Trading Basics: Misconceptions

Mechanical vs High-Frequency

Mechanical or system trading often gets a bad rap because people associate it with high-frequency trading, which is unjustly perceived as an evil form of financial vampirism. And yes, high-speed trading is indeed a form of system trading. But so are the vast majority of techniques used by market participants, from systematically scalping tick charts to artfully selecting portfolio candidates once a quarter.

Mechanical vs Automated/Automatic

Mechanical trading and automated trading are not the same thing. Mechanical systems, however sophisticated, usually require human intervention (to place orders, move stops, etc). Automated systems, on the other hand, usually require only basic human supervision once put into production (maintaining the software and servers, etc). They essentially run like a plane on autopilot, letting the machine execute the orders based on a strict set of pre-determined rules.

Mechanical vs Discretionary

The antonym of mechanical trading is “discretionary” trading. In essence this means the person is trading entirely on intuition, using his gut and experience to predict market direction. That is how most independent traders start. And how they blow up their first accounts. The ones who survive then learn that mechanising the trading process is the only way to achieve long term success and to contain the stress inherent to this line of business.

I would also argue that traders using a system whose edge has not been confirmed thoroughly backtest is also a discretionary trader. This person may be operating in a systematic way, but his strategy is based on a simple hunch or maybe a theory. The strategy itself is therefore discretionary, in that it cannot be objectively shown to have merit.

Trading is Exciting

Most people who first open a trading account find things very exciting. Speculating without a plan is fun, just as much as watching the roulette wheel turn at a casino and hoping for a big win. But trading for a living is a different story. Every bet has to be carefully calculated. Capital preservation becomes you most important objective and risk management and position-sizing become your key activities. Plus there are computers to maintain, accounts to balance, orders to place, records to keep. So the day-to-day of system trading is fairly boring and repetitive. This, unfortunately, is the price of success.

So what is the upside, besides the financial rewards that trading is intended to generate? For me and for most traders I believe it is satisfaction one gets from feeling that they’ve “tamed the beast”, got the better of a market which is essentially out to get you. The gambler has managed to switch odds with the bank, turning the probabilities in his favour. This feeling is not exciting, but it is very rewarding.

Research is Boring

It takes a tremendous amount of time and work to develop a portfolio of sound strategies. The bulk of the information available in trading books and professional journals, at seminars and on internet sites is often disingenuous and sometimes even dishonest. There are some notable exceptions, yet finding true edges in this sea of (mis)information is akin to getting a reliable tip on a horse.

Independent research is the only reliable way to find workable edges, and the somewhat nerdy satisfaction of turning a simple theory in a tradable strategy is huge. Yes, the computer programming involved can be tedious. And there are a lot of dead ends and lots of red herrings. Still, finding patterns where most people see mere noise is great fun. If you are that way inclined of course!