Day Trading Systems: The Good, The Bad and The Ugly

by Tom Reavis

For thirty-two years I traded for myself on the floor of the Chicago Mercantile Exchange. I didn't fill orders, I didn't work for the clearing houses, and all my income came from trading my own account. At times my job could be very physical, much like a sporting event. A bell started the trading day and another bell ended it, with frequent bouts of pandemonium in between. Many days I came home with a ripped shirt or a stab wound from a pen. Fist fights were not uncommon. In the 1980's they instituted a $500 fine for throwing a punch at a fellow trader. The fine soon rose to $25,000 for a first offense. Too many traders had been willing to pay the $500 fine to take a swing at another member. Passions run high when a missed trade can cost you tens of thousands of dollars.

Very short term day traders, like myself, would take large positions for just a tic or two. That kind of trader was called a "scalper" They added liquidity to the market and made price discovery easier and order flow smoother. High frequency trading gets a bum rap but it serves the same purpose in today's market place. As you can imagine, it was easy to lose track of your position when trading thousands or tens of thousands of contracts per day. Most traders like myself had "card counters", whose job it was to keep a running total of your positions. I had a very personable and intelligent young woman that was my card counter. On one particularly hectic day, she and I both completely lost track of my position. I had no idea whether I was long or short. Just when I needed her most she disappeared! She had gone to the lady's room, for some peace and quiet, and to get my "count". She didn't return until after the market closed. As smart as she was, I had to fire her. Working in the "pits" was not for everyone.

It didn't take long for me to realize that the most successful and most consistent traders were those that had a definite trading plan and they stayed with it every day. That was an epiphany for me. From early 1984 on I worked at becoming a good "Ruled Based Trader". I constantly looked for patterns in the market that tended to generate consistent directional moves. As a day trader, I looked first for very short term time frame trades. I soon learned that the same patterns that made money in the short term could also be applied to medium and long term approaches. I look for robust systems that are simple and work in most markets. However, I realize that no system works in all markets. I have seen far to many smart developers ruin their systems by trying to make them too good. It is a natural inclination to try to perfect your system but I have found that it usually works against the developer. In his effort to make it better he usually unconsciously curve fits the system which dooms it.

Between 1984 and 2003 I developed over 220 systems to trade the S&P market. I think our approach is unique in that we have so many systems and we test each to make sure that it is successful by running Monte Carlo simulations, Worst Case Scenario, and Random Exit test. If a new system fails any of the above, it's out. Many of the systems we have tested are currently offered for sale or lease by other developers. Amazingly, a great many of them simply don't make money. If they do pass our tests, we then compare them for correlation with all our other systems. If there is over a .3 correlation, only the stronger system is selected.

People often approach me with systems that " just take a couple of points all day long". Over the long run, I don't think that approach works. Over 95% of our programs are based on "cut your loses short and let your profits run". In day trading that means letting your position run until the end of the day. By doing that, you positively skew the volatility inherent in futures trading. In other words, you are taking the low margin that is required to trade futures and making it work for you.

Our systems are not for sale. We will trade them for clients but we never let them out of our hands. If a system works, why would you release it to the public? I have seen several very good systems that once they were released, never really produced consistent profits going forward. If a system is good, it will get so many followers that it will create slippage that can make even the best system unprofitable. Once the “genie is out of the bottle”, it is impossible to put it back. If you have a consistent money maker, my advise is to guard it with your life.

I have always believed that the best systems are robust. They work in most markets but not all. As I mentioned before many of our systems were developed in the 1980’s and early 1990’s. I don’t think markets change that much over time. I don’t believe that systems work for a while and then they all fail. I do believe however that curve fit systems can work for a short while and then fail. I know the trend today among many large funds is to trade very complex derivative combinations. I believe that complex derivatives are hard to control. Remember that the huge loses incurred by the banking houses in 2008 was caused in a large part by complex derivatives gone wrong. Because correlations do change, we monitor correlations between our systems on a daily basis. I believe that you need to be vigilant against placing too large a bet. During very active markets those changes can happen quickly and endanger your whole portfolio. Placing the right bet size during good markets and bad is critical to our approach. It is my observation that almost all systems traders “chase performance”, that is, they start trading a system when it is over performing its equity curve. When a system goes into a normal drawdown, the new trader decides it doesn’t work and he stops trading it and begins tracking a new “hot” system. Of course, this approach is doomed to failure. I believe that this is the main reason people lose money trading good systems.

After our biggest year ever in 2008, in which we saw returns in excess of 150%, even though we made money 2009 was a disappointing year for our system. After a reasonably good first quarter of 2009 the markets suddenly turned against us and the consistent returns, that we had become accustomed to, disappeared. We instead saw a long string of losing months. It was obvious that the markets had changed. After the stock market crash of 2008, investors had left the market and were not returning. Although the market was steadily rising from an oversold position, the volume, volatility and most importantly for us the daily range of the market was contracting severely. Research showed us that although the stock market was “climbing the wall of worry”, the public and large institutional money was not taking part in the climb. Quite the contrary, the daily range and the difference between the open of the market and the close of the market had shrunk to a 20 year low. If you are day trading and your model requires you to cut loses short and let profits run, you have a problem. You get a string of false break outs up and false break outs down and the markets just end up inching higher. It was a very frustrating and expensive experience. It was at that point that we added our “73 Filter” to our day trade portfolios. (See issue #1-2010). This filter was designed to keep us out of markets that are in contraction which we believe have a low probability of success, and conversely, it gets us fully invested during market expansion ,when we feel we have the best chance of success. We are very pleased with the success of this filter since we began implementing it in our day trading portfolios in mid 2009.

Making money trading systems is not easy. It is often counter intuitive. It is not so much the direction of movement of the underlying market, S&P 500, for clearly we can make money in either an up or down markets. But, having sufficient volatility and daily range is critical to our success. Even my friends and family have a hard time understanding why we are often not trading our systems and making money when the S&P 500 is grinding higher every day. Ironically, they were able to understand why we were able to make triple digit returns in 2008 when the S&P 500 collapsed.

It's been a long journey since those "wild west" days in the pits 40 years ago. I enjoy letting my systems do the work for me. I enjoy the results. But, I still yearn for a good fight every once in a while. Luckily, the feeling soon passes.

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