What Does It Take to Become Consistently Profitable?

Luck vs. Skill in Trading

In the markets, luck and skill are difficult to untangle. A lot of price action is often noise, leading to semi-random returns over a lot of time frames. Our win rate with any investing strategy will never be 100 per cent, so we have to contend with the frustration of putting on positions and frequently losing money. Even the best traders will experience drawdowns. But that shouldn't deter us from the pursuit of genuine skill and mastery. Hedge Fund trader Bruce Bower explains how to handle this; in addition, he will discuss the premier way to becoming consistently profitable – via focusing as much on understanding and improving the process instead of putting too much weight on single trades.

» Better Lucky than Good

How often have we heard this expression? In some ways, it's quite funny: We assume that luck can't be taught and skills can, so we'd prefer to have luck and learn the skill part later. We find it interesting in a trading context, because most would prefer to possess just true skill, or even better, skill and luck.

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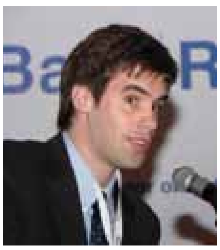

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Know Your Stats

Despite all of the talk about luck, we have to ask: How do you even measure skill and luck? What would you measure in order to evaluate it properly? The answer to these questions is relatively straightforward in a card game like blackjack, where the odds are fixed in advance and known. With those, you can evaluate the situation and make a very good estimate of your odds versus the probabilities that you're getting. If the pot is giving better betting odds than the implied probabilities, then it's a good bet and you should do it. For instance, if it's a ten per cent chance of winning but the betting odds are 20-1, then it's a great bet.

However, this is more about statistics than anything else. That bet will hit and win lots of money approximately one out of every ten times, more than compensating you for the risk taken. If you did it 10,000 times, you would come out as a huge overall winner. But on any particular bet, any old thing could happen. You could conceivably lose 15 times in a row and it wouldn't be out of the ordinary.

With your trading and investing, how do you know what the probabilities are? You need to keep similar records and/or undertake comprehensive historical research in order to know your own odds and probabilities. You have certain entry criteria for putting on positions – which setups work and how often? How much do you make versus how much do you lose? And what exit criteria work best for positions, and when? From this huge mass of data, you should be able to work out a few of the most important statistics, like what works, how much it makes when it works, and how frequently it works.

The point of gathering this data is to face what the data is telling you about your trading. Once you have all of the data accumulated, then you can start to draw conclusions about your aggregate results. While you may remember one particular trade that worked really well, once you see all of the data, you may conclude that that whole strategy doesn't actually work well.

Probabilities and statistics assert themselves over long periods of time and large quantities of data. Thus, you need large sample sizes and a host of data to figure out what works. The more data and time, then the more you can discount the role of luck and attribute results just to skill.

Outcome Bias

Take the example of a mutual fund manager who puts a disproportionately large percentage of his fund into one stock and massively outperforms the index in a single year. That could be attributable to luck, because he made a reckless bet which just happened to work out; or it could be to skill, because his methodology suggested that the stock was poised to outperform and he had the foresight to bet heavily on it. You can't tell if this manager is really skilled based on one year, as it's too small of a sample size.

Most often, people fall prey to "outcome bias", where they make a judgment based on the most recent outcome, no matter what the inputs were into the process. The fund manager in question could be a terrible manager and have done the investing equivalent of "betting it all on black" – but his big bet got results in the short term, so people fawn over him and call him a genius.

The way to tell if he is actually a genius is to look at a decade of performance, looking at his performance overall and at how his over weights do relative to the benchmark – measuring both frequency of outperformance and the magnitude of outperformance. This kind of sustained and consistent outperformance would demonstrate a strong process that is able to identify outperforming stocks and to take large positions in them. If the manager is lucky, then you would see a couple of spectacularly good years, but the overall trend would be one of underperformance and the lack of a demonstrable advantage in the markets.

The Process Is Key

What do you do in the absence of a long series of results—how do you evaluate yourself or another manager? As Michael Mauboussin puts it in his white paper on skill versus luck, "Where there is luck, focus on the process". If luck is involved, then you can't control luck and any particular outcome will be somewhat random. Instead, focus as much on understanding and improving the process. This is why we maintain that trading is all about decision-making and that you need to concentrate on making the best risk/reward decisions possible. Make sure you have a robust process; make sure that there is a solid foundation for why it would work; have either your own results or historical research demonstrating that it works and what kind of statistics it produces.

Ultimately, the way to mitigate the role of luck is keep working on your decision-making skills. There are several ways that you can build on an existing process to make it even stronger:

1. Devise a checklist, where you lay out specific criteria that need to be met before getting into and out of a position. This will help discipline you and prevent you from "shooting from the hip".
2. Learn the difference between "good trades" and "winning trades". A winning trade is one where you make money, even if the research and decision-making were haphazard. A good one is where you stuck to your process and put on a position that was consistent with it, no matter what the outcome is on that particular trade. Focus on making good trades and the outcome will take care of itself.
3. Sharpen up your risk management. By being vigilant in getting out of losing positions, you can't lose a crippling amount of money if you are just unlucky. «