Worldly wisdom

In the second of our occasional series, **Philip Halperin** answers more readers' questions on practical risk management issues

Is my trader *still* OK?

Last month, a desk manager wrote of his concerns over his newest traders' trading habits. (The trading signature revealed last month can be seen in the graph opposite.) The advice given was that the trader appeared to be quite professional but was in need of close supervision at least in the short-term. Here the saga continues… and concludes.

Thanks for your insightful analysis. Your assumption that the trader increased his size as he hit a winning streak and then did not cut his size quickly enough to avoid the drawdown really squared with what little I know of this person. A review of the trades and positions revealed that you are exactly correct! Very accurate analysis.

By way of clarification, the 20% drawdown I mentioned is 20% of the maximum total value of the account. He doubled the *account and then had a 40% drawdown of winnings. That is equal to 20% of the value of the account at its peak.*

PH: I understand your 20% calculation now, thanks for the clarification. My 40% terminology may perhaps be a little strange to you (it reeks of commodities bias), but I actually consider the problem in the following way:

A trader's performance should be considered in terms of risk vs P&L, and the amount of capital put down is irrelevant (not as an economic investment decision, there it is most certainly relevant!). This is because the commitment of capital to fund a position is essentially an accounting concept, whereas in the risk management world, a more informed concept is something close to 'economic capital' – a quite fashionable term nowadays, but meaningful conceptually nevertheless. We are concerned here on an even more basic level – is the guy lucky/unlucky, or is he smart/stupid? This speaks really just to the mensuration of P&L vs ex-post risk.

In the case at hand, I tend to look at pullbacks from a peak as inevitable, the only question being the rate and relative magnitude of the move (remember, we are in trader measurement-land, not investment-land, for the sake of this question). One rule of thumb I have devised is that pullbacks of over 50-60% off a campaign high are evidence of a serious lack of control, or evidence that the hired gun considers the profits to be 'his' (in reality they are not, they are yours, because you pay the freight). This is not science, just art and experience, and I don't know how I could express it if I muddied the waters with investment levels (which are a function of gearing choice, often out of the trader's hands) or even prior P&L – just a rule of thumb.

Anyway, that is why I talk about 40% in this context.

The past four days went as follows:

16/6	*(240,535)*
17/6	*103,812*
18/6	*(143,568)*
21/6	*(120,755)*

The trader appears to have reduced size somewhat, but not significantly. However, the fluctuations are smaller. I'm not sure whether he is exercising better risk management (better controls on positions) or whether things have just worked out for him. I think your guideline of not taking another 500k loss was reasonable. However, what are your thoughts about the present situation – a gradual decline towards the 500k loss?

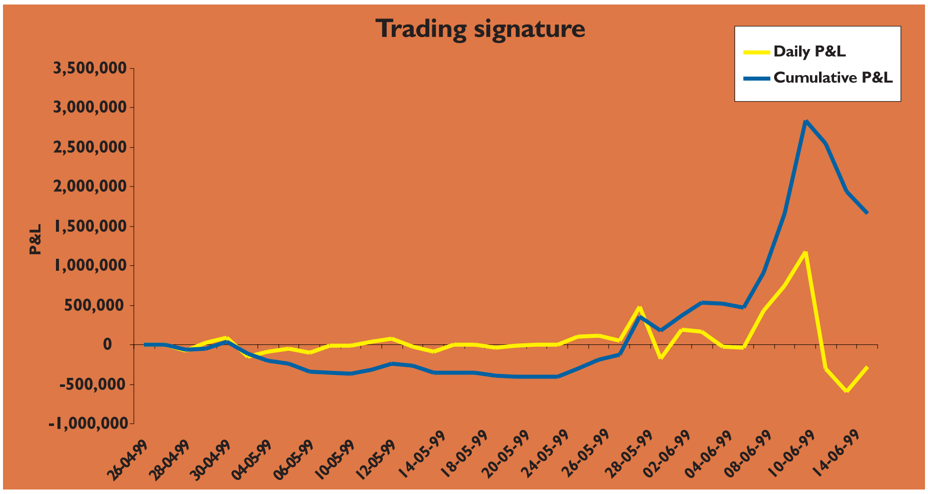
Luck vs skill is certainly tough to determine. What is most interesting is the amount of information that the 'trading signature' is revealing about the trader's pathology with only very limited data. A most valuable tool. In your experience, have you found that a blend of different trading styles, eg 1 long momentum + 2 ratio spreader + 3 arbitragers etc makes for a smoother equity curve – ideally one that increases at a 450 angle (smile)?

As an aside, some background about this particular trader:

- *He has freedom to trade whatever market either from the long or short side.*
- *So far he has traded exclusively US equities (all technology, Internet or pharmaceuticals) about 95% from the long side.*
- *The initial restriction was a 30% drawdown of initial equity.*
- *He is to receive 20% net profits.*

PH: Re: your comments about the 'trading signature'. Thanks for the vote of confidence in my baby!

Actually, everyone has a blend of trading style habitats, but my experience is limited to running 40 or so traders, and most of the analytic framework I built up has been at first anecdotal, then inferential, and only then empirically replicable (on a conceptual level). It is an interesting thought to try to combine these things in some additive, ratio-based manner, but I do not think that that is in



One of the tough things about trading management is that in general you very often never know whether you are looking at luck or skill

the domain of the trader, rather that of the desk manager, to combine traders into a desk.

Basically, in my experience the most powerful combinations (although they don't always work), combine opposites in a one-to-one weight to form a desk (short momentum and long momentum, for example). This gives you the orthogonality you need to get a better risk/return. (This sort of thing is really in its infancy, however, and although it has great utility as a qualitative tool, I would be very wary about getting too quantitative with it.)

Let me know how the story continues.

Here are the latest figures:

22/6	*2,038*
23/6	*141,481*
24/6	*98,433*
25/6	*92,148*
28/6	*149,350*
29/6	*(158,350)*
30/6	*27,360*
1/7	*112,175*
2/7	*387,640*
6/7	*(145,390)*

Although the P&L looks good, the size of the positions is increasing again and actually is quite large. The margin used is 4 x 1, and sometimes 10 x 1 on day trades. Also the frequency of the trades has increased.

I am thinking of making my decision based on how the trader handles this run. Do we see a repeated pattern of a large advance and then a deep 50-60% retracement, or is the retracement more controlled? Also how much of an advance will we see?

PH: For the moment, it looks OK to me. One of the tough things about trading management is that in general you very often never know whether you are looking at luck or skill. This is a good case in point. Nassim Taleb is coming out with an entire book devoted to just this issue.

Regarding the continued drawdown, the lightening-up is encouraging. I don't think an artificial 500k cut-off makes sense as a gradual thing, in the absence of further information, such as a-priori risk guidelines, the nature of the deal, the experience of the trader, etc. I would not have tolerated it for a one-period move in this instance, because it would have pointed out a pathology which we worried about, in the context of the peak-control discussion previous.

The present situation is about what I would expect from a long-momentum trader, and is not of serious concern in that instance; I would be much more concerned if the mandate was exclusively day-trading.

So, for the moment, I would say things are going well enough, but keep an eye on it.[1]

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Where can I get more data?

I am interested in trading FTSE-100 futures. Before I attempt anything I would like to implement my proposed system theoretically. To do this I need access to real-time prices, where would I find such things?

PH: As a professional, I have always had someone else paying for this for me, so I had the usual – Reuters, Bloomberg, etc. My motto is, take nothing but the best, when the other guy is paying for it!

This is an interesting question for me, so let me check around and get back to you. Do you need real real-time prices? Or is a five, ten or 15 minute delay acceptable (it makes a huge difference in price, you know)?

Thanks for your response. I checked out Reuters and Bloomberg which were a bit out of my league, I also checked out a company called 'ICV datastream', which seemed to provide the most appropriate service. ICV can broadcast to a PC using a TV aerial and offer a slim-lined service providing only Liffe prices (real-time), which is what I really want. The hardware costs about £500 and the service about £2000 per annum. I can't justify this expense on research alone, though it would be worth it if I decided to trade from home using an Internet broker. Do you have any advice about trading on the Internet? Is it strictly a no-no as most UK traditional brokers would have you believe?

Regarding dummy-running my system, I have done this to some extent using historical data I've been able to get from local libraries, though the data is clumsy and not specific enough for my needs. I think the only way I can achieve an accurate dummy run is to use the private client broker rooms with some up-market brokers. Though I don't want to do

[1] Addendum

Some days later I learned that the reader wound up firing the trader, who was perfectly competent in my view, because the reader simply could not bear the stress!

this just yet, I am not familiar with the set up, software, etc. I am familiar with trading terminology in theory, though have yet to buy or sell a real contract. What I really want is to get hold of about three months' detailed data. Because my trading system is designed to minimise losses I need to be able to see how the market has moved in relation to time; rather than seeing the price range for a particular day I need to see what direction the market took, and when it took a particular direction.

In reference to your reply, I would like access to real-time prices and any suggestions or info will be greatly received, though I think for the time being at least it will remain too expensive. Any info or advice on accumulating detailed historical data would most helpful.

Please do not feel obliged to waste your time assisting me, I just thought a few snippets of your professional advice here and there could save me hours of headaches, and you might enjoy helping a novice!

PH: Thank you for your detailed description. I do enjoy helping out and teaching – this is one of the reasons I started my discussion board and my website. I must say, after many years of trading futures markets, that although I have a lot of experience, it is not at all clear to me that I know the shape of the future, or even understand the real nature of current technology. (On the other hand, it is very clear to me that Liffe certainly does not – witness DTB's ability to take massive amounts of biz away from them with a simple-ish open system.)

I can thus not respond well to your Internet trading query at this juncture – certainly in my experience, it seems you have your priorities reversed: you want real-time prices, but are willing to settle for the delays of Internet trading. I do Internet trading on my American equities PA with Schwab and Co, but even for my equity options PAs, I generally use the direct line to their special traders – I do use the Internet for such things as limit orders, where I am not time-dependent. But the Internet will not give you an indication of either the size of the market or its temperature; and size you can generally get from a voice broker. You can get a list of real-time data vendors from this URL:
http://www.liffe.com/liffedata/realtime/internet.htm

Liffe also produces CD-ROMs of its historical data. Try contacting
webmaster@ifsys.demon.co.uk
or
market.dataservices@liffe.com
and see the following URL for a description of end-of-day data:
http://www.liffe.com/liffedata/historical/cd-rom/eod.htm

For what it is worth, let me put in my own two snippets of advice here: I have seen lots of systems over the years, and most of them worked a heck of a lot better on paper (or electronic media) than they actually did once deployed. This is for many reasons:

1) Most systems tend to be optimised about a particular period, so they would work very well for, say, 1997-1998. But the future is always different. Beware – robustness is a very serious issue.

2) The systems do not take into account the 'f*ck factors' that exist in real life – like that you cannot get your trade off at the print, or anywhere near the print, that the floor broker is front-running someone else, or artificially crossing to set the tape (or many others – these things are, of course, not supposed to happen). Or even something so simple as you can't get through on the phone, or your ISP hiccups, just when you need to execute.

3) Most traders, when facing reality, have a hard time taking the system at value, and override. Basically this is a big key issue; I suggest you do trade, small first, and learn to face and control your own greed and fear.

4) Profitability in trading is not so much a function of frequency of getting it 'right', but rather a matter of discipline and weight when getting it 'wrong'. In my most profitable periods, I was generally 'right' about 40% of the time or less, but the super-strategy of stop-losses, halving-out profitably, averaging down, and many other techniques, as well as good old-fashioned cutting the position quickly when it no longer smelled 'right', made the difference. Again, I suggest that money-management, and developing such a set of strategies, is much more important than the naive reliance upon a system that is better than average in projecting future path from current conditions. ❖

Help yourself and others too

This series relies solely on genuine questions from readers, so if *you* wish to receive some wisdom and share it with the 'World' please contact:
phalperin@internet.com
or keating@risk.demon.co.uk

Philip Halperin has had fifteen years of experience in trading systems, trading management, and risk management in banking and derivatives houses. Currently he divides his time between London and Moscow, as director of risk management for Alfa Securities, London, and AlfaBank, Moscow, where he manages all operational, credit, and market risk.

Con Keating chairs the European Federation of Financial Analysts Societies' sub-committee on analytic techniques and methods. The *FOW* credit risk series from earlier this year was based upon one of the current strands of this research. ❖