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Logging Profits in Futures is a Matter of Discipline

Of brokers, quote vendors, publishers, commodity exchanges and traders, who stands the best chance of consistently making money in the futures industry? Not surprisingly, the answer is everyone except the futures trader. The trader is the only one of this group who may or may not make money on each transaction.

I have heard that 95% of all futures traders leave the market because they have lost all the money they could afford to lose. With this dreary statistic flying around, you might wonder if trading is worth the effort. I think it is. Here's why: making consistent profits is not as difficult as you might believe, and those who succeed stand to gain a great deal from the markets.

With so many futures investors losing money, it isn't always obvious that consistent trading profits can be made. I know that long-term profits are possible from my own experience and from that of friends and customers. The Futures' Funds Review confirms that dozens of trading advisors and pool operators excel in the market. In fact, many fund managers regularly deliver a 20% to 30% annual net return.

How can you be among the winners instead of the losers? You can start by examining the differences between the two. I think the investor who expects to reap hundreds of percent per year is grasping for the Holy Grail. This is a highly unlikely result, and pursuing it can lead to disastrous results. The main difference between the 95% of losers and the 5% of winners is that the winners have

well-designed plans which yield feasible returns of 20% to 40% per year.

From my perspective, the methods used by the consistent winners are fairly simple mechanical procedures with very few parameters that are generally applied to daily data. Some winners optimize their procedures for each commodity separately. Others use the same parameters for all commodities. When many commodities are examined with the same parameter set, the profit or loss calculations are sometimes handled in percentages. This evens out the playing field for unlike markets.

A very important requirement for any winning approach to trading is the evaluation of large amounts of data in system design. No system should be considered that uses less than five or ten years of historical information. I prefer to measure the needed data in decades rather than years whenever possible. A full spectrum of experience that covers freezes, wars, currency dependence, etc. should be sought. These and other infrequent, but significant market-moving events can be better controlled with more abundant data.

Although I would not say that daytrading is a hopeless pursuit, I know of no traders who consistently accumulate profits year after year by following day-trading methods. The daytraders I know seem to lose money at a much faster rate.

I believe the consistent winner must also have a prudent plan for minimizing drawdown. Statistical

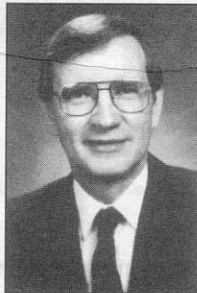
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The NFA Questions Simulated Performance Based on Continuous Data



Robert C. Pelletier

“On a hindsight basis, each parameter that controls trade timing is a source of misleading profit projections.”

In my years as a participant in the futures industry, I have seen many, many advertisements for trading systems. Most offer a track record showing their outstanding success rate. I have always viewed these claims with a grain of salt, as I know that bias can creep into any track record. I have long been concerned about the impact of such advertisements on novice investors, and it seems that the National Futures Association (NFA) now shares my concerns.

The NFA is investigating at least one Commodity Trading Advisor (CTA) regarding the nature of his advertised record. The NFA is asking questions because the CTA's record was produced with simulated trading results based on artificial market data.

The artificial data series in question was a concatenation of many delivery months for the same futures market. Previous contract prices were adjusted to stay in line with current contract prices. This “continuous contract” data allowed the simulation to take place over a long period. The NFA is apparently questioning whether this CTA published a misleading advertisement by supplying a profit figure derived from such input.

The investigation is still under way, so we'll have to wait and see the NFA's findings. I would like to comment on this now because the issue raises some questions that are of importance to software developers, CTAs, and their clients.

The first question is the one raised by the NFA itself. Does the use of artificial market data invalidate simulated trading results? I believe it can be misleading to project future performance based on artificial data. On the other hand, misleading conclusions can be avoided if simulated results are handled properly. The nature of the data must be disclosed. Also, simulated profits must be degraded to compensate for the hind-

sight bias. If used properly, artificial market data can be a powerful analysis tool.

A growing number of traders favor the “continuous contract” described above for long-term analysis. Unfortunately, most people do not realize this data set has an inherent bias favoring long positions. This is due to inflation and the price adjustments made as contracts expire. Another drawback of this type of data is the fact that it cannot be stationary. The term “stationary data” is used when the data's mean and variance remain the same. Stationarity is particularly helpful when analyzing a historical time series. Without stationarity, the cyclic time to delivery alternates each year from one day to twelve months to delivery. The “continuous contract” approach does not remove the birth and death process of any futures market. CSI does not offer a “continuous contract” in the form stated above because of these limitations.


The “Nearest Future” series offered by any data vendor does not introduce an artificial bias favoring long positions, however it does have a serious limitation of its own. A step function in price for this type of data abruptly jumps or drops when a transition from one contract to the next occurs. Simulated trades derived from data of this type must be removed or adjusted during the period when the rollover occurs. The result is a trading record built on many real contracts, with the cyclic contract birth and death process remaining in place.

For long-term analysis, it is our opinion that CSI's Perpetual Contract® data series is the best option. It offers a single, continuous data set that focuses on a constant period forward. An important advantage of the calculation formula is that statistical

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Cutting Developer Claims Down to Reality

CSI's Trader's Money Manager™ program accepts optimistic simulated records and degrades them through analysis that corrects for hindsight bias. Profits are reduced to correct for artificial time series use, parameter control and sample size. The software then produces a cautious assessment of possible practical performance.

This product and its predecessor, the Trading System Performance Evaluator™, have saved many of our customers money that might have otherwise been lost to ill-conceived methods. 

The NFA Questions...

(continued from page 2)

stationarity is more closely approached because the contract birth and death process is removed. Please see the August 1990 News Journal for more information on stationarity. Like all longer-term artificial time series including "continuous contracts," Perpetual Contract data is subject to an inflationary bias.

Since Perpetual Contract prices are artificial, simulated trading results don't exactly mirror actual trading. Simulated profit projections derived from Perpetual Contract data should therefore be corrected to a certain extent.

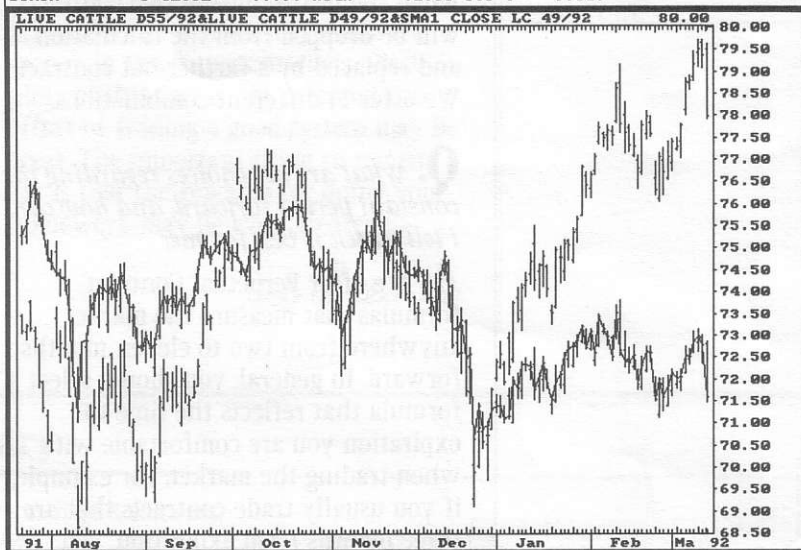
The chart shows a nearest future series and a Perpetual Contract series for Live cattle. The Perpetual Contract series has a line connecting the closes.

In defense of the CTA under investigation by the NFA, the practice of using artificial data to validate a timing system is quite common. Unfortunately, it is often used naively. I believe it should be permitted so long as results are treated properly. The nature of the input data should be disclosed and simulated profits should be degraded appropriately.


As I see it, there are other more serious reasons why any simulated

performance is misleading. Mechanical trading systems, for example, are based on several parameter settings. On a hindsight basis, each parameter that controls trade timing is a source of misleading profit projections. Each freedom-restricting control idea, including "continuous contract" data will inhibit the trading system's performance in actual trading. A high parameter count can produce much more misleading results than would the simple use of artificial data. Perhaps the NFA should consider this aspect of simulated profit calculations

QUICKPLOT 4.01 OPEN = 79.50 TOT V= 23482 LOW = 71.46 SMA1 = 71.59
 I(C)1990 CSI11 HIGH = 79.62 TOT O= 97507 CLOSE= 71.59
 DATE = 920311 LOW = 77.32 OPEN = 72.79 TOT U= 23482
 DYNUM= 3 CLOSE= 77.97 HIGH = 72.86 TOT O= 97507



in their future investigations.

The NFA's investigation is a good sign because I believe the public will benefit from tighter restrictions in this area. Our industry harbors many well-intentioned, but uninformed developers who can adversely impact the finances of their clients. The classic "past performance is no indication of future success," disclaimer is an insufficient defense, and can, in itself, be misleading when it is applied to artificial data. CTAs and software developers should be required to disclose the magnitude of control behind their trading records. 

Ask Customer Service

Each month in this column, the CSI Customer Service staff addresses questions that are frequently asked by our customers. This month, they will review some questions and answers regarding Perpetual Contract Data.

Q. *I want to analyze Perpetual Contract data, but I'm confused about the different delivery month codes. There seem to be a lot of choices. What are the differences between them?*

A. As you may know, the Perpetual Contract formula is based on a forward time-weighted average of the prices of two future delivery months of the same commodity. There are two variables in the formula, which account for the different codes. The first is the constant period forward, which determines the two delivery months to be averaged. The second is the roll-forward date which determines when the nearest of the two contracts will be dropped from the calculation and replaced by a farther-out contract. We offer 14 different combinations.

Q. *What are my choices regarding the constant period forward, and how can I tell which is best for me?*

A. We offer Perpetual Contract formulas that measure the market anywhere from two to eleven months forward. In general, you should select a formula that reflects the time to expiration you are comfortable with when trading the market. For example, if you usually trade contracts that are three months from expiration, you would want to monitor a Perpetual Contract formula that looks forward three months. We suggest that customers focus on a period forward when volume and liquidity peak. Spread traders who trade near and far contracts might want to follow two Perpetual Contract series that reflect two time frames which are spaced like the interval between successive delivery months.

Q. *What difference does the roll-forward date make in the Perpetual Contract formula?*

A. We offer three choices on the roll-

forward date, which also impact the contract selection in the Perpetual Contract formula. The choices are:

1. Contracts that roll on the tenth day of the delivery month. This is the latest enhancement to the Perpetual Contract formula. Data in this type of series tends to be smooth, but reactive to current market trends. We offer only a three-month forward formula for this time series, which uses code 46. This contract tends to smoothly follow most markets in their most liquid state.

2. Contracts that roll upon expiration of the near delivery month. This was the original formulation. As one contract expires, it is replaced with the next farther-out delivery month. This time series allows you to track the market from two to eleven months forward. It is particularly appropriate for energy markets, which are often traded close to expiration and for tracking spread possibilities between near and far contracts. This data uses an estimate of the last trading day for interpolation, which may result in daily updates being slightly different from a historical file for the same code. See the Data Resources Appendix of the Quick-Trieve manual for a complete listing of these codes.

3. Contracts that roll on the tenth day of the month preceding the delivery month. This option was developed as an enhancement to the original formula (#2 above). The early roll-forward date makes for a slightly smoother time series that appears to track the market from a little greater distance. There are only two codes for this option: Code 49 uses a 91-day-forward formula, but the early roll date lets you track the market about 45 months forward. Code 48 uses a six-month-forward formula, but actually tracks most markets about 75 months forward. ■

Logging Profits in Futures...


(continued from page 1)

diversification combining uncorrelated markets in a single portfolio with varying contract weighting is important. To achieve protection against account drawdown, the trader must consider all common market forces. Such efforts should greatly reduce the chance that many of the trader's holdings will simultaneously experience losses.

A trade timing system that satisfies diversification requirements must also follow money management rules. The 5% of traders who make money seem to have steadfast rules for controlling risk. For even a potentially profitable timing approach requires good money management to be successful.

Most winners use just 20% to 30% of an account as margin. Minimum margin levels are set by exchanges to protect the broker against an uncollectible loss. While margin is good for the broker, it can be dangerous to the trader because it very often understates the risk of trading the market. Margin should not be thought

of as the only required investment capital. In most speculative situations, the amount of capital to be made available should be much greater than the exchange-imposed margins. Every trading plan requires that the trader allocate sufficient capital to minimize the chance that his account will become insolvent while trading. The wise trader recognizes he may have to sustain many losses before a large profit will occur. Recognition of this fact is perhaps why successful fund managers commit such a small proportion of an account's capital to required margin.

The trader who lives by these principles can consistently make money in the futures markets. Discipline of this sort is not easy and the effort of finding a good system may be great. The important thing to remember is that the rewards for doing your homework may be even greater. 

Bob Pelletier



CSI will be closed for voice communication on Friday, April 17. The host computer will be operational for updates throughout the holiday weekend and Customer Service will be open as usual on Saturday, April 18.

CSI Software Product Summary

- QuickTrieve®/QuickManager®** - To retrieve, manage & edit data; includes Alert Calendar \$99/Unrestricted use \$39/Daily data user
- QuickPlot®/QuickStudy®** - Charting & analysis software (requires QT/QM) \$156
- Trader's Money Manager™** - Introductory price \$499 (a \$200 savings)
- TraDesk™** - Traders' complete accounting system-(price varies with number of accounts) Starting @ \$446/Unrestricted use \$299/Daily data user or 12-month lease starting @ \$22/Mo.
- Seasonal Index Value Pack** - Three years of history for 33 popular commodities \$444
- CSI News Journal** - Aug. 1990 to present \$35/Yr. or \$5/Reprint
- CSI Mailing List** - \$200/1,000 names (CSI users omitted)

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SIGNATURE _____

5¼" DISK 3½" DISK

04/92

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