SPECTRA MARKETS

Friday, May 06, 2022

The most important trading decision

2,900 words, 12-minute read

Today's am/FX is a cross-over with my educational Substack, 50 Trades in 50 Weeks. You can listen to it on the web here, Spotify here, or Apple podcasts here.

The biggest trading decisions of my life were when I had to decide whether or not to leave a trading job where I was no longer fully happy. You spend so much of your time working; ideally you want to choose a job that is intellectually satisfying and where your day-to-day experience of coming into work is mostly positive. A perfect job is an unrealistic goal, of course, and we don't always have a choice of jobs. But when there is a choice, here's how I think about it.

Trading is hard. Your odds of success are heavily influenced by the seat you choose. I have worked as a retail trader, and for a variety of Wall Street institutions over the years. My decision to switch jobs was usually driven by a failure on one or more of the metrics I describe below. Here are common features of the best places to work as a trader.

- Healthy trading environment (this is the big one; I go into detail below)
- The company or division you work for targets revenue growth more than cost cuts. It's much more enjoyable to work for a company that is trying to grow, not one that is trying to cut. And you'll get paid better.
- Your manager believes in you and gives you enough runway to screw up now and then. You will screw up at some point and the tone and content of the interactions between you and the firm at that point are critical.
- No micromanaging. A great trading manager who trusts his peeps checks the P&L once a week, not four times / day.
- Passionate peers and a mentor who all love trading as much as you do.
- Filled with people that are hungry, smart, and humble.

Nothing matters more than a healthy trading environment, so let me go into detail on that. Most of the section below borrows heavily from my book, Alpha Trader.

Healthy trading environment

You cannot succeed in an unhealthy trading environment. You must have a risk-taking environment that is not hostile to risk and is not thinly capitalized. In the wrong environment, even the most rational, disciplined, skilled and self-aware trader will fail. There are many features of a trading environment that can be desirable but there are two that are absolutely necessary for survival and success:

1. Appropriate capital
2. Healthy and supportive risk-taking environment.

Let's look at each one separately.

Appropriate capital

In terms of external factors, sufficient capital is an absolute prerequisite for successful trading. Let's look at what this means for the three main types of trader.

am/FX

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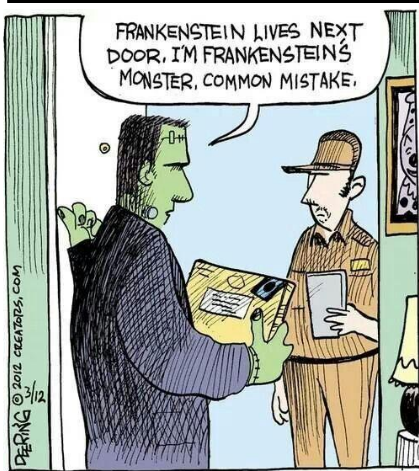


Happy Friday

Current Views

Flat

USDSEK was stopped out yesterday.

Retail traders
No retail trader can succeed with a $1,000 trading account because the income generated from the most successful strategy will be too small to move the needle. Even a 300% return will not be enough to make a difference and so the trader is very likely to employ too much leverage and blow up the account via gambling.

A tiny trading account is OK for learning the markets and much better than paper trading. It might give you a sense of the emotional and psychological hurdles that come with live trading, but it will never give you a chance to learn what kind of trader you are.

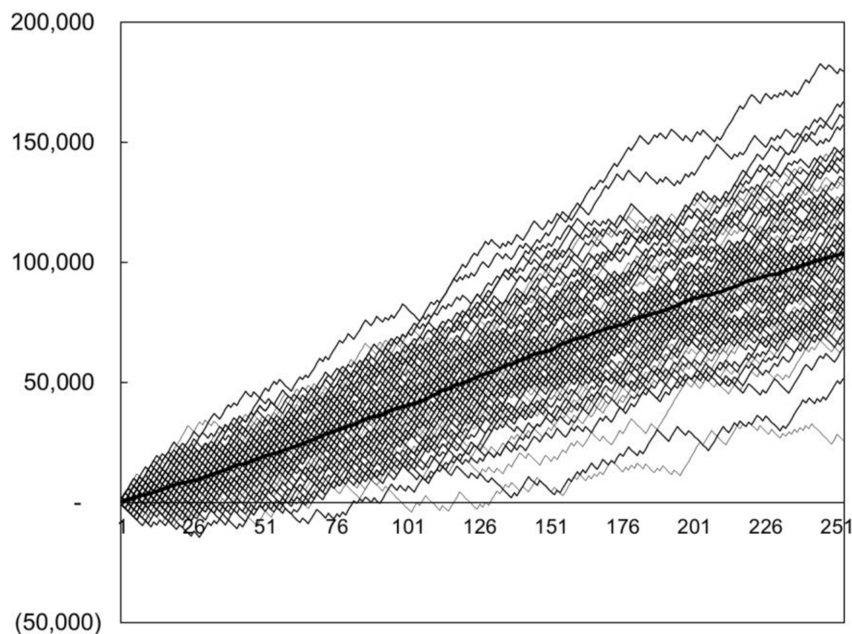
In general, position sizing can account for most issues around insufficient capital. If your capital is small, you need to take smaller positions. But there are thresholds below which you cannot hope to succeed. For a young retail trader with no family to support and low expenses, this amount could be as low as $25,000. For a dentist with three kids in private school looking to quit his job and trade full time, this number would be significantly higher.

Bank traders
If you work in a bank, you don't have a fixed amount of capital. Instead, you have risk limits. As such, your risk limits need to be properly aligned with your performance expectations or budget. If you have a $30,000 daily stop loss and a budget of $10,000,000, you will fail. It's impossible to make ten million dollars in a year with such a tight daily stop.

The easiest way to determine whether your risk limits are appropriate in a bank is to run simulations. You can set up simple simulations in a spreadsheet to look at a 252-day period[1] and spit out ranges of outcomes based on various inputs. Retail traders can do this as well to determine risk of ruin. The greater idea you have of your prior performance statistics, the more accurate the simulation will be. Here are two examples.

The first simulation approximates the performance of a retail trader. She makes money 50% of days and loses money 50% of days. Her average winning day (net P&L) is +$2,000 and her average losing day is minus $1,200. Based on these figures, she will expect to make $100,800 in an average year. Here is her cumulative YTD P&L simulated 100 times.

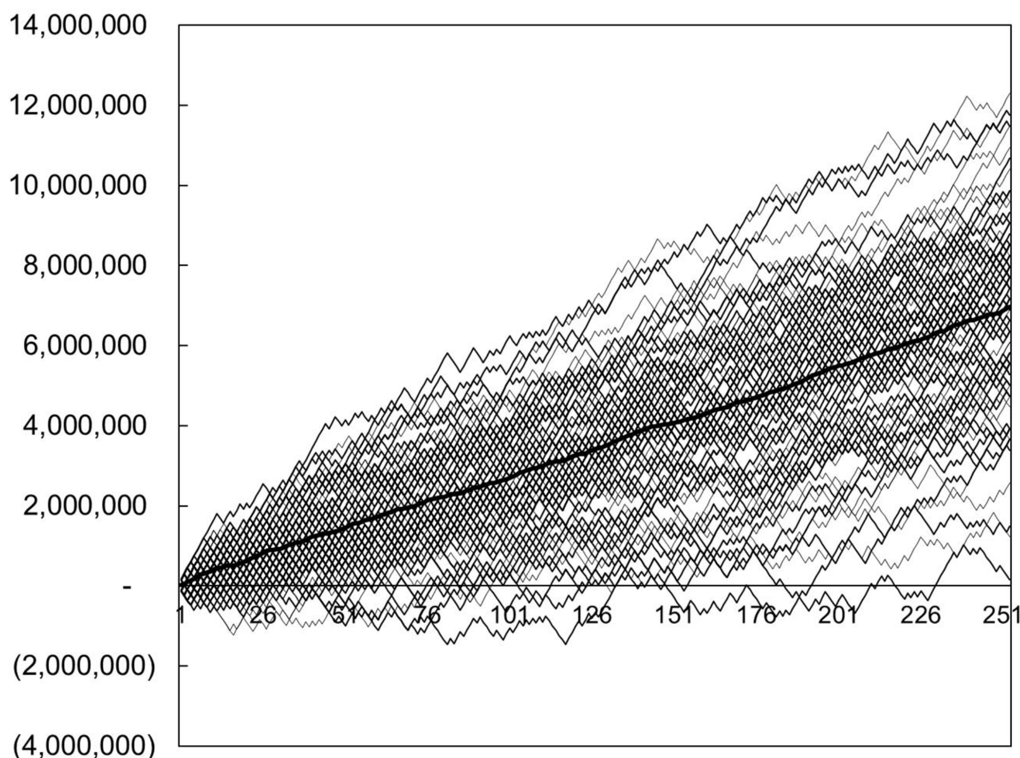
Variance simulation for a retail trader



The same trader using the same strategy in a world with the same probabilities might make $50,000 one year and $150,000 the next, with variance—and literally nothing else—to blame.

[1] There are 252 trading days in a year, on average.

The second simulation represents a bank trader. He makes money 55% of days and loses money 45% of days. His average winning day (net P&L) is +$150,000 and his average losing day is minus $120,000. Based on these figures, his expected value is +$7.2 million. But here is how he fares in 100 simulations:



You can see that despite employing a process with substantial edge and positive EV, a trader's annual performance is all over the place simply due to variance. This is a big reason why it is so *flipping* difficult for management to properly assess traders and for traders to evaluate themselves. It's easy to be fooled by randomness!

Portfolio managers

Capital or assets under management is a critical variable for every hedge fund and real money portfolio manager (PM). Good PMs can scale their strategy substantially and tend to think of performance in terms of basis points, not dollars. Good PMs comfortably scale their risk up or down as necessary based on the capital they are managing. On the other hand, PMs that think about P&L in terms of dollars tend to have trouble sizing up (or sizing down) because they are anchored on various P&L thresholds. If you think of a good day as $1 million of P&L, you won't adjust very smoothly as your capital increases from $100 million to $1 billion. On the other hand, if you think of a good day as 100 basis points, you will.

Note that it is possible to have too much capital. In fact, a common issue with hedge fund portfolio managers is that they have *too much* capital, not too little. Many traders at hedge funds are pressured to take on more and more capital, regardless of the capacity of their trading strategy. And it takes a trader with courageous integrity to say "no" to more capital. It is a bit like refusing a promotion—quite often it could be the right decision, but it can feel strange and potentially risky to do so.

Every trader and every trading strategy has an optimal level of capital. The more capital you take on, the worse your returns will be after a certain point, because your best strategies will reach capacity and additional capital will need to be allocated to inferior strategies. If you are a PM at a hedge fund, you should target your optimal level of capital, not just look to increase your capital year after year.

Capacity depends to a great extent on the products you trade. A boutique institutional trader specializing in microcap stocks will have much lower capacity than a hedge fund PM trading G10 currencies. Capacity is mostly determined by liquidity.

Research shows there is a sweet spot for hedge fund size in the $250 million to $1 billion assets-under-management range. Below $250m, costs are hard to cover and above $1 billion, returns and Sharpe ratios fall[2]. This is logically true for individual managers as well. This does not mean all increases in capital are bad. You need to think about what your optimal capitalization level looks like and aim for that, not higher. As your capital rises to higher than optimal levels, the opportunity set is diluted, and transaction costs increase disproportionately. The high-alpha opportunities are slowly drowned out by inferior trades.

A healthy risk-taking environment

A healthy environment breeds successful risk takers. Even the best trader is unlikely to succeed in a toxic environment. A healthy risk-taking environment means different things for different types of traders.

Retail traders
For people trading their own money, a healthy environment means enough runway to learn, make mistakes, bounce back and eventually prosper. Capital is crucial, as mentioned in the last section, but so is support from family, financial flexibility, and the ability to focus and get in the zone all day.

If you want to be a trader, but your wife wants you to get a "real" job and you have twins screaming from the other room and no money to pay rent next month… You should come back when you have a more conducive environment. Trading is hard enough; anything that makes it harder usually makes it impossible.

You own your life, so if you want to be a trader, do it. But pick the right time and circumstances to do it so that you give yourself a proper shot at success. There is nothing worse than wondering what could have been. Quite often, you can work full time and find ways to trade on the side (and more importantly, study trading) so that as you gain experience and confidence in trading you are still earning a steady income. Then, once you have a decent amount of money in the bank, you have a bit of runway to trade full time and see if you have what it takes.

Bank traders
You would think that most or all bank traders would operate in a healthy risk-taking environment, but this is absolutely not the case. Banks have different levels of risk appetite and managers within those banks can have dramatically different incentives.

Let's say you trade 10-year bonds at a large commercial bank. Imagine two environments:

1. The manager that hired you and mentored you got a job offer at an investment bank and just left under somewhat acrimonious circumstances. Instead of replacing the head of trading, the bank has given the current head of sales responsibility for your group. He never liked your old boss, he has never traded before, and he plans to retire in a few years. He just wants to survive the last few years of his career and pay for his kid's last few years of college. He is extremely risk averse. He views the business model as an agency where clients do trades, the bank goes to market and offloads the risk, and the bank earns a small, nearly risk-free commission.

Or…

2. Your manager is fired up and entrepreneurial and previously ran global macro at a big hedge fund. He wants that kind of ambitious risk culture at your bank because he believes a strong, healthy risk culture best serves the clients of the bank. By employing meaningful risk appetite, the bank can provide best-in-class pricing to clients, world class trade ideas and expert market intelligence. Customers get superior service from the bank and the bank makes more money than the competition in the process. Win/win.

[2] See for example: https://www.aurum.com/insight/elephant-in-the-room-size-and-hedge-fund-performance/ and https://docs.preqin.com/newsletters/hf/Preqin_HFSL_Mar_14_Fund_Size_Performance.pdf

It is obvious which trader is going to have a greater chance of success and most enjoy coming to work each day. If you work at a bank, you should regularly evaluate your environment and study where your incentives are aligned with the bank's and where they are not. To succeed, you need clear risk limits and rules of engagement so that no one is ever second-guessing your actions, and you don't have to second guess them yourself.

Portfolio managers

Portfolio managers are most likely to work in a healthy risk-taking environment. Since hedge funds and asset managers are often exclusively in the business of taking risk, they best understand the nature of risk and they are usually good at creating a clear set of rules and then letting traders trade.

Still, it's important to understand where your incentives align with those of the firm and where they do not, so that you don't misfire. The most important example of this is that many hedge fund risk managers focus as much or more on volatility of returns than on absolute returns. This is because the risk manager at a pod-based hedge fund sees each trader as part of a portfolio.

If the returns of each PM look approximately like those of a call option (small downside with unlimited upside), then the aggregate performance of all those traders at the end of the year is likely to look pretty good. If, on the other hand, most traders are targeting 6% volatility while two or three are realizing 25% volatility, the business model does not work as well.

While you are paid a percentage of your absolute returns, quite often your manager is almost as concerned about your volatility as she is about the headline returns number. This makes perfect sense, especially as risk managers are constantly trying to separate luck from skill. A trader that makes money consistently with low volatility is much more likely to be displaying skill than a PM that puts up three years like: +70%, -24%, + 35%. Furthermore, the risk of ruin of a *Steady Eddie* is significantly lower than the PM I just mentioned, and nobody wants to be the one managing a trader when he blows up.

This is not an argument for you to target a specific level of volatility and forget about returns. All I am saying is that you should be acutely aware of your manager's (and your investors') incentives, not just your own.

A related phenomenon you will see at many hedge funds is that while your contract may have a stop loss, your real stop loss might be much tighter. Contractual risk limits are often wider than reality, depending on the personality of the business and risk managers involved. If you are new at a hedge fund, make sure you fully understand all the written and unwritten rules the fund follows. Your official stop loss might be -15%, but if every other trader that ever went down 9% at the fund got a shoulder tap, you should probably calibrate to a 9% stop loss (or tighter!)

Think about your manager's (and investors') incentives. Does your strategy and behavior align?

This advice applies to traders at every type of institution. When you understand the incentives of management, you can make sure you are playing by the correct rules and that you will not put yourself or your manager in an unwanted or awkward position. It's not just playing the game well, but also playing the correct game.

Other features of a healthy risk-taking environment:

Rule-based limits and risk-taking framework. The clearer the rules of engagement, the easier it is to develop a clear process and proper risk management. You don't want an environment where a loss is fine one day, but the same loss two weeks later results in a bunch of emails flying around asking what happened. Ask for clear, numerical limits and goals.

Peers. There are other good risk takers to talk with and bounce ideas off. Hopefully there is at least one trader that is more experienced and/or more skilled than you. Otherwise, you are always the mentor and never the mentee. For retail traders, I believe there is a huge benefit to working in a trading office, not at home. You learn from others, have people to share ideas with and share the pain with when things go wrong. A robust network of peers gives you a chance to talk about specific trades, general risk management and other trading-related topics.

Make a concerted effort to build a strong network of trading peers. This can be online or IRL. Learning takes longer if you have to figure everything out yourself.

Management risk appetite. Management understands that if you take real risk, you will lose money sometimes. It is common to hear bank traders joke about the "Take risk, but don't lose money" business model. This is a model that works well for management as it essentially means they can sleep well at night knowing that traders are monetizing client flow but not taking any meaningful risk. It is less attractive for individual traders because their leeway to express views is severely limited. The only time traders can take "risk" in this model is when they are already profitable (usually from a client trade). This model allows traders to risk money earned but not take real financial risk that may result in losses.

A mentor to teach you, support your risk taking and help you maintain confidence during the inevitable down times.

A clear connection between performance and pay. Risk appetite fizzles when traders don't expect to get paid for alpha they generate. Taking real risk requires significant mental effort and endurance and traders will not give their all to a business they do not believe will compensate them for doing so.

That's it for today! Thanks for reading. Happy birthday Dougie Witz. Have a green day.

good luck ⇅ be nimble

https://en.wikipedia.org/wiki/Frankenstein%27s_monster

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