KNOW WHEN TO QUIT A TRADING SYSTEM

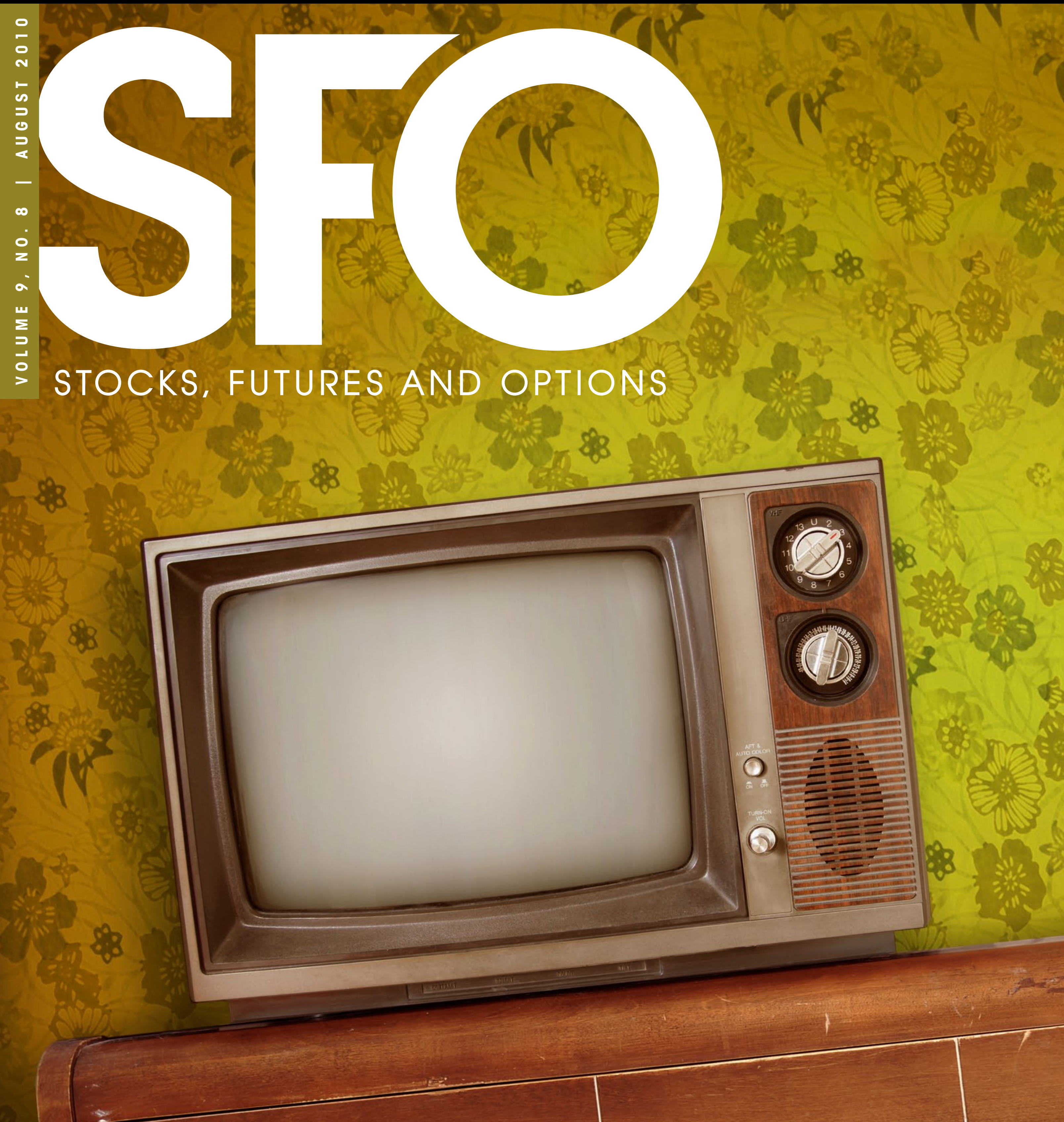
PATTERN-RECOGNITION APPS GUIDE THE WAY THROUGH CHARTS

DOES CREDIBLE FORECASTING EXIST?

VOLUME 9, NO. 8 | AUGUST 2010

SFO

STOCKS, FUTURES AND OPTIONS



Feature Interview with Direct Edge CEO William O'Brien

Home on the Range: Lasso Trades Without Time

A Demanding Market for Corn: Can the Grain Top Expectations?

The Early Days

Search for Systematic Trading

Traders never seem to give up in their quest for the holy grail trading system. But that is not a new phenomenon. Traders were searching for the same thing just as diligently 30 or 40 years ago.

That was long before high-frequency trading, algorithmic systems, dark pools, hedge funds, electronic markets … even before many of today's most active futures and options contracts and exchange-traded funds existed and prior to computers being available for retail traders.

"We did a lot with pencil and paper," recalls John Murphy, whose book, *Technical Analysis of the Financial Markets*, succeeded *Edwards and Magee* as the textbook standard for technical analysis. "Our main focus was on charting itself, and I think old-timers are still better chart readers."

By Darrell Jobman

Murphy managed money for Merrill Lynch in the 1970s and 1980s, and even major brokerage firms such as his did not have computerized charts or indicators at the time.

TRACKING HISTORY

The development of mechanical trading systems closely follows the path of advances in technical analysis and technical indicators as traders have dissected and repackaged price action in almost every conceivable way during the years in an elusive effort to gain an edge on other traders.

"The 1960s and 1970s were the wild cowboy years of technical analysis," recalls Larry Williams, one of the most creative minds in developing trading indicators and strategies. "We often thought we had something, and it turned out to be nothing at all. This was the learning period. Everything was done by hand. I punched the numbers in my adding machine every day."

Although that process might seem tedious to today's traders, back then traders got to know their indicators on an intimate basis and understood how they were constructed and what they were showing, notes Williams, author of numerous books on trading and a well-known seminar speaker who still presents his trading insights on Larry Williams University.

"I realized the purpose of an indicator was to show us what we don't naturally see on a chart," he says. "We don't see the impact of volume and price coming together. The better indicators are, the better trading will be."

His research led to Williams %R, an overbought/oversold indicator; the ultimate oscillator, which combines three time cycles into one overbought/oversold index; and a valuation tool that assesses what the commercials are doing, among others.

Watch it now! John Murphy on Money Management Pre-computer Age

DO THEY WORK?

No matter how many twists traders found for indicators or what market insights they might reveal, one thing was still missing: How would they perform in actual trading?

Louis Mendelsohn was a hospital administrator in Fort Lauderdale, Fla., in 1977 when he read an article in the Wall Street Journal about microcomputers.

"I was fascinated by it," he remembers. "That evening, I went to the local Radio Shack store to see what it was all about. As I spent time in the store tinkering with one of the computers, I immediately realized that, wow, this is really going to change the world. This could be a game-changer in my own trading."

He invested in an "expensive" microcomputer and began writing software to help him trade stocks and options. Then he became exposed to commodities and the greater leverage and potential profit they offered. He intensified his programming efforts but realized he was just using the computer as a faster calculating machine.

"What I needed was a way to test my ideas and indicators to see if they would really enhance my trading performance—a backtesting capability," Mendelsohn says.

But such backtesting software did not exist for personal computers. The dilemma for Mendelsohn was whether to ignore this need or do what it takes to develop the software. Trading won out; he decided to leave hospital administration and put his full-time effort into trading and developing software.

After a series of his articles on backtesting appeared in Futures in 1983, he was contacted by traders all over the world and decided to share his knowledge to help defray his research expenses. Later that year, he introduced ProfitTaker, the first commercially available strategy backtesting software for personal computers. Most traders today probably think such backtesting capabilities always existed, but this was a new concept for individual traders at a time when most of them did not even own a personal computer.

ERA OF TRADING INNOVATIONS

Mendelsohn's pioneering work came during the same general period when IBM was introducing its personal computer and the trading industry was launching a number of innovative financial instruments. The first cash-settled futures contract (eurodollars, 1981), stock index futures (1982), options on futures (1983) and other concepts greatly expanded the trading universe for financial instruments and the interest in developing computerized systems to trade them.

Watch it now! Larry Williams on Technical Analysis in the 1960s and 1970s

Initially, most trading systems were fairly simple, Murphy says, noting that one of the popular early systems was the four-week breakout rule developed by Richard Donchian, an early systems pioneer at Shearson who also developed the 5-10-20-day moving average crossover system.

Donchian's breakout rule was similar to the method used by Richard Dennis and William Eckhardt in their efforts to determine whether traders are born or whether a person could be trained to be a successful trader, an experiment that produced the legendary "Turtles," some of whom continue to use the same basic breakout system today.

ENTER MONEY MANAGEMENT

"The big difference in trading systems then and in 2010 is money management," Williams says. "Back then, we had no form of money management at all. We bet a lot on every trade because we thought every trade would win."

He attributes that to being young and having just discovered technical analysis, which traders thought was perfect but discovered it was not. Money management and position-sizing techniques have led to improved systems.

"With computers and more data to analyze, we should be better traders today," Williams says. "But we still have to deal with our own emotions and our indicators. That challenge is always going to be there; it's what makes this business so fascinating and rewarding."

The personal computer and backtesting capabilities in trading software have obviously been major contributors to developments in technical analysis and trading systems during the past 30 years. Other developers picked up on Mendelsohn's backtesting concept

Watch it now! How Backtesting Software Became Available to Traders

Watch it now! John Murphy on Intermarket Analysis

as part of their own systems development software, for example. This includes Bill and Ralph Cruz, who introduced TradeStation in 1991.

INTERMARKET APPROACH

For both Mendelsohn and Murphy, the personal computer and its ability to analyze and compare vast quantities of numbers led them into an arena known as intermarket analysis.

"I began to see different patterns becoming evident in the markets in the mid-1980s and became keenly interested in how markets affect each other," Mendelsohn says, prompting him to find a way to computerize those influences.

As with backtesting, no such software existed, so he began to work on software to delve into his intermarket approach.

"October 1987, the first global market crash, was a tremendous eye-opener," he says, making him realize he needed to intensify his effort in looking at intermarket relationships.

That led to Mendelsohn's release of the world's first intermarket analysis software program in 1988, followed by VantagePoint software, first introduced in 1991, featuring leading technical indicators that give daily market forecasts based on hidden relationships between global markets.

"It became clear that linkages existed between markets," agrees Murphy, who wrote a book on the subject, *Intermarket Analysis—Profiting from Global Market Relationships*. "The difference between then and now is that the computer enables us to keep an eye on all of these correlations."

A complete history of all the traders, analysts and software programmers who contributed to the development of trading systems over the years would include a long list of other names, but Mendelsohn, Murphy and Williams stand tall as trailblazers in an earlier era. All three are still very active in the trading industry, helping speculators navigate today's volatile, global financial markets.

Darrell Jobman is a senior analyst at TraderPlanet.com, a free educational website for traders of securities, futures, options and forex.