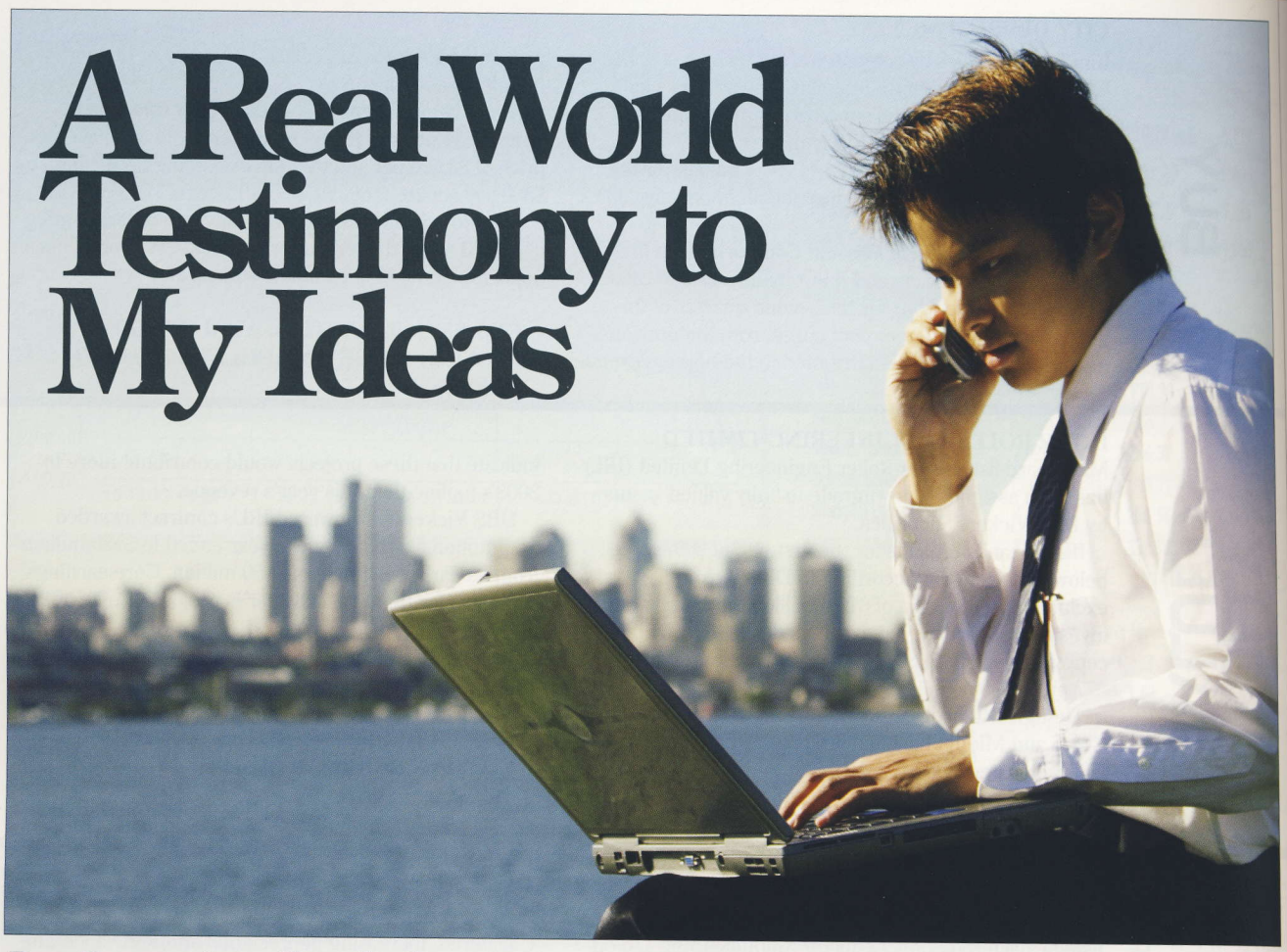
A Real-World Testimony to My Ideas



Ray Barros describes the lessons he and a novice learnt from a short trading competition using methods better suited for trading over longer-time frames.

In June 2007, Daniels Trading (www.danielstrading.com), a Chicago broker, held a currency futures competition that was to last until July 31, 2007. Unlike CNBC's Million Dollar Competition, this one involved 'real' money: the participants had to lodge a minimum of US$5000.00. The winner was the trader who showed the greatest Return on Investment (ROI) and he'd win US$25,000.

The competition was biased towards day traders. The low minimum capital requirement meant that day traders and scalpers could return a high ROI since day trades incurred lower initial margins: moreover, the designated platform was geared to facilitate day trading and scalping.

The Daniels Trading Currency Futures Competition was an interesting challenge in other ways because:

- It was a short competition, June 1 to July 31 2007. Short competitions favour lucky traders: would be one that 'places all your eggs in one basket, roll the dice and hope that the trade returns a mega profit - then let the others play catch up'.
- Its structure favoured scalpers and traders - Both Ana and I are monthly trend (18-day) traders, and I was unwilling to change our trader's timeframe for the competition.

GEARING UP FOR THE COMPETITION

My outcome for the competition was to see if a novice armed with the appropriate strategy and money management guidelines would do well. I define novice as someone who has had at least 30 trades in 3 years and one who has not been profitable for 3 consecutive years.

Q: Why 30 and why 3 years?

A: 30 trades because it's the minimum number for statistical significance; and

A: 3 years because in my experience, results under 3 years can be the result of luck. Of course, traders can get even luckier e.g. in the period 1991 to 2000, the US stock market convinced many that they were extraordinarily talented whereas in fact they were lucky.

My trading partner, Ana Wang, falls into the category of novice but has several strengths: she knows how to enter trades, she has a good feel for the market and she is extremely disciplined. Her weaknesses are: she still needs to learn that not all trades offer the same opportunity and she needs to adjust size depending on the trades' assessed probability of success.

My role in the competition was to strategise; Ana's role was to execute. As chief strategist, I was to:

1. Identify the instrument whose volatility provided our best chance of success – volatile enough to compensate for the longer tim frame, yet tame enough to accommodate our capital size.

2. Determine if we would be buyers or sellers.
3. Determine position size
4. Determine maximum risk per trade
5. Identify potential support and resistance areas for entry, stop and profit exit targets.

In my role, I had determined to risk 4% (double normal risk per trade) and this meant I would scale into my optimum position size of 9 contracts. I also decided to stick to my 18-d timeframe. Ana's role was to take the strategy and employ the best tactics. This meant zeroing in on the zone, and executing the trade.

I chose a trade in the Aussie-US dollar (ADUS) because its volatility suited our capital base and it offered the prospect of a strong directional move in the two months of the competition. Our capital base was large enough to provide adequate protection against risk of ruin. This was another disadvantage when trading against smaller bases - we needed to generate greater profit to bring about the same ROI.

The technical condition showed the ADUS was preparing for a strong run: it was basing around 0.8400 and I believed that if the ADUS could breakout (up or down), the markets would go for a run. The upside target was 0.8800 (possible 400 point profit) and a downside target of 0.7990 (about a 400 point profit). For reasons I won't go into here, I favoured the upside. I decided to risk 4% per trade for longs and 3% for shorts.

HOW THE TRADES WENT

Our first four trades were singularly unsuccessful; after 4 trades we were down 11%. Then on June 28, Ana took the first trade in a set of three. As the market moved in our favour, she added to the positions. By the time the market moved to 0.8800, we had our 9 contracts.

Also by then, July 16, I had become concerned because the market had been showing signs of a possible downside correction. This was to be expected; after all, the monthly swing that had begun on March 6, at the 0.7680 low, had not had a single monthly correction. Also, as the markets had moved higher, the daily ranges had shrunk from about 65 points per day to 60 points per day. In addition, the move from .7680 to 0.8800 meant that the impulse move had gone mean (average) + 2 standard deviations. Statistical theory says this means that the market has only a 5 per cent chance of moving up further. Finally I had some projection targets in the area of 0.8820 to 0.8860.

Now, I am not a believer in the application of simple statistics to the markets because markets have 'fat tails' i.e. the 2nd and 3rd standard deviations occur far more frequently than the theoretical 5 per cent and 1 per cent respectively. But in this case, the fact that the impulse move had achieved 'mean + 2 standard deviations' added to the weight of evidence that a temporary top was in the making.

On the evening of July 25, Ana called and said she felt we ought to exit. I agreed. For the first time since hitting 0.8800, the market had broken the previous day's low and formed a neutral bar (open and close about the same price). Ana exited all positions the next day from 0.8800 to 0.8820 and on that day, the market broke. We had exited within 71 to 51 pips from the high - an excellent exit!

With our exit, we had achieved a 60% return on capital and we were leading the competition. Our closest competitor had a result of 31.06% and I felt that if the currency volatility would remain low, we could actually win - something I had not considered possible, given our disadvantages.

Unfortunately for us, volatility increased rather than decreased and the 2nd placed competitor, on July 27, moved from 30.06% to 70.13%, while we remained at 60.81%.

The pressure was now on. Only 2 trading days left, and I had to find at least another 15% to have any chance of success. Luckily, on Monday July 30 I had two day-trading signals. A high probability sell signal that was worth 15% that was followed by a lower probability buy signal worth 8%. As is my nature, I opted for the sell and ignored the buy.

On July 30, the results were:
- Ana and Ray, 74.40 per cent; and
- Second place, 70.13 per cent.

We were in front again!

On July 31, I managed to squeeze another 0.89%, bringing our total to 75.29% but alas, it was not good enough, the winner achieved 77.04%. You can view the results at www.fxfutures.com.

You appreciate that had I taken the lower probability buy signal or had been prepared to risk more on the short trade, we'd have won the competition. But, if 30 years of trading has taught me anything, it has taught me this: if you place trades with a high probability of success and use appropriate position sizing, you will, in the end, attain the success you desire; trade anything less and the road is paved with ruin.

It's worth reflecting the lessons taught by the competition. It showed:
- The risk management tools I teach and employ work: to achieve our result we had a maximum risk of 15% of initial capital (11% loss plus the 4% risk on the initial 3 contracts; thereafter we had no capital risk);
- The tools I use provide an edge in the markets;
- We were lucky. I would not try to duplicate the results on a long-term basis. I am happy to achieve 25 to 30 per cent per annum with single-digit or low double-digit drawdowns. At 25 per cent p.a., I'll double my money about every 5 years and believe me, that doubling can make one quite wealthy.

Why were we lucky? Luck came in two forms:

1. The ADUS actually did what the probabilities said the ADUS would. On a trade-by-trade basis, the fact that the probabilities favour a trade does not mean that trade will make money; it is only on a long-term, large sample size basis that probabilities provide the edge.

2. The ADUS having broken up provided a great return by moving directionally. It did not have to move from 0.8400 to 0.8800 in a month. True, I did believe the odds favoured the move but again this did not mean it would happen.

What then were the lessons derived from the competition? For all of us, the lessons are:
- Trade with a plan with an edge;
- Don't gamble; Apply effective position sizing;
- Employ stops and profit exit strategies. **SI**

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