The Most Important Concept – Market Prudence

Imagine this, Jack bought Apple stock because he likes iPhones.

Jill bought marijuana company A's stock because she knows that Country X is going to legalise it.

Apple proceeds to do well as iPhone sales go up and the overall stock market is going up.

Marijuana got legalised in Country X, but company A's CEO got into an accident and passed away. Company A's stock crashed.

Jack made money. Jill lost money. Who is a better trader?

Answer: Jack got lucky, Jill is a better trader.

Jack's stock selection method is not market prudent, but Jill's is.

Market Prudence

Market Prudence: Market prudent trading strategies are based on identifiable, falsifiable and fundamental market inefficiencies.

Market prudence is the most important concept to learn in trading (both algorithmic and manual).

It is what separates luck from skill.

Let's look at the 3 aspects of market prudence: identifiable, falsifiable and fundamental.

1) Identifiable

Let's say you bought an American stock index ETF[1] (this means you bought a bit of everything in the stock market, more elaboration on ETF in later chapters) because you think the American economy is strong.

The ETF went up. Is that because your hypothesis on America's economy is correct? Or is it because the central bank lowered interest rates, or that there was a tax cut, or that <insert 20 other possible reasons here>?

In this case, you are not able to identify if your reason for the trade is correct no matter what the outcome.

At best you are lucky, at worst you lose money. And if we just aim to be lucky, let's shut down our computers now and head to the nearest casino.

Market inefficiencies that are not identifiable are not market prudent.

2) Falsifiable

To falsify is to prove that something is wrong. If something is not falsifiable, it means you can never prove that is right or wrong.

For example, the statement "we have not discovered aliens yet" is falsifiable. It is true that we have not officially discovered aliens (for those UFO believers, humor me for a second).

On the other hand, "aliens don't exist" is non-falsifiable. We have not discovered them, but this does not mean we will never discover them in the next thousand, or million, or trillion years. Thus, we are not able to prove that statement wrong.

Similarly, if you cannot prove your market inefficiency wrong, you won't know if the reason for your trade is right.

Non-identifiable market inefficiencies are not falsifiable. If you can't identify the market inefficiency, you can't prove that it is wrong. Identifiable market inefficiencies are falsifiable.

3) Fundamental

A fundamental market inefficiency is something that withstands the first principles test.

This means to question your decision until you reach the base rationale/assumption.

For example, I want to short Macy's (it is a department store).

Why? Because the price will drop.
Why? Because analysts expect the earnings to be XXX dollars but I know it will be much less.
Why? Because less people are shopping there
Why? Because I bought customer credit card expenditure data, and the data says so

[1] https://en.wikipedia.org/wiki/Exchange-traded_fund

Bad Examples of Market Prudent Strategies

- Drawing triangles on a chart and longing at the point where the triangle is sharp.
- Drawing an imaginary line underneath the data point on a chart and using that as your trading guide
- Buying Google stock because everyone says they dominate the web

Good Examples of Market Prudent Strategies

- Buying cryptocurrency and selling them on a new and inefficient crypto exchange (because the price there is higher).
- Check the traffic activity of the gaming forums to check if more or less people are playing Activision (Activision is a game making company) games. Then long (or short) if the traffic goes up (or down).
- Longing coffee bean futures[2] because you used weather data (temperature, humidity etc) to predict a poor harvest in Country X, which produce most of the world's coffee beans. Lower supply, higher prices.

Ending Notes

Rarely do you find strategies that are perfectly market prudent There is usually always some extent of uncertainty.

Fortunately, we can do something about it. In the later chapters, we will talk about a method called Inefficiency Sandboxing that will help us make our strategies more market prudent.

[2] https://en.wikipedia.org/wiki/Futures_contract