

Embracing Uncertainty

Accepting that even though we do our due-diligence, check out the past statistics and set up our account/systems... We can never predict what will happen.

We CAN however, predict how we will respond to what happens.

By Michael Levin

As I was telling different people in our industry (brokers, developers, execution technology firms) about the article I was going to write and that you are now reading, almost everyone to a "T" said the same thing: "Wow, we really need an article like that in our industry so people will stop worrying and just sit back and relax as their trading system performs".

Funny, I didn't come up with today's topic for those in our industry; I came up with this for you, our reader to address what I see as the MAIN problem in dealing with trading systems and methodologies:

How to handle the losses (draw-downs) not just "handle them" but to actually be unmoved swayed or bothered by them...

WHY?

So you can THEN reap the rewards of the Long Term payoff of winning trading systems.

If you are fortunate enough to find a winning system and have some sort of diversification within a system portfolio, the gains over time (3-10 years) can be Staggering.

BUT

You can't get ANY reward from ANY trading system by leasing it for 2-4 months, experiencing a draw down, getting scared and jumping out. It DOESN'T work that way.

We've all seen mountain charts, years ago when mutual funds were showing you that if you put in \$10,000 in 19XX and now, X years later your account would be worth (pick a number) \$400,000 or \$1,000,000 or whatever they were showing.

It was and is a fact, that over time that DID happen. Heck, just look at Walmart or Berkshire Hathaway or Franklin Resources, Amgen etc. etc. etc... There are stocks and funds that grew by leaps and bounds.

Take Berkshire-Hathaway for example; what a chart! Glad I held all the way from \$300 a share (when I was a broker back in 1982, that's roughly where it was trading)



Now I know that (growing by leaps and bounds) pertains to a fund of stocks that had a 10-20 year timeframe to grow and compound. There were no leasing fees involved, it was a small % fee that was taken out each year (mutual fund management fees) and the fund kept compounding without a lot of leverage. Just so you know that I know we aren't talking apples to apples here... But you get my drift.

The drift is this: Long term success isn't made by getting out; it's made by getting IN and staying IN.

Stay with me through this article and you will gain a new level of understanding (or level of "being" as I call it) of not only the trading systems realm, but also of a psychological "node" in the grand scheme of your life as well.

1st off, there is a little back story here, a few items to understand before I get into the meat of this.

1. I am going to use the words “acceptance” and “resistance” a lot. Don’t get caught up in the right or wrong of it, just notice the nuance of these words and how I will use them for our benefit
2. If you don’t know what “Dante’s Inferno” is about, don’t worry, you soon will (LOL)
3. *Human nature* by its own definition may not have to apply here, so if you can believe that your beliefs can be shifted by new information that may counter what you had believed before this article then you are already on your way.
4. Any “edge” when applied for an extended period of time will usually provide substantial deviations from an average or norm. That’s why it is deemed an edge in the 1st place. However, that same edge taken or viewed in a small time-slice may not exhibit any benefit at all and perhaps even a detriment.

The Bamboo Story

Have you ever heard the story of the farmer that decides to not plant the traditional crops that the other farmers in his county plant? (It’s called the Bamboo story and I have taken pieces of it here to show you a few points. I have also boiled the story down a bit and adapted it to systems/methods trading)

This is a guy that says to himself “there has to be better crops with different/better payoffs than the corn, wheat and soybeans I’ve been planting for the last 20 years”... So he set about the business of researching alternative crops. Making a living and supporting his family was critical, so he wanted to make sure he made a wise choice. Therefore, he began reading, researching and speaking with experts with more knowledge than he before making his final decision.

After studying a variety of options, he decided on Bamboo. The climate, soil conditions and equipment at his disposal could make growing and harvesting bamboo a profitable business. He was convinced he was making the wisest choice and began making the changes needed to become a Bamboo Farmer.

Now remember, this farmer lived in a farming community. For generations his neighbors had all grown traditional crops like corn and wheat. You can only imagine how the idea of growing bamboo was received. Upon telling his fellow farmers his idea, they mocked him calling him foolish, all the time warning him of his impending peril. They were unwilling to accept change or progress. However, the farmer was unshaken; he had done extensive research and was

confident of his knowledge. He would not back down from the belief that he could grow bamboo and even turn a substantial profit in the business.

Well, if you know anything about bamboo, you know that the first year it's been planted...nothing happens. You don't get so much as a twig or a leaf! His neighbors were ruthless. They had all harvested their crops while he had nothing at all to show for his efforts. He was undaunted and confident in his knowledge. But wait, there's more bad news. The second year nothing happens either, not a sign of a bamboo tree anywhere. Again he was forced to endure a second year of ridicule by his heartless neighbors. Still, he was unshaken in his confidence.

The third year came and guess what? Bamboo; everywhere bamboo. His crop grew 4 to 6 inches a day! By the end of the summer he had a virtual bamboo forest. He harvested his crop and sold it for a huge profit. His neighbors were astonished. In fact, several who had once ridiculed him began to show interest in becoming bamboo farmers as well.

The farmer went on for many years enjoying the benefits of his new crop, bamboo. He and his family enjoyed a very happy and successful life, unafraid of growth, progress or change, confident and determined when facing challenges.

This story teaches us two lessons. First, when you have knowledge you have tremendous power. Knowledge itself isn't power; it's the application of it that gives power. Knowledge gives you confidence to pursue your dreams and goals... Regardless of what others think or what may happen in the short run.

The second lesson is that just because we don't see immediate progress, doesn't mean we should give up. The reason the bamboo tree doesn't grow until the third season is because it spends the first two years growing roots, building a foundation so that when it is ready to grow it will have the stability to stand tall reaching tremendous heights. Without those roots, the tree would fall over with the first strong wind. Had the farmer lost faith, had he not had confidence in his knowledge, he might have tilled the crop under during the first or second year and created disaster for himself and his family.

Results or benefits in a Trading System program may not be immediately visible either. Sometimes there are losses where gains are expected. While some systems respond almost instantly with gains, others may need 6 months or up to a few years to fully benefit from their edge in the market. It's critical that we allow the system to stay the course, to ply the edge it has as its roots. We must understand that although there may not appear to be any gains in

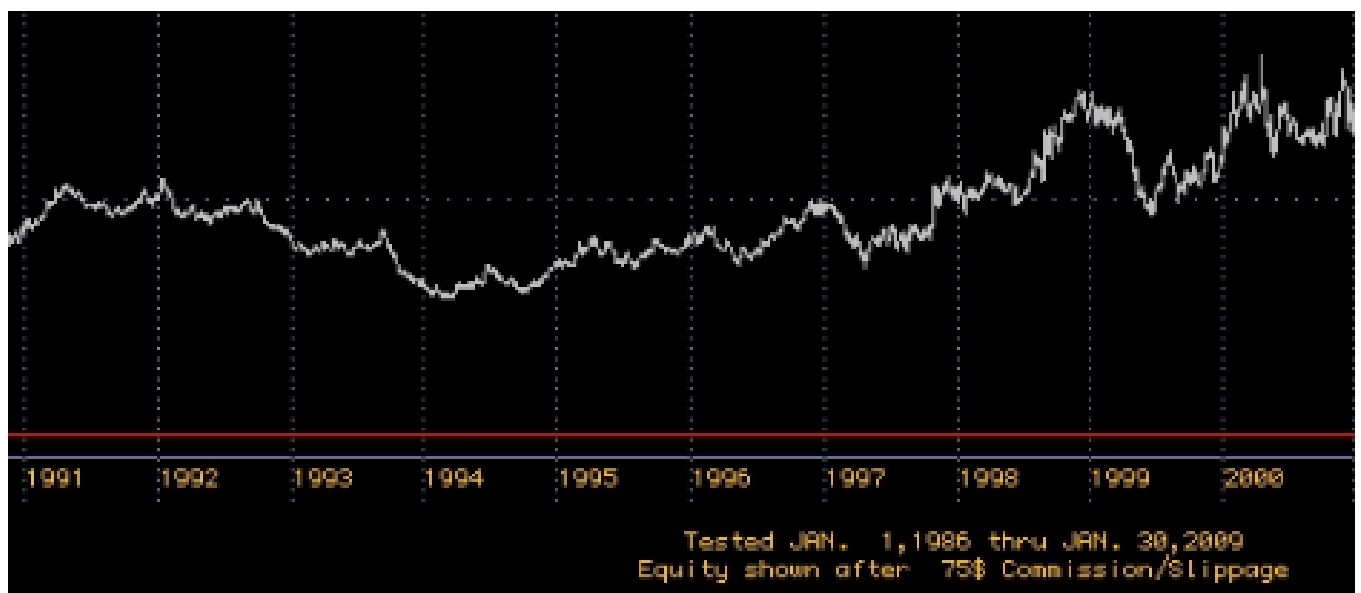
excess of our leases or our commissions, progress is happening on the inside. Actually, it's on the inside of YOU, which I'll be tying all together by the end of the article.

As for me, no matter how hard anyone tries to convince me otherwise...I believe in the power and value of Automated Trading Systems. I've seen many people in life, give up on a tried and true program just as it turned the next week or month and generate profits as someone gave up... They then go onto other vendors and systems and give up again and again and again, when the system they were in and left, turns around and hits new highs year after year...

Savvy traders/investors grow and develop both mentally and psychologically with sound portfolios of winning systems working on their behalf. Those who were ready to give up, but stayed the course have seen substantial gains over the years and are expectantly confident they will for many more years to come...

OK, that's the Bamboo story and it teaches us to have faith in our convictions, our research and our homework and to "allow" events to unfold without our attachments as to what should or should not be.

Let's take a break for a second and see how this applies to a picture:



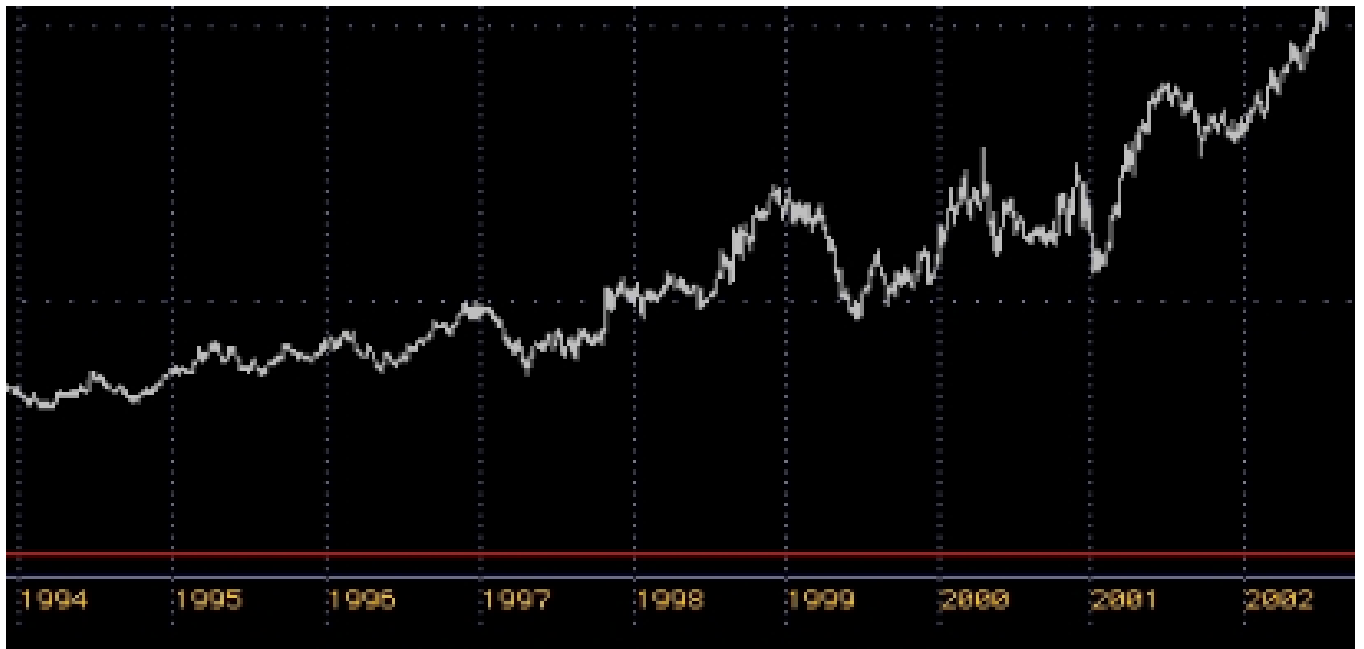
What makes this awesome is not what has happened; it is what is coming next. This is a snapshot of a system that I work with a developer on, looking back in time. The system has been doing decent and is about to break to a new low:



For most investors or traders that follow technical analysis and trend lines, etc, this move down might make many give up hope. For many that I know that can't control their emotions, they may experience frustration, anger, bewilderment and a whole host of emotions that say to them: "Get out, this is going down", "the system is broken, things are different this time, what the heck is going on?!"

Would they be right? Maybe in the short term they ARE right... but trading systems make \$ over time, not in any one time-slice....

See what happens next, which I could never have predicted:



That's right; it reversed back up after hitting an intermediate low and made new highs! Want to know what's worse? (Worse for the guy that got scared out)...

This system never gave another pullback over 6 years to get back in:



What's the moral of this story?

When we have found a winning system and it has handily beaten the market for 3-5 years or more, we "know" that if we only gave it the same 3-5 years we may very well experience the same or even greater gains as time goes by.

So what stops us? Is it:

- A. The Markets our systems trade
- B. The Fed
- C. Draw downs
- D. A glitch in the system
- E. All of the above
- F. Us

You're not going to like the answer, but it's E. Us

Think of a system as random coin flips. We know that eventually, after a number of flips (100 or more) that the tally of heads and tails should be about even. If we assign a profit amount to heads of plus \$10 and a loss to tails of \$5, then the pure math will Always tell us that given the propensity of the results to be evenly split between heads and tails that winning \$10 for heads and losing \$5 for tails over 1000 flips would be a \$2500 profit.

However, trading systems are an unknown future payoff. We can only "assume" that because the past X years yielded an average X% return, that it may also do that in the future.

Flipping a coin is easy; we KNOW that eventually the odds will even out. There is no mechanical failure there, it is like "paper trading" a trading account; because it is paper \$ we have no real stake; there is no real loss, so our reactions from an emotional standpoint aren't triggered because it doesn't matter.

When we eventually choose and lease a system, put up our \$ and pay for a defined period of time for a system, we have no clue what each trade will bring us, we are only hoping for the best whilst having done all the due diligence we could to hopefully get the same future results that the past has generated...

So much for past performance is no guarantee of future success.

The conundrum? NO ONE EVER picks a crummy system that hasn't made \$ and decides to trade it, hoping it turns around. People ONLY pick winning systems that have done well over time and they HOPE IT HOLDS FOR THE FUTURE.

In the immortal words of Harvey Firestein in the movie Torch Song Trilogy: "Is that so wronnnng?"

Not at all!

Choosing the best from the past is a pretty darn good way to gear up for the future. It's in "accepting" that the future will most likely bring different results at different times than in the

past and that we as Humans have no control over that and unfortunately we have no control about how we FEEL ABOUT IT.

Here's a tough point I'm going to bring out here that no one wants to listen to or experience because we would almost all fail if we were to go through it.

Here's the scenario:

You take 2 months of searching and researching on the net, magazines, interviewing brokers and developers and guys like me... Then you choose a system and you fund the account and everything is leased and paid for...

The system starts trading for you in May and by the end of your lease period (say you only did this for 3 months) the account is down 7% net from where you started. Let's make it worse, say the market itself is up 10% during that same time...

How do you Feel?

- a. good
- b. bad
- c. indifferent
- d. ticked off but not mad
- e. disappointed

Let me tell you, at this point, answers b through e probably apply.

Now, same scenario, but during this 3 month window, the system is down 25% Net.

How do you Feel?

- a. good
- b. bad
- c. indifferent
- d. ticked off but not mad
- e. disappointed

95% of the people I deal with are not only "experiencing" answer b and e, they are berating the developer and their broker by email as to "why isn't the systems working" and why aren't there better trades being taken and why am I paying \$X commission per trade, etc etc etc..

Are they wrong for feeling that way? NO, they are exhibiting normal human behavior. But the behaviors they are experiencing have nothing to do with the systems long term record, it is the

fears and expectations that humans allow to affect them and their judgment that interfere with the humans long term acceptance of the returns that will be generated.

Most people that I have spoken with (and I have gone to great lengths in asking about these areas) about trading systems and methods complain about only a few things:

1. Paying leasing fees as opposed to paying for performance
2. The draw downs that occur and how to minimize or eliminate them
3. The commissions that add up

I am not going to address paying leasing fees vs. paying for performance here, but I have put together a great excel sheet that shows that in MANY cases you pay less by leasing then the typical 2/20% CTA/hedge model. Send me an email to mlevin@genuinetrading.com and I will send you the comparisons for free.

I can and will address #2 above, the draw downs part. This is why I wrote this article.

Draw downs are the ONLY thing to COUNT on when having a system or portfolio of systems trading on your behalf.

That's right, Count on draw downs, expect draw downs and ACCEPT draw downs as part of the results that trading systems provide for you.

You can't have heads without tails; you can't have gains without losses. Humans have had a tough time with this because they RESIST having a loss and they resist that losses "should occur" and they resist the idea that their system isn't always winning.

Acceptance of something doesn't make you powerless, it makes you stronger.

I live in SE Florida and let me tell you, you can resist a hurricane coming all you want, but surely they will come between June and November every year. Will they get close enough to cause real damage? Who knows? But time and "back testing" has shown that X amount of storms will turn into Hurricanes and that every X amount of years one will hit. Ignore the stats all you want and resist whether it "should be" or not but it isn't going to change the reality of the numbers and the odds.

Accepting that this may happen allows you to prepare for the inevitable (hurricane insurance or tougher windows/doors etc) and to accept its eventual arrival and to be prepared to survive it (or fly away and escape) and thrive and get to the end of the season and continue living in a wonderful climate/geography...

How does this apply to draw downs you may ask?

Here's how, 2 different things to consider. First is therapy. I'm chuckling here but I really mean it. Too many humans don't have the skill set to handle their emotions when it comes to trading. I'm talking trading on their own or trading systems or the market as a whole. They are too caught up in what "should/ought to be" that they miss the reality of a different world that they could be experiencing.

I can write reams of articles on this and I will be in the future, so in keeping this article under 4000 words, I will get to the next crucial element in handling draw-downs...

The correct funding of your account is another huge area that affects the severity of the emotions of draw-downs.

Keeping it simple:

You choose a portfolio of systems that have 6 markets and the recommended size of the account (by the developer) is \$75,000. This takes into effect, the largest draw downs experienced over the past 7 years, the average margin for each market and a buffer of an extra 50% larger draw-down happening. The actual average allotment per market turns out to be \$12,500 per market traded. Are you with me?

Trader A decides that he only has \$45,000 to trade with, but he really likes the history of this portfolio and the 39% draw-down experienced a few years ago doesn't faze him "In Theory". He figures that this portfolio of systems looks so good there is only one way for it to go and that is UP!

He funds the account through a broker, leases the systems for 6 months and away he goes. Lucky for him the account grows by 10% the 1st month and starts the 2nd month up 5% in the 1st week, but over the next 2 months he finds his account is now at \$32,000 and he is scared!

The portfolio of \$75,000 that was supposed to be the correct funding level is off 17% which is well within the norms it has exhibited in the past, but for Trader A, that underfunded the account, he is now down almost 29%... You know where I am going here...

The next day, the portfolio takes a \$4,000 hit and now Trader A is beside himself with anger, frustration, bewilderment and regret. "This always happens to me, whenever I find a good system; they seem to go bad... I'm Out!"

Funny part is, he DID experience a 38% draw-down, based on how he FUNDED the account, but Trader B, that funded the same account the way it was intended, with \$75,000, experienced the same \$ draw down, but for him, the \$17,000 swing down was only a 22% drop, much easily handled and because he knows that this system has swings because of the volatility, he doesn't get "caught up" with his emotions, he rises above them and allows whatever to happen, to

happen without him reacting irrationally. he continues to do this year in and year out, always finding some new system, underfunding or getting scared out when things don't go his way...

Trader B continues leasing this system and makes 44% his 1st year, 86% his 2nd year and 61% his third year... Hypothetically speaking, we never know what will happen with any of our systems, but we do know we can control our emotions OR have someone to help us do that so we stay with a winning hand and system to ALLOW it to do what it does best; Find trades, make trades, rinse and repeat...

Meaning that if you fund an account properly, use sound decisions when you lease a system and let time be your ally while remaining calm, cool and collected... You just may finally find the secret that's been with you all along: It's in your attitude and level of funding that allows the altitude of your account to soar.

Well, that and a winning system of course!

So why did I mention Dante's Inferno before? Just to illustrate that we can go through many levels of emotion when reacting to what is happening vs. what we want to happen but it doesn't mean that our reactions help us any if at all. It's in the elimination of emotion and the rationality and expected preparedness that allows us to rise above our emotions and hopefully for our accounts to rise up in great % returns over time...

Heaven and Hell on earth at the same time... Same circumstances to 2 different people can yield either. Which will you choose?