



Special Report

Evaluate A Trade Properly And Improve Your Opportunity For Success

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Successful trading is about how well you exit a trade, not the method you use to get in. How well you exit can be measured by your profits, but can also give you some idea of how well your methodology will perform in the future. The evaluation of performance is called money management. While there are many ways to measure performance, I prefer the Reward-to-Risk plus Percent Winners method.

Let's start with the premise I use, as a professional trader, when setting performance guidelines for any system I develop. A system can be anything from fundamentals to charting to intuition to computer models to flipping a coin. Regardless of what strategy I chose, I want it to meet the following standards: produce 50% winners and make twice as much on my winning trades, as I lose on my losing trades. So if I make 10 trades, then I would expect 5 to be winners. If the average profit on the five winners is \$1000, then I would expect the 5 losers to have an average loss of \$500 or less.

If my system produces only 30% winners, then it is still equivalent to my 50-50 2:1 goals, if I can produce a reward-to-risk of 4:1, instead of 2:1. Likewise, if my average profit is \$1000 and my average loss \$900, for a 1.1:1 ratio, then I can still count this as a good strategy if I can produce 70% winners.

The easy part of achieving my goal of 50% winners with a 2:1 reward-to-risk ratio is the 50% winners. I can flip a coin and get that. The hard part is the 2:1 ratio. How do I exit my trades so that I produce the 2:1 performance results? And further, if my ratio is not 2:1, then how do I adjust my percent winners to compensate for that? How traders determine when to enter a market position is as varied as anything I've seen. I almost never criticize someone's approach to getting in. What works for some people may not for others. For instance, I have never figured out how to use the relative strength study as a consistent signal in any trading approach I've used. Yet many people readily use this indicator as a trading signal. So what approach you use ends up being very personal.

I recently had a query where the caller questioned the use of system trading (the black box approach as some call it), where a computer tracks a rigid set of rules and spits out buy and sell signals. I agree that system trading has its flaws, but then so do most trading approaches. If they didn't, then they would make tons of money and everyone would be using it and we would all make tons of money, which, as we all know, doesn't happen.

I believe that what happens is that any trading approach works for awhile. Then, for whatever reason, a change in market dynamics perhaps or too many people using the same approach, the strategy quits working. This is what often happens to black box programs. The programs are developed using historical data. We optimize (curve fit) the trading rules so it produces the results we are looking for. For instance, you might discover that from 1990 to 1995, any time a market goes up 4 days in a row, you can sell a higher opening the next day and exit with a profit on the close of that 5th day with a profit.

Satisfied that this approach produces the appropriate reward ratios, the next step is to test the theory on different data from another time period. So we choose 1996-2000. To our delight the system holds up in the test period. We are now confident that we have found a solid method for trading. We put our money in an account and begin using our thoroughly tested strategy. For awhile the system continues to work, so we add more funds, and trade larger positions. Then, the market dynamics change. Trends start running longer before they break. Volatility increases because of the record high prices. Suddenly our system isn't working at all and we are taking huge losses.

I've seen this happen so many times, not only from my own experience, but from watching and evaluating other professional commodity trading advisors, of which I used to be one of them for 15 years. High flying traders one year often find it impossible to produce a winner the next year. So what's the solution?

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Awareness is probably the answer. The important lesson is that a trader can't rely on just one approach. Markets are dynamic and have personalities. They often change, and without warning. The key is to be flexible and to have a variety of strategies that you are comfortable with. That way you can evaluate the market and see what it is offering. Then you select the best strategy for what the market is giving you.

The final step is to evaluate the trade against a reward-to-risk and percent probability test to make sure that the trade makes sense from a money management standpoint. It's funny how a strategy that stops working, usually revives itself several years later and you find yourself coming back to it. So if something stops working don't give up on it, re-evaluate, tweak it, and keep it for future situations, when the markets are conducive to its use. Now let's look at a few examples of using different strategies for different market conditions.

Lately I have been using an option ratio spread strategy in soybeans and coffee. The options for these markets are priced right, and they offer a good reward-to-risk. For example, let's look at the coffee trade. With the September '04 coffee futures at 71.50 on 7/7/04, I bought one September coffee 80 call at 1.40 points or \$525. At the same time, I sold three September coffee 90 calls at .80 points or \$300 each, totaling \$900 in collected premiums. The net between what I paid (\$525) and what I took in (\$900) was a net \$375. If I subtract our \$49 per contract commission rate, then I have a net income, to me, of \$179.

Now let's look at several scenarios to see what can happen. First let's assume the price of coffee, on the day these options expire, which is 8/13/04, never gets above 80.00. Then all the options expire worthless because neither the 80 nor the 90 strike price has been exceeded. In this case I would make a net profit equal to the \$179 of excess premium income I collected. So any price of 80 or less, I profit by \$179.

If the price of coffee closes at 90.00, on the day the options expire, then we are 10 points in-the-money on the 80 call. This is a profit of \$3,750 plus our excess option income of \$179, which then totals \$3,929. The 90 calls expire worthless because we have not exceeded the 90 strike price. Under this scenario, we realize the maximum profit we can make on this trade, \$3,929.

If the market closes at 95.00, then we are in the money on the 80 call by 15 points, that's a profit. However, we are also in the money on the 90 calls by 5 points each (15 points total on all three options), and that's a loss because we are short these options. At this point our profits offset our losses and we are ahead only by the \$179.

At 95.24, this trade is at breakeven. Above 95.24, we start losing money at the equivalent rate of being short two futures contracts. The final piece to the puzzle is how I hedge my risk above 95.48.

My plan is to buy two 95 calls if and when the market reaches 90. If that happens, then these options could cost anywhere from \$100 to \$700 each, depending on how much time is left to expiration. Let's assume the worst case scenario and say I have to spend \$700 for each option. Then my total risk for this trade is \$1,400 plus \$98 for commissions minus the \$179 excess premium income, which equals \$1,319. With a profit potential of \$3,929 and a maximum risk of \$1,319, I have a reward-to-risk of 3:1, which is excellent.

Normally, with this level of reward, I would want a 40% chance of being right. That's because we usually are in a trade that if it doesn't work there is a loss to it. In this case, if the market stays down, moves lower, or doesn't get above 80, then I still profit by \$179. From 80 to 95, I make a profit of some kind, while above 95 I lose the cost of my 95 call options.

In this trade, the market would have to move 23.50 points from 71.50 to 95.00 for me to lose money. With 30 days until expiration, I have seen a 25 point or greater move in only 5 one-month periods in the last 60 months. Thus, the chance of hitting 95.00 is less than 10%. However, there were many monthly moves of 15-20 points, so I have some reasonable belief that I have a good chance of exceeding 80.00 but not 95.00.

Therefore, I conclude this to be an excellent trade with good structure, and it meets my money management requirements.

Let's look at one more. This is actually a 1-2-3 trade. It's in September '04 wheat. Wheat made a 12 month high on April 4, 2004 at 432 1/2. It made a 1-point low on July 2, 2004 at 337. There was a 2-point high on July 7, 2004 at 351 1/2, and a 3-point low on July 9, 2004 at 337 1/2. The rules for 1-2-3 trading state that if the market now rallies above the 2-point high of 351 1/2, then it should continue to rise to the 50% retracement price of the 12 month high to 1-point low. By taking the 432 1/2 high and adding to it the 337 low and then dividing this sum by 2, we get our 50% retracement objective of 384 3/4. We now know our profit potential, which is from the 2-point high of 351 1/2 to the 50% retracement objective of 384 3/4, which equals 33 1/4 points. Our risk, according to the rules, is from the 2-point high of 351 1/2, back down to the 1-point low of 337, which equals 14 1/2. This creates a reward-to-risk of 2.3:1. Not bad.

To determine our probability of success, I went back over the past five years to determine how often a 2-point breakout continues on to reach the 50% retracement objective within a six month period. The answer is about 40% of the time. At 40%, I would like a reward-to-risk of 2.8:1. So 2.3:1 is close. Does this rule this trade out? Not necessarily.

I can look to other things to confirm this trade as a good investment risk. For instance, there is a seasonal up-trend in wheat from August 5th to August 24th that has worked in 14 of the past 15 years. I can also see from my stochastics, which currently is under 10%, that the market is very oversold. Lastly, I know from my own research, that by using certain proprietary measuring devices, that the downside objective has probably been reached.

Now that I am satisfied that the trade is one to take, the question is how to structure the trade. Do I use options, futures, options and futures, or do I create synthetic futures using options, or do I use some sort of ratio trade like described above, or maybe our buy-and-write strategy might work best? This is the subject of another article. Until then, if you have any questions or want to visit about how we would structure the wheat trade described above or any other market, please contact your Slipka Trading representative at 1-800-753-3665 or email us at info@slipkafutures.com.

Kindest regards,
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