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High Water and House Money

am FX

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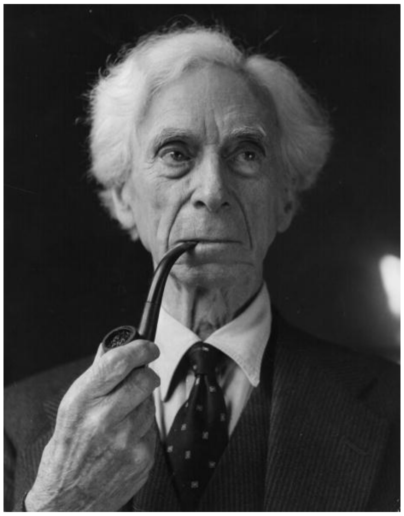


Bertrand Russell

Current Views

17JUN 157/154 GBPJPY put spread

Cost around 37bps
Spot ref. 160.20

There are a number of PMs and spot traders in my network who are making money and outperforming their budget/goals right now. This brings up an interesting problem which is fun to have, but tricky to handle. The issue with rapid jumps to high water is that **overearning leads to overconfidence.** The urge to increase risk on a hot streak is strong and sometimes logical. But also dangerous.

In my trading, I tend to have more of a performance issue around euphoria than frustration. When I am frustrated, I tighten up and wait for outstanding opportunities and that makes me better, not worse. On the other hand, when I am doing very well, I sometimes increase my risk more than is justified by the set of market opportunities. This is the "house money" effect.

Rarely will I see my P&L crash after a moderate or bad trading period. My biggest drawdowns almost always come after a sustained period of overearning. I get overconfident. Cartoon dollar signs flash in my eyes. I double a position that is deep in the money when I should be taking profit. For me, trading well seems to lead to more good trading up until a point and then eventually I hit a point of overconfidence/sloppy trading which sometimes leads to a big drawdown.

This phenomenon is also called "Winner's Tilt" and I discussed it in a March 2022 note. You can read the full note here on Epsilon Theory. *Tilt* is usually a condition associated with traders or poker players that are losing or on a run of bad luck. They go on "tilt" which means they start chasing with bad cards in bad situations because their minds are flooded or they are seeing red.

In contrast, Winner's Tilt is another way of describing the house money effect: temporary madness brought on by a series of winning trades or winning days. I can usually feel this coming on as I feel a bit giddy when it's happening and might even find myself singing or joking around more than usual on the desk.

Be aware of your own emotions at all times and watch for the house money effect in your trading. Do you trade strong when you are up money? Or do you trade overaggressive and sloppy? If you are singing on the desk or yelling with excitement or pumping your fist… Achtung! You are about to get punched in the mouth.

Rational bettors evaluate current odds and do not factor in prior outcomes.

A P&L preservation strategy that works

Here's a simple approach you can use for P&L preservation. After you go on a great run and you are feeling euphoric, do the thing you least want to do: Square up. Then, pick a level of P&L to defend.

For example, your budget is $10m and you're up $8m in May. This is a situation where many traders will go pedal to the metal and then: *Whoops, I'm only up $5m now*.

Then, instead of focusing on market opportunities, they are focused on that old high-water mark of $8m and how good it felt to be up there. *If I can just get back to $8m, then I'll chill.*

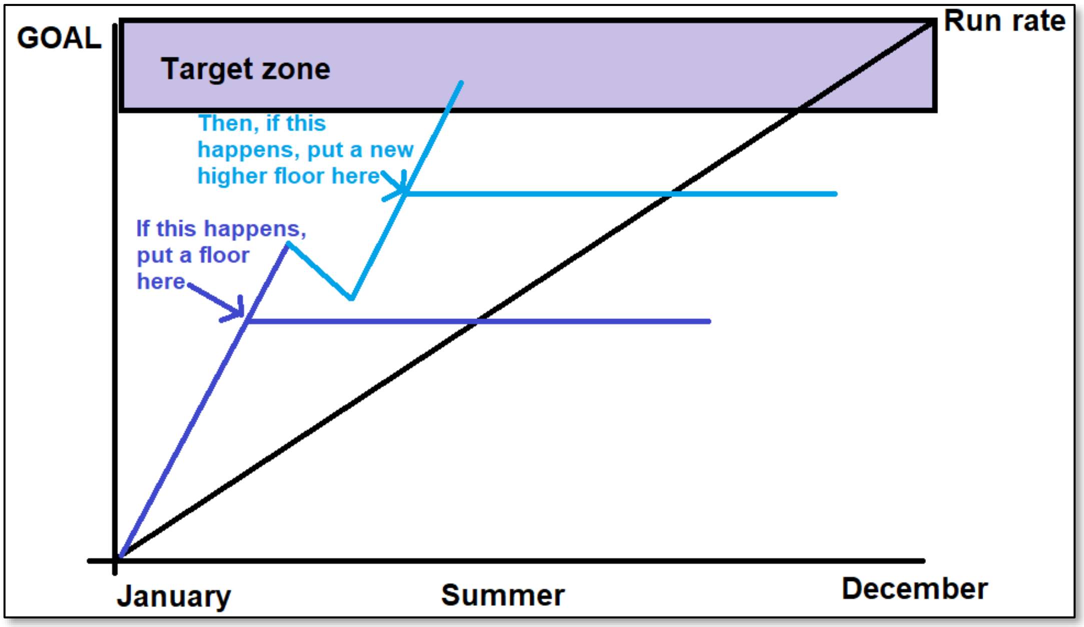
They keep pushing, and then suddenly they're up $3.2m and getting questions and emails from the boss. At that point, $3.2m feels really bad and the trader isn't quite sure what to do. Keep trading aggressively (*what if I end up back at flat!*)? Reduce risk (*then I'll never get back to $8m!*)?

The better answer is to never put yourself in that position in the first place. You need to make the decision and the plan when you are at high water and in the strongest mental position. But first, you need to square up.

Then, you set a level at which you will dramatically reduce risk. In my example, that might be $6m. That gives you some flexibility but puts a fairly tight floor under the P&L. If you draw down to $6m, you declare the big run is over and you start small again, working to stay above $6m while pushing back towards $8m. Then, if you break through to (say) $11m... Move the floor up to $8m.

Here is a diagram:

If you are overearning, put in a floor and treat it like a stop loss



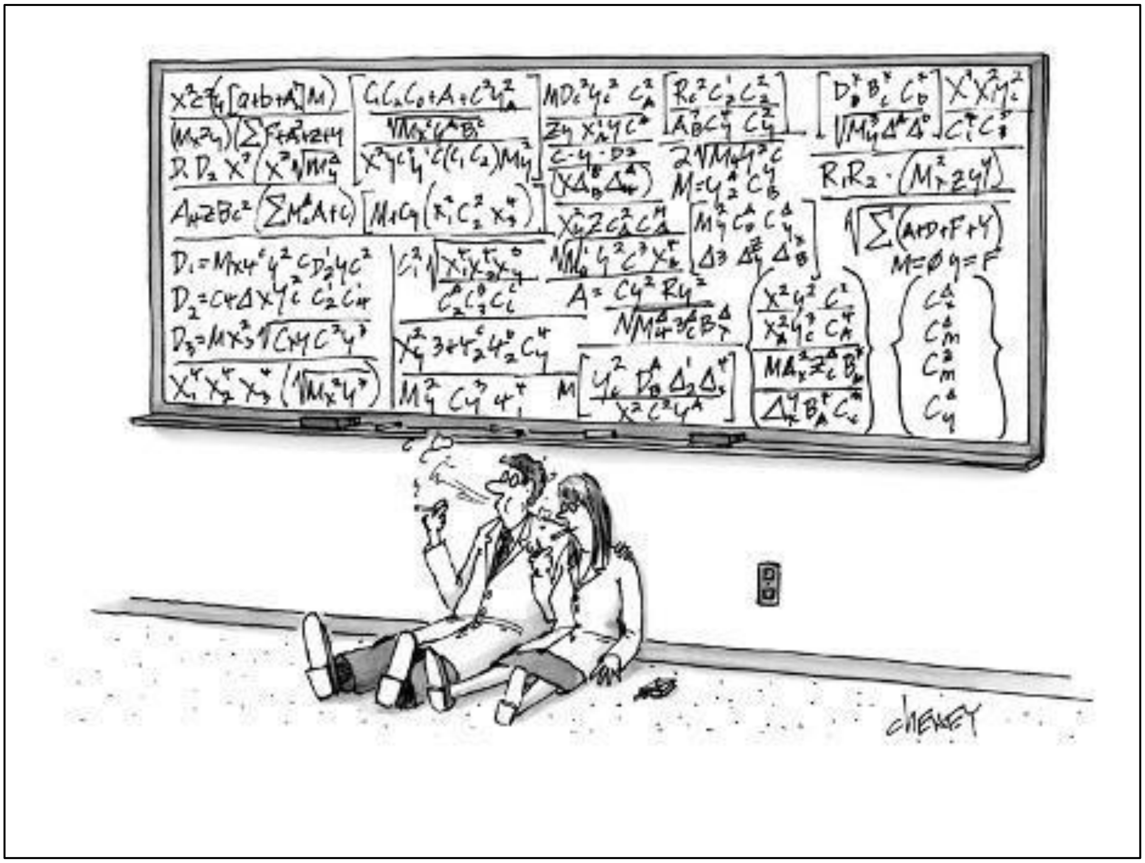
If you're a really good planner and you have been trading long enough to form reasonably accurate expectations for how your year might look, you can even create these steps before the start of the year in January. But the steps need to be related to **slope of P&L**, not level. That is, reaching your goal on April 4th is completely different from getting there on December 19th. If you get there April 4th, you are massively overearning and the risk of mean reversion is high. But you are also in a strong position to go for it and have a career year…

You don't want to ring the register and sit on your hands for the rest of the year. You want to mentally lock in some portion of your gains and if you give back to the point where you are approaching the lock-in level, you cut risk as if you were approaching a stop loss. Keep the ceiling unlimited, but keep raising the floor.

The longer you trade, the more you will recognize a) signs of euphoria and overconfidence in your self and b) the approximate slope of your P&L when you are overearning. Take action and **make a plan at high water**, not after a huge drawdown.

Have a mathematical weekend.

good luck ⇅ be nimble



Source: [New Yorker Magazine]

Have a happy Friday

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