THE HOLY GRAIL!- Learning to Handle Variance in Returns

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A little less than 2 months ago a good friend (Ray) decided to start trading Forex with one of my personal volatility breakout systems that needs to have orders placed daily. You only get 2 or 3 trades a week per pair, but the frequency of your trades, multiplied by the edge can multiply capital faster than longer-term methods.

As of today, Ray has taken 88 trades with this system. And he is in a sizeable drawdown.

Ray has read a lot of forex info for years on the internet and bought numerous books about this system and that..., figuring correctly that profitable forex trading can't be as easy as most say it is. He opened a number of small starter accounts in the last 3 years, and had very little success until recently. He has ***Tradestation*** trading software and knows about curve-fitting, etc.

Of course, he knows that I've been trading successfully for many years. He has followed my blog with great interest since I started it, has taken most of the trades and is pretty happy with his current results from trading ***OneNightStand*** and ***FirstStrike***. And they were free!!!

Except, he wanted to know if it could be reasonable to trade a little more often than ***FirstStrike*** and ***OneNightStand***, even if the average trades were for for smaller returns. I told him that the volatility breakout methodology is perhaps the most robust out there, but the variance in returns from trading it – even if you know what you are doing – can make it seem like the system isn't working right.

In fact, when the system works like it is supposed to and you get your big winners, it *appears* like you were just lucky. Psychologically, that can spell death to your following a system. When your psyche starts to feel that your results are just due to chance, defection from a system is inevitable.

When you have any doubts about the way you're trading, the next time you see a Google ad on the side of a search page about "***-The NEVERLOSE system- Our EA makes money everyday-- The Last EA you'll ever need!!!!***"------ you will click it and be on your way to losing a different way.

Back to Ray's situation. I showed him a daily forex volatility breakout system (***London Squeeze***) that I trade every day as part of my trading stable. I showed him the theoretical equity curves (included below) for each of the pairs I trade, and all the pertinent data to mechanical systems. I showed him actual trades I had taken for the last year. He was sold, even though I still had my doubts about whether he could really trade it.

It is very stable over a wide range of parameters (in no way curve-fitted!). It can hold a trade up to 4 or 5 days sometimes, but that is extremely rare. When that happens your profits can be huge.

Based on many thousands of actual trades trading London Squeeze, your loss trades last an average of 12 – 18 hours, while your average time in a profit trade is 36 – 48 hours. It wins about 44% of the time and it has a profit factor (Gross profits/Gross losses) between 1.30 and 1.60 on the 4 markets I trade it on, Gbp/Usd, Eur/Usd, Usd/Chf, and Usd/Jpy.

Not to make this too long..., he said, "Let me at it!"

I warned him that even with the edge the system has (which is very respectable in my view) the amount of consecutive losses per pair can be substantial. In the last 8 years, (7.5 in the case of Eur/Usd) the pairs traded have the following consecutive ***losses/profits*** trading ***London Squeeze:***

- **Gbp/Usd:** 10 maximum consecutive losses, 10 maximum consecutive winners
- **Eur/Usd:** 8 maximum consecutive losses, 11 maximum consecutive winners
- **Usd/Chf:** 9 maximum consecutive losses, 10 maximum consecutive winners
- **Usd/Jpy:** 8 maximum consecutive losses, 14 maximum consecutive winners

Fortunately, not all of the losses happen at the same time on all of the pairs. But when you get strings of losses, the opportunity to see big drawdowns increases tremendously. The currency markets are correlated enough that you still tend to get losses in the same periods, and within days of each other. Your money management becomes critical when these consecutive trade extremes start.

He still said, "Let me at it!"

He has taken every trade that was indicated and traded the right amount of size on each trade with very few mistakes. I know this because he sends me copies of his trades every night before he enters the orders. His performance is within 1% of my own trading the system, his trading being a little more profitable than my own.

Like I mentioned above, he has taken 88 trades with ***-London Squeeze-***. And has won on only 28 of the trades. That is 32% of the time. Since the lifetime average of winners is 44%, it is obvious that the system should be losing right now.

He proved the system's long term edge to himself. The current drawdown he's experiencing is well within parameters of past action.

London Squeeze trades since 3/26/08:

Pair	Total Trades	Winners	Losers	Aver. Trade (pips)	Aver. Trade (Lifetime)
Gbp/Usd:	22	11	11	- 1.5	15.0
Eur/Usd:	29	7	22	-19.0	10.5
Usd/Chf:	22	4	18	-10.2	11.0
Usd/Jpy:	15	6	9	-15.0	10.5

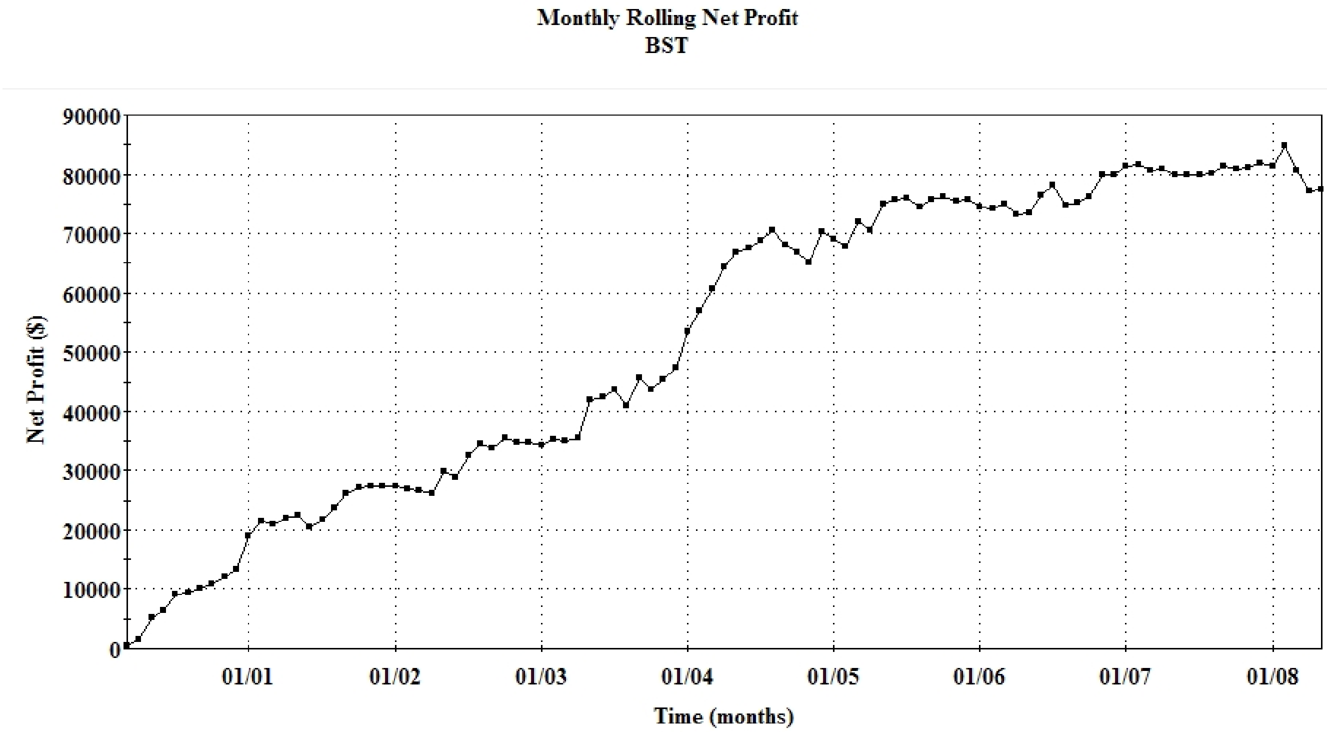
Just looking at the above figures, I have no doubt very few people would be jumping up and down to trade this method. I will, and very likely – so will Ray.

Perspective helps.

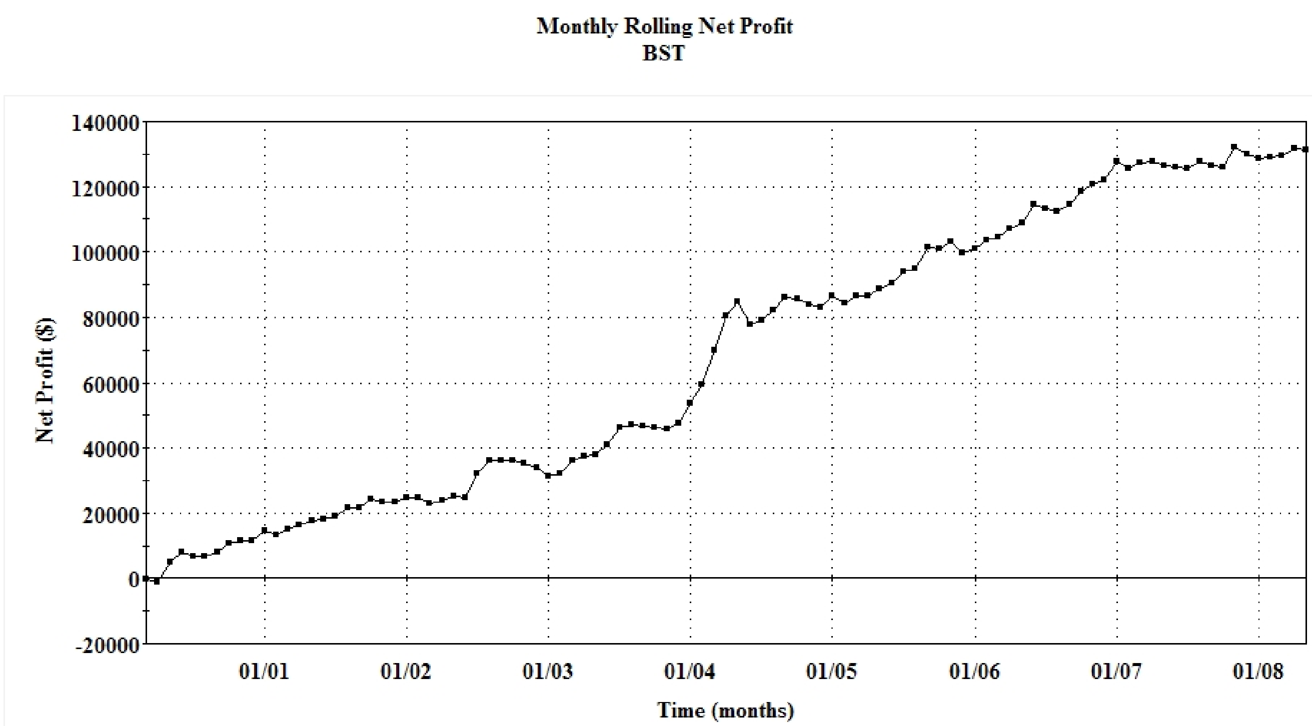
Below I am attaching the last 7 – 8 years of theoretical equity curves for the 4 pairs mentioned above. While the system does work adequately on some other pairs too, the majority of forex capital is traded in the main four.

As you will notice, none of the equity curves is a mirror image of another. But there are definitely times when they dramatically move the same direction for months at a time. This is when you may appear "lucky" to be trading this methodology. (No money management is applied. One contract of 100,000 units is assumed to be traded per signal. $20 costs included per trade to handle slippage.)

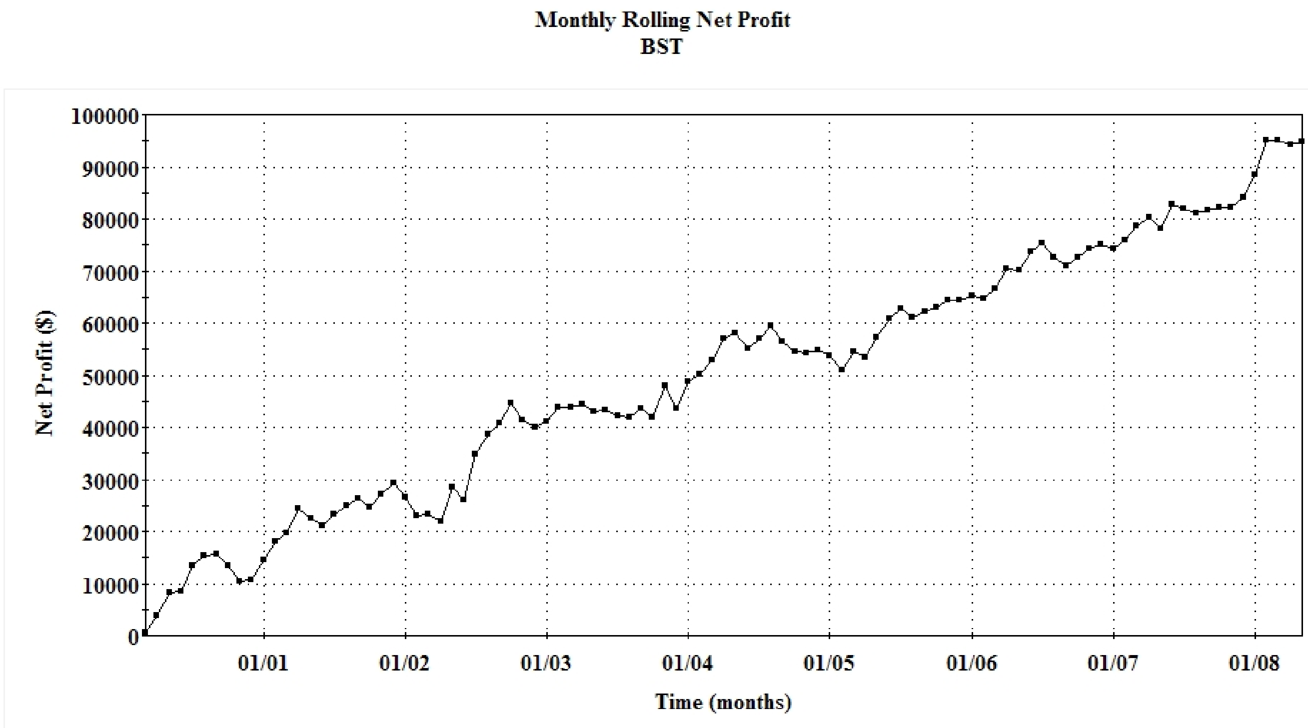
The following Equity curve is from 3/2000 to present in the EUR/USD:



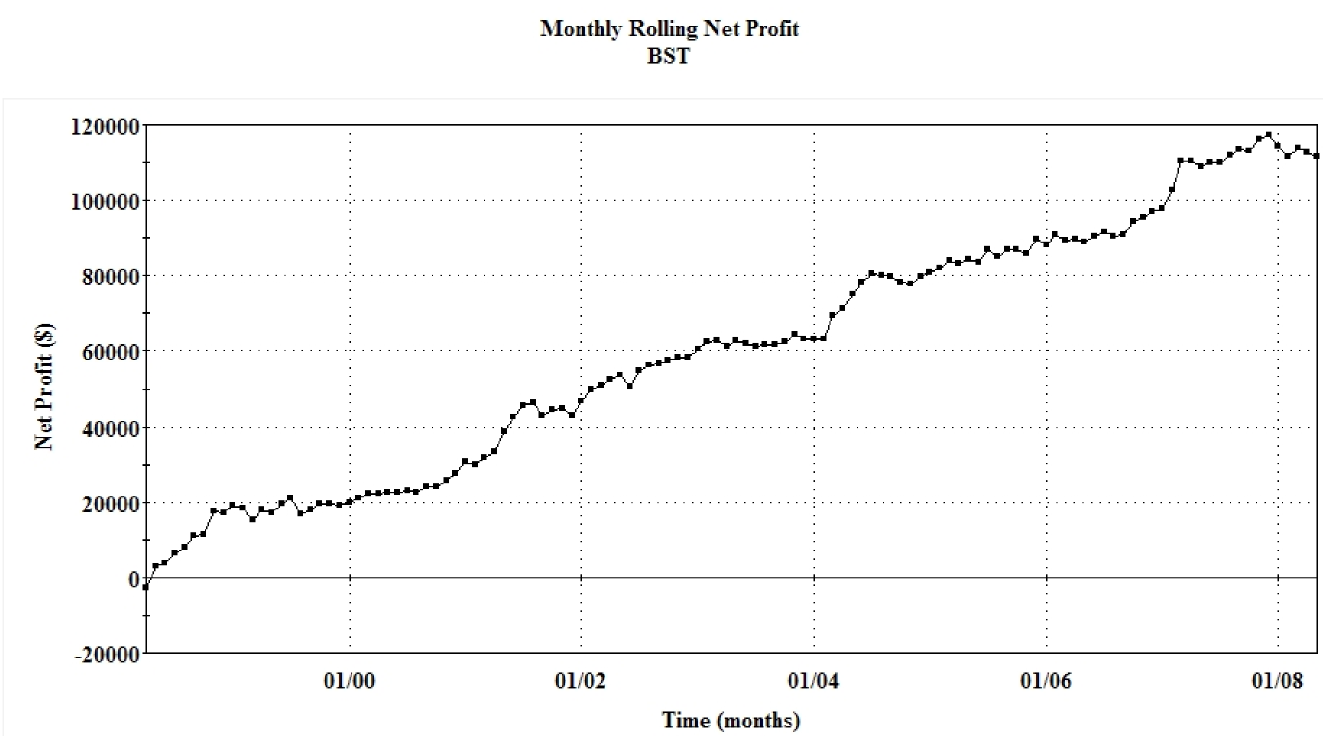
The following Equity curve is from 3/2000 to present in the GBP/USD:



The following Equity curve is from 3/2000 to present in the USD/CHF:



The following Equity curve is from 5/1998 to present in the USD/JPY:



Is Ray going to quit?

I doubt it.

Before I let him trade the system, I insisted that he verify that the trades could be taken by him and that he understood the "why" of the system, why it has to work over time.

A trader's profits are a tangible representation of his real edge. So to live with a system you have to TRUST that edge.

He called me this morning telling me how impressed he was that his account wasn't down a lot more than it is. He has lost more in much better markets than we're in now, so he is very happy. His verifying the methodology before his actual trading it made all the difference.

After checking out the equity curves above you can probably see why Ray is still willing to trade ***London Squeeze***. He is in for the long haul and believes that there are good reasons to believe that each of the pairs he's trading are going to be experiencing equity highs soon.

I keep you posted about Ray from time to time. Maybe he'll write down his experiences for us sometime.

Profits come, losses come, but the ultimate profits come to those who execute on time, every time!

London Squeeze is durable and is only in the market, long or short – about half of the time. And if a position is held for very long, it likely has substantial profits.

Variance in returns, especially in the short run, must be thoroughly understood to make trading any good and viable system possible.

The reason I brought this business about variance is because it affects whatever method you trade.

You need to "know" what is likely in the returns for the method you trade. ***FirstStrike*** and ***OneNightStand*** are great methods, but only in the hands of those who respect the type of returns that can be delivered. And those who can handle waiting for the big trades, and make sure they have enough position size in the winners.

All traders are usually happy with profits. But when the losses come in first, then it takes a strong will to keep going. Do you have that strong will?

It is one thing to say you can handle a "good" system's ***average*** 45% drawdown, but entirely another to start trading that "good" system with a $50,000 account and within 7 weeks be at $27,000 (46% drawdown). Do you take the next trade?

It doesn't matter at that moment whether the system will eventually pull out of the drawdown and go to new equity highs in 3 weeks or 3 months, because you don't know that. It comes down to you and the method.

You need to trade solid methods that you absolutely will take a bullet for. Or you will regret it.

Until next time –

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