How To Create Trading Strategies

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There exists a multitude of highly effective systematic rules-based trading strategies you can learn out there in the wide seas of the internet which require minimal originality or creativity on your part.

You could choose to learn the personal trading rules of a seasoned professional trader and trading mentor like I did from someone like [Steven Hart](https://www.thetradingchannel.net/).

Or you could scour the web for free trading strategies from websites like [BabyPips.com](https://www.babypips.com/learn/forex/the_so_easy-its-ridiculous-system), and try to master them and make them your own.

It’s a wise idea to learn from others and many reputable trading coaches will recommend this approach, especially if you’re brand new to trading. After all – it’s easier and more time-efficient to copy an approach that someone else has found to be profitable than to try to reinvent the wheel. This applies to capitalism and business in general, not just trading.

But for many traders there will come a time when they want to create their own trading strategy and trading plan that is completely unique to them.

Once you have some experience in the markets and you’ve begun to find your own feet as a trader it’s likely that you will begin to notice patterns in the market that you’d like to take advantage of, but which your current strategies don’t allow you to act on.

While it can be a waste of time in the beginning stages of your trading career to try to be too original, once you’ve got some experience under your belt it’s entirely possible to invent your own unique trading strategies and use them to extract consistent profits out of the markets.

However before you do this, it’s important that you intimately understand the core fundamental concepts and scientific process of trading strategy development.

In this article I will explain exactly what goes into profitable strategy development across ALL markets – from crypto and forex to stocks and futures.

I’ll be breaking the process down into 8 steps:

1. [Develop Your Thesis](https://zenandtheartoftrading.com/blog/how-to-create-trading-strategies/#Step_1_Develop_Your_Thesis)
2. [Identify Market Conditions](https://zenandtheartoftrading.com/blog/how-to-create-trading-strategies/#Step_2_Identify_Market_Conditions)
3. [Choose Your Indicators](https://zenandtheartoftrading.com/blog/how-to-create-trading-strategies/#Step_3_Choose_Your_Indicators)
4. [Entry Reasons](https://zenandtheartoftrading.com/blog/how-to-create-trading-strategies/#Step_4_Entry_Reasons)
5. [Stops & Targets](https://zenandtheartoftrading.com/blog/how-to-create-trading-strategies/#Step_5_Stops_Targets)
6. [Risk Management](https://zenandtheartoftrading.com/blog/how-to-create-trading-strategies/#Step_6_Risk_Management)
7. [Negative & Positive Filters](https://zenandtheartoftrading.com/blog/how-to-create-trading-strategies/#Step_7_Negative_Positive_Filters)
8. [Testing & Optimization](https://zenandtheartoftrading.com/blog/how-to-create-trading-strategies/#Step_8_Testing_Optimization)

## **Step 1. Develop Your Thesis**

The first step to trading strategy development is coming up with an underlying thesis.

Like any scientific or problem-solving endeavor, it’s important to have a clear goal and desired outcome **before**you start working on the problem. If you don’t clearly understand what you’re aiming for, then you will likely waste countless days or months chasing ghosts and mistaking activity for progress.

There are many valid trading theses that you could pursue. In fact I’d go so far as to say that there is an infinite amount of valid potentially profitable trading theses you could think up.

But the main variables that should factor into your consideration are as follows:

* What patterns have you noticed in the markets that repeat themselves regularly?
  + eg. After a daily breakout of a key level, intraday timeframes tend to develop strong directional momentum during the next day
* What are your strengths and weaknesses as a trader?
  + eg. Do you prefer short-term trading, long-term trading, counter-trend trading, trend-continuation trading?
* What is your trading personality like?
  + eg. Are you patient or impatient, very aggressive or conservative, do you need many or few confirmation signals?
* What timeframes do you trade most effectively?
  + eg. Do you have time to babysit a 5-minute chart or do you have a full-time job so you can only trade a 4HR or Daily chart?
* What market do you understand the most intimately?
  + eg. Do you know what makes your market move? Just because you’re a great forex trader doesn’t mean you’ll make a great crypto trader and vice versa!
* What indicators are you most proficient with?
  + eg. Do you have a good understanding of RSI or Stochastics, moving averages, Fibonacci retracements etc?

A crude example of a strategy thesis might be something like this:

I notice that EUR/JPY makes large intraday swings after a break of a key structure level. I’d like to develop a day trading strategy that captures these large swings on the 15-minute chart. I want to get in on a pullback and get out on the first sign of trouble.

I’m an aggressive trader and I’m impatient, so I want to trade a single position with a 1-in-1-out approach. I want to be in and out of the trade within the same day, so I will not be using large stop losses or trailing stops.

I’ll use an exponential moving average as my directional bias – if price is trading above the moving average, I look for longs. If it’s trading below the moving average, I look for shorts. I want to use tight stops because this a momentum strategy, so I’ll use a half ATR stop loss distance from my entry point.

I want to get out at the first sign of price struggling, so I will exit on a lower-low lower-close candle for long trades, and a higher-high higher-close candle for short trades.

Once you have your thesis roughly thought out, you can begin the next step of designing your initial objective strategy rules designed to repeatedly exploit the opportunities you perceive.

When you’ve completed the development of your rules, the final step is to test them to see if they work – and then improve them if the test results indicate they need improving.

But first things first – let’s go over what kind of rules you should include in your strategy.

# Step 2: Identify Market Conditions

Once you’ve decided on what exactly it is that you’re trying to exploit in the markets, that’s when your rules development begins.

Your rules development should follow an if-then syntax, much like programming computer code.

The rules should be extremely simple to understand and as objective as possible. A simple example would be: **if**the market is trending, **then**I look for a breakout of the previous high or low before entering the market.

By stacking these if-then syntax rules on top of each other and testing them to see how effective they are, you can eventually achieve a consistently reliable edge over the markets.

The first rule you need to decide on is what market conditions you plan to act upon.

No strategy works in all market conditions. The sooner you accept that there is no single strategy that will perform well in all market conditions, the sooner you can begin creating a realistic trading plan of multiple strategies in order to truly conquer the markets.

Many traders spend their entire lives chasing the “holy grail” trading strategy which simply doesn’t exist. No matter what strategy you choose to employ, there will be times when it under-performs and loses you money. There’s no way around it.

Trying to circumvent that reality is like trying to make clothing that keeps you warm in winter, cool in summer, waterproof in the rain, deflects heat on hot days, isn’t too heavy or too light, is always comfortable, looks great, and never frays from exposure to the elements.

A much more reasonable approach is to have a wardrobe of appropriate clothing that you choose from depending on the circumstances and the weather outside.

The way to achieve this in trading is to have multiple trading strategies at your disposal that are designed to take advantage of multiple market conditions. If you want to be able to profit in consolidation as well as during trends, then you must have a consolidation trading strategy and a trend-continuation or trend-following strategy within your trading arsenal.

In other words, your trading plan should have multiple trading strategies inside of it that allows you to take setups in all market conditions.

These strategies will be different in nature to each other, and when one is performing excellently typically the others will be under-performing. But just the same way as a portfolio manager might diversify their stock holdings to mitigate the risk of putting all their eggs in one basket, an active trader does the same by diversifying their strategies.

When one strategy is losing money, another is making money, and vice versa. But on balance, if you manage your risk:reward ratios appropriately and you’re not cutting your winners short or taking unnecessarily large losses, then on balance you will come out ahead in the end over a large sample size of trades.

That’s the essence of successful trading and all professional traders understand this dynamic.

When designing a trading strategy it is wise to only target one market condition for it to profit in. The main market conditions to choose from are as follows:

* A trending market
* A consolidating market
* A reversing market

They are the only 3 market conditions you should be focused on exploiting. Any other market conditions you can think of will be a subcategory of one of those 3.

For example, trading around key levels of structure could fall into any 3 of those categories. It’s up to you to be specific and drill down on what exactly you are looking for before you start looking for trading opportunities.

# Step 3: Choose Your Indicators

The next step in developing your trading plan rules is to decide on which indicators or trading tools you intend to employ.

These can range from simple oscillators like the RSI and basic metrics like volume to tools like the ATR, or even “exotic” things like sentiment indicators or market positioning stats (e.g. how many people are long in the market vs. how many people are short).

Whichever indicators you choose to use, it’s important to make sure that they serve a legitimate purpose and enhance your edge over the markets given your thesis.

For example, if you are trying to design a mean-reversion strategy that attempts to capture retracements from over-extended tops or bottoms in the markets, it may make sense to use an RSI or Stochastics indicator as part of your setup conditions.

You could design your rules so that when the reading exceeds an extreme upper or lower limit, then you begin looking for a certain candlestick pattern that indicates confirmation of your thesis.

However, using the RSI or Stochastics indicator in a trend-continuation strategy wouldn’t really make much sense.

For example, if you’re trying to use the RSI to capture lows or highs in the market during pullbacks, you may never get a signal because the market might never go oversold in a healthy bullish trend or overbought in a healthy bearish trend.

There are countless indicators to choose from when designing your trading strategy. No single indicator is better than all the others. It really depends on what you’re trying to achieve and what works.

When I’m designing my strategies I prefer to use as few indicators as possible to achieve my goal. I typically use no more than 3 indicators at most in any of my trading strategies.

The indicators you choose are purely a matter of personal preference and efficacy – obviously, if it doesn’t work, you shouldn’t use it. But if it does work, then there’s no reason not to use it even if everyone in the world is against it.

For example, many traders believe that the RSI indicator is not appropriate for forex trading. But I personally have found several ways to use it to develop an edge over the markets, and just because another trader says it’s stupid to use it doesn’t cause me to stop using it. I’m here to make money, not please others.

If you’re wondering what indicators are best to use in a trading strategy, I’ve written an article covering what I’ve found to be the [3 Best Forex Trading Indicators](https://zenandtheartoftrading.com/blog/forex/3-best-forex-trading-indicators/) in my own testing and trading journey (according to my style of trading).

# Step 4: Entry Reasons

Once you’ve decided on what market conditions you want to trade and what indicators you plan to employ in order to exploit those market conditions, it’s now time to design your entry reasons.

Your entry reasons could be as simple as a moving average crossover, but realistically it’s probably wise to go a little bit deeper in your strategy design and add some more specific entry reasons.

I’m a huge fan of designing your strategies to be simple and I believe in elegance over complexity, but that doesn’t mean that your strategies should be too simple. By being too broad with your entry reason you could be sacrificing a lot of potential profit which could be achieved by timing your entries better.

My favorite entry reasons are based on price action itself. Once my market conditions and indicator conditions are met, I like to see price action confirmation before I initiate my trade.

Common price action confirmation entry reasons are candlestick patterns such as double-tops and double-bottoms, higher-high higher-close and lower-low lower-close (HHHC/LLLC), engulfing candles, pinbar candles (shooting stars & hammers), head & shoulder patterns etc.

Your entry reason could be a simple candlestick pattern of 1 or 2 candles, like a pinbar or engulfing candle – or it could be a more complex pattern like a double-top or flag pattern which requires perhaps a dozen or more candles to play out on the charts.

Just like your indicator selection, there is no “best” or “worst” entry reason you can choose from. There are only entry reasons that **work**, and entry reasons that don’t work with your thesis.

It all depends on what you’re trying to achieve. For example, waiting for a HHHC/LLLC entry reason might make a lot of sense and work great on a structure-based or trend-continuation trading strategy, but perform horribly on a mean-reversion strategy.

The reason for this is that the HHHC/LLLC candlestick pattern requires more pips or distance to play out than a single candlestick like a shooting star or hammer candle. During a pullback or around structure, waiting for the market to move further away from the level before you enter may increase the accuracy of the strategy.

But waiting for 2 candles to play out before you enter a mean-reversion trade could mean sacrificing a large chunk of the mean-reversion move itself, which could turn a potential winning strategy into a losing one. In such a case, it might make more sense to enter on a pinbar candle than a HHHC/LLLC or even engulfing candle.

A short list of potential entry reasons you might choose to employ depending on your thesis are as follows:

* Moving average crossover
* Engulfing candle
* Pinbar or doji candle
* HHHC/LLLC
* Double-tops and bottoms
* Head & shoulders
* Flags, pennants and wedge breakouts
* Break and close beyond swing highs/lows
* Advanced patterns and Fibonacci retracements

# Step 5: Stops & Targets

The next step in your strategy development process once you’ve decided on your market conditions, indicators and entry reasons is your stop loss and profit target placement.

This is perhaps the **most important**aspect of your trading strategy. Adjusting your stops and targets can turn a losing strategy into a winning strategy (and if you’re not careful, a winning strategy into a losing strategy).

Just like your entry reasons, your stop loss and target placement has an infinite amount of possibilities and there is no “right” or “wrong” way to go about it.

Your stop loss should be placed in a position that **invalidates your thesis**, not at a place where you want to stop the pain or cut your monetary loss short. Once you place your stop loss, then you determine your position size based on how far away that is – not the other way around.

The same is true for your profit target. Your profit target should be set at a place that you are confident that price can make it to. In other words, don’t set your profit target where you hope price will go (based on greed). Set it where you think it’s likely to go.

And don’t set it too close to your entry simply because you want to win (based on fear of losing), set it where you think price will struggle to move past. This will maximize your profit potential which will increase your average risk:reward profile which will dramatically improve your [odds of success](https://zenandtheartoftrading.com/blog/forex/what-is-a-good-win-percentage/) over the long-term.

One thing I would suggest you try before you get too creative is using some variation of the ATR indicator. The ATR or Average True Range indicator is designed to give you an objective reading on the recent volatility in price action.

My favourite way to employ the ATR is to use it in my stop loss placement rules (and even my profit target placement in some cases).

The reason for this is that setting your stop loss on a trade is where most traders come unstuck. By using pure discretion to set your stops, first of all you are going to be inconsistent with your trading which is a huge problem since you [can’t improve what you can’t measure](https://zenandtheartoftrading.com/blog/importance-of-consistency/).

Second of all, you run the risk of your emotions interfering with your self-discipline or best judgment. After a losing streak you may be inclined to either push your stops further back or maybe even tighten them in an effort to “swing big” and try to make up for your losses by using larger position sizes.

The best way I’ve found to combat this risk is to use the ATR indicator for stop loss placement. I typically use some multiplier of the ATR (usually 1x) beyond the swing low or swing high of my entry pattern.

For example, if I were to go short on a double-top, I would place my stop loss 1ATR above the highest point of the double-top pattern. If the ATR indicator value reads 20 pips and the distance from my entry point to the swing high is 10 pips, then my stop loss will be 30 pips from my entry price.

The reason for this is simple. If recent price action has been moving 20 pips on average across the past 14 bars, then I want to be out of my trade if price exceeds that value against my thesis. If I expect a double-top to roll over to the downside, and instead price exceeds the double-top pattern by a full ATR, then the chances are I’m wrong on this particular setup and price is going into trend-continuation rather than a reversal.

Don’t be afraid to be wrong. Being wrong is a part of trading. In fact, it’s a huge part of trading. The main thing is to keep your loss small when you’re wrong, and keep your profit as large as possible when you’re right.

Learn to lose gracefully, or else you will forever struggle to win.

# Step 6: Risk Management

The next most important aspect of your trading strategy besides stops and targets is your risk management plan.

Your risk management can make or break your trading. Even a trader with a 70% win rate or higher could still blow up their account if they fail to employ healthy risk management practices.

If you’re risking 20% or more of your account on a single trade, it only takes 5 losing trades before you’re out of the game. Losing 5 trades in a row is not only possible, it’s extremely common.

In fact I’ve personally endured losing streaks of 10 or more losses in a row even with a strategy that has a win rate above 50%.

We’re dealing with probability theory here, not certainties. Even a coin toss will land on heads 10 times in a row at some point if you flip it long enough. The same is true of trading.

It doesn’t matter how good you are at trading, it doesn’t matter how fantastic your strategy is, it doesn’t matter how conducive the market conditions are to your trading plan – ***you will take losses.*** It’s one of the few things that ALL traders have in common.

And it’s ok! It’s fine to take a loss. All successful businesses in the world lose money somewhere. They have to pay staff, they need to front the money for inventory, they have operational overhead like rent and electricity bills.

But a successful business brings in more money than they send out, and that’s what makes them profitable. [Exactly the same reality is true for traders](https://zenandtheartoftrading.com/blog/forex/treat-your-trading-like-a-business/).

It doesn’t matter that you lose money sometimes. That’s the cost of doing business as a trader. What does matter, just like in business, is that you keep those losses small and allow your winners to make up for them.

The only way to achieve this is through having a sound risk management plan. If you allow large losses to creep into your trading then you dramatically decrease the chances of success (and dramatically increase your chances of imploding).

Any business that is mismanaged and allows their outflow to exceed their inflow is headed for bankruptcy. And traders are no different.

### **Risk Per Position**

I would encourage you to **never**go above 3% risk per trade. In fact, the highest I ever go is 2% and I’ve never seen any of the professional traders I’ve learned from go any higher than that either.

Depending on your win rate you may be able to stomach 2% risk per trade without any danger of implosion. But once you get to 3% or higher, things become a little bit too volatile. If you encounter a 10-trade losing streak like many traders do at some point, you will lose **a third**of your trading capital.

If you lose 30% of your trading capital (ie. encounter a 30% drawdown), you need to make +43% of profit on the remaining money in order to get back to break-even.

Here’s a great article explaining the mathematics behind drawdown recovery: [How Much You’ll Need To Recover After A Trading Drawdown](https://blackstonefutures.co.za/how-much-to-recover-after-trading-drawdown/). The formula is this:

Required Gain = (1 ÷ (1 – Percentage Loss)) – 1  
Required Gain = (1 ÷ (1 – 0.3)) – 1  
Required Gain = 0.43%

In other words, the deeper the hole you dig yourself, the more work it requires to get out of it!

On the other hand, if you’re risking 1% per trade and you lose only 10% of your trading account in a 10-trade losing streak, you only need to make +11% profit on the remaining money to get back to break-even.

So that’s why most professional traders choose to risk only 1% of their trading capital per trade. By risking 1% of your capital, you’d have to lose 100 trades in a row or several hundred trades with very few winning trades over a large sample-size in order to go bankrupt.

The chances of that happening are basically zero, because by risking 1% per trade it gives you plenty of time to reflect and analyze your results each month. Before you hit -100% drawdown you’d stop somewhere between 20-50% and reassess your strategy (and hopefully find a way to improve it).

Risking 1% or even 2% per trade can guarantee that you stay in business for the long-term. You might not make as much money as you wanted to, but the risk of you losing everything is pretty much neutralized.

There is also the added bonus of emotional stability. If you’re risking more than 2% per trade then emotions may begin to creep into your decision-making process. If you’re risking a large chunk of your trading account with any particular trade, then the fear of losing or the greed of making money quickly could cause you to treat the trade differently to how you normally would. This leads to inconsistency creeping into your trading.

And once you lose your consistency it can become extremely difficult to pinpoint what’s going wrong with your trading and what you need to improve (or even make it impossible to determine what things you could improve).

So don’t be reckless. Keep your risk small so that you can compound your gains over the long-term. That’s what leads to sustainable wealth accumulation.

### **Max Exposure**

The other two factors to consider in your risk management plan are **max exposure**and **correlation risk**.

Max exposure simply means how many trades you allow yourself to have open at any one time. Or in other words, what is the largest hit you’re willing to take on your account within one week or one day.

If you have 10 trades open and due to some freak market event they all lose at the same time, can you handle that? Or will that throw you off your game?

### **Correlation Risk**

Correlation risk means how many of your open trades are correlated in their outcomes. For example, in forex, if you’re long AUDUSD and you’re also long AUDJPY and AUDCAD, then you have 3 positions that may all share the same outcome.

If the Australian dollar suddenly rallies against you and stops you out, then it’s likely to do the same across the other pairs.

So make sure that when you place your trades you take this into consideration. If you risk 2% per trade and have 3 correlated trades open, then you may be exposing yourself to equal odds of suffering a sudden 6% loss without realizing it.

### **Max Drawdown**

You should also determine your maximum pain point before you begin trading real money with your strategy, referred to as your “max drawdown”.

Max drawdown is a loss limit in percentage terms that, if hit, means that you stop trading altogether and go back to the drawing board with your strategy thesis and trading plan.

Typically this number is derived from your backtesting process and past trading records. After you’ve tested your thesis over many hundreds of trades or you’ve been trading your strategy for a number of years, you should have a good idea of what your “statistically reasonable” maximum expected drawdown is.

If you exceed that number by a significant margin then it means it’s time to reassess your trading strategy to confirm that it still has an edge and that you’re not bleeding yourself dry trading something that doesn’t work.

Most traders have a max drawdown between 20-30% depending on their risk tolerance and the risk they take per trade. I would recommend staying within those bounds unless you are comfortable losing up to 50% or more of your trading capital.

When this max drawdown threshold is hit, you should thoroughly analyze all your trades for the past year, make sure that it’s your strategy that is the problem and not just a lack of discipline or an accumulation of trading errors and mistakes, and then go back to the start of this entire process.

Determine what you might be able to improve about the strategy, and then backtest and forward test the changes you make to see if it improves your results. If the changes work, then you can resume trading the strategy with real money again.

If it’s trading mistakes and a lack of discipline that is causing the excessive losing, then you should stop trading and seek help from a mentor or perhaps even a psychologist as that’s [another problem altogether](https://zenandtheartoftrading.com/blog/importance-of-discipline/) that requires urgent addressing.

### **Daily Loss Limit**

The final factor that you may want to consider is a daily loss limit.

This is only applicable to day traders who place multiple trades per day. Many highly reputable Wall Street prop firms such as [SMB Capital](https://www.smbtraining.com/blog/the-right-daily-stop-loss-amount) are big proponents of this rule, and if their day traders do it, then it’s probably a good idea for you to do it too.

As always, it’s important to decide these things long before you place a trade. The main considerations for your risk management plan are:

* Risk per trade
* Max exposure
* Correlation risk
* Daily loss limit (if you’re a day trader)
* Max drawdown

# Step 7: Negative & Positive Filters

This step is optional compared to all of the others, but it can dramatically increase the expectancy of your profitable trading strategies so I figure it’s important for me to briefly cover it in this article.

Negative and positive filters are rules that you include in your trading strategy or trading plan that are designed to either keep you out of trouble or put your foot down on the accelerator whenever certain favourable or unfavourable conditions are met.

A simple example of a negative filter would be not trading on Mondays. In my own backtesting process, I found that certain strategies I use to trade perform terribly on Mondays.

Because I live in Australia, a Monday morning for me is a Sunday night for the rest of the trading world. Which means that there is limited global trading activity, and volatility tends to dry up and there is less directional conviction in price action.

In other words, my trend-continuation trades tend to lose far more frequently on Mondays than on any other day of the week. And so I simply don’t trade on Mondays anymore with my trend-continuation strategy.

That simple rule saves me a few losing trades per month, and by negating a few losing trades with this negative filter, I increase my average yearly return. It’s essentially addition by subtraction.

I also found on some of my intraday strategies that certain times of day were worse than others for my win rate, so if you’re an intraday trader that might be a negative filter you could consider investigating.

There are an infinite number of variations you can use for negative and positive filters. Like most things in trading, there are no “right” or “wrong”, “best” or “worst” filters.

So long as whatever you’re doing (or not doing) increases your chances of winning trades, makes you more money, or simply avoids losing money unnecessarily, then it’s a good addition to your trading plan.

An example of a positive filter would be something like seasonality.

I don’t trade stocks very much because my Australian stock market is downright boring compared to international stocks (and I like my sleep too much to stay up all night trading U.S. markets).

But when I first began my trading education journey I learned the basic foundations of trading from an extremely successful American stock trader named [Courtney Smith](https://twitter.com/courtneydsmith).

One of the rules in his trading plan is that he is allowed to double his position size during certain times of the trading year. He refers to these time periods as “bullish seasonality”, and he has identified that during these particular times of the year his odds of winning trades dramatically increase.

By employing this positive filter of increasing his risk during favourable market conditions, he is able to significantly improve his average yearly return. He doesn’t have to change anything else about his trading – he just doubles down on each trade he takes. Very simple, but very effective.

Obviously this is an advanced tactic and not something I’d recommend beginner or inexperienced traders do, but over many years of experience you may come to a point where you have the confidence to do such a thing.

One other positive filter worth mentioning could be using a higher timeframe for reference. For example, maybe you only look for long trades on your intraday trading timeframe if the Daily chart is in a bullish trend.

These are just some ideas for potentially improving your expectancy. Of course, certain positive and negative filters could also diminish your expectancy and sabotage your trading results.

So it’s very important to be careful what filters you employ and always make sure to **backtest**the hell out of them to prove that they do in fact have the desired effect on your trading results.

# Step 8: Testing & Optimization

The final step in this process is [backtesting](https://zenandtheartoftrading.com/blog/forex/5-reasons-why-backtesting-is-important/) and forward-testing. No one enjoys it, but we all have to do it.

By backtesting the market conditions, indicators, entry setups, risk management plan and all of your filters across many months or years of historical price action, you can get a great indication of how effective your strategy is.

Obviously past performance is no indication of future performance, but it’s all we have to go by in order to stress test our strategy over a large sample size of trades within a reasonable period of time, so it’s best that you take advantage of it.

Backtesting is simply the process of going as far back in your price charts as you can and then cycling through the charts literally one bar at a time until your trading rules are met.

Then you enter the trade information into a spreadsheet (ie. date, time of day, type of setup, stop loss size, profit size, and outcome).

Once you’ve collected a large sample of these tested trades (ideally 1000+, but a minimum of 100), then you have enough statistical data to work with to determine whether or not your trading rules have an edge over the markets as well as your potential expectancy vs. your maximum drawdown.

Depending on your test results your strategy may be be ready to go, a total failure, or it may show potential but need some further work.

Deciding this depends entirely on your personal preferences. If the strategy has what you would consider a reasonable return and a reasonable drawdown then you might not need to change anything about it at all before moving forward.

Alternatively, if you find that the strategy showed potential but lost too many trades in a row at one point and exceeded your max drawdown tolerance, or it didn’t quite make as much money as you would’ve liked over the period of time you tested it, then it may require tweaking to optimize the results.

By adding more filters or rules (or removing some), you might find that the strategy performs better on your second round of testing.

This is a never-ending process and you will need to do this even once you begin trading live. But it certainly helps avoid a lot of pain and suffering if you can go through this process as thoroughly as possible on historical data before putting your real money at risk.

Once you’ve gone through this process properly and you’re satisfied with your testing results, then it’s time to forward test for a little while.

Forward-testing simply means demo trading (or trading with a very small amount of capital). The purpose of this part of your testing is to prove to yourself that you can actually trade the strategy as you intend to on live markets.

For example, if you’re trying to trade the 5-minute chart and your backtesting results show great promise, but then you begin forward-testing and find that you miss too many opportunities because you need to go to work or you’re asleep or whatever the case may be, then you’re not going to be able to execute the strategy as it is designed to be traded and that’s a problem.

Whichever strategy you intend to use, you should make sure that you are able to take as many as 90% or more of the trading opportunities that present themselves.

If you are unable to execute on the majority of the setups that occur then your live results are not going to be consistent with your testing results, which contradicts the entire purpose of testing in the first place.

This entire process could take you anywhere from a few weeks to a few months or even a year or two. It all depends on how much time you have to devote to the process, how passionate and dedicated you are as a trader, and how much extra work the strategy needs in order to meet your expectations.

A few things you might consider during your optimization phase are as follows:

* Stop loss variation
* Profit target variation
* Using multiple positions and targets
* Position sizing adjustments
* Adjusting entry reasons
* Trying other markets or timeframes
* Adding or removing positive & negative filters

### **How To Backtest**

The backtesting process should be simple but thorough.

If you’ve never backtested before or you struggle to find consistency with it, then here’s a video lesson I made explaining my own personal backtesting process and methodology:

And here are a few links to download my personal backtesting spreadsheets if you need them:

**BACKTESTING SPREADSHEET TEMPLATES**

* [Forex Backtesting Template (**1 Target**) – Excel](https://zenandtheartoftrading.com/wp-content/uploads/2020/03/Forex-Backtesting-Template-Single-Position.xlsx)
* [Forex Backtesting Template (**2 Targets**) – Excel](https://zenandtheartoftrading.com/wp-content/uploads/2020/03/Forex-Backtesting-Template-Double-Position.xlsx)
* [Forex Backtesting Template (**1 Target**) – Google Sheets](https://docs.google.com/spreadsheets/d/1PBwIfQkYZ71fIoqChw-yeDmsPhYpmJIwUc4VIP7Cc0A/)
* [Forex Backtesting Template (**2 Targets**) – Google Sheets](https://docs.google.com/spreadsheets/d/1SHsn5B-KX2kUziqN6tm81YBieAfiFZkZ7EPL8vivO8c/edit?usp=sharing)

# Conclusion

That about sums up all I have to say about strategy development.

It’s a long, monotonous, arduous process, but it’s obviously well worth the effort when you finally stumble across a winning set of rules.

If you don’t have the time to go through this process then there are legitimate ways to fast-track your trading progress. One way is to sign up to a mentorship program where a seasoned professional will show you exactly how they trade.

My trading mentor [Steven Hart](https://www.thetradingchannel.net/) taught me almost everything I know about forex trading and strategy development and dramatically sped up my trading journey by saving me the time of fooling around with things that don’t work.

When I began trading forex I started out by copying his strategies note-for-note, and it made backtesting, forward-testing and even live trading a lot easier and far less stressful than I ever imagined.

If you’re already an experienced trader and you don’t need to learn the basics, another option is to just copy the strategy rules of someone else.

I’ve created an indicator that [detects pullback setups](https://zenandtheartoftrading.com/indicators/ultimate-pullback-indicator/) according to my personal trading rules, and so you’re welcome to sign up for a free trial to that script and see if it suits your trading personality.

Paid subscribers get access to my written trading plan which I have backtested and found to be profitable across multiple forex markets, and includes a series of video guides demonstrating various ways to adapt the strategy to your own preference.

Good luck with your trading journey, I wish you massive success and I hope that you found this article helpful in understanding your own trading process.

Speak soon!

– Matthew.