

Initial System Assessment

Prepared for [REDACTED] by Paul King

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1 Introduction

This report is an assessment of [REDACTED] trading system previously described to me via email. The assessment is based on my opinion, expertise, and experience and covers the completeness, robustness, and likely effectiveness of trading the system.

It does not include any results from actual system testing or simulation; that will be performed after any questions raised by this report regarding the system have been answered or clarified.

2 System Assessment

The [REDACTED] as described is a long term trend following system designed to capture all major trends in the selected markets and instruments while limiting total risk, and attempting to protect open profits.

Objectives for this system are [REDACTED] per year return on capital, with maximum of [REDACTED] drawdown of initial capital or equity high.

Proposed system allocation is [REDACTED] which represents half of the total capital available.

2.1 System Hypothesis

The system is based on the hypothesis that [REDACTED]

2.2 Market Selection

The proposed markets are: [REDACTED]. These markets have excellent liquidity, almost infinite scalability, and reasonable implementation costs (spread, commission, slippage). These markets generally move based on macro-economic factors which tend to be long-term and slow to change; this means the selected markets are ideal candidates for a trend-following system

2.3 Instrument Selection or Filter

The instruments selected for trading are:

[REDACTED]

Since this is a fixed portfolio, total maximum risk is pre-defined ([REDACTED] of system allocation), and a liquidity filter to determine tradable instruments is not necessary.

2.4 Setup Conditions

Possible Long [REDACTED]

Possible Short [REDACTED]

The system can take both long and short positions, so it is not dependent on an up-trending market. Use of the [REDACTED] is more sophisticated than a simple price crossing a moving average approach and should reduce the number of false signals generated. [REDACTED] are long enough to avoid frequent whipsaws due to market noise.

2.5 Entry Signal

Enter Long on [REDACTED]
Enter Short on [REDACTED]

The entry signals ensure that positions are always entered in the direction of the prevailing trend. Waiting until [REDACTED] is reached rather than simply using the [REDACTED] will make the entry slightly later, but will reduce the number of false-entries by waiting for this confirmation. I believe this is a sensible entry signal.

One implementation decision that needs to be made is whether to allow intra-day entry at the moment the [REDACTED] is hit, or enter at the open the next day. If entering at the open on the next day a possible additional entry criterion may be that the open is in the correct direction (i.e. the trend has resumed the next day).

2.6 Position Sizing

[REDACTED] Risk based on current system allocation

[REDACTED] risk per position would be considered a good 'normal' setting. Less than [REDACTED] would be conservative, and greater than [REDACTED] would be aggressive.

Adding profits and losses to the system allocation as trades are made is a sound anti-martingale position-sizing technique. A more conservative approach would be to deduct open risk from the current system allocation before calculating position size (i.e. assume open trades will be stopped out at maximum loss).

A more aggressive approach would be to increase the position sizing percentage for the part of the system allocation that is realized gains from a certain point in time (e.g. the beginning of the year). This has the effect of risking more of the portion of the allocation that is profit than the base capital and will amplify returns during profitable periods.

Since the position size is based on a stop that is volatility-based, during periods of very low volatility, required position-sizes may be too great for the account size available. Historical simulation would determine the minimum account size required to trade this system on the full portfolio.

I suspect that [REDACTED] risk may not be large enough to achieve the desired yearly return of [REDACTED]. Historical simulation could also determine this.

2.7 Loss Limiting Stop

██████████

Having a loss-limiting stop based on recent volatility measured by an average true range is an effective way to determine when the trade is not going to work and should be exited.

██████████ should be large enough to be outside the normal noise of the instruments traded.

One issue is what should be done if volatility significantly increases after the trade is placed. Should both the position-size and stop be adjusted to account for this, no adjustment (i.e. keep the same stop), or adjust only the stop (i.e. take more risk on this position)?

Another issue is whether to allow intra-day exits, or to exit at the open the next day if a Loss Limiting Stop is hit?

2.8 Profit Taking Stop

Exit Long at ██████████

Exit Short at ██████████

Using some kind of a trailing stop to protect open profit is a sound technique to allow profits to run, but attempts to protect some of the open profit.

One issue is that simply using the ██████████ and ██████████ means that this profit taking stop is not a true trailing stop and can move further away from your position during the duration of the trade. A possible solution to this is to use the ██████████ *since trade entry* rather than simply over the preceding ██████████ days.

Another issue is whether to allow intra-day exits, or to exit at the open the next day if a Profit Taking Stop is hit?

2.9 Exit Signal

No additional exit signals are required, since the Profit Taking Stop and the Loss Limiting Stop will be hit before a signal in the opposite direction can be generated.

3 Summary

The system as described is based on a sound hypothesis, trades liquid instruments, and has all the essential components of a complete trading system.

The following issues or areas for clarification were outlined:

- Whether to allow intra-day entries, and exits.
- What the minimum required account size to trade the full portfolio would be.
- How to manage volatility increases in open positions.
- Whether [REDACTED] risk per position is sufficient to achieve a [REDACTED] per year return.
- Whether the Profit-Taking stop should be changed to a [REDACTED]

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