# Trading systems

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You see them all the time in the news groups. S&P futures mechanical trading systems, commodity trading systems, stock systems. All are pretty much the same in principle, some sort of algorithm for creating buy and sell signals for trading with.

Now right at the start of the FAQ there is an article on speculation vs investment, there are other articles on trading and some articles on gurus and software. Some trading programs are ok, but most are downright fraudulent.

Mechanical trading systems go for anything from a couple of hundred dollars to a hundred thousand dollars. Money-back guarantees are not worth very much really, since the company may not even exist when you come back to claim your money, or there may be fine-print clauses that prevent you getting your money back.

Writing a system is easy, you can either make up just about any old thing and flog it for a high price, which is common enough, sell it at $5,000 a pop and you won't need too many customers to pay for your professional spamming software, or make something at least remotely plausible. Work may have gone into creating the system, but it will be curve fitted by a computer, or is some tricky little scheme that worked over the test period, but not necessarily at any other time.

Try not to get overly impressed with tables of past results that are computer backtests, give a neural net program a completely random curve and it will be able to find some sort of mathematical equation that will follow this exactly, and mathematicians and engineers do this all the time with Fourier series. What you must insist on is an actual trading record. You want to see a broker's trading statement, showing genuine trades pulled off in the real market. You also want to see all trades, not just a selection of them. Very very few system sellers will provide this, though apparently there are a few that do. If they don't provide the trading statements (which any reputable vendor should be happy to do, since they would be the most compelling form of advertising possible!) then forget it. A computer can generate a "predictive" system out of any data at all, the system may be spurious though and won't work once you take it out of the box.

The vast majority of trading systems available are garbage, truly worthless. It is a very lucrative business though, at $2,000 a pop you find 50 suckers through the Internet and ads in the back of magazines then you have $100,000! The promoters of trading systems flaunt their wealth as "proof" that they are great traders, in light of this figure though one can see that just because a system promoter drives a Ferrari to the marina to cruise around in a big yacht doesn't necessarily mean he made all that cash through trading. In fact the majority of real traders make a relatively modest living, with returns that would not excite most punters. You are more likely to become a millionaire flogging crappy systems than you will day trading, not that I am suggesting you give up your dreams of becoming a trader or investor and becoming a con man instead!

The system may be a proprietary indicator of some sort. As it will probably be generated by computer back-testing, and because it is "proprietary" you won't be told how it works, it will be a true long/short black box program. Or it may be a completely transparent system that you follow like a robot. An example being something along the lines of "Buy S&P minis on a Monday if the price rises after gapping down over the weekend, add to your position Tuesday if the trend continues and confirmation is seen in the Dow and use a 5% trailing stop at all times. If the price falls below the Monday open use that as a short selling stop, with a 2% trailing stop, to be closed out if there is bullish divergence in the Russell 2000 index." Whatever you do, don't trade that system as I just made it up while typing (I don't want to type out a "real" commercial system as that might not go down too well with ASIC), it is quite similar to a couple of systems I have seen, they were just as simple and even managed to produce large historical returns.

For $2,000 or more, that is what you will get. Either some little .exe file on a disk that runs some strange test over the data or half a page of instructions. Needless to say the provided trading historical returns will be excellent, they may reflect "actual" simulated results (the computer did test this and this is how it went in the last 18 months) or the results may be completely fabricated.

Occasionally the information may be more voluminous. David Bowden's Safety in the Market system is an ultra simple trend following system that can be summarised in a little booklet, though of course the package is bulked up with plenty of videos and audio tapes, posters, basic commodity info. We are supposed to be impressed by his trading wealth, yet he has sold thousands and thousands of these packages for almost 20 years at $995 each. Yeah, I'm sure he is a millionaire, but that means exactly zilch really as far as he goes as a trader.

Why hasn't word gotten around that his material stinks? Well it has, all over the Internet there is critical stuff, few people who buy the system do proper searches for reviews first. As long as he provides standard disclaimers and offers some sort of money back guarantee the law can't really touch him. In the SITM case the money back guarantee doesn't carry fine print, but the money back period is very short and it is doubtful a beginner will have the time to fully analyse the system fully enough in the period allowed to conclude conclusively the program is at fault. The SITM money back period is only just long enough for most people to read through the material once, never mind actually getting a chance to first do a month or two of paper trading and then some of the real thing. If you have never traded before, how do you differentiate between an initial setback with a good trading plan and a truly bad system?

Unless the results given are actual trading records, showing all the bad trades as well as the good, from this trader who had real money on the line, don't bother. Of course another possibility, and something that is common enough is that for your $2,000 you don't get anything, the guy takes off with your money!

Sometimes system sellers come up with mumbo-jumbo reasons why the statements can't be provided. They say such a thing is in breech of ASIC rules concerning traders/privacy/proprietary information or some other excuse. Before you hand over that much money you really should insist on proof that it works. Like I said earlier, money back guarantees aren't proof, nor is "pay 25% now, the balance out of your trading profits". Both can be used by the unscrupulous, the former could be abused by people who vanish or refuse to pay on a technicality, the latter could simply mean they want to milk you for the 25% of $20,000, knowing that this of course looks much more attractive than a system that is simply sold for $5,000. When you fail to make profits they can then vanish or get you on the technicalities.

Just because someone has an adviser's license doesn't mean much, there are a variety of ways of getting one. Plenty of ripoff merchants "borrow" a license from some third party who has no idea what is going on, others may have a certain restricted license but intend to vanish soon after. The license might be fake. They might have a legitimate license but are selling a system for someone else (they won't keep that license if ASIC finds out, but the rewards are attractive enough to risk it). They might have a license but have decided to leave the investment industry, as it doesn't matter if they get banned they can secure themselves one last golden handshake by flogging a system. Alternatively they might even be operating from overseas, outside of the regulation of Australian authorities.

You may note that apparently software sellers have little trouble getting restricted investment licenses. Many vendors of rather sus software packages manage somehow to get hold of advisory licenses from ASIC, albeit ones restricted to talking about a very narrow range of topics. When I got my proper authority as a financial planner I was made to jump through a variety of hoops and pass a variety of exams. This seems to mainly apply to financial planners, as far as I can tell anyone with a trading package can apply for a license to sell their software or system, and there seems to be very little scrutiny from ASIC over this. I wouldn't go so far as accusing ASIC of rubber stamping applications from gurus, but I must admit that it certainly seems to be what happens. The ASIC consumer protection web site (http://fido.asic.gov.au) does everything but actually name the shonky operators, they describe in detail the operations of shonky system vendors but don't actually mention them by name. Somehow these companies got licenses, I don't know why. Suffice to say that certain restricted advisory licenses are fairly worthless as an indication of that vendor being "straight" or not.

While there are professional traders who do quite well, they rarely use a rigid system. If they do use one they use something they developed themselves, and of course it is under constant development, with many refinements and nuances.

What sort of argument could possibly prevail here? The exchanges are full of full time floor traders who spend every waking hour trying to refine their techniques. They run from trend followers to market makers and scalpers. They use techniques like dynamic hedging (continuous purchase and sale of options) in a complex mathematical system based on the Black-Scholes option pricing model. They get in on every single technique available and milk it for all it is worth. If they find some little exploitable anomaly in pricing you can be sure that they will be on it as soon as they see it. They don't just read the same technical analysis books you do and see the same trading adverts, they read a whole lot more. If a mechanical trading system is out there that can be encapsulated in a video tape and little indicator they already know about it. If Gann is such a well kept secret and enables you to make unlimited wealth, why do trading pros not use these methods? So David Bowden advertises in the Sunday newspaper every week on the quotes page, fills auditoriums with total beginners, yet somehow this has failed to attract the attention of a single professional trader?

Professional floor traders have the advantage of very low transaction costs and access to every single piece of data that is publicly known, they have their orders filled faster than any home trader listening to a broadcast announcement could, often they make up a large proportion of trading volume by sitting on thinly traded securities providing both the bid and the ask offers, making money all day long as the market simply trades up and down without going anywhere. They use sophisticated options strategies a lot, using live data fed computers to calculate fair option prices. If you are interested you can quite easily find out what these techniques are by reading various trade journals. Unless you are a floor trader though you won't make a cent after paying brokerage. Floor traders do frequently use what might be described as mechanical trading systems, but at the same time also throw a lot of money after rumours (then closing out as soon as the rumour hits the rest of the market).

In the interests of being long winded, to summarise: floor traders sometimes use sophisticated mechanical trading systems but only with discretion, they constantly adapt their techniques as conditions change, mainly profiting via their low trading costs and the speed of execution you can only get by putting on the rainbow jacket and being there in the trading pit. Those that trade from home expose themselves to far greater risks per trade, but are master speculators with a keen eye for trends and a disciplined approach to risk management. The percentage profit per trade has to be much higher of course, and very few are really this good.

Between these two lie those that use mechanical trading systems from home, lacking the sophistication of the speculator and the cheap trading costs of the floor trader, but equipped with a boldness that comes naturally to the most blissfully ignorant, they trade with all the finesse of a crash test dummy for a few days or weeks until the margin calls force them to stop and quit trading for ever, or at least until they can save up enough money to buy a "better" system.