

Futures Truth Magazine

#4-2007 Issue

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The Real Nuts and Bolts of Trading System Selection

This article is the follow up to last month's email article: Wants vs. Expectations in Professional Trading System Selection. **Be sure to sign up for the email list at www.FuturesTruth.com to get full access to **BONUS** articles and discounts available **ONLY** to list members.**

Ok, last month I went over a few items regarding buying a trading system. I went over some of the different types of systems, whether they were day trading systems, trading an index or swing trading systems trading an index or a futures product or even certain ETF's.

We briefly went over the triggers for systems such as price, trend break, trend bounce, technical analysis signals like a CCI break or moving average crossover.

We talked about whether YOU will trade the system or whether someone else will trade it or even if it is traded on a system with a broker for you.

We further went over many items in regard to who you are buying your system from. Like a car dealer, you want to make sure they will be around for a while to give you support/service when you need it.

Here is the outline I used and a further look into each item from last month's article:

1) Who are you buying the system from?

- a. Has your vendor been in the business for a while or are they new?
- b. How reputable are they?
 - i. Are they run by industry professionals/veterans or opportunistic salesman hoping to sell to you and then turn and run or to not honor their agreements? There are many firms that I know of that rip people off constantly without any conscience of doing so.
- c. Check the regulatory agencies to make sure they are in good standing.
 - i. If there are red flags, stay away. Some legitimate vendors have had a problem or two so don't just run if there is a complaint, but make sure that they aren't running afoul of the BBB, NFA or CFTC
- d. How do they treat you during the process of your evaluation?
 - i. Are you belittled for asking too many questions or for asking for real documentation? That in itself is a red flag
 - ii. Are you welcomed with any question and provided the info you desire? That is a good sign
- e. How is the price of their system relative to performance?
 - i. This is a BIG component of System selection, often the higher performing system from a % standpoint may NOT be the best for you when the leasing fee, monthly fees, slippage and commissions are subtracted.
 - ii. Make sure you get EVERY FEE that is associated with the system in WRITING and that YOU verify it for yourself before you commit.

WHAT TO WATCH OUT FOR WHEN BUYING/LEASING A SYSTEM (continued)

2) What type of system is this?

- a. Do they manage it for you? Well, how good are they, how long have they been doing it and what makes them so good at managing their system vs. you doing it?
 - i. What happens if they are in a position for you (others too) and their power goes out or some glitch happens? What is their answer and does it sound believable?
 - ii. What is their chain of command in their order entry, how many levels does it go through and who checks to make sure the signals are real and are entered in a timely fashion?
- b. How is their support, are they readily available for you or does the phone ring and ring and ring?

3) Who trades it? As in the points above, if someone else is trading for you, make sure they have a reputable clearing firm behind them.

- a. Are you trading it? If you have a system that YOU are trading, are the signals to buy/sell easily produced or is there a lot of effort on your behalf to decipher the signals? If so, then the price shouldn't be so high, because YOU are doing the work.
- b. Does the system trade on its own? Great, you have a system that is housed elsewhere, you "turn it on" and it trades for you
 - i. How do you risk manage your system? Can you set daily limits for losses? What about a great day, can you turn it off when it is up "X" amount? What controls/access do you have for your system?

4) Does it trade multiple markets? Can your system apply to multiple markets at once? Like the S&P and NASDAQ?

- a. If not, are you familiar or comfortable with that market that it is good for?
 - i. Can it be tweaked for other markets too and what are the charges for that
- b. If it does have the ability to trade other markets, which markets are best at any given time to trade?
 - i. Is there a way to back test that? And if so where can you get and verify that data?
- c. Do they offer assistance in choosing the markets to trade and how good are they in that selection process?

5) What is the system based on that you are looking to buy?

- a. Technical triggers?
 - i. Which ones are they and how good are the signals?
 - ii. Any filtering techniques to select better signals?
- b. Seasonal triggers
 - i. For futures traders is this seasonality updated regularly or do you have to do it?

WHAT TO WATCH OUT FOR WHEN BUYING/LEASING A SYSTEM (continued)

c. Correlating events

- i. This is my favorite; can the system have the "If this" then "do this" type of entry/exit?
 1. An example is a market opening up on a gap then seeing declining breadth, reverses and gives a sell signal
 2. Or a market opens down big, rallies, tests and then breaks out, what does the system do?

6) Has the system been optimized or tweaked? This is HUGE.

a. So many of the firms that are ripping people off are selling systems that aren't really trading and the fake results they show are just optimized results from a trade station system showing "what would have happened" and those systems almost ALWAYS are the ones that people love, then buy, then in 3 months their accounts are drained and they ask "what happened" and they get no real answer other than "Oh, we went into a drawdown". Yeah, all of a sudden a drawdown, but no real explanation why.

b. I have sold and been in systems that have had drawdown's (as every system does) and although some people have been frustrated and angry because it happened to them, at least by showing WHY it happened, you as an investor can at least deal with it from a logical standpoint and not think it was because YOU entered the market.

c. It is VERY important to have good rapport and know that your developer is reputable and that no matter what, your hand will be held and the answers to your questions answered in a concise, forthcoming manner.

7) What is the cost for the system, the REAL and TOTAL cost?

a. Is this a 1 time fee, you buy it, you own it system?

- i. Usually systems like the Turtle system are sold this way. You are given the codes to use on your own and that is that. No hand holding, you do it you have the codes and that's that.
 1. That is usually better for those who are computer savvy and know what they are doing, but for newbies I don't recommend that.

b. Monthly fees?

- i. Many systems that you buy still have monthly developer fees to make sure the developer makes \$ throughout the years from their system.
 1. Make sure you negotiate those fees as low as you can get and factor them into the equation when buying the system of your choice.

c. Commissions included? If the system is being traded FOR YOU, make sure you get a commission schedule and that it is adhered to when you get your statements. Many firms will say one thing in selling you a system and then when it starts trading will say "Oh, we charge "x" amount which doesn't include the additional fees charged by the clearing firm or the additional fees from the exchanges. Get the NET commission to you.

d. What about slippage? This is always a tough one as deep markets absorb small orders readily,

WHAT TO WATCH OUT FOR WHEN BUYING/LEASING A SYSTEM (continued)

but lesser traded markets can literally bend you over and stick it to you with market orders. Make sure you know how the orders are triggered and how they are executed and how many other clients are in the same boat as you.

- e. Do you give up a % of the gains? I hope not!
 - i. If you are buying a system, don't give up any of the gains, keep them for yourself. If a developer wants some of the gains, make sure the price of your system reflects that!

8) What is the payback? At what point do you break even and start REALLY earning a return above and beyond what you laid out?

- a. Factoring in your cost for the system, monthly fees and commissions and slippage, how well must the system do for you to get back to zero?
- b. Look at the best the system has done and then look at the drawdowns. Then look at how much you are using to trade the system.
- c. If you started with \$10,000 and the system has had drawdown's before that were \$10,000 from the high to the low, then you may wipe out your capital before being able to recover it in a drawdown scenario. BE AWARE of that.
- d. Some of the BEST systems can have drawdowns of 30-40% and it will scare the heck out of you. Decide what your tolerance is and stick to it. Some only buy/trade systems when they DO have a drawdown. Not a bad idea, but it takes guts/conviction
- e. If it is a monthly lease, how long is the lease for? Can you get out when you want and do you have to trade if you don't want?

9) Are there any Guarantees?

- a. Performance guarantees vs. downside guarantees
 - i. Make SURE that your guarantee is based on the NET results in your account!!! I can't stress this enough. I hear horror stories of sham type firms selling systems for \$4995 to people with only \$5,000 to trade with guarantees that are only good for the numbers that the firm SAYS are the results, even if you are losing EVERYDAY. Yes, this happens a LOT, please be careful as these firms will make you sign contracts where it does state that they do that (The Bastards) but if YOU sign it, YOU LOSE.
 - ii. Many of my clients went through that and they tell me they wish they could take these people to court, but you MUST read the fine print when you buy ANYTHING these days.
- b. Ask about different scenarios of profit and loss and how the guarantees are applied and what are your options for requesting a refund.
 - i. Again, see above; if you are in doubt, don't do it.
 - ii. Remember though that no one owes you a guarantee, this IS the stock/futures market, anything can and does happen.

WHAT TO WATCH OUT FOR WHEN BUYING/LEASING A SYSTEM (continued)

c. READ the FINE print and if you like what you see, you like who you are dealing with and if you can handle the risk... Go for it!

I know much of what was printed here is review for many, but for those who are starting their search these questions may help you make better choices and make fewer costly mistakes.

Even though my firm markets very profitable systems we also go through the drawdown process too, so no one person or firm is immune to that. Make sure you do your homework and the potential for gains can often be better than doing it yourself.

I am happy to answer questions that are to help you in your selection criteria. I am an excellent resource in our field and am always happy to help/lend a hand...

Email me at mlevin@tradeangle.com All the best in your trading!

Michael Levin has been in the financial markets since 1981, having been a broker and trader on the PHLX Equity Options floor in the 1980's and ran trading firms in New York in the 1990's to 2002. Mike briefly set a record in the options trading division of the US trading Championships years ago.