Why Your Algorithm Will Fail

Reason 1: Psychology

"I know that I know nothing."
- Socrates

Remember when you first started trading? You probably heard about someone making a ton of money sitting in front of their computer, living the dream…

So you tried it. And you won -

<u>Without knowing a thing about trading.</u>

Then you thought to yourself: **"This trading thing is a piece of cake. I'm going to be the next Warren Buffett!"** -

Then you lose. No big deal, right? Then you lose again -

And again. Now, you start panicking.

You start doubling, tripling, and quadrupling your position sizes -

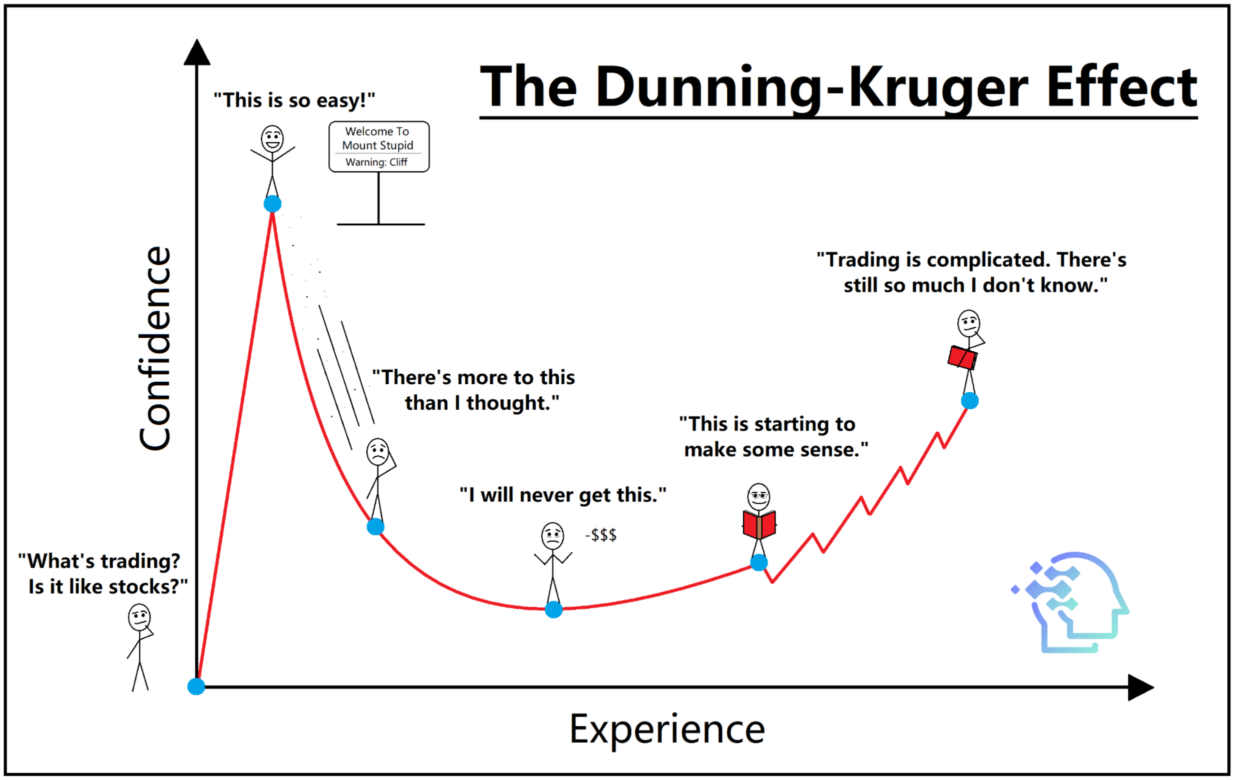
And blow your trading account.

Then you tear your hair out, punch a hole in the wall, and your wife leaves you for the real Warren Buffett.

What happened here?

This would be your first of many experiences with trading psychology - a concept you probably weren't even aware of.

Psychology is a double-edged sword. To make it work for you, you need to be aware of when it works against you. This is best described by a phenomenon known as the **Dunning-Kruger Effect:**



The Dunning-Kruger effect is a cognitive bias that causes people to overestimate their knowledge or ability, particularly in areas with which they have little to no experience. If you follow along the chart, you will likely recognize yourself at a particular stage of development, or a stage you have experienced before. Notice the initial boost in confidence. Yours may have been caused by your first string of wins, or by finding some convincing YouTube trading system. At that point, you knew *everything*, right? Now, remember that first drop you experienced?

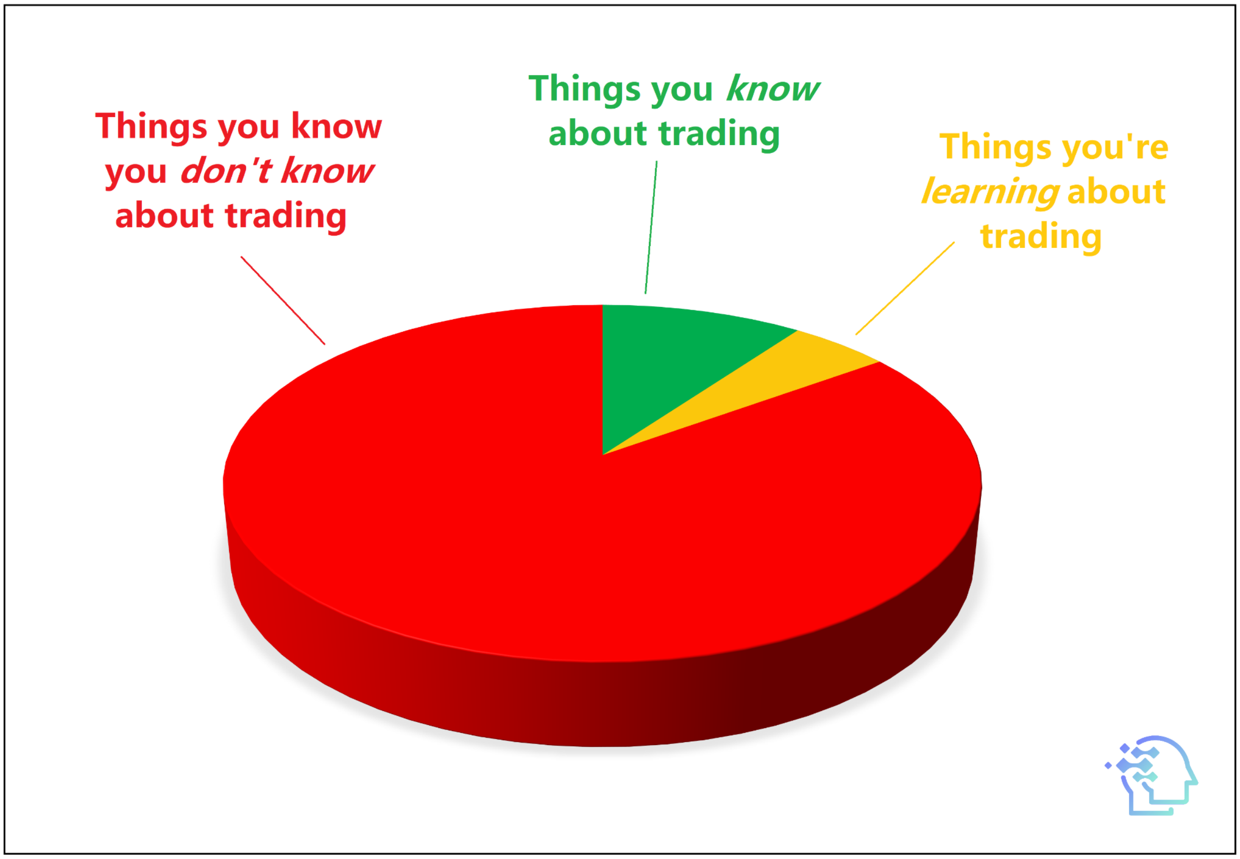
It was probably caused by a string of losses, systemic failure, or by blowing out a trading account - maybe several. We need to **avoid** this. A bad Dunning-Kruger episode feels like getting hit in the head with a sledgehammer, yet episodes themselves are **inevitable**. So how do we control the severity of your next Dunning-Kruger episode? First, we must understand how Dunning-Kruger works.

Notice that the Dunning-Kruger effect kind of moves like price on a chart. The x-axis represents your experience, and the y-axis represents your confidence. When you learn something new, your confidence rises. When something unexpected happens, your confidence drops. If any **drop** in confidence is too steep, you can be traumatized and **quit trading altogether**. If any **rise** in confidence is too steep, this indicates a **severe** Dunning-Kruger episode may be coming. Beware of your blind spots.

Here's the silver lining: if we seek to both cause these drops and increase their frequency, their severity can be reduced. When done in small, bite-sized chunks, this can actually have a net **positive** effect, as demonstrated by the curve.

In trading (and all other professions), your knowledge acts as a bottleneck for your potential. Using simple pie charts, we can visualize just how imperative it is to expand this bottleneck. If you were to distribute your knowledge onto a chart, you might have two categories - **things you *know* about trading, and things you know you *don't know* about trading.**

However, there is another category of knowledge you should be aware of, and it may just may be the most important, because it's your **only** hedge against your current limitations - **things you're *learning* about trading:**



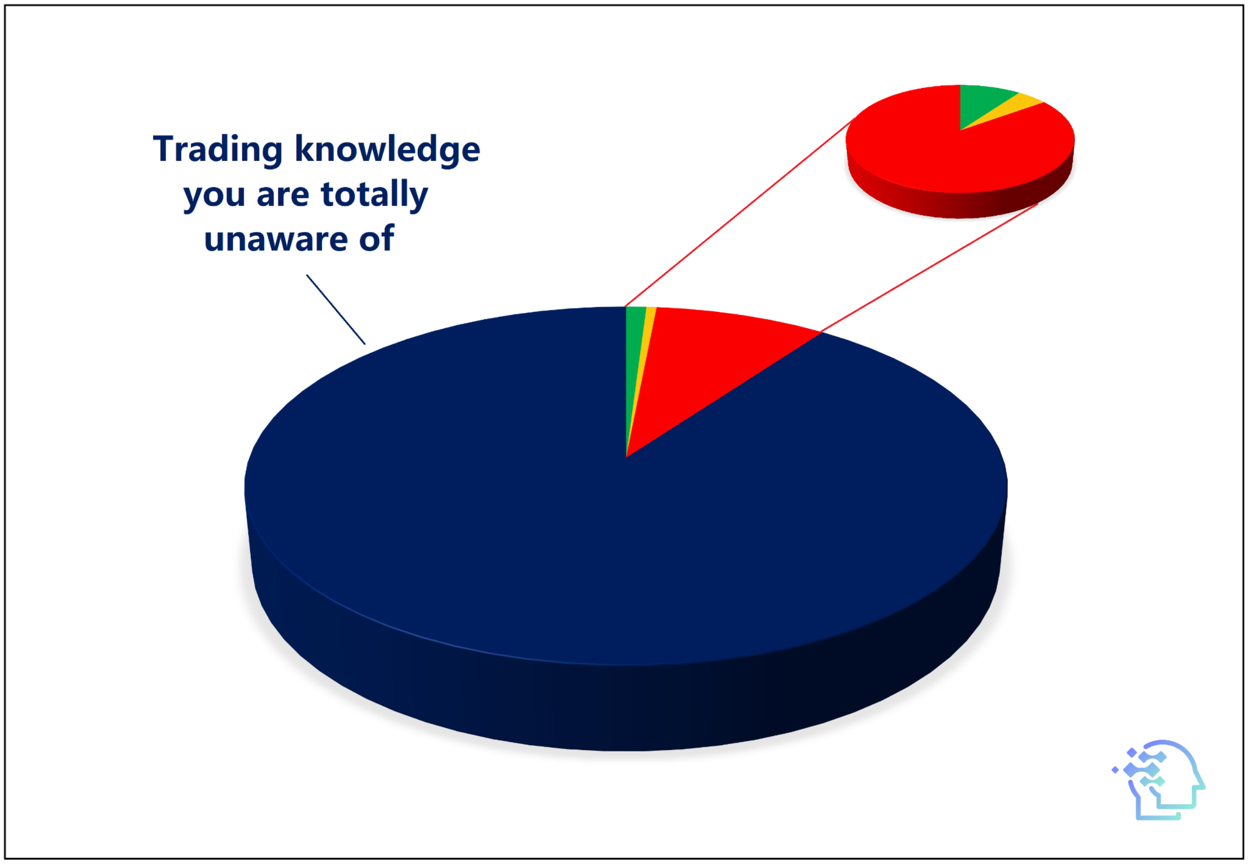
We have already learned that you cannot sustain the same level of knowledge and expect to be the best trader you can be. In order to maximize your potential as a trader, you need to continually expand your horizons. That is, unless you know everything -

Which you don't. Nobody does.

When you stop learning, or simply confine your ideological boundaries to a specific trading system, **it is simply a matter of time before your stagnation becomes degradation.** In trading, edges diminish as markets evolve. Therefore, you must evolve your trading to sustain your edge. This trading evolution depends entirely on how far you can stay ahead of the curve. Such is the nature of the beast.

In fact, there is yet another category of knowledge that illustrates just how much there is to discover about trading. This category is less quantifiable on an individual level, but should serve as a continual reminder that there is so much more to this profession than one might expect -

Trading knowledge you are totally unaware of:



If you think your current level of trading knowledge is all you need, you’re in for a **very** rude Dunning-Kruger episode, one way or another. It’s just a matter of time. My mission is to reduce the severity of your next one, ***when*** **it happens**. This leads me to the second article in this series - the next slice in your knowledge pie. It is a sinister concept that the world of retail YouTube trading does not popularize, and one that you may not even be aware of: **overfitting**.