

Equal Traders

Michael Covel and **Justin Vandergrift** put 'no memory' trading into practice.

Trade Equally

Consider two traders who each have the same amount of capital, the same tolerance for risk and the same trend-following trading system. What must they do? They must both trade in exactly the same way. What do we mean? If two traders are essentially equal then there is neither room nor reason to act differently. Successful trading requires precision and discipline. There is no room for ego, personal opinion, subjective interpretations or emotional indecision.

Here are some of the rules of 'no memory trading'.

Do not try to recoup your money

Trade for today, not yesterday. Trade what you have now. Since you can't change the past and you can't change the market, don't let your past trades determine what you trade today. Take Cisco (or any other stock that has risen a ton and fallen straight back down). Many people rode Cisco straight up and they made a fortune. Many of those same people rode Cisco right back down and lost most of it. Were there sure signs to sell Cisco after it peaked? Yes. There was the falling share price – a clear signal. However, once many of these traders became fixated on Cisco, with fond memories of how much they made originally and how good winning felt, they could not stomach accepting a loss, any loss. Instead of following a system and selling Cisco after it peaked, they elected to keep holding on in the hope that it would come back. As Cisco continued on its death spiral their focus was still on the past as they asked themselves, "How do I get my money back in this one stock?"

Do not try to take revenge

Why do you have to get even with the market on this one stock? No one but you cares that you lost money. Trying to recoup in the one stock that sank you is not a strategy. It's an emotional attempt at revenge that is doomed to fail. You can't get revenge on the market. You can only do the right thing, the right way. Trade for today, without regret, without wishful thinking, without anger. Trade by following a system.

William Eckhardt, the great trend-following trader, has spoken forcefully about the idea of not having a memory in your trading:

"Suppose two traders, A and B, are alike in most respects except the amount of money they have. Suppose A has 10 per cent less money but he initiates a trade first. He gets in earlier than B does. By the time B puts the trade on, the two traders have exactly the same equity. The best course of action has to be the same for both of these traders now. Mind you, these traders have very different entry prices. What this means is that once an initiation is made, it does not matter at all for subsequent decisions what the entry price was. It does not

matter. Once you have made an initiation, what your initiation price was has no relevance. The trader must literally trade as though he doesn't know what his initiation price is."

Another way that traders may be tempted to take revenge is by increasing the position size of the market they are trading, especially after generating a string of losers. Perhaps soybeans had four losers in a row and you decided to double your position size on the fifth trade. After all the market has to give a winning signal now, right? Wrong. Each trade you take at double position size shortens the life of your trading career!

Putting 'no memory' into practice

Putting 'no memory trading' into practice requires testing the system or the set of rules that you will use for trading. When evaluating any trading system, ask these questions:

- Is it profitable in a wide variety of market groups?
- Is it over optimised?
- Is it profitable across a range of parameters?
- Are the trading rules fully disclosed, with no black-box 'secrets'?
- Do you know your risks every step of the way?

Risk control is one of the fundamental reasons a trading system works. Risk control is the game plan, or the play pattern for trading. An entry into a market is just like swinging a bat in a baseball game. If you connect with the ball then you need to know what to do. Do you try to take second, or hold on first and wait for the next pitch? If you hit the ball long, do you keep running and try to make it home? In the same way, do you have all of your if/then contingencies ready in advance before you ever get into any market?

An example:

Recently we researched a trend-following system. Its entry, exit, and risk control are fairly 'textbook' for that type of system. It is a fixed fractional trading system – meaning the system risks the same percentage of the account on each trade. There is no unit weighting; all markets are traded with the same percentage. You trade all markets equally with no favouritism (or memory) given to any one sector or market. The system trades 24 markets across several sectors - financials, currencies, grains, meats, softs and energies.

The first run through the system generated the following returns over a 15-year period:

Maximum month to month drawdown: 36.47 per cent

Average annual return: 48.57 per cent

Average win/average loss ratio: 2.17

Winning percentage: 36.27

We decided to look at the optimal 'heat' (see www.seykota.com) of the system to see if performance could be enhanced through risk control. Optimal heat shows the maximum total account risk that generates

the most robust trading returns from a risk control perspective. When we re-ran the portfolio using optimal heat the portfolio generated the following results:

Maximum month to month drawdown: 28.75 per cent

Average annual return: 44.29 per cent

Average win/average loss ratio: 2.15

Winning percentage: 36.27

We used a simple ratio to quickly compare the results of the two: the average annual return divided by the maximum month-to-month drawdown. The ratio for the first portfolio was 1.33 and for the second was 1.54. The second portfolio, the one trading at optimal heat, is 15.8 per cent more efficient than the first. It generates more return as a percentage of risk, measured as month-to-month drawdown.

Notice two important points. First, no basic system parameters were changed. The entry and exit conditions stayed the same. The winning percentage and the average win/average loss ratio are nearly identical across the two runs. The only change made was the total account risk. If the optimal heat was calculated to be 36 per cent, then we would trade each market at 1.5 per cent (optimal heat divided by the total number of markets: $0.36/24 = 0.015$).

Secondly, both portfolios perform at a winning percentage of less than 40. You can earn profits even when you are wrong most of the time! Novice traders get lured into the illusion that trading is about

stroking your ego or being 'right'. Being right or wrong does not sway the most successful traders. They simply follow the markets in a fluid fashion by using a system with 'no memory'.

Final thought

Human beings want patterns and/or connections to the past. They want to answer the question 'Why?' 'No memory' thinking forces you to break away from constantly searching for patterns, and forces you to test your trading ideas vigorously.

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