run. If I've entered initially with a wide stop and it looks like the trend's kind of faltering and it's doing double bottom, triple bottom, whatever, and prices are stalling, then I'll take the small win. I'm insuring a high win rate, but I'm also giving myself an opportunity to get the wins as well, so it's like the best of both worlds, really.

Walter: Right.

Darren: Yeah. For entry, a lot of people ask me about specific entry types. Just use something simple and repetitive and use something that's going to give you a decent frequency of trades. If you've got too few trades, I think it's really hard to maintain a system. You've got to have a very strong will to only take a few trades a month and I know it's when you ... You trade much higher time frames, don't you?

Walter: Yeah, I think so.

Darren: Yeah, but you then look at many more instruments to find your ... That raises your frequency. You know, a lot of people ask you how many instruments can you trade and what time frame. Really, that element, you're looking for a decent amount of frequency, so you give yourself a decent probability of having some winning trades. If you take one trade a month, you've got very few opportunities. That's my personal view, but it's certainly not the only way to do it...

Walter: Yeah, that's interesting. I heard about this guy who traded, he did the op- ... Well, not the opposite, but he did this thing where he would just pick, I think he actually automated it. What happened was the system would take these trades and it would lose like ninety-eight percent of the time and it would just try and pick these turning points and you have a really, really tight stop, like a few pips. He would, of course, get stopped out almost all the time. Well, once in a while he would get hook into one that would just go and he would just leave it open. He would close the trade eventually, but it was sort of like trying to pick a sixteen week trend on the five-minute chart or something like that.

Of course he failed miserably most of the time, but once in awhile, he'd hook into these with two pip stops or three pip stops or something like that and it would just go and go and go and it would cover all of his previous losses. I don't think that's necessarily one that most people could do. I think an easier one would be to look at the line chart, so if I were a trader and I wanted to simplify things, what I might do is probably somewhat similar to what you do or I'm not sure, but you would say, "Okay, look. The euro's going down. Right? I want to sell the euro-dollar. I see that it's making lower lows and lower highs on the line chart, so what I'm going to do is wait for it to swing and go up and go against the trend and then as soon as it makes on of those nice bends back down in the direction of the trend, I'll just get in there.

You could just do something like that or you keep stacking those whenever you see a trending market make a turn, you just assume that it's going to keep going lower and lower and lower. Same thing with Bullish Trends. You just assume that when it makes that buy ... You could stack those on and that would be a really simple way and it probably would fit with, what you're talking about, with a wider stop. My interest, though, is when you say it's a judgment call about how far you let it go. How do you know? Is it just based on sheer velocity? You see it seems to be going really strong in my direction, so you assume it's going to keep going further? You mentioned you don't want to hear any news that's counter to the trend and things like that, but I think a lot of people might be listening to that, Darren, and saying, "Oh, I don't know. That sounds a bit iffy."

Darren: Yeah, but I really think that that's the way to do it. You have to look at the real big picture and the context, so let's say it's been stinking for you for ages, and you finally got a nice runner and a decent win. You might decide, "Well, I really need to cover my loses here and take a little bit of profit and get back on a ... It's been a nasty, rangy period and this is going to get me out with a small bit of profit." In this context, okay, I'm going to call it a day and close it. Let's say, for instance, two of your pairs have not been doing great, but the other two are in a really nice trend and you've got two big wins going. Well, in that case you might say, "Well, you know what? I'm going to take half the profit off that one and then let the rest of it grow." I think a lot of being a trader is making good judgment calls. If you're going to say, "Well, I'm not going to use judgment calls at all in my trading." Then are you basically saying that I'm not going to be a good trader?

You think about anything else you do in your life that you're good at. I am particularly good at cooking. I can chuck a seabass in the oven. I can pull it out, I can touch it with my finger and tell you if it's cooked perfectly or over-cooked or under-cooked, within an instant. There's nothing that's telling you that other than good judgment, and I think the same thing must come into trading. Surely, you must be able to sort of judge your, you know...

Same if you run a business. You get particularly good at judging what stock to buy and how to staff certain events and these are skills that you haven't gotten any specific measurements that are giving you the whole answer, but you're using your judgment and experience as well. I think experience kind of comes into it a little bit.

That's how I see it, really. I think a lot of people seem to think that they can draw a line on the chart and be more accurate, and I question that massively.

You can pick some good areas to get out, but how many times have you put that weekly support and it sits on it for two days, and then drops for another three hundred pips. I think people believe what they want to believe. If they use support and resistance for example, they believe in that. It's not right for everyone, but for me it feels comfortable because there's no right or wrong. I can't beat myself up if I take an exit and price drops again because you're going to be wrong sometimes. You can't predict. What does help, though, is have a system where you can reenter, which is something I get from using Breakout. If I do exit and it looks like the trend's continuing, I've a valid entry to step back into the trend. Yeah, maybe a bit vague, but it works for me. I think when a lot of traders play with this idea, it's not as mad as it sounds.

Walter: Yeah. I think one of the things that's coming through, just to wrap up from my end, is, I think, the experience that you get is really what's going to help you. I believe that it doesn't really matter, even if you're trading at a completely different, even if it's a more complex system. Having that experience in the markets and seeing the markets and banking that experience and seeing that chart, having those all in your mental file is really helpful. I would encourage people to ... I knew a trader who would just load up Forex Tester and he would just let it run and just watch it like a movie. He wasn't actually trading. Most traders, of course, when they're back testing, they actually take trades and make decisions and pull the numbers out of there and look at their data and all that, but he was actually just watching it in terms of "let me just see what happens here" trying to experience the market.

I think there's something to be said for that. If I were a trader and I were thinking about simplifying my approach to the markets in the hopes of perhaps doing better, what I would say is definitely try and get more experience. You can manufacture that by look at the older charts, by using Forex Tester, by doing things as if you were trading back historically. It doesn't really mean that you're going to see the exact same thing in the future, but what it means is you'll have more of those experiences in the bank.

Also, seriously look at systems like how Darren trades, which is basically to look for really simple reasons to get into the market. Right? Like really simple. In that way, what you might do is find one that resonates with you that makes sense to you and fits your beliefs of the market as we all trade our beliefs, and then you can stick with that over the long haul. That's my basic take away from today. What about you, Darren?

Darren: Yeah, likewise, really. If you're struggling in trading, just think about what elements you could perhaps remove from your trading, what elements are really important. Perhaps try something a lot simpler for a while and see if that makes a difference.

Walter: Thanks for your time, Darren, we'll see you next time and until then, happy trading.

Darren: Yeah, cheers, Walter. Good bye.

Walter: See you. Bye.