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Minimizing Drawdown in Your Personal Investments

This article is about how we should all cope with our personal investments and how we can ride the crest of the equity wave instead of the trough. There are many investment industry participants who, with the best of intentions, could give you a sound push toward the poor house. This month I'll share with you the story of one such nudge I received years ago that could have resulted in the ultimate drawdown. Although the majority of commodity trading advisors, brokers, analysts, etc. are honest, hardworking professionals, there are some who may mislead you and cause great harm. Dealings with the corrupt or disreputable few could place you in financial jeopardy.

> ***"By selecting investments that are uncorrelated or negatively correlated, you substantially limit risk."***

Here is my story:

I don't normally take unsolicited phone calls, but now and then a resourceful salesman makes it past my secretary. On one such occasion, a salesman for an oil drilling company got through and sold me one unit in an oil well. He told me the minimum investment for this exciting program required a five-unit purchase. After some negotiation, I downgraded my exposure to one unit. This turned out to be my one success with this guy.

In the period that followed, the company drilled the well and hit "an abundant oil field." When the salesman called to tell me about my good fortune, he said there was 1,500 feet of oil in the well. He told me the well would be in production in a matter of weeks and I would recover all of my investment money in just a few months.

In the same breath, he presented another exceptional deal which he wanted me to consider. However, this time the five-unit minimum would have to be enforced. I told him I wanted to wait until the 1,500 feet of oil was pumped out and I recovered my investment. Only then would I be ready to move on to the next venture.

The next thing I knew, he called me with the bad news that, although my well had 1,500 feet of oil, the drill had inadvertently penetrated the chalk. We were at risk of losing the well. He said I would have to give him more money to cement the hole in the chalk, and then some horizontal drilling would be required to realize the forecasted potential.

To make a long story short, even after the horizontal drilling, the well produced no return on investment and none of the alternative wells produced. I was very lucky I hadn't invested more.

It still smarts to recall this investment fiasco, but I feel it is worth repeating to save you from the same pitfall. Here are some lessons I learned from this unfortunate episode and a few others like it. I offer these ideas to help you to ask the right questions on which to base your own investment decisions.

#1 Don't Accept Cold Calls

The message I'm trying to convey with my oil well story is that you should avoid cold-call solicitations under all circumstances. Although the promised rewards are tempting, the

What's News

chance that something can be gained is next to nil. By avoiding the temptation, you also avoid the risk.

The main problem with the cold caller is that you don't know him and you are probably unfamiliar with what he's selling. There is usually pressure to invest large amounts of money urgently so you won't miss out on an outstanding, but limited opportunity. This type of approach should set off warning bells in your head.

Before entrusting your money to any firm, take the time to check them out. What is their track record? What does the governing body (CFTA, SEC, etc.) have to say about them? What is the big rush, anyway?

#2 Don't rely on trust where investments are concerned

I have had experiences with brokers, where because I let down my guard and relied on trust, I was seriously hurt. On the other hand, in most cases where objective decision-making was practiced, I did much better.

Based on my experiences, I believe the investor should avoid dealing with his or her friends in market matters. Don't buy insurance from friends; Don't buy stocks and commodities from friends, and don't take advice from friends. To survive, you must be objective and perpetually suspicious of those you hire. You cannot be objective with friends because you trust them and you want to keep your friendship alive.

#3 Be diligent in controlling commission expenses

As investors, we have come to expect to pay commissions for various services we use. The one that comes to mind first is the sales commission. It is important to check your monthly statements carefully to make sure you are not being overcharged.

> ***"Harry Markowitz showed how to mix risky investments to produce a safe overall investment."***

One place investors pay hidden commissions is when purchasing cash-value life insurance policies. Many people are not aware that agents can receive up to 90% of the first year premium on these policies. Although commissions typically level off from 30-60% the first year to about 10% the second year and 2% thereafter, this is a sizable front-end load.

The National Insurance Consumer organization does not advise buying any insurance policy which has a first year cash surrender value of less than 50% of the annual premium.

When buying cash-value insurance policies, be sure to check the surrender value. Ask where the rest of your money goes. How much goes to commission and administrative costs? A reputable agent should be willing and able to answer these questions.

Before buying any policy, it is also wise to get several quotations and check out the company ratings. These are produced by S&P, Best, Moody and others. I recommend reading the July 15, 1991 issue of U.S. News and World Report for more information on this subject.

#4 Diversify to minimize risk

I believe the best way to adequately control risk is through investment diversification. By selecting investments that are uncorrelated or negatively correlated, you substantially limit risk. The goal is to minimize risk within the general market and minimize your equity drawdown.

This idea is not new. In March 1952 issue of the Journal of Finance, Harry Markowitz showed how to mix risky investments to produce a safe overall investment.

This technique depends on the mathematical study of correlation. A correlation coefficient is a signed number that lies between zero and plus or minus one. To maximize your gain and minimize your risk, the best results on a pair of markets can be obtained when one market is negatively correlated with the other. When markets are positively correlated, they move up or down together; When they are negatively correlated, one moves up as the other moves down.

Each market that is introduced to build on a portfolio should produce positive dollar-return effects. Correspondingly, less overall risk will be assumed as long as the correlation factors are step wise and sequentially taken into account as new markets are added to the portfolio.

For example, suppose you have many market opportunities in which to invest, but you only have sufficient funds to take on two markets. Assume further that you will only take positions in the direction of the trend. Your best approach would be to select a pair of markets which have the highest negative correlation or, if none are negative, the lowest positive correlation.

In the June 1991 issue of the CSI News Journal, we showed how the crude oil contract was inversely correlated to the S&P 500 Index. In the trend follower mode, by trading both these markets, your chance of success would be highest. Trading one without the other would leave you vulnerable to the serious drawdowns that occur before market reversals.

This example used a simple analysis of two markets. I believe that great investment opportunities can be found through careful study of correlation on many markets. This continues to be the focus of my research and programming work.

In my early trading experiences, I did not fully understand the importance of negative correlation on diversification. Over time it became clear to me that investing in several correlated markets did not provide sufficient diversification to minimize risk. This knowledge is one of the reasons I passed on the second oil well opportunity. While I was willing to participate in one risky venture, the compounded risk of adding an identical position was too much from a mathematical standpoint. Fortunately, despite the temptations of a very convincing salesman, I followed my better judgement on that decision.

I hope you can apply some of these insights to your own investment decisions. A major goal of this News Journal is to help you, our readers, conduct your trading and market interaction in a way that will improve your chances of coming out ahead. □

Best Wishes for Prosperous Trading,

Bob Pelletier

Spread Corner

The Crack Spread was introduced in last month's CSI News Journal as one of several new features of QuickPlot/QuickStudy version 4.02. Since we'll be shipping the new software about the time this News Journal is published, we'd like to discuss the Crack spread and some of its uses.

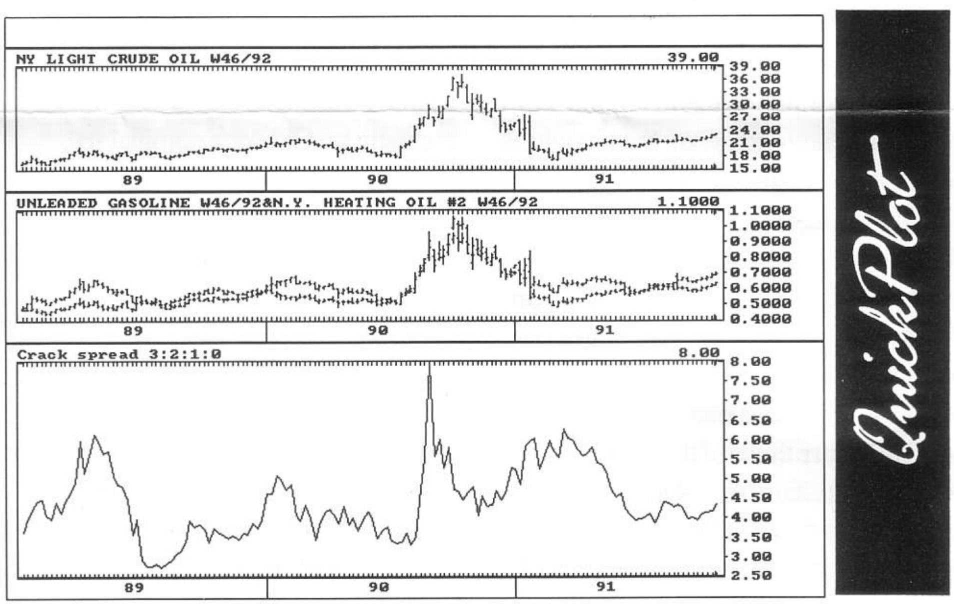
The Crack Spread relates the futures prices of NY Light Crude Oil with those of its major refined products, Unleaded Gasoline and Heating Oil. They are related in a 3:2:1 ratio which approximates the production process. Three barrels of crude oil are refined to produce roughly two barrels of gasoline and one barrel of heating oil. There is also a small residual of byproducts such as asphalt and lubricants.

The value of the refined products (two barrels of gasoline and one of heating oil) equates in a market sense to three barrels of crude plus expenses. These expenses include refining, storage and transportation costs plus profit. Variations in the pricing of these commodities result from several factors. Among them are differing seasonal demands, extremes in weather conditions, worldwide stocks and crude oil production.

Below is an example of this relationship, using closing prices from 9/26/91. We analyzed the February '92 contracts for 1000 barrels of crude oil and 42000 gallons each of gasoline and heating oil. *continued on page 4*

Gasoline component = $0.6015 x 42Gal/Bbl x 2 contracts = $50.526
Heating oil component = $0.6468 x 42Gal/Bbl x 1 contract = $27.166
Total = $77.692
NY crude light = $21.74 x 3 contracts = $65.220
Difference = $12.472
Ratio = 12.472/3 contracts = 4.16 (in this example)

Variations in this ratio are shown in the QuickPlot charts below. These display the weekly ranges from early 1989 through the current date using CSI Perpetual Contract data.



When the prices for the refined products increase above the price of crude plus the refining costs, the spread increases. This produces an incentive to purchase the crude oil and sell the refined products.

When the prices of the refined products start to decrease relative to the crude price, the spread begins to narrow and a reverse position may be warranted. The relationship is vividly illustrated in the charts on page 3, which include data for August 2, 1990. This date is significant to traders of energy futures. It is the day Iraq invaded Kuwait.

As you'll note in the charts, on Aug. 2nd the price of Crude Oil began a dramatic climb. The Crack Spread immediately widened from four to eight. The shock to the world oil markets was short lived, and was over before the prices of the refined products caught up. Consequently, the spread narrowed. The spread widened and narrowed to a lesser degree throughout the remainder of the Persian Gulf conflict. These variations reflect changes in the price of crude oil.

Although the Aug. 2nd example is more dramatic than most, there are significant swings in the crack spread values throughout the chart. Traders who take advantage of these swings often reap substantial profits.

To implement a crack spread trade, buy three light crude contracts and sell two gasoline and one heating oil contract. To account for the refining process time, many traders select a crude oil contract whose maturity date is one month before those of the refined products. Good timing, adequate capital and appropriate stops are essential in the often-volatile energy markets. ☐

QuickTrieve 4.02 Reminder

The response to our QuickTrieve 4.02 offering has been overwhelming. We have had positive reports from our beta test sites and expect to ship all orders on schedule. For those of you who missed the announcement last month, here is a recap of version 4.02's capabilities:

QuickTrieve version 4.02 will offer a graphic display showing which days are on file at CSI for collection and which have already been updated. Users will have the option of selecting any group of days to update or pressing a function key to update all uncollected days from the most recent eight weeks. Up to two different portfolios can be collected in any single call, updating a maximum of 1,000 contracts or stocks for all days.

Version 4.02's Commodity Alert Calendar will keep you informed of upcoming first notice days, delivery days, last trading days, etc. It will also tell you when to expect government reports on crops, housing starts, unemployment and other related government data which might impact the markets. This calendar is included courtesy of Futures Magazine and will be updated annually by CSI for a nominal fee.

QuickTrieve version 4.02 is planned for release in late October and early November.

QuickPlot/QuickStudy:

QuickPlot/QuickStudy version 4.02 includes the enhancements we have made to version 4.01 over the last year, such as improved Candlestick chart handling and the addition of the Crack Spread to the Study menu.

A complimentary upgrade from QuickPlot/QuickStudy version 4.01 will be provided when a QuickTrieve version 4.02 upgrade is purchased.

Upgrade Software Pricing

A nominal fee of $20 will be charged to upgrade from QuickTrieve version 4.0 or 4.01 to version 4.02. This package includes software with manual revision pages and the Commodity Alerts Calendar through December, 1991. A new package including the 1992 Commodity Alert Calendar may be purchased in January for $20. To order, clip and fill out the form below. Return it to CSI with your invoice and payment. Prepayment is required for all software orders. ☐

QUICKTRIEVE ORDER FORM

(For upgrade orders only)

Name________________________

User I.D.______________________

Phone day (_____) ___________

Phone eve. (_____) ___________

QuickTrieve disk #_______________

Disk size (*circle one*): 5¼" or 3½"

Check all that apply:

☐ QuickTrieve version 4.02 upgrade **$20.00***

☐ Complimentary QuickPlot upgrade (Subject to verification of QuickPlot 4.01 purchase) **$-0-**

* This rate covers QuickTrieve 4.02 with the balance of the 1991 Commodity Alerts Calendar. It applies to current users of QuickTrieve version 4.0 or 4.01 only. All others please see the regular rates in the Product Summary Listing.

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New Report Option offered with TraDe$k

When you talk, we listen - and then we act! Since CSI began marketing TraDe$k (*The Trader's Accountant*) early this year, we've learned a lot about what investors want from an accounting program. Fortunately, the original TraDe$k program could deliver just about everything investors needed. The one possible shortcoming we could identify from your comments was that TraDe$k lacked a single, comprehensive report for recording all aspects of a trading account.

No more! We asked the TraDe$k programmer to go back to work on the project. The result is a new improved report feature that offers a daily "statement." It covers all open/closed trades, cash transactions, trade notes and balances. It even gives a summary showing the total and average profit and the percentage of winning trades on each market. (*See inset.*) As with all TraDe$k reports, the user may decide which of these records to include.

The "statement" option is now part of the standard TraDe$k package, which is available for lease or purchase from CSI. For more information on TraDe$k, contact CSI Marketing.

Current TraDe$k users are encouraged to order this new release which is perfectly timed to coincide with the 1992 Commodity Alert Calendar supplement. Enclose an additional $49 for the new release and we will send your copy early in January when the Alert Calendar supplement is ready. If you want the new software capability now and the Alert information later, send $79 to cover the cost of a double mailing. □

Date: OCT 18,1991 Account Statement PAGE: 1

PERIOD: 1/01/1991 through 10/18/1991 ACCOUNT: DEMO

<INCLUDES: -Closed Trades- -Open Trades- -Cash Transactions->

	L/S	Symbol	Option		Qty	Entry Date	Entry Price	Exit Date	Exit Price	Profit
	S	GC	12/91	F	1	7/29/91	370.10	7/29/91	370.80	95.00-
	L	S	11/91	F	5	7/29/91	598-0/0	7/31/91	600-0/0	75.00
	L	S	11/91	F	5	7/31/91	600-0/0	8/01/91	624-1/2	1,200.00
	L	SP	9/91	F	1	7/29/91	383.80	8/01/91	387.45	1,800.00
	L	SP	9/91	F	2	7/30/91	387.25	8/01/91	387.45	175.00
	L	SP	9/91	F	2	7/29/91	383.80	8/01/91	387.45	3,625.00
	L	S	11/91	F	5	8/01/91	609-0/0	8/01/91	624-1/2	750.00
	L	C	12/91	F	5	6/21/91	239-3/4	8/06/91	258-0/0	887.50
	S	DM	9/91	F	1	8/13/91	0.5774	8/13/91	0.5754	225.00
	L	DM	12/91	F	1	8/15/91	0.5784	8/15/91	0.5739	587.50-
	L	LC	10/91	F	1	8/22/91	72.725	8/22/91	72.650	55.00-
	L	S	11/91	F	5	8/26/91	591-0/0	8/27/91	586-3/4	237.50-
	L	BP	9/91	F	3	7/22/91	0.1674	8/29/91	0.1694	350.00
	L	IBM		S	35	8/15/91	95-5/8	9/20/91	105-1/8	307.50
								Total Closed Trades:		$8,420.00
*	L	CL	11/91	F	2	10/04/91	22.00		23.93	3,860.00
*	L	DIS		S	45	9/20/91	110-1/4		116-3/4	292.50
*	L	DM	12/91	F	1	9/24/91	0.5778		0.5840	775.00
*	L	IBM		S	50	9/03/91	96-0/0		99-7/8	193.75
*	L	IBM		S	50	10/04/91	98-1/8		99-7/8	87.50
*	L	IBM		S	35	10/09/91	96-3/4		99-7/8	109.38
*	L	LC	12/91	F	2	10/09/91	72.500		76.950	3,560.00
*	S	SF	12/91	F	1	9/24/91	0.6819		0.6696	1,537.50
*	L	TB	3/92	F	1	9/23/91	94.86		95.08	550.00
								Total Open Trades:		$10,965.63

Cash Transactions	Debit	Credit	Net
6/30/91 dividend		$350.00	$350.00
9/30/91 interest		$48.62	$48.62
Net Cash Transactions:			$398.62

	Open Profit	Closed Profit	Total Equity
PERIOD GRAND TOTALS:	$10,965.63	$8,420.00	$19,784.25

TRADE$K (tm)

Date: OCT 18,1991 Account Statement PAGE: 2

PERIOD: 1/01/1991 through 10/18/1991 ACCOUNT: DEMO

<INCLUDES: -Closed Trades- -Open Trades- -Cash Transactions->

T R A D I N G S T A T I S T I C S

	Open Trades	Closed Trades	Total
Number of Wins:	9	10	19
Total Profit (wins):	$10,965.63	$9,395.00	$20,360.63
Average Winner:	$1,218.40	$939.50	$1,071.61
Number of Losses:		4	4
Total Losses:		$(975.00)	$(975.00)
Average Loss:		$(243.75)	$(243.75)
Number of Trades Total:	9	14	23
Winning Percentage:	100%	71%	82%
Net Profit (Loss):	$10,965.63	$8,420.00	$19,385.63
Average Profit (Loss):	$1,218.40	$601.43	$842.85

Symbol	Open Trades Number	Open Trades Profit	Closed Trades Number	Closed Trades Profit	--Total-- No.	--Total-- %Wins	-----Profit----- Ave.	-----Profit----- Total
BP			1	$350	1	100%	$350	$350
C			1	$888	1	100%	$888	$888
CL	1	$3,860	1	$308	2	100%	$2084	$4,168
DIS	1	$293	1	$308	2	100%	$300	$600
DM	1	$775	2	$363-	3	66%	$138	$413
GC			1	$95-	1	0%	$95-	$95-
IBM	3	$391	1	$308	4	100%	$175	$698
LC	1	$3,560	1	$55-	2	50%	$1753	$3,505
S			4	$1,788	4	75%	$447	$1,788
SF	1	$1,538	1	$55-	2	50%	$742	$1,483
SP			3	$5,600	3	100%	$1867	$5,600
TB	1	$550	1	$55-	2	50%	$248	$495

TRADE$K (tm)

Stock Prices Slashed to Beat All Competition

Every afternoon, just after the NYSE, AMEX and NASDAQ exchanges have tallied up their trades for the day, the CSI host computer begins updating its extensive stock data base. We currently offer daily updates on nearly all stocks traded in the United States, complete with open, high, low, close, volume and dividend activity. This fact seems to be one of the best kept secrets in the investment industry.

The under-use of this resource had prompted us to pull all the stops in promoting the CSI stock data base. We are now offering daily updates on a standardized portfolio of approximately 800 optionable stocks starting at just $49 per month!

The new QuickTrieve version 4.02 permits dual collection with a more targeted portfolio of stocks, futures, options, mutual funds, etc. Historical data disks for all these stocks are available at a fraction of our custom-order prices. □

Monthly rates for daily updates of all optionable stocks:

Long distance base rate......	$ 49
U.S. & Canada network access	$ 89
Toll-free international access.	$109

Annual rate* for historical data disks:
(All optionable stocks)

Current year .... (prorated to current date)	$250
All previous years..............	$200 ea.

*These rates apply to historical data prepared by full calendar year only.

Host System Hardware Changes Nearing Completion

We have been making slow but steady progress in our hardware improvement project. More reliable system operation, greater redundancy and 9600 baud access capability will be among the more significant benefits to our customers. By the time you receive this newsletter, most of the improvements should be in place. Your patience during the transition was greatly appreciated. □

CSI Software Product Summary

	Unrestricted Use	Daily Data User
❑ **QuickTrieve®/QuickManager®**..................... To retrieve, manage and edit data. Includes Alert Calendar	$ 99	$ 39*
❑ **QuickPlot®/QuickStudy®**........................... Charting and analysis software (requires QT/QM)	$156	$156
❑ **Trading System Performance Evaluator™** Computes your system's capital requirements	$199	
❑ **TraDe$k™** (Price varies with # of accounts) Starting @ Traders' complete accounting system	$446	$299*
12-month lease starting @		$22/MO
❑ **Seasonal Index Value Pack** .... Three years of history for 33 popular commodities	$444	
❑ **CSI News Journal** .... $35/Yr. $5/Reprint August 1990 to present		
❑ **CSI Mailing List** .... $200/1,000 NAMES		

*A Free non-expiring copy is provided upon request that is not tied to the daily service after 12 months use.
All prices subject to change without notice.

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Ask Customer Service:

Each month in this column the Customer Service staff addresses a topic of interest to many CSI users. In this issue Karen, Kathy, Kim, Rudi, Susan and Tami will discuss the year-end file maintenance required for updating continuous contracts into 1992.

Q. ***Lately when I distribute my daily updates from CSI, my data listing includes a message that some of my files may need extending. What is this all about?***

A. Since QuickTrieve always posts prices to pre-created data files, there must be a pre-defined ending date for each file. To save on disk space, the end of the current year is usually used. Everyone updating Perpetual Contract® data, cash prices or nearest futures series with ending dates of 1991 should see this message toward the end of the year. It is simply a reminder that something must be done by January to avoid lost data. This message will disappear when you have extended your files properly as explained next.

Q. ***1992 is fast approaching and I'm concerned about my stock files. They all have ending dates of December 31, 1991. How can I continue to update my stocks next year?***

A. This question applies to all continuous data files including indexes, cash, nearest futures and Perpetual Contract data. QuickTrieve's Move/Split a Data File (Move a contract file on version 3.1) will help you extend your files.

The file extension process is much easier with QuickTrieve 4.01 or 4.02 than with previous versions. These later releases can autocreate all necessary files in a single run. They can also automatically create new data directories when the limit of 120 files is reached.

To begin, select <H> from the QuickManager Menu. A list of your files will be displayed. Press the letter designator of each continuous file ending in 1991. When finished, press <F3>*.

You will be asked if you want to create files for all items or just those not existing on your target path. Say (A)ll. You will be shown each selected file and will be asked if you want to change the beginning or ending date of each. Answer (Y)es. Change the ending year for each item to 92. You may substitute 93 or 94 as desired to avoid doing this next year, but be aware that this practice tends to waste disk space.

When finished, check your new files to see that the data was transferred properly. If the new files are O.K., you'll probably want to delete the original files using <B> Delete data file from disk.

You can do this any time before the end of December, as long as your new files are ready by January 2, 1992.

*The <F3> feature is included in version 4 series QuickTrieve only. Users of prior releases must move each file individually.

Q. ***What will happen if I don't extend my continuous files by the first business day in January?***

A. This will not be a major problem for users of QuickTrieve 4.01 or 4.02 who request autocreation of new files with each update. QuickTrieve will simply create a new file for each continuous series, using the ending date you specify. The new files will hold only 1992 data, however, so they won't be very useful for charting. We would still recommend combining your 1992 data into a larger file with past data using the procedure described.

Users of QuickTrieve 4.0 or earlier versions will have a greater problem. Since new files aren't created automatically during daily distribution, 1992 data could be lost. Be sure to print a data listing on January 2 to make sure everything is posting correctly. A NOFL (no file) status indicates that a contract was not posted. If your data listing shows NOFL for any of your contracts, go through the file extension process described above to create a larger file. Then distribute your update again.

Q. ***I use QuickTrieve to retrieve daily updates, but I only distribute the data to CompuTrac-format files. Must I extend these files with QT?***

A. No. CompuTrac-format files are self perpetuating. The annual extension process only applies to continuous QuickTrieve-format files. □