

How To Build a Portfolio Of Trading Systems That Really Work . . .

by Michael Levin

In a previous article I wrote for *Futures Truth Magazine* (What To Watch Out For When Buying/Leasing a Trading System - #4-2007 Issue), I went into a litany of areas to focus on when selecting a trading system to buy. That article was written more for 1st timers looking to get into the “systems game” than for those who already knew a thing or two about trading systems and those who sell them.

This time, I want to up the bar a little and start speaking/writing to the audience that actually has a few dollars and wants a portfolio approach to help diversify “within” a portfolio of systems.

I like to lay out the big picture 1st, so here is what we are going to look at in no particular order:

1. Automated systems vs. discretionary systems (Systems traded for you vs. systems you trade yourself)
2. What kind of underlying vehicles are best to trade systematically? Is it Stocks, ETF's, Commodities, equity futures, bonds or Forex?
3. What timeframes are best to focus on, which ones not to. For example, are intraday systems better than overnight systems and is there more or less risk overnight?
4. Are “seasonal” tendencies better than technical strategies? Or are other technical analysis systems better?
5. What systems work best in particular markets and how do we know when a “shift” occurs?
6. How to handle draw downs in a system and is it due to YOUR entry or not?
7. Does the “operator” of a system follow their own rules? And how would you know? How to tell if you are being taken care of or being taken advantage of.
8. What to do when you actually make money with systems and how to grow your portfolio? When to take money out and when to compound?
9. How to get the best deals when buying or leasing?

Ok, let's get right to the meat of things. I'm going to pretend I am consulting for a couple who are looking to set up a portfolio of trading systems. Bob and Carol (we'll leave out Ted and Alice for now) have about \$250,000 and they want to diversify within their entire portfolio and have designated this amount to start.

Don't go crazy here and think that if you don't have \$250k that you can't also have a wonderful portfolio, bear with me til the end and you'll see many options for portfolios as small as \$25-50,000. Here is a typical conversation I would have with them, from beginning to end.

ML: Ok, Bob and Carol, I understand you want to design a portfolio of systems to trade the various markets, why do you want that?

Bob: Well, from what I've read, Futures, Indexes and Forex seem to be the fastest growing area of the market right now and from what I've heard, system developers are designing some great systems to take advantage of the incredible volatility and volume going on right now.

ML: Why systems, don't want to do it yourself?

Carol: He is NOT going to trade anymore, we wasted 20% of our portfolio the past 3 years with Bob trying every trading tactic known to man. He tried Fibonacci waves and Elliot waves and the only thing that waved was our money as it walked out the door. I do believe that some people CAN and do make money trading, we just aren't the ones to do that. We both work hard and we want to keep our hard earned money and make it work for us, not take a hike out the door on some trading idea that we may think about that usually winds up only hurting us.

Bob: Hey, I tried, it's just too tough for us, not enough time and we never seem to time things right. We give up.

ML: Seriously Bob, don't feel bad, statistics show that 9 out of 10 traders don't make money and many folks who trade from home usually wind up losing too. It's the rare breed that can make money consistently and often it is the systems that are set up to trade unemotionally that are gaining the share of the headlines today. At least, in our industry that is what's happening.

Funny thing also is most mutual fund managers can't even beat their own industry averages, so how can the "at home trader" hope to be better than them, with all the resources they have at their fingertips?

How about I give you a snapshot of the different areas of concern, we go over them and help you discern what tactics might be best for you.

Carol: Fine, I am most concerned with risk; can you go over that 1st? Tell us about the risks in systems.

ML: Ok, here is what I see are the major risks when looking for/choosing a system:

1. You chose a developer that gave you bogus results for their system, just to sell it to you and now you are losing money hand over fist in that system.

This is the toughest one, so many are burnt by this. It's always wise to have someone assist you in the selection as a 3rd party buffer in the process.

2. You bought a system that only does well in one type of market (bull, bear, sideways).

This isn't necessarily bad, if you also have other systems correlated to other timeframes or market scenarios like a long only fund and a short only fund. One may do better than the other if only for gains that are left to run where losses are cut short.

3. You bought into a system that trades too much and the commissions and slippage are eating up your account.

This should always be verified 1st. A long track record of average number of trades per month should be reviewed as well as the slippage per trade. This can add up if not attended to.

4. You bought a system and can never get a hold of the developer or broker and feel neglected.

One of the worst things to go through is a system declining and no one to talk to. The best developers are used to dealing with unhappy clients if they have been around for a while. EVERY system has drawdown's and initially new clients may need some hand holding, make sure you get that as a commitment upfront.

5. The system has a drawdown and now the developer wants to change or "tweak" the system.

No one wants to buy a system that they based on one set of criteria to be told that now that they are IN, new criteria will be introduced. It's a little different if you buy into an energy traded system that does say 35% Oil and 65% Nat gas and then the market shifts and they shift the mix a little. That is a different story then a developer that trades based off of certain "criteria" that then shifts the criteria such that a new "system" is born... with your money as the guinea pig, so to speak.

6. The system parameters for trading say they only take "x" risk, yet the losses are way bigger than planned.

Every once in a while, certain things DO happen in the market and a loss may be bigger than planned, this is reserved for once in a blue moon event, not regular weekly terrors...

7. You bought a system that is at the whim of world news events and although technically good, it gets whipsawed by the prevailing trends that may work against you.

Imagine buying a grain system that works off of Daily and 60 minute bars and you're doing great because of the gradual volatility... Then one day your long wheat short Soy flips on you and instead of predictable and steady gains with an occasional small loss, now your positions are lock limit down 2 days in a row on one end and lock limit up on the other and your spread program turns into a nightmare of biblical proportions. This is NO ONE's fault, but it is a risk to consider.

Bob: Wow that sounds a little scary, all those scenarios, I'm wondering what the way out is. How do we make sure that we handle all of these areas?

ML: Just pay attention to what I'm saying and for the most part, you can set up a great portfolio that USES the risk in the market and USES an EDGE to mitigate some of the risk and attempt to capture a portion of the movements that provide excellent returns versus a market that may be stagnant or too volatile.

Carol: Ok, we have \$250,000 tell us where to begin.

ML: Ok 1st off, we are going to set up a diversified portfolio spread out over time, developer, markets traded and how we even ENTER each system. What I mean is this - don't put all your money to work at once, don't go with the same timeframe, don't go with the same methodology and don't go with too few markets traded.

Bob: What markets do you find best for systems developers and for us to have trading for us?

ML: That is easy. You want highly liquid markets; those with a lot of volume and very thin spreads. An example is something like the S&P 500 emini or Bonds. Less liquid markets like Cotton may be tough to get in and out of with adverse moves. There are many to choose from though like Equity indexes, Oil, Gold, Currencies/FOREX, Grains etc...

Carol: Tell us more about timeframes.

ML: I have found that the systems I like best happen to not trade a lot, ones that work off of longer timeframes like Daily bars or 60 minute bars. They seem to capture larger trends and not get as caught up in the whipsaw movements of the 5-15 minute variety. I personally like systems that work off of Daily Bars, so my entries/exits are not so fine tuned that slippage plays a factor. That is something to consider over the long term of any system.

Again, we are looking for "High probability" entries and exits, areas where we have an edge. If there is no edge, we should not be trading.

Example: If we were playing blackjack and were dealt a 7 and a 3 and the dealer was showing a 4 with the other card down and unknown, what would the edge be and what must a smart player do?

Answer: You would double down and take a hit with an increased bet. You do this because you know you will not bust, the dealer HAS to take another hit and may bust and there is a statistical edge and it is present while we are still playing the game, therefore giving us the edge to bet more where the probability is better than at the start.

Result: Here's the funny thing, the result is not guaranteed. The result may be a win or a loss, but BECAUSE we have an edge, we always play it and let the odds settle the score... If we lost it wouldn't matter because we would do the same thing over and over.

THIS is the KEY component of ANY system: Does it have an EDGE and how does it play the edge...

Bob: So in system development they look for an edge and try to exploit it? How do they know?

ML: That's the best part, no one really knows until they line up their criteria, set it in a code to determine results then they back test it through time to see how it would have done.

Carol: Is that what they call hypothetical trading?

ML: Yes, hypothetical trades are those that "would have" been executed given the instructions of the code of the system. Codes are made up of many variables. Some are things like MACD crossovers or stochastic moves up through "X" % or combinations of technical analysis tools or candle stick patterns confirmed with volume... There are thousands of variations to look at and at different times, they all do well, because no one would spend time and effort to market a system that hasn't at least done well at SOME point, right?

Carol: So how do we know when a system is going to do well or not?

ML: To be quite honest, I don't know how anyone can tell in advance whether any system is going to do well on any trade, but I do feel that some systems have a way of doing so well over time that billions of money are poured into them and they continue to do well. One has confidence over time and in varying markets that a system will do

well, when they have experienced it for themselves.

Bob: Like what kind of systems?

ML: Long term trend following systems have some of the best long term track records in the business. That is what spawned the “Turtles” and what has made John Henry and many other traders huge fortunes; buying breakouts and selling breakdowns (actually a bit more complicated than that) in major markets. Look at ANY chart of a commodity that has ripped higher and long term systems are in them. Look at many breakdowns (like the dollar) and long term trend followers have been short.

Bob: Is there any downside to those systems if they do well over time?

ML: Yep, unfortunately, these same systems that can do so well, if entered at the wrong time, can get chopped up by many losers in a row or a whipsawed market and the drawdown’s can be 30-50% at times. That will scare even the most hardened trader to pull the plug on a system and run.

That brings me to talk about draw downs. Here is my take, plain and simple: Chose a system that does not have a high degree of draw down and then diversify within that system if possible and hopefully you will mitigate the SIMULTANEOUS drawdown of all systems.

Example: I know a firm that has systems based on the same methodology over 5 different markets (4 equity and 1 bond) Last year at one point, 2 of their systems (Russell and Dow) were up over 175% gross, each, while the others were up anywhere from 40-90%. Over the next 2 months, those 2 top systems pulled back 35% in tandem just as people were flocking to them. The other systems (bond and NASDAQ) each moved up roughly that same amount while the remaining system was flat.

Result: Those that piled into single systems with the previous winners were scared out with 30-35% losses in less than 6 weeks and the ones who were in a portfolio actually held steady as they were balanced. Those that jumped out were even further disappointed as the systems they jumped out of, hit contract highs 2 months later.

Carol: Is your point that it is ok to hold during drawdowns and hope for the best or what?

ML: The point is to know WHY a system is doing what it is doing and to always be diversified within a portfolio and KNOW that some systems will do well, some won’t but if you have the “2 steps up, one step back” approach to system trading, you won’t be too disappointed when they lose

a bit and you won’t get too giddy when they are running well, just have a disciplined and detached way of looking at this and have the mentality, like a farmer, that it takes time for crops to grow and allow for that.

Bob: So how long do we let a system run and when do we “cut and run”?

ML: I have 2 answers, 1st, if there is a real and verifiable track record and if the average drawdown is say 20% and you’re now sitting at 30% without a suitable explanation for the losses, I may be tempted to say “uncle” and stop trading. If I started my account at a contract high for the system and then it started to descend and I was down 25-30% I would chalk it up to natural oscillations in ANY system and I just got in at the wrong time. It happens to everyone.

Example: I know of an excellent firm that was offering a very interesting way to take advantage of “Long only” commodity funds. They had a way of doing spreads as large funds were taking positions and long story short, they had a nice edge of roughly 5-8% per month when they were on. In some months 12-15% was the norm... THEN, last year, “backwardation” in the oil, grain and meat complex’s stunted their results and from June through October they could do nothing right. To their credit, they stuck to their guns, cut back on risk a bit and lost an average of 5% per month for 6 months or so, scaring many people away from a method that had worked so well for so long. Many clients bailed out grumbling along the way. I have to say that I was impressed with the firm that ran the strategy that they stuck with it and from that point til now, a period of about 10 months, they are now up 85% from the lows and those that stuck it out are all whole and up \$.

Result: Some systems may not do as well and it isn’t anyone’s fault, it’s a timing issue with the trend or the system. Good developers go through downturns all the time. It’s what they do during that timeframe that show how skilled they are in their craft and how much they care about you, the client.

Carol: I have talked to so many brokers and salesreps of these firms, they just want to sell what they have and move on, they just don’t care and many don’t listen.

ML: Yes, as in any industry, 90% of those in the game, I wouldn’t want a thing to do with them, pure BS slingers out to line their own pockets. Then again, having been in this business since 1981, I can say there are some VERY fine people in this business and they stand out like beacons compared to their brethren who would try and sell ice to Eskimos.

This conversation is really getting detailed, but I want to focus on some of the topics at the top of this story...

I say that the best systems I have seen are those that humans only factor into 5% of the decisions. That means they are almost purely mechanical, they have a code (if this, then do this) and it is an automated strategy that humans may verify 1st then allow to trade second.

Bob: You mean computers will make the decisions and humans are 2nd on the list?

ML: Absolutely, that is what you want. You don't want humans making up whether or not to do a trade because of so many factors; fear and greed being the top two. Systems haven't been out drinking the night before because they made a lot of money and systems don't get despondent when their methodology isn't exactly working well. You want a system that is a system, not just someone's interpretation of a system. Too many traders I know follow a system 'til they don't. They have reasons and justifications etc. for doing a trade they shouldn't and not doing trades they should. A REAL system has criteria and parameters and an EDGE, when it is time to pull the trigger they DO and then the best systems become better because of how they manage the trade.

Carol: Is that risk management?

ML: Yes, exactly. I know a firm that is so rigid in their risk management that when the market was closed on Martin Luther King's birthday and world markets were tumbling and the US markets were closed, that they got all their clients out of 2 trades that went against them and saved each client over \$700 per contract in losses because they cared enough to go through Globex and offset positions on a Monday, when in fact had they waited til Tuesday, their clients would have been much worse off. You definitely want a firm like that on your side.

Bob: Stupid question here but how do you know who is good and who isn't?

ML: For me, it's how do they answer questions, how do they present their products/services. How do they respond when you get technical, how do they really feel about what they do and how long have they been doing it? It's a gut instinct thing. Like in relationships, there are always red flags at some point, pay attention if you feel they are popping up.

Bob: Ok, so here is what I know now: I know that I want to be able to trust who I am dealing with by paying attention to the dialogue when interacting, I want to see as

much info as possible about HOW they do what they do, right?

ML: Yes, that is so important, the relationship you will have with the vendor is often as important as the one with your broker and the information exchange must be to your liking as well as the information itself.

Carol: Ok, and then I gather it is important to find different types of trading systems based on different markets and timeframes within markets. Can you give me an example?

ML: Take a system that uses, say volatility and support/resistance and if applicable have that through a few equity indexes. Like equity indexes in that they are diversified within themselves. An S&P system has 500 stocks as part of the index. That won't move as much of a percentage as say a grain system or an Oil or Gold system percent wise. It has less of a chance (mostly) to go haywire all at the same time. Now the Dow with only 30 components may not be as great an example. Again, we want some balance in a portfolio so having a few equity index systems may be smart, just now we have to look at the systems as to how they perform in each type of market. Do we have a bearish system that looks for weak divergences? Do we have a bullish system that tried to buy support and breakouts?

Carol: This can be overwhelming in one respect but if you have the right guidance, is it really possible to build a nice portfolio?

ML: In my perspective, it's almost fun in looking at the potentials and choosing good vendors and with good guidance in these waters, the rewards can be great. Some systems do 30-75% per year on a regular basis and just being a student of the game is a great way to start, as well as knowing people in the industry and taking advantage of publications like *Futures Truth Magazine* that have been around for so long, giving their subscribers a real edge by following system developers, promoting good people and by eliminating those who only want to take your money while selling junk.

Bob: I know we've been talking a lot here and we have a lot to digest. Can we pick up this conversation a little later, Carol and I want to go over all that we have spoken about here and we can go over some of the topics we haven't covered next time we get together. Maybe our friends Ted and Alice can join us next time, I know they have been interested in managed products and systems as well and we can cover more topics to consider as we roll out our 1st few systems...

ML: Yes, it will be my pleasure to go over all the various systems and how they work and what to do in assembling a portfolio. One thing to keep in mind is this: ALL systems go through an up and a down period; some more than others. Just “allow” the system to do what it does and allow for the markets to do what they do and in the end, if you have chosen wisely and “entered” wisely, you should be ahead of the game.

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Be sure to check the #5-2008 issue of Futures Truth Magazine for the continuation of this “conversation” on building a portfolio of trading systems.