

Australian Technical Analysts Association



Times are Changing

Part 5: Summary.

Have markets changed?

How do we manage money and risk?

What do we look for in an Entry?

What do we look for in an Exit?

By Lee Osman

Has our Market Changed?



If so ... how do we know?

Let's look at Volatility

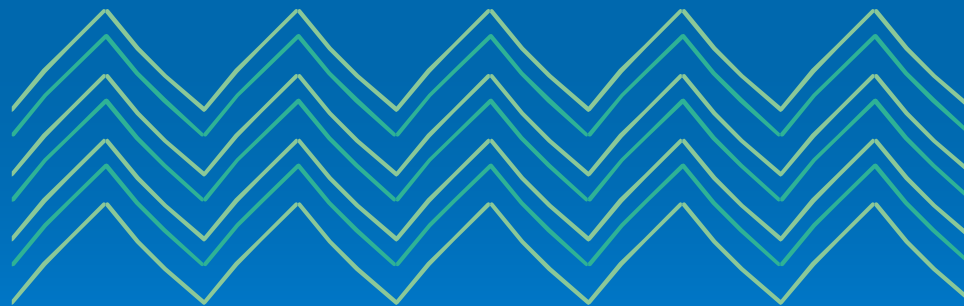
ATR (Average True Range) measures volatility.

High ATR values often occur at market bottoms after a panic sell off.



Low ATR values are often found during:

- extended sideways periods
- consolidations



XAO weekly chart 00-09



12/09/2009

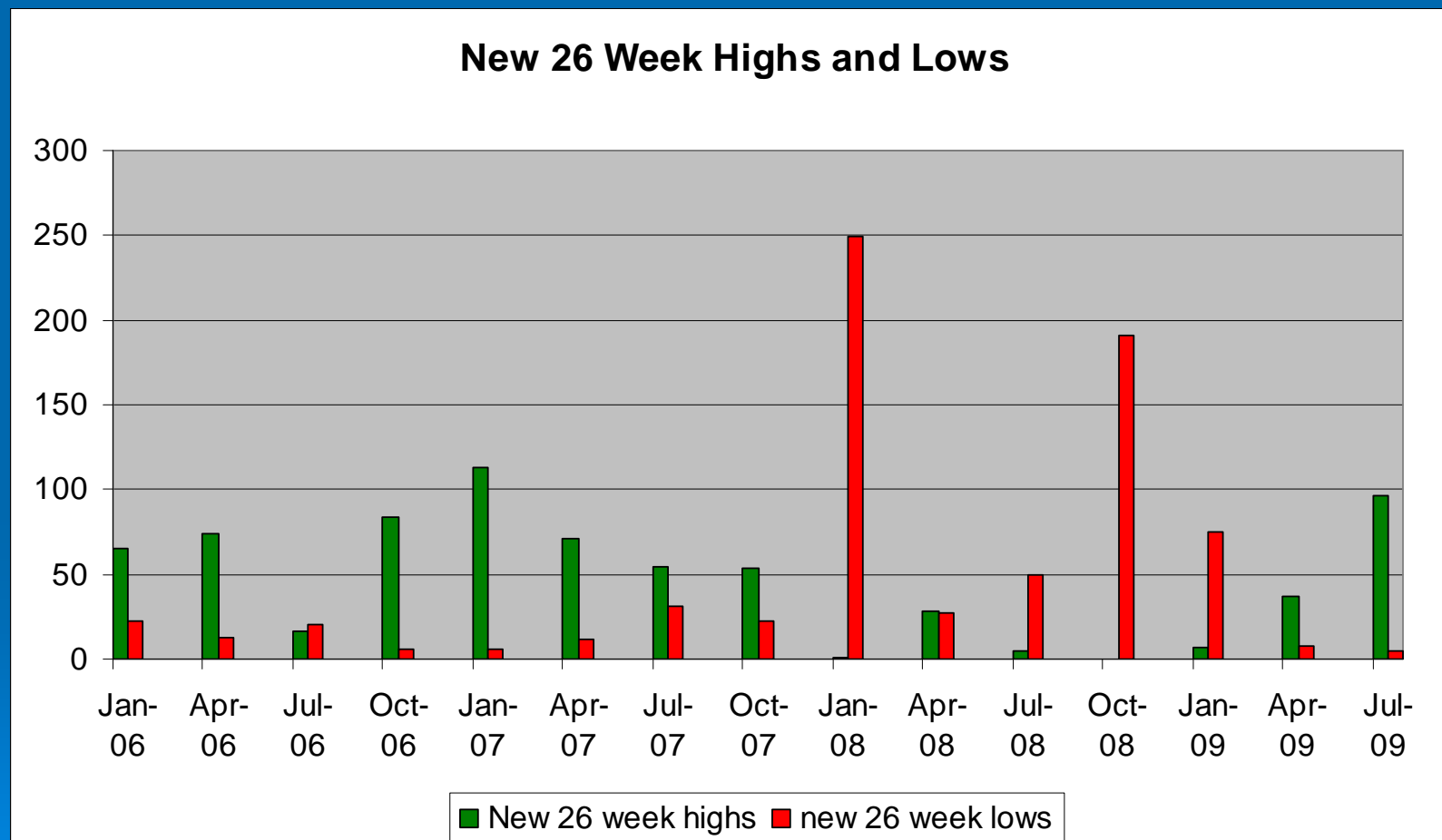
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Let's look at New Highs and Lows

- In a rising market we expect the number of stocks making New Highs to increase.
- We also expect the number of New Lows to decrease.
- We expect the reverse of this to happen in a falling market.

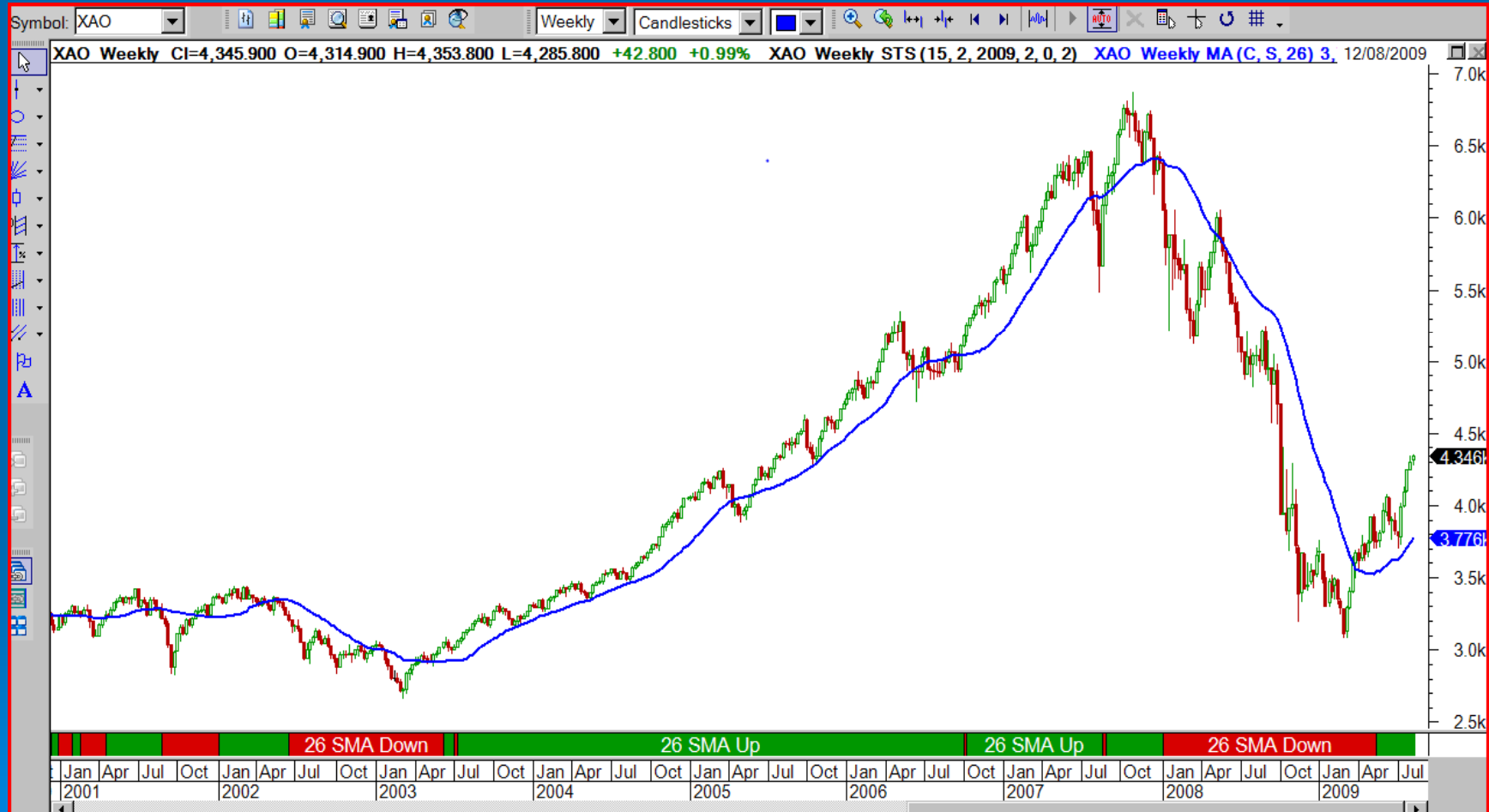
Stocks in All Ords making New 26 week Highs and Lows



Let's look at a Moving Average

- In a rising market, we expect our Moving Average to be rising.
- In a falling market we expect our Moving Average to be falling.

Weekly XAO with 26 SMA



12/09/2009

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So has our Market Changed?

Well, I think it has.

So we need to pay closer attention than ever before to:

- Money and Risk management.
- Selection of a decent entry.
- Trade management ... the Exits.

Money & Risk Management

In volatile times it is **imperative** to manage your risk.

WHY???



we don't want to end up like this little guy...

... beaten up by Mr Market.



Position Sizing

Three popular ways of deciding how many shares to buy are:

1. Equal value parcels ... say \$5000 per parcel.
2. Each parcel contains the same number of shares. E.g. always buy 1000 shares.
3. Each parcel has the same risk. e.g. always risk 2% of your portfolio on each parcel.

Best Position Sizing Model?

Peter Furner spoke about this in July.

Peter had been using variable % risk.

He analysed his completed trades.

Results noticeably improved if his %risk was kept at a constant 2%.

Portfolio Heat



Portfolio Heat ... definition

Portfolio Heat is the total risk to your portfolio if you had to close out ALL your positions at their current stop loss level.

Position Heat = Current Price – Stop Loss.

Portfolio Heat = Sum of all Position Heat.

Portfolio Heat ... example

Suppose you had a portfolio of 7 stocks
and all trades obeyed the 2% risk rule.

You calculate your Position Heat.

WOW! ... Position Heat is almost 20%!

Portfolio Heat ... example

Q: How could 7 stocks bought under the 2% rule have a Portfolio Heat of almost 20%??

A: Some (all) of them have moved in your direction.

Portfolio Heat ... example

Q: So is this a problem?

A: Only if you have strong objections to giving 20% of the current value of your portfolio back to Mr Market.

Portfolio Heat ... example

Q: So what can I do about it?

A: Raise your stops for those positions whose value has increased.

A: Take some profits.

A: Close out some of the underperforming positions *before* the stop is reached.

Entry Strategies ...

Consider the following scenario ...

You create and test your newly developed system.

The results are less impressive than you had hoped for.

Entry Strategies ...

So what do you do about the poor results?

... fiddle with the entry?

... fiddle with the exit?

... fiddle with the whole lot?

... toss it all out and start anew?

Entry Strategies ...

Each part of a strategy should be tested independently of the other parts ...

... So we would start by testing our Entry.

Entry Strategies

In today's trading environment we HAVE to be more selective in our trades.

Neil Wrightson asked us the following question ...

“How do we know if our entry strategy is going to push us in the desired direction more than 50% of the time?”

Entry Strategies ...

Neil's expectation of a good entry was ...

... that it should achieve breakeven after $\frac{1}{3}$ of the preferred trading timeframe had elapsed.

So, if your trading timeframe is 30 bars, you would expect to reach breakeven after 10 bars ... and so forth.

Entry Strategies ...

With a timeframe of 10 bars, we expect breakeven by the close of the third bar.

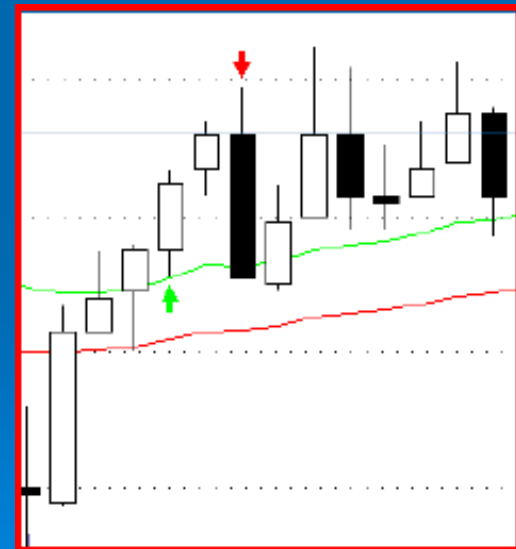
The entry should continue in the desired direction at least 60% of the time and be better than a coin toss entry.

The minimum Risk:Reward is 1:1.

Entry Strategies ...

So how do we test an Entry?? ...

Exit on the Close of the bar that marks a **THIRD** of your **Trading Timeframe** ... We've used 3 bars here.



Entry Strategies ...

If the Entry is generally profitable then we can go one step further and look at its efficiency.

Efficiency of Entry Strategy ...

For each trade we calculate ...

Maximum Adverse Excursion (MAE)

i.e. Lowest Low of the 3 bars - Entry.

Max Favourable Excursion (MFE)

i.e. Highest High of the 3 bars - Entry

Max Adverse Excursion ... MAE

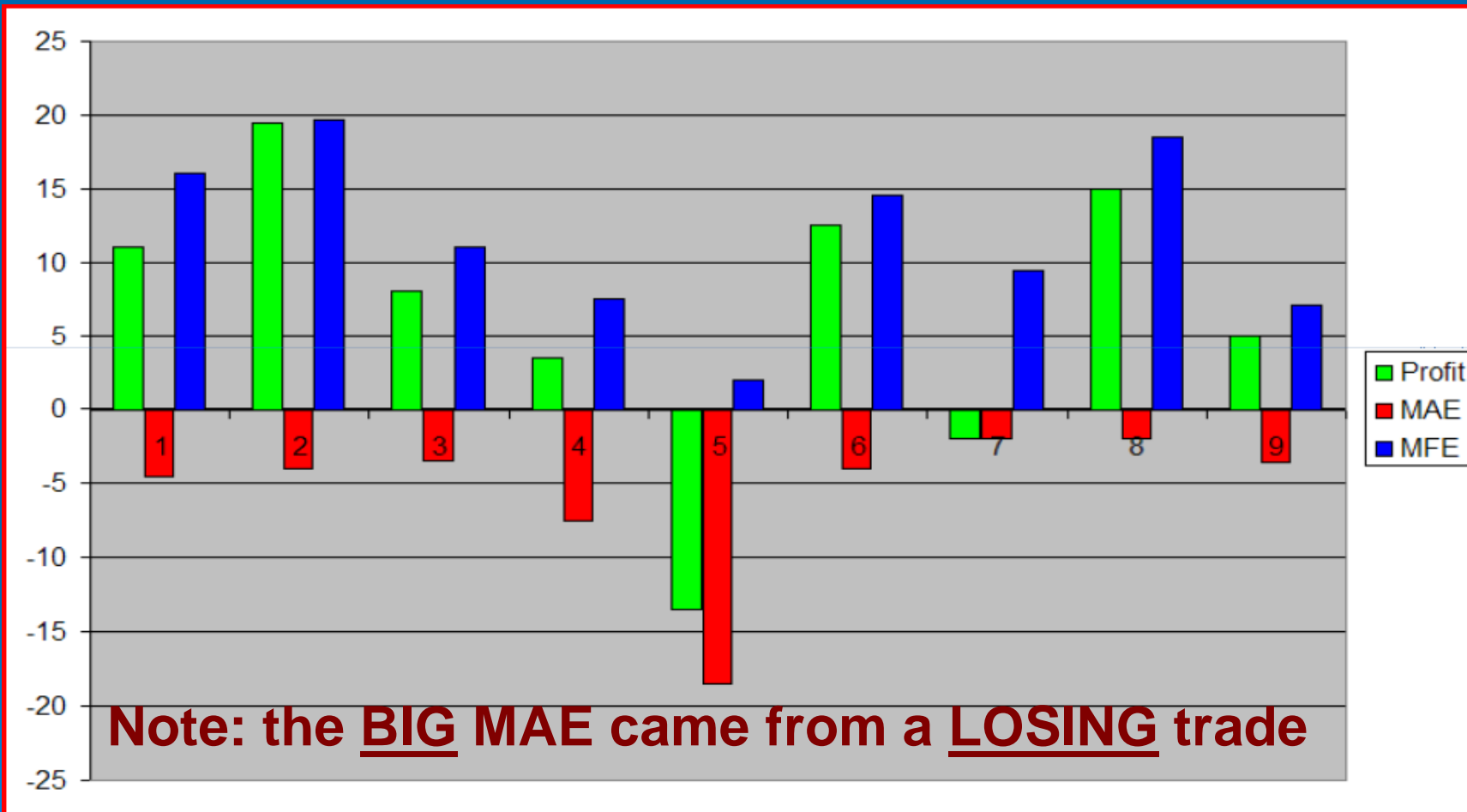
Van Tharpe said ...

“The MAE of winning trades will seldom go below a certain value”

The advantage in monitoring and knowing this is that you could set a tighter stop than you first thought.

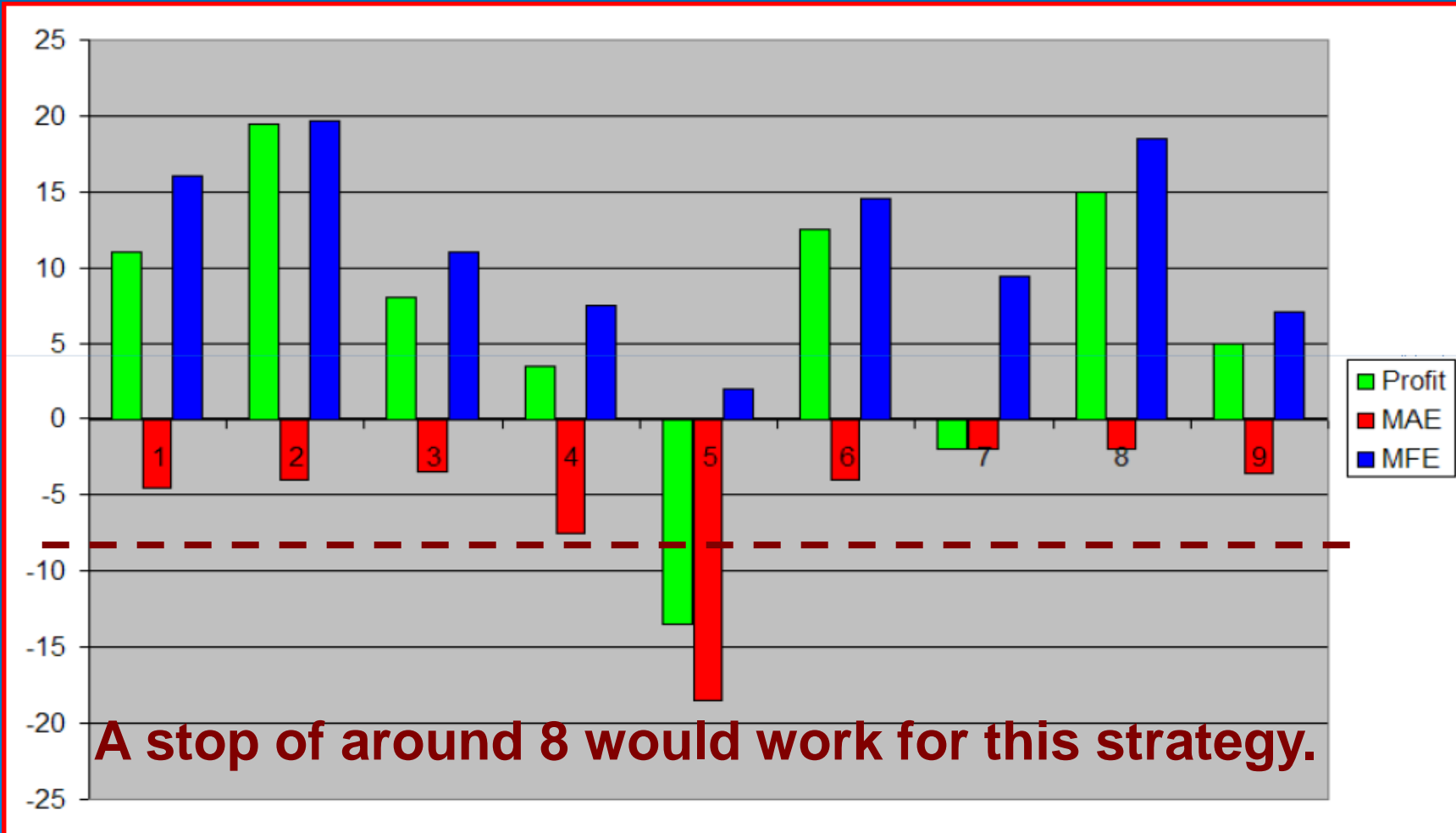
MAE and MFE

A slide from Neil's recent Presentation



MAE and MFE

We could use this info to tighten our stop.



Max Favorable Excursion ... MFE

Note that the $MFE > MAE$



Exit Strategies

So you have a profitable Entry Strategy with a satisfactory equity curve.

You combine it with an Exit Strategy and now the equity curve doesn't seem to remember which way was up...



Exit Strategies

... no need to “throw the baby out with the bathwater” and scrap the whole system.

You KNOW it's the exit that needs tweaking.



Exit Strategies

An Exit Strategy needs to be in tune with your Entry Strategy.



Suppose you have a short term focus and use a 10 period moving average in your entry strategy ...

Exit Strategies

... Consider using a compatible time frame in your exits, e.g.



10 period Moving Average

5 period ATR

MACD(5,10)

SAR(0.2, 0.2) ... and so forth.

Various Exit Strategies

Various Stops or Exits should include ...

1. Money Stop
2. Initial Stop
3. Stall or Consolidation Stop
4. Breakeven Stop
5. Profit Protection Stop.
6. Time of Day Stop.

Various Exit Strategies

Neil's August presentation dealt with this in detail, and you can find that information on Neil's website ...

<http://www.nwe.net.au/trading>

Or on the ATAA website.

Various Exit Strategies

Some of you could be thinking that I've listed more exits than you care to worry about.

Others could be thinking that I've left a few out.

The important concept is ...

Once you are in a trade, how will you manage each **stage** of it?

Various Exit Strategies

Think about how you will manage an exit in:

1. The initial stage of the trade.
2. The stage where you are between Breakeven and Risk Free.
3. The Risk Free stage.

Various Exit Strategies

Some stops or exits are more appropriate to one stage of your trade than another.

Think about what you need to do in each stage to protect both your Capital and your Profit.

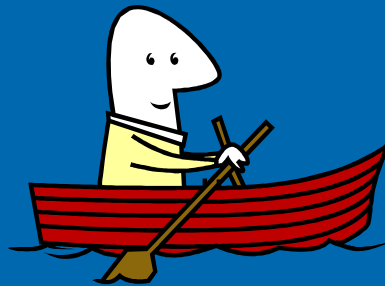
Benefit of Exit Strategies.

Neil did some testing of the effect of various exit strategies on his already profitable entry strategy.

Incorporating a Stall Exit lifted profits.

A Profit Protection Stop as well as a Stall Exit, lifted profits even further.

We've all heard the phrase "A rising tide lifts all boats" and for many years, the rising tide of the market was all we needed to make profits.



That is no longer the case, so we have to play the game "smarter" than before.

To Wrap it up...

The Trading Environment *has* changed. So ...

Ensure you have a good Entry Strategy.

Use appropriate position sizing and money management.

Use an Exit Strategy that complements the Entry.

Consider all stages of the Exit.

And may your \$\$ grow from this



... To this ...



