The BIG Secret To Trading Success

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Introduction

Thank you for purchasing my **book "Building Winning Algorithmic Trading Systems - A Trader's Journey From Data Mining to Monte Carlo Simulation to Live Trading."** I hope you find many different ways to improve your trading, based on my writing.

As a special thank you, in this document you'll find what I consider the secret to trading success. It is a simple concept, although to implement it properly you need a solid foundation. I'll give that foundation, and more, in this report.

Warning

Before you go any further, make sure you read and understand the disclaimer at the bottom of the page. The US government requires it, and it is there to protect you. Keep this warning in mind when you look at trading systems - it will help you immensely.

What The Secret Is NOT

Practically everyone involved in trading will tell you they have the secret. Some Holy Grail that no one else has, that no one knows about. One vendor used to require you to become a member of a "secret society" to learn his mystical secret. Another described how he came across the secret to trading in an old trunk left in an attic, and that he now felt "obligated" to share it with the world.

Of course, these kind folk will sell you the secret, for a few thousand dollars.

How nice of them --- NOT!!!

Well, in this report I'm going to give you my secret to trading success. For FREE. That comes later. But first, I'd like to tell you what the secret is not. Knowing what is not involved in the secret will help you take advantage of what the secret is all about. You'll be able to stop wasting your time where most people expend the most wasted effort, and instead concentrate on what really matters the most.

It is Not Magic Entries

Take a look at any ad you see for trading systems. What do they usually talk about? 90% win rates, "golden entries," charts with perfect entry points shown. Just looking at all these advertisements, one would conclude that entries were the most important aspect of trading.

In fact, entries are **not** the most important part of trading.

Dr. Van Tharp once showed that even a random entry system could be profitable, if the right exit management was selected. So much for entries being the key! Now, I don't recommend you select entries at random, but realize that entries are not the "be all and end all" of trading.

Don't get me wrong: entries are important, especially as your time duration shrinks. Someone who is trying to scalp needs more accurate entries than someone who is trading off of monthly charts. But entries are only a piece of the trading puzzle.

The point is - try to select good entry methods, but realize entries are not the key to success.

It is Not Magic Exits

Many people argue that exits are key. Certainly, they are important, and are probably more important than entries. A properly designed exit will keep losing trades small, let winning trades run as much as possible, and if desired will protect profits during a trade.

But really, once you are in a trade, there is only so much you can do. You are at the mercy of the market. And the market has a way of tearing apart any "Holy Grail" exit technique you think you have.

So, just as with exits, don't waste time searching for that perfect exit. It is easier to find a good exit than a great exit, and takes much less searching time, too.

It is Not Money Management or Position Sizing

A few years ago, a book came out touting a "revolutionary" new position sizing technique. The author claimed it was the Holy Grail, and sold a lot of books based on that assertion. Of course, the book had example after example of how this new position sizing technique was just AWESOME.

Only problem was, it wasn't so awesome after all.

The author's Holy Grail position sizing technique worked great, IF your account equity grew in a certain manner. Basically, if you had more winning trades at the beginning, you traded larger and then dialed back the aggressiveness as the account grew. The problem is that if you start out losing, being overly aggressive would kill your account. The Holy Grail suddenly became Holy $&#*$(!

And that is actually what happened to one of the author's account. He wiped out an account using his Holy Grail position sizing method. So much for that idea.

That doesn't mean that position sizing should be ignored. Another author, Ralph Vince, once said that 90% of performance was related to position sizing and money management. Ralph is a very smart guy, as you can tell by reading and studying his books. So, I agree with Ralph that position sizing is pretty important. Plus, it dovetails nicely into what I feel is the real secret to trading success.

So, What Is The Secret?

Diversification is the secret to trading success. Not entries, not exits. Diversification. Pretty simple, huh? The devil, of course, is in the details.

What Exactly Is Diversification?

Diversification means that you don't put all your trading eggs in one basket. To take advantage of diversification, you have to diversify your trading:

- Different markets
- Different entries
- Different exits
- Different timeframes (bar sizes)
- Different trade durations (intraday, swing, long term)
- Different styles of trading
- Different trading systems
- Different position sizing approaches

The unsavory alternative to diversification is to trade just one market, with just one trading system. Then, you are at the mercy of that market, and that system. While it is possible that you will do fantastically well, the reality is that you are much more exposed on the downside. For example, what if your one system stops working? It could be "game over" for you. On the other hand, if you trade 5 systems, and one goes bust, you still have 4 other systems to make up the difference. So, the downside is what you have to worry about, and that is where diversification really helps.

Why Don't You Hear More About Diversification?

OK, so if diversification is so great, why doesn't the average retail trader hear more about it? How come very few people talk about diversification?

1) It Is Hard To Do For The Little Guy

Let's face it, there are a lot of little guys in trading. I should know, I was one of them way back when, struggling to survive with my $5,000 account. I felt lucky to trade one system back then, much less 4 or 5. I just did not have the margin to be in many different trades. To be properly diversified, you need a larger account. Most people, unfortunately, never get to that point.

2) There is Nothing For Vendors To Sell

How does a typical vendor sell "diversification?" He really can't. It is not a fancy new indicator, a "secret" entry method, or something you can see on a mini S&P price chart candlesticks. So, if there is nothing to sell, there is no reason to talk about it.

3) Why Multiple Systems, When Many Vendors Sell "Perfect" Systems

So many of the scummy trading vendors market their trading system as the ultimate, the best, the only one you'll ever need. Obviously, this sales scheme works, or they would not do it. For them to admit that their super terrific trading strategy needs the help of diversification just leads to their whole sales pitch falling apart. And they cannot handle that!

4) It Is An Advanced Concept

In this fast paced, need it now Internet age, people want answers fast, and don't want to take time to learn the right way to do things. People want to be Warren Buffett, but most aren't willing to put the time or effort into learning something complicated. Diversification takes analysis, and also requires multiple trading strategies. It can be done, but it is work and it is tricky at first. But once you understand it, and develop trading algorithms to exploit it, diversification can become a trader's best friend.

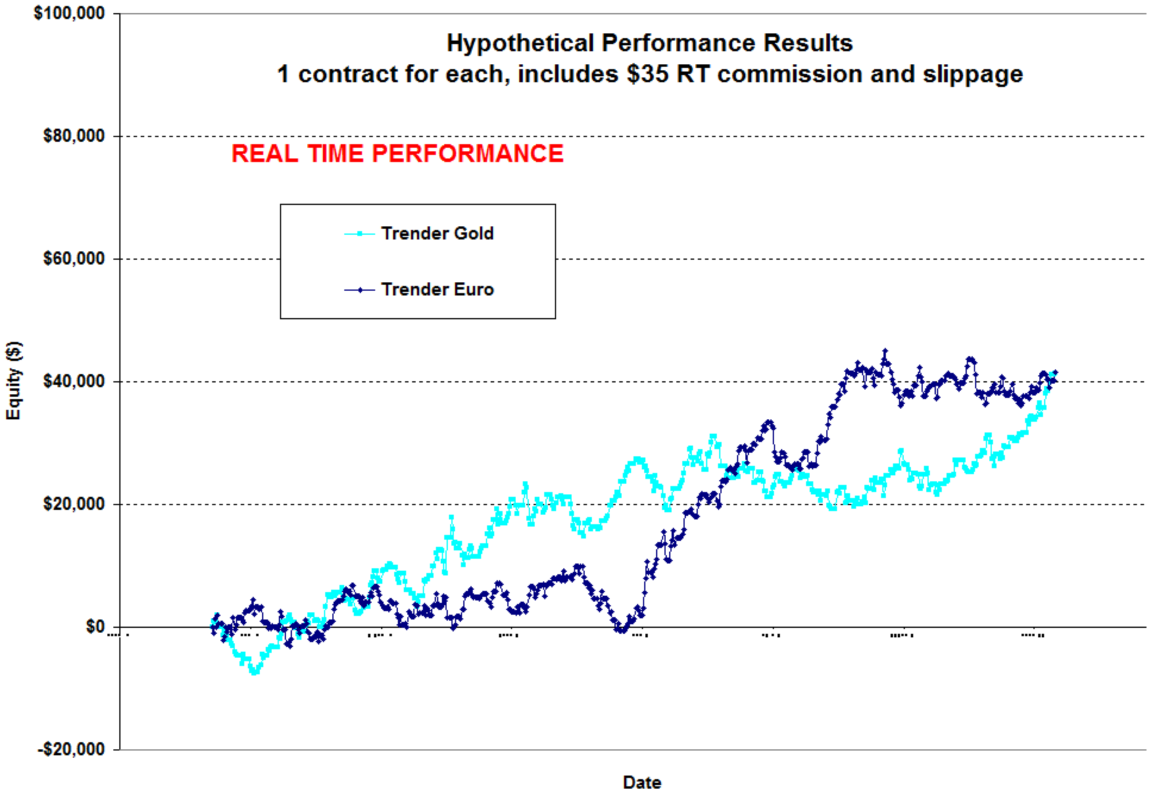
Diversification In Action

EXAMPLE 1 : MULTIPLE FUTURES TRADING STRATEGIES

Here is an example with 2 futures trading systems. One trades Gold, and the other trades the Euro currency. These systems are uncorrelated (a key part of diversification, as I'll describe later).

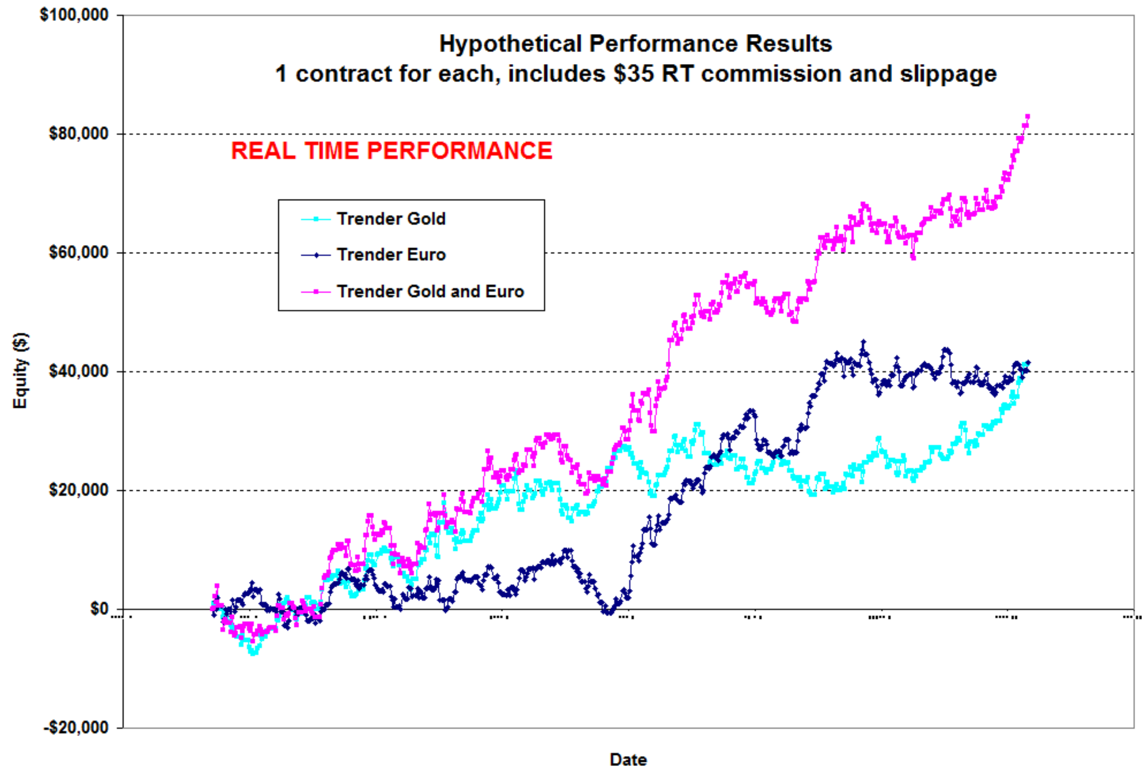
First, let's look at some hypothetical return statistics for each alone.

	Gold	**Euro**
Profit	$41,410	$41,512
Max Drawdown	$11,830	$10.377
Profit/ Max DD	3.5	4.0



Both of these strategies by themselves are decent enough. Of course, they have drawdowns and flat periods, as does any real trading system. The "magic" occurs when you trade them both at the same time.

	Gold	Euro	Gold and Euro
Profit	$41,410	$41,512	**$82,922**
Max Drawdown	$11,830	$10.377	**$10,002**
Profit/ Max DD	3.5	4.0	**8.3**



Look what happens when you trade both systems together:

- **Net Profit doubles**
- **Max Drawdown actually decreases**
- **Profit/Drawdown ratio more than doubles**
- **Equity Curve is Smoother (note how pink curve is smoother than either of the other curves alone)**

Clearly, adding two uncorrelated systems together produces an overall result better than each by itself, any way you look at it! The end result is a smoother equity curve, with drawdowns that are usually not as severe.

EXAMPLE 2 : OPTION SELLING TRADING STRATEGY

The example above achieved diversification by utilizing multiple trading strategies. You can also become diversified by trading the same strategy on multiple markets (assuming it has successful historical testing in those markets).

Consider two traders. Trader C likes to be concentrated in his trading, working only with 2 markets. Trader D, on the other hand, likes to be diversified. He likes to trade 10 markets.

Both traders have an identical option selling strategy, one that wins 90% of the time. The only difference is that Trader C makes 2 trades per month, and Trader D makes 10 trades per month. They use the same position sizing method, so Trader C's wins and losses will always be 5 times as large as Trader D's (since Trader D takes 5 times as many trades).

Trader C is Mr. Concentrator. He has a $100 account. He takes 2 uncorrelated trades per month. He wins 90% of the time. When he wins, he makes $2.5 on his account. When he loses 10% of the time, he loses $10.

In one year, on average he'll win 24*.9 = 21.6 trades at $2.5 each = $54.
In one year, on average he'll lose 24*.10=2.4 trades at $10 each = -$24.

Overall in one year, Trader C will earn $30.

Trader D is Mr. Diversified. He has a $100 account. He takes 10 uncorrelated trades per month. He wins 90% of the time. When he wins, he makes $0.5 on his account. When he loses 10% of the time, he loses $2. Note that his wins and losses are exactly 1/5 of Trader C's wins and losses. This is because he is making 5x as many trades. This is accomplished by sizing his positions.

In one year, on average he'll win 120*.9 = 108 trades at $.5 each = $54.
In one year, on average he'll lose 120*.1=12 trades at $2 each = -$24.

Overall in one year, Trader D will earn $30.

OK, so overall, Trader C and Trader D, on average, will both earn the same return over time. Their performance looks equivalent, and it is as far as profits go.

The question is: would you rather be Trader C, or Trader D? Or does it even matter?

As it turns out, Trader C and D are a lot different, and it is because of diversification.

Even though both traders, in this example, have the same average annual gain, it turns out diversification matters a lot, especially if you are concerned with drawdown and downside risk.

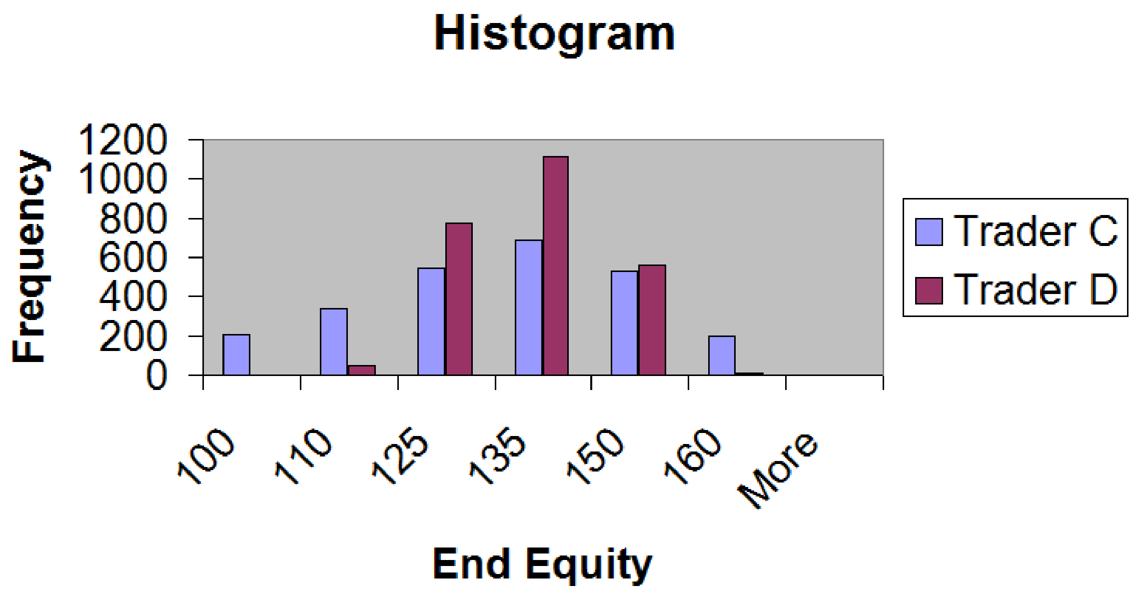
The answer has to do with standard deviation of the trade results. All other things being equal, if you want to minimize the downside, you always want to strive for the lowest standard deviation of trade results as possible. This leads to smaller drawdowns, as one tangible benefit. The drawback is that it gives up some upside potential.

If we look at Trader C's trades in one year (24 trades), his trade standard deviation is: 3.53

If we look at Trader D's trades in one year (120 trades), his trade standard deviation is: 0.75

That is a huge difference - almost a factor of 5. That is why it is better to be Trader D - lower standard deviation leads to smaller dispersion of trades, which shows up as smaller drawdowns.

Another way to show this is by running some Monte Carlo simulations, over 1 year's worth of trades. By showing final equity in a histogram, it is easy to see that Trader C has a more widely dispersed set of results than Trader D. Again, if everything else is the same, you want to have a tight distribution of final equity values (unless you are only trying to maximize gain).



Hopefully, these two examples make it clear that you want diversification, whether it be by trading multiple systems, trading multiple markets, or some other technique that produces uncorrelated results!

How Can I Check For Diversification?

The easiest way to check for diversification is to check for correlation. Two items are said to be correlated if the results are closely aligned. For example, let's say that every day the Gold system above made money, the Euro system also made money. And vice versa. Chances are, those systems would be very highly correlated. For proper diversification, you want low/zero correlation.

You can easily create an Excel spreadsheet to check for correlation. Simply put daily trading results for system A in one column, and System B in the other column. Then, you can run Excel's Data Analysis - Regression tool, and you'll get your results. You can also plot the results, and look at the R^2 value.

The screenshot below shows both types of analysis for the Trender Gold and Euro systems:

Gold Daily Results	Euro Daily Results
0	0
1030	-925
-260	2325
380	-1387.5
765	2012.5
-1940	-1450
0	0
0	0
-1250	-2787.5
550	737.5
-1105	1487.5
370	-725
-755	650
0	0
0	0
-445	-1087.5
-350	2712.5
-1140	-1962.5
-260	787.5
-170	1150
0	0
0	0
10	87.5
-1425	-500
1480	-335
-717.5	1465
-97.5	525
0	0
0	0
-1065	325
-805	375
225	950
-660	-2287.5
210	1100
0	0
0	0
735	-312.5

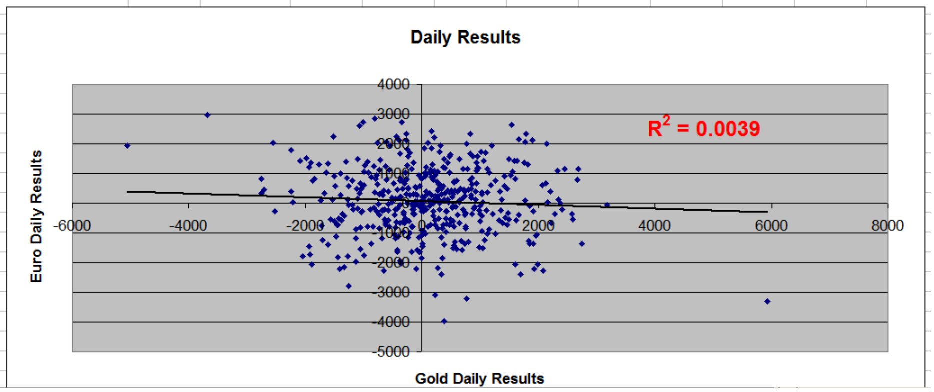
SUMMARY OUTPUT

Regression Statistics		
Multiple R	0.062321	
R Square	**0.0039**	**Correlation**
Adjusted R Square	0.002337	
Standard Error	950.9353	
Observations	646	

ANOVA

	df	*SS*	*MS*	*F*	*ignificance F*
Regression	1	2270654.88	2270655	2.511015	0.113544
Residual	644	582354949	904277.9		
Total	645	584625604			

	Coefficient	*Standard Erro*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*	*ower 95.0%*	*pper 95.0%*
Intercept	68.14244	37.5008243	1.817092	0.069668	-5.49619	141.7811	-5.49619	141.7811
X Variable 1	-0.06287	0.03967707	-1.58462	0.113544	-0.14079	0.015039	-0.14079	0.015039



The correlation for these 2 strategies is .0039. This means the strategies are practically non-correlated.

- Correlation = +1 perfect positive correlation
- Correlation > +.7 mild to strong correlation
- Correlation < + .7 weak or no correlation
- Correlation = 0 no correlation

The opposite holds true on the negative side (R^2= -1 is perfect negative correlation)

How Do I Achieve Diversification?

OK, so now that you know that diversification can greatly enhance your trading by smoothing the equity curve and reducing drawdowns. You also know how to check for correlation using simple Excel tools. But the questions remains: how do you achieve diversification?

Based on my experience, there are quite a few ways to achieve diversification, and all have their pros and cons:

Purchase a lot of trading systems from vendors

- **Pros**: there are certainly a lot of systems for sale out there
- **Cons:** 90% of them are junk, over optimized or curve fitted system sold by wannabe traders
- **NOT RECOMMENDED, UNLESS YOU TRUST VENDOR**

Find a lot of free systems on internet, magazines, that STILL work

- **Pros**: plenty of free systems available in public domain, with excellent track records
- **Cons:** over time, many systems stop working. If a system is in the public domain, chances are it doesn't work too well anymore
- **NOT RECOMMENDED**

Trade every new idea you see

- **Pros**: it is easy to keep incorporating new entries, new exits, etc. as you read about them or think them up.
- **Cons:** Unless you test and evaluate each idea, how do you know it works? And how do you know it is increasing diversification, instead of decreasing it?
- **NOT RECOMMENDED**

Find various CTAs, allocate money between them

- **Pros**: it is relatively easy to find 4 or 5 CTA programs that provide good return, and are uncorrelated. Many "fund of funds" use this approach, and it works well
- **Cons:** You'll pay 2% of assets each year, and 20% of profits, for the privilege of trading multiple programs with multiple CTAs
- **RECOMMENDED, WITH DUE DILIGENCE**

Find systems on Collective2.com, WorldCupAdvisor.com, Striker.com

- **Pros**: there are certainly a lot of systems for sale out there, and some of these systems are pretty good. Many of the developers of these system trade it themselves, which is a very good thing
- **Cons:** High subscription costs can eat away at your profits, many of the developers are not full time traders
- **RECOMMENDED, BUT BE VERY CAREFUL**

Develop Your Own Systems, Create a Strategy Factory

- **Pros**: With proper training, putting your financial future into your own hands is almost always a good idea
- **Cons:** Do you have the skills to create your own trading systems? Not everyone can do it, even if you learn from an experienced trader
- **HIGHLY RECOMMENDED, IF YOU HAVE THE ABILITY & DESIRE**

For me personally, I have tried many of the approaches listed above. **In the end, though, I found that creating my own systems, using my own "Strategy Factory" approach, was the best way to achieve diversification through trading multiple systems, markets, timeframes, etc.**

Creating my approach to develop trading systems took me years, though - and I certainly made quite a few wrong turns along the way. Luckily, though, you can benefit from my experience. I have a special webinar that teaches you how to create your own strategy factory. With the tools I'll teach you, diversification and all its benefits can definitely be part of your trading experience. Details can be found at the end of this report.

Example: Step By Step Diversification

In this section, I'll run through an example of creating a diversified trading approach. I'll assume you have decided to build your own trading systems (smart choice!).

1) Create strategy #1, using walkforward testing (the best kind, short of real time testing). The strategy has to have positive expectancy.

2) Note the characteristics of strategy #1. In particular, note the:

- market/instrument
- bar type
- bar size/timeframe
- type of strategy (trend following, mean reverting)

3) Begin to develop Strategy #2, taking care to change a few of the particulars above. For example, if Strategy #1 is based on 30 minute Gold bars, try to build a strategy on daily Crude Oil bars.

4) If you want to use the same exact strategy code for strategy #2, but just a different market, make sure that a) the parameters of the strategy are different, or b) that the price streams of the 2 instruments are non-correlated. For example, don't try to trade the exact same system on ES (mini S&P) and TF (mini-Russell). Chances are they results will be highly correlated.

5) Once you develop what you feel is a non-correlated, positive expectancy strategy #2, check the daily returns of both systems with Excel, and determine the correlation coefficient R^2. If it shows the 2 strategies to be non-correlated, go to step 6). Otherwise, go back to step 2) and try again.

6) Create strategy #3 just as you created #2. When you check for correlation though, make sure you check strategy 1 versus strategy 3, and strategy 2 versus strategy 3 (you already checked strategy 1 versus strategy 2 in step 5)). All correlations should be as close to zero as possible.

7) Continue the process until you have 4-6 non-correlated strategies. Once you begin trading, you will be diversified!

Conclusion

So, that is the secret. One word, **diversification**, that says so much. Employ diversification, and your trading career will be much easier. Ignore it, and trading becomes a lot tougher. Trust me, I've been there and done that!

Of course, if you have questions, please feel free to e-mail me.

Good Luck, and Happy Trading!

More Info

I hope you have enjoyed this report. If you like my material, please visit my website: http://kjtradingsystems.com There you will find TONS of free information of REAL trading.

At my website, you can also read about my award winning Strategy Factory® workshop – the best way to develop strategies properly, with my one on one support to guide you.

Thanks!