Trading Systems Series

HOW DO I TRADE STOCKS.COM

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TRADING SYSTEMS AND TECHNICAL ANALYSIS INDICATORS

Many new traders have a tendency to confuse trading systems and technical analysis indicators. From observations, the majority of the confusion comes in the form of confusing the use of technical analysis indicators with systems. Nevertheless, I'll discuss both here.

Technical Analysis Indicators

A technical analysis indicator is used to determine the trend of a market, the strength of the market and the direction of the market. A technical analysis indicator may be specific or non-specific. Some technical analysis indicators can be quantified in the form of an equation or algorithm. Others show up as patterns (e.g. head and shoulders, trendlines, support and resistance).

At some point, the technical analyst will receive a signal. This signal is the result of one technical analysis indicator or more than one technical analysis indicators in combination. The signal indicates to the technical analyst a course of action (e.g. buy, sell, hold). The technical analyst will determine the method to use. However, it must be specific, objective, and reliable. The method is a subjective and not mechanical. This is a significant difference between a mechanical trading system and a technical analysis indicator.

Anyone with an imagination can create a technical analysis indicator. Everyday at least one new technical analysis indicator is created. Over the years thousands have come and gone. Most of them don't tell us anything about a market that time tested technical analysis indicators tell us. They're useless. Many others are of no use whatsoever.

Timing indicators tend to work in some types of markets (e.g.

trending or sideways) and not others. They may also work with some securities and not others. Therefore, they tend to be unreliable. Timing indicators are also subjective and require interpretation. Based on my experience, most amateur traders tend to use timing indicators and base their decisions to buy, sell, or hold on them. Many traders, after using an indicator or indicators with success turn them into a trading system. This does not mean that the trader has found the holy grail of trading systems. Instead, what many traders find is that when the indicators are combined into a trading system, they lose their effectiveness.

Technical Analysis Trading Systems

A trading system is created by generating signals, setting up a decision making procedure, and incorporating risk management into the system. A trading system is supposed to be objective and mechanical. The analyst combines a set of objective trading rules (usually in a formula(s) or algorithm(s)).

As a general rule, good technical analysis indicators are the building blocks of good trading systems. However, as previously mentioned, even good technical analysis indicators can lose their validity when combined in a trading system. Therefore, it is important to not only back-test your system but to also forward-test your system in real time.

Pitfalls of Trading Systems and Technical Analysis Indicators

Trading systems are supposed to be objective and mechanical. They take the intuition out of trading. Buy when the system tells you to and sell when the system tells you to. The problem is that there are not a lot of good trading systems out there.

Traders tend to lose objectivity when using technical analysis indicators. The trader is not able to remain objective and the subjectivity of using the indicator overwhelms him. I think it has to do with a compulsion many traders feel to have to trade. They then tend to subvert their indicators by trading when the signal is not entirely clear.

Traders have a tendency to test their trading systems and technical analysis indicators on an insufficient amount of data. Analysts need to test trading systems and technical analysis indicators on a wide array of data in different types of trading markets. Additionally, many traders and analysts don't forward test their trading systems and technical analysis indicators in real time. They rush to trade based on insufficient back-testing and forward-testing. Thus, it is really hope that they are trading on and not a sound, valid basis.

Many traders fail to incorporate sound risk management techniques in their trading systems. Additionally, many traders fail to incorporate stop loss orders with their initial orders when using technical analysis indicators only.

Traders also tend to over-optimize their trading systems. They start asking the what-if question and back-test the trading system with different parameters. Of course they are going to trade with the parameters which generate the highest amount of wins. However, in real time these over-optimized systems rarely perform well.

Another trap traders fall into is to use too many technical analysis indicators. Find the few that work consistently well for you and go with them. I find the time tested technical analysis indicators to be the best. However, there is no reason you won't find some new indicator that works consistently well for you. Just make sure that you forward-test it in real time.

Conclusions

I have always considered speculative trading more of an art than a science. The best traders I've ever seen use technical analysis and intuition. However, despite their intuition, one thing common to all of them is that whether they can articulate them or not, they all have a set of well-defined rules they trade by. They consistently generate very nice profits.

If you are considering buying technical analysis software be very skeptical of systems that advertise tremendous results. They have probably been over-optimized to show excellent back-tested results and won't work when you try to use them. Of course the company will have a whole list of reasons why it isn't working well at that particular point in time. However, excuses don't do you any good when you're losing hard earned money. Drawdowns are money out of your pocket. You will never make it back.

Source: **Solerinvestments.com – Trading Systems and Technical Analysis Indicators**