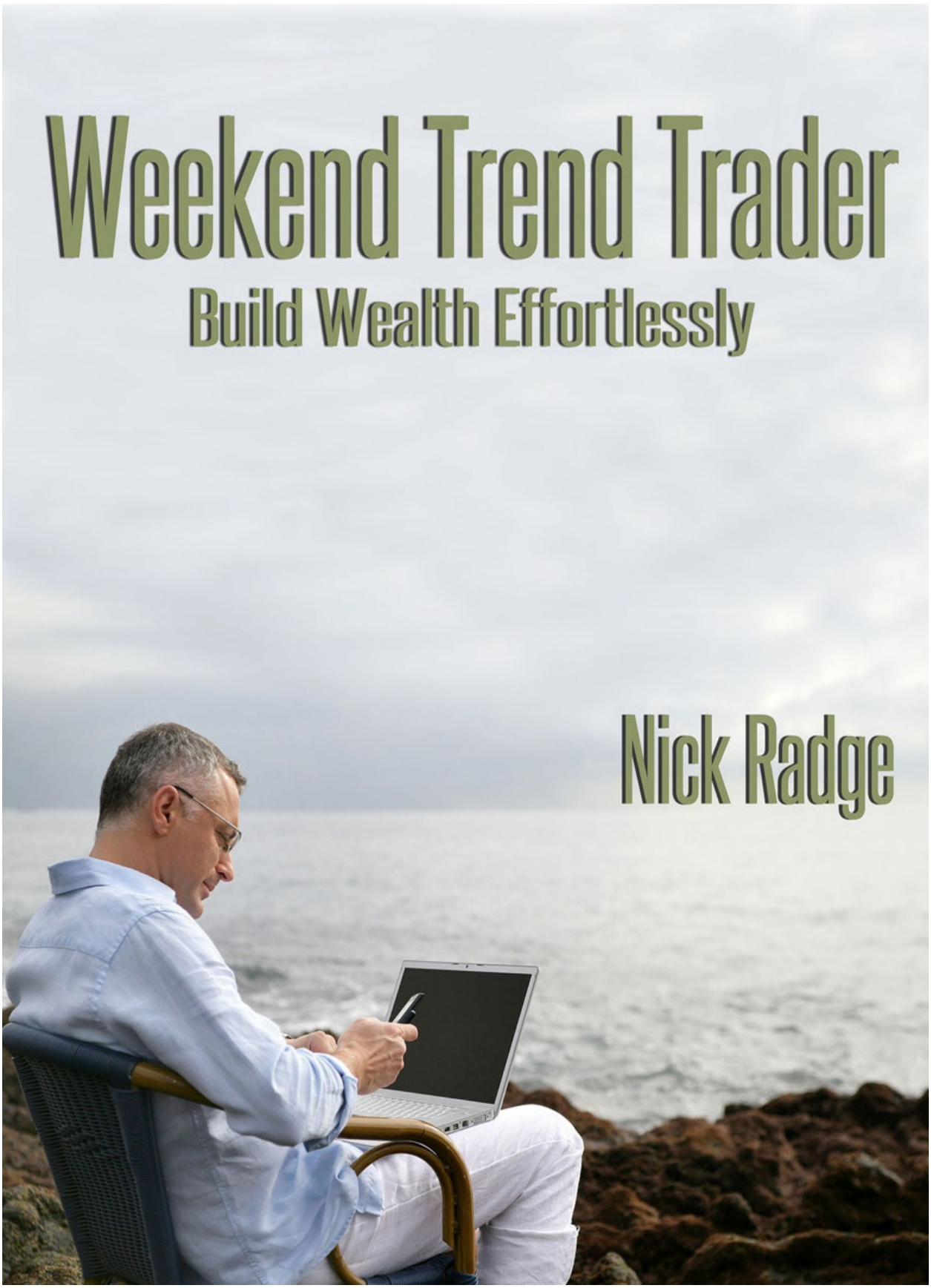
Weekend Trend Trader

Build Wealth Effortlessly



Nick Radge

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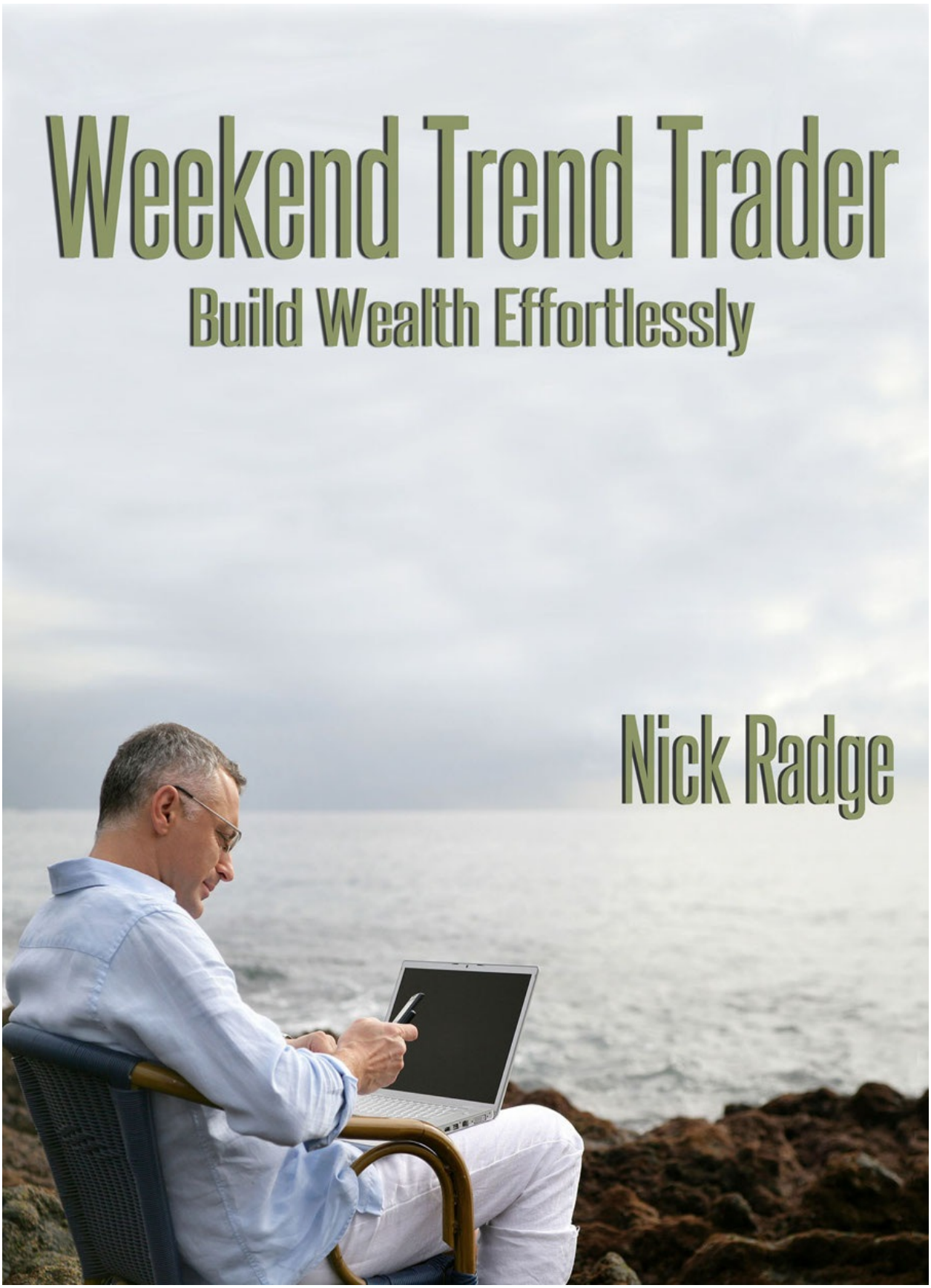

Nick Radge

WEEKEND TREND TRADER: BUILD WEALTH EFFORTLESSLY

By Nick Radge

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INTRODUCTION

Welcome to the Weekend Trend Trader strategy manual, designed to assist you trade and invest successfully. This is a simple, fully tested strategy that you only need to run once a week. It is ideal for people who work full time or those with busy schedules.

The financial markets provide ample opportunity to profit from speculation. Unfortunately, a large percentage of individuals fail to make any profits at all, with many succumbing to total loss of capital and consequent emotional anxiety. There are very specific reasons why the vast majority of people constantly lose whilst only a minority wins. By defining the rules of your personal trading plan it becomes possible to back test your methodology and therefore gain an understanding of the strategy's strengths and weaknesses. With the insight of back testing it becomes possible to build on these strengths and limit the weaknesses. This is what professional traders do and continue to do on an on-going basis. I devote many hours each day to research and development. For the novice, this gets squashed into a few hours reading a trading book and therefore leads to potential failure before the first trade is even placed. In other words, you need to know if your strategy is plausible before starting to use it.

To give you an idea of the kind of work and commitment that is required to design and test a trading strategy, back in early 90s, before computerised trading software, I came up with my first trading system. I spent 2 hours a day for 18 months looking at charts and going back through some 30-odd years of data. I recorded all trades the system generated on a spread sheet, plotted the profits and losses with maximum drawdowns, plotted excursion analysis and compiled as much statistical information as I could gather. After subtracting commissions and slippage, I discarded the largest profitable trades and then divided the yearly returns by half and still came out with something that looked viable. Technology has come a long way since then, but the same principles need to be applied.

The basis for successful speculation is in its design or plan. Let's face it; you wouldn't attempt to build a house without a plan. You wouldn't build an aircraft without understanding aerodynamics, lift, thrust and drag? So why do so many people approach trading and investing without a plan? The answer is because

they are sold the dream of making a quick buck with no effort. Therein lies the problem and the reason why 80% to 90% of traders fail. Elite athletes don't achieve overnight success, and neither do successful traders.

An appropriate plan can be extensive, yet basic. This is the objective of this manual; to work towards a simple yet profitable plan that can be applied to any equities market.

Methods of speculation are infinite. Everyone has his or her own way of using information to trade. It should be recognized that there is no 'holy grail', there is no 'ultimate' or 'correct' way to approach trading or investing. Everyone has a different comfort zone, methodology, risk appetite and psychological makeup that makes it impossible for one strategy to fit all.

The primary aim of this manual is to give you a comfortable platform to trade from. You will learn how to stop losing your capital as well as how to make profits. Therein lies the secret to successful trading, limiting your losses. Being comfortable in the fact that you are able to control your losses will be the start of a journey that may well change your life. It certainly changed mine.

There are two types of trading:

Trading for maximum return

Trading for a good reward to risk ratio

Both of these goals can be achieved using the same entry technique. The difference lies within the on-going trade management, money management and the utilization of capital and profits. However, it is important to understand that if you lose a substantial amount of your capital in pursuit of higher returns you may not be able to complete the journey to success.

Before moving forward, you have to ascertain your ability to trade and your reasons for trading. The types of questions to ask yourself include:

How much capital do I have to start with?

How much of it am I willing to risk/lose?

How much time do I have each day or week to devote to my trading?

Am I willing to follow, without question, my pre-set plan to achieve my goals?

Am I willing to resist my emotions and the opinions of people around me to achieve my goals?

Trading should be viewed as a business. Once you have a ‘business plan’ you then start working towards achieving your ‘business goals’. Decide if you wish to fully commit yourself to the task of trading or tinker around the edges. Be assured though, that a half-hearted effort will only make your goals harder to attain and, most likely, will end in losses. Along the way there will always be people who try to influence you; like the tip you get at a dinner party for the next ‘sure thing’. The reason these trades are so tempting is because there is no work involved on your behalf and if it’s a losing trade, you’re not really to blame because, after all, it wasn’t your idea in the first place. The carrot of big rewards for very little effort will be dangled in front of you constantly. These tips rarely have any technical or fundamental basis to them and chances are the person passing on the information has heard it second or third hand anyway. In which case most of the benefit derived from the information has been realized, generally by someone else. People close to you will often suggest that you are gambling. Trading using a well-managed plan is NOT gambling. Gambling is a random act with a binary outcome. Trading to a plan is a discipline that has a proven mathematical edge or expectancy. Be prepared to work as an individual and not be influenced by others.

One of the hardest lessons to learn when trading is that you are never right 100% of the time, in fact, you will most likely be wrong more than you are right. Being

wrong is generally frowned upon in society. This is why it can be hard to accept being wrong when in the trading environment. Being wrong does not equate to being a failure. In fact, I am wrong close to 49% of the time yet continue to make money.

Losses tend to unnerve us. A common reaction is to make a rash investment decision straight after a loss in an attempt to make back the money lost. However, a better strategy is to learn how to minimize losses and stick to your proven plan. Keep in the back of your mind that being right or wrong is not important. Running profits and limiting losses is all that counts. If you feel that trading is like a casino, you cannot afford to lose or you cannot control your emotions, then I highly recommend you go no further as you stand to lose your trading capital and increase your stress levels. The stress of large losses will impact your life with serious and long-term implications.

Trading is a journey and through every journey small readjustments are required. These may be to your system, money management or more often than not, to your attitude. Be mindful of your thoughts at all times and be alert for warning signs of hope or greed as these will place large amount of stress on you and possibly your family.

THE WEEKEND TREND TRADER STRATEGY

The Weekend Trend Trader strategy is a turnkey strategy that uses no discretion. In other words the strategy has a set of rules and users should understand why they entered a trade and when and how they will exit. Because the rules are strictly and mathematically defined we will be able to back test the strategy on historical data. This enables us to understand the strategy's nuances and therefore better understand how the journey to success will be travelled.

The strategy is a combination of several tools that

ensures you will always be aligned with the trend of the broader market,

enters positions at specific points and with reasonable confirmation,

manages existing positions with a trailing stop loss,

defends existing positions if the trend of the broader market reverses,

outlines how much to invest in each position.

We will fully step through each of these points in detail and slowly build the system from the ground up.

Tools Required

To complete any task there is usually a requirement for various tools. Using the Weekend Trend Trader strategy is no different. The two core tools required are:

Analysis software

Some kind of software is required to scan the market for setups or alert you to potential trading opportunities. Such software can be simple, like the charting tools your broker supplies with their platform, or advanced and dedicated software specifically designed to scan, test and generate signals such as Amibroker, TradeStation, WealthLab, Metastock, Telechart or Trading Blox. Some of these dedicated packages are extremely expensive and really designed for the professional systems trader.

We use Amibroker. It is one of the best value-for-money pieces of analysis software available. It enables us to scan thousands of stocks within a minute and specifically tell us what to buy and sell.

If you own Amibroker you can buy our fully operational Weekend Trend Trader strategy code which allows you to back test, amend inputs according to your own wants and needs, as well as scan the market for specific buy and sell signals.

A broker platform to place the orders

There are a multitude of brokers willing to facilitate your business. As the Weekend Trend Trader strategy is fully disclosed with specific rules you do not need to use a full service broker or investment advisor. An online platform with low cost brokerage is all that is required.

Time Frame

Whilst the Weekend Trend Trader strategy can be effective on any time frame, this manual, and therefore the default settings, will only be referring to the weekly timeframe. This means you only need to generate buy and sell signals once a week and place the orders with your broker once a week. This can be done any time after the close of trading on Fridays and before the open of trading on Monday. There is no need to monitor share prices during the week.

The great advantage is that we don't need to spend hours poring over charts and placing orders with our broker. We do it once a week, shut the computer down and get on with our lives.

So the first rule is that we'll only use weekly time frames. The following chart (Figure 1) shows several years of weekly data for the S&P 500 Index ($SPX).

Figure 1: A weekly chart of the S&P 500 ($SPX)


$SPX - Weekly
1,450
1,403.44
1,350
1,300
1,250
1,200
1,150
1,100
1,050
1,000
950
900
850
800
750
700
2010
2011
2012

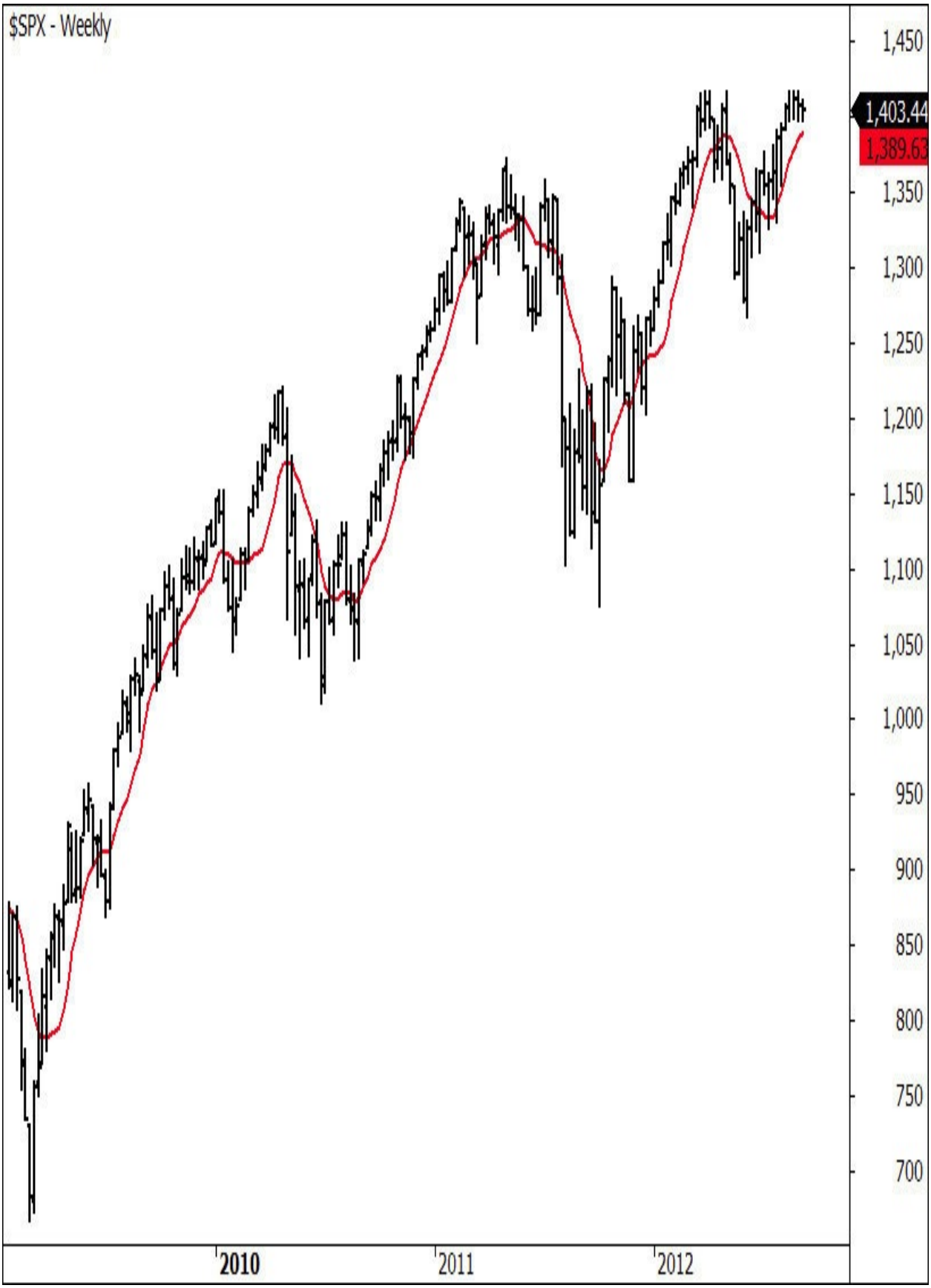
Defining the Broader Market Trend

The Weekend Trend Trader strategy is a ‘long only’ strategy, meaning it will only be active when markets are trending up. History and experience shows that this is the easiest way to generate profits over the longer term. Whilst markets can trend down, the length and scope of down trends is very different to that of up trends and as a result the risk adjusted returns of trading downtrends is not really worth the effort. As a result we only wish to participate when the market in general is rising. When the market is falling there may be a few stocks going against the trend, but the probability of them continuing to do so diminishes the further the broader market falls. Just think back to 2008 - not many stocks went up. By defining the broader market trend we are always aligned with the line of least resistance and therefore can increase our risk adjusted returns.

To do this we use a mechanism known as an Index Filter.

To create an Index Filter we place a 10-week moving average on the underlying index, in this case the S&P 500 Index ($SPX). You may use any Index if you are trading more specific universes of stocks but we have found the $SPX works very well. 10-weeks is an arbitrary number - more conservative investors may wish to use a slightly longer filter thus delaying entries to the point that the trend has been confirmed by stronger price momentum. Figure 2 below shows the moving average index filter against the $SPX from 2009 through 2012.

Figure 2: The weekly $SPX with a 10-week moving average Index Filter.


$SPX - Weekly
1,450
1,403.44
1,389.63
1,350
1,300
1,250
1,200
1,150
1,100
1,050
1,000
950
900
850
800
750
700
2010
2011
2012

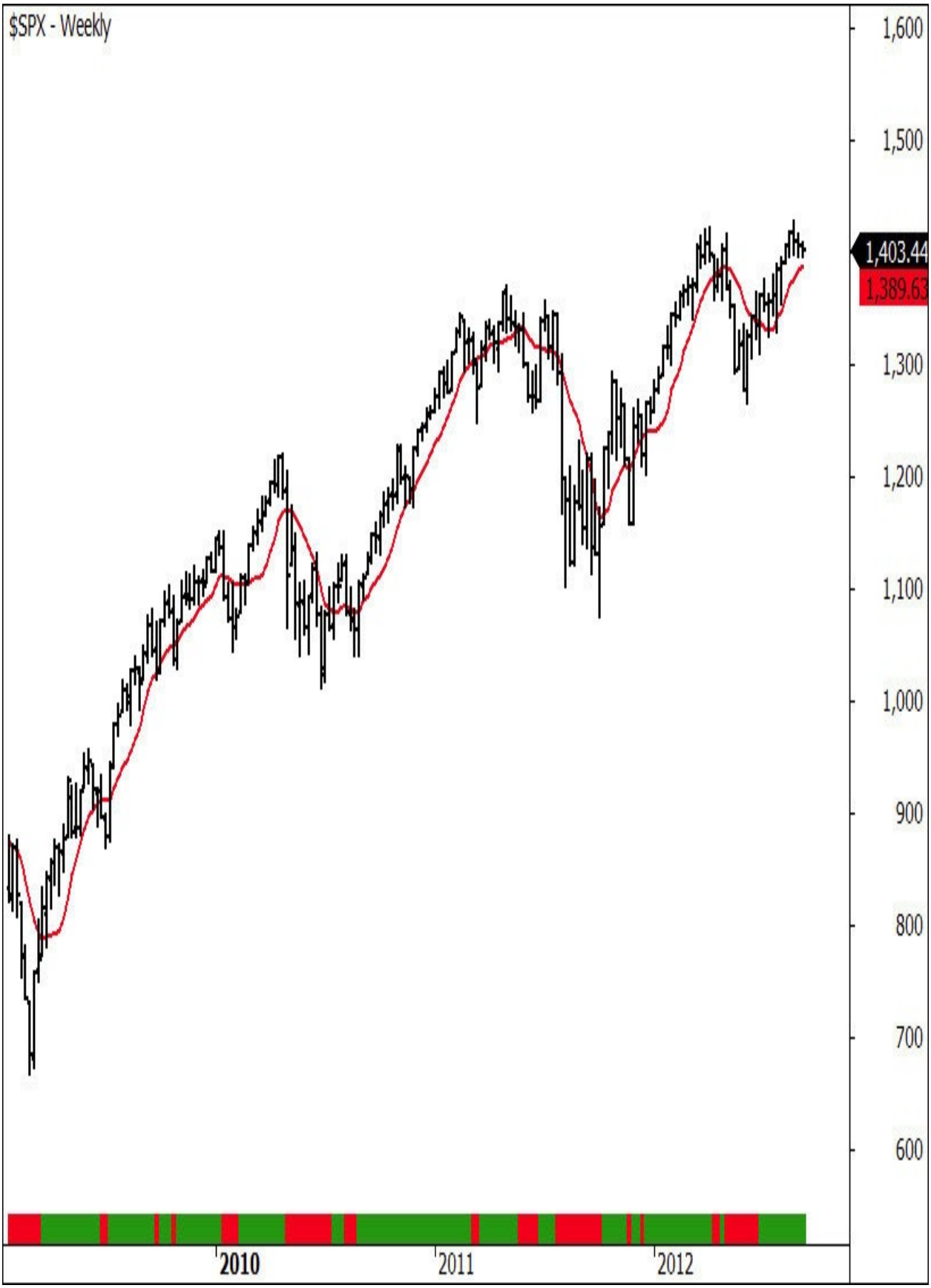
If price is above the Index Filter then the trend of the broader market is UP. If the price of the $SPX is below the Index Filter we define the broader market trend as DOWN. We are not interested in the moving average pointing up or down, just whether or not price is above or below the filter. The following shows the same Index Filter except this time we're looking at the Russell 2000 Index ($RUT).

Figure 3: The weekly $RUT with a 10-week moving average Index Filter.


$RUT - Weekly
850
821.23
804.81
750
700
650
600
550
500
450
400
350
2010
2011
2012

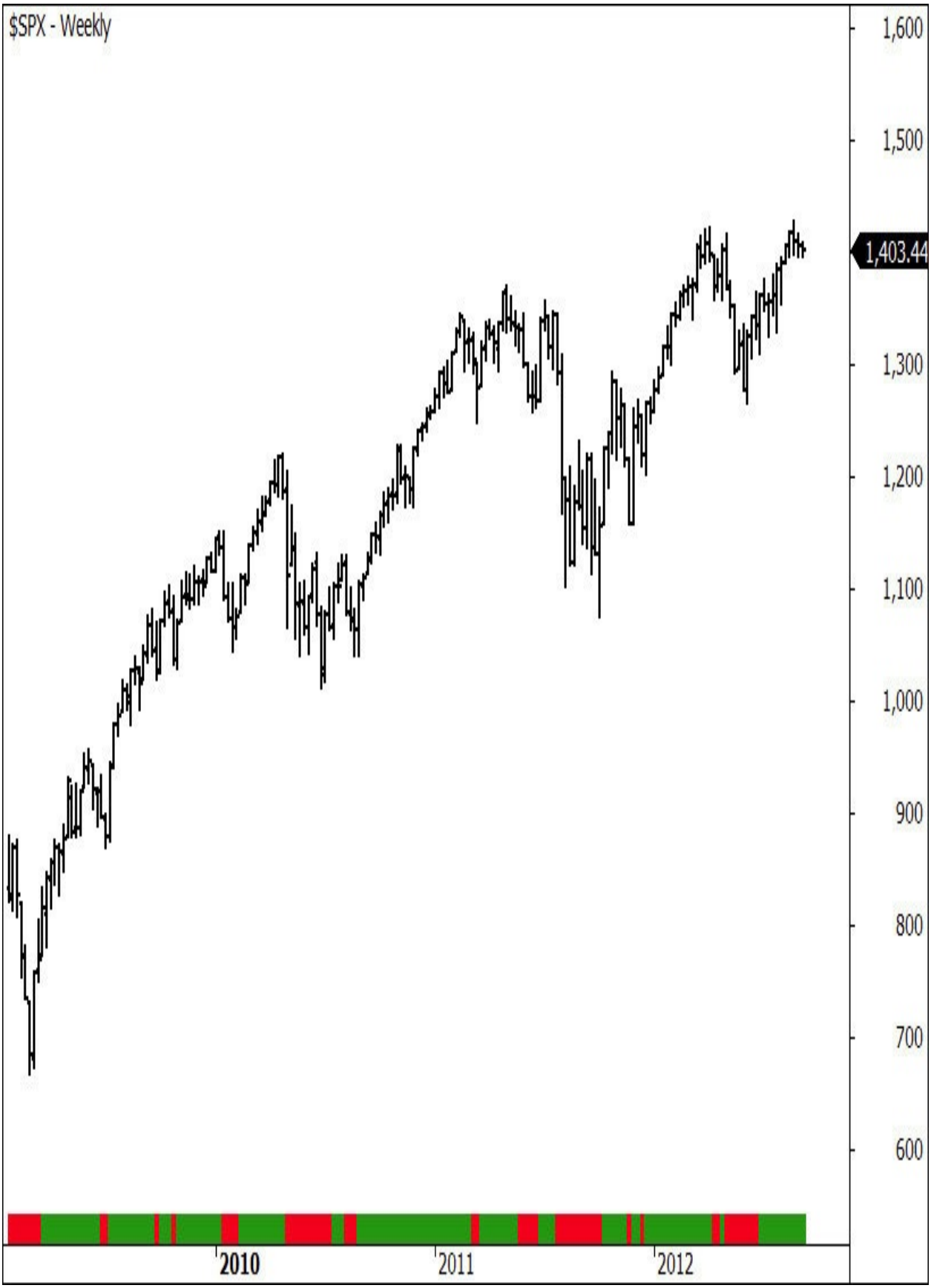
To make our charts easier to follow we're going to replace the 10-week moving average with an Index Filter ribbon which is placed at the bottom of the chart. When the Index Filter ribbon is GREEN it simply means the $SPX price is above the 10-week moving average and therefore the broader market trend is UP. When the Index Filter ribbon is RED it means the $SPX price is below the 10-week moving average and therefore the broader market trend is DOWN.

Figure 4: The weekly $SPX with a 10-week moving average Index Filter as well as the Index Filter ribbon on the bottom of the chart.


$SPX - Weekly
1,600
1,500
1,403.44
1,389.63
1,300
1,200
1,100
1,000
900
800
700
600
2010
2011
2012

Now that we have the ribbon we can remove the moving average, and thus some of the clutter, from the chart. This enables us to view the price action more clearly.

Figure 5: The weekly $SPX with just the Index Filter ribbon on the bottom of the chart.


$SPX - Weekly
1,600
1,500
1,403.44
1,300
1,200
1,100
1,000
900
800
700
600
2010
2011
2012

Now when we look at individual stocks we can see the price action of that stock, but at the same time see the trend of the broader market using the Index Filter ribbon. The following chart shows a weekly view of Microsoft ($MSFT), however, the Index Filter ribbon at the bottom of the chart is not the trend of $MSFT - it's the trend of the $SPX.

Figure 6: The weekly Microsoft ($MSFT) with the Index Filter ribbon on the bottom representing the trend of the $SPX.

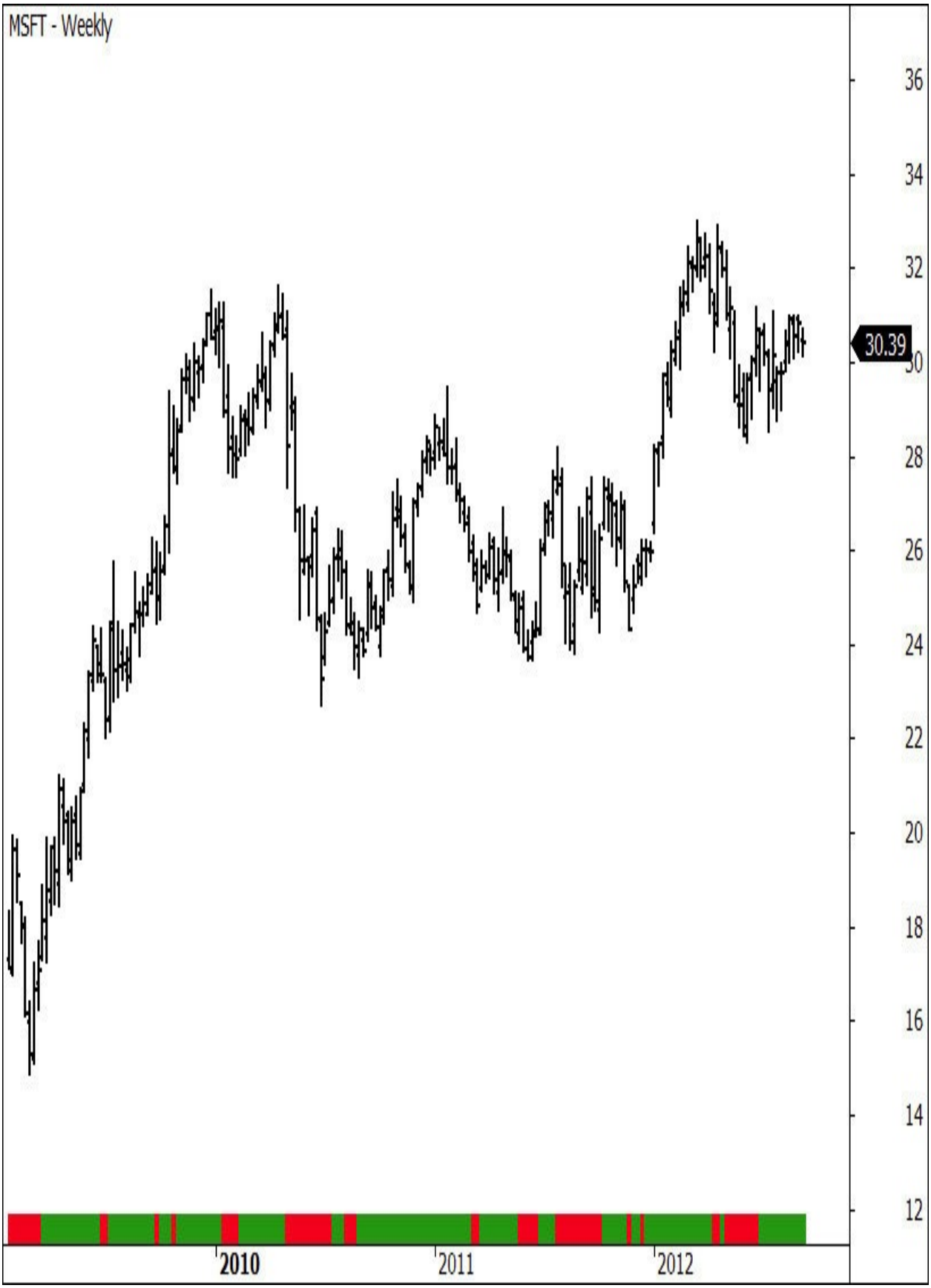
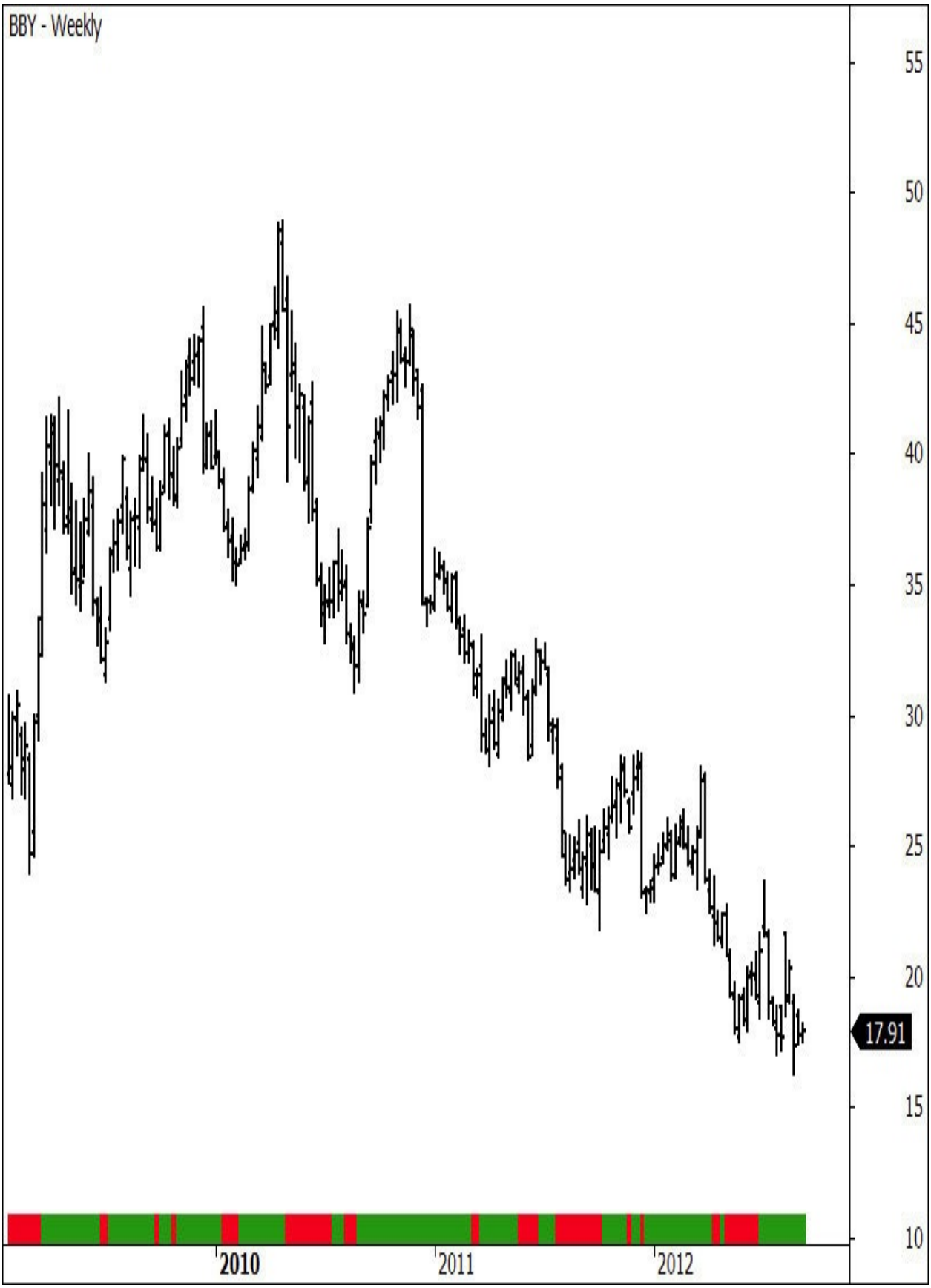

MSFT - Weekly
36
34
32
30.39
28
26
24
22
20
18
16
14
12
2010
2011
2012

Figure 7: The weekly Amazon.com ($AMZN) with the Index Filter ribbon on the bottom representing the trend of the $SPX.


AMZN - Weekly
300
280
260
246.22
240
220
200
180
160
140
120
100
80
60
40
20
2010
2011
2012

Figure 8: The weekly Best Buy Inc. ($BBY) with the Index Filter ribbon on the bottom representing the trend of the $SPX.


BBY - Weekly
55
50
45
40
35
30
25
20
17.91
15
10
2010
2011
2012

The Entry Mechanism

Now that we know the direction of the underlying market we can focus on entering individual positions. The entry rule is a two-step process using a breakout coupled with a confirmation tool. Every sustained trend that occurs is preceded by a breakout to new recent highs - it's impossible not to. A stock trading at $10 must pass through $15 to get to $20, and must travel through $20 to get to $30 and so on.

The following chart of Fossil Inc ($FOSL) shows the stock trending down during 2008 and 2009. The black line shows the highest high point over the preceding 20-weeks and therefore any breach signifies a breakout and the start of a new trend higher. As you can see, in early April 2009, the stock penetrated that boundary line near $17 and started trending higher till mid-2011. During this time the price moved from $17 to over $130 and all one needed to do was sit, wait and enjoy the ride.

Figure 9: Fossil Inc ($FOSL) declined during 2008 before breaking higher in early 2009 and trending from $17 through to $130.


FOSL - Weekly
160
150
140
134.98
130
120
110
100
90
80
70
60
50
40
30
20
10
0
-10
20-week
high
Breakout
2008
2009
2010
2011

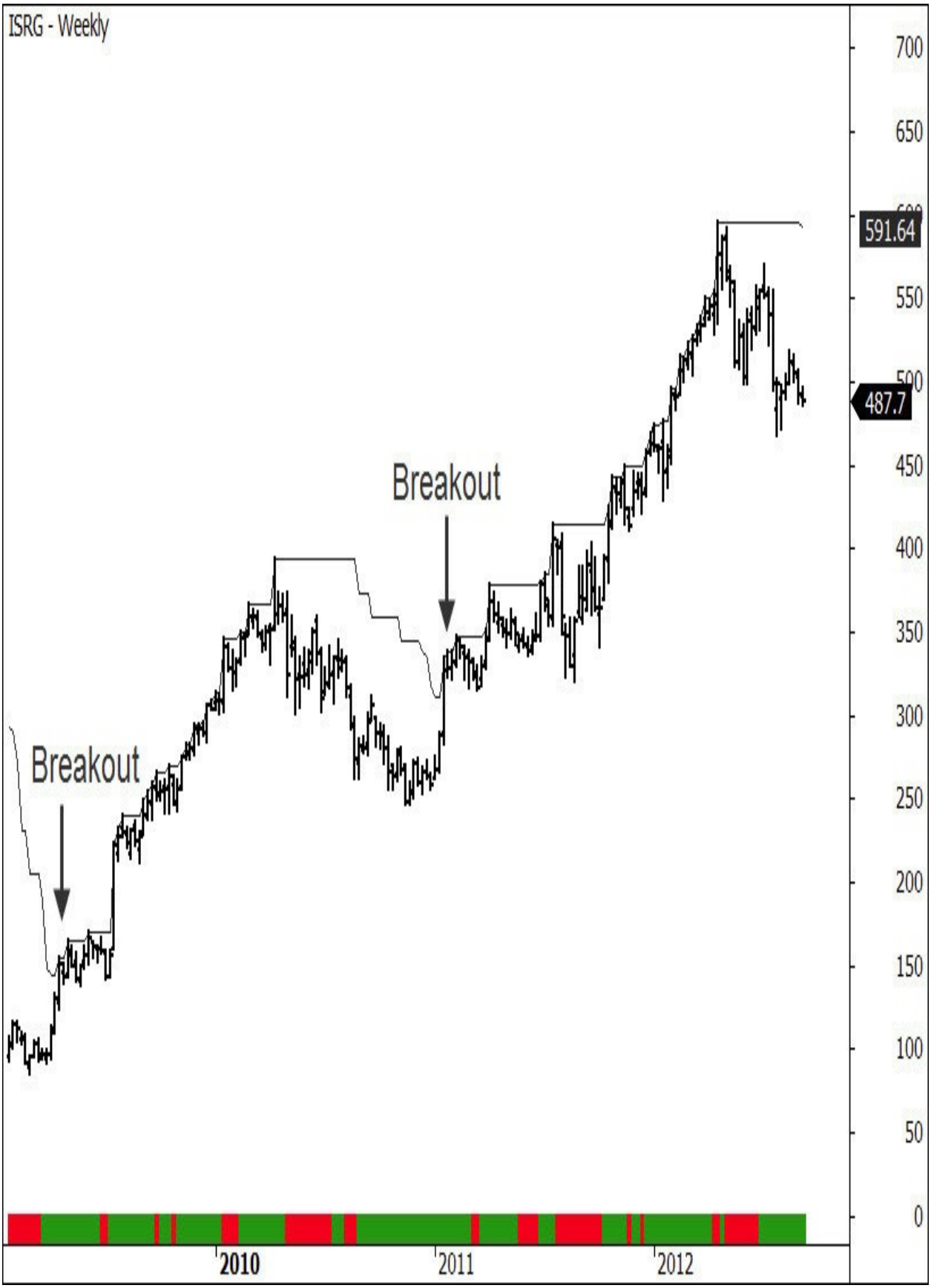
But let’s not forget that the trend of the broader market, the $SPX, must also be up as shown by the Index Filter being GREEN. We only want to take new positions when the broader market is deemed to be in an uptrend so before we buy $FOSL on the 20-week breakout we need to firstly ensure the Index Filter is UP, which in this case it is.

Figure 10: Fossil Inc ($FOSL) breaks through the 20-week high whilst the Index Filter ribbon is GREEN indicating that the $SPX is also in an uptrend.


FOSL - Weekly
Is the Index Filter UP?
Yes
No
Buy on 20-week breakout
No trade
Index Filter is UP
160
150
140
134.98
130
120
110
100
90
80
70
60
50
40
30
20
10
0
-10
2008
2009
2010
2011

In the following chart Intuitive Surgical Inc ($ISRG) breaks the 20-week high in late April 2009 and did so when the Index Ribbon was GREEN. This is a valid buy signal and the stock travels from $150 and peaks 12-months later just below $400. During the rest of 2010 the stock dips back to $250 before breaking the 20-week highs a second time in January 2011, again when the Index Ribbon was GREEN. Another valid buy signal and the stock travels this time from $325 to almost $600 in early 2012.

Figure 11: Intuitive Surgical Inc ($ISRG) breaks out twice and each time followed by a nice trend.


ISRG - Weekly
700
650
591.64
550
487.7
450
400
350
300
250
200
150
100
50
0
Breakout
Breakout
2010
2011
2012

So far we have two rules to justify an entry; firstly that the underlying broader market, specifically the $SPX must be trending up. Secondly the stock itself must make a new 20-week high at the same time as the $SPX is trending up. However, we need to add a last confirmation rule and this is done for two reasons.

Firstly, during a very strong bullish environment many stocks will be breaking highs resulting in numerous trade signals. Statistically the more trade signals that are generated, the more our end result may vary from the expected. This is known as Selection Bias and can add an element of discretion to the strategy if we need to pick and choose from many signals. In theory every strategy has some level of discretion; even the question whether to trade the strategy in the first place is a discretionary decision. However, Selection Bias occurs when there are too many signals and not enough capital to trade them. Most strategies that are exposed to a vast universe of stocks will have some level of Selection Bias but we want to try and at least limit that to some degree.

Secondly, not every breakout will continue higher as has been shown so far in this manual. Many breakouts tend to fail and there have actually been strategies developed to fade these breakouts because the failure rate can be quite high.

As such our next rule is designed to tackle both these issues, specifically limit the number of available trading signals and hopefully increase the number of successful breakouts that occur. We now introduce the Rate of Change indicator or ROC.

This indicator displays the rate-of-change of a stock's price and is displayed as a percentage rather than as a ratio. ROC is calculated by dividing the price change over the last 20-weeks by the closing price 20-weeks ago to give the percentage that the price has changed during that time.

Next we add a central line at the 30% reading. When the 20-week ROC line is above the central line, the price is considered to be moving with strong momentum. You may experiment with different central line readings, but our historical testing shows that the 30% reading is effective for our purposes.

The next chart shows Apollo Group Inc ($APOL) in a steady downtrend from 2009 through to 2012. However, on five occasions the 20-week breakout line

was penetrated before the stock rolled over and continued down. On two occasions, marked as “X” the 20-week penetration was not a valid signal because the Index Filter was RED meaning the trend of the $SPX was down. These are good examples of why we should always align our entries with the broader market trend as neither resulted in a new upward trend.

The other three breakouts, marked as “False”, all show a penetration of the 20-week breakout level but note that the ROC indicator was not above the 30% line, shown as the blue horizontal line. This means that whilst $APOL was moving higher, it was not doing it with any significant degree of momentum and is more than likely why the stock was unable to keep pushing upward. The ROC did eventually get above 30 in early 2012, but it was not aligned with a break of the 20-week high and was therefore not a valid signal.

Figure 12: Apollo Group Inc ($APOL) shows numerous false breakouts which were avoided due to the inclusion of the ROC indicator.


APOL - Weekly
False
X
False
False
X
100
90
80
70
60
50
40
38.34
30
28.19
20
40
30
20
0
-19.0873
-40
2010
2011
2012

The next chart also shows the usefulness of using the ROC indicator for confirmation. Whilst not every trade will be a winning trade, and here we can see the first breakout was a valid entry but led to a loss, we can still escape many false breakouts. Activision Blizzard Inc. ($ATVI) shows four further breakouts which fail to move higher into a sustained trend. These breakouts are not valid because the ROC indicator is below 30 suggesting there is no momentum behind the strength.

Figure 13: Activision Blizzard Inc ($ATVI) shows numerous false breakouts which were avoided due to the inclusion of the ROC indicator.


ATVI - Weekly
Valid
False
False
False
False
19
18
17
16
15
14
13.01
13
11.82
12
11
10
9
8
7
40
30
20
-3.11476
-20
-40
2010
2011
2012

The following hierarchy chart outlines the steps involved to get to a valid buy signal. In simple terms the three steps are:

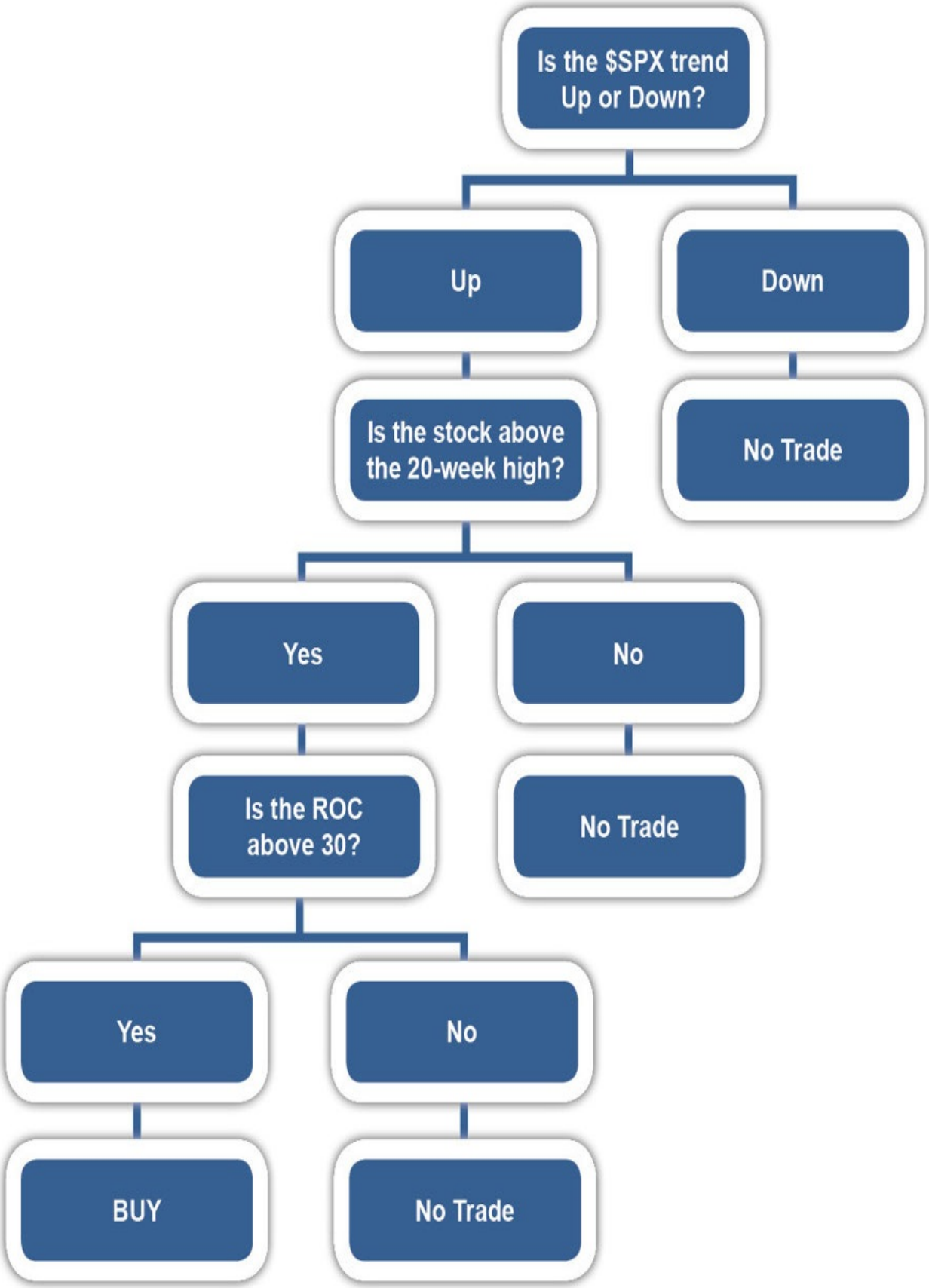
The $SPX must be trending up as defined by the 10-week moving average

The stock must make a new 20-week high

The ROC indicator, set to 20-weeks, must be above 30

When a stock meets these 3 criteria we can buy the stock on the open on Monday morning.

Figure 14: A hierarchy chart stepping through the entry setup.


Is the $SPX trend Up or Down?
Up
Down
Is the stock above the 20-week high?
No Trade
Yes
No
Is the ROC above 30?
No Trade
Yes
No
BUY
No Trade

The Exit Mechanism

A strong strategy is more about the exits than it is about the entry and the following exit mechanism is not only simple to understand but is one I have been using since 2006. The key to successful trading and investing is ensuring that the winning trades far outweigh the losing trades. Therefore we need to cut the losing trades quickly to limit the losses, but at the same time allow the winning trades to continue higher. As you may have noticed, stocks don't trend in a straight line. When they trend they oscillate back and forth. In order to capture the trend effectively we need to allow the stock to naturally oscillate yet at the same time be prepared to take defensive action if the broader market trend reverses.

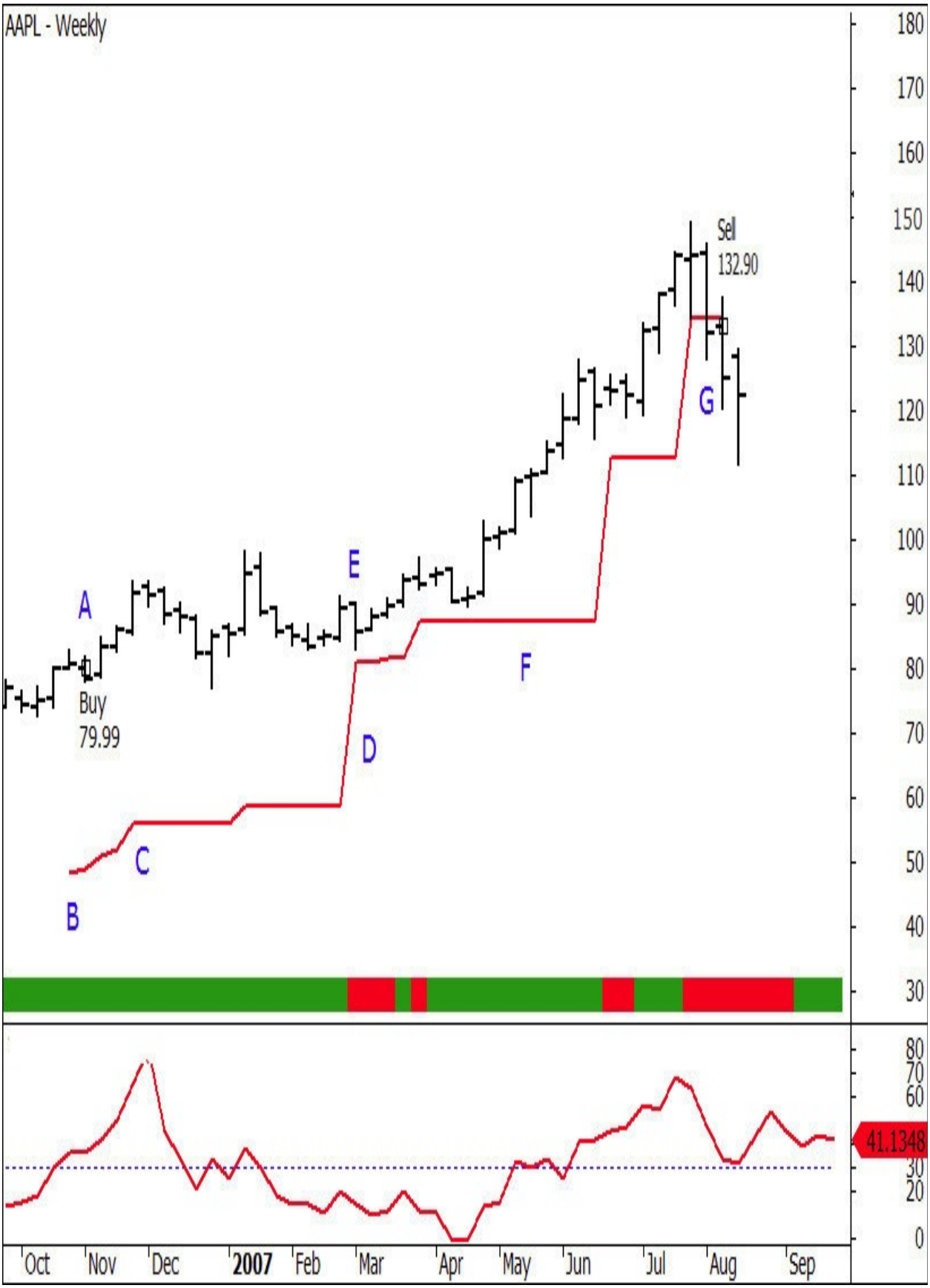
In order to trail the stop higher with the trend we use a two-step approach where the first step takes into account the price action of the individual position and the second step takes into account the trend of the broader market using our Index Filter.

We will exit a position if the stock declines by 40% from its highest point on a closing basis. That is, if it falls and closes 40% from our entry price or from a successive high point on Friday afternoon we will exit first thing on Monday morning. This may seem like a long way and I know what you're thinking - but don't panic! Firstly this rarely gets triggered, less than 1% of the time. Secondly, when used in conjunction with our portfolio construction (see Building the Portfolio) the risk on the complete portfolio is only 2%. As you may already know, the 2% rule is broadly recommended across the industry and is an acceptable level of risk on a portfolio level.

The second rule will only occur when the Index Filter turns RED, meaning the S&P 500 ($SPX) has entered a new downtrend. As a result of the broader market starting to trend down we will adjust the trailing stop from the 40% level to 10% from the high of the most recent week's trading. If the Index Filter turns GREEN again, meaning the trend of the $SPX has turned UP, we will leave the stop at the new level and only adjust it up if the stock starts trending higher again.

Let's zoom into a trade and take a close look at the price action and the trailing stop loss movement.

Figure 15: A close up view of Apple Inc ($AAPL) and the use of the trailing stop.


AAPL - Weekly
Sel
132.90
Buy
79.99
A
B
C
D
E
F
G
180
170
160
150
140
130
120
110
100
90
80
70
60
50
40
30
80
70
60
41.1348
30
20
0
Oct
Nov
Dec
2007
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep

Let’s start at point-A. The stock has broken its 20-week high, the ROC has moved above the required 30 level and the Index Filter ribbon is GREEN. We have a valid buy signal and we buy the open the next week at a price of $79.99.

The initial stop loss will be calculated from the high made during that first week of trading which was $81.68. Therefore the stop loss will be at $49.01 ($81.68 x 0.60). Remember we do not place the stop loss in the market. We monitor and await a close below before exiting the next week. This is important because sometimes we can get adverse price action intra week based on a news event and can see the stock decline but recover. Our extensive computer simulations show that using a stop-on-close is a much more effective way to manage positions than using a stop placed in the market.

Notice at point-C the stop loss has moved up to $55.85. This is because the price has moved up between point-B and point-C. The highest price the stock has made during those few weeks was $93.08, therefore, $93.08 x 0.60 = $55.85.

Over the next few weeks the stock declines a little, the usual oscillation we expect during a trend, and because no new highs have been made after the $93.08 high, the trailing stop remains at the $55.85 level.

What we have seen so far is the first part of the stop loss process. However, at point-D notice that our Index Filter ribbon has turned from GREEN to RED. The $SPX has now entered a downtrend. Notice as well that as soon as the Index Filter turns RED that the trailing stop loss jumps. This is the second rule. To calculate the new stop level we take the high at point-E, the week the Index Filter turned RED, and place the stop just 10% from that high. The high at point-E was $90.00 and therefore the stop loss will be placed at $81.90 ($91.00 x 0.90).

Basically at point-E we have said that we’re happy to give the market room to move, but because the $SPX has now started trending down we don’t wish to give the stock too much room, so instead of 40% stop loss it’s now just 10%. This allows the trend to continue higher if it can. If it can’t, and it closes below that line, then we will exit.

In this case $AAPL moved sideways for a few weeks then started to move higher. On each successive new high we adjust the stop up that little bit more to

lock in profits.

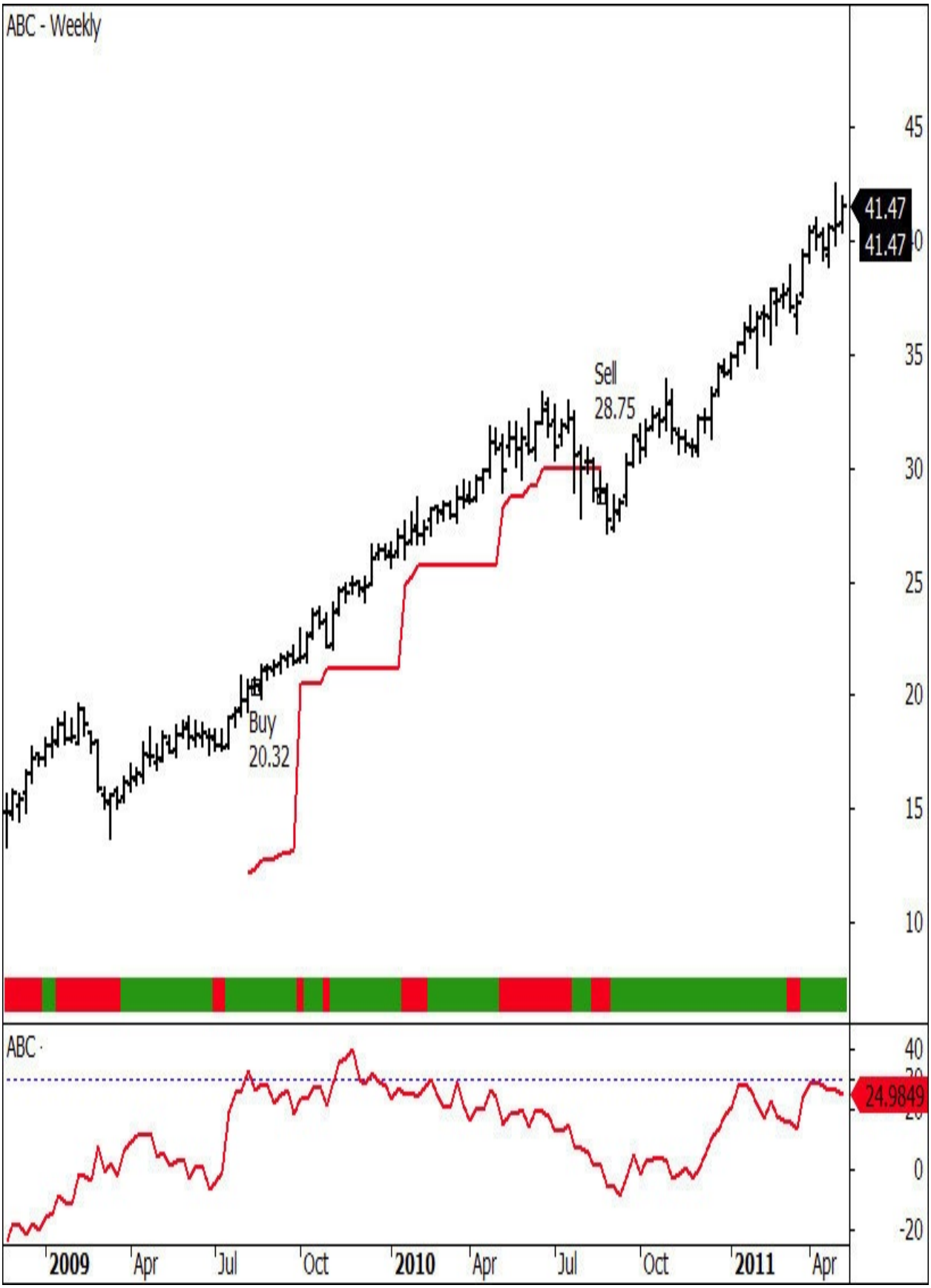
Next, at point-F, the Index Filter has returned to GREEN meaning the $SPX has started trending higher again. Now we will start using the 40% calculation from each successive high point but only if it is higher than the current stop loss level. In other words we NEVER move the stop loss backward. You can see that during this period at point-F the stop loss remains flat.

Just after this flat period you can see the Index Filter ribbon turns RED again and the stop loss jumps higher once again. This process will continue until we get a Friday close below the stop loss line.

This finally occurs at point-G and we exit the week on the open at $132.90 for a return of 66% on that single position or a 3.3% return on the full portfolio.

Let’s take a look at some other examples and, when doing so, note how the stop loss moves higher when the Index Filter ribbon adjusts.

Figure 16: Amerisource Bergin Corp ($ABC) gets a buy signal at $20.32 and exits 12-months later at $28.75 for a return of 41.4%.


ABC - Weekly
45
41.47
41.47
35
Sell
28.75
30
25
Buy
20.32
20
15
10
ABC
40
24.9849
0
-20
2009
Apr
Jul
Oct
2010
Apr
Jul
Oct
2011
Apr

The following chart of Arch Capital Group ($ACGL) shows that the trailing stop loss had been penetrated on three separate occasions after an entry in late 2009 at $20.92. The stop loss was NOT valid because we require the Friday close to be below the line and on these occasions this did not occur. This was lucky for us because in 2010 the line was penetrated and the stock kept trending higher and is currently showing a gain of 91.6% excluding any dividends that have been paid during the holding period. You would be annoyed if you had exited because, as you can see, the ROC did not go back above the 30% trigger line so no new entries would have been triggered.

Figure 17: Arch Capital Group ($ACGL) showing intra week breaches of the trailing stop that all reversed by Friday's close.

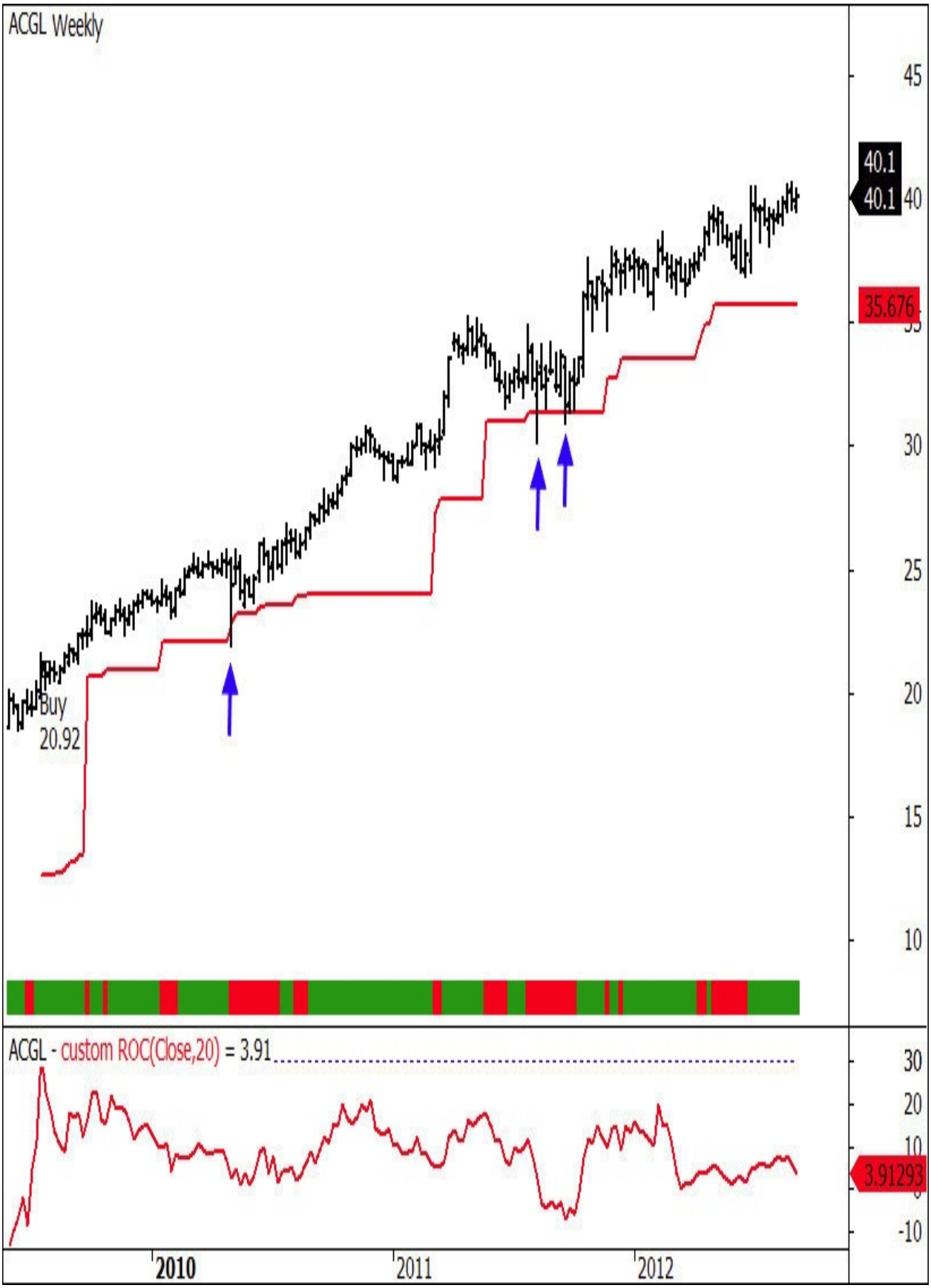
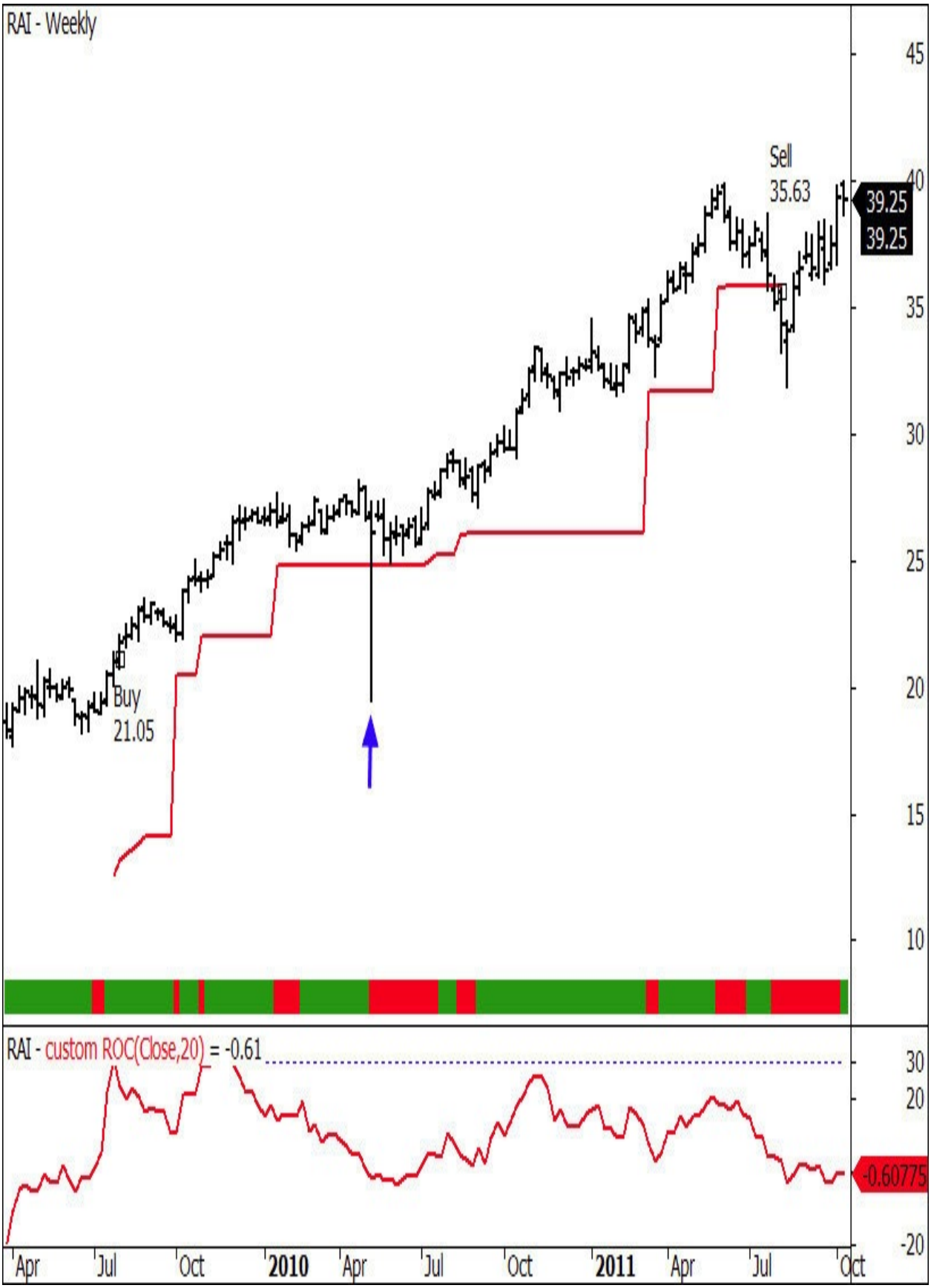

ACGL Weekly
45
40.1
40.1
40
35.676
30
25
20
15
10
Buy
20.92
ACGL - custom ROC(Close,20) = 3.91
30
20
10
3.91293
-10
2010
2011
2012

Figure 18: Reynolds American Inc ($RAI) also showing a significant intra week penetration of the stop loss line, but reversing and closing above so no exit signal triggered. It continued higher and a solid 69% gain.


RAI - Weekly
Buy
21.05
Sell
35.63
39.25
39.25
45
40
35
30
25
20
15
10
RAI - custom ROC(Close,20) = -0.61
30
20
-0.60775
-20
Apr
Jul
Oct
2010
Apr
Jul
Oct
2011
Apr
Jul
Oct

Building the Portfolio

There are many ways to build a portfolio and there are many ways to measure and manage risk. Whilst we could extend our discussion into advanced portfolio theory and management it really detracts from the key messages of this manual which are simplicity and robustness. For the average retail investor the use of hedging or other portfolio tools are complex to understand, usually very expensive to facilitate and, more often than not, aren't overly effective over the longer term. Sticking with vanilla techniques will tend to get the job done adequately and substantially lower the extra stress that comes with managing hedge positions.

Using an active investment strategy will automatically enable us to establish positions when broader market trends are running higher and revert to cash when these trends are running lower. This automatic moderating of exposure relieves much of the tension and guesswork surrounding the best time to be invested and the best time to take defensive action.

There are two effective ways to build a portfolio and ensure both robustness and simplicity. These include:

The number of positions to open, and

The universe of stocks traded.

The number of positions to open is probably the most important because it can involve sample bias or position variability, which is an error involving the number of stocks chosen to trade. In its purest form sample bias cannot be avoided because in certain market conditions almost all investment strategies will generate more opportunities than one has capital to trade.

For example, a strategy that generates 100 consecutive signals in 100 consecutive days will have 81 different permutations of a 20 stock portfolio. However, a strategy that generates 30 signals in the same period has just 11 permutations of the same 20 stock portfolio. The higher the level of permutations the more variance of returns and the more the real time results could diverge from historical testing if the strategy is not robust. As a rule of thumb, the more simplistic the strategy the more prone to sample bias it will be and therefore the more likely returns will vary considerably in the future.

This error can be extrapolated further by suggesting a differing quantity of positions be allocated to different capital amounts. If we suggest a $100,000 account takes 20 positions, yet a $30,000 account only takes 10 positions, then the smaller account will be at a distinct disadvantage to the larger because its sample of possible permutations will increase. Over a 30 trade period the 20 position portfolio has 11 different permutations possible yet the 10 position portfolio has 21. The incidence of diverging from the historical test results has almost doubled simply by choosing to trade a smaller portfolio size.

There is no specific right/wrong answer to this question but there are two definitive conclusions;

Simplistic strategies are more prone to position variability.

The same number of positions should be used regardless of the capital allocated to the strategy.

Experience shows that using 20 positions, regardless of capital allocation, tends to offer the best risk-adjusted return relative to time taken to implement and manage the portfolio.

The second consideration is defining a specific universe of stocks to trade. A universe represents a group of candidates to which we will apply our strategy; however, experience again suggests that candidates should fit within the same

broad risk boundaries unless your intention is to have a diversified portfolio. Trading highly speculative stocks and conservative stocks together will offer some diversification but ultimately it will degrade performance and more seriously could be incompatible with your risk tolerance. Trading a universe of stocks of the same breed, such as all blue chip or all small-cap, will keep volatility in check, or at least offer an understanding of likely portfolio volatility.

A word on using sector-specific universes; a core philosophy of active investing is ensuring we do not predict. If you attempt to anticipate which sector will be the next best performer you run the risk of falling into the prediction trap. In reality the best performing sector, or the constituents that make up that sector, will naturally float to the surface as momentum increases.

Lastly the other benefit of running multiple positions is that risk is also managed on an individual holding basis. With 20 positions the risk per individual stock is a maximum of 5% of the full portfolio value. If we assume an exit point set at 40% from entry then risk per trade is just 2% of portfolio capital. There can be some very complex methods for allocating capital to specific trades and whilst some of these are extremely beneficial for short term trading, they can also be detrimental to equity-specific investing. Using a portfolio broken up into 20 equal sizes is a very robust way to manage risk without diluting returns.

Proof of Concept

This is where most books finish. You get given a set of rules and basically told to trust the judgement of the author. However, how do we really know if their strategy works in the real world? There is rarely proof offered and why would you invest your hard earned capital into a strategy simply based on the hearsay of an unknown author? There are certainly some strategies that cannot be coded into a computer, known as soft strategies, so an element of forward testing or paper trading is required before real time trading commences. Put it this way - you wouldn't get in an aircraft unless you knew the pilot had some real time flying experience, would you? You wouldn't go to a doctor that had no formal training either. So why is it we download an eBook on trading, read it in one sitting and two months down the track wonder why our account is fast declining?

The Weekend Trend Trader manual, being a systematic strategy, offers various benefits because we're able to hard code it and then back test using historical data. In layman's terms, it's like seeing how our strategy would have performed over the years had we indeed traded it as it was supposed to be traded. The benefits of a systematic approach include:

A map of how the strategy has performed in the past and therefore a better indication of how it may perform in the future.

An understanding of what the strategy can and can't do, as well as understanding what the journey to successful implementation entails.

Removal of emotion from the decision making process.

Set guidelines which enable the strategy to be replicated in the future without discretion or deviation.

Time spent implementing the strategy tends to be lower as technical analysis software such as Amibroker can be programmed to 'spit out' the required orders and automatically manage positions.

The key with simulating historical trading performance is to ensure it’s done accurately. Remember, garbage in, garbage out: if you feed the computer garbage it will spit out unreliable and inaccurate results.

Test Universe

We need to select a universe of stocks from which to run our simulations. To do this with reasonable robustness we will select all securities from the Russell 3000 including current constituents and those that were once in the index but have now been removed. The use of historical constituents ensures we reduce survivor bias and makes the simulations substantially more accurate. In summary our test universe will contain a total of 9550 securities, 3000 current and 6550 that have been removed, and will therefore provide a fair idea of how the strategy has fared over the years without giving too much bias to a single sector or index.

Our simulations will run from 1st January 1995 to late-2012. This period encompasses a wide variety of major ‘price shock’ events such as:

1997 Asian currency crisis

2000 Tech crash

2001 September 11

2000/03 Bear market

2007/08 Global Financial Crisis

Monte Carlo Simulations

There are two important factors to consider when simulating investment strategies on historical data. Firstly it's not an exact science and the future will not look exactly like the past although, if simulations are done correctly, the future will look something like the past. When simulating a strategy using historical data on a single back test run it's impossible to know whether the result generated from that single run is average, above average or below. If the results from a single run are above average we may have heightened expectations for our strategy and become disillusioned when it fails to perform according to the test results. On the other hand, we may discard a perfectly good strategy if the single run doesn't appear to meet our goals.

Monte Carlo simulations ask the question, "What if the past had been slightly different?" It allows us to view a range of possible outcomes and statistical probability which in turn gives us a better expectation of what may occur in the future.

Put simply, it's like giving the strategy to 5000 individuals and asking them to come back in 10 years' time to collate their results. For various reasons a range or distribution of statistics will be presented. Some people will ignore system signals at times due to personal biases; others may not take signals if they go on vacation or become emotionally detached to the longer term goals. Position variability means that different people may choose to take different signals. By collating the 5000 sample results we gain an insight into the variability of the strategy and can therefore make a better informed decision than that of a single run back-test.

Not all technical analysis software is capable of running Monte Carlo simulations.

It is a well-known fact that smaller cap stocks exhibit greater volatility and, as can be seen in the table below, we will use price limiters to seek out those higher volatility stocks and therefore increase potential returns. The strategy is extremely robust and will operate well on any universe of stocks and any price however calibrating for higher volatility makes sense for retail investors willing to pursue greater rates of return.

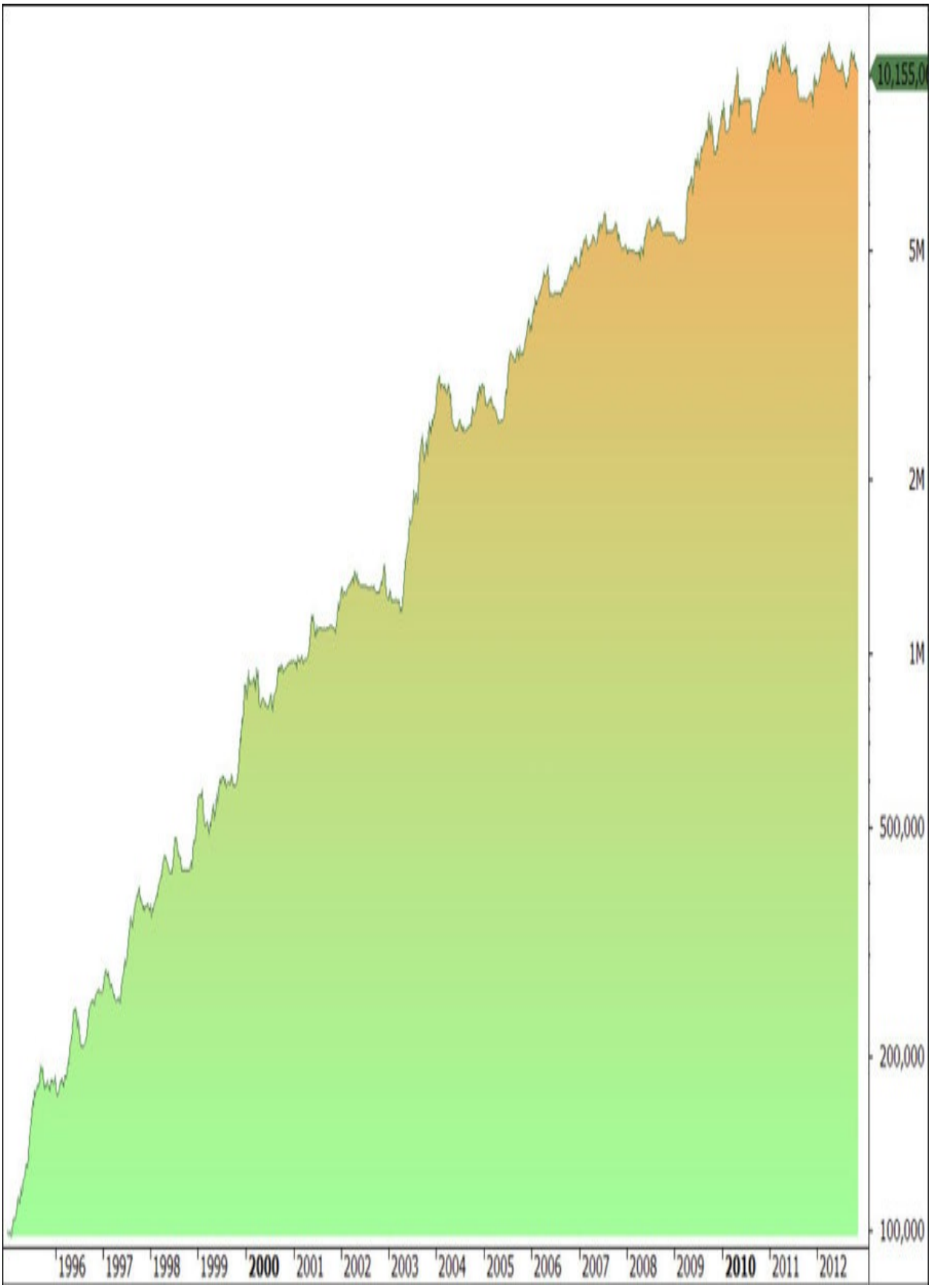
We removed dividends from the testing process so any dividend income received would be deemed a bonus return, however, based on the universe we’re trading it is unlikely that there would be much dividend stream generated.

Simulation Capsule Summary

General Inputs	
Universe	Russell 3000 (current and historical constituents)
Period	Jan 1995 - Nov 2012
Dividends	Excluded
Commissions	$0.005 per share or minimum $1.00
Strategy Filters	
Index Filter	$SPX
Index Filter Length	10 weeks
Minimum Price	$1.00
Maximum Price	$10.00
Minimum Turnover	$500k average for 7-days
Minimum Volume	500,000 average for 7-days

The following chart (Figure 19) shows a smoothly rising equity curve from 1995 through late 2012. As can be seen, the significant bear market declines suffered by Buy & Hold investors do not appear here because the strategy takes great care to defend capital during bear markets.

Figure 19: Equity growth of the Weekend Trend Trader strategy since 1995.


10,155,0
5M
2M
1M
500,000
200,000
100,000
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012

The following table outlines performance metrics of the Weekend Trend Trader strategy based on extensive Monte Carlo Simulations.

Table 1: Performance of $100,000 account between January 1995 and December 2012

PERFORMANCE CAPSULE SUMMARY			
	Average	Range Min	Range Max
Annual Return (CAR)	27.90%	23.86%	32.48%
Max Equity % Drawdown	-24.08%	-29.44%	-19.21%
# Trades	944	918	970
Trade Win %	50.76%	48.51%	53.07%
Trades Loss %	49.24%	46.93%	51.49%
Av % Profit / Loss	11.31%	9.72%	13.60%
Profit Factor	1.79	1.58	2.07
Av Profit / Loss	$8,347.67	$4,550.65	$15,814.65
Av Win trade	$37,146.55	$21,897.14	$59,579.22
Av Loss trade	-$21,413.41	-$34,326.48	-$12,254.89
Av Position (Days)	70	68	73
Win Position Time (Days)	94	89	99
Loss Position Time (Days)	46	44	48
Net % Profit	8159.32%	4477.55%	15136.73%
Net $ Profit	$8,159,323.15	$4,477,545.11	$15,136,727.57
Payoff Ratio	1.74	1.54	2.05
MAR Ratio	1.16	0.81	1.69
Recovery Factor	3.70	2.58	5.47

There are various ways to measure performance but it is important to not only look at the absolute return, but also consider the risks as well. The S&P 500 has returned a little over 6% per year over the last 20-years, but in order to achieve that return a buy and hold investor needed to withstand a 57% decline in the value of their portfolio, so the 'pain to gain' ratio is extremely poor. The MAR Ratio measures this 'pain to gain' metric by dividing the annualized return by the maximum equity decline during the investment horizon. A buy and hold investor has a MAR Ratio of 0.10. The Weekend Trend Trader strategy has a MAR Ratio of 1.16 which is extremely high. Most mutual fund managers struggle to gain any level above 0.20 and the best funds just make it toward 0.30.

So why does the Weekend Trend Trader do so much better?

The key reason is the ability to go to cash when broader sustained bear markets come along. Almost all fund managers have a mandate to remain invested meaning they will suffer capital declines during these poor periods of time. The last 20-years have seen two dramatic bear markets, 2000 through 2003 and 2007 through 2008 which have caused major damage to mutual fund returns. The inability to play a good defence destroys the long term return profile.

That is not to say the Weekend Trend Trader strategy is a painless strategy to trade. There are no painless strategies when it comes to capital growth however the level of pain is measured in degrees. Where a buy and hold investor, and most mutual fund investors, have suffered capital declines circa 50%, the Weekend Trend Trader suffered a decline of 24.08%. Whilst this is not particularly comfortable, it is far from a 50% decline.

Interestingly the largest equity decline was not due to the GFC but the Tech Crash when prices dropped suddenly. During the GFC the market rolled over slowly which allowed our defensive tactics to kick in and protect capital, but during a sharper decline from a high, such as the Tech Crash, then those defensive actions were a little slower.

Even so, several important points should be made about the performance of the strategy. Firstly it significantly outperforms the S&P 500 from both an absolute return basis and from a risk basis. Secondly, it ensures we have a systematic and non-emotional entry and exit into the market ensuring that we'll capture upside

trends when they appear as well as defend capital during sustained bear markets. Next, the strategy removes the onerous task of shuffling through investment candidates. There is no need to read company reports or analyze fundamental metrics. The strategy will automatically tell you which stocks to buy and sell.

Bringing It Altogether

There are three steps to successful trading and investing. They are:

Find a strategy that works

Validate it

Do it

The Weekend Trend Trader strategy offers the first two and now it's up to you to complete the third task. The rules of the strategy are quite simple, but operation becomes even easier when a software package is used to generate the orders. We use Amibroker, but there are many others on the market that allow the rules to be coded and then generate orders.

If you do not have the time or the ability to program, then you may like to consider purchasing the Amibroker code so you can test, make changes and run the strategy yourself. AUD$660

Weekend Trend Trader in a Nutshell

Entry:

10 week moving average of the $SPX must be greater than last week

20 week ROC must be above 30

Stock must close above a new 20 week high

Initial Stop:

A 40% decline on a weekly close basis

Trailing Stop:

If 10-week trend of $SPX remains up then continue to use a 40% decline on a weekly closing basis.

If 10-week trend of $SPX turns down then use a 10% decline on a weekly close basis

Portfolio Construction:

20 equal positions

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