

Chapter 3 has been repeated here for those that may not have bought or read my book the Zen Trader. Chapter 3 is “Obstacles of Logic” After the chapter is more data and information about the system.

Rather than learning to detach, traders seek maximum control in an attempt to deal with the second obstacle. They apply the following form of logic (which on the surface seems logical) and combine this logic with maximum control: they reason that, if they trade frequently and successfully, a huge amount of money can be made. However, within the two words *frequently* and *successfully* lies the challenge. Moreover, this approach does not use the powerful method of Zen detachment.

I prefer what I originally wrote here, I think it leads into the next chapter better. Here it is:

Many traders think that the more they shorten their trading time frame, the better. However, ‘better’ also requires that their methods realise a higher rate of success. That is because in many cases, a shorter trading time frame can dramatically tilt the mathematical probability of consistently winning with a big payoff ratio to the downside. For many traders, it is within the longer-term trends of daily, weekly and even monthly time frames where large amounts of money can be made. I am sure many of you have short-term traded stocks for what you thought was a good profit, only to re-examine the stock later to see that it has rocketed well beyond your exit price. Often with trading, fewer trades can mean more profit. Exerting less control and flowing with the movements of the market often results in a better outcome, and that methodology can apply to any trading time frame.

Time is a difficult choice

Directly linked to the matter of control, one of the hardest decisions you will need to make when trading is: what trading time frame will you use to execute your method? Most beginners start with analysing and then trading stock prices in a daily time frame. Focusing the majority of their attention on analysing daily charts creates an expectation – and then a need – to analyse charts and individual stock performance intra-day. The analysis of charts over intra-day time scales then seems to lead to a desire to shorten the time frame to 4-hourly or even less, perhaps hourly or even 10- or 5-minute charts. The problem here is you are not focusing on what is most important: developing your mind to detach from undesirable outcomes.

In fact, you are doing the opposite: attempting to exert more control over an uncontrollable situation. You cannot control the market by viewing it in a shorter time frame, but you can control how you respond to it. Notice I did not use the word *react*, for it is the heedless reactions in your trading that Zen will help eliminate.

Some traders shorten their trading time frame because they think this is the requirement to make a lot of money. What they are not aware of is the strong possibility they are simply reacting to unpleasant feelings – feelings created by their thoughts about the market movements. Unpleasant feelings create a desire to control. The control they have at their fingertips is to buy and sell frequently – to alleviate uncomfortable emotions. But now they are likely just compounding existing obstacles, and creating new ones.

Frequent trading can increase obstacles

Considering that statistically 90 to 95% of traders lose or break even, one of the reasons for poor performance is probably that they are buying and selling at the wrong time. This can be a result of trading too often.

Increasing your time frame to weekly, or even monthly, charts for analysis and even trading, could be the best option to put you in an area where the winners exist. Away from the anxiety-ridden losers poring over charts every day.

My personal trading experience and coaching of others leaves me in no doubt that shorter-term trading is more challenging than longer-term trading. However, many find longer-term trading also difficult, because of the challenges of boredom and the need to practice delayed gratification. It seems as if there is no escaping the emotional component of trading, whether you trade short-term or long-term. Whatever your time scale preference or goals, stepping back for a look at the big picture can assist you in detaching from the short-term movements of the market. After all, detachment is key.

Frequent trading and mental health

My trading partner once described frequent trading as, “being sucked into the market vortex.” As any experienced trader will tell you, that vortex can be very stressful, particularly when trading in short time frames. So, a re-examination of your trading time frame can improve both trading results and your mental health.

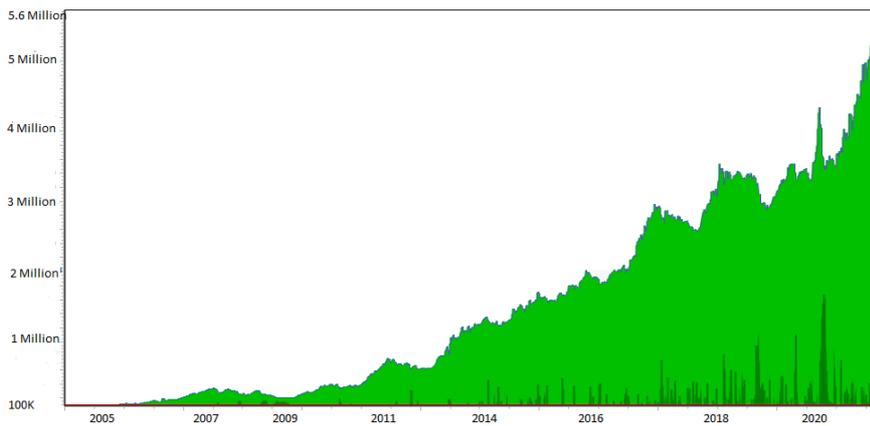
However, regardless of what time frame you use to trade, the market movements will challenge you, sometimes to what can feel like – or can in fact be – breaking point.

It seems whatever strategy or time frame a trader uses has its challenges. The obstacle that is the root cause of poor performance in trading is the inability of the trader to detach. Attempting to control the market by complicated or short-term systems is not a long-term solution. The solution is to learn the Zen skill of detachment – a technique that will be discussed at length in the following chapters. To satisfy the reader with an appetite for more risk or trade frequency, we will look at some shorter-term trading methods later. However, in the meantime consider the results achieved from the weekly trend trading system below: a system averaging just one trade a week. A result like this can only be achieved by using a method with winning probability, then being able to detach from the inevitable adverse movements any system produces.

Pete’s Personal Trading Story

Here is an example of how detaching from the daily movements of the market can be very profitable. In 2005 a trading friend showed me a weekly trend-trading system. It had just three rules: buy a stock’s 52-week closing high; give preference to the lowest priced stock; then use a trailing stop as your exit (average true range of 3 calculated over 4 weeks). Below is a simulation chart of the result on the Australian ASX 300 using accurate adjusted data. The method averages only 38 trades a year, and risks just 1.5% of total portfolio equity per trade. This leads to an end result of \$6 million AUD from starting capital of \$100k. At the time I thought it was interesting but was convinced I could do much better trading on a daily time frame. I started using the system but became impatient and never stuck with it, thinking that short-term methods would be more rewarding. The Zen saying below sums up the value of a good idea, combined with commitment and time.

Figure 3.1: Australian ASX 300 (Simulation)



Commented [SE1]: Mism

Source: wealth-lab.com

A Zen saying

An idea that is developed and put into action, is more important than an idea that exists only as an idea.

Chapter summary

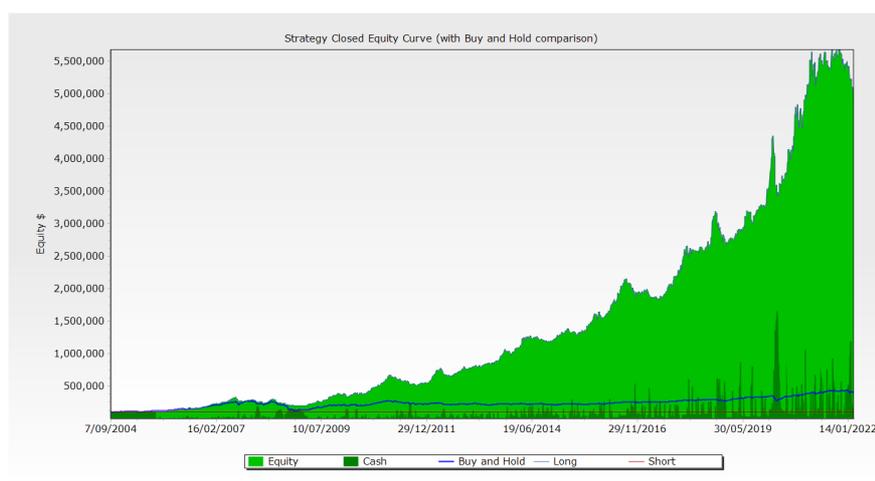
- Many traders are impatient, think control is the answer, and want instant gratification.
- Less (trading) can be more (money).

New Statistics and Data about this system

The following part of this document was written 6th March 2022

The System in Chapter 3 from the book The Zen Trader

Authors reference note: System 52WH book unlocked.



This document was prepared around 6 months after the final draft of the book so results vary a little as to the example given in the book— however not a great deal has changed from what was presented in the book The Zen Trader. The main difference is that equity has pulled back a little due to the Covid rally finishing and the beginning of the Ukraine war.

The chart above shows the equity curve of the system as of 6th March 2022.

The light green in the chart represents the rising equity, the dark green represents cash held. You will notice it is normal for the system to be rarely in cash. If it is in cash (as a result of the market falling) those periods are not for long.

The blue line is a benchmark comparison using the SP ASX 300. This is a “buy and hold” benchmark indicating the return achieved if one was to buy evenly every stock in the index and hold those

trades for the duration of the testing period. Obviously, the system far outperforms that particular buy and hold strategy.

Data:

The data used for the testing is Norgate “Current and Past” data for the ASX 300. This data adjusts the constituents of the index - to only include stocks in the testing that were in the index at the time the buy signal was triggered.

This reduces the much debated “survivorship bias” issue often attributed to compromising the validity of back testing.

Rules of the system:

Buy rules:

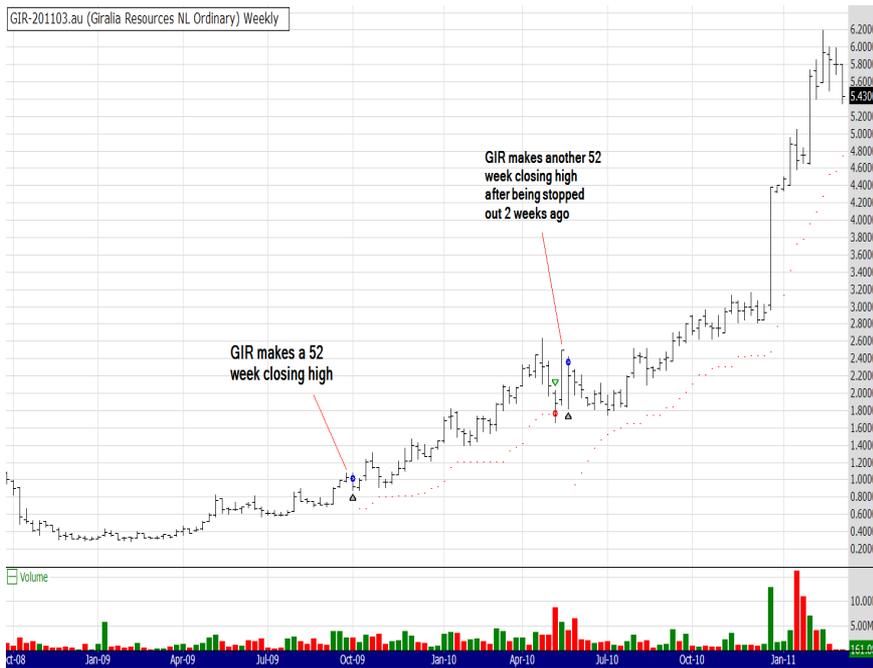
If the stock price makes a 52-week closing high - **greater than** the closing high 52 weeks ago, buy the stock.

The stock is bought at the **next weeks opening price**, as this is a **WEEKLY** trading system. Signals are normally triggered on a Friday at the end of the week’s trading and bought on a Monday at the beginning of the trading week.

This will sometimes vary depending on public holidays. For example, if the Monday is a public holiday and the market is closed, the system will buy on the Tuesday – as it is the first trading day of the week.

If the Friday is a public holiday and the market is closed, then Thursday becomes the last trading day of the week and all buy signals are calculated at the close of trading that day.

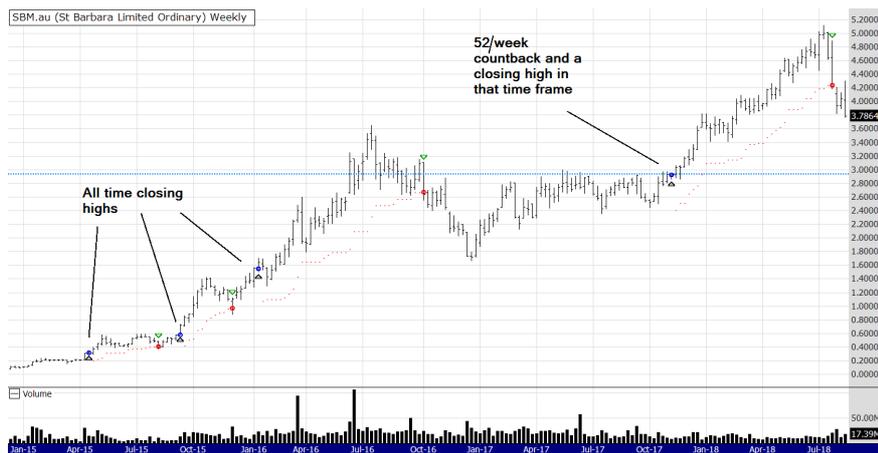
See the chart below as an example of the buy signal.



The chart above displays two winning trades. The blue dot is the entry point. As mentioned this entry day is normally a Monday - unless the Monday is a public holiday then the system will enter on the first trading day of the following week.

The red dot is the exit point. **This could be on any day of the week** as the exit point is a trailing stop using a pre-set conditional order. The trailing stop is indicated by the small red dots on the chart and the exit price by the large red dot – the point the price “hits” the exit price.

Clarifying the 52-week closing high rule.



The chart above displays a horizontal blue dotted line. This is shown to clarify the 52-week closing high entry rule. Repeating again: the entry rules apply when

Condition 1/ the **closing price** is the highest close in the past 52 weeks

Or:

Condition 2/ the **closing price** makes an all-time new high

Looking at the chart above you can see the **1st condition applied** with the **fourth and last** buy signal on the chart. The signal to buy was triggered because the close was higher to the closing price over the previous 52 weeks.

The 2nd condition applied – an all-time closing high - with the first three buy signals on the left side of the chart. Looking back through the price action on the chart you can see that those three closing highs surpassed any other closing high in the past. Each time the stock made an all time closing high and it was bought. The exit trailed the price up and was stopped accordingly when it fell.

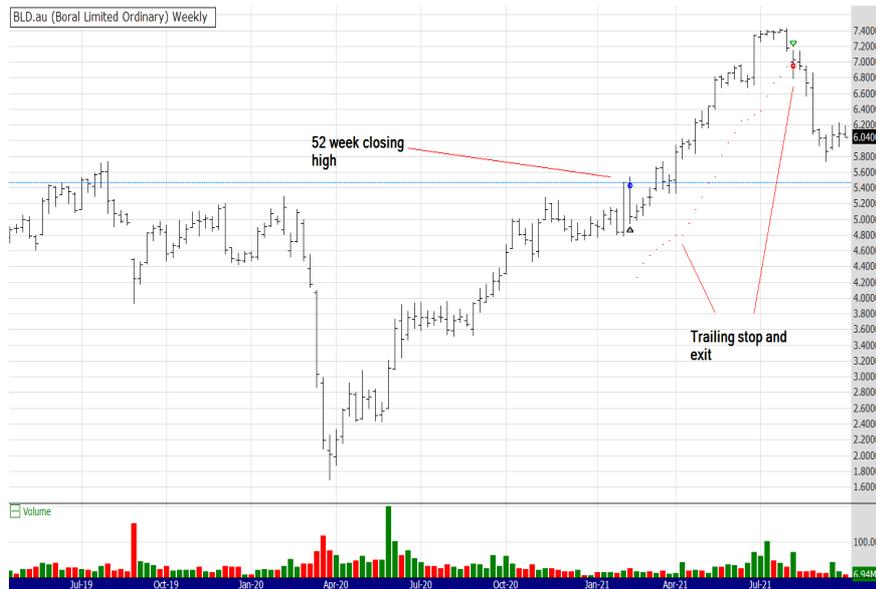
Sell rule:

The sell rule is a 3 ATR, calculated over 4 weeks. A pre-set sell order is placed in the market at all times. This pre-set sell order is adjusted **once a week** after the close of trade on a Friday. If you do not completely understand what a trailing ATR stop is, I suggest you read the brief explanation here

<https://www.stockopedia.com/learn/charts-technical-analysis/atr-trailing-stops-462698/>

The sell stop order is never lowered, only raised, **and it is only raised if the stock price rises.**

The sell order is not lowered if the stock price falls.



The chart above displays clearly the buy signal, the trailing stop and the exit point when the trailing stop was “hit” by the stock price.

Trade Exit and Sizing rules:

As mentioned the sell rule is a trailing ATR of 3 - the sizing rules of the trade use the same calculation which is:

3 ATR calculated over 4 weeks.

The chart below explains the trade sizing process.



The chart above shows the stock APT being bought in May 2020. It is stopped out around April 2021 for a handsome profit.

Importantly though is the sizing methodology, because **how trades are sized makes a big difference to the performance of any system.**

Step 1: 1 ATR is calculated over the last 4 weeks.

Step 2: ATR is multiplied by 3: The example in the chart above shows APT with a 1 ATR of \$5.

\$5 is multiplied by 3 to give us the 3 ATR exit on the trade.

So, the risk amount in dollars and/or cents becomes \$15. (1 ATR of \$5 x 3)

\$15 is the amount of **stock price risk** calculated from the buy signal to the ATR trailing stop of 3 ATR.

So, in the worst-case scenario - the trade fails from the initial entry and falls almost immediately to the pre-determined exit point of 3 ATR - you will lose \$15 on each stock you buy.

Calculating how much of the stock to buy:

The system displayed in the book uses a risk of 1.5% of trading capital per trade.

If your capital was \$100,000 then the risk on each trade would be \$1,500.

In the case of the example trade in APT, the calculated exit 3 ATR and \$15 is divided into the total portfolio risk

A pre-determined amount of 1.5% of 100K or \$1,500.

So, your next step is to do this calculation: $1500/15 = 100$

You will buy 100 units of APT to keep your risk at 1.5% of total capital -which in this example is \$1,500.

Very important note: there is a difference between trade sizing and trade risk.

Trade sizing is the amount of stock to buy based on the stocks past volatility, **as per the pre-set exit** (in this case 3 ATR).

Risk is an **amount** of money you are risking to lose in the trade, normally **a percent of the portfolio e.g.: 1.5%**.

You could choose to risk only 0.75% of (or \$750) capital on the trade - but the volatility calculation (ATR) to determine the exit remains the same.

The two calculations are related, but are very different.

Trade selection process:

If there are more buy signals than you have the capital to purchase, give preference to the lowest-price stock.

The system may generate three buy signals on the same day, so how do you choose which ones to buy? You have enough capital to buy only two trades but three signals are given. The answer is you buy the two stocks that have the lowest price, ignoring the third stock that signalled.

The three trades signalled may have prices of \$10, \$111 and \$327. In this case you would buy the \$10 and the \$111 stocks, leaving aside the \$327 stock. That example is more for the U.S. market, in other stock exchanges average stock prices will be a lot lower, as is the case in Australia.

Another example of stock selection may be: you have remaining free capital of just enough to buy one stock, as the portfolio may be already holding other stocks. If you have capital to buy only one more stock - that would be the one with the lowest price at \$10.

There are two reasons why the system has this rule of favouring the lowest-price stock:

- 1 Knowing what stock to buy because of a set rule, removes all bias from the decision-making process – and obviously makes the decision process simple. However, it has an added benefit. At a later date when revising the performance of the system, evaluation is simpler because there has been no discretion used in the buying process.
- 2 The other reason is mathematical probability. Back testing shows that lower-priced stocks appreciate at a faster rate than higher-priced stocks. Using this rule in our selection method we are adding a momentum rule to the system and buying stocks that have a greater chance of appreciating quickly – maximising the use of our capital.

If you want to know more about the “cheapest price rule” you can purchase my eBook “Mindful Trading using Winning Probability” from my website. Chapter 6 of that eBook goes into more detail and the book also explains another complete system. Click below for more detail and a sample of each chapter here

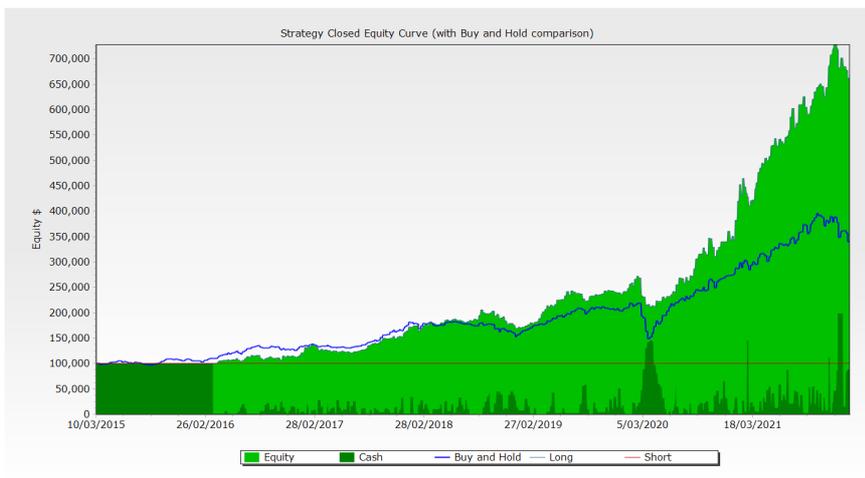
<https://www.easyssharetradingsystems.com.au/products-and-services/e-books>

Statistics of the system:

The equity graph of the system displayed on the first page of this document, shows the result from trading the system for 17 years. Profits are reinvested. The results do not factor in brokerage costs. However, nor do they factor in dividends received. I am aware dividends are not a significant contributor in US markets, however they are in Australia with an average yield of 4.5% p.a. easily covering any expenses of brokerage or slippage. If you do not know or understand about slippage then again, I recommend you read the link below for a good explanation.

<https://www.investopedia.com/terms/s/slippage.asp>

I am often asked to show results from systems over different time frames, so I have selected the last 6 years as alternative example for this system.



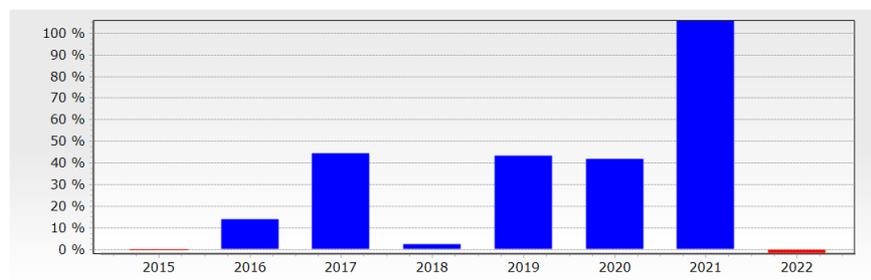
Statistics:

Win rate:	48%
Total number of trades during testing period:	271
Average return on winning trades:	72%
Average loss on losing trades:	14.6%
Payoff ratio (dollar payoff of winners to losers)	4.9 to 1
Maximum Drawdown (March 2020)	22.3%

Average number of positions in the portfolio	20
Average trades per year (slightly less than one a week)	45
Average annual return (see Monte Carlo)	31%

Chart below displaying the returns year by year:

Note: a low return year is normally followed by a high return year. 2021 was an exceptional year due to the post Covid crash rally.



Monte Carlo results

The last statistic mentioned in the list above was Monte Carlo with an average of 31% p.a. Monte Carlo is a testing tool for analysing stock market systems and used by many back-testing software programmes.

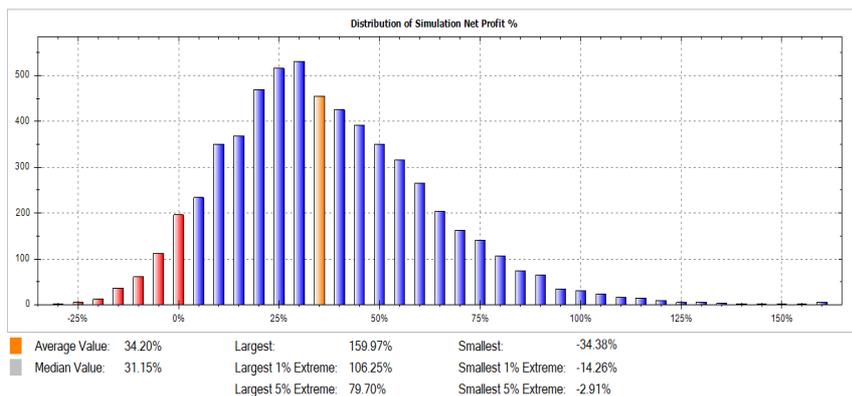
Here is a definition of Monte Carlo testing as found on the Wealth Lab website, the software I use for my own back-testing. "Monte Carlo analysis consists of computing a large number of randomized runs based on the original results, and can provide insight into the trading system's potential in the future. It can also give you an idea of the probability of achieving various profit objectives."

That is a bit of a mouthful, but it is an explanation of Monte Carlo testing. This clever piece of technology takes every possible trade generated by the system, randomises the start dates along with all possible trades taken - then calculates the average return based on 1,000 simulated portfolios.

Although two traders can adopt the identical system - such as the one in The Zen Trader, they can get different results. If our two traders start their portfolio one week apart, obviously they are going to be holding different trades. This starts a variation of portfolio content which continues over time causing the results to vary between portfolios.

With so many variations possible, how do we truly estimate what the average return from a method will be? The answer is: Monte Carlo testing.

In the graph below, Monte Carlo has taken all the trades from the system over the last 6 years, simulated 1,000 traders' equity curves and averaged the return.

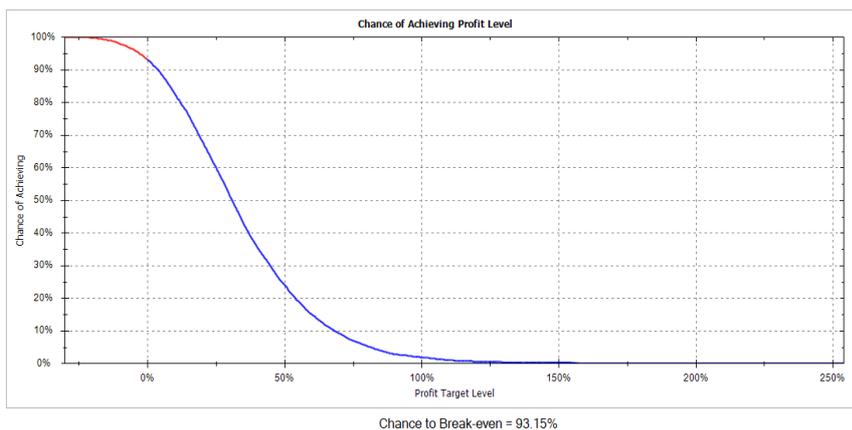


The median return is 31.15% p.a. Bear in mind this result is influenced by the Covid rally. The longer-term average (20 years) is around 25% p.a.

Another useful chart:

The chart below shows the chance of achieving a particular profit level.

Perhaps importantly for the risk averse trader or investor is the 93.15% chance to break even – calculated over the last 6 years, longer term the number is around 90%.



Comments about Draw Downs:

As with any trading system with the goal of applying the strategy to the market for the long term, the most difficult part is sticking to it.

Drawdown is arguably the most emotionally challenging factor with trend trading systems.

Tweaks and changes can be made to alleviate the severity of drawdown.

Some strategies to reduce drawdown with a system are:

Reduction in position size.

The use of a market filter to determine if it is Bullish or Bearish.

Quicker exits.

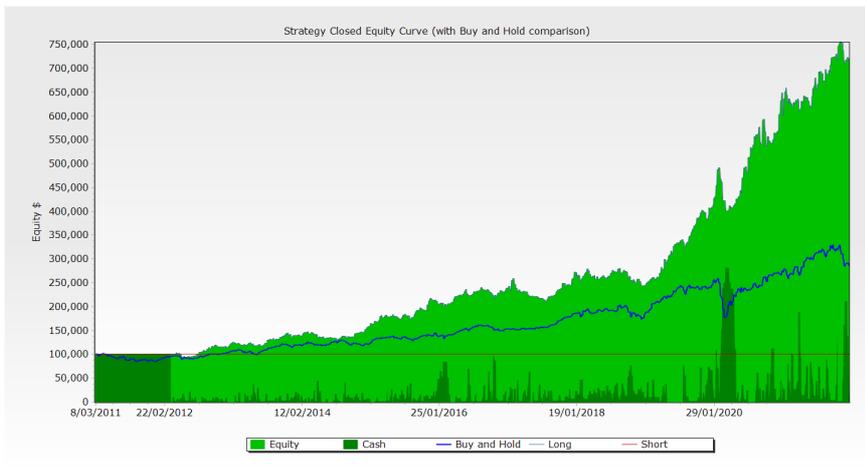
A volume indicator to accompany the buy signal.

For example, with the addition of volume and turnover indicators on this system, the maximum drawdown reduces to 19%. However so does the average return to 22% p.a.

This is normal for portfolios of a larger capital value to have reduced returns due to liquidity and less opportunity due to their size.

With the addition of a position sizing alteration (based on the equity curve) the maximum drawdown reduces to 18% and still keeping the return to 22% p.a.

The longer-term chart of 10 years (below) gives an example of that. Notice the reduced drawdown in 2022 using that strategy.



These different and enhanced strategies are taught to private clients. Alternately, other systems using similar strategies are available to purchase on the systems page on my website.

Summary:

As mentioned many times before in all my writing and teaching, one of the main objectives in my work with clients is to develop a system – for many traders do not have a workable system with a profitable edge. It is important to STICK TO a system.

If a trader is not committed to a process, good years such as 2021 displayed in this example are missed – severely affecting results of the system (or any system).

The process from then on is a matter of trade size, trade execution, review, adjust etc., continually reviewing the methods performance ALONG with the performance and mindset of the trader.

Choosing and implementing a system will always be a balance between desired results and the trader's ability to cope emotionally with the volatility of the system.

Thank you for purchasing this PDF and reading. I hope it helps you on your trading journey,
Regards, Peter

For more info about trading and my writing go to

<http://www.easyssharetradingsystems.com.au/easy-share-trading-systems/about-the-author>

<https://www.harriman-house.com/zentrader>

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Reverend Taishin Shodo (Peter Castle), is a Zen priest in the Mugendo Zen Kai tradition. This tradition is associated with the Rinzai Zen tradition of Japan.

For more info about Zen go to

W: <http://www.silkyoakzen.org/>

Regards

Peter Castle

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