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Milking the System

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Saturday, September 18th

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About Simon...



- Co-Founder & Head Trader at Hedgehog LLC
 - Isle of Man based private fund www.Hedgehog.im
- Author of popular Simon Say's newsletter
 - Available free at www.Simon-Townshend.com
- Developer of S-I-R swing trading system
 - A self-directed or managed service www.SeriousInvestmentReturns.com
- We have worked together for 3 years and in this time become great friends as well as having a close working relationship

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Milking the System

Maximising the earnings from a successful trading strategy

Presented by Simon Townshend

18th September 2010



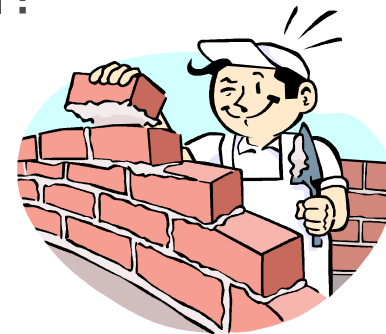
My hypothesis (and its logical implication)

Hypothesis:

“A trading strategy built upon credible foundations will work in any market and on any timeframe”

Implication:

With solid foundations, why settle for a single brick when you can build a wall?



What we will cover today...

- Defining a successful strategy
- Leveraging without size
- Thousands of roads, but only one car
- Finding the right portfolio of activity for you personally
- My own personal journey as a worked example
- Questions & answers

Slides available at: www.Simon-Townshend.com/Milking

Have you ever been a butterfly?

- Did you leave the S&P to trade Gold as that looked much better – only to discover it wasn't?
- Have you ever had a failing trade on a 5 min chart, that still looked OK on the 10 min chart – only to be stopped out?
- Have you held a position overnight, even though you are a day trader – and completely ruined your next day?
- Have you increased size on the sure thing trade and reduced it on the scary looking one – and been wrong to do both?
- Have you switched from continuation trades to reversal trades – only to time the breakout perfectly?
- Do you know your strategy is profitable – yet somehow in practise you just can't seem to make it deliver its potential?
- Have you been flitting around like a butterfly doing a bit of this and a bit of that – but always catching the losing run?

If so – Today should be helpful to you, I hope!

- There are so many things we could be doing that sometimes we just don't know what to do or where to look.



- Before you go any further you need a successful strategy
- Only once it has proven its value in real time with real money should you start looking further afield
- But then you can start milking the system (but only in a logical planned fashion else you go back to being a butterfly!)

How do we define a “successful strategy”?

- A small number (1 – 5) of clearly defined trade setups built around your own personal model of market movement
 - <http://media.libsyn.com/media/electronictrader/Electronic Trader with Jeff Quinto 11-12-2009.mp3>
 - I once ended up with 32 setups! (which had to be seriously pruned)
- It should work in all markets and on all timeframes
 - If not its foundations are suspect and need to be revised
 - But it should only be used in one market and on one timeframe
- Its performance statistics must be suited to your own personal circumstances and psychological profile
 - %age winners, size of avg winners and losers, outlier independence
 - If not you have no chance of replicating the results in practise
- A track record of profitability (obviously!)
 - Both back tested and forward tested (in real time live or simulator)

Beware!

- You don't need to speak French to know that this sign is not good news!
- There is no coming back from a fall into a 1,000 foot hole!
- You only get one chance to avoid major pitfalls



3 big holes to avoid falling into

○ Size is a killer

- Drawdowns are as much a function of size as they are of the strategy
- 100% of traders who blow out do so as a result of size!

○ Mechanical systems

- How many consistently profitable traders do you know who use mechanical systems?
- I only know 2 personally and know of 2 others
- There is no substitute for learning a profession

○ Data mining

- Your strategy must be based upon the sound logic of your own model of market movement – this is the single most important requirement
- If it is just based upon some quirk in a dataset you are heading towards that 1,000 foot drop, without any brakes!

The profit equation

- Profiting in any market requires 2 things:

A productive market environment

&

A successful strategy

- One or the other is insufficient, we have to have both!
- If either is missing drawdowns will occur
 - Accept the fact and just move on
 - But don't throw the baby out with the bath water

What next?

- Right so you have a successful strategy that:
 - You own and trust
 - Has a clearly defined trading plan
 - Is in regular use
 - Has a good track record
 - Generates consistent real-time profit
- Many of the traders here today are in this position
 - ...and now face a difficult choice
 - “where do I go from here?”
 - “what is the next stage of my evolution?”



The options

- We want to use our successful strategy to grow our earnings
- The usual approach is to do more of the same
 - Increase the unit size – but size is a trap just waiting to snare us
 - Vary the unit size – attractive but extremely difficult in reality
 - No diversification to alleviate the bad times – just bigger drawdowns
- Another approach would be to apply it elsewhere
 - Leverage a successful system by doing more things with it
 - But not leveraging by increasing unit size
 - Remember our starting point - “A successful strategy will work in all markets and on all timeframes”
 - By applying it to something new we also achieve diversification as well as increased earnings
 - → A smoother equity curve



Thousands of roads but only one car... where do we start?

Element	Number
Trade setups	6 x
Markets	36 x
Timeframes	12 x
Time zones	3
	= 7,776

- Currently trading 6 setups, in 1 market, on 1 timeframe, in 1 time zone
- Now we have to choose from the 7,770 other possibilities
 - Flip a coin?
 - Be a butterfly?
 - Develop a logical plan?
- Let's break it into bite sized pieces, to narrow the field down first of all...



**How do I
choose
from that
lot?**

What factors should influence the decision process?

○ Internal Factors:

- Market suitability per timeframe (liquidity, bid-ask spread etc.)
- Activity per time zone (relative bar ranges)

○ External Factors:

- Where you live / the hours that suit your body clock best
- How much you want to work (hours per day, days per week)
- Lifestyle choices, family needs, age even

○ Personal Factors:

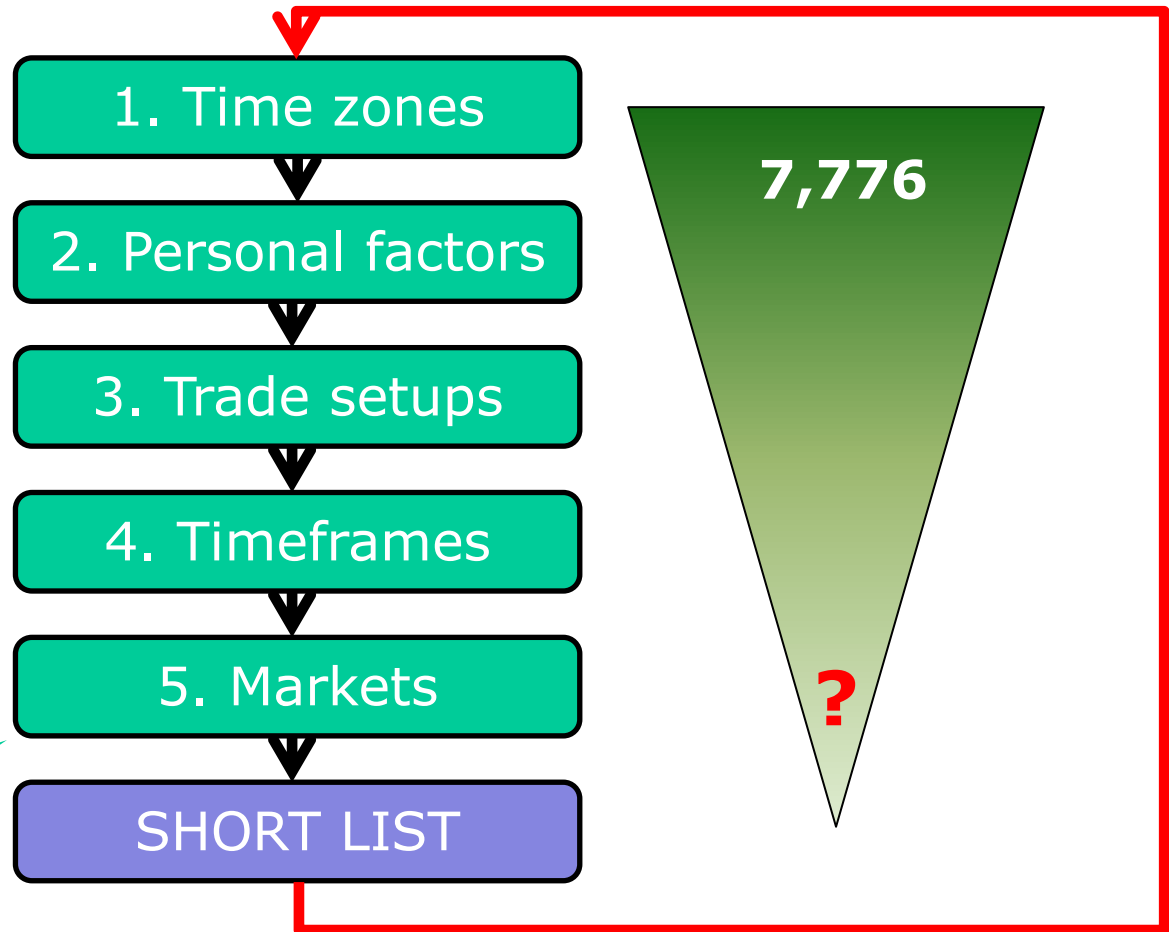
- Experience (execution efficiency)
- Discipline (to hold onto a good trade and pass on mediocre ones)
- Comfort (anxiety indicates an inappropriate solution is being used)

Its a crude process, but this gets you started quickly...

Each step narrows down the list of options by asking a series of challenging questions

The first shortlist will still be several 100, so we just repeat the process – several times if necessary to get down to a manageable number (<30)

Note this is step 5 not step 1 !



6. Iterate !

Step 1 – Time zones (Asia, Europe, USA)

- You cant trade 24 hours a day, so do you want to:
 - Trade small timeframes in one time zone? E.g. 1 min during Europe
 - Large timeframes across all 3 time zones? E.g. daily charts
 - Some of each? E.g. daily swing trades plus 1 min scalping
 - Something in between? E.g. hourly charts across 2 time zones
- Remember you only want to add one extra element at a time to your existing activities (one more brick in the wall)
 - In another year maybe you repeat the process and add a third
 - Don't try to run before you have learned to walk, else you risk becoming a butterfly!
 - Getting this right can double your income, without increasing unit size and while smoothing your equity curve

Step 2 – Personal factors

- What would you actually like to do?
 - May sound a daft question but it will be much easier to stick at it!
- What would fit in well with your personal situation / family life?
- Next, do you have the necessary experience or will you need to gain that?
 - Smaller timeframes require much better execution skills
- Do you have the necessary discipline
 - Larger timeframes require great patience for the good trades to perform
- What is physically possible for you to expect to handle?
 - You can easily trade 36 markets off daily charts
 - Try 1 minute scalping in more than 1 market
 - You must be realistic, whatever you decide you can manage will still be twice as challenging as you think now!

Step 3 – Trade setups

- Are you seeking a small number of new market / timeframe combinations to apply all of your setups to?

OR

- Do you have a favourite type of trade? Would you prefer to concentrate on 1 setup only and apply it in more places?
 - You can easily trade 4 setups in the ES 2 min
 - You can easily trade 1 setup in ES, GC, BP and Bund 2 min
 - In each case you are watching for 4 things and this is realistic, but you cant run with both – 16 is way too impractical
- Decide which is your overriding priority

Step 4 – Timeframes

- Weigh up the benefits of smaller and larger timeframes
- Smaller timeframes:
 - Give immediate results
 - Have many trades, none of which feels significant
 - But suffer from terrible noise, are your setups good in noise?
- Larger timeframes:
 - Are much more relaxed
 - Have many fewer trades so each one feels important (win and lose)
 - But they require much bigger initial risk, are you adequately capitalised?
- Not all timeframes are viable in all markets
 - So chosen timeframes can dictate which markets to trade
 - The following chart gives a very rough guide to viable timeframes, based on a combination of factors: liquidity, activity, slippage, bid/ask spread etc.

Viable timeframes

Timeframe:	D	960	480	240	120	60	30	15	5	2	1	tic
Australian Dollar	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
British Pound	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Canadian Dollar	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Euro	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Japanese Yen	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Swiss Franc	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Dollar Index	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
T-Bonds	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
T-Notes	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
German Bund	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
S&P 500 e-mini	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Dow e-mini	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Nasdaq e-mini	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Russell 2000	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
German Dax	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Eurostoxx 50	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Corn	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Wheat	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Soybeans	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Soybean Meal	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Soybean Oil	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Live Cattle	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Lean Hogs	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Cocoa	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Coffee	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Sugar	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Cotton	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Orange Juice	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Crude Oil	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Heating Oil	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Unleaded Gasoline	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Natural Gas	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
Platinum	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Gold	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Silver	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Copper	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green

Step 5 – Markets

Next we eliminate markets by examining possible conflicts:

- What is your current market / timeframe?
 - Your new addition must not conflict with your existing activities
 - If it is ES 5min, would you really want to add ES 15min? Or ES daily?
- What markets are closely correlated?
 - Remember you are looking for something new, not more of the same
 - If ES 5 min is your game, why add 15 min Russell? How about Corn?
- On shorter timeframes volume matters much more
 - Choose Crude, over Heating Oil
 - Choose Gold, over Silver
 - Etc.
- Eliminate any markets you don't personally like for any reason
 - You are seeking maximum comfort not anxiety!

Step 6 – Iterate to slowly home in to the right solution

- The first round will narrow the list down dramatically but you will still end up with too many options on the table
- Next put the remaining set through the same process, several times if necessary until you arrive at a manageable number

By this time you will have eliminated 99% of the possibilities, but the hard work now begins!

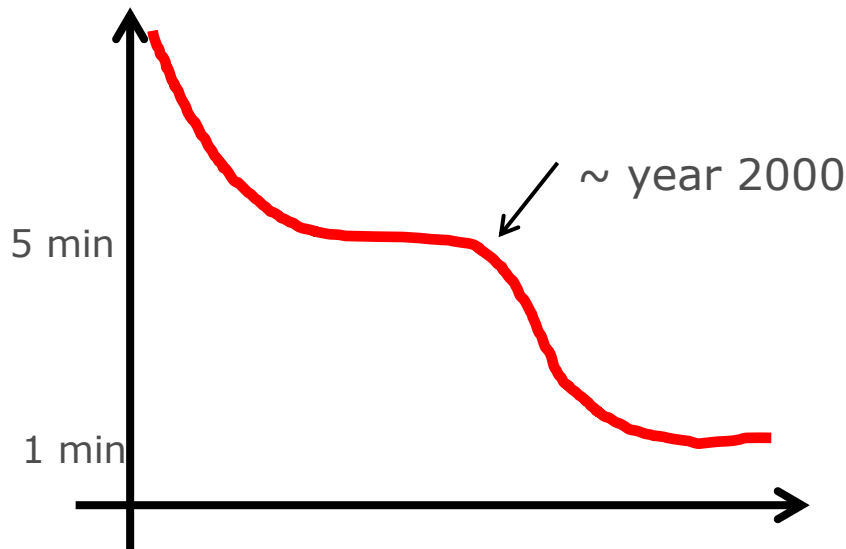
- Then research those new markets / timeframes, paper trade for a bit, get a feel for where you prefer to spend your time.
- Keep asking how they feel? Don't be afraid to keep eliminating, experimenting and even adding back occasionally if there is a logical reason to do so.

Overall be aware that this is a long journey, it does take time. Remember your goal is to double your income without increasing size and that is why this time is such a worthwhile investment.

My own journey

ES 1 min

- The S&P has been my main market for at least 15 years
 - The ideal timeframe used to be 5 min, which was as small as it was realistic to trade off the floor in the pit contract (calling in orders by phone)
 - When volume moved to the E-minis, technology made that all change and shorter term trading become both feasible and desirable
 - Throughout this time we regularly achieved ~50% annual returns on very modest unit size



However, that was then and in the last couple of years we have seen dramatic developments

A turning point

ES 1 min

?

- Who can forget the S&P in 2008?
 - Volatility hit levels not seen in decades
 - 2 point initial risks, became 4, then 8, then 15 and more still
 - This is perfectly tradable as long as you reduce size to keep \$ risk static
- But I feared what might follow
 - Those sorts of market moves so often lead to a “hangover” as volume decreases while volatility normalises again
 - This can make trading very difficult, so I wanted to have a contingency to offset a difficult time in the S&P if it materialised (as it did alright!)
 - I knew my strategy was sound, but the future market might not be, so I undertook exactly the process we have just discussed and designed a second brick for my wall...

My second brick

ES 1 min

SIR daily

- It had to be quite different to my usual 1 min ES work
- I felt that the stock market generally should be avoided
- It needed to be pressure free and not absorb lots of time

The eventual conclusion was very different, yet used the very same time proven strategy:

Brick #1

6 trade setups

1 market only (ES)

1 min timeframe

USA pit session only

No overnight positions

Full unit size

Brick #2

Same 6 setups

36 markets

Daily timeframe

24 hour markets

Only overnight positions

1/20th of the unit size

Under Professor Quinto's supervision (and curiosity!)

- I did the research and back testing – all looked pretty good
- If the strategy was as robust as I thought then it should work in any market and any timeframe – right?
- So 18 months ago we went live, starting with small positions initially and increasing size as profits were delivered and confidence grew
- The results so far...



Conclusions

ES 1 min

SIR daily

- The hypothesis seems to have been validated
- The strategy remains robust
- These longer-term swing trades have compensated for a period when the S&P has largely been junk and prevented a nasty drawdown
- I learned a lot from this 2 year exercise and that will also help me revitalise brick #1 (in case this junk continues)

You can't rush this, but when you have a successful system it now seems crazy not to further exploit it.

Brick #3 (in R&D)

ES 1 min

SIR daily

SIR 60

- The last 2 years delivered our second brick, now I am working on #3 (this time I'm developing it before a live audience!)

Brick #1

6 trade setups

1 market only (ES)

1 min timeframe

USA pit session only

No overnight positions

Full unit size

Intensive work



Brick #2

Same 6 setups

36 markets

Daily timeframe

24 hour markets

Only overnight positions

1/20th of the unit size

30 mins per evening



Brick #3

Same 6 setups

10 – 15 markets (t.b.c.)

60 min timeframe

Bit of Europe, mainly USA

Some day, some overnight

3-lots / paper trading

Check every 2 hours



- Important - note each brick is designed to be sufficiently different to avoid conflict between signals and for the time required still to be manageable by one person

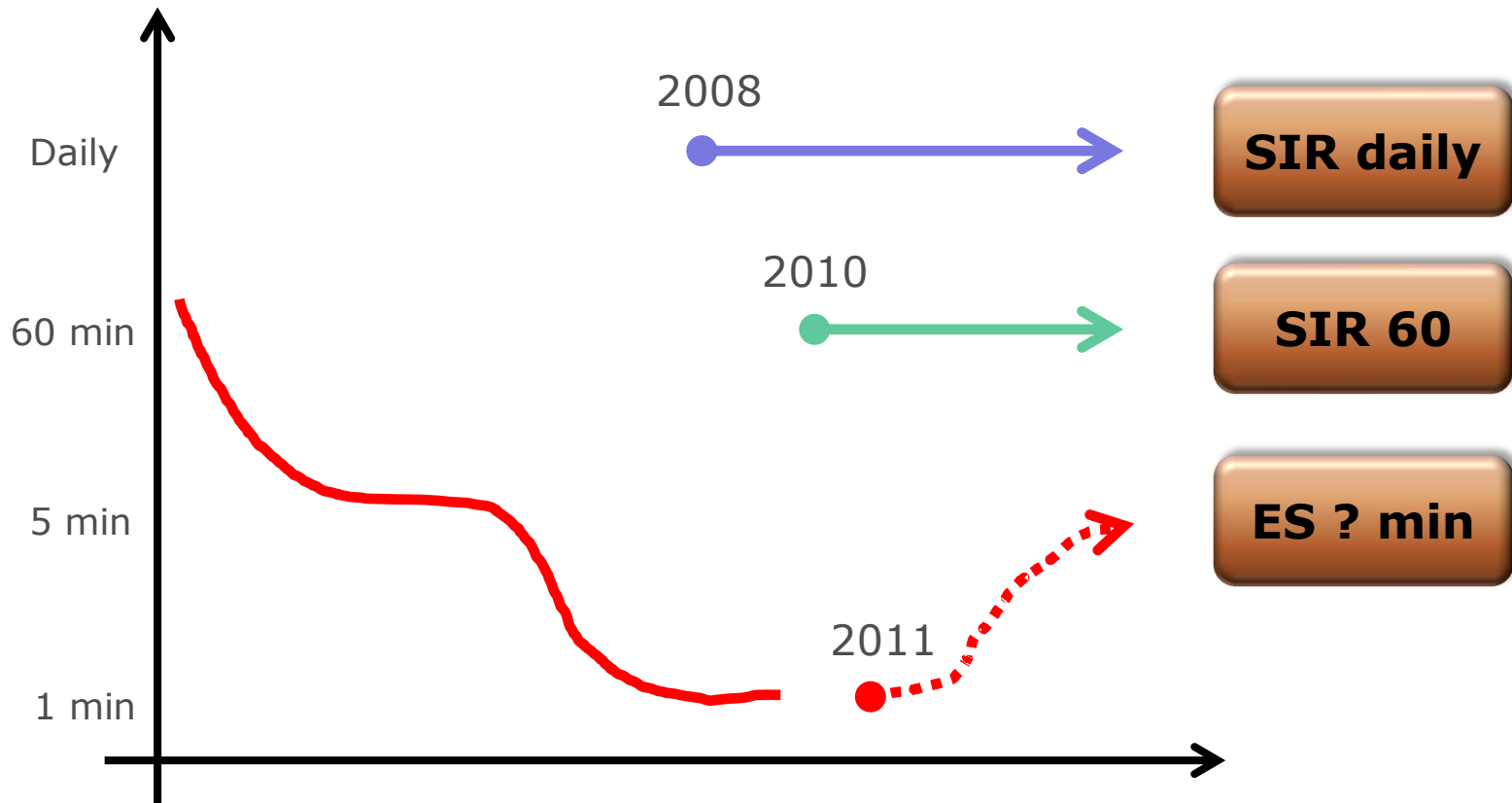
Beyond Brick #3

ES 1 min

SIR daily

SIR 60

- Brick #1 will get an overhaul, but that's another story!





Now for my
favorite part:
Questions
for Simon





Thank you, Simon.

I know I speak for everyone here in thanking you for a great presentation.

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A better person would not have used **this** moment to ask Systematic Trading Guru and Best Selling Author – Perry Kaufman to present at the October 16th **Saturday Strategy Session.**



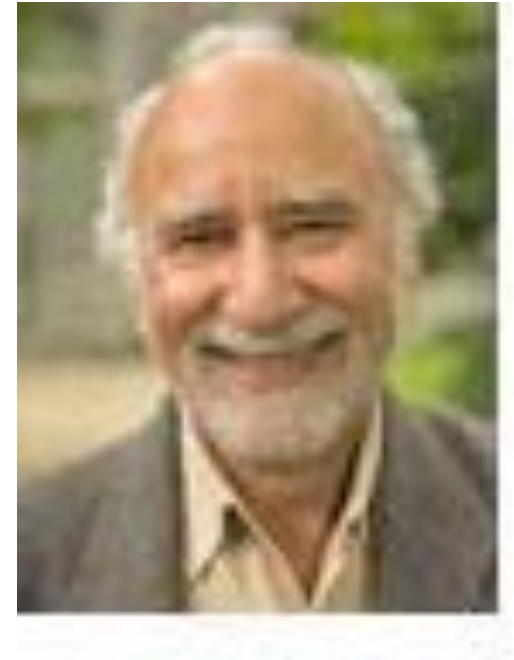
Jeff, have you no shame?



Next month's
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October 16th at 10:00AM CST
Perry Kaufman

Rocket-Scientist, Systematic Trading Guru,
Best-selling Author of 11 books including his
New Trading Systems & Methods

Perry will be talking with Jeff about how to
get started in systematic trading, how to
develop trading systems, and smart risk
management



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