

## The Fallacy of Outsized Returns

It is amazing to me to read some of the expectation of traders new to forex. Perhaps lured by outsized claims of shady forex brokers, greed or simple naiveté, some newbie traders are expecting 50%, 100% or more per year. To do so is to place yourself far, far ahead of all other investors and investment types.

Let's take a look at several groups who should be expert, and see how they really do. Take hedge funds to start. Over the last decade, their returns (according to Institutional Investor) barely exceed the market returns of 10%. And surprisingly, they're not even that good! Consider survivorship bias. About 9% of hedge funds go out of business every year- 3 or 4 times the rate of mutual funds. The returns of dead hedge funds don't get counted in the now too rosy record.

Really lucky and well-run mutual funds in good years (that is, years when the market matches their strategy) might make 15-20%, but the average 5 year return is 9%.

What about "Real Money"? This is the term used to refer to large pension funds, endowments and other expert managers of money. They are very good at diversification, often using 10-12 different markets to extract risk premia, balancing them right in a Markowitz efficiency frontier sense. They have large teams of researchers, and because of their size are able to demand the best terms of trade and narrowest bid-ask spreads. Yet they perform in about the same 10-20% return per year.

What makes a lone, new forex trader expect to beat large teams of experts? The science of behavioral finance tells us that we are subject to a number of rather embarrassing biases. Among them are Overconfidence, Confirmation Bias, Mental Accounting, Illusion of Control and Optimism. If you are not familiar with these concepts, I suggest you do a Google search to understand how our minds work in this space, because these fallacies fan the flames of outsized return expectations, and also lead to demolished accounts.

I am sure someone, somewhere, knows a trader who really did strike it rich, making winning trades 90% of the time with some special strategy. Remember survivorship bias - you aren't hearing about the 99% of traders who blow themselves up, never to return to the game. And luck plays a part, too. As Nassim Taleb points out, if you did find that special monkey who types out Homer's Iliad on his well-built typewriter, are you really going to expect he's producing the Odyssey next?

It is very difficult to find trading strategies that reliably make money, especially big money. This just makes sense. If some incredible trading strategy was able to produce 100% every year, everyone would use it (which would diminish its effectiveness), and Goldman Sachs would probably own it and license it.

If you can generate a forex strategy which returns 10-20%/year regularly, you are doing fantastic, beating the experts and the markets by 2X.