

Date: October 26th, 2005 14:00GMT

Expert: David Lyder, Co-founder of iExpertAdvisor, LLC,

Mechanical Trading Systems

- Why everyone trader should have one?
- Various types of systems
- Strategy for building a system

Who is David Lyder?

David Lyder is a co-founder of iExpertAdvisor, LLC, as well as the author of Automatic Alpha: How to Build a Winning FOREX Trading System. iExpertAdvisor is a newly formed company dedicated to providing information and ideas about FOREX trading systems. Visit us at <http://www.iExpertAdvisor.com> .

If someone offered you \$10 a day, everyday, what would you say? Would you reply: No, thanks - \$10 isn't that much.

If your smart, you'll take the money. Why not? After all, \$10 is \$10, and it adds up quickly. Running a profitable mechanical trading system is similar to someone giving you money almost everyday. Whether it is \$10, \$100, or even a \$1000 – the work required after building the system is the same. Simply turn on your computer and start the program. If gaining access to an automated trading platform was expensive, that might be a legitimate reason for a trader to not have a mechanical system. After all, who wants to accept more risk. Now, in addition to beating the market, you also need to generate enough profit to cover the cost of the trading system. But a free platform is available. And as a FOREX trader, you are already aware of demo accounts and mini accounts.

So here is the situation:

You have a free platform capable of developing, testing and executing an automated trading system.

You have a demo account so you can run the system live and evaluate its performance before risking any money.

When you are satisfied with the system's performance on the demo account, you can open a mini account and risk a limited amount of capital.

Given the upside of running a mechanical trading system, there is no reason every FOREX trader should not run at least one mechanical system.

Whether you are a technical trader or a fundamental trader or a discretionary trader – why not have a mechanical trading system running in the background continuously generating profits for you?

And here is the bonus: the skills used to develop a mechanical trading system will enhance your skills as an overall FOREX trader. Once you have learned the framework used to develop a robust mechanical trading system you will naturally apply the same methods to all of your trading decisions. This will make you a better FOREX trader. Okay, so you realize and appreciate the benefits of building and running a mechanical trading system. Well then, how does a trader go about building a mechanical trading system? That is what this Q&A session is about.

Various Types of Systems There may be as many kinds of mechanical trading systems as there are traders. To name a few types of systems:

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Breakout System

This system determines a breakout price level. If the price of the currency pair breaks through this level, the system trades in the direction of the breakout.

Reversal System

This system looks for signs that a price movement is near exhaustion and will soon move in the opposite direction. When the price exhaustion is confirmed, this system trades in the direction of the reversal.

Indicator System

An indicator system simply follows the rules of the particular indicator. Wells Wilder's oscillator systems are often built as mechanical trading systems.

Trend Following System

A trend following system determines the existence and direction of a trend. If a trend exists, the system trades in the direction of the trend. Any of these systems can prove profitable. But be warned, the road is littered with new traders who were fascinated with the "holy grail" system. I can not even count how many traders I have worked with that were

- just looking for a scalping system that
- just went into the market a few times a day and
- just scalped about 20 pips everyday
- A system like this can be difficult to build. (Especially if it is your first system). There are a few reasons:
 - with so many trades, trading costs become a significant factor;
 - while price movement in general may not be random, the lower the timeframe, the more random it behaves;
 - these systems are difficult to backtest – most historical tests do not use tick data, which is required for testing this kind of system;
 - many of these systems usually do not work for long.

Actually, there is evidence that suggests the only type of trading system that proves to be profitable over the long run is the trend-following system.

Gary Hirst, of Hirst Investment Management Inc., conducted research on technical analysis (TA) in 1991 and found that most TA systems, besides trend-following systems, eventually give back their profits. (See this [article](#)).

This does not mean that many of these TA systems are never profitable. In fact, many of these systems have a good run – maybe 5-10 years of profitability. Then they stop working.

Therein lies the problem with building a TA system as your first mechanical system. You don't know when the system will stop working. (Probably when you start trading it.)

So there are at least two good reasons to build a trend-following system (especially if it is your first mechanical system).

Trend-following systems have produced steady and consistent results historically. The market has been shown to distribute returns unequally – that is with long fat tails.

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A trend-following system is easy to divide into separate parts; each part can be developed and tested separately.

Strategy for Building a System

A good strategy for building a mechanical trading system is to break the system into parts. Each part is then individually developed and tested. A trend-following system is easily separated into the entry and the exit.

The Entry

The job of an entry in a trend-following system is to get the trade started in the right direction.

An effective method for testing the entry is to simply exit the trade after a fixed number of bars (the exit-bar test) and record the winning percentage. The trading costs are not considered in the test. Neither is the profitability. The only metric considered is the winning percentage:

$$\text{Winning percent} = (\text{number of winning trades}) / (\text{total number of trades})$$

The winning percent must be greater than 50% - otherwise the entry is no better than random. Generally, the higher the winning percent, the better the entry.

After an acceptable entry has been proven through the exit-bar test, the entry can be tested for robustness.

In this context, a robust system is defined as a system whose input can be varied without significantly changing the output.

Generally speaking, a system with fewer input parameters is usually more robust than a system with many input parameters.

If an input parameter can be removed from the entry, without reducing its effectiveness, the parameter should most certainly be removed. This will increase the robustness of the entry.

The entry can be tested for robustness by varying the input parameters greatly, and retesting the entry using the exit-bar test.

For instance, if the entry uses a 10 period moving average (MA) as an input parameter, test the entry using a 5-period MA and then a 20-period MA. If the winning percent is still acceptable, the entry is probably robust.

The Exit

Most traders place too much emphasis on the trade entry. Again, the sole purpose of the entry is to get the trade started off in the right direction. It is the responsibility of the trade exit to actually make a profit.

The quality of an exit is judged by its profitability – so when performing exit testing all trading costs should be included in the test.

The simplest exit strategy is the fixed stoploss and fixed take profit. This is often used as a benchmark against other strategies.

An exit strategy can be based on a technical indicator, a time factor, and of course a price-level.

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The most popular price-level based exit strategy used with trend-following systems is the trailing stop.

There are many creative ways to implement a trailing stop strategy. The simplest is for the stop to trail the price by a fixed number of pips. More advanced trailing stop strategies may consider the highest and lowest price values in the last few periods as well as the time the trade has been open.

In order to test an exit objectively, the entry must remain constant. With a constant entry, each exit strategy can be tested and the results can be compared and evaluated.

In general, fixed stops usually provide a greater profit than trailing stops. However, trailing stops usually have a higher winning percentage. The trading system developer must choose what metric is more important: profits or winning percentage.

Session: **FXstreet Moderator** (Oct 26, 2005 10:00:21 AM)

Thank you for joining today's Live Q&A Session. We will begin with the pre-registered users' Questions in approximately 5 minutes. Meanwhile please read the text speech that you will find on the left of this chat window

FXstreet Moderator (Oct 26, 2005 10:00:34 AM)

Thank you for your participation.

FXstreet Moderator (Oct 26, 2005 10:00:51 AM)

Please find the whole speech of our guest in the left box of the chat. Be sure to read the whole speech at once without any interruption, making its reading and comprehension easy. You won't miss a single thing from our guest host.

FXstreet Moderator (Oct 26, 2005 10:01:03 AM)

Our guest host will first start answering a selection of the pre-registered user's questions

FXstreet Moderator (Oct 26, 2005 10:01:20 AM)

When reading the speech please jot down any questions you may have so you are ready to post them live.

FXstreet Moderator (Oct 26, 2005 10:01:33 AM)

Our guest will answer live Questions sent to the FXstreet Moderator during the course of the session

FXstreet Moderator (Oct 26, 2005 10:01:53 AM)

For those who are unfamiliar with chat sessions like this, please feel free to ask questions at anytime to the moderator.

FXstreet Moderator (Oct 26, 2005 10:02:15 AM)

At the end of the session, the link for the transcript and the PASSWORD will be posted.

FXstreet Moderator (Oct 26, 2005 10:03:26 AM)

Today I am delighted to welcome back our good friend and guest speaker David Lyder CEO and founder of www.iexpertadvisor.com

David (Oct 26, 2005 10:04:03 AM)

Hello and welcome FOREX traders - thanks for joining us today.

FXstreet Moderator (Oct 26, 2005 10:04:29 AM)

David Lets begin with pre Reg questions.

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David (Oct 26, 2005 10:04:48 AM)
Ok, we got some great questions already ...

David (Oct 26, 2005 10:04:55 AM)
First question

David (Oct 26, 2005 10:05:07 AM)
Would you charge for MetaTrader in future?

David (Oct 26, 2005 10:05:27 AM)
I don't represent MetaQuotes, the developer of MetaTrader,

David (Oct 26, 2005 10:05:41 AM)
or any of the brokers that support the MetaTrader platform,

David (Oct 26, 2005 10:06:10 AM)
so I can't answer for them. so I can't answer for them.

David (Oct 26, 2005 10:06:24 AM)
As far I know, there are no plans to charge for MetaTrader.

David (Oct 26, 2005 10:06:33 AM)
Some brokers that offer MetaTrader add an extra pip to the spread.

David (Oct 26, 2005 10:06:52 AM)
So it's not exactly free. But if you shop around,

David (Oct 26, 2005 10:07:14 AM)
you can probably find a broker that offers a good deal on your favorite pair

David (Oct 26, 2005 10:07:26 AM)
For instance InterBankFX offers a 2 pip spread on the EUR/USD.

David (Oct 26, 2005 10:07:50 AM)
Next Question:

David (Oct 26, 2005 10:07:57 AM)
How does one backtest a mechanical system? What tools are available? Thanks.

David (Oct 26, 2005 10:08:14 AM)
That is one of the great things about MetaTrader

David (Oct 26, 2005 10:08:38 AM)
the same platform that you use to build the trading system offers provides back-testing.

David (Oct 26, 2005 10:08:53 AM)
It is built in, and pretty easy to use.

David (Oct 26, 2005 10:09:08 AM)
Next Question:

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David (Oct 26, 2005 10:09:23 AM)

What is a good software program to setup a Mechanical system? What do you use? Thanks!

David (Oct 26, 2005 10:09:41 AM)

In the past, TradeStation has been one of the most popular platforms.

David (Oct 26, 2005 10:09:59 AM)

But TradeStation is expensive – especially if you are new to mechanical trading.

David (Oct 26, 2005 10:10:16 AM)

I recommend FOREX traders try out MetaTrader – since it is free.

David (Oct 26, 2005 10:10:34 AM)

It is a risk-free opportunity to try out mechanical trading.

FXstreet Moderator (Oct 26, 2005 10:11:37 AM)

Thank you very much for that, David

FXstreet Moderator (Oct 26, 2005 10:11:49 AM)

Please post your questions now and David will attempt to answer as many as possible.

JSB (Oct 26, 2005 10:12:40 AM)

I use four hour bars for entry so to test my entry system would I take the the close of the third bar after the entry bar?

David (Oct 26, 2005 10:12:54 AM)

Great question

David (Oct 26, 2005 10:13:10 AM)

You can try a few scenerios

David (Oct 26, 2005 10:13:27 AM)

one would be to test the exit after 3 bars

David (Oct 26, 2005 10:13:35 AM)

to see if the trade started correctly

David (Oct 26, 2005 10:14:06 AM)

another test would be to exit after the average time most trades are opne

David (Oct 26, 2005 10:14:24 AM)

maybe about 8-12 bars (?)

Omar (Oct 26, 2005 10:14:39 AM)

what's the use of backtesting or simulation if 'past performance is not indicative of future results'?

David (Oct 26, 2005 10:14:51 AM)

Really good question Omar

David (Oct 26, 2005 10:15:19 AM)

You can still test if the system was robust in the past

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David (Oct 26, 2005 10:15:31 AM)
this means it has a better chance of working in the future

David (Oct 26, 2005 10:16:00 AM)
if it was not even robust in the past, there is very little chance it will work going forward

kb (Oct 26, 2005 10:17:00 AM)
In a trailing stop system wich you think is the best number to trail, for scalp in 10 min window, i think 15 pips, do you?, following a daily trend. Thanks a lots. Hernan

David (Oct 26, 2005 10:17:34 AM)
This depends on the currency pair. I am not a big fan of scalping systems

David (Oct 26, 2005 10:18:04 AM)
it must be outside the noise. I would use a multiple of the ATR, instead of a fixed number.

greg (Oct 26, 2005 10:18:35 AM)
Using a successful mechanical trading system, what return per year should one expect?

David (Oct 26, 2005 10:19:09 AM)
It's hard to answer this question. You need a few mechanical systems

David (Oct 26, 2005 10:19:25 AM)
but you could expect 20-50% a year

David (Oct 26, 2005 10:19:36 AM)
depends on the risk you are willing to accept

David (Oct 26, 2005 10:19:47 AM)
if you are looking for low risk, closer to 20

Jack1 (Oct 26, 2005 10:20:38 AM)
David, it is most hard part to identify an early stage of a trend for a trend following system, so may it be never, never got a useful mechanical trading system for trend-following system?

David (Oct 26, 2005 10:20:48 AM)
Great question Jack!

David (Oct 26, 2005 10:21:16 AM)
The key to developing a trend following system is to realize 2 things:

David (Oct 26, 2005 10:21:38 AM)
1. if there is no trend, you are not in the market

David (Oct 26, 2005 10:21:58 AM)
2. you never get tops and bottoms - only a portion in between

David (Oct 26, 2005 10:22:27 AM)
if you build the system following these rules, it can be done

JSB (Oct 26, 2005 10:22:40 AM)
Is "forward" testing a reasonable alternative to "back" testing if one is not confident of their program abilities?

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David (Oct 26, 2005 10:22:48 AM)
Good one JSB

David (Oct 26, 2005 10:23:04 AM)
Not only a reasonable alternative, but generally a better one!

David (Oct 26, 2005 10:23:22 AM)
Backtesting allows you to speed up the development process

David (Oct 26, 2005 10:23:44 AM)
but if you have time, and can test going forward, you will get more accurate results

greg (Oct 26, 2005 10:23:59 AM)
How are you defining risk? Would 5% of your balance be high? and 2% be low for example? Thanks

David (Oct 26, 2005 10:24:31 AM)
Greg, the actual numbers a personal choice - those sound reasonable

David (Oct 26, 2005 10:24:58 AM)
I define risk using: account equity, max drawdown of the system/s and the number of systems

David (Oct 26, 2005 10:25:28 AM)
it can get a little complicated. A simulation method is required.

Guest (Oct 26, 2005 10:25:44 AM)
What stops and profit limits do your systems use?

David (Oct 26, 2005 10:26:37 AM)
Next Question: What stops and profit limits do your systems use?

David (Oct 26, 2005 10:26:55 AM)
Our systems use multiples of ATR

David (Oct 26, 2005 10:27:14 AM)
On an hourly chart, some where between 4 - 6 ATR

David (Oct 26, 2005 10:27:25 AM)
the ATR is usually based on 24-periods

David (Oct 26, 2005 10:28:00 AM)
Next Question: I have backtested a trend following system and will likely start trading it. Over 100 trades the system has 39% accuracy and a 3.5:1 reward/risk ratio. In your opinion, how does this measure up compared to other trend following systems?

David (Oct 26, 2005 10:28:25 AM)
Not great, from my personal point of view.

David (Oct 26, 2005 10:28:37 AM)
I like to see a higher winning percentage

David (Oct 26, 2005 10:28:52 AM)
especially if it is a black-box system

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David (Oct 26, 2005 10:29:10 AM)
39% can get real hard to run after a few tough losses

David (Oct 26, 2005 10:29:53 AM)
You might be tempted to turn the system off

David (Oct 26, 2005 10:30:12 AM)
unless you have a real good understanding of how the system works

David (Oct 26, 2005 10:30:28 AM)
that's why I think it is best to develop your own system.

David (Oct 26, 2005 10:30:51 AM)
Next Question: When using a trending following system is it reasonable to determine the trend on a higher time frame than the time frames used for entry and exit?

David (Oct 26, 2005 10:31:30 AM)
I think that is a great method to confirm your market setup - quite a few of our systems do exactly that.

David (Oct 26, 2005 10:31:59 AM)
Next Question: David, forex market often change its behaviour, so how can we make sure new built mechanical trading system with past features of forex market to be workable in future market condition? any mechanism to be adaptive?

David (Oct 26, 2005 10:32:19 AM)
Great question

David (Oct 26, 2005 10:32:31 AM)
There are no gaurantees

David (Oct 26, 2005 10:32:50 AM)
we can only test the system in the past and see that it is robust

David (Oct 26, 2005 10:33:09 AM)
then test going forward to see if the results are good

David (Oct 26, 2005 10:33:29 AM)
eventually we have to pull the trigger, and YES, the market can change

David (Oct 26, 2005 10:33:47 AM)
that is why money and risk management are always used

David (Oct 26, 2005 10:34:27 AM)
Next question: if i want to implement some algorithm and test it, can i do it in my platform or get a mechanical trading system platform alternatively?

David (Oct 26, 2005 10:34:35 AM)
Good question

David (Oct 26, 2005 10:34:59 AM)
personally, I always think it is best to test on the platform you will use for execution

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David (Oct 26, 2005 10:35:39 AM)

Next Question: Long Term Capital Management had an automated system yet went totally under. This people had the top brains. What makes the Forex market different using automation?

David (Oct 26, 2005 10:35:56 AM)

Great question!

David (Oct 26, 2005 10:36:01 AM)

It not different

David (Oct 26, 2005 10:36:36 AM)

The mistake that LTC made is they assumed there was no, or little, correlation between their trades

David (Oct 26, 2005 10:37:14 AM)

FOREX traders need to diversify, like all traders, and to try to understand market coorelations

David (Oct 26, 2005 10:37:48 AM)

I think it is safe to say that all currency pairs are correlated to some extent

David (Oct 26, 2005 10:38:30 AM)

so one way to approach the problem it to develop trading systems that react to diverse market behavior.

David (Oct 26, 2005 10:38:58 AM)

Next Question: Do ur systems allow for descretionary decision based on short or long term fundamental analysis?

David (Oct 26, 2005 10:39:14 AM)

Great question

David (Oct 26, 2005 10:39:22 AM)

currently, no

David (Oct 26, 2005 10:39:42 AM)

the reason: we have not found a good way to backtest this kind of input

David (Oct 26, 2005 10:39:54 AM)

but it is something we are actively working on

David (Oct 26, 2005 10:40:38 AM)

Next Question: is it not true that trend following methods typically cannot expect more than 30-45% accuracy, for the most part?

David (Oct 26, 2005 10:40:55 AM)

I have not found that to be the case

David (Oct 26, 2005 10:41:17 AM)

it is true that markets do not trend more then about 20% of the time

David (Oct 26, 2005 10:41:42 AM)

the key is to not enter the market, unless the trend is welll established

David (Oct 26, 2005 10:42:05 AM)

and then use a wide stop to give the trade a chance to develop

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David (Oct 26, 2005 10:42:50 AM)

As I said before, I think it is important to have a high winning percentage

David (Oct 26, 2005 10:43:01 AM)

even at the cost of profitability

David (Oct 26, 2005 10:43:07 AM)

for 2 reasons:

David (Oct 26, 2005 10:43:23 AM)

1. it makes the system easier to run

David (Oct 26, 2005 10:43:45 AM)

2. if the market behavior changes, and the system is no longer working

David (Oct 26, 2005 10:43:53 AM)

you find out earlier

David (Oct 26, 2005 10:44:43 AM)

and can make changes, or turn off the system.

David (Oct 26, 2005 10:45:05 AM)

Next Question: So what is a high percentage of winning trades in ur opinion? Above 50%?

David (Oct 26, 2005 10:45:35 AM)

I shoot for 70%, and I pay very close attention to maximum consecutive losses

David (Oct 26, 2005 10:46:01 AM)

I use the losses to monitor the system.

David (Oct 26, 2005 10:46:31 AM)

Next Question: Do ur recommend going to lower time frames to look for trends? For instances move from a trendless market on a weekly chart to a trending market on a daily or 4 hour chart and then trading on an even lower time frame?

David (Oct 26, 2005 10:46:40 AM)

Great question.

David (Oct 26, 2005 10:47:12 AM)

Personally, I think the lowest time frame to use to try to determine a trend is the 1-hour chart.

David (Oct 26, 2005 10:47:46 AM)

anything below 1 hour is very noisy, and difficult to avoid false entries

David (Oct 26, 2005 10:48:21 AM)

Next Question: What have you done to minimize technical glitches on your trading system? I am always concern that retail platforms might place orders, close positions etc without reason and with no recourse to reverse such mistakes

David (Oct 26, 2005 10:48:50 AM)

I share your concern - but I have not seen it happen

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David (Oct 26, 2005 10:49:25 AM)

most of the bugs you find with the system are related to testing and determining indicator values

David (Oct 26, 2005 10:49:39 AM)

but I have never had a trade placed incorrectly

David (Oct 26, 2005 10:50:02 AM)

The best you can do is to run your system on a go-forward basis

David (Oct 26, 2005 10:50:19 AM)

to see if all the trades are placed correctly and honored

David (Oct 26, 2005 10:50:40 AM)

and of course, use a broker you trust.

David (Oct 26, 2005 10:51:11 AM)

Next Question: do you believe in optimization? in your experience, how often do you need to review your parameters?

David (Oct 26, 2005 10:51:30 AM)

I do not believe in optimization.

David (Oct 26, 2005 10:51:48 AM)

backtesting should be done to prove the system was robust

David (Oct 26, 2005 10:52:06 AM)

optimizing simply finds the parameters that worked the best in the past

David (Oct 26, 2005 10:52:36 AM)

the chances those parameters will work the best in the future are almost zero!!

David (Oct 26, 2005 10:53:17 AM)

You should review your parameters whenever the metrics of the system deviate a good deal from the past.

David (Oct 26, 2005 10:53:56 AM)

If you use parameters, like ATR, that move with the market, you need fewer changes.

David (Oct 26, 2005 10:54:38 AM)

But markets do change, and you probably will need to make adjustments.

David (Oct 26, 2005 10:54:49 AM)

Last Question:

David (Oct 26, 2005 10:55:03 AM)

Does the system trade for us or do we have to enter and exit?

David (Oct 26, 2005 10:55:41 AM)

The MetaTrader platform allows you to automate the entire process - from entry to exit. It is very powerful.

FXstreet Moderator (Oct 26, 2005 10:57:34 AM)

Thank you very much for that, David Excellent session

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David (Oct 26, 2005 10:58:26 AM)

Thanks to everybody for joining us today - those were great questions.

David (Oct 26, 2005 10:59:07 AM)

Take a look at our website www.iExpertAdvisor.com for more information and our new book - Automatic Alpha: How To Build a Winning Trading System.

FXstreet Moderator (Oct 26, 2005 11:00:01 AM)

• If your question was not answered during the course of this chat, please contact David

FXstreet Moderator (Oct 26, 2005 11:00:15 AM)

David Lyder

FXstreet Moderator (Oct 26, 2005 11:00:34 AM)

Apologies all as of November the 1st the transcript will only be available for premium users.

FXstreet Moderator (Oct 26, 2005 11:00:53 AM)

what is premium?

FXstreet Moderator (Oct 26, 2005 11:01:18 AM)

<http://www.fxstreet.com/premium/premium.asp>

FXstreet Moderator (Oct 26, 2005 11:01:32 AM)

• Transcript request: Lyder18526 • Link: <http://www.fxstreet.com/chat/transcriptrequest.asp>

FXstreet Moderator (Oct 26, 2005 11:01:46 AM)

Thank you all