

Stop trading in the dark: **Gary Stone** outlines the benefits and the essentials of a trading system.

# TRADING SYSTEMS



s traders, investors and students of the financial markets we are constantly advised by virtually all educators and experienced traders to 'trade according to your plan' or 'trade with a system'. We are told to write a trading plan that meets our own investing style and risk profile. Yet for many this can be a daunting prospect because it is a very open-ended and often ill-defined topic. Most investors have no idea of what their own style or risk profile is, as it is discovered only after some years of being active in the markets. Also, many educators confuse what a 'plan' and what a 'system' is. They can be very different, depending on the educator's 'style'.

There are many dubious trading systems in the market place and a lot of less-than-reputable promoters spruiking the benefits of their particular system or strategy. For the unwary, the uneducated, or those with the bright lights of instant success in their sights, these systems can seem like a path to instant wealth and overnight success. These dreams usually end in tears however, as the so-called system is nothing more than some simple signals that appear to be working well in current market conditions. When conditions change, the 'system' implodes and the unsuspecting client is left poorer – but a lot drier behind the ears.

On the other hand are those advocating that we develop our own trading system and then stick to the rules of this system as it generates buy and sell signals according to the rules that we have developed. Whilst this seems relatively easy in theory, many

people find this a difficult task mentally as they have not fully conditioned themselves to think in terms of probabilities and overall market outcomes. These traders are still preoccupied with the outcome of each trade, and wanting to be 'right', rather than knowing and understanding the range of outcomes their system may produce over the long term.

### What is a trading system?

A trading system is any set of rules we can repeatedly execute to engage the markets consistently and objectively. Trading systems vary from those that require orders to be placed manually to fully automated, auto-executing systems that send buy and sell orders electronically into the market. Regardless of the level of complexity of a trading system, all have the same basic structure. There is a set of vitally important components to every successful trading system.

### Entry signals

A well-researched set of clear and unambiguous filters and rules is needed for entering each trade. The signals are based on technical and/or fundamental indicators, mathematical algorithms, price movement, volatility and other parameters, either of a standalone sort or in combination. The trading system uses a computer to scan the market to generate buy signals based on the parameters that have been set.

### Exit signals

The measure of a well-developed trading system is its emphasis on the importance of exiting trades. Exits will be either taking profit or accepting losses, based on the predefined rules of the system. Profit-taking strategies will vary according to the markets being traded, and the average hold time for trades. Shorter-term trading systems will generally focus on exiting trades at a predefined profit target, whilst systems that hold positions open for longer periods will exit based on a trailing stop mechanism. All systems will exit losing trades according to predetermined stop loss rules. These will be a function of the risk and money management parameters

of the system and will ensure that profitable trades are allowed to run and losing trades are cut quickly and efficiently as the need arises, in the time span that the system is designed to trade.

### An edge

Entry and exit signals combine to give the system a positive expectancy or 'edge' in the market. That is, over a large sample of trades the system makes money. Expectancy determines not only how much average profit is made on our trades, but also the size of winning trades over losing trades, and how often we expect to win and lose when we trade the system. The overall effect of expectancy is that a system that loses more often than it wins can still have a profitable 'edge' over the market if the size of the winning trades far outweighs the size of the losing trades. A comprehensive understanding of all the numbers associated with the trading system is necessary to implement it successfully. Too often, traders attempt to 'out-think' the system, taking selected signals that they want to believe are better than others, taking profits too early, and worst of all, cutting losing trades too late, because they fail to grasp the probabilities of the system playing itself out over the long term. Successfully using a trading system involves taking each signal as it comes along, when there is available capital, and sticking rigorously to the rules of the system. Only in this way can the trader reap the positive returns generated by the trading system.

### Position sizing and money management

An unambiguous answer to the question of 'how many?' is an integral part of any successful system. The answer will be based on such factors as risk profile and management. It will include capital allocation, trade size, maximum loss, adding to winning positions, number of open positions and the like. This factor is the key difference between a successful trading system and one that fails to perform over the longer term. Successful traders understand that,

over time, money management and risk management far outweigh the importance of entry and exit signals. Having said that, position sizing cannot make a negative edge positive even over many trades; but poor position sizing can turn a positive edge into a negative one.

### Proven performance

Your system needs to show it works over many years and in varying market conditions. For those developing a system this will involve back testing and modelling the system over many years and with a large data sample, to

indicators or other parameters to all line up at the same time, or that require too many complex interrelationships to occur, will typically under-perform a solid strategy based on a few simple rules – particularly if that system is deployed consistently and with solid money management and position sizing rules.

### A trading plan

All the rules of the system will be documented as part of a written trading plan that includes all the points mentioned above. The trading plan must also include the ‘soft’ issues that

the trade, and with no plan as to how and when to exit both winning and losing trades. The emotional roller coaster experienced by these traders is directly proportional to the highs and lows of their winning and losing trades. Winning – which will occur due to randomness alone, not necessarily skill – leads to feelings of euphoria and happiness, whilst losing trades (the majority) lead to sadness, anger, and feelings of defeat and betrayal by the market.

Vividly contrasted to such traders are those who trade using a tested system, with an edge over the market that aims to deliver consistent returns over the longer

**Without a system, trading can be frustrating and an emotional roller coaster: the occasional and random big win is constantly being offset by a continual stream of losing trades or, even worse, the odd very large losing trade can wipe out portfolios.**

ensure the system is robust across a range of market conditions and that it is not ‘curve fitted’ to maximise returns in the prevailing market. For those purchasing a system from a reputable system developer it will involve closely – and objectively – examining the results of the system and ensuring that the system has been trading profitably over many years. If the system is solid and profitable, the vendor should have no qualms about disclosing the overall results of the system and the trades that it has taken. Whilst we all know that ‘past results are no indication of future returns’, they do give us a valid way to examine the system and determine its suitability for our own trading style, favoured time periods and lifestyle.

### Simplicity

More often than not it is the consistent and disciplined implementation of a relatively straightforward set of concepts and rules that leads to success in the long run. Trading systems that require a large number of

are relevant to each of us and that vary from person to person. They will include such things as your mission statement (which states your personal purpose for trading); your financial and skills goals and objectives; your trading routines, stating at what time of day you do your analysis and execution; when to stop trading during times of personal crisis such as sickness and relocation, or when taking a vacation; and how to manage strings of winning and losing trades.

### Benefits of trading with a system

Without a system, trading can be frustrating and an emotional roller coaster: the occasional and random big win is constantly being offset by a continual stream of losing trades or, even worse, the odd very large losing trade can wipe out portfolios. Moments of joy associated with winning trades are countered by long periods of fear, hesitation, frustration and anger as the trader bounces around from one trade to the next, unsure of the reason (if any) for entering

term. These traders simply execute trades according to the rules of the system. Devoid of emotional attachment to the outcome of each trade, they know that some trades will win and some will lose according to their edge, and if they continue to take all the signals generated by the system when they have available capital, they will be successful. They are able to avoid the ‘noise’ of the market (as the system listens only to the price action that emanates from the markets in the present) and simply place trades according to unambiguous rules. They are also well disciplined in the management of risk and the allocation of capital. They have developed an empathy with the market that can be achieved only through the confident execution of their trading plan. After all, the market is the only truly unbiased and neutral supplier of information on which to base decisions. <sup>VTE</sup>

*Gary Stone is the founder and lead research analyst for ShareFinder Investment Services. For more information on ShareFinder and its SPA3 system, see [www.sharefinder.com.au](http://www.sharefinder.com.au).*