Beating the Financial Futures Market

Combining Small Biases into Powerful Money Making Strategies

ART COLLINS

Foreword by Robert Pardo

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Beating the Financial Futures Market

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Collins, Art.
Beating the financial futures market : combining small biases into powerful money making strategies / by Art Collins ; with a foreword by Robert Pardo.
p. cm.—(Wiley trading series)
Includes indexes.
ISBN-13 978-0-470-03865-9 (cloth)
ISBN-10 0-470-03865-9 (cloth)
1. Financial futures. 2. Futures market. I. Title. II. Series.
HG6024.3.C63 2007
332.63'2—dc22 2006011072

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

For my wife Pat and daughter Maggi,
to whom I am especially biased

Contents

Foreword

I first met Art Collins when he contacted me to see whether I would be interested in being included in his book *Market Beaters*—which, by the way, is a very good book with a not so good title.

Always happy to get some press and always equally happy to do what I can to help traders of all sorts understand what it takes to be successful at the difficult art of trading, I expressed my interest.

Since that time, I have taken Art under my wing—as an informal student trading system developer work in progress, so to speak. I did so for a number of reasons.

When Art asked me to write the foreword to his newest book, I was both honored and glad to be able to help bring a book as interesting and unique as this one before the trading public.

First, I found Art to be refreshingly honest and forthright in a business, which—to say the least—does not always exemplify these qualities. It was also striking to me that—even as a middle-aged man with years of real-time trading experience and as a man who has interviewed a number of highly successful traders for his various books—Art was possessed of an almost childlike curiosity and enthusiasm for trading system research. It was a refreshing contrast to the know-it-all-ism, cynicism, and hypocrisy that one can find among those who vend information to the trading community. I was further impressed by Art's objectivity and lack of bias. If I had a nickel for every time that Art asked me to puncture the balloon of his latest and greatest trading idea . . . And, last, but far from least, I have been—and continue to be—impressed by Art's persistence and diligence. Art is not a quitter, nor do I expect that to change.

We all know about the flim-flam guys and the snake oil salesmen, so enough about that. Fewer know—or understand—about those honest vendors who just don't know enough or are not rigorous and/or realistic enough to really deliver the goods on a trading product that can produce trading profits in real trading and over the long haul. Fewer yet know much about those who actually are the real deal—for example, the folks talked about in the *Market Wizard* and *Market Beater* type books—who know how to develop trading systems and to trade effectively but are so tight-lipped that they will say nothing about how they do it for fear that they are “arming” future competitors.

I have been in this business a long time—as a software developer, trading system expert, trading consultant, and money manager to mention a few hats that I have had the pleasure to wear—and, as a result, have had the opportunity to deal with a lot of very successful traders from all walks of life, a variety of vendors of different trading products, and a cross-section of trading “pundits.”

I can tell you that to be successful in trading is difficult—and not strictly because it is difficult to find and validate a successful trading methodology. For while that process can be rather daunting—especially for the neophyte—it is not the most difficult part of the trading equation. Trading system development is a skill that can be acquired if one works at it hard enough. And this book will most certainly be a valuable asset in that process.

The most difficult part of successful trading is that it demands steely self-discipline and a tremendous confidence—if not in one’s self, at least in one’s trading system. Discipline and confidence both emerge—in the most healthful way—from a clear, objective, compassionate and penetrating self-knowledge. But that is a story for another time.

Suffice it to say, that if you were to take a survey of successful traders, you will find some things in common. First among those will be discipline, next confidence, and last but not least, you will also find honesty, passion, enthusiasm, curiosity, and objectivity.

I think that you will also find that successful traders share another trait in common—an insatiable curiosity about what makes the markets tick and an equally insatiable urge to learn and to continuously improve their skills.

So, for the trader—beginner to expert—education is an ongoing and continuous process. Of course, books on trading are a big component of this process. However, in fairness, there aren’t that many great books out there about trading. I would even be so bold as to say that there aren’t even that many good books written about trading. If you have read many trading books, you will probably agree with me that there are a lot of really poor, redundant, and undocumented books out there clamoring for your dollars.

I am glad to say, that Art’s book is *not* one of those books. In fact, this is a very good book. If it were not a good book, friend or not, I would not and could not write this foreword.

However, because I say this book is a very good book does not mean that I agree with everything Art says in it, for I do not. Nor does it mean that I would not do things differently if I were writing it, because I would do some things differently.

However, this should in no way diminish your view of this book, because it is a book that has a lot of information packed into it—in fact, if one were to price Art's book in the same way that some of these "lesser" trading books are priced, it would be costing you a great deal more—and it is a book that looks at these ideas in some new and interesting ways.

Suffice it to say, that as a reader of many a trading book, a developer of countless trading systems and a successful trader, I can assure you that this is a book that can teach you something, whether beginner, intermediate or advanced trader. In truth, it is will probably prove more helpful to the beginner-to-intermediate trader, but even the advanced trader will probably find something useful in this book.

This book reads a bit like a mystery novel. Art's passion and enthusiasm for the "hunt" for the "perfect" trading system is infectious. He takes you through the process of discovery that he followed in the exploration of these trading ideas.

As I have said, this book is pretty well loaded when it comes to trading ideas. I know—both from my years as a vendor of trading system software and from some comments about my book—that people (especially beginners) are really looking for trading ideas. In fact, what they are really looking for is trading system that will turn $10,000 into $1,000,000 in one year . . . and all in a book that costs $49.95. I would suggest that if this is the goal, keep looking. It will be a long search.

I have always found this emphasis to be rather ironic because it doesn't take all that much digging to come up with decent trading ideas. A lot of really good trading ideas are out there in the public domain. The irony comes in, in that people generally don't recognize them when they see them, or discard them as "old-school," or they set the "profit bar" way too high. And, even when they do settle on trading ideas, they do not know how to test and evaluate them. For the trader who has gone even that far, in the end, most cannot follow the trading system with the consistency required when it is winning (enter greed) or when it is losing (enter its sidekick, fear).

When asked the question "Do trading systems work?" Larry Williams once said "Trading systems work, traders don't."

How does this book help with all of that? Well, first, it provides ten different trading ideas. I will say that in my career as a trading system developer and trader, I have encountered and explored just about every one of the ideas Art researches in this book. I won't comment further on their relative merit—so as not to "spoil the story" nor relieve you of your responsibility to make your own informed decision. Read the book and make up your own mind based on the evidence Art has so painstakingly presented.

Secondly, Art takes an approach to the integration of these different ideas into one trading system that I have not seen discussed too often—if at all—in the trading literature. That is, he creates various indices or indicators out of various configurations of these different indicators, triggers or trading ideas. It is an idea that I have had occasion to employ myself over the years and—ironically—I am currently exploring an application of this indexing approach to one of my new trading systems. Suffice it to say that indexing can be very powerful if it is done correctly. It can be a very effective way to "summarize" large amounts of complex information. Art handles this well, but do remember that there is a lot of information that is presented in this book and that there are even more complex and useful ways to interpret and index it.

Part of the fun and the uniqueness of this book is that there are enough tools in here that can be configured in so many ways that it is possible that any number of people—if they exercise their creativity and the required effort—will be able to come up with unique trading systems of their own.

Third, Art demonstrates a sound methodological approach to this process. If one wants to know what it really takes to have a shot at developing a profitable trading system, read this book and see the work that it does take.

Certainly, there are more advanced methodologies. But Art's methodology is sound and sufficient for what he sets out to accomplish. And, once again, there are developers of trading systems who dig even more deeply that Art has done. However, do keep in mind that, as in all arenas, there are many levels of skill and experience. Trust me, however, Art digs a lot deeper than many authors of similar books that address the same audience as this one.

I feel safe in saying that if everyone searching for a trading system made as much effort to be as exhaustive and thorough as Art has in this book, the fruits of their labor would be far sweeter.

What is the bottom line here? Trading is difficult. Developing a trading system that has a positive expectancy is the first step to success in trading. To develop a successful trading system takes a lot of blood, sweat and tears. To develop a trading system and to trade it successfully requires objectivity, discipline, and honesty.

Art has delivered a very honest book. Does he provide you with a "get rich quick scenario?" No. Do I believe that you will be able to develop a successful trading system? I cannot promise that you will, for that is up to you, but I do think that the effort will prove fruitful in many ways.

Will you learn some new trading ideas? Unless you already have a very extensive background in trading systems, I am pretty sure that you will.

Will you get a sample of how much effort it really takes to develop a trading system? You bet.

Will you see an effective application of a somewhat unknown but effective approach to trading data application—indexing? Yes, you will get that as well.

You will find within these pages the blow-by-blow account of an honest and sincere man's effort to develop a reliable and effective trading system.

In the end, if you are one who considers himself to be a serious student of trading system development, will you be better off for having read this book? I can honestly tell you that even though I have seen and explored just about every idea in this book individually, I personally have not put them together the way that Art does in this book. I learned a few new tricks. Perhaps you will as well.

As a matter of fact, to demonstrate our commitment to these trading ideas, Pardo Group Limited—in conjunction with Art—will be responsible for the creation of a web site that will serve as an idea and information exchange and clearing house regarding various incarnations, refinements and developments of and from these trading ideas.

For more information, please visit us at www.pardocapital.com.

Enjoy the hunt . . .

Bob Pardo
President
Pardo Capital Limited
Pardo Group Limited

Preface

I used to bet professional football in a strictly technical fashion. I was not a true fan. I knew next to nothing about the players and how they matched up. In fact, I've seldom watched a game I didn't have money on. I did, however, recognize the true significance of professional betting lines. They had nothing to do with a sports book's opinions about the outcome. Their only purpose was to entice half the gamblers to bet one way, and half the other. If the bookies achieved that ideal, they were automatic risk-free winners because the losing side paid an additional 10 percent "vigorish" (or "juice") of their betting amount.

Such logistics convinced me that any fundamental information about the players, the teams, the coaching, the weather, the stadium, or anything else was going to be reflected in the lines. You weren't likely going to out-Einstein the odds makers or come up with something brilliant that they didn't consider.

There seemed to be only one potential winning path, and it's the same one I follow in markets. The path of past performance. How did the teams do against the lines and under what circumstances? You'd get these little imbalances, like home teams covered a greater percentage on Monday nights than during the season at large. Home underdogs tended to reward more than average during most years. Some teams covered more on grass, others more on Astroturf. Many small groups of stats. Sometimes, the tendencies held up into the future, and sometimes they became anti-stats.

It was all one big win-loss hopper, and when the smoke cleared, I had overcome the 5 percent bookie edge. That it wasn't by much should hardly be surprising. Five percent over many trials is huge. Ask Vegas.

This is part of where I learned about the beauty of simplicity. I wasn't great, but I tended to do no worse than the season ticket holder who knew everything about the rosters—much to their annoyance. Fan-oriented analysis too often comes more from the heart than the head. Besides, it didn't seem too attentive to the only thing that mattered—the lines.

Stats are fascinating but elusive little animals. If you put too many biased trials together, you can lessen your sample size to unreliable levels. Combining raw elements doesn't automatically make them better, nor even commensurate with what the sum of the individual parts would suggest.

Complexity usually implies advancement—higher levels, but markets are frequently unlike the world at large. I got an inkling of that as a 20-something trading hopeful in the precomputer age, noting the dozens and dozens of trend lines a chartist had meticulously penciled in. He had filled his page almost to the point where every tick was on a support or resistance line—the whole sheet was almost solid gray. I think of that image when some giant like Elaine Garzarelli (or even the Fed for that matter) makes their pronouncements. What is behind these master mechanisms? Automated rotating compass points and belching computers? Labs that look like a James Bond villain lair? Obviously, I'm oversimplifying the point, but not by much. How much more right can Alan Greenspan be if he has an extra dozen computers backing him? Certainly not 12 times as accurate as before. In market analysis, you see near instantaneous application of the law of diminishing returns.

When I wrote *Market Beaters* and interviewed 13 mechanical and technical experts, I asked each of them to give me one mechanical system for promo purposes—just one system no matter how simple. Not one complied, so I abandoned the idea. In looking back, maybe I was asking for something unreasonable. It's too easy for even a well performing system to look bad. It could hit an air pocket just as it's printed and released. There will always be debatable points even about good performance summaries. Nothing gives you a smooth perfect return.

Winning systems depend on many things, including money management and the temperament of the trader himself. (A system loses if the operator loses his nerve prematurely—"woulda-shoulda" doesn't count.) The more you break something down into a basic component, the less extenuating circumstances you'll have.

I offer raw stats the same way Al O'Donnell does in his fabulous *Point Spread Playbook*—my bible during my football involvement. Like O'Donnell, I'll suggest you use it as a tool in conjunction with whatever else suits you. You might want to consider whether to take a trade fighting against some given bias, for example, or maybe you'll decide that your own input overrides that. On the other hand, I will be presenting several complete effective stand-alone systems. My only caution there is, follow them 100 percent exclusively as they're designed.

The choice is yours. Regardless, you certainly can't object to having the facts made available.

Acknowledgments

I want to thank the following people, without whom this labor of love would have been a lot more laborious.

David Mecklenburg, editor of Tiger Shark Trading (www.tigersharktrading.com) for the media exposure, good advice, and tireless assistance he's extended.

Tony Blumberg, my soon-to-be son-in-law, for alleviating my computer woes.

Master Bill Cho, for being a great inspiration.

My fellow Cleaning Ladies, John, Scott and Dan, for periodically shaking up my cloistered writer-trader existence. (www.cleaningladys.com).

Ditto for Hatman and Landis—I appreciate your market input even though I'll still stubbornly follow my systems regardless of how "wrong they are this time."

All the e-mail respondents who have offered feedback on my writings and online commentaries. It's gratifying to know you're out there.

My cousin, Bob Zeman, for reading all my books, even though he isn't market-oriented.

My mother and father, for standing by me as always.

My trading partner, Mark LaSarre, for keeping me on the straight and narrow.

The people in Japan who bought my last book. I look forward to someday meeting you.

About the Systems and Studies in This Book

I treated the enclosed studies as though they were nitroglycerine. I'd like to think I always do that—what's normally at stake, after all, are my own finances. If my signals are inaccurate due to faulty testing, transposing, or order placement, I stand to lose money. Why would one need more incentive than that to be careful? Still, somehow I manage to make periodic, sometimes costly mistakes while trading. I am not alone in this. My partner has made errors when he's taken over the order execution helm, and he's a professional computer programmer. Floor traders make errors. You'd think they'd be bearing down constantly and yet out-trade issues are part of the everyday landscape of the exchanges.

I don't excuse mistakes in any of my market-related endeavors, but somehow, presenting an accurate book feels like the greatest pressure of all. I guess it comes down to this—if I lose money, I'll be wounded, but I'll recover. If I get something wrong in my book, it will be in stone for the ages, for all the world to see, at least until the next printing. I don't wish to take grief from my peers or my readers.

Nevertheless, I have to admit to the possibility that not everything within these pages is 100 percent virtually guaranteed error-free. Sheer volume dictates that, combined with a great deal of copying and recopying. Furthermore, I know that there are more streamlined, less clumsy ways to code some of the enclosed Trade Station formulas. (And I'll probably be hearing all about them. As I'll reiterate, I'm not all that mathematical.) Some of my contentions may be arguable and others may even ultimately prove unsupportable. Overall, though, I feel confident in the validity this work because I know it has been motivated by a desire to tell market truths as best as I understand them.

Again, though, logistical issues kept popping up here and there in the course of the writing and research. Believe anyone who tells you it's the little things that drive you crazy. I spent hours and hours in "crazy."

Let's start with TradeStation—a software server for which I have a high regard overall. I have recommended it to many people asking how to get started in research. But there are these little inconsistencies—maybe true of all software—maybe just unavoidable programming realities but, nonetheless, real irritants to anyone trying to keep stats straight.

Within TradeStation, given the same formulas, the same charts and the same testing time periods, one of my computers will spit out slightly different results than the other. I'm not sure why. Maybe it has something to do with open trades being counted differently depending on when you first accessed a data stream. Also, sometimes different procedures within the same time frame in the same market on the same computer will give you slightly different results with two different studies—say a performance chart verses an optimization report. Or the difference between a performance summary and an annual periodical return chart, which I used in two successive charts in this book. The yearly total sums should be equivalent to the performance summary totals, but they aren't. They're slightly different—not enough to induce panic, but certainly enough to irritate.

And, yes, I did recheck these numbers several times. I used a January 4 start date in some fields rather than January 2 because it was the only way I could then synch up a periodical study—showing exactly the number of years I wanted—with a performance summary page. I'd get different results if I were testing in a single data stream versus one in which another market was inserted. I'd go back two weeks after first constructing a table, and get the same results everywhere except in two of the markets. Obviously, there had been some erroneous ticks down the line that were subsequently readjusted. Can't beat fun at the ol' ballpark.

I'm not implying any TradeStation results are wrong—merely that computations from different points of origin are apparently producing dissimilar results. TradeStation has always given me plausible (albeit convoluted) explanations when I've questioned similar discrepancies during my personal trading research. I could make it my quest to fully understand everything they're doing and why to the point where I could explain it, but then this book would be coming out about three or four years past my deadline. And again, it is a good company overall and life is short.

So there were logistics I had to work around. For some reason, daily data in the mini indexes sometimes only goes back about four years; consequently, full contracts were used in daily charts. The software's bias leans in the other direction when it comes to intraday trading—therefore, mini contracts were used there. The two contracts should be roughly interchangeable for practical trading purposes.

All testing was done on day session bars only—never overnights. For daily bars, I used @ and then the market symbol followed by a dot d suffix, which is usually "P" for pit session. For intraday continuous bars, I used only the @ symbol followed by the market—no P or D dot suffixes. (You'd get more history that way.) The intraday market had to then be formatted in the "view/customize" function to make it reflect the day session time frame. For indexes, the trading hours are 8:30 A.M.–3:15 P.M., Central Standard Time. The remaining targeted financials trade from 7:20 A.M.–2:00 P.M. CST.

I invite any serious reader to duplicate my posted results. You don't need to rely on the veracity of these printed pages. You merely need the proper controlled environment (i.e., the same setup) I have. Hopefully, not all of the following will prove absolutely necessary for identical results, but just for the record, here are my lab tools.

1. I'm testing in TradeStation, version 8.1, Build 2826. The company's frequent updating of versions and builds will presumably not impact the data fields.
2. The beginning and ending dates of the testing periods are always noted. Sometimes, it's a little hard to synch up a first date, especially in longer term studies. It seems that x amount of run-up bars are required before a first trade date can be generated. For the daily five-year continuous data studies, 10-18-00 was inputted into "first date" which then pinpointed January 2, 2001, as the first possible entry date. The "last date" input was 11-19-05.
3. Unless otherwise noted, strategies should be formatted as follows:
   a. Commission: 0
   b. Slippage: 0
   c. Maximum contracts per position: 1
   d. Fixed shares: 1
4. Type in the appropriate TradeStation formula (see Appendix) exactly as it appears. It will be referenced by the appropriate table or figure number (Table 5.1, Figure 6.2, and so forth).

The necessity of personal involvement in system development from the ground up will be a frequently cited theme of the book—ergo the invitation to verify my studies. You won't be able to consistently profit by blindly following advisors. I have access to some of the most talented people in the industry, and I haven't been able to prevail in such a fashion. What is it President Reagan used to say about the Soviets?—"Trust but verify." I'm not sure how much I'd concur with the "trust" part.

Finally, to respond to an anticipated question of probable general interest, yes I do personally trade various incarnations of some the enclosed methodologies.