



Losing to Win

By Matt Blackman

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The hardest but also most important lesson to learn in trading is how to handle losses gracefully. Most traders will inevitably encounter a string of losses at some point, so those who can't lose without being thrown off their game won't survive the market. The traders who have realistic win/loss expectations and a trading system they trust have the best chance of prevailing over tough market conditions. Here we look at what kind of losses traders can expect and how they can adjust their focus and strategy to deal with these losses.

Losing Battles...

Every trader worth his or her salt knows that trading against the [trend](#) is not a good idea. So it seems logical that the best trading systems would be those that follow the trend: when the trend is going up, take [long](#) trades only, and when it's going down, it's time to go [short](#). That being said, you'd think that trend-following systems would have the best win/loss ratios, right?

In his new book, [A Short Course in Technical Trading](#), Perry Kaufman offers some sobering statistics on the matter. According to this veteran program-trading expert and author, "[y]ou can expect 6 or 7 out of 10 trend trades to be losses, some small some a little larger." And yet, Kaufman says that trend-following systems are some of the best trading systems around. In other words, trend-following systems won't yield huge profits, but they'll still do better than most systems.

It will probably come as a shock to those who have spent countless hours searching for a winning system, but Kaufman makes it absolutely clear in his book that having realistic win/loss expectations means expecting losses--lots of them. He states, "As a trend trader, you should expect mostly small losses, some small profits, and a few large profits."

If it gets across this point alone, *A Short Course* is a worthwhile addition to your library. Kaufman provides an example to demonstrate a phenomenon traders in the game for the long haul have come to learn the hard way:

[I]n a normal distribution of 1,000 coin tosses, half of them would be single runs of heads or tails. Half of those, 25 percent, would be a sequence of either two heads or two tails. Half of the remaining, 12.5 percent, would be sequences of three in a row, and so on. Therefore, in 1,000 coin tosses, you can expect only one run of 10 heads or tails in a row.

In other words, in 1,000 trading days--or about four years--a trader could expect to experience 10 wins (or losses) in a row only once, that is, if trading were as random (normally distributed) as a series of coin tosses, which it is not.

So, your odds of winning with trend-following systems are better than your odds of winning a series of random coin tosses, but there are other challenges

to having more winning than losing trades. Although markets are not random, you can still expect short-term random movements within a trend, major reversals at the end of each trend, and the time lag most trend-following systems experience when getting into and out of the market.

As a result, thanks to lags and unexpected short-term random movements, you are still subject to the effects of randomness. Given enough time, an experienced trader can expect to suffer 10 or more losses in a row. It is not a matter of if, but when.

When asked about realistic trading expectations, Thomas Stridsman, author of [Trading Systems that Work](#) and [Trading Systems and Money Management](#), had this to say:

What is more important than how large your winning trade is when you win, or how many winners or losers you might have in a row. It is the mathematical expectancy of your strategy. That is, how much are you likely to win on average on all trades, winners and losers combined, and how much this value is likely to fluctuate in the short term.

For an even further increase of peace of mind, you also probably are better off looking at profitable time periods, such as weeks or months, rather than profitable trades. Simply looking at a win/loss ratio is not enough.

If you think that doing either more or fewer trades would be a more successful strategy, think again. Kaufman demonstrates in *Short Course* that the more trades the trader performs, the lower his or her profits over the long haul. On average, longer-term trades generate more eventual profits. However, if you're a long-term trader, your risk of getting one or more big losses is increased, since you are in the markets longer and therefore exposed to risk for more prolonged periods. Bottom line, no matter what your trading style or preferred time in a trade, you will lose and lose big on more than one occasion.

Kaufman has the data to back up his claims. He has performed thousands of tests on various systems, and some of these are presented in *Short Course*. In one example, he tested Microsoft for 10 years ending January 2001 and covering a period when the stock moved from a pre-split price of \$1.04 to a high of \$60 in December 1999. It should be pretty easy to beat the odds following that kind of trend, right?

Using an 80-day [moving average](#) during the period to generate buys and sells the system, trading both long and short positions, generated a total of 88 trades. Of these, only 36 trades--or 41%--were profitable. And Kaufman comments in the book that "[t]hat's actually good for a trend system, which often has closer to 35 percent good trades."

These depressing stats are echoed by John Murphy in his book, [Technical Analysis of the Financial Markets](#). Murphy says that professional traders, on average, experience losing trades about 60% of the time. In other words, they win only about 40% of the trades they enter. Given the grim facts, rookie traders may wonder how it's possible to make money in the markets. All of this begs the question: how can a system that has more losing than winning trades be profitable?

...While Winning the War

Let's look at an example of a system that does very well in a relatively short

period, but falters over time. A while ago, I ran a number of tests to determine if using commercial commodity traders' net positions--published each week by the Commodity Futures Trading Commission (CFTC) in the "Commitment of Traders" (COT) reports--was useful in trading an index. Tests were performed for the period of 1999 through 2003 using the [S&P 500 Index futures](#) and results were impressive.

Using a five- and 22-week simple moving average of commercial traders' positions, buying each time the five-period SMA crossed above the 22-period SMA and selling when it crossed below, the strategy earned 804 points. Contrast this to a loss of 245 points for a [buy-and-hold strategy](#) during the four-and-a-half-year period between February 12, 1999, and October 3, 2003. If we assume the trader traded one S&P 500 e-mini contract with a [margin](#) (risk) of \$1,800, the profit would have been more than \$40,000 after commissions. Out of a total of 12 trades, seven were profitable--that's a win/loss ratio of 58%.

The same tests were performed for the 13-year period from February 16, 1990, through October 31, 2003. Results were far less impressive. The system returned a total of 555 points, whereas a buy and hold over the same period returned 696 points. Our win/loss ratio also dropped: only 26 out of 55 trades were profitable, giving a ratio of 47%. Not only was the system not nearly as impressive over the longer period, but it was also significantly outperformed by a simple buy-and-hold strategy.

The moral of the story? Whenever you see claims that systems generate outstanding returns over short periods, remember that such statistics are worthless without looking at the bigger picture. Even worse, these claims often create unrealistic expectations in the mind of the new trader who takes them at face value.

Stridsman explains how to compare a trading system to a buy-and-hold strategy:

The trick here is to analyze the system for its effective time spent in the market. For example, if a system is in the market only 50 percent of the time, you can put on twice as many contracts each time the system enters into a trade, as compared to what you would have in a buy-and-hold situation over the entire period to achieve the same amount of contract hours spent in the market. Looked at this way, in the 50 percent case the profits made per contract traded should be at least half that of the constant-contract, buy-and-hold strategy. Proper money management also allows you to increase the number of contracts traded as your equity grows, whereas a buy-and-hold strategy doesn't give you the same flexibility.

When you approach trading with the assumption that there will be more losing than winning trades, your primary focus shifts dramatically. Instead of spending inordinate amounts of time buying, testing and discarding systems that fail to meet your unrealistic expectations of 70 to 80% (or more) wins to losses, you can concentrate your efforts in the more important but far less sexy area of money management. (For more on money management, take a look at [this tutorial](#) on the subject.)

On average, traders spend at least 10 times more time and effort on seeking the magic formula for trading than on learning to manage the trade. This is obvious if you compare the number of trading signal systems available to the

number of money management systems available. The same is true for best-selling trading books. When was the last time you saw a best-seller that concentrated on money management? This may explain why so few traders actually graduate to the point of being consistent in the trading game.

Conclusion

Since a large number of professional traders experience more losing than winning trades, learning how to lose is essential to making it as a trader. Furthermore, an effective money management program is absolutely necessary to a trader's survival and long-term profitability. A key part of any money management program is having an effective trading plan and sticking to it. (For more on constructing a trading plan, see the article "[Ten Steps to Building a Winning Trading Plan](#).")

Consider what veteran trader and market teacher Larry Williams said in a recent e-mail: "Since losses are an integral part of this game, a strategy is as essential as the proper attitude. All jobs have good days and bad days so deal with it. There are no 100% certain trades."

Looking for a system that will win 80% of the time or more is a fool's game. Those who adopt a hope-for-the-best-but-plan-for-the-worst mentality and concentrate their efforts on far more important issues will set themselves up for long-term success. It is the difference between taking a short-term view to win a few battles at any cost and marshalling resources in the battles you lose to ultimately win the war.

If you're serious about getting a handle on this topic, check out the books by Kaufman discussed in this article. You will also find Thomas Stridsman's book, [Trading Systems and Money Management](#), a worthwhile read for its detailed discussion of win/loss ratios, realistic expectations for various trading systems, and money management strategies. Consider it a reading assignment with potentially big dividends!

Cheers,

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