ALGOTRADES

The Paradigm Shift from Financial Advisors to Algorithmic Trading Systems

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Over the last 50 plus years, people have been using the same methods of investing for their future, and not much has really changed. The norm of hiring a financial advisor to plop your money into generic mutual funds, RYDEX funds and insurance plans (while taking a 2 percent annual fee on your life savings) has been good enough for the masses. Because it's the norm and what everyone has and is doing, we naturally think that it's the right thing to do with our money. But is good enough really GOOD ENOUGH for you?

Think about it. You work hard, save money, plan for your future and hire a financial advisor to guide you through the shark-infested waters of investing so you can live your dream. But what really happens? You hand over your money, and you put your trust and future into the hands of someone who simply follows an old-school way of investing. This method is loaded with front-end fees, back-end fees and annual fees. And in most cases, it does not make you money during market downturns!

Your retirement money isn't protected in the event of a market crash or multi-year bear market. So what happens? You end up riding the financial roller coaster, which is something you don't really want to do (or do again for that matter). But you do it because it's the only way you know and the way everyone else has done it.

The industry average is roughly one percent, but fees can range from 0.80 percent to two percent in the U.S. and Canada. Typically the more assets you have, the lower the fee. While that may not sound like much up front, don't forget that most of these funds they put your money into also have roughly another one percent annual fee. This extra percent you pay makes a big difference in your long-term return.

For example, an investor with a $250,000 portfolio earning seven percent per year would be sitting on $967,000 after 20 years. Had they paid an advisor using mutual funds with a two percent fee of their assets during those years, however, their account value would fall to $663,000 — a difference of roughly $304,000.

So, the financial advisor who likely didn't protect or make you money (although he or she might be a perfectly nice, competent professional with excellent intentions) during the multiple bear markets that you would have encountered made away with a good chunk of your nest egg. They did this with virtually no downside risk to them; they get paid every year no matter what the financial market does, whether they made you any money or not.

Does that sound like a plan you want to stick with going forward?

It doesn't to me.

The two most important things you can do to improve the performance of your portfolio is to reduce your trading fees and to have a proven strategy that makes money in a bear market.

This old-school way of investing for your future - without downside protection and without a trading strategy for your money during market crashes and bear markets - is just that. Old school.

Today, you can do things differently. You can use proven algorithmic trading/investing strategies. This not only allows you to potentially avoid market crashes and multi-year bear markets, but you can actually profit from them handsomely. Algorithm trading systems are starting to gain traction with the average investor because the old way of doing things doesn't make sense.

People are finally starting to communicate more about their financial situation and experiences, and they are realizing they've had the exact same financial outcome and ridden the same emotional roller coaster. This realization has triggered individuals to gain a better understanding of what happened, and more are starting to see the new ways money can and should be managed. In short, they are having an epiphany. Epiphanies are relatively rare occurrences, and they generally follow a process of significant thought about a problem. They are often triggered by new information, processes and tools that are available.

So what does all this mean?

The investment world is about to have a paradigm shift. It means the old-school way of investing is being challenged with newer, more sophisticated, proven, rule-based strategies that perform well in all market conditions. These systems also automatically manage positions and risk for your maximum benefit and income potential.

In order to truly understand Boom-Bust Cycles (paradigm shifts), you'll need to review the work of Carlota Perez (especially her book Technological Revolutions and Financial Capital). In this work, you can see how economic paradigms rise and fall.

Perez explains an interesting phenomenon: that every 50 years or so, there have been new economic structures that caused the collapse of what came before. Perez identified five economic paradigms (or "Great Surges") throughout this period:

- Industrial Revolution in Britain (1770-1830)

- Age of Steam and Railways (1830-1870)

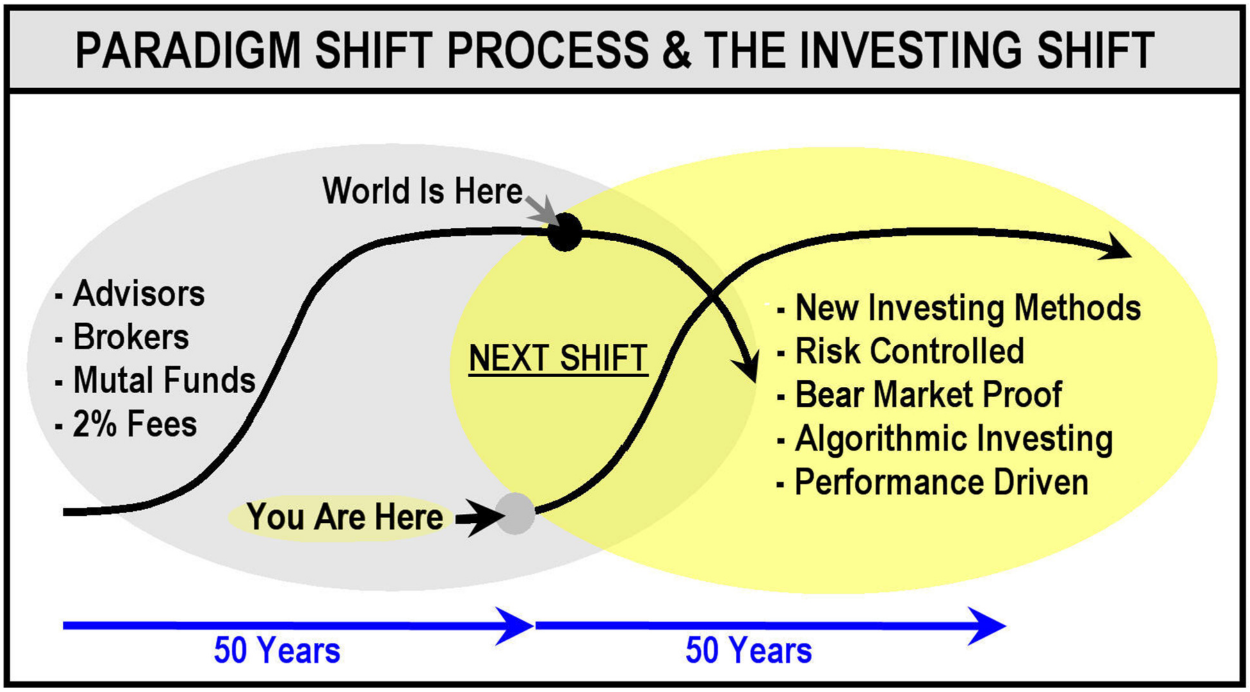
- Age of Steel, Electricity and Heavy Engineering (1870-1920)

- Age of Oil, Automobiles and Mass Production (1920-1975)

- Age of Information and Telecommunications (1975-20??)

- The use of Financial Advisors and Mutual Funds (1970-20??)

Each of these times represents a major technological breakthrough. These breakthroughs resulted in a fundamental restructuring of how things were done. Each of these periods had its own paradigms for wealth-generation, institutional structures, regulatory environments and desired trajectories for society. The technologies themselves were only one piece of the vital inputs that ultimately defined each era.



Be Aware of Paradigm Paralysis

Perhaps the greatest barrier to a paradigm shift is the reality of paradigm paralysis. This is the inability or refusal to see beyond the current models of thinking, and it is similar to what psychologists call confirmation bias. A couple examples would be the rejection of Galileo's theory of a heliocentric universe and the discovery of electrostatic photography. Across history, there have been many errors in thinking and many traditional processes that were maintained by the crowd simply because there wasn't yet a better way. Then along came a Henry Ford or some other innovative individual, and one was created. There is a better way to investing, and now is the time to get on the path.

The Shift Is Happening Now

In the year 2010, more than 70 percent of the stock shares traded on the NYSE and NASDAQ were generated from automated trading systems. Today it's much higher, and it is continuing to grow. Most of these systems are done by large institutions, but individuals with their own trading system are a category growing at an incredible rate each year.

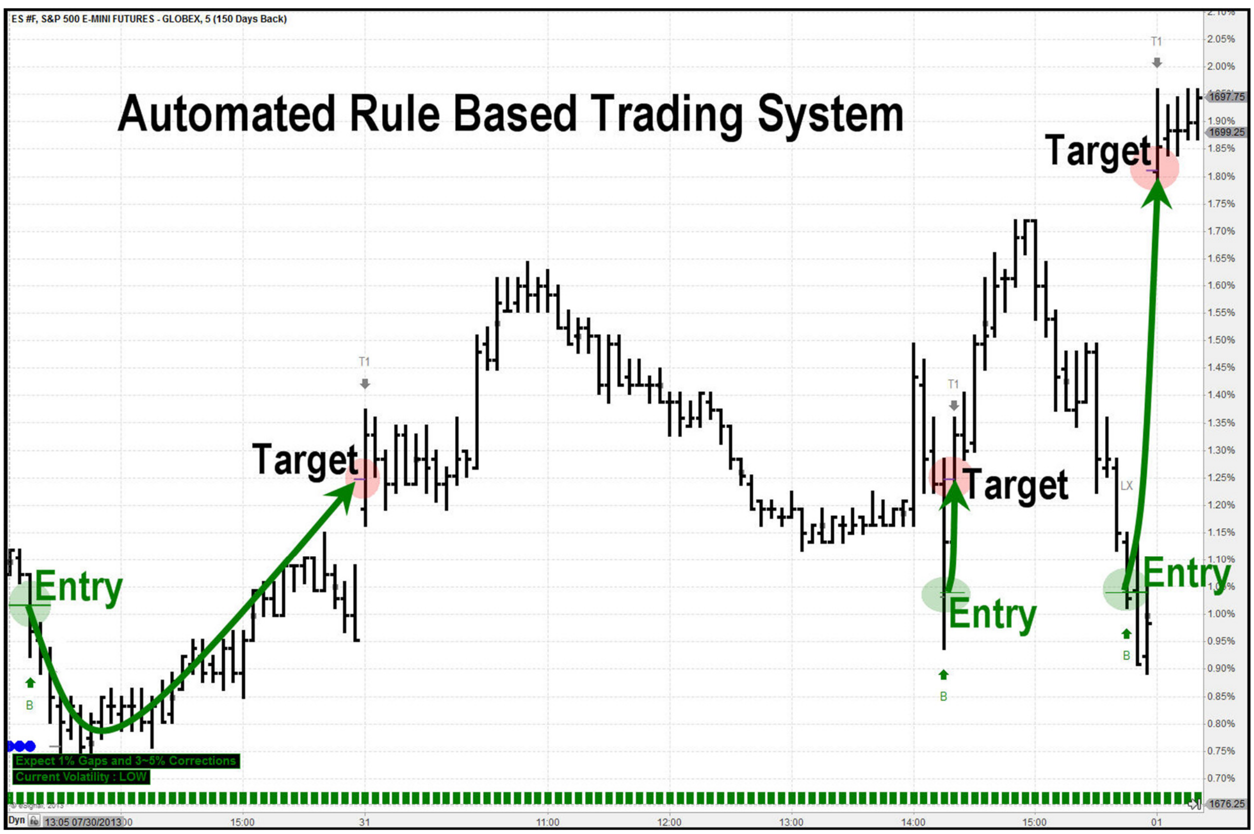
Traders and investors can now turn precise entry, exit and money management rules into automated trading systems. This allows computers to execute, monitor and manage positions.

The biggest attraction of automated strategies is that it eliminates some of the emotion from trading. Since trades are automatically executed once a specific criterion has been met, emotion is taken out of the equation. This next section will educate and explain some of the advantages and disadvantages, as well as the realities, of automated trading systems.

What Is An Automated Trading System?

Automated trading systems, also referred to as mechanical trading systems, algorithmic trading, automated trading, block-box trading, or system trading, allow traders to create specific sets of rules for both trade entries and exits that, once programmed, can be automatically executed via a computer. Each trade rule can be based on simple conditions, such as a moving average crossover, or each trade can be more complicated by using an individual's proprietary indicator, ratios and data points. Automated trading systems typically require the use of trading software capable of running the trading systems' code and trade execution.

Figure 1: A 5-minute chart of the ES contract with an automated strategy applied.



Once the system rules have been established, the trading platform can monitor the market or a specific investment you intend to trade for entry and exit points based on the trading strategy specifications. In general when a trade is executed, orders for protective stop losses and profit targets will automatically be created and executed. During volatile fast moving markets, automated order entry can mean the difference between a profit and a loss.

Advantages of Automated Trading Systems

Ability to Backtest. Backtesting allows us to apply trading rules to historical market data. This tests allows us to determine the viability of an idea. When building a system for automated trading, all rules need to be absolute, with no room for interpretation. Computers cannot make guesses and must be told exactly what to do for each and every possible scenario. Careful backtesting allows us to evaluate and fine-tune a trading idea. Backtesting also determines the system's expectancy going forward. Important data points you should track are your average maximum dollar drawdown, your average winning trade amount, your average losing trade amount and your percentage of trades that are winners.

Achieve Consistency. One of the biggest challenges in trading is to plan the trade and to trade the plan. Even if a trading plan has the potential to be profitable, traders who ignore the rules are altering any expectancy the system would have had. Losing trades can be psychologically traumatizing, so a trader who has two or three losing trades in a row might decide to skip the next trade. Automated trading systems allow traders to achieve consistency by trading the plan.

Improved Order Entry Speed. Since computers can respond instantly, automated systems are able to trigger orders as soon as a set of trade rules are met. Getting in or out of a trade a few seconds earlier can make a big difference in the trade's outcome. This is especially true over a long period of time when hundreds or even thousands of trades have been taken.

Minimize Emotions. Automated trading systems minimize emotions throughout the trading process. By keeping their emotions in check, traders typically have an easier time sticking to the plan. Because trades are executed automatically, you will not be able to hesitate or question the trade. Those who are either afraid to pull the trigger and those who are more apt to overtrade benefit greatly from an automated system.

Preserve Discipline. With trading rules already established and trade execution performed automatically, discipline is preserved even during volatile market conditions. Discipline in most cases is lost due to the fear and greed factor. The fear of taking a loss, or the desire to squeeze out a little more profit from a trade, hurts discipline. In addition, pilot error is minimized, and an order to buy 500 shares will not be incorrectly entered as an order to buy 5000 shares, for example.

Diversify Trading. Automated trading systems allow us to trade multiple accounts and various strategies at the same time. This has the potential to spread risk over various instruments and timeframes. What would be incredibly difficult for a trader to accomplish can be efficiently executed by a computer in a matter of milliseconds.

Disadvantages and Realities of Automated Trading Systems

Automated trading systems boast many advantages, but there are some downfalls and realties of which you should be aware.

Mechanical Failures. While automated trading in theory seems simple: set up the trading software, program the rules and watch it trade. The reality, however, is automated trading is a sophisticated method of trading but not infallible. Depending on how the system creator has the entire process set up, a trade order could reside on an individual computer and not a server. If this is the case, an order might not be sent to the market when an Internet connection is lost. There could also be a discrepancy between the "theoretical trades" generated by the strategy and the order-entry platform component that turns them into real trades. Individuals new to the automated trading arena should expect a learning curve when building, testing and running their first few systems. It is generally a good idea to start with small trade sizes while the process is refined.

System Monitoring. Although it would be great to turn on the computer in the morning and walk away for the day, automated trading systems require monitoring. Because of the potential for mechanical failures, such as internet-connectivity issues, power losses, computer crashes or system idiosyncrasies, it is possible for an automated trading system to experience anomalies. These could result in errant orders, missing orders or duplicate orders. If the system is monitored, these events can be identified and resolved quickly.

Over-Optimization. Though not specific to automated trading systems, traders who employ backtesting techniques can create systems that look great on paper and perform terribly with a live market. Over-optimization refers to excessive curve-fitting that produces a trading strategy that is unreliable. It is easy to create and tweak a strategy that achieves exceptional results on historical data. You must be aware of all the known issues with backtesting to be sure your new plan has been built to work within the backtesting guidelines for accuracy. If you do not, you may end up with over-optimization systems that look good on paper only.

Server-Based Automated Systems

Traders do have the option to run their automated trading systems with a server-based host. Operating your trading platform and system on a dedicated server provides you with a potentially faster and more reliable platform. This minimizes unnecessary platform crashes and server failure or loss of internet, and it improves your order execution times.

Being able to leave your trading software running 24/7, not worrying about restarting applications, reloading strategies or filling in missing tick data, is a huge benefit if you plan to operate your own automated trading system.

How to Take Advantage of the Trading and Investing Shift

The power lies in the masses… and you and millions of others who have been using the old-school method of trading and investing (and are just now reaching the breaking point) should say enough is enough!

With so much information available, it is just a matter of time before average investors start demanding performance from their advisors. Most advisors are not technical analysts and cannot read into the charts, nor can they provide you with automated trading systems that are both backtested and forward tested. Most do not have multiple trading strategies within to profitably trade bull, bear and sideways trading markets.

Automated trading is about to explode, and when it does, the doors will open for investors around the world to allocate portions of their trading accounts or investment capital to specific systems and strategies traded for them in their brokerage account. Get ready to do things a better way.