September 14, 2014

Randon Rambling Ruminations of a Relic (Part 1)

Most often I comment on specific chart developments. I have much more to say about markets and trading than the matter of pattern recognition. There are numerous rabbit trails I have not had time to wander down. In no particular order, I will do so in this email.

Interactive Brokers

I get more questions about this brokerage firm/FCM than about all others combined – and I have taken a few well deserved jabs at the firm from time to time. I have an account at IB for one particular reason – it operates as a poor man's prime broker. On one trading platform and with one account I can trade the world – from U.S. to global futures markets, U.S. and global stock exchanges, options, forex, you name it – with all trades co-margined.

Credit Suisse would offer me the same package for an account was $50 million. Ditto for Goldman and D-Bank. No other firms I know of provide this capability for accounts under $5-10 million. If there is another firm doing so, let me know.

Other positives about IB include:

- The trading platform is not fancy or complicated – but it works
- Contingent orders can be placed
- GTC orders can be specified as good for the day-sessions only
- Commissions are competitive
- The bid/offers spread in spot forex is relatively tight

Now for the bad news – and some of the bad news is quite disturbing to me as a trader:

- The charting package is world-class awful
- Client services are average at best and non-existent many hours of the day
- The financial statements are a bastardized mess. Every other firm I have traded with since 1975 have had fairly standardized and simple reporting statements. Not IB! Not once since I started trading with IB – not a single time – have I been able to reconcile IB's statements with the performance reporting structure required by the National Futures Association.
- IB charges some very strange and questionable fees. Combined with the complicated statements, one starts to wonder if IB is fleecing its clients a few dollars at a time.

- IB's annual tax reporting statements could not be more complicated if one tried to make them impossible to understand. My tax accountant charges me more to deal with IB's tax statements.
- Trading spot forex is a nightmare. There are at least four major problems with trading spot forex at IB that a trader does not encounter at other dealers.
    - Offsetting a spot forex trade is complicated. For example, if I were to buy $1million USD/CAD, at any other firm I would offset the trade by selling $1 million USDCAD. Not at IB. Offsetting a spot forex position always results in a residual balance.
    - Offsetting a residual forex position often results in a second commission charge. So much for reasonable commissions!
    - Specific spot forex trades can become unintentionally offset by other specific trades. For example, if I bought $1 million USD/CAD (being long $ and short C$) as a trade, then a week later I were to sell $1 mil GBP/CAD (short GBP and long C$), rather than keeping these as two separate trades, IB would offset the short C$ from the first trade with the long C$ from the second trade. I end up with a complete bastardized reporting mess. It is often impossible to track individual forex trades at IB.
    - IB charges three times more for the roll on reverse-roll forex trades and credits two-thirds less for the roll on roll forex trades than other retail dealers. These costs are hidden as other fees and not clearly reported as roll charges.
- It requires extra effort to bring profits from foreign stock trades back into U.S. Dollars
- IB reports balances in a category they call "FX Portfolio – Virtual FX Position" that I have never been able to understand. IB representatives have never been able to clearly explain these balances, but they say, "Don't worry about it because these balances are not real!" Does anybody else have a major problem with this?

I no longer trade spot FX with IB for the reasons cited above.

The futures brokerage firm I most trade with is Archer Daniels Midland (ADMIS). There are several reasons I trade with ADM – competitive rates, compatible with the CQG bridge (important), great service and a firm that is highly unlikely to go bankrupt or commit fraud (unlike MF Global, PFG and Refco). If anyone wants a referral to my ADM client group, let me know. I am not an introducing broker and receive no soft or hard compensation for referrals.

<u>Trading in 2014 to date</u>

Every year is different for me. 2014 has been extremely different in several ways.

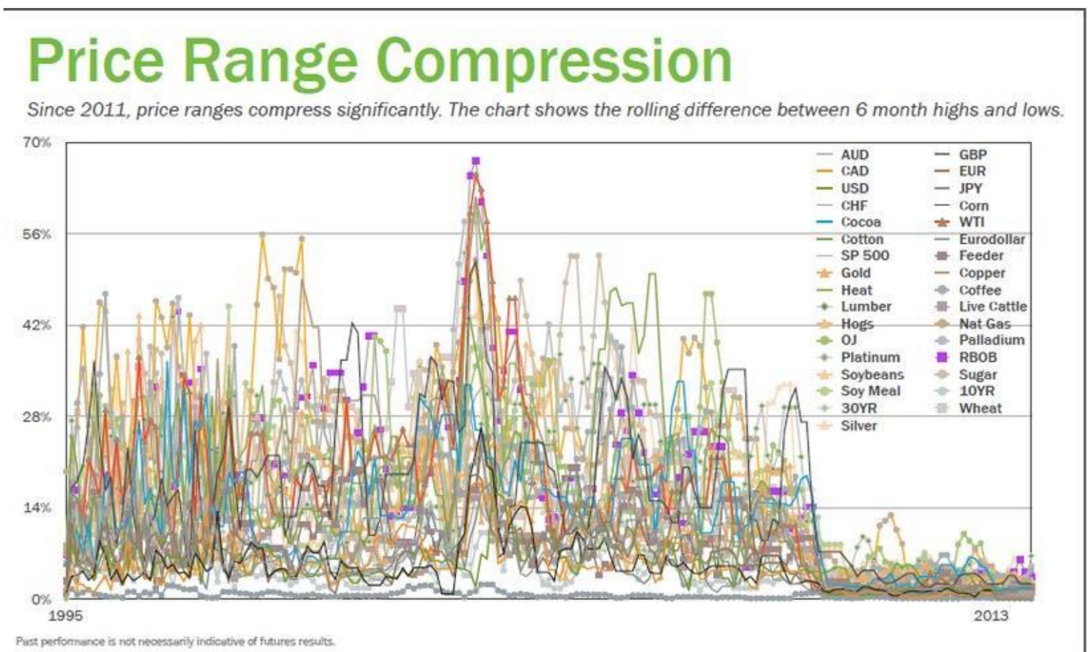
- I have traded far more in the equity markets than during a most other years
- I have not scored big in futures. Historically I have relied on triples and home runs to make my year. That has not been the case in 2014.
- My holding period for trades has been shorter than during a typical year

- I have been more active than I would prefer to be

Relative to point #4 above, during the time period of the Factor Model Portfolio (since June 11) there has been 14 different stock trades, 20 different futures trades and three different spot forex trades. A position unit (PU) and quick profit unit (QP) count as a single trade in my mind. Additionally, all trades in a specific market based on the same overall chart interpretation count as a single trade in my mind. The best examples of this in recent months are Soybeans and the Canadian Dollar. I have had a few trades in each market, but in my mind they are all part of the same campaign.

<u>The trading woes of Commodity Trading Advisors</u>

I monitor the Barclay's BTOP 50 as the benchmark for how the CTA world is doing. The rolling annualized ROR of the BTOP 50 was negative for 23 consecutive months prior to August 2014. The previous record was three consecutive months. CTAs have had a very difficult time making money. The reason is due to the lack of volatility within the futures markets. The graph below is picture worth a thousand words. It shows that the volatility of futures contracts have been greatly constrained since 2011. By contrast, the past two years have been generous to equity managers.



This price compression, or lack of follow-through, is one reason I attempt to employ the Quick Profit. If futures were to once again trend strongly I would likely discontinue the QP strategy and attempt to ride full positions to measured targets.

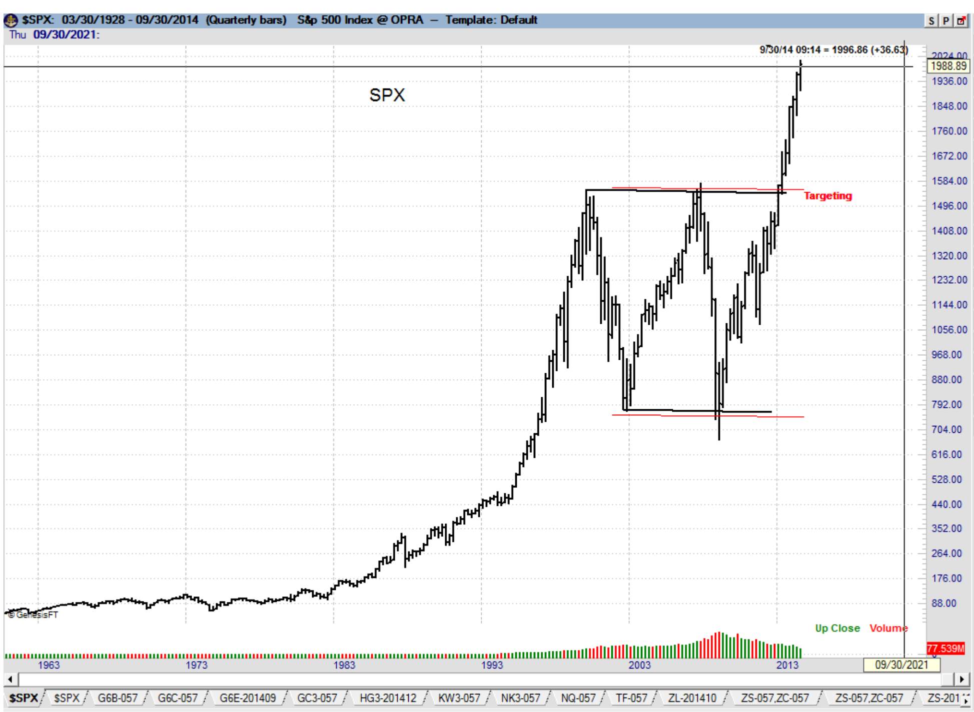
The begging questions deal with why price trends have been scarce in futures since 2011. This is a subject for a different day, but I would say this – I believe that price trending will return to futures markets at some point in the near futures. This could be wishful thinking.

Futures vs. equities

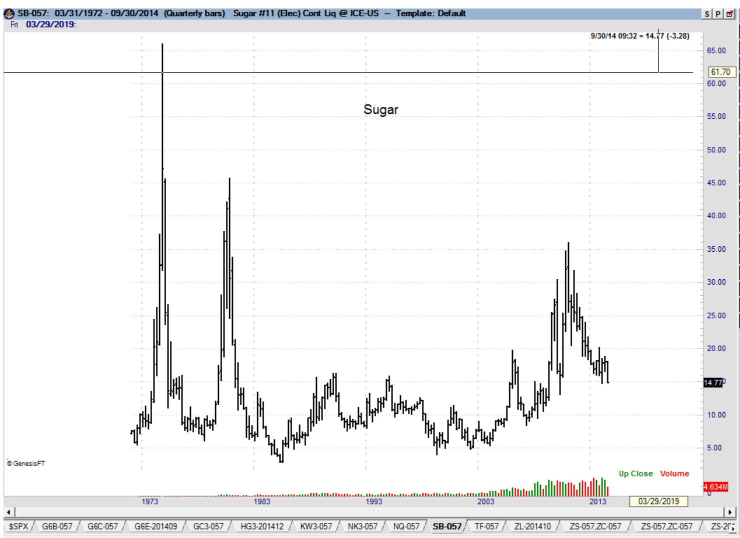
While I trade both, traders need to understand there are important differences between the two asset classes (actually, to be truthful, I do NOT consider futures to be an asset class – it is a "trading" class).

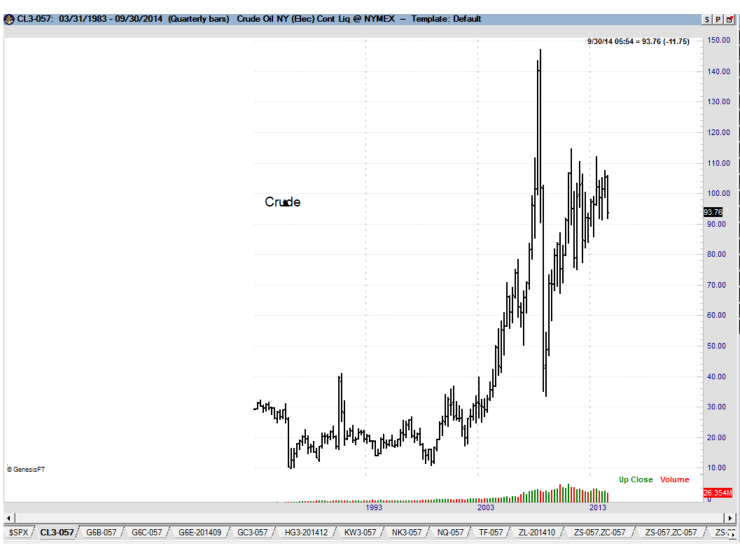
The differences include:

- Futures do not pay dividends
- Futures positions must be rolled when one contract month is ready to expire. At times, the price of the "roll-into" contract can be considerably different than the price of the "roll-from" contract. In the case of ag products (grains) the position switch could be from one crop year to the next crop year – and each crop year could have dramatically different chart structure and fundamentals. As a general rule, it is bearish to neutral when ag markets are in a "carrying-charge" structure with each successive contract at a higher price. It is neutral to bullish when prices are inverted with the nearest contract higher in price than successive contracts.
- Equities have an historical upward bias while most futures are characterized by "popcorn" behavior – bull markets are followed by bear markets that often completely negate the bull market advances. The charts below show this behavior, using Wheat Sugar and Crude Oil as proxies for the futures market.




ZW-057: 06/28/1968 - 09/30/2014 (Quarterly bars) Wheat CBT (Elec) Cont Liq @ CBOT – Template: Default
Wheat
Up Close Volume
1973
1983
1993
2003
2013

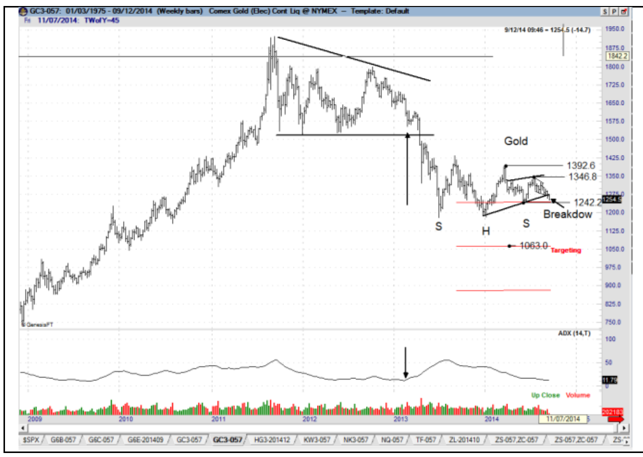

SB-057: 03/31/1972 - 09/30/2014 (Quarterly bars) Sugar #11 (Elec) Cont Liq @ ICE-US – Template: Default
Sugar
Up Close Volume
1973
1983
1993
2003
2013


CL3-057: 03/31/1983 - 09/30/2014 (Quarterly bars) Crude Oil NY (Elec) Cont Liq @ NYMEX – Template: Default
Crude
Up Close Volume
1993
2003
2013

Indicators

While I make selective use of indicators, I am of the general opinion of “Why study a derivative of price when I can study price itself?” Yet, I am completely supportive if you as a trade have success with indicators. I do pay periodic attention to a few indicators, including:

- A 14-bar moving average. Nothing special about the number – I view it as a proxy for trend.
- ADX – I actually like this indicator quite a bit and use it primarily to determine sizing and leverage. Periodically a market will complete a large pattern accompanied by weekly and daily ADX readings turning up from under 12. When this happens I want to make sure I max out my leverage (1.5% to 2.0% of capital). This condition occurred with the early 2013 bear trend in Gold as shown on the following two charts. [Note: A similar price/weekly chart/daily chart profile exists right now in Gold to verify a bear move.]



Factor performance

Factor LLC is proprietary trading firm with no obligation to provide verifiable performance records. When I started my blog in 2010, I felt an obligation to inform readers of my own trading performance. After all, why should anyone care what I would say about trading or the markets if I had done nothing but lose money in my own trading?

So, I submitted my brokerage statements, tax statements and my own calculations of performance to an auditing firm to prepare an attestation of performance. It was not a cheap endeavor. I placed the attestation on my web site, but removed it earlier this year. The removal had a legal/regulatory reason.

The auditors determined performance by reconciling tax returns with brokerage statements. This method reflected the fact I have withdrawn substantial sums from my trading accounts over the years. Trading has been, after all, the way I have made my living. In contrast, the National Futures Association and Commodity Futures Trading Commission require performance to be calculated using a method called Value Added Monthly Index, or VAMI.

The attestation reported an annual compound ROR through 2009 of 41.6%. However, a VAMI calculation produced a far higher ROR. I wanted to report my performance based on what I knew I had made, not with a method that did not reflect reality. Should Factor ever decide to become a trading advisor it would be necessary to use the VAMI method. Accordingly, my legal advisors recommended that I remove the performance information from the web site. I am attaching the attestation as a sister document herein.

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS

I have not had Factor's performance reviewed by auditors since 2010. I would not report any performance not subjected to an auditor's review. All I can tell you is that Factor has been profitable in recent years.

The Factor's Model Tracking Account

A few words on the tracking account are in order.

First, if you ever plan to be a full time trader you need to find your own niche. I could care less if your niche uses charts. If you are starting out as a trader and have no idea what your niche is, let me offer you this word of advice – TRADE SMALL, REALLY SMALL. The process of discovering a profitable trading approach requires the "Two Ts" – time and tuition. You will find your way by making many mistakes and missteps. You will need to have your capital intact when you finally have a clue what you are doing. Preserving your capital is your singular challenge in learning how to trade. How do you preserve capital? By not over trading, by being intentional and reflective in your trading manuevers and by risking no more than 25 basis points per trade!

Second, we have had very good markets during the past three months. Based on the tracking record issued last weekend, the model account (marked-to-the-market) was up 84% (annualized) since inception. I make no pretense this reflects skill or should be assumed as the norm. As I tell my staff often, "A broken clock is right twice each day." Good periods come and go. Of course, I need good periods to be profitable, but tough times come after good times. I have no control over what the markets will do. My only control is over the orders I enter. I am a glorified order enterer – and that is all.

Day trading

I am not a big proponent of day trading – but as I have said, if it works for you that is great, go for it.

Trade Navigator

I have had never ending problems setting up charts that can be shared with you during a two-month of Trade Navigator. I am hopeful we can announce the launch of this free trial soon, but it will not contain all of my charts. Stay tuned.

Synergy (or lack of same) between the email service, the blog and Twitter

I am sure you have noticed that I seldom post blogs anymore. It is my desire to share trading and market ideas with members of the Factor community before I post them as blogs – although at times it does not work out this way. I often post new charts/trading ideas on Twitter rather than sending them to you first via email. Sorry – but I do not want to flood you with emails. I am really trying to be selective about the frequency of my email correspondence.

Conviction and confidence in trading

One of the frequent questions I am asked by novice trades deals with the challenge of consistently "pulling the trigger." Problems with pulling the trigger, in my opinion, come back to two issues.

First, pulling the trigger implies that your gun has a trigger. Having a trigger means that you know exactly what a trading signal is within your approach. If you do not know precisely what a trade is for you, then your problem is trade identification, not trade execution. Does this mean that you must be 100% certain of signals? If you are a systems trader, the answer is yes. If you are a discretionary trader, like me, then there is some wiggle room.

Second, if you know exactly what a signal is for you, then pulling the trigger is a matter of confidence and discipline. Pulling the trigger is reduced to a "leap of faith." And, "a leap of faith" is no easy matter.

Most novice traders believe the holy grail exists in the form of trading signals. WRONG! Trading, at its most basic level, is a battle against one's emotions. Trading is an issue of the heart and the gut. Look in the mirror if you want to know your worst trading biggest hurdle to trading success.

Drawdowns make pulling the trigger especially difficult for discretionary traders. Someday I might get time to write an entire piece on drawdowns – it is not today. Every trading approach – no matter how good it is – will be subject to the random distribution of results (something I call "sequencing"). Is a drawdown an indication a trading approach is broken or simply a product of randomized trading results? This question must be answered by traders during a drawdown period.

The correct response to a drawdown – in my opinion, for whatever it is worth – is to reduce size and keep reducing size as the drawdown continues.

Market orders

In my trading history, the proportion of total trades represented by market orders is inversely correlated with trading success – the more market orders, the less success. Trading must be intentional and thought out in advance. Market orders – at least for me – are a reflection of an emotional response. Enough said – for now!

Trade sizing

I have received a number of emails from members of the Factor community expressing surprise at how small my sizing is. I generally trade one to two contracts per $200,000 of capital. My experience – and the experience of many, many traders I know – is that performance increases as sizing decreases. Novice traders believe the key to profits is larger size. Just the opposite is true. There are many reasons for this phenomenon. Mark Ritchie, a trader featured in Jack Schwager's first *Market Wizards* book, has done extensive statistical study on sizing. According to Ritchie, in a book he is presently writing for publication,

> *"Cut your percent to invest by half and you will cut your losses in half and reduce your profit margin by 25%. Any time you can cut your risk in half and only hurt your profit by a quarter, do it. That is, as we say in the business, a no-brainer."*

I have studied the statistics developed by Ritchie, and they are sound.

The art of charting

Charting is an art. I see things in charts others might not see because I have looked at numerous charts every day since 1976. That is a lot of charts. I believe whatever skill I have at chart trading is due to three factors:

1. I believe that most markets, most of the time, cannot be understood from the charts
2. I believe that most chart patterns that begin to form end up failing
3. I believe in the concept of chart morphology and am willing to change my mind quickly

You need not agree with me on a chart interpretation. You are as likely to be right as am I. Welcome to trading. Remember, chart interpretation is only the "signal" part of trading – and as such, it plays a minor role in long term success.

Intraday Price Thrusts

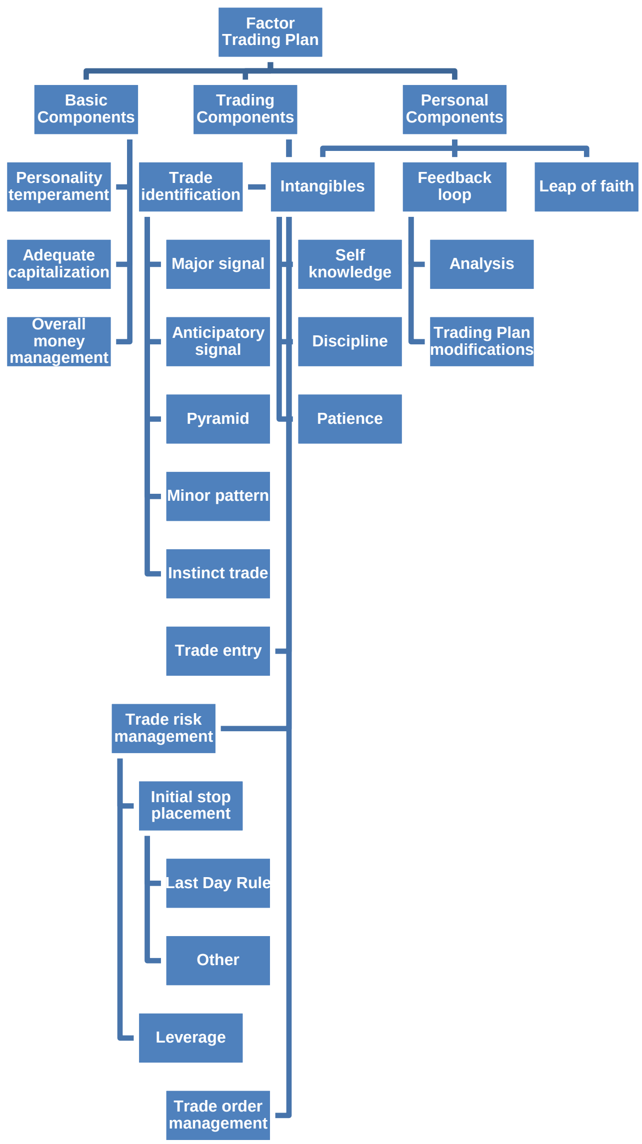
There was a time in the markets long, long, long ago when intraday price thrusts continued throughout the day. Back then one could hop aboard a market that started to trend and stay with it until the close. That day is long gone. A trader cannot trust intraday price action. Buying intraday bursts and selling intraday busts is not a profitable endeavor.

In my opinion, the only price of the day that is important is the closing price (or exchange settlement price). Most HFT operations and day traders are flat by the close, so the closing price reflects the price toward which market participants are willing to obligate overnight margin money.

This is why I want to see a market breakout of a pattern decisively on a closing basis. Do I use intraday stops for trade entry? Sometimes, at least on a portion of a position, but I must tell you that when I do so it makes me nervous in anticipation of confirmation by the closing price.

Having a trading plan

Let me circle back to the subject of having a trading plan. If you have not read my book, “Diary of a Professional Commodity Trader,” I encourage you to do so. In the book I detail all the factors I believe go into developing, executing and self-correcting a trading plan. The graphic below is really the road map of the book.



From time to time I will ruminate again.

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