MODULE 5 UNIT 3
Video Set Video 2 Transcript

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NIR VULKAN: Investors or the technical people doing the due diligence, what they'll try and do is push you a little bit. So, you have your model, and you say, "This was my in-sample. This was my out-of-sample. This is the performance." And it looks great because it always looks great. And historically, it always look great. And the only people who come to you are the people with fantastic models. So, then what they'll try and do is they'll try and push you a little bit. So, they're obviously going to ask you about your in- and out-of-sample, yes? And they would want to see that the performance is similar in an in- and out-of-sample. And, like always in business, honesty pays. So, for example, if your in-sample was— let's say, it's a daily system with 20 years— your in-sample was 1.4, and your out-of-sample was 1.35 or 1.3. That's a good thing. There's a little bit of, you know, it comes off down a bit. It kind of looks real. Whereas if it's exactly the same, it looks a bit "Madoff", to use that famous example. Bernie Madoff, here, I'm talking about someone who made up this return. Because they don't know you, maybe you made it up. They don't know.

So, they look at the in- and out-of-sample. They really want to understand how that works. Then they would look at the various assumptions you make in the model, and they would ask you to simulate what would have happened if these assumptions were different. So, for example, what would happen if slippage was twice more expensive than what you put in the model? Would the model collapse? Or will the model still be decent? I've done this many times; I've been asked to do it; I've asked other people to do it; I've made you do it in Module 4, in that spreadsheet example we have done. And the point of this exercise is to understand. And it's okay. It's okay if the model then gets much worse, that's fine. But then you understand that this is a good model, but it really depends on the execution being like that.

The other thing is delay. This is something that I have done with hedge funds, and that's been done with me as well. When you take the model and you say— now let's say that half of the positions, you couldn't get them until the next day – it took a day. This is obviously a daily model, yes? So, it's a model that holds position for a week or two weeks— and so, you might say, "Well, it wouldn't happen. I will make sure it doesn't happen." But it's still a good question because we want to see what will happen to the performance of the model if that does happen.

And again, if the model completely collapses, then that's a weak point of the model. It doesn't mean they wouldn't trade it, but they will understand that this is an issue. Or, if the model still does well, not as well, but still does well, then they think, "Okay, that's a fairly, very robust model in terms of position sites." So, that means the model identify good trends, stay on them, and so on. And so, the sensitivity on the in and outs, if you like, is an important thing. This is the kind of things they would make you do, and you should expect that, and you should be welcoming that, if that makes sense. They would want to understand all these things.

Another thing is the capacity of the model, you know, because often people come up with model and they trade them with small amount of money and the performance is really good. But there's an issue of how can you extend that? Will this— you know, if this is a hedge fund, they would want several millions to be traded using this model, maybe even a hundred million traded on these models. They want to see that there is "capacity" in this model. And so, they would look then not so much in the position size, but on the trade size,

if that makes sense. Because the trade is how you move markets by having a really big position. And so, if you have very big positions relative to the liquidity in that market, again, that's a sensitive point.

Basically, they would look for the weak points in your model, and the more you understand those weak points, the better. And it's okay that there are weak points in the model – that's what I'm trying to say to you. Don't be afraid of this process, work with them, and understand this thing. And I think, again, honesty will be your friend here that you together work and you understand these things, and that you are not perfect and that the model has issues. That's okay, because then you understand what's the bit that you can't screen. If it's about always getting in on time, then that's your weak point, and that you make sure that you never fail on that. And you work with the fund to ensure that it works like that.

So that would be the process, and I'm hoping some of you will get to experience in person in one side or another. And hopefully these tips will give you some guidance on what to do in situations like that.

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