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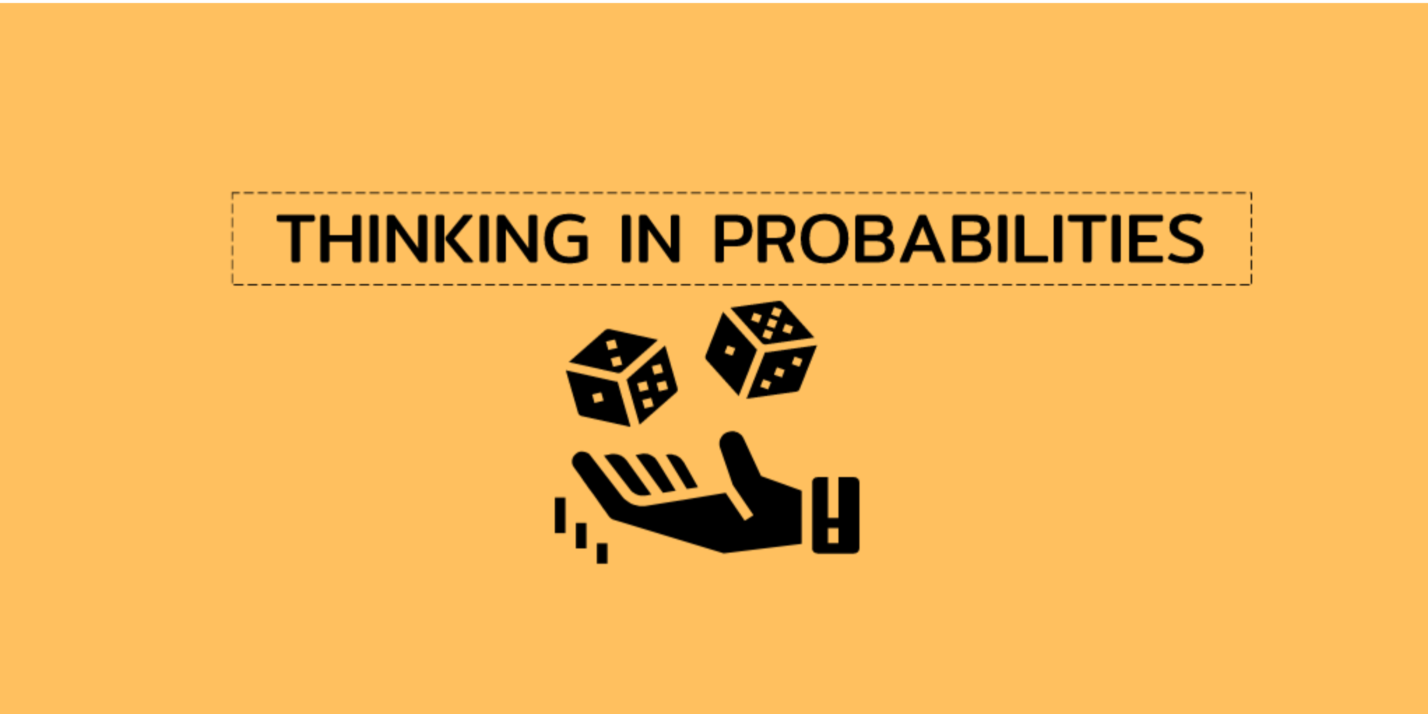
THE TRADER'S EDGE: THINKING IN PROBABILITIES

Casinos make consistent profits day after day and year after year, doing something random

At the same time, most traders believe that the outcome of the market's behavior is not random,yet can't produce consistent profits

Thread ■



What casino owners ,professional traders know is that probable outcomes can also produce consistent results if you " Have an edge" and trade on a large enough sample size.

The best traders treat trading like a numbers game.

1. To illustrate, let's look at the game of blackjack-

In blackjack, the casinos have approximately a 4.5-percent edge over the player.

This means that casinos will make profit over a large enough sample size, even after several winning streaks and big profits of many players.

At the end of the day, week, month, or year, the casino always ends up with approximately 4.5 percent of the total amount wagered.

That 4.5 percent might not sound like a lot, but let's put it in perspective.

Suppose a total of $100 million dollars is wagered collectively at all of a casino's blackjack tables over the course of a year. The casino will net $4.5 million.

What casino owners and pro traders understand about the nature of probabilities is that each individual hand played

is statistically independent of every other hand.

This means that each individual hand is a unique event, where the outcome is random.

If you focus on each hand individually, there will be a random, unpredictable distribution between winning and losing hands.

But on a collective basis, just the opposite is true.

If a large enough number of hands is played, patterns will emerge that produce a consistent, predictable, and statistically reliable outcome.

HOW TO THINK IN PROBABILITIES-

1. You have to believe in the uncertainty and unpredictability of each individual trade.

2. You have to believe that the outcome over a series of hands played is relatively certain and predictable.

Why, because there are many variable on which the result of each trade will depend ,

In trading, the known variables (from each individual trader's perspective) are the results of their market analysis.

Market analysis finds behavior patterns in the collective actions of everyone participating in a market.

In trading, the unknown variables are all other traders who have the potential to come into the market to put on or take off a trade.

The known variable is the result of the analytical tools we use, support and resistance, trend lines, moving averages .

Suppose you are putting on a trade based on a breakout and you are buying because you think that the buying will continue to be there in stock.

But the outcome of trade is not in your hand , is it?

It’s the unknown variables or the other traders whose collective behavior will determine the outcome of that trade.

They will be acting on their beliefs about what is a breakout?

At any given moment, some percentage of other traders will contribute to an outcome favorable to our edge, and the participation of some percentage of traders will negate our edge.

So there's no way of knowing how other traders will react on a given condition ,

so the results of a single trade are random and should not be predicted.

Since all trades have an uncertain outcome, then like gambling, each trade has to be statistically independent of the next trade, the last trade, or any trades in the future.

Also, there must also be a random distribution between wins and losses in any given set of trades, even though the odds of success for each individual trade may be in the traders favor.

Casino operators have learned that all they have to do is keep the odds in their favor

and have a large enough sample size of events so that their edges have ample opportunity to work.

So ,keep putting up the trade if you have a statistical edge ,and you will win over a large enough sample size of the trades.

Thanks for reading till here.