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DATA ♦ SOFTWARE ♦ SERVICE

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An Official Guide to Trading System Design Part I *A Practical Procedure for Mining Market Profits*

More and more traders are discovering that the only path to market success is through a well designed and implemented trading system. The best of these address a diverse set of markets and technical disciplines.

Unlike the single-market fundamentalist who might argue that a diversified portfolio can't be sufficiently researched or managed, technicians with a thoughtful plan can easily navigate the well-charted waters.

In this and the following two CSI Technical Journals, we'll present a variety of considerations for investors interested in planning, designing and implementing a trading system. Thus, we consider this a practical guide for mining market profits.

Futures markets, unlike blue chip stocks, do not pay dividends. This is among the reasons why futures trading takes a level of skill beyond that required for the average stock transaction. Nevertheless, many larger commodity funds, complete with stiff fees and heavy profit sharing, consistently make profits. In fact, some investors in particular segments of the futures industry log profits on a regular basis. A plan can help you join this minority.

THE PLANNING PROCESS

The first step in the planning process is to aim for success. If you are wondering if there is any hope of profit for the futures and stock market

trader, the answer — in your own mind — has to be "yes." Know that even without Hillary's help and influence or insider information, you, too, can succeed. A well-structured plan is often the key. This month's installment will help you structure that all important plan.

As you might imagine, we believe that a trading system for generating explicit buy and sell signals is integral to every trading plan. We'll discuss various trading systems and their uses in the next two installments of this article. Before getting into that area, there are important factors that must be considered for plan development.

THE BROKER TAX

Let's start by acknowledging the truth in the rumor that brokers make a good profit regardless of their clients' success. Investors using the New York and Chicago markets support a huge complement of brokers and floor traders. These professionals perform a needed service, assuming risks and expenses that justify their fees. Each time a trade is consummated, there is a broker's fee, the floor broker's fee, the exchange fee and a slippage charge represented by the bid/ask spread.

In the absence of a disciplined plan, losses often equal your commission bill plus the market-fill slippage, which I consider to be the unquoted commis-

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An Official Guide...

(continued from page 1)

When considering any new position, your plan should include investigating the three alternatives:

- 1) Buying or selling a given futures contract,***
 - 2) Buying puts or calls on the contract, and***
 - 3) Writing puts or calls on the contract.***
-

sion. This is no coincidence; It is common for anyone playing a zero-sum game. The "house take" in Las Vegas is what we pay to play the game. In trading, the "house" is the exchange itself and those who work to implement your trades. Their take, which boils down to the trader's total commission bill, can make the difference between a losing or winning trading record.

You should definitely plan to limit these expenses. The proper way to reduce these charges is to trade less and give your full trading plan a chance to work. Making infrequent trades is a strategy many successful traders have come to appreciate. Not surprisingly, the trader is encouraged by the commission merchant to trade with great frequency. It is an invitation we suggest you respectfully decline.

POSITION TRADING, SPREAD TRADING AND INTERMARKET ANALYSIS

Every trading plan should explore position trading, spread trading and intermarket analysis. Position trades, which may be held anywhere from a few days to several months, involve buying or selling contracts based on the anticipated market direction. It is typical that they are independently selected and are not paired with an opposite position in a complementary market, as in a spread. Because there is no hedging involved in a position trade, the "naked" position trader stands to make great profits if his projections are correct. Of course, the flip side of this is greater losses if the market turns against him.

The spread trader, on the other hand, pairs his long positions with short ones, attempting to profit from the change in price relationships. A spread trader might trade different delivery months of the same commodity, or the same months in different, substitutable commodities. The possibilities for spread positions are almost

limitless. In a spread trade, the commission and margin expense are generally lower than if the two positions were taken independently, but the potential for both profit and loss are diminished a bit.

Intermarket analysis can involve analyzing markets that have been paired either according to their similarity or their diversity. It is a curious fact that trading a pair of negatively correlated systems, one a winner and one a loser, can generate a greater profit per dollar at risk than trading the winning system alone. The secret lies in the profit summation over time. The capital required for the negatively correlated pair (the winner plus the loser) can be much less than the capital required for just the winning system. In this example, required trading capital is defined as the maximum level of drawdown computed as the maximum peak-to-trough loss.

FUTURES OR OPTIONS

When considering any new position, your plan should include investigating the three alternatives: 1) Buying or selling a given futures contract, 2) Buying puts or calls on the contract, and 3) Writing puts or calls on the contract. Given a situation for market entry and the fees, commissions, information costs, risks, rewards, premiums and market volatility for each of these three possibilities, one choice may be clearly superior at a given time. All three alternatives will produce a profit if the market goes in the projected direction. Only one of the alternatives has a maximum return/risk ratio.

ASSET ALLOCATION

No plan would be complete without an asset allocation method. We suggest one that would trade off asset return with risk for every market. By allocat-

(continued on Page 6)

CSI's On-Line Stock Advisory Report

Recommendations as of August 13, 1994



SECURITIES

SYM.	STOCK	DATE	SIG.	POS. PRICE	PRESS PRICE	\$/SH GAIN	CLOSED POS. P/L
AA	Aluminum Co. of Am	8/8	HS	78.75	77.00	+1.75	-3.25
ABX	Amer Barrick Res		N				
AMGN	Amgen	8/8	HS	50.62	53.12	-2.50	
AAPL	Apple Computer		N				+1.38
BEL	Bell Atlantic Corp	7/5	HS	55.00	56.62	-1.62	
BV	Blockbuster Ent.		N				+3.38
BTY	British Telecom	6/20	HS	56.25	57.62	-1.38	
BC	Brunswick Corp		N				
CS	Cabletron Systems	8/8	HS	96.00	101.75	-5.75	+5.50
CAT	Caterpillar Inc.	7/25	HS	106.75	106.25	+5.0	
CHV	Chevron Corp		N				
C	Chrysler Corp		N				+7.5
CPQ	Compaq		N				
DIS	Disney	8/8	HL	42.50	43.38	+88	+1.62
DOW	Dow Chemical	7/25	HS	67.00	70.38	-3.38	
DD	DuPont		N				+1.50
EK	Eastman Kodak		N				
XON	Exxon Corp		N				
F	Ford Motor Co.		N				+2.50
GD	General Dynamics		N				
GE	Gen Electric Co.		N				+1.38
GM	General Motors Corp.		N				
GENZ	Genzyme Corp.	8/8	HS	29.00	30.75	-1.75	
HWP	Hewlett-Packard		N				+2.62
HD	Home Depot	8/15	BO	41.50	42.00	+50	
INTC	Intel Corp.	8/15	CL				+4.75
IBM	Int'l Bus Mach.		N				
IP	Int'l Paper	7/18	HS	72.88	72.00	+88	+2.62
LOTS	Lotus Development	7/25	HL	31.75	44.50	+12.75	
ML	Martin Marietta		N				
MDT	Medtronic, Inc.	8/8	HS	85.75	88.25	-2.50	
MRK	Merck		N				
MSFT	Microsoft Corp.	8/8	HS	52.37	54.37	-2.00	+4.26
MMM	Minnesota Mining		N				+1.38
MOB	Mobil Corp		N				
JPM	Morgan (JP) & Co.		N				+4.50
MOT	Motorola, Inc.	8/8	HS	53.00	52.62	+38	+88
ODP	Office Depot		N				
PEP	Pepsico, Inc.		N				
MO	Philip Morris	7/11	HS	53.37	55.37	-2.00	+2.88
PG	Procter & Gamble	8/8	HL	54.50	55.88	+1.38	+6.3
PBEN	Puritan-Bennett		N				
SK	Safety-Kleen		N				
SUNW	Sun Microsystems		N				
TX	Texaco Inc.	7/25	HS	62.75	61.37	+1.38	
COMS	Three Com Corp		N				
TYSNA	Tyson Foods "A"	8/8	HS	23.88	24.00	-12	
UTX	United Technologies	7/5	HL	64.37	62.12	-2.25	+1.75
USS	U.S. Surgical		N				
WAG	Walgreen Co.		N				
WMT	Wal-Mart Stores	8/15	RSB	24.00	23.75	-.25	-.37
TOTAL						-\$5.10	+37.66

Minor discrepancies are due to rounding.

As of the August 15th market close, current profit = \$32.56 per share. The "Date" is the date a position was taken at the opening price; The Position Price is the price at which the position was entered, and the "Press Price" is the close price of the stock the day before the Technical Journal went to the printer (August 15). The \$/Share Gain is the positive or negative difference between the position price to the press price for one share.

The report makes use of certain signals, (see "SIG." in the title) abbreviations for which are decoded as follows:

SIG.	MEANING
CL	Cover long at the next opening price, i.e., sell your long position and remain neutral.
CS	Cover Short at the next opening price, i.e., buy back your short position and maintain a neutral stance until the next signal.
N	Neutral. Stay out of this market until a signal occurs.
BO	Buy at the opening.
SO	Sell short at the opening.
RLS	Reverse your long position by selling it then sell an additional unit short.
RSB	Reverse your short position by buying it back and buy an additional unit so that you are net long a unit.
HL	Hold your long position.
HS	Hold your short position.

Past performance is no guarantee of future results.

RECOMMENDATIONS:

Recommendations as of August 13th were to maintain short positions in AA, AMGN, BEL, BTY, CS, CAT, DOW, GENZ, IP, MDT, MSFT, MOT, MO, TX and TYSNA, while keeping long positions in DIS, LOTS, PG and UTX. The long position in INTC was to be closed. The short position in WMT was to be reversed to long and a new long position was advised for HD. These recommendations were effective August 13th and may have been superseded prior to delivery of this Journal. New market positions should be entered only at the time of recommendation.

INVESTED CAPITAL: (Chart)

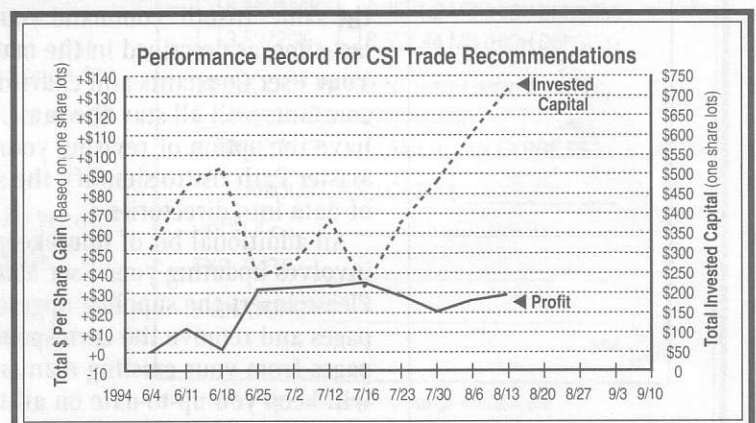
The total invested capital shown on a weekly frequency represents the sum of the entry share prices for all long positions plus one-half of the sum of all entry share prices for short positions.

PROFIT: (Chart)

The total profit includes the \$/share gain for all open trades plus the per-share closed position profit. A commission expense of \$0.50 per share has been charged against all closed positions. The total profit is an equity reading and includes all open and closed positions taken since commencement of the record on June 6, 1994.

REPORTING FREQUENCY:

The CSI Technical Journal which includes our past record is offered monthly and is typically prepared two weeks before delivery. The advisory report, for which a recent summary is listed here, is computed weekly and made available on Saturdays at noon. Recommendations posted from month to month may be closed out or reversed in the weekly updates offered in the electronic reports. Users of QuickTrieve 4.06 may access the weekly advisory to obtain recommendations that take effect on the following Monday.



Ask Customer Service

Each month in this column the CSI Customer Service Staff reviews some common questions and answers that may be of interest to all. This month, QuickTrieve® version 4.06 has been a topic of great interest from our callers.

Some version 4.06 features underwent substantial enhancements based on Beta Test Users' suggestions. Although these changes contributed to the delay in releasing QuickTrieve version 4.06, we feel they improve the program substantially.

Q. *I ordered QuickTrieve version 4.06 over a month ago but have not received my software. What is the status of my order and why haven't you cashed my check?*

A. The release of QuickTrieve version 4.06 was delayed as our programmers worked to implement some very good suggestions from our Beta Test users. We hope to be shipping software upgrades by the time this Journal reaches you. If yours hasn't arrived, please be patient. It will be there shortly.

Whenever possible, we have held the check or credit card payment slip for 4.06 upgrades to simplify bookkeeping. In these cases, your check will be cashed or your credit card debited when the software is shipped. Those of you who paid for QuickTrieve version 4.06 in the same check with your normal monthly payment have already had the credit applied to your CSI account. In this case, please pay this month's service charge as shown, leaving your pre-payment for the software on account.

QuickTrieve 4.06 will be shipped as soon as possible, on a first-come, first-serve basis. We appreciate your patience!

Q. *What is involved in installing a software upgrade?*

A. Upgrading from QuickTrieve 4.05 to 4.06 is really simple. You just use the same "Install" command you used last time, as described in the manual. Your User Constants and charting constants will all stay the same. You'll have the option of revising your Master Path list to simplify the sorting of data into directories.

An additional bit of housekeeping involves updating your User Manual. Please insert the supplied upgrade pages and remove the corresponding pages from your existing manual. This will keep you up-to-date on all the system's capabilities.

Q. *Please explain how I can subscribe to your stock advisory service.*

A. First, you must have QuickTrieve version 4.06 to retrieve the advisory reports. Once you have the software, you can simply request the reports by calling a Customer Service, Bookkeeping or Marketing representative. We'll code our host computer to automatically deliver the weekly report with each Friday's update retrieved after noon on Saturday. The service will be free through November, 1994. Starting with the first December report (12/3/94) there will be a monthly charge of \$15.00 for using the service.

To view the report, simply select <J> View Incoming Messages from the QuickTrieve Main Menu. From there, you may print and save the report as desired.

Q. *I collect Friday's data right after the close of the markets. If you deliver the report on Saturday, how can I get it with Friday's data?*

A. You'll need to make a second call for just Friday of the Current Week on Saturday (after noon) or any day during the following week. If you wait until the subsequent Friday to retrieve the report, please request Friday of the Previous Week. Please keep in mind that signals posted on Saturday are for execution the following Monday at the open. If you retrieve the report after that date, no new positions should be assumed.

Q. *Will I be charged for extra updates if I re-collect data for every Friday to get the advisory report on Saturday?*

A. No. We've made provisions in our billing system to accommodate subscribers of the advisory service.

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Coming Next Month:

The October '94 CSI Technical Journal promises to be one of our best issues ever. The Practical Procedure for Mining Market Profits will continue with lots of tips on selecting or designing a powerful trading system.

As always, the issue will be packed full of new Market Statistics, including IPO and stock splits and our error report.

Check out the Purchasing Power Preservation stock picks and follow our updated performance record.

If you are NOT a CSI subscriber, but plan to become one soon, please fill out the box and return it to CSI to continue receiving this Journal.

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CSI Technical Journal Subscription

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COMPUTER TYPE: IBM (compatible)
 MACINTOSH

MARKET INTEREST: COMMODITIES
 STOCKS/FUNDS
 BOTH

Holiday Schedule

CSI will be closed for voice communication on Monday, September 5th for the Labor Day holiday. The CSI host computer will be accessible as usual throughout the holiday weekend.

CSI Software Product Summary

Please check all that apply and complete the information box at right.

Mail or fax to CSI, 200 West Palmetto Park Road, Boca Raton, Florida 33432; Fax: (407) 392-7761

- QuickTrieve®/QuickManager®** for PC - To retrieve, manage & edit data (includes 1994 Alerts Calendar); Unrestricted use \$99. New daily user \$59. QuickTrieve/QuickManager version 4.06 upgrade (for current QuickTrieve users only): \$39
- QuickPlot®/QuickStudy®** for PC - Charting & analysis software (requires QT/QM) \$89
- Trade Data Manager™** - Macintosh downloader & accounting program \$59; upgrade \$49 or *FREE* with \$100 history order
- Trading System Performance Evaluator™ (TSPE)** for PC - Computes your system's capital requirements \$149
- Trader's Money Manager™** for PC - \$399 (includes TSPE); Demo disk: \$15
- TraDesk™** for PC - Traders' complete accounting system - CSI daily user \$149; Unrestricted use \$299; 30-day trial version \$22
- Seasonal Index Value Pack** for PC - Ten years of history for 33 popular commodities \$315
- Daily Updates** for PC - Starting at \$10.80 per month
- CSI Technical Journal** - Aug. '90 to present \$35/Yr. - \$5/Reprint
- CSI Mailing List** - \$200/1,000 names (CSI users omitted)
- CSI Product Catalog** - *FREE*
- On-Line Stock Advisory Report** - \$15/mo. *FREE* til Dec. '94. (requires QT 4.06)

Please add \$29 per software package for overseas shipping.

NAME _____

ADDRESS _____

DAY PHONE (____) _____

USER ID# _____

DISK PREFERENCE

5.25"/360K 5.25"/1.2 MB (HIGH DENSITY)
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9/94

All prices subject to change without notice.

An Official Guide...

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ing trading capital to markets in this way, you may find the most profitable result with the least overall risk. Please see CTJ1192 and CTJ1292 for a review of the efficient frontier that was first introduced by Nobel prize winning economist, Harry Markowitz. His work has been known as Modern Portfolio Theory and the substance of the theory is the allocation of capital resources to the performing assets in a given portfolio.

HILLARY'S LESSON

Our first lady is a now-famous former trader who enjoyed a spectacular run in the markets, parlaying \$1,000 into \$100,000 in a short period of time. Mrs. Clinton's tour de force may have been in knowing when to stop. Few traders possess the necessary restraint to step aside and preserve their winnings following an extraordinary market strike. We recommend that your trading plan include specific goals and provisions to hold onto your monetary rewards.

Once you have set your sights on success and laid the groundwork for realizing that success, you are ready to select or design a powerful trading system. Over the next two months, we will discuss the types of trading systems that have promising analytical merit, the evaluation of results and issues of training, testing and implementation. Please join us. ♦

Bob Pelletier

Ask Customer Service

(continued from page 4)

Q. *I'm not sure if I want to order QuickTrieve 4.06, although I am very interested in the Continuous Contract feature. Will you please give details on how the continuous contract feature works?*

A. In its automatic mode, the pro-

gram finds all contracts of a given commodity on your data drive and constructs a single, back-adjusted, continuous file from matching data files. You can choose whatever rollover date you desire. A back-adjustment value representing the price difference between consecutive delivery months is applied to the entire historical data set prior to each incidence of rollover. We originally planned on a back-adjustment formula that used exclusively the difference from the close of the expiring contract on the day prior to the rollover to the open of the new contract on the rollover day. This allows for back-adjustment without the need for dual contracts on the rollover day.

Because there is market movement during evening hours, many beta testers requested we offer two additional rollover formulas. One uses the close-to-close difference for the old and new contracts on the rollover day and the other uses the open to open difference for the pair of contracts on the rollover day. The new formulas require that two contracts be available for each commodity on every rollover day. If you choose one of these options and only one contract is available, the original close-to-open formula will be used. Users are notified of each instance where this action was required.

If less automation is desired, you may select specific directories to be scanned for input data. In all cases, you have the option of selecting which delivery months are to be included for your continuous contracts.

The new back-adjusted continuous data files are labeled with the delivery month code 63. Once QuickTrieve has calculated your continuous contracts, you can then update them automatically during daily data distribution. You also have the option of recalculating the series whenever you add new history into your data base or change the back-adjustment rules. ♦