SEQUENCE TRADING

Creating a resilient trading model in volatile markets

KNOCKOUT FOREX

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EXECUTIVE SUMMARY

As with most industries, the use of automated trading systems continues to grow within financial markets. While many have argued that financial markets have been demonstrably inefficient in pricing all available information, these arguments have been presented during times of greater human involvement in the trading process.

With the advent of machine based trading and the expansion of the implementation of automation in trading, the speed and degree to which prices can move have been increasing with greater severity. As such, seemingly irrational price movements have been greatly exacerbated in recent years, leaving many manual traders flummoxed, as the market moves against open positions in an abrupt and sometimes violent fashion.

While we propose that trade automation is not only the most crucial element of successfully navigating highly volatile Forex markets, we note that it is also critical to develop a series of trades that make up a broader overall strategy with a focus on recovering losing trades within the overall sequence. In order to achieve this, profit objectives should be based not only on profit targets for individual trades, but also on overall profit objectives for an entire sequence of trades. When applying this as our basis for strategy development, a natural process of developing protective measures to maintain the integrity of the trade sequence emerges and a more resilient strategy results. Developers of trading algorithms both for private use and for institutional use are developing algorithms with greater complexity and using advanced hedging methodologies to react to unforeseen market moves. In markets that move as quickly and aggressively as some of the most active foreign currency pairs, the days of accurately picking market tops and bottoms are behind us. The winning traders focus on a bigger picture and start with developing methods of protecting against downside risk. The traditional terms of “position trading” and “swing trading” don’t truly apply to this style of trading. In many cases, Technical or Fundamental analysis may not even be considered and only price, individual trade profitability, and sequence profitability are the factors that inform the strategy’s next move. This style of trading can only be described as sequence trading and we believe that if market volatility is sustained, this approach will be adopted more widely in years to come.

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SHIFTING MINDSETS TO ACCOMMODATE AUTOMATION

Picking Market Tops and Bottoms - the Common Trading Education

The Forex industry, as with most trading industries, is littered with education programs, both free and for purchase. While some companies are based solely on providing the education for sale, a number of Forex brokerages offer education courses as well, with the presumably with the hope that the abundance of information will convince the trader that the brokerage is a one-stop-shop for all things Forex. Others may interject with more nefarious assumptions of the brokers' intentions in offering to educate a client against whom they intend to trade, but we believe that in the information age, a broker would benefit most from a client remaining at "home" with the broker than seeking education elsewhere.

When one reviews the basic concepts found especially in the free brokerage-provided education, it becomes clear that the mindset that is indoctrinated in the new trader is that the most important elements of trading are deciding on a point of entry for a trade, and then determining where to place one's stop loss. There is rarely a discussion of hedging tactics, especially since hedging is no longer available to U.S. retail traders as an option in individually traded Forex accounts. It is a logical result of an industry educating traders to focus on entry points that there would be an ever growing demand for information that might help a trader find a statistical advantage in the form of a technical indicator, or a bit of news that could provide just the right point of entry. Of course, it's human nature to believe that advantages like this exist, because sometimes they do, for awhile, until they don't. There is no better evidence of this than the very fact that the majority of traders lose most if not all of their trading accounts in the first six months of trading.

Because the industry is mindful of the potential lack of efficacy of the proposed indicator(s), entry techniques, the impact of the news, or whatever prediction the proponent offers, much of the trading education is quick to issue guidelines for placing stop losses. Traders generally do follow the prescribed tight stop loss approach to avoid catastrophe when the trade goes against them. This is especially true when the broker does not permit hedging, as there is truly no other means whereby a trader can protect their account from losses. Unfortunately, for most traders, the special trade entry techniques fail all too often and the stop losses accumulate quickly.

With so many educational programs available, there is certainly trading education contrary to this basic premise, however, it is rare. People who actively trade often enjoy taking part in all of the traditionally accepted "trader" activities; watching the news, joining chat rooms, sharing opinions on whatever broad macroeconomic events may

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impact a currency pair, looking for formations, etc. This industry is, for many traders, as much about entertainment as it is about profit and the industry obliges these tendencies with a deluge of information.

Shifting From a Focus on Individual Trades to a Sequences of Trades

While we will be proposing that Sequence Trading may very well be the path to success for those creating automated trading algorithms, we note that this approach requires a paradigmatic shift from the common approaches to trading. Additionally, this approach requires hedging as an option for trade protection, so traders wishing to develop trade sequences, will need to trade with a brokerage that will permit hedging

This methodology completely ignores the news, typically incorporates none of the prescribed market formation entry suggestions, and in many cases will ignore both technical and fundamental analysis. The success of the initial trade in hitting a profit target, while welcomed, is not the primary concern of those incorporating this methodology, as the initial trade is only a portion of a group of trades that will comprise a broader strategy for capturing profits. If structured correctly, the trades will work as a team with individual trades, often times in hedging positions succeeding or losing to various degrees and closing together at overall profit targets and other trades closing, partially closing, or triggering trailing profit stops and contributing to the overall profitability of the trade sequence.

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SEQUENCE TRADING STRATEGY CHARACTERISTICS

Smaller Targets Bigger Profits

Most professional traders agree that one of the main reasons that inexperienced traders fail is that they open trades that are too large, compared to their overall account size. While it could be said that inexperience plays a big role in this, the other major contributing factor is that new traders are bombarded by images of rich people and stories about traders turning $1,000 into $1 million in a few months. New traders often scoff at the notion of a 1.0% weekly return because they believe they too can land a big Forex payday like the ones they read about online. More often than not, traders come to realize, many times way too late, that this requires a significant amount of gambling. Professional sequence traders typically seek profits of 1-2% or less per sequence and anticipate closing a few small sequences per month, with the understanding that the market is the ultimate determining factor in the equation. Sequence traders can, and often do, experience several successfully closed sequences during some months and sometimes find themselves waiting for a successful sequence close for a month or more. Patience is a virtue in trading and this is especially true in sequence trading.

Smaller targets are often easier to achieve than larger ones and may provide more opportunity as sequences close faster. The ability to “clear out” losing trades with winners in an ultimately profitable sequence can allow for new trades to open and possibly catch a run in the market. Catching a big market move is the goal of every trader and having a strategy that is nimble can open this opportunity easier than having a bloated basket of open inventory. Of course, one’s trading parameters are critical variables and require the trader to carefully consider a number of factors. Here are some critical questions that a trader must evaluate for themselves before setting parameters:

1. How much drawdown am I comfortable withstanding?
2. How long do I want to wait for a sequence to close?
3. How much margin am I comfortable contributing to my sequence?

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The first two questions will, of course, require the trader to accept that market forces invariably impact the outcome of both the size of one's drawdown and the time it takes to achieve the overall sequence profit target. While rhetorical in nature, the trader will still need to consider these preferences as they develop the parameters of their strategy. The third question, however, can be answered in concrete terms. A trader can, in fact, develop a strategy with a maximum margin setting in mind, however, the trader will need to consider ways to free up margin by selectively closing open trades to avoid a sequence getting stalled at maximum margin levels.

Ultimately, the ability of a sequence trader to consistently and frequently reach profit objectives on the entire sequence is the true measure of the efficacy of a strategy.

Delineating Worst Case Scenarios

Coming to terms about worst case scenarios is of paramount importance in any kind of trading, but with automated strategies, one must be keenly aware of the fact that the tool (the series of algorithms) can be as powerful in generating losses as it can be in generating profit. One must carefully consider the impact of even the slightest variables to avoid a systemic failure of the strategy. Developing an automated strategy with functions and parameters that can "pump the brakes" is critical to keeping the strategy from running away from a trader with unintended consequences. Sequence traders often use the following methods to keep the strategy in check and manageable:

1. Individual trade sizes are typically kept very low; generally fractions of 1% of the capital in the account.

2. Positions are incrementally built in the direction of the market as the direction is revealed.

3. Adequate spacing is placed between subsequent trades in the same direction. "Trade Intervals" ranging from as low as 10 to as high as 100 pips are implemented and are correlated to position sizing.*

4. Profit stops and/or trailing stops are implemented to protect profits.

5. Hedging trades are often used when the market reverses position against open trades.

6. Dollar-Cost-Averaging techniques are used in some instances.**

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* Traders entering positions with larger trades will often consider using wider trade intervals to keep margin usage low and reduce overall risk. Large trade sizes and small intervals can create a scenario where overtrading and even margin calls can occur.

** Item 6. is often dependent on whether or not the traders' strategy incorporates technical analysis of trend indicators. Some traders will only "buy down" a position (also known as Dollar-Cost-Averaging) when longer term trends are reflected by prevailing indicators. Some traders, however, will structure a sequence based on current daily price ranges and buy down a position until the buy-down meets their maximum margin requirements.

Keeping Score

The final crucial element to sequence trading is the methodology for determining when to close a trade, a group of trades or the entire sequence. Sequence traders actually vary widely in their approach to profit taking. While it may seem like the simple answer is to close every profitable trade at a specific profit target, or to do the same for the entire sequence, there is actually much more that needs to be considered. More complex strategies will have a series of logical algorithms on both individual trades, trades in a recovery sequence and trades in an overall profitable sequence and the execution of orders to close trades can be structured by priority.

In dealing with losing positions, some traders will prefer to keep these losing trades open until an equal size opposing trade's profit outweighs the loss of the losing trade and close the two trades together with a net profit on the pairing. Other traders will decide that the opposing trades need to remain open in relation to one another if the winning position is support for an overall hedged position on the entire basket of open trades. Others still will prioritize profit targets on individual trades regardless of the impact on the overall position.

Regardless of how a sequence trader prioritizes the closing of trades and profit taking, it is vital to any sequence trader to be able to maintain a running total of profits and losses against the overall sequence profit objectives. Accounting is crucial to avoid losing track of the score on the overall sequence. After all, if the objective is to compile winning sequences, one has to be able to track performance.

Analysis of the Sequence

Like any successful trader, a sequence trader analyzes his or her trading results in the aftermath of a sequence. The sequence trader, however, may focus much less attention on the initiation of the entry trade and focus more on the response of the strategy to adverse market moves. The wise sequence trader will consider each and every parameter in reviewing the performance of the strategy, posing questions like:

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1. How many trades closed as winners versus losers?

2. How many times was my trade entry challenged by the market?

3. What was my deepest drawdown?

4. How deep could my drawdown have been?

5. What was the most margin I used?

6. What is the maximum margin this sequence could have used in a worst case scenario?

7. How does the spacing of trades impact my overall profitability?

8. How might closing partial positions and employing trailing stops impact the profitability of the strategy?

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SUMMATION

With our adoption of a fully automated trading system, we have come to find that sequence trading is the most effective way to confidently trade within volatile markets.

Our algorithms required years of careful consideration, back testing and testing in live markets. The ability to prepare a detailed response to adverse market conditions in advance of those conditions creates considerable advantages for a trading system. Just as one prepares for handling emergencies in any situation, the level of one's preparedness is directly correlated to one's ability to survive difficult circumstances. Trading is no different. Having a solid and well-prepared game plan eliminates confusion and frustration, reduces risk, and positions a trader to capitalize on market action that may perplex other traders.

Overall, we see little evidence to lead us to project an abatement of volatility in the coming months and years. The involvement of central banks in affecting the pricing of currencies appears to occur with ever greater frequency. More attention is spent on the directives and even the musings of the various Central Bank Chairs than ever before in history. Where others may see this as a perilous environment for trading, we believe there is ever greater opportunity for us and for our clients.

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