Trading Systems

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A trading system consists of a set of rules for viewing markets and making trades. The advantages of trading systems can be hidden when they become associated with trading platforms involving trade order submission and processing. A clarification of their roles can help explain the benefits of using a trading system. This can be done without identifying a particular platform or system. Once the platform infrastructure is isolated, a brief look can be taken at why a trader can benefit from a trading system.

An online trading platform consists of the infrastructure for viewing market prices and making trades. While platforms make use of user provided hardware and the internet itself, platforms consist of software linked to a database while displaying price quotes, enabling order entry and routing orders to an exchange. A platform of software and order routing services is provided by many brokers. It often includes programmable charting software that allows a user to select from an array of formats for price, volume and technical indicators. Links to real time databases are used by day traders while free delayed quotes are quite adequate for position traders who analyze data after the markets close to minimize the emotional stress of changing prices. Platform software saves time and reduces errors by automating repetitive tasks.

Some platform tools have become quite sophisticated, allowing a user to add his personal rules for making trades. Rules tell the software which set of indicators and prices to monitor and the levels at which traded instruments are to be bought and sold. Automated systems trading software are preprogrammed with trading rules enabling them to make trades with minimal user input. These software modules, designed by third party vendors to operate under existing platforms, are based on algorithms that identify price trends and market turning points. Since their accuracy is limited by the presumed market volatility, an algorithm is needed to recognize when market volatility falls outside the envelope for which the software rules were designed. The quality of a set of rules can be estimated from historical back testing on past market prices stored in a database. It is often pointed out that back testing lacks the realism of real time emotional stress and that past performance is not an indicator of future performance. While the latter is valid in all cases, the nature of trading system rules reduces emotional stress to the degree that the rules are consistently followed.

In any case, it is the rules themselves that comprise the trading system. In their purest form, trading systems take the form of a compact set of rules written on paper.

The ability to consistently make error free decisions amid changing prices in an environment of fear and greed is unlikely without the discipline that rules provide. It does little good to have all the price monitoring, charting, order submission and routing infrastructure if one does not have a consistent set of rules for making trades. Most of us find this out the hard way, judging from the statistic that only about 12% of stock traders are successful. For futures traders the number is closer to 5%. It is not just a coincidence that the percentage of traders that rely on a proven trading system is near these same levels. The consistent use of a proven trading system can be most beneficial to traders with all levels of experience.

Seeing the difference between trading systems and platform infrastructure makes the characteristics of a good trading system more obvious. A good trading system explains when trading should not be attempted, thereby, avoiding forced trading under inopportune conditions. It should specify how to independently generate a strong watch list of candidate trades to eliminate the need to chase after the latest hot tip from an advisor. For obvious reasons, a trading system should be easy to use, totally objective, take little of a trader's time and make consistent profits. It should also avoid large draw downs and give clear trading signals.

A trading system is best learned from a master trader who remains actively engaged in teaching. The master can help the student tailor the system to his personality, financial means, risk tolerance and skill level. The next best approach is to simply read what has been written and adopt it to one's personal situation. But under no circumstances should one try to wing it without the support of a set of trading rules. The advantage of rule based trading systems lies in their objectivity and consistency. When followed consistently, emotional trading and its associated errors are removed from the equation. As an investment, trading systems more than pay for themselves, not only in profits gained, but also in the amount of capital preserved. This is true not only for advanced automated trading systems but also for a compact set of rules on paper.