

Analysis Paralysis and Other Traders' Rule Clichés

By Barbara Rockefeller

The best of all possible worlds is when a long-term model, a medium-term model and a short-term model all point in one direction. Then you can feel confident that your trade is going to win, right?

Well, maybe. All the timeframes hardly ever line up. Short-term players take profit on a different schedule from position traders, and your short models will all too often give you a discordant signal. You may decide to stick to the medium and long-term signal, since at least they agree. You feel virtuous. You are being mature and taking the big-picture view. You are not going to be stampeded by feckless specs. You are a "position trader." This is where the money is to be made, not least because you are saving on commissions and slippage. *Let your profits run.* Overtrading is the amateur's mistake.

But then a nagging doubt sets in. Medium and long-term models get rid of confusing noise, but they lag. What if the short-term version is the right one? What information is out there that you don't have? A price move can stop and reverse on a dime when there's fresh information. How far into a loss are you willing to go to defend being right--instead of making money, the real goal? You could believe in a long-term uptrend but trade on the short side, can't you? It's a sign of intelligence and sophistication to be able to hold two opposing ideas in your head at the same time.

So you reverse positions to go with the short gang, only to get stopped out with a loss. The short-termers were playing mind-games. Maybe they were trying to get a new trend started. Maybe they were trying to flush out the weak longs so that they could buy at a better level. *Maybe they were just wrong.*

Most advisors will tell you to narrow in your timeframe when this happens. You correctly identified that something is happening in the short-term, but your mind is still contaminated with the long-term view. Your eye can't see the new perspective. When your short-term technique fails you, maybe you need a new one.

The worst part of trading against what you think is the trend is doing it on a new idea that somebody presented to you only ten minutes ago. We've all done it: you go to a seminar or read an article about a technique--always short-term and always requiring a specific configuration or "set up"--and before you know it, you just have to take it out for a spin. It's ridiculous. We spend hours and days grinding away to devise properly back-tested models, and then blow precious capital on a new kind of trade because some credible-seeming guy has showed you how much it made for him. Think about it: if a trader has a well-defined and truly workable new idea, would he tell *you*? Most of us have best friends who won't tell us how they trade. There's a reason these are called "set-ups." What's getting set up is you. This is not to say the new trading idea is a bad one or its purveyor is a fraud. In a majority of instances, the new idea is presented with the best of intentions. The party doing the setting up is you. What's bad is putting money on the table without back testing it and paper-trading it for a while.

Why do we do this to ourselves? Trading shrinks and coaches really do have the answer to this one--we don't believe in our deepest hearts that our system works. This is the root cause of analysis paralysis. If one technique is good, two should be better, and three should be positively the road to riches. It takes only three to get paralyzed, but if you are using four or more techniques, you are practically guaranteed to lose money.

You can detect that your real problem is not believing in your own work when you start repeating the litany of traders' cliches to yourself, like "Let your profits run." There's nothing wrong with traders' rules, but they should already be built into your system. When you are starting at the screen with total indecisiveness, you need help, and it's **not** a new short-term technique.

What you need is a tie-breaker rule. Let's define a tie as the condition of two opposing teams having the same score in a game where there can be only one winner. Analysis paralysis encompasses more than a simple tie, of course, but for practical purposes, we need to make a decision--stick with the long-term models in the face of a short-term reversal, or discard the long-term altogether? Lots of tie-breaking decision rules could be devised, but here is one that might work for you.

Paralysis reaches a peak of unbearability when a previously trending price pattern is flattening. Usually it reverses first, or seems to, but then just goes sideways. We don't yet know if it will actually reverse to the opposite direction for a whole new trend. In fact, we may feel that we know the big-picture bias is to the upside, but some short-term indicator--usually the wildly popular stochastic oscillator--is telling you to exit. You may reason that it doesn't matter whether the price is going into congestion or reversing--your profit opportunity is disappearing as trendedness is disappearing, and we are in this to make money. Logically, we should *always* exit when trendedness goes away. We may or may decide to continue to trade in a shorter timeframe when this happens, but we have to take the first step, which is always to exit.

Some securities trend more than others but they all spend some proportion of time doing nothing much by way of direction. In Chart 1, the euro/dollar futures prices were nicely trending from about February 1 to July 19, when a peak was formed. The first line is a linear regression of that move. Since then the euro has hunkered down in a range of roughly 9569 to 9946. The second line is a linear regression of the entire move, to October 11. The slope is less sharp, but it is still an upward slope. The third line, however, is the linear regression from the July high to October 11, and it is dead flat. (These are daily bars. If you are a more active intra-day trader, just imagine these are ten-minute bars. As long as we can get the lag out of our tie-breaker indicator, it should work on any timeframe.)

The linear regressions define the problem but they also contain the solution. The slope of an indicator can tell us if prices are trending. If the slope is flat, prices are not trending. If prices are not trending, we shouldn't use any trend-following techniques. This may seem blindingly obvious, but the next time you are brought to a dead halt by indecisiveness, stop and ask whether your price is trending or not. A lot of the time, you have just entered trader's nightmare, a flat market. Don't complain that you can see a bias to the upside. It may be perfectly true that the price series has a historical bias to the upside, as shown by the linear regression or any other directional measure. So what? True is not useful. Besides, we don't yet know whether the now-horizontal linreg is going to start pointing downward--it's a work in progress, like any other indicator. If you are a trend-following model trader, you just got booted out of the game.

The linear regression and its offspring, the standard error channel, are handy tools, but have one tremendous drawback--you don't always know where to start and stop them. An obvious peak and an obvious low are sometimes the "right" place, but may not be representative of the trend, especially if they are spikes. Sometimes a linear regression drawn from a spike doesn't even touch many of the data points. Much of the pretension of using a "non-judgmental" technique goes out the window when you start choosing the starting and ending points.

But never mind. If we really like the linear regression, we can look at its slope as a separate indicator. Chart 2 shows the slope indicator. This can be further refined and tested for significance, but more interesting is that we can employ the same "slope" idea using just about any indicator. Chart 3 shows a 24-day momentum indicator in the top window and a 24-day adaptive moving average in the main window. At the point the prices moved below the adaptive moving average and momentum turned downward-sloping for the third day, we knew we wanted to exit a long position. Actually, the simple rule of exiting on the lowest low of the past three days would have given us the same outcome in this case, although it isn't always that tidy. Notice that afterward the indicator lines are flat.

Here we are eyeballing the slope. We can look at slope more directly by creating a regression oscillator. Most software packages contain one or the ingredients for one. If you don't like regression because it's too fancy or too removed from the price action itself, use momentum. All we need is some smoothing technique applied to momentum in such a way as to show us a derived (relative) slope. A good one is the smoothed momentum indicator created by William Blau, which he names the True Strength Index. This is a double smoothing of momentum, which Blau defines as the close today minus the close n days ago (rather than the close today divided by the close n days ago). However you want to define momentum, it's the key to identifying the absence of trendedness.

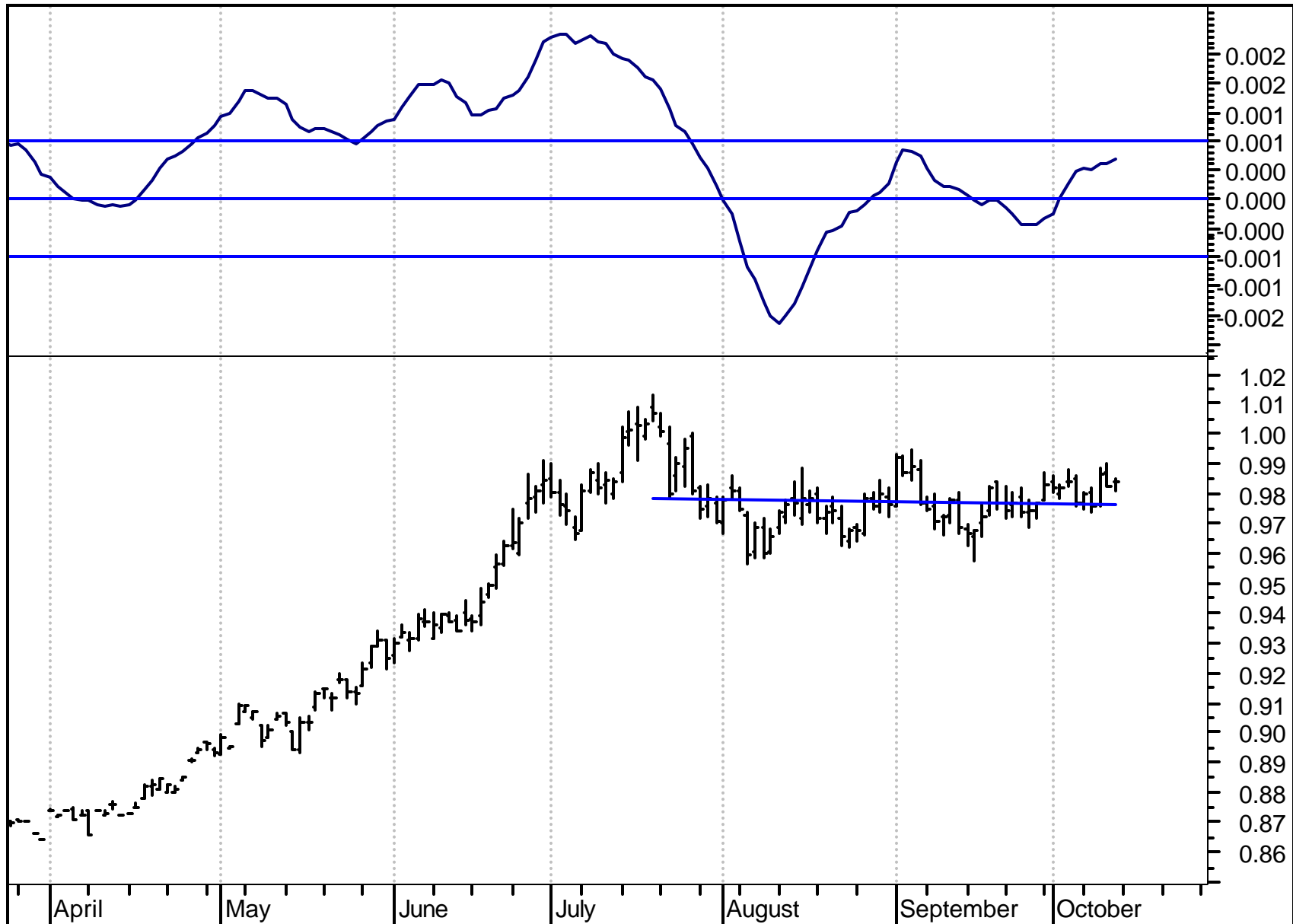
When prices are flat, it's time to leave. In fact, you can even use a moving average of the standard deviation. Just as a narrowing of Bollinger Bands shows directional indecisiveness, when the moving average of the standard deviation contracts, it means the same thing. Chart 4 shows the 21-day moving average of 2-day standard deviation. The main window shows the standard error channel around the linear regression line of our flat period. You can probably devise a dozen more indicators that directly or indirectly identify the same thing, or just look at what you've already got for "slope."

We say "the trend is your friend," but it's also true that the absence of a trend is your friend, too. Once you break the paralysis brought on by looking at indicators across multiple timeframes and accept that you are in an untrended situation, you have to decide whether you have the right techniques and the right mindset to trade in a really short timeframe. In the euro case, prices are flat overall but that doesn't mean there are no profit opportunities. If your time horizon is only a day or two, or less than one day, there are mini-trends to exploit. If you are nimble and flexible and have really good money management rules, money can be made in an untrended market. Actually, you may find that you do better in an untrended market because you know it's untrended and many other participants are still "seeing" a trend or at least a bias to the upside. In this instance, you could find yourself employing another trader's rule cliché--nobody ever went broke taking profits.

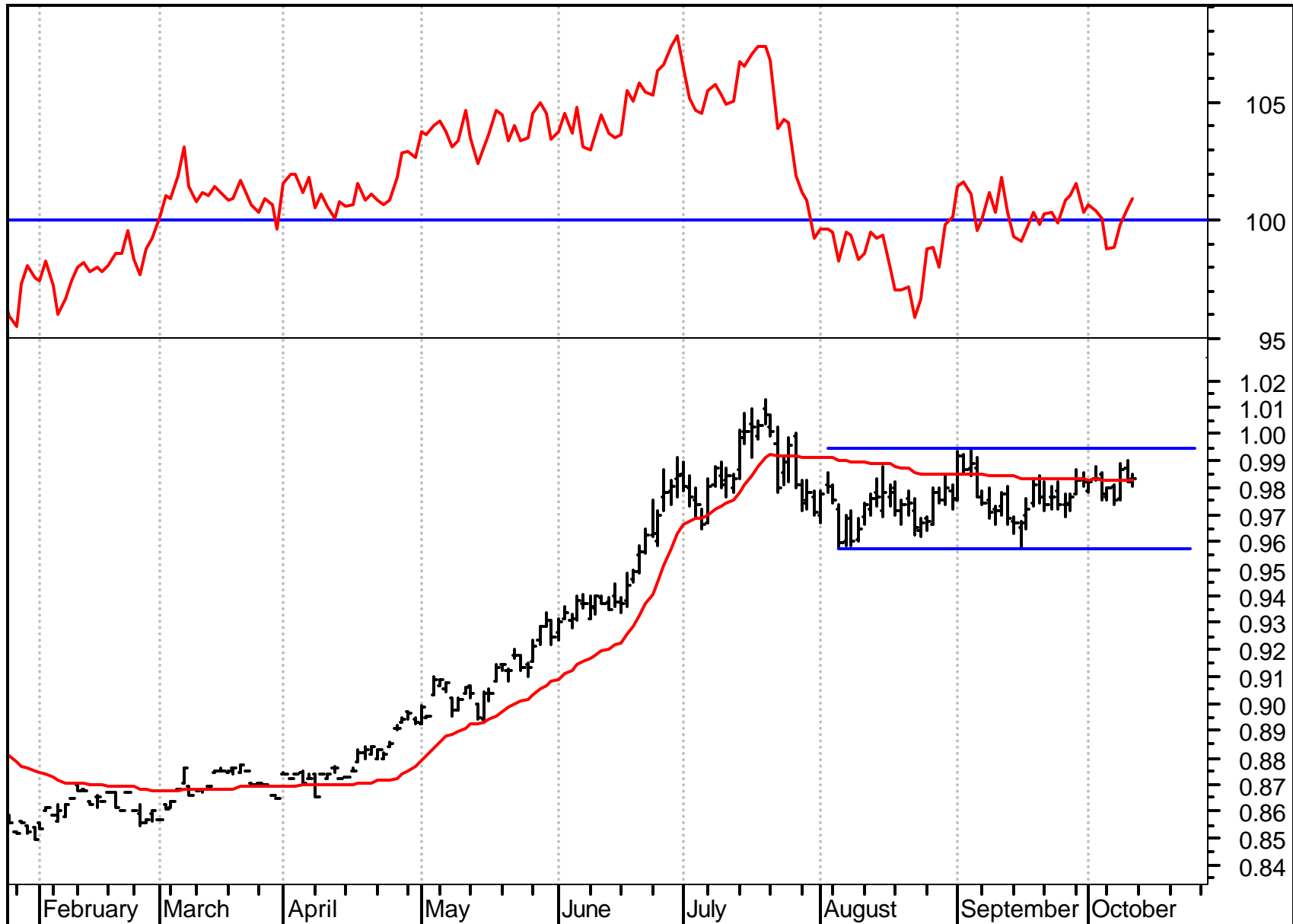
“Analysis Paralysis” for **Chartpoint**
Chart 1, Linear Regressions
Euro/Dollar CME Dec '02 Contract



“Analysis Paralysis” for **Chartpoint**
Chart 2, Slope of the Linear Regression
Euro/Dollar CME Dec '02 Contract



“Analysis Paralysis” for **Chartpoint**
Chart 3, Adaptive Moving Average and Momentum
Euro/Dollar CME Dec '02 Contract



“Analysis Paralysis” for **Chartpoint**
Chart 4, 21-day Moving Average of Standard Deviation
Euro/Dollar CME Dec '02 Contract

