



Development Methods

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Our approach is middle of the road. I look for robustness in the development of a trading system. Alternately I am not going to throw it away by back fitting, but I do not throw out the use of experience or optimisation either. As one of our good clients said about the systems I take public: they "strike the right balance between simplicity and complexity.

Every system has input variables. Most systems, in fact all systems have at least one or more sets of variables. Many good systems have 12, 16, 32 variables. One of my better competitors had a system programmed up for him that has 32 variables. These variables are, he says, adjusted for current market environment. This is based on his experience. This is based on his knowledge of market history and he manually will adjust these variables to fit current market environment until the system starts walking forward in time, producing profit or alternatively without any degradation to the historical look-back. He doesn't use the computer's ease; the computer's capability to do iterations, to grind it out with little time spent looking at permutations of the variable. He doesn't use the strength, the processing speed of a computer to optimise the input variables. He uses his experience, based on his perception of current market conditions as to what the input variables should be. He may not do this to all 32, but they are available to him if he wants. I am sure he has a couple or three sets that are most meaningful based on experience. Point one, there is no difference between back test and experience and neither one can assure future results.

The point I am trying to get to is that there is no such thing as a system that is not based on past history. There is no such thing as good trading systems that are not based on current market environment. All market systems to some degree or another are optimised, no matter how strictly you want to define the term or how loosely you want to define the term. Every system is conceptualised based on the system developer's experience, his observations of what has worked and what is working! Whether or not he uses the power of the computer is a matter of convenience, it puts to work the technology mankind has developed just for this purpose.

The key is I don't trade the past, I trade the future. I have to develop a system that is going to walk forward in time and make money in the future. So to do this, I have to devise methodology or methods to avoid over-optimising the trading system. So it does not back-fit historical price to the degree that when the strategy is trading real time it

degrades into a draw-down straight away. There are rules at Creative Breakthrough control how to go about developing the systems to avoid back fitting or over-optimisation.

All the propaganda put out there, all the misinformation put in your face is primarily, from individuals who have no experience in trading or market analysis. Rather they are likely trained in sales, marketing, accounting, compliance or as programmers. They have no idea or very little idea of what it takes to be control risk, execute a trader, and have no idea that going short is different from selling a long position. Their goals are dissimilar to the objectives you as a trader are trading to achieve.

Who do you want giving you advice on trading and investing, a salesmen or a market analyst? These professionals from other fields and areas of expertise may think they are not but they are dead wrong in the informational guidelines that promote in the majority. So when you are looking to educate yourself, "consider the source of the information. While many of my so called competitors come form checkered backgrounds, I am in the same vocation for over 25 years and choose my partners wisely. With that said, the notion of a robust trading system is very simple.

I have eight guidelines every time I develop a system. Here is my personal checklist.

1. I do not combine more than two set up conditions. For example, if Stochastic is at certain level and CCI indicators are at a certain level then initiate a trigger to get in at a certain level. Going beyond 2 pre-conditions or set ups lead to too many things going wrong. When you do, it is trying to form fit your past data history into your performance summary.
2. I only want to capture one type of trading style per market system; I leave the diversification to be amongst market systems not within the same one. So in that case my preconditions, my setups will be looking for one style of market trading range, breakout, scalping, trending etc.
3. While the length of the look back period is important, the key is to focus on a strategy which generates enough trades over that period time – no matter what period of time it is – so that the performance numbers you're receiving are statistically significant. When you start getting 500 trades or greater, the performance statistics you're looking at are meaningful and you're walking away from curve fitting. So a lot of my competition says the longer the period of time the better is not 100% true, because it takes a fair number of trades to produce robust performance.

For example I can develop a system, based on the last 20 years of market data. Yet it generates maybe two or three trades a month. The system is so filtered out that it is back-fitted over 20 years. So it does not have to be good just because it is tested over 20 years, it is the look back period and the number of trades generated. In most cases a 3 to a 5 year look back it just fine.

4. I always isolate two or three sets of input variables that should be optimised. The other variables are fixed in the code. What I focus on when I optimise these variable inputs provide more than the best results at the peak of a bell-shaped curve. I also need to see positive results on either side of the optimum variable where there is a gradual degrading of the performance. In other words, the results just don't drop off to nothing on the right and left-hand side of the optimal number. But the numbers are reasonable 2, 3 and 4 places away from the optimal variable factor. This is part of the definition of a robust trading system.

5. For trading rules to be robust, you should expect portability of the rules from one market to another but don't look for perfection! I always take into consideration the size and character of the crowd that trades the market. This is something learned early in my career and it is a matter of fact. As a technician I am always looking at my job as a behavioural science. I am analysing "crowd behaviour." As a rule the smaller the herd, the more idiosyncratic its behaviour. The bigger the crowd the more generic its price patterns will be. So you take that into consideration. Furthermore the character of a market can be affected by special sub groups. Some markets are dominated by Framers being different than markets being dominated by crude oil producers and markets being dominated by Wall Street vs. traders on LaSalle Street. So I look for differences between markets but assume one similarity, they are all HUMAN. So I expect some portability of a trading rule where it shows promise in many different markets. But what the "pundits" would have you believe for a trading system to be "robust" the same set of rules and the same set of values have to carry across most if not all markets is balderdash!

When people get out there and tell you they have market systems that trade well in all these various markets with the same set of rules and factor values, it's just not reasonable. For the same strategy to work well across markets the values assigned to factors will have to vary, the systems will either be adjusted to current market conditions based on the developers knowledge or optimised via a computer. However, in either case it does not mean the systems are "back fitted."

6. Another part of our methodology in developing a good, robust a trading system involving exits. When I develop a day trading system, I want the entries to show "promising results" (the -preconditions and the triggers) with various standalone and simple exits. The first test for a robust day trader is to show good results with an Exit Market on Close (MOC). It's the most liquid period of the day. It fulfils all the rules of the day trading system. As a robust characteristic if you have a trading system that does well, exiting MOC, no other exits – you have a promising-looking system.

So the same basic rules are used as entry and exits with profitability will give you strong indication the system is robust. For a Globex (24 hour a day) trader, it is the same rule to apply simple and generic exits to that set of entry rules and looking for profits across the

various set of exits. The simple dollar stops, price objectives, profitable open next day – all those types of exits. They will tell you. Lastly on entries as exits - a stop and reverse – if your current position has its opposite entry also as its exit and is showing profitability without any money type exits, you have the makings of a robust trading strategy.

7. I take into account the asymmetry in the markets. I was one of the original, if not the first system developer to lecture on the idea, to educate the idea of the asymmetry in the markets. It is something market technicians have understood for decades but they really hadn't sunk their teeth into it when it came to real life trading. The whole notion that market behaviour, which is what the markets are all about, depends on what the market's psychology is dictating how prices will unfold. For example, during periods of panic, prices unfold rapidly in a certain fashion and during periods of greed, prices unfold in a totally different pattern, since prices unfold in different sequence or series based on mood the markets are basically asymmetrical. So you are clear, the amount of time taken for example, to erase 62% of a bull market, let's say 1,000 points rally over a year, will be done by a bear market in 12.5 per cent of that time. So 60 per cent of the 1000 point bull market can be corrected in 12.5% per cent of the time or just 6 weeks. What it took the bull in one year to create, a bear can pretty much undo the 62% of it a much shorter time span. I'd say that's a fair rule of thumb and a good reason not to have your input variables set the same for both your long side and your short side.

The bottom line is that you have to use your head. Many, many of the people providing systems today are trained statisticians who have no idea regarding the markets, and have never traded a day in their life and have very little insight into what risk management or money management is. So what they purport may hold true in perhaps some other industry. It just doesn't hold true in futures trading. Traders are dealing with human behaviour, not some type of mathematical Newtonian formula of cause and effect. You and I are dealing with human behaviour which is unpredictable in a many cases and can veil what future events may lay ahead of us. No single mathematical formula is going to encompass it. Therefore advice from the right source on timing and diversification becomes a critical consideration.

8. When the market changes, a system will have to change as well. Stating that there is this one robust system which will meet all market conditions over the passage of years is just absurd to consider. After the crash of 2008, traders had to go back in and make some re-adjustments to their input variables to walk forward in time profitably. The knowledge of what type of market condition to expect after a crash is not "back fitting" it's called study and experience, adapting to current market conditions. So to be a good developer of systems and a good trader I don't get fixed in my ways, but I don't back-fit systems either, since I trade the future, I am always looking ahead.

So those are really the keys from my point of view to developing a good trading system – ones that walk forward in time.

However, one last comment is that another part of it is putting strategies into incubation, i.e., walking forward with them in time, paper trading them to see how they do, and if they do things that are on a dollar basis risky, then I isolate the reasons why they're doing those risky things and take those features out of the trading system. They could be, for example, making too many trades in a single day, so governing the number of trades that can be handled during the day will reduce risk. So by controlling these risks and others up front before going public will keep the on going profits from "degrading." No one can guarantee that all conceivable risk is controlled but my goal is to reduce it. I think somedays risk is prevented proactively, on other days it is in reaction. None the less it has to be on an on going basis. A very key point to understand is that a good developer is constantly looking for and implementing ways to control those risks, because it's all about staying in the game to letting the profitability take care of itself.

Great and Many Thanks,

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