1
There is NO Holy Grail

"Everything works and nothing works."

Richard Russell

A MARKET JOURNEY

I started my career in the financial markets the way most people do. I went to university, earned an honours degree in economics and entered my first full-time job at the age of 22 believing that the markets obeyed the laws of macro- and micro-economics I had just spent the last four years studying. How wrong I was!

I have subsequently come to realise, as I think many people do, that the financial markets do not actually behave according to the textbook laws of economics and capital market theory. In fact, my own personal belief now is that the markets can (and will!) do anything at any point of time and "prediction", as we commonly think of it, is a totally impossible and futile exercise. However, I do not look back and think that my years studying messrs Fischer, Begg, Dornbusch, the theory of comparative advantage, the theory of purchasing power parity, the capital asset pricing model and a host of other "laws" was a complete waste of time. Not at all and I will tell you why.

There are two broad schools of thought for analysing the financial markets. One is the fundamental market analysis approach that makes use of "fundamental" data such as macro-economic statistics, corporate balance sheets and corporate profitability in order to predict the future course of prices in the markets. These statistics, backed up by perceptions and guesses about what they will be like in the future, are the so-called fundamentals of financial and commodity markets. The other approach is the technical market analysis approach that makes use of past market price data and sentiment indicators in order to anticipate the future course of prices in the markets. Proponents of the technical approach shun the fundamentals, as being irrelevant to an analysis of the actual supply and demand of the market itself that they say will be apparent in the market price alone. The technical school also differs markedly from

the fundamental school because the technical school has a much more pragmatic approach to "forecasting" future market prices than the fundamental school, which is something we will look at in detail later.

These are the two broad schools of market analysis and market participants generally fall into one group or the other for their preferred method of analysing the markets with some market participants using only one form of analysis and some using both simultaneously. However, no matter what your chosen school of analysis is, in my opinion it should be every market participant's goal (indeed obligation) to study the methods and theories involved in each school of thought in order to gain a complete and as full an understanding of market theory as possible. I find it incredible that, even now, technical market analysis is not as widely taught in universities or finance courses as, in my opinion, it should be. The behavioural finance aspects of markets are thankfully becoming much more popular in courses though and, when you consider that behavioural finance is merely another term for technical market analysis (because technical analysis is an analysis of market psychology), then at least there is an element of balance appearing in modern finance teachings. Would we expect a lawyer specialising in criminal law only to have studied criminal law and nothing else? Would we expect a doctor specialising in cardiology only to have studied heart-related medicine? Of course not. We expect other professionals to have studied and have a broad understanding of their subject in order that we, as customers of their service, can have confidence in their knowledge and experience. Why does it seem different in the investment field? Both fundamental and technical analyses have recognised industry-accepted qualifications, but still only the minority of people in the investment industry will have badges from both schools. In this regard, therefore, my early market years submerged in the fundamental market approach have proven to be very useful indeed as I believe it has allowed me, as a keen student of the markets, to gain a much deeper insight into what makes markets tick and how the fundamental school interacts with the technical school.

In fact, as the years have gone past and my market experience and analysis has developed I have come to realise something that I believe many market participants do not fully appreciate. Most technical market analysts or investors started out as fundamental market analysts or investors before, having become disillusioned with the fundamental school, steering themselves in the direction of the technical approach. However, most fundamental market analysts started life as fundamental market analysts and dismiss the technical approach without ever having studied any of the theories at all! This, I think, is extremely instructive and is one reason why market price action behaves and cycles the way it does. More of that later.

So having completed my economics degree I went to work for a stockbroker where I gained my first market experiences of managing stock portfolios by analysing company accounts, profit and loss statements, attending corporate meetings and taking account of news flow. Younger readers may be shocked that our desk of three people had to share a quote screen for the stock prices we monitored! That was 1991! How times have changed. While working there I actually believed that reading the

financial press, diligently studying the company accounts, talking to the people in the company and following the news flow from the company would help me to predict the future course of the company share price.

And this is when it hit me. Why, when all the news was positive, the company was making money and the balance sheet was in healthy shape, would the share price go down? Why, when all the news was negative, the company was losing money and the balance sheet was a joke, would the share price go up? This was not how the markets were supposed to work for goodness sake. The textbooks all told me that if *a, b* or *c* happened then logically *x, y* or *z* should happen to the share price, but the only problem, it seemed, was that no one had decided to inform the markets that this was the case! I was intrigued and determined to find out as much as I could about the reason for this beguiling market behaviour.

As luck would have it my next job, in London, was managing bond and currency portfolios with Hambros Bank – one of the last of the venerable blue-blooded British merchant banks in the City – and it was here that I worked closely with a true giant in the technical analysis field, Tony Plummer. It was an honour to work with someone who took a much more rigorous intellectual approach to technical analysis than the majority of his peers and his classical work on price cycles became a major influence on my market analysis. I joined the UK Society of Technical Analysts, learned all I could about the subject and passed the diploma in technical market analysis. Now, one of the most undermentioned aspects of technical analysis is just how broad a subject it is. Essentially, technical analysis is concerned with using past price data in order to anticipate (anticipate rather than predict!) future price action but this encompasses a massive range of methods and theories. Dow Theory, Japanese Candlesticks, Elliott Wave Theory, Cycles, Gann Analysis, Behavioural Finance, Point and Figure, pattern recognition, trend lines, Chaos Theory, quantitative analysis, the hundreds and hundreds of price derivative indicators and Trend Following are only a part of the subject that is known as technical analysis. Add in sentiment indicators such as survey and positioning data and you have something that is massively broad in scope. Yet many people still think of technical market analysis as quite a narrow field. It is not. The term *technical market analysis* refers to anything that involves a study of the market price action as well as other related indicators, such as volume, to gauge the sentiment and psychology of the overall market in order to take advantage of trends and discernible patterns in price that the psychology cycle emits. The subject is extremely broad and the theories that underpin it pre-date modern theories such as the Capital Asset Pricing Model (CAPM) by centuries. As I wanted to incorporate such theories into my overall investment approach, I worked with technical analysis throughout my time in London while at the same time paying attention to the so-called fundamentals of the market.

By this stage in my career I had armed myself with a very broad understanding of all aspects of market analysis from the fundamental approach to the technical approach. I had seen throughout my career that some forms of analysis worked well at certain times but then didn't work very well in the next period, and those that

gave very bad results would all of a sudden come into their own and produce stellar performance. It was for this reason that I still struggled with the age-old question, the grand daddy of market analysis, the big kahuna of them all, that anyone who has had any interest in trading or investing in the markets has asked themselves at some point of their lives.

That question very simply is . . . *what works?* What method of analysing the markets works all, if not most of the time? What is the Holy Grail of market analysis and trading or investing? If we are honest with ourselves, anyone who has a passion for the markets would admit that this question has vexed us all in our quest for reliable and consistent profitable trading or investing and I am sure it will continue to do so because it is, at the end of the day, human nature to look for the consummate answer to puzzles and things that we, as human beings, seem powerless to control. And the markets are by far and away one of the biggest puzzles known to man. The question will also keep the steady supply of books, courses and what not with titles like *Trading Secrets* and *How to Make a Million Dollars in the Markets* coming in and being snapped up by people searching for that elusive Holy Grail.

After my stint in bond and currency market asset management I went on to concentrate full time on currency markets specifically. The currency or FX (foreign exchange) markets are sometimes referred to as the "most efficient" markets. This is confusing for the layman because the word "efficient" here is being used to describe the ease of dealing or the liquidity of the markets in terms of the bid (selling price) and offer (buying price) spread. At nearly three trillion US dollars turnover *per day* there is certainly enough liquidity to dwarf all other markets in that respect, but in terms of "efficiency" in the academic sense the currency markets are maybe the least efficient markets.

The efficient market hypothesis, the academic idea that information is absorbed into the price almost immediately and that, as a consequence, fundamental and technical analysis is useless, has been rightly condemned by practitioners in the markets. What the efficient market hypothesis is essentially saying is that prices move randomly, and therefore there should be no trends in the markets, but one only has to glance at a chart of a financial market to see that this notion is complete nonsense. Markets *do trend* up and down. Admittedly they do not trend up and down all the time and they sometimes trend sideways! This, in fact, is what this particular book is about.

Now, one of the assumptions that the efficient market hypothesis makes in coming to the conclusion that information is almost instantly digested into the price is that the market participants are all what is known as profit maximisers. That is, the market participants' motivation for trading or investing in the market is to secure a profit. This assumption might well be true for markets like stocks and bonds, but when we examine the diverse range of participants involved in the foreign exchange markets then the assumption breaks down. The foreign exchange markets are made up of some profit maximisers like bank traders and currency investment managers but the market also has, among others, governments whose role in the market can be

to attempt to smooth out fast moves, industrial and commercial corporations whose actions in the market can involve buying and selling for import and export purposes and tourist companies whose actions are the result of retail tourism decisions. So with not everyone in the foreign exchange markets being profit maximisers, the informational importance contained within the efficient market hypothesis gets diluted a great deal and the market transactions, at any one time, can be the result of a multitude of very different decision criteria. Therefore, the FX markets are actually one of the least efficient markets in the academic sense and this partly explains why the foreign exchange markets can show a greater deal of persistence (or trend) than other markets as information seeps into the foreign exchange markets, or more accurately is acted upon in the market, contrary to the popular image of the FX markets being lightning speed and dynamic, at a much slower speed than the efficient market hypothesis would suggest.

Realising this, however, did not help me in my career-long search for the illusive Holy Grail of trading. "Foreign exchange markets trend more than other markets." Great, I thought. So employ a trend-following method and watch those profits roll in. Hhhmm . . . not quite! Yet again I found that there is not one method of trading or investing in the markets that is consistently profitable in every time period. Sometimes the best results came from following the trend, sometimes the best results came from fading the trend, and sometimes the best results came from doing absolutely nothing at all!

Therefore, from where I sit today, having managed institutional money in stocks, bonds and currency markets (and my own private money in commodity markets) I feel that I have a pretty good understanding of what makes most markets tick. After years of painstaking research, academic testing and a huge amount of real world trading of methods and theories trying to work out the best way to trade and invest in the markets, I have come to this not so startling conclusion. *Everything works . . . some of the time.*

This is what this book is about. It is about a pragmatic approach to trading and investing rather than a "trading method that will make you rich" type book. This book is not about a "guaranteed" way to make money and is certainly not about some sort of "magic" system that will make you a millionaire. If that is what you are looking for, I suggest that you stop reading now. Incidentally, there is actually a book called *The Trading Rule That will Make You Rich* by Edward Dobson and I thoroughly recommend it because it has some very valuable insights about market behaviour. However, as will become clear to the reader, I would not recommend trading all your capital on just one methodology.

The realisation that "everything works but only some of the time" is, in my opinion, crucial to long-term success or survival in the financial trading market place. Over the course of my career in the financial markets I have found out that there is actually no holy grail for trading success and there is no magic method that will guarantee you to trade or invest consistently profitably. Instead, what I have found is that by analysing the probabilities of what *trading environment or "regime"* the

market is in, or about to be in, can enable you to adjust your trading or investment risk parameters and game plan in such a way as to increase your chances, your probabilities, of long-term success. And probably the best barometer of success in the markets is the longevity of staying involved. To paraphrase a quote from Jesse Livermore, probably the greatest trader who ever lived, the real aim of the investment or trading game is "to be able to come back tomorrow and play it again".

HORSES FOR COURSES

On the subject of games, Lee Trevino, in his day, was a great golfer. He won six major championships (the four top competitions in the sport) and he was known as one of the best strikers of a golf ball who ever lived. He could hit low, boring shots into a fierce wind and he could hit high floating shots that would land on the green like, as he said, "a butterfly with sore feet". There was however one thing Lee Trevino never did. He never won, in fact never really played very well, at the Masters tournament played at Augusta National, Georgia, USA. The reason for this is that Trevino played his golf shots with a fade (a left to right spin on the ball for a right hander), whereas the layout of the golf course at Augusta dictates that golfers play a lot of draws (a right to left spin on the ball). So Trevino's game was simply not suited to the Augusta National layout.

Pete Sampras was one of the best, some say *the* best, tennis players that ever lived. He won a record 14 Grand Slam men's singles titles, for six consecutive years finished ranked number one on the ATP rankings and *Tennis* magazine named him the greatest player from 1965 to 2005. Yet, despite all this, there was one thing Pistol Pete never did. He never won a significant title on the clay court playing surface and the generally accepted wisdom is that this was because the slower surface didn't suit his natural serve and volley game.

In the business world, the commodity sectors in quoted stock markets are, on the whole, filled with very well run companies. They sell a product that has a limited supply, keep costs under control for the most part and are, with a few exceptions, generally prudent in not over-extending themselves with debt. However, everyone knows that the share prices of commodity stocks will still generally underperform the rest of the market when the prices of commodities in general are going down.

The point is this. Lee Trevino was still a sublimely talented and successful golfer, Pete Sampras was still one of the all-time tennis greats, and mining companies still have successful business models over the long term. Great athletes and solid companies can be renowned as such even if they do not perform in each and every environment in which they ply their trade. Of course, when someone or something does come along that is so great that they *do* perform in each and every environment (such as a Jack Nicklaus or a Tiger Woods in golf!) then we just have to sit back and admire the exceptional brilliance of that. They are the very rare exceptions to the rule though, and if this *variable* performance behaviour can be observed in what are

essentially competitive endeavours where the environment in which the endeavour is performed is changeable, then should it not be true for other competitive endeavours such as investing in or trading the financial markets?

Investing in or trading the markets has many similarities to sports. Both have a scoring system, league tables and defined rules. Both have direct competitors and both involve a judgement of risk versus reward. These are just some of the reasons why a lot of the most passionate people involved in financial market investments or trading have sports backgrounds or are keen followers of sports. They have a natural competitive spirit and are motivated by endeavours whereby gaining an edge on your competitors can be the difference between winning and losing. They constantly strive to be better at what they do. However, just as their sporting counterparts develop their own skill sets, they will develop a *style* of trading or investing that will suit some market conditions perfectly and others not so well. The realisation we come to therefore is that, just as racehorses perform best on certain race courses or in certain weather conditions, just as golfers perform better on certain golf courses, just as tennis players perform better on certain surfaces, and just as different companies perform better under certain economic conditions, various styles of financial and commodity market trading or investment will work better under different market conditions.

As an example, take trend following as a market strategy. Trend following is perhaps the most simple and straightforward market strategy where, as the name suggests, the strategy is to follow market trends as they develop. Identifying where trends start and end is done through various means but the most popular would be by using moving averages of the price. Let us assume for simplicity that we are using this strategy on just one market. A proper and complete trend-following methodology would include many other markets because of the good diversification benefits that accrue, but let us assume for now that we are trend following on just one market. Now, when the market in question is trending then this strategy will produce good, solid, perhaps even spectacular results. However, when the market in question is not trending then this strategy will produce bad, perhaps even disastrous, results. This is just common sense and not rocket science! It is a statement of the blindingly obvious. When this market does not trend then trend following as a strategy will lose heavily, but when it does trend the strategy will win superbly. The questions therefore become (a) do you as the investor in this strategy think that a trending market will occur more often than it does not, and/or (b) how much does the strategy lose when markets are not trending and how much does the strategy win when markets are trending?

I remember trying to explain this latter point in a presentation at one time. My presentation was on trend-following strategies and, as a believer in the strategy myself (over the long term and with appropriate diversification), I was essentially trying to persuade a group of board level people why we should use them. Now, there is a certain phrase that people use in the market that is very misleading. In fact there are a few but more of that later! This particular phrase I am referring to is one that people like to trot out from time to time in a light-hearted jovial sort of way as

if they are saying that they are experienced market people and know what they are talking about. The phrase is "as long as you are right more than you are wrong then that is all that matters". If there was ever a saying that has misled and is still misleading market professionals then this is it. It is up there at the top of the list of market sayings that sound good but, when you actually examine the details, turns out to be the biggest load of rubbish. If the people that said this sort of guff just sat down and thought for a while about what they were saying, then they would surely realise the absurdity of the statement.

There are two elements to a trade or investment in the markets. One element is the direction of the trade you want to express. That is, do you think the market will go up, down or sideways? Do you buy hoping for an up move in the market, do you sell (go short) hoping for a down move in the price or do you put on a trade that benefits from a sideways market move? The other element to a trade is how much risk you put on the trade. This element is actually the most important part of the trading or investing decision yet it is discussed very little in the sea of literature on the subject. It is this *how much* question that will have the biggest effect on your trading decisions. Let's say you are bullish of the stock market and you buy S&P Index futures. If the market goes up 10% and you have bought only one futures contract you will have a very different economic outcome than if you had bought five futures contracts. I apologise if the reader thinks that this is so simplistic that it borders on the condescending but I honestly believe that most people in the markets do not fully appreciate this money management (or bet sizing) element to trading or investing. We spend the vast majority of our time concerning ourselves with timing the market as to when to get in or when to get out when, in reality, the biggest determinant as to whether the trade or investment will be profitable or unprofitable is how much risk we put on initially, and how we manage that risk through the life of the trade. Much, much more on bet sizing later.

So, there I was presenting on trend-following strategies to these old colleagues of mine and had gone through various performance statistics over and over again to emphasise the point that trend following tends to work over the long term. One particular old boy, who had, in common with a lot of people of that generation, spent his entire career with the same company and also had a worrying habit of falling asleep in meetings, arose from a slumber and said "yes Murray, these trend-following strategies are not very good you know because only 30% of the trades are right. In this business you have to be right more than you are wrong." Fantastic I thought. Here was a chance to really emphasise why trend following is a good long-term strategy and went on to make the point that although the system loses 70% of the time the actual amount that it loses each time it is wrong is far, far lower than the amount it wins each time it is right. The average win is much, much higher than the average loss on good trend-following strategies and that is why, over the long term it tends to be a good strategy.

However, no matter how many times I reiterated this, the man in question simply could not get the point. I think his colleagues got it but we spent many, many minutes

discussing the point and this man still repeated the mantra of "you have to be right more than you are wrong". It really underlined the fact to me that many people in the trading or investing world have such closed minds that they simply cannot comprehend anything that goes against their perceived bias. The problem is that most people take the expression of "you have to be right more than you are wrong" to mean that you have to be right more *times* than you are wrong and this is plainly incorrect. It is a mathematical fact that you can be wrong more times than you are right, but so long as your wrong trades lose, on average, less than your right trades then, over the long run, you make money.

Nevertheless, the investment world is filled with people who have closed minds and an unwillingness to adapt, and it is this stubbornness of attitude which turns out to be good news for trend followers because by its very nature trend following forces the investor to align himself or herself with the forces of change. As Charles Darwin so famously said, "It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is the most adaptable to change", and so it is the people that take risks and change that take advantage of the people that do not. It is having this ability to change when, as the economist John Maynard Keynes famously said, "the facts change, which is critical to long-term success in any business, and particularly when it comes to trading or investing in the markets having the ability to accept, embrace and *follow* change is absolutely essential".

Charles Sanford was at one time the head of Bankers Trust, a company that in its day was one of the biggest and best risk takers in the markets. He made a speech in June 1989 at the University of Georgia, USA, to college graduates in which he quite distinctly and superbly summed up the nature of risk taking in relation to what it means in the context of change. Here is an extract from that speech.

> From an early age, we are all conditioned by our families, our schools, and virtually every other shaping force in our society to avoid risk. To take risks is inadvisable; to play it safe is the counsel we are accustomed both to receiving and to passing on. In the conventional wisdom, risk is asymmetrical: it has only one side, the bad side. In my experience – and all I presume to offer you today is observations drawn on my own experience, which is hardly the wisdom of the ages – in my experience, this conventional view of risk is short sighted and often simply mistaken.
>
> My first observation is that successful people understand that risk, properly conceived, is often highly productive rather than something to avoid. They appreciate that risk is an advantage to be used rather than a pitfall to be skirted. Such people understand that taking calculated risks is quite different from being rash.
>
> This view of risk is not only unorthodox, it is paradoxical – the first of several paradoxes which I'm going to present to you today. This one might be encapsulated as follows: playing it safe is dangerous. Far more often than you would realize, the real risk in life turns out to be the refusal to take a risk. In other words, the truly most threatening dangers usually arise when you shrink from confronting

what only appear to be the most threatening dangers. What is widely regarded as "playing it safe" turns out not to be safe at all.

I'm suggesting that you take a positive view of risk . . .

. . . We all know that modern civilization owes much to the ancient Greeks. As the 20th century draws to a close, it's difficult to single out a Greek thinker who speaks more directly to us than Heraclitus. "All is flux, nothing stays still," said Heraclitus some twenty-five hundred years ago. "Nothing endures but change."

Most of us have come to believe that "nothing endures but change", but its consequences still deserve some reflection. Obviously, if change is the fundamental rule of life, then resistance to change is folly – doomed to defeat. Just as obviously, if change is our constant, then uncertainty is an inescapable part of our lives. Uncertainty is unavoidable. Life is unpredictable. The very essence of life is the unexpected and the unintended, the unanticipated turns which we may metaphorically ascribe to Fate or Destiny or Providence.

Therefore, unless we wish to be tossed about like so much flotsam on the waves of inescapable change, we must place ourselves squarely in the midst of change. We must learn to ride the current of change rather than to swim against it – although people who haven't taken the trouble to learn how the world really works will think we're doing exactly the opposite.

In other words, risk is commonly thought of as going against the current, taking the hard way against high odds. In a world of constant change, however, a world where Heraclitus said we can never step into the same river twice, taking risks is accepting the flow of change and aligning ourselves with it. Remember the first paradox: risk only looks like reckless endangerment. For those who understand reality, risk is actually the safest way to cope with a changing, uncertain world.

To take a risk is indeed to plunge into circumstances we cannot absolutely control. But the fact is that the only circumstances in this life that we can absolutely control are so relatively few and so utterly trivial as hardly to be worth the effort. Besides, the absence of absolute control – which is impossible in any case – does not entail the absence of any control, or even significant control.

There, again, is the paradox: in a world of constant change, risk is actually a form of safety, because it accepts that world for what it is. Conventional safety is where the danger really lies, because it denies and resists that world.

I trust you understand that when I say risk is actually safety, I'm talking about a certain sort of risk. I'm not advising that you leap off tall buildings in the hope that the operation of constant change will reverse the law of gravity in mid-flight. I'm speaking rather of a sort of risk which actually aligns you with the direction of change.

[Reproduced by Permission of Charles Sanford]

This speech, in my opinion, is one of the most eloquent portrayals of what the trend-following investment strategy is. Charles Sanford speaks the language of the risk-taking pragmatist. The pragmatic person takes account of change, accepts it for what

it is and instead of trying to fight against it he follows it and tries to take advantage of it. Things change. Life changes. Trading and investing market conditions change. This is why trend following is such an attractive proposition not just in the investment world but also in life itself. For those willing to *surrender* themselves to the forces of change without feeling the need to understand all the reasons why that change is happening, they will, over the long term, have the wind at their back and, contrary to the popular opinion of trend following, actually be *ahead* of the majority when important, long-lasting change happens. The expression "one must move with the times" is another way of saying the same thing. To surrender yourself and accept change, even if you do not understand why it happening, is to find contentment. Fighting change and swimming against the current is mentally and physically tiring.

At this point readers might be thinking that I am very biased towards a trend-following style of investment and they would be right. Do not fear though. This book is not a sales pitch for trend following despite the fact that, in my opinion and experience, a diversified, long-term trend-following portfolio is not only the most logical way to invest but is actually, as Sanford alludes to with regard to risk and change, the safest way to invest. Long-term trend following is the only investment methodology that I know that guarantees the investor to be on the correct side of a sustained movement in the price. Think about that for a second. It *guarantees* the investor to be on the correct side of a sustained movement in price. When I first started getting involved in trend following I thought this was an amazing statement and I still do. If the key to long-term success in the markets is, as many investors no matter what their own personal style bias is would agree, to run your winners and cut your losers then trend following is the very embodiment of such a philosophy.

However, trend following, like any other investment strategy, needs to take account of change in other ways like changes in market conditions. As has been noted, certain trading and investing strategies work well in certain circumstances and not in others so the challenge to the market participant, as I see it, must be to try to detect changes in those market circumstances. Once they have been detected the participant then needs to accept the changes for what they are and embrace them in order to fully benefit from the ebb and flow of the markets. I may be biased towards a trend-following philosophy and methodology just as others might be biased towards a fundamental approach to trading or investing in the markets, but one thing I have learnt over the years is that having this ability to take account of changes in market conditions can enhance one's own personal investment style bias in such a way as to, at least, smooth out the losing periods or draw downs in equity that inevitably occur from time to time. Moreover, if no inherent style bias exists then an analysis of changing market conditions can enhance returns over the long term.

So how do we define these market conditions? Very simply, these are the general states of *volatility* under which the market in question is trading in the period under review and it is these states of volatility conditions that have generally become known as trading regimes.

TRADING REGIMES

The phrases trading regime or trading regimes can actually mean different things in the context in which it is used, so it is worth stressing the context that I am using in this book.

The *Oxford English Dictionary* defines regime as, among others: *a manner, method or system of government, the condition of a body of water with regard to rates at which water enters or leaves it and the set of conditions under which a system occurs or is maintained*.

In the financial markets reference to a trading regime has three broad contexts.

Firstly, a trading regime can be referring to the rules and regulations that are set down for something to trade under. Take a currency as an example. It can be freely traded or "floated", it could be fixed to another currency or basket of currencies, or it could operate under a "dirty or managed float" whereby the country's authorities attempt to keep it within a band around another currency or basket of currencies. At the time of writing, for instance, the Chinese Yuan is pegged to a basket of currencies and the Hungarian Forint has a managed float plus or minus 15% from the Hungarian exchange rate with the Euro.

Secondly, a trading regime could be referring to strategies that can be employed in the markets. In the currency markets, for example, there are many different strategies used for attempting to make money. The "carry" strategy refers to a strategy of going short a low yielding or basket of low-yielding currencies (those with low interest rates) and going long a high yielding or a basket of high-yielding currencies (those with high interest rates). The idea is that the positive interest rate differential (the carry) will produce solid long-run returns. Another strategy that would apply across all asset classes could be a value strategy where the idea is to buy undervalued assets and sell overvalued assets. This is probably the most widely used strategy in discretionary market trading. Discretionary market trading is when the decision to buy, sell or do nothing is taken mostly by human beings acting subjectively and weighing the various factors involved in the decision-making process in their heads or having the ability to overrule a more formal process. This differs from systematic market trading where the decision to buy, sell or do nothing is taken mostly by a computer and the human involvement is limited to the initial setting up of the computer model. Yet another trading strategy could be the previously mentioned trend-following strategy where the idea is to follow the trend of the market by using systematic calculations and methods such as moving averages to decide in which direction the trend is going. Each of these strategies plus a lot more could be referred to as a trading regime in certain contexts.

Thirdly, trading regimes have been referred to in quantitative and econometric modelling studies as states of macro-economic conditions such as low (high) tax economy, low (high) inflation and above (below) trend growth economy to name only a tiny amount. These "regimes" are widely referred to in studies that involve optimisation of investment portfolios using quantitative techniques such as those pioneered

by Harry Markowitz. This definition of trading regime is probably the one that most economists and econometricians will think of in any discussion on the subject.

However, lastly, and this is the context in which this book is referring to trading regimes, a trading regime could be referring simply to whether the market in question is in a trending mode or in a range-trading mode. A market can do one of three things. It can trend, it can trade in a general range or it can do a little bit of both. The purpose of trading regime analysis is to identify what trading environment the market is in and, crucially, to identify when it is *probable* that the market is about to enter either a trending or range-trading regime. To me this is the essence of the markets. Markets trend, then they don't trend, then they trend again and this cycle continues on and on. As a trend follower I, of course, get frustrated when the markets do not trend, which is actually the majority of the time, but as per the earlier comment about being more right than wrong, the times that they *do* trend tends to more than compensate for the times they do not. Nevertheless, this was my main motivation for studying trading regime or *volatility* conditions in the market because if I could identify when the market was likely to enter a non-trending period then I could take appropriate action to defend my investments because I knew that a period of range trading would be bad for trend following. By the same token if the volatility conditions of the market meant that a trending regime was more likely, then maybe I could take advantage of that by increasing the risk I was applying to the market. So in this regard, trading regime (or volatility) analysis actually assumes a very important role in determining many aspects of the overall investment process.

Now, how you may ask do I propose to measure whether the regime in question is a trending regime or a range-trading regime? Well this may disappoint the more quantitative readers but my criteria for identifying what type of trading regime the market is in is for the most part the good old-fashioned, original and arguably the best computer in existence. That is the human brain and more specifically the eyes. The good old eyeball method of analysis is, in my experience, the simplest and most intuitive method of analysis for looking at price action for the purposes of deciding whether the market is trending or ranging and, in my opinion, because I am not advocating a purely systematic, mechanical method of actually trading the markets, a subjective and loose definition of what constitutes a trend and what constitutes a range should suffice.

Many people have tried to define what a trend is and many people have tried to define what a range is, but the trouble with these definitions is that they all have the one thing in common in that the parameters of definition that go into the models were, at the end of the day, thought up by a human brain. So someone's definition of a trend could be that the market has to have an upward sloping 20 period moving average and a rolling correlation coefficient relative to time of ± 0.75 but someone else's definition could be completely different. In the same vein, someone's definition of a range might be that the market is being capped within a 1% price range high to low for five days or more but, again, someone else's definition of a range might be completely different. You see, the definition of a trend or a range is in the final

analysis a subjective exercise. Of course by including hard filters of constitutional definition it can be less subjective than purely looking at the time series and saying "that's a trend" or "that's a range" but not, I would argue, by much. In my opinion, it is pretty obvious to the eyeballer of a time series chart whether a market is in a trending regime or a range-trading regime and, as we shall see, how one takes advantage of these regimes can differ between methodology and time frames anyway.

To be clear, therefore, a "trading regime" in this book is referring to whether a market is in a trending mode, range-trading mode or whether it is doing a bit of both. For many years my market analysis focus has been to identify when such trading regimes exist and when, more importantly, they are likely to change or switch because it is then that we, as market participants, can choose the right trading or investment techniques that go with the particular trading regime and not try to persist with something that would obviously not produce good results in that regime. The remainder of this book outlines why the markets behave the way they do, what some of the techniques and methods are to identify what type of trading regime a market is in or about to be in and how best to use these techniques to help us in our overall trading or investing game plan.

TRADING REGIME ANALYSIS FOR THE LONG TERM

Many readers may be thinking that a lot of what I have been discussing in relation to trading regime analysis is very similar to existing methodologies such as volatility breakouts, and they would be right. In that sense trading regime analysis is trying to identify exactly the same periods of low volatility or price range contraction rising to high volatility or price range expansion. On the other side of the coin, when trading regime analysis is looking to identify periods when conditions will calm down, at least in the direction of the immediately preceding trend, then this is similar to other so-called trend exhaustion techniques.

Over the past few years there has been new quantitative research in this area with regard to identifying volatility regimes and a lot of this research has been useful. However, my contention has always been that most, if not all, of the cycles in volatility can be captured by using traditional technical analysis techniques, where volatility expansion or contraction can be anticipated just as well as volatility predictive quantitative models. In fact, a lot of traditional technical analysis techniques will not only anticipate the direction of the volatility but also, in the case of an expansion in volatility, the direction of the market.

The problem, however, has been that a perception of technical market analysis both in relation to traditional technical techniques and in relation to volatility breakouts has grown whereby most people tend to think of these analyses as useful only for short-term market movements. This, as we shall see, is unjustified because whatever time frame (or fractal) is being examined, the market is being driven by the same underlying psychology that comes from human emotions. Price patterns

repeat themselves at every degree of the market. A time series chart of one-minute closing prices will look similar in certain circumstances to a chart showing one-month closing prices because the underlying driver of the market is the same human psychology that causes price trends and reversals of those trends. This notion that our more fundamentally minded colleagues have that technical market analysis is suitable only for short-term market analysis is simply flawed. Yes, the so-called fundamentals will change over the long term, but they will do so at the very best coincidentally with changes in the price of the market. More than often the market price will discount the changes in the fundamentals before they come to be noticed by market participants and so, in this regard, technical and volatility market analysis is perhaps even *more* relevant for the long term than the short term. Therefore trading regime analysis, at least as I see it, can be broadened out considerably to look at the long time frames and add value to those who follow long-term investment processes as well.

Knowing where the probabilities lie as to whether currencies for example will be in a trending or range-trading environment over the next few months will add value to a currency overlay manager who has a choice of models or styles to utilise in extracting profits from the markets. Trying to estimate the longer term probability of volatility can yield some spectacular results in terms of strong long-term trends and, in a sense, volatility analysis could be said to be most applicable to longer term analysis because strong volatility can occur at exactly the time when a market has been doing nothing for a long period of time. If a market has been going sideways in a period of very low volatility for a long, long time then it tends to get forgotten about by the market. Then what seems like all of a sudden the market springs to life and because it has been in a low volatility environment for so long the subsequent trend can be much stronger and longer lasting than the majority expect. A perfect example of this was the exchange rate of the Euro versus the Great British Pound in 2007 and 2008 when, subsequent to this period, the exchange rate had been in an extremely low volatility period for nigh on two years before moving up by over 20% in a strong trending fashion in only eight months – a huge move for a major exchange rate.

As we shall see, therefore, I have concentrated a lot on *longer term* examples of trading regime but an analysis of volatility is very applicable to all time frames.

TERMINOLOGY

Throughout this book I refer to analysts of a trading regime or volatility as, you might have guessed, trading regime analysts. I recognise that technical analysts might point out that I could just as easily use the term technical analyst for most of what I describe and I would have to agree with that. However, I would like to make it clear that what I am describing in this book is an analysis of the markets that, first and foremost, is attempting to identify and anticipate the current and likely trading *conditions* of the market, be they trending or range trading. This analysis is not as its primary goal

attempting to anticipate *direction* but it does include traditional technical analysis methods and pattern recognition that would, as we shall see, anticipate direction as an inherent part of the analysis. So while technical analysts will be very familiar with most of what is in this book I believe the potential use of the techniques and methods that go into an analysis of the trading regime of the markets has a slightly different bent to it; for instance, in the uses of position sizing and/or risk budgeting. I would ask the reader therefore to keep in the forefront of their thoughts when I use the term *trading regime analyst* that the primary goal of this endeavour is to look for the probabilities of underlying market's *volatility conditions* and not necessarily the *direction* of the market.

In this sense it is the probability of *volatility*, in whatever direction that occurs, rather than the probability of *direction* that is our main aim. An understanding of the current and anticipated volatility conditions will help the market analyst in many ways; for example, in terms of the position sizing of investments, the allocation of risk to certain investment styles and the choice of markets in which to invest. Volatility analysis does not have to be the realm of the quantitative community only, and orthodox technical market analysis can give the analyst a good gauge as to the current and likely trading regime.

In the next chapter we shall discuss how it is the primeval driver of human beings themselves that is the primary driver of all market price action and the subsequent volatility, or lack of it, that it creates.