CHAPTER 1

Invest in Yourself, Not a Trading System

Emotional qualities are antagonistic to clear reasoning.

—Sherlock Holmes

Those individuals with a passion for trading know success comes from within, but are they applying themselves in this direction?

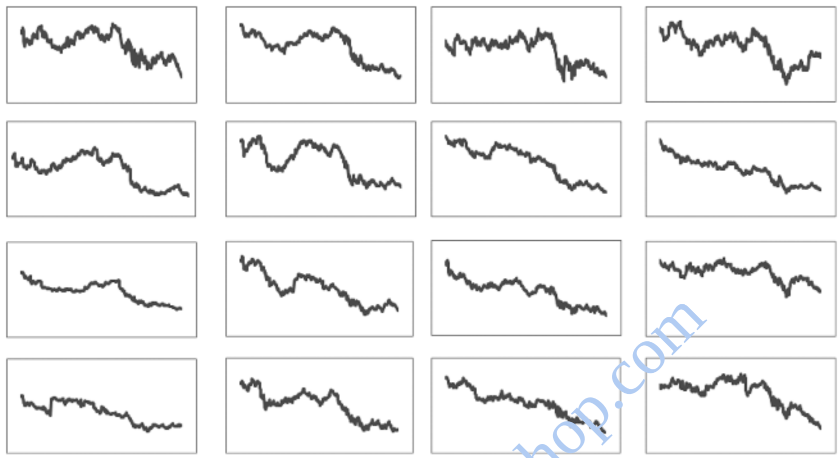
In this book, the operational definition of beating the market begins with making incremental improvements; that is, as you confront the everyday challenges of the market, you become more adept at finding an imbalance between what you can win and what you can lose.

Are You Good at Decrypting Chart Patterns?

Most technicians claim to be good at decrypting chart patterns. Figure 1.1 shows 16 different stocks ready to breakout from a 340-day (October 31, 2007, to March 9, 2009) bear market. If you study these charts, can you pick the four best and four worst stocks from the bunch?

The line charts record the price movements of 16 companies during the bear market. On March 10, 2009, the bear, after being on the run for 340 trading days, finally hibernates as the bull resurfaces. The market charges ahead over the next 562 trading days. With your prowess in reading chart formations, can you actually make a performance distinction among these 16 stocks?

FIGURE 1.1 These 16 line charts are ready to break out from the 340-day bear market. Can you pick the best-performing from the worst-performing companies over the next 562 trading days (March 10, 2009, to May 31, 2011)?



Few investors can spot the best-performing companies, but if you were unable to discern the best from the worst, does it say something about being a chartist? This exercise is not about your current stock-picking acumen, it is about spending all those days, perhaps years, trying to identify future price patterns on the basis of prior results without making a discernible improvement in your trading.

The fundamental question is: Within the year, will your ability at reading chart patterns actually improve, and will you be more profitable because of it?

Beware of Ineffective Solutions

Some technicians, by glancing over candlestick charts, can correctly forecast market direction. Cognitive psychologists would argue as to whether this is something you are born with or a developmental learning process.

Although we want these extraordinary powers, if you do not have them, get over it. The worst thing you can do is to go on deluding yourself.

At any rate, if you do not have this ability after years of trading, can you someday acquire it? This question of whether it continually develops over the years is debatable, but if it is a learning process, does its performance peak? For instance, in running, you can go on improving until you reach your maximum performance, but in trading there are no limitations.

If you are simply maintaining your pace or slowing down, you have to take a different approach in order to make further strides. But where do you turn? Obviously, not every trading system will bring you sustainable success. Some do not complement your ability, emotional disposition, or work schedule. Since everyone runs at a different pace, it is to your advantage to replace a less effective system with something more constructive.

Running in Place

Why would you keep using a system when you are unhappy with its performance? With the market producing a winning performance record, most systems will produce positive results. Since its inception (January 29, 1993, to August 19, 2011), for every 40 trading days, SPDR S&P 500 (SPY)—informally known as the spiders—have had a positive return on 21 of them.[1] Given this uninspiring performance, almost any system will bring us a halfway chance of success; therefore, it elicits a steady sprinkling of positive reinforcement. And with positive feedback coming intermittently, it is more difficult to extinguish.[2]

When any system performs poorly, we attribute our unexceptional performance to external forces by rationalizing our misfortune on bad breaks or transfer the blame directly to ourselves. Still, we believe that if we stay at it, with hard work, someday soon we will put it all together—so we keep trudging along.

Somehow, we never master the chaos, but continually create within it.[3] We constantly toy with minor revisions, which do not alter our unimpressive performance; they do, however, keep us in the game because our occasional wins, along with our attempts to fix things when we have a down day, make it difficult for us to discard our current approach to trading the markets. Recognize the presence of this destructive behavior, and take control over your trading—begin by playing the percentages.

Armed to the teeth with a dazzling array of bells and whistles, your powerful program comes fully packed with every indicator under the sun.

[1]In these 4,675 trading days, the spiders had a 2458-2166-51 daily W-L-T record. See the appendix for a description of the spiders.

[2]According to the principles of operant conditioning, "performance is least persistent after it has been reinforced continuously and most persistent after it has been reinforced intermittently." C. B. Ferster and S. A. Culbertson, *Behavioral Principles*, 3rd ed. (Englewood Cliffs, NJ: Prentice-Hall, 1982), 98.

[3]This is a concept of the venerable existentialist, Simone de Beauvoir. See her *The Ethics of Ambiguity* (New York: Citadel Press, 1948).

Although they give you the illusion of surefire success, it is important to keep them in perspective; more information does not automatically return more revenue.

These bells and whistles are often counterproductive, because when you are using these indicators, they frequently take you in completely opposite directions. Ambiguous distractions adversely affect your analytical powers; when they occur, they often undermine your success because you are likely to fall prey to emotional trading. Certainly, these superfluous indicators are an embellishment of your trading arsenal, but they are not a condition of your success.

Is your program good at crunching numbers? For instance, can it answer this question by giving you the past performance results for this specific trading condition: If the major market indexes close within pennies of their lowest price, can your trading program give you statistics on the performance of the overnight trading session? More specifically, if you are trading the spiders (SPY), can it instantly produce a report of its winning percentage over the previous 300 trading days, its past performance scores, a listing of its outliers, or display a scattergram of the trading days satisfying this requirement?[4]

Supplementing Your Analysis: A Restrictive Trading System

Despite these restrictions, I am not advocating that you replace your powerful programs. In fact, keep your collection of technical indicators, but supplement your analysis by using my statistical techniques.

Crunching Numbers

Following is an analysis of a trading situation lasting 10 years, in which you would take a long position at the closing bell, holding it throughout the night, but sell it when the market opens for trading. It includes a description of the overnight trading sessions (OVS), as well as the regular trading session (RTS). Historical prices showing the specifics of the trading day can be found at popular websites, such as http://finance.yahoo.com.[4]

At the closing bell, the spiders fall to close within $\leq$ \$0.08 of its lowest daily price. What action do you take in response to this information? Given that its price is at the bottom of the trading day, can your trading program produce an analysis of its performance in the overnight session?

[4]Instructions on downloading historical daily prices can be found in the appendix.

TABLE 1.1 Description of overnight trading session.

Date	Open	High	Low	Close	Volume
06/16/2011	127.06	127.97	126.32	127.30	307,830,500
06/15/2011	128.24	129.30	126.68	127.02	300,958,000

OVS: 06/16/2011 (opening price – 06/15/2011 closing price)
OVS: 06/16/2011 (127.06 – 127.02) = .04

TABLE 1.2 Description of regular trading session.

Date	Open	High	Low	Close	Volume
6/16/2011	127.06	127.97	126.32	127.30	307,830,500
6/15/2011	128.24	129.30	126.68	127.02	300,958,000

RTS: 6/16/2011 (closing price 127.30 – opening price 127.06) = .24
RTS: 6/15/2011 (closing price 127.02 – opening price 128.24) = −1.22

Before presenting the findings, Tables 1.1 and 1.2 define the two trading sessions.

Working Hypothesis

If the spiders close within $0.08 of its lowest price, how does it perform in the overnight trading session?[5]

Trading Specifics

When this condition occurs, we want to take a long position at the close of trading but offset it at the ringing of the opening bell. Table 1.3 provides a small sample of this trading condition.

This restrictive system has a winning percentage of 68 percent; it illustrates how we can turn to the percentages to make trading decisions without the emotional distractions, which often are destructive to traders.

Statistical Findings

The analysis for this system looks at the spiders' trading performance over a full 10 years. On December 29, 2000, SPY sat at $131.19; on December 31, 2010, it was at $125.75.

[5]Chapter 4 discusses the reasons for replacing a $ change with a % change when making pricing comparisons.

TABLE 1.3 This is a small sample of seven days from the 10-year analysis. It shows the two days (gray shade) that qualify for this restrictive system because the (close – low) is within $0.08.

Date	Open	High	Low	Close	Volume	(Close – Low)
12/15/2010	124.44	124.93	123.89	124.10	160,823,100	0.21
12/14/2010	124.75	125.23	124.29	124.67	147,249,600	0.38
12/13/2010	125.05	125.20	124.52	124.56	133,812,700	0.04
12/10/2010	124.14	124.60	123.73	124.48	117,571,700	0.75
12/09/2010	123.97	124.02	123.15	123.76	123,705,100	0.61
12/08/2010	122.98	123.38	122.41	123.28	138,019,200	0.87
12/07/2010	123.94	124.01	122.76	122.83	206,581,000	0.07

After 10 years of trading, the spiders had a slight drop in price. This system, which is counting on an overnight recovery, had 119 winning against 55 losing trades. Although we were trading in an unprofitable setting, we were able to construct a system with an attractive winning percentage.[6] In these 175 trades (one tie), it brought in a profit of $22.08 (an average of $12.62). The system affords you one trade in every 14.37 trading days. Occasionally, there was a long respite between trades; however, in trading, patience is often rewarded with profits.

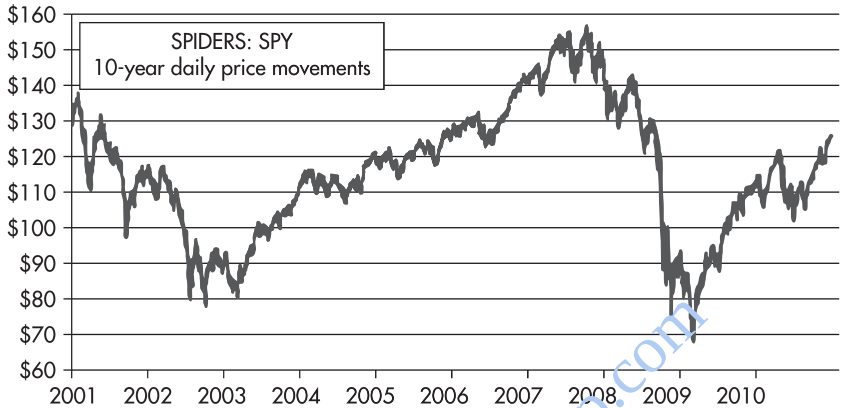
Advances	119
Declines	55
Ties	1
Winning %	68.00%
Sum	$22.08
Average Return	$0.1262

Summary of the System

I refer to this as a restrictive trading system because it is not an everyday play. When constructing these systems, you are generally looking for a high percentage of success; in contrast, we can be profitable if the system has a high

[6]When calculating the winning percentage, a tie is put in the loss column. After all, you do have to pay commissions.

FIGURE 1.2 A snapshot showing the price movement for the spiders (SPY) over 10 years. This SPDR fund replicates the movements of the 500 stocks in this popular index, leaning heavily toward large-capitalization companies.



percentage of failure by playing the downside. The unattractive part of this system comes from having only one play in 14.37 trading days. With experience, however, you will construct a handful of these restrictive systems to complement your trading arsenal.[7]

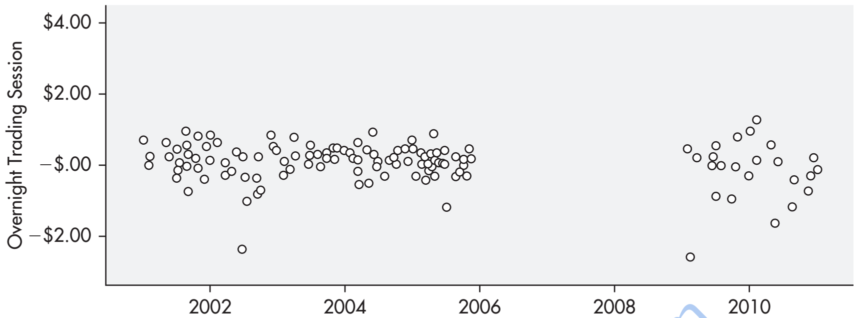
During these 10 years, the financial markets had two excessive meltdowns. The line chart in Figure 1.2 displays these ugly downturns. Always run an analysis to determine if the systems you are using can weather the storm.

The list below gives the summary results of using this system during the 885 days representing these two sharp downturns shown in the 10-year price chart of the spiders. Despite taking a long position during the 885 trading days comprising the two strong corrections, this has a remarkable 36-19-1 record, returning $8.30 in 56 trades.

Advances	36
Declines	19
Ties	1
Winning %	64.29%
Sum	$8.30
Average Return	$0.1482

[7]Chapter 11 focuses on restrictive trading systems. It contains many more of these gems.

FIGURE 1.3 Performance results of the overnight trading session: By separating the winning from losing days, we can easily spot the outlying score along with the more recent performance scores.



Interestingly, this system was able to stay afloat during two economic recessions. Most often, there is no immunity when taking a long position in a bear market or a short position in a bull market, but it is not uncommon for some of these restrictive systems to still prove profitable, although they are going against momentum.

As we go on, we will uncover more of these anomalies. They certainly deserve our attention.

Next, it is advantageous to display a scattergram (Figure 1.3) showing each one of the 175 trades using this system. Each dot represents a single trade made during this 10-year period.

In these 10 years (2001 to 2010), when the closing bell rang, if the closing price was in the vicinity of its lowest daily price, taking a long position appears to have given us a trading advantage.

Notice that in 2007, the scores in the scattergram begin producing more volatility. Observe the wider spacing between the scores; when this occurs, it often invalidates future performance and therefore is an incentive to reassess our analysis.[8]

Modifying Your Behavior for Better Results

Again, it is important for me to emphasize that this book introduces many of my systems, but unlike most investment books, they are not the primary

[8]Chapter 3 evaluates the ongoing performance of a system; we want to know if it is still performing admirably, or if its performance is starting to fade.

focus. Rather they are a roadmap for enduring success! Think of this book as a tour guide with the express purpose of expanding your imagination so that you can construct your own trading systems. Once you begin experimenting, you will become more self-determining, which promotes a more positive attitude.

Coming from this cognitive perspective, you eventually become less dependent upon external sources for making your trading decisions. This strengthens your self-confidence, and in turn, will give you the conviction that you can execute winning trades despite market adversity.

In addition to taking you through the process of creating a system, there are other discussions within the book, such as designing the worksheet, implementing the assessment functions in Excel, running the analysis, and interpreting your findings. After you amass this information, there is a discussion on how best to place your trades on the basis of your findings.

Always do your homework. Allow your analysis to put you on the correct course. Make your trading decisions only after you discover an obvious advantage. And remember that you are playing the percentages; you may have the advantage, but this does not ensure success. A few trades are not a measure of success or failure. Cultivating a positive learning environment takes you halfway; in order to arrive at your destination, you have to consistently discover new profitable opportunities.

The solution to the earlier problem portraying the 16 charts of companies in the bear market is shown in the appendix at the back of the book.