December 17, 2014

Random Rambling Ruminations of a Relic (Part 2 of a continuing series)

In the first edition of "RRRR," issued in September 2014, I commented on the following items:

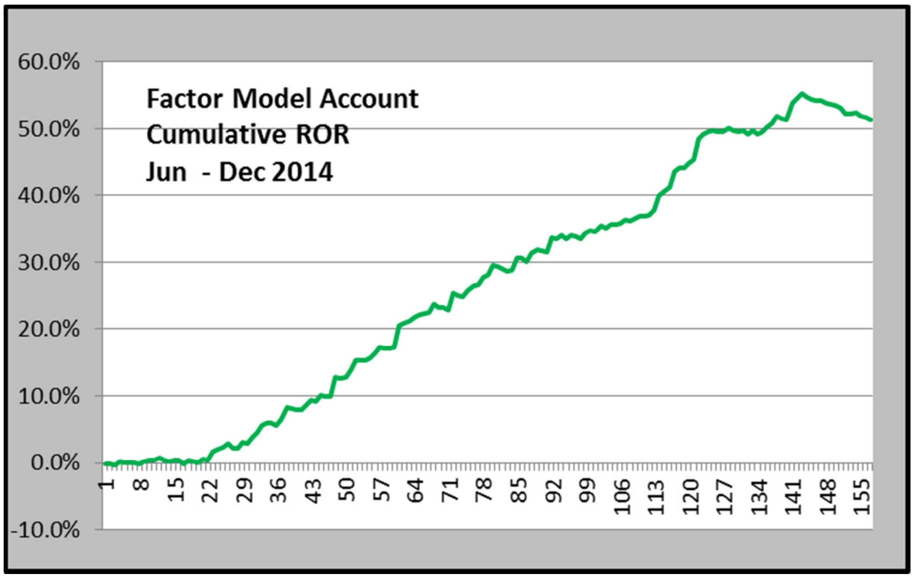
- Interactive Brokers
- Trading in 2014 to date
- CTAs and the compression of raw material prices
- Trading futures vs. equities
- The use of indicators
- The Factor's Model Tracking Account
- Day trading
- Trade Navigator
- Synergy (or lack of same) between the email service, the blog and Twitter
- Conviction and confidence in trading
- Market orders
- Trade sizing
- The art of charting
- Intraday price thrusts

This edition is not nearly as lengthly, but there are a few things I want to speak to that are not directly related to specific markets, including a revisit to some of the items listed above.

Review of Factor Model Tracking Account

There is market analysis … and then there is trading. The two are very different things. Factor Trading is primarily a proprietary trading firm. The market analysis shared with Factor members flows from the research component of our proprietary trading. The Factor model tracking account is intended to be a proxy for our prop trading activity. The purpose of sharing the model tracking account with Factor members is to allow you to peak behind the curtain at our sizing, risk management and trade management. How risk is managed is far more important than what trades are entered. I view myself not as a trader, but as a risk manager and order enterer. I would rather be excellent at risk management and average at trade selection than the other way around. Worded differently, it is easy to make money in the futures and forex markets, but keeping it is the challenge. How much trading profits remain after a losing period is the real measure of a trader.

The last six months have provided an excellent trading environment. I would not be honest if I suggested that the past six months were normative. The graph below shows the cumulative closed trade ROR of the Factor tracking account since inception in June 2014. The trade-by-trade details are attached as a PDF.



There are three primary methods used by traders to calculate trading drawdowns.

1. Daily peak-to-valley, marked-to-the-market NAV
2. Month ending peak-to-valley, marked-to-the-market NAV
3. Closed trade-by-closed trade NAV

The standard in the hedge fund industry, including futures and forex trading, is month ending, marked-to-the-market NAV. I prefer to monitor trading on the basis of closed trades. The graph above is based on cumulative closed trade-by-trade ROR. By this measure, I ended the year with a (4.1%) drawdown. Typically, a daily peak-to-valley, marked-the-market drawdown will be 50% or more greater than a drawdown measured by closed trade NAV. I prefer to monitor closed trade NAV because it keeps the focus on managing trades as opposed to reacting emotionally to reverberations in open trade equity. In my experience, traders who obsess over the intraday value of their accounts end up making decisions in reaction to equity levels, not on the merits of individual trades. If this hat fits you, then wear it and acknowledge the danger of paying too close attention to your account balance. Trade the markets, not your equity.

<u>Charting as an art form</u>

I do not believe charting is a science. In fact – this may come as a surprise to many of you – I do not believe in using charts for the purpose of ongoing market analysis. Attempting to maintain a constant (or even regular) interpretation of a particular market based on charts is futile. Charts reveal nothing about a market the overwhelming proportion of time. Most of the time, most markets defy understanding from a classical charting point of view. I know of traders who spend hours “studying” the charts to discover what a given market is doing and might do. This is a waste of time! Most of the charts most of the time do not reveal a clear pattern. Even chart patterns that are quite well defined fail 50% of the time. [Note: I do not dispute the fact that charts show if a market has been trending or consolidating – and this fact, in itself, has importance.]

So, what is the value of charting? Of great value -- but not as a means to maintain a market opinion at all times, or even most of the time. Every so often a market will form a decisive “no-doubt-about it” geometric configuration, break out cleanly and run to an implied target with little hesitation. I personally believe that major moves take place only through exerted sponsorship by very large global speculative, commercial and/or government market participants. I also believe that such market sponsorship has finger prints recognizable by classical charting principles. Yet, the big dogs do not come out to eat every day. In fact, they are very selective when they make a play. Keep in mind, the big dogs sometimes go hungry.

Every so often a market will declare itself with a decisive chart configuration. It is an absolute thing of beauty when a formation develops and comes to fruition. The real challenge for a chartist is to develop the discernment to distinguish between “noise” and real signals. This ability is more of an art than a science. My advice to new chartists is as follows:

- Do not look so hard for patterns
- If it is a diagonal pattern (symmetrical triangle, trendline), forget it
- If the pattern you see is part of a larger congestion area and not a “stand-alone” isolated pattern, forget it

<u>Intraday market behavior</u>

There was a time when intraday trends were quite dependable. In fact, one of the trading techniques floor traders would use during the 1970s – 1990s was to go with a market in the direction of a breakout of an early trading range. With the advent of 24-hour markets and influence of quant and HFT operations, intraday price thrusts are better faded than followed. In recent years there have been many, many examples of patterns that broke out intraday, but were not confirmed by closing prices. For this reason I attempt to base trading decisions on closing prices. In the era of 24-hour electronic markets the “exact” close is a bit allusive. Several alternatives include:

1. Official exchange close used to set margin requirements and to peg overnight positions (e.g., 14:00 CT – EuroFX; 13:15 CT – Grains; 15:00 CT – Copper)
2. The end of the day’s electronic session (between 16:00 and 16:30 CT for most markets)
3. The time when volume dries up – varies from day to day and market to market

As a general rule, I make a decision on markets between 13:45 and 14:00 Central Time, or toward the end of the electronic session.

The 80/20 adage

I am often asked by traders how they should go about formulating a trading plan. My answer is actually quite simple.

- What has worked for you in the past?
    - Holding positions for an extended period of time?
    - Day trading? Trailing stops?
    - Trend following?
    - Mean reversion? Spreads?
    - Options?
    - Etc.
- What types of trades have given you the least amount of unwanted stress?

The reality of trading for almost every consistently successful trader I know is that 20% of their trades produce 80% of their profits. I know this is true for me. I calculate profits and losses in terms of basis points (100 BP = 1% of nominal capital). We analyze our trading on a contract-by-contract basis, on a trade-by-trade basis (a Position unit and Quick Profit unit, plus any Swing unit pyramids and QP reentries are considered to be a single trade) as well as on the basis of themes. For example, short Soybeans and short Canadian Dollars were themes in our trading in 2014.

Since the inception of the Factor tracking account in early June I traded 68 different themes (an average of 10 themes per month. This is more frequent trading than hopefully will be the case in 2015.

Predictably, 16 of these themes, or 23%, contributed a full 80% of the net bottom line, as follows:

Market	Pattern	Trade or Theme	BP profit
Aussie	6-mo H&S top	Short trade	144
British Pound	Failure top	Short trade	213
Canadian	4-yr M top	Short theme	616
EuroFX	9-mo H&S top	Short trade	178
Peso	68-mo tri	Short trade	347 (to date)
Crude Oil	39-mo triangle	Short trade	147
GBP/CAD	7-mo rounding	Short trade	375
Gold	15-mo H&S failure	Short trade	246
QLYS	9-mo asc tri	Long trade	133
Sugar	5-mo rectangle	Short trade	146
Silver	16-mo desc tri	Short trade	307
THC	14-mo rectangle	Long trade	146
USD/SGD	3-yr triangle	Long theme	432 (to date)
WHR	10-mo asc tri	Long trade	213

Soy Meal	2-mo rectangle	Short trade	141
Soybeans	42-mo H&S	Short theme	613

A review of the trades above is very instructive and goes a long to explain the risk management protocol I use in trading. With few exceptions, the trades above trended immediately from the point of breakout. A fabulous trader from Cargill befriended me when I started trading at the CBOT in the 1970s. He was one of the best minds I have encountered in the futures market. He used to say that he only had one job as a trader – to make sure he never took a losing trade home. He viewed his job in a very singular way: to manage his losses. What a great lesson I learned as a beginning trader – it has paid huge dividends!

Resting orders

When I enter a trade, I immediately place an “OCO” order to exit the trade – a hard “limit” order at my target to take a profit and a hard or soft “stop order” to take a loss. Stop orders are a necessary evil in trading. The markets gun for stops. Yet, having a stop in place can prevent the trades that cause the worst damage to an account.

- A “hard” stop is one submitted to a broker (the broker may transmit the order to the exchange or hold in in a queue)
- A “soft” stop is either an alert price I have sent to my cell phone, pending action by me, or a stop entered with a contingency (good only for the day session, enter if, enter when, etc.)

But, the important part is to have a plan for taking a profit or cutting a loss.

Trading – A game of trade-offs

The idea of optimizing trading rules is a fool’s dream. All trading decisions have trade-offs. As the saying goes, “you cannot have your cake and eat it too.” If you want to ride a trend for the full extent of a move, you must make trade-offs (increased asset volatility, giving more capital away at the turn). If you want to use close stop protection, you make a trade-off (not riding a move). If you want to protect trades overnight, you make a trade-off (having the thieves run your stops). If you want the opportunity to have a hugely profitable year you accomplish this by taking extraordinary risks and incurring much greater asset volatility. Do you want to minimize your asset volatility? – then there goes the opportunity for a 50%+ year. If you do not want to be in positions overnight you make the trade-off of missing a “gap-and-go” and never getting properly positioned for a move. Do you not want to be stopped out of a trade only to have it go in your direction? Then don’t use stops and risk trades that could cost you 500 basis points or more. As traders, you cannot have it all. You give up certain things to get certain things. You design a trading plan to achieve a performance profile in lieu of other performance profiles.

My goal is to achieve an average annual ROR of 30% over a multi-year time frame with a maximum drawdown of 15%. These data points produce a rolling Calmar of 2.0. The Calmar and Gain-to-Pain ratios are far superior to Sharpe. There are years when I exceed the profit target (e.g., 2014) and periods when I enter a drawdown (last half of 2013 and early 2014).

I have control over my trading only to the degree I properly execute my game plan. Yet, ultimately markets have the final say. When the markets I trade enter prolonged choppy periods it is all I can do to hold my capital together. When markets trend, as has been the case in futures and forex during the last half of 2014, trading can seem easy. The reality is that I must live through periodic stormy seas to enjoy smooth sailing.

If my goal was 10% annual ROR, my approach to trading would be different. Likewise, if I wanted to take a shot at doubling or tripling an account within a year I would also trade quite differently (and would need extremely good markets).

Right or left brained

While an oversimplified view of human reasoning and thought, the concept of being left-brain or right-brain dominant makes sense. Which hemisphere of your brain is dominant? If you are left-brain dominant, you likely would do best with a systematic approach to market speculation that is rules-based, perhaps even completely automated.

If you are right-brain dominant, a more discretionary approach to market speculation would probably be your strong suit. This might include trading special situations, chart analysis, analog-year analysis, global macro and the like.

Which brain hemisphere dominates my trading? Both – for different reasons! For market analysis and trade identification I believe I am right-brain dominant. For trade management and the entire process of market speculation (the business side of things) my left brain rules. This is just the way I am put together. The left-brain activities are the most difficult and least intuitive for me. Yet, I know that money and trade management is a bigger challenge for me than is market analysis.

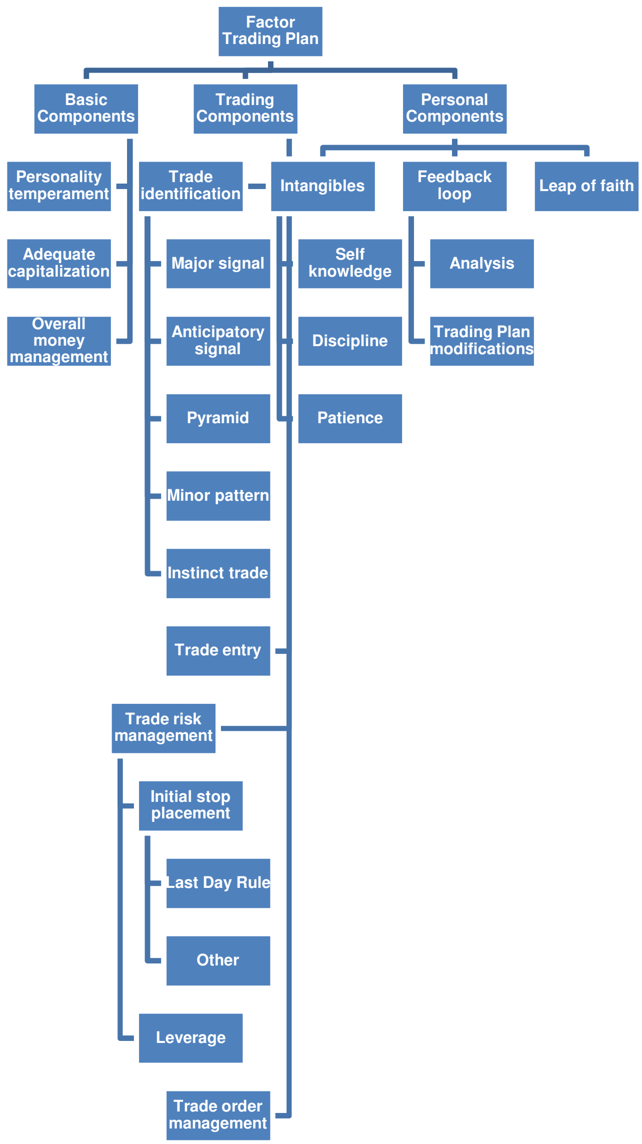
Here is the point – as a trader you need to come to terms with a number of factors in order to be consistently successful:

1. What is the goal of your market speculation – what exactly are you trying to accomplish?
2. What are the constraints to achieve your goal (i.e., capitalization, markets traded, market conditions, time availability, risk aversion, etc.)?
3. What are your personal strengths and weaknesses?
4. What approach to trading is the best fit for your personality traits, circumstances, risk tolerance and goals?

There are no right or wrong answers to the above questions.

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 the factors of my trading plan. The graphic below is really the road map of the book. I have thought through each and every box.



Making changes to a trading plan

I cannot imagine what it would be like to trade without rules. Rules impose discipline. Without rules I am convinced I would become a very undisciplined trader – blown about by every wind change. The temptation I have is to tweak my rules based on the outcome of the last trade or series of trades. I must resist this temptation. A trading plan that is constantly changed to optimize the most recent trades is not a trading plan at all.

There is no magic formula or golden key to trading. Trading is hard work. The best a trader can hope for is a small advantage or niche that can be exploited over a large number of trades.

My niche is quite easy to explain. I believe that taking trades based on clearly identified horizontal chart configurations – subject to specific guidelines on leverage, risk management and trade management – will produce a net profit. Further, my experience is that the rolling annual ROR of this approach is approximately two to three times the maximum peak-to-valley drawdown incurred.

Annually I tweak my trading plan. The changes can be significant (eliminating an entire price pattern from consideration or adding a signaling set up) or minor (reworking how QP profit targets are determined).

I will be making some changes to my trading plan in 2015. In recent years I have shed off too much volatility. I have also taken more signals than I think is optimal. I am playing around with some ideas that could decrease my trading frequency and increase my annualized volatility without increasing my downside volatility. More on this later!

From time to time I will ruminate again.

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