Trade Like a Hedge Fund

20 Successful Uncorrelated Strategies & Techniques to Winning Profits

JAMES ALTUCHER

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Trade Like a Hedge Fund

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To my father, Seymour Altucher, who taught me

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Introduction

When I first told my investors and partners I was doing a book, most of them were somewhat upset. One of my investors, a prominent hedge fund manager in his own right, was very upset at the thought of sharing good research with people. One of my partners, after reading a few of the sample techniques, told me he was going to buy all of the books when they came out and hold a big bonfire. And then there is always the question I wonder when I read investment books: If these systems are so good, why not just use them to print money all day long? Why write about them?

Well, I have several answers. For one thing, I have learned a lot during the process of researching this book. Although I have been using many of these systems for years, there are always new subtleties, new twists, in every system. Despite being a systematic trader, I am a personal believer that it is impossible to just rest on your laurels and use a black box that prints money forever. Every system needs to be constantly researched and further developed, new avenues explored, former old paths disbanded. Many of the new twists I have looked at during the process of putting together this book actually helped make me money over the past several months—money I perhaps would not have made for myself and my investors if the research had not been so focused. System development and trading is a constantly evolving process. It is that process of continual development that makes someone a successful systematic trader, not the systems themselves.

For another thing, while I believe the systems and patterns mentioned in this book will bring success to those who apply them with discipline, I also feel they should be viewed as stepping stones for further research. The markets are a very big place with many hidden pockets of inefficiency. And yet those pockets are constantly changing. I think the ideas in this book are great places to start when looking for further inefficiencies, and I think the ultimate success readers will enjoy is when they start finding those inefficiencies for themselves.

In addition, I like to correspond with an interested community of other developers, traders, and researchers. Unlike many people I do not believe that the sharing of systems (in most cases) degrades the system. Every year trillions of dollars are put to work in the markets. There are trend followers, countertrend followers, buy and hold mutual funds, day traders trading off gut, and thousands of other types of traders and system followers out there. No matter what system you have or approach you use, it is a guarantee that there is someone out there more than happy to fill your trade in general. By sharing ideas with a community of interested parties, I hope to learn from their ideas as well. The saying, "give and you shall receive" certainly applies here.

Finally, I like to write. I hope people enjoy reading what I write.

In terms of how I would use the ideas in this book: No one system is a Holy Grail for the markets, in the same way that no investor should bet on one stock to blaze his or her way to riches. Just like the buy and hold stock investor, the hedge fund trader relies on diversification, only it is diversification of uncorrelated systems, rather than diversification of uncorrelated stocks. Having a portfolio of systems whose successes do not depend on the successes of other systems is the best way to smooth out any volatility in your personal equity.

Almost all of the systems used in this book were built on top of a simulation software package called Wealth Lab. I cannot recommend this package enough to people. The software can be found at www.wealth-lab.com and comes equipped with a Pascal-like language for building very sophisticated trading systems that can be tested easily on indexes as well as baskets of stocks. The support desk responds quickly to any queries, and the community of developers that can be found on the discussion of forums at the Web site is a useful starting point when developing one's own systems.

One thing to keep in mind is that although testing and research in the markets requires a scientific approach, there is an element that is art as well as science. In other words, do not believe everything you see. Just because something works 500 times out of 500 times does not mean that the developer has not curve fit a system to the data. With every system you ever play, try to ask: Why does this system work? What aspect of the psychology of mob behavior can possibly produce this result?

The markets can only be exploited when there are inefficiencies. That said, there are a lot of smart people trying to find those inefficiencies, and when they occur, they just as often quickly disappear. The inefficiencies that are exploitable, year in and year out, and even decade after decade, are those that have deep roots in the fears and greeds that drive investors and gamblers alike to the world's markets. Keeping this fact in mind will help you avoid the perils of data mining and curve fitting, and will ultimately lead to your own ideas that can be used to trade the markets.

TECHNIQUE 1

The Bread and Butter Trade—Playing Gaps

The gap trade is the bread and butter trade for many day traders and hedge funds. Many day traders *only* play gaps. They wander into the day trading firm at 9:25 AM, coffee and *New York Post* in hand, settle down, look for the stocks that are gapping up or down, and then fade them. They go the opposite direction: shorting gap ups until they get back to flat with the prior day's close, or going long gap downs. Four times out of five they make money and life is great; they can spend the rest of the day at the movies. But the fifth trade will wipe out all the profits and then some when the gap continues in the direction it started and all the gap-fillers get squeezed in one direction or other.

Research and the systems described in this technique will help the hit rate of the gap filler. The key is to identify those situations where it is more probable than normal that the gap is actually fadable. Making sure in each instance that, through testing and a commitment to research, you know that your edge is real and quantifiable off of all these day-trading wannabes is a key to success in playing gaps.

A gap occurs when a stock opens lower or higher than the previous close. For instance, on October 10, 2001, QLGC closed at 27.98. The stock opened the next day at 29.45 and kept running until it closed at 34.24. In other words, it never "filled the gap," or moved back to the close the day before. Shorting that open would have resulted in a disastrous 17 percent loss that day. (See Figure 1.1)

Note: All example trades are simulated with $100,000 unless otherwise specified.

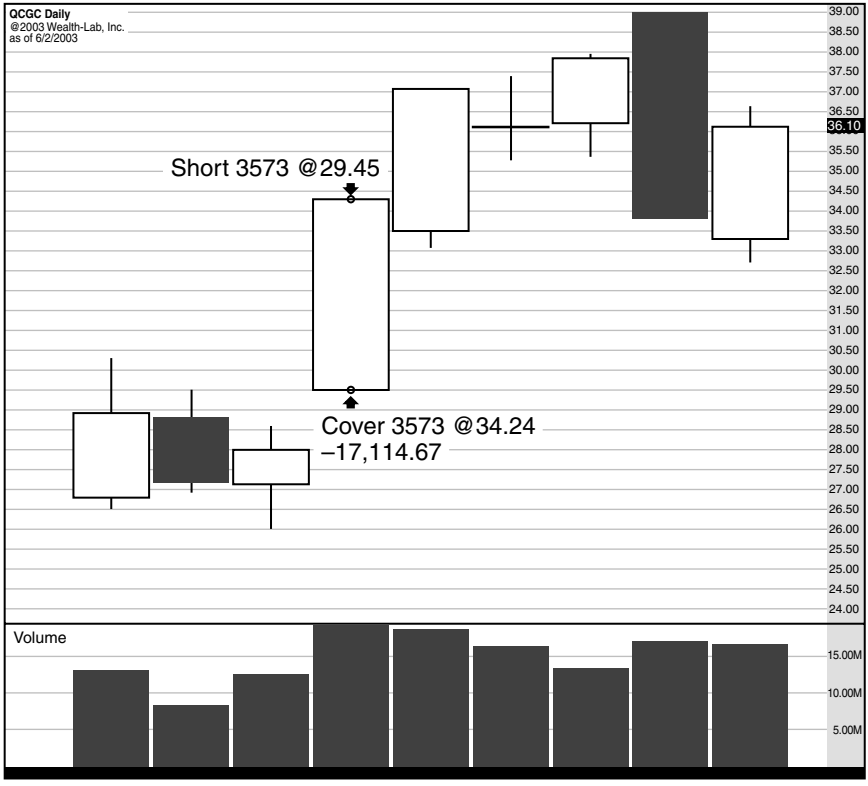

FIGURE 1.1 QLGC on October 10, 2001.

Before deciding to play gaps, first ask the question, "do gaps fill in general?" and then see if one or more trading strategies can develop out of the answer.

SYSTEM #1: FILLING THE GAP

The following is a test of the basic gap-fill approach:

- Buy a stock when it opens more than 2 percent lower than the prior close.
- Sell at yesterday's closing price *or* at the close if yesterday's closing price is never hit.

Test All Nasdaq 100 stocks (including deletions), from January 1, 1999, to June 30, 2003.

Result See Table 1.1. This is not a bad result, but it is not something I would want to play either. While 0.58 percent is a great result per trade if you are dealing with Nasdaq or S&P futures, it is only barely adequate when dealing with individual stocks where commissions and slippage have more of an effect.

This system gets a modest boost if the day before is down, possibly because short-sellers would already be modestly in the money and then the gap gives them an additional profit that they might, at that point, want to take.

TABLE 1.1 Filling the Gap

	All Trades
All Trades	9,821
Average Profit/Loss %	0.58%
Average Bars Held	1
Winning Trades	6,174 (62.87%)
Average Profit %	3.21%
Maximum Consecutive Winning Trades	58
Losing Trades	3,647 (37.13%)
Average Loss %	−3.97%
Maximum Consecutive Losing Trades	20

SYSTEM #2: FILLING THE GAP AFTER DOWN DAY

The rules for System #2 are the same as for System #1 except only buy when not only is there a 2 percent gap down or greater, but also when the day before was a down day for the stock.

Result See Table 1.2. The improvement is decent. The average return per trade goes from 0.58 percent to 0.75 percent. While across 5,000 trades an increase in the average return per trade generates a significant return, it is still not enough per trade if you take into account commissions and slippage, which could be as high as 0.40 percent per trade or more.

A 2 percent gap down does not give us as much to work with as a 5 percent gap down, so let us try a third approach.

TABLE 1.2 Filling Gap after Down Day

	All Trades
All Trades	4,938
Average Profit/Loss %	0.75%
Average Bars Held	1
Winning Trades	3,157 (63.93%)
Average Profit %	3.40%
Average Bars Held	1
Maximum Consecutive Winning Trades	44
Losing Trades	1,781 (36.07%)
Average Loss %	–4.04%
Average Bars Held	0.98
Maximum Consecutive Losing Trades	15

SYSTEM #3: THE 5 PERCENT GAP

- Buy a stock if the stock was down the day before and if the stock is opening 5 percent lower than the close the day before.
- Sell either if the stock hits the close the day before or the stock closes without hitting the profit target.

Result See Table 1.3.

We are finally getting to the point where we might have a system to play. We need to make one more tweak before we arrive at a significantly

TABLE 1.3 5% Gap

	All Trades
All Trades	993
Average Profit/Loss %	1.97%
Average Bars Held	1
Winning Trades	605 (60.93%)
Average Profit %	6.02%
Average Bars Held	1
Maximum Consecutive Winning Trades	18
Losing Trades	388 (39.07%)
Average Loss %	–4.47%
Average Bars Held	0.97
Maximum Consecutive Losing Trades	10

profitable trading system. So far, gaps get filled more often than not on average, and the results are slightly better when things are even worse (the day before is down and the gap is 5 percent instead of 2 percent). What happens when the market as a whole is gapping down?

SYSTEM #4: THE 5 PERCENT GAP WITH MARKET GAP

- Buy a stock if the stock was down the day before, if the stock is opening 5 percent lower than the close the day before, and if QQQ is also gapping down at least one-half percent.
- Sell if the gap is filled or at the end of the day.

Example: RFMD, 6/26/02

On June 26, 2002, the market had a double-header. Intel had warned on earnings the night before of and on the morning of June 26, consumer confidence numbers came in well below expectations. Basically June 26 was in the middle of a death spiral that culminated in a major low for the market on July 24, 2002. That said, the market backlashed at least for the day on June 26 and buying gap downs produced great profits to the buyers as shown in Figure 1.2. The June 26 bar is in the center of the daily chart in Figure 1.2. After a down June 25, which closed at 25.46, June 26 opened 24.43, almost 4 percent down from the close the day before.

RFMD (in Figure 1.3) closed on June 25 at 6.44 and opened the next morning at 5.70—a disastrous result for those longs who might have felt

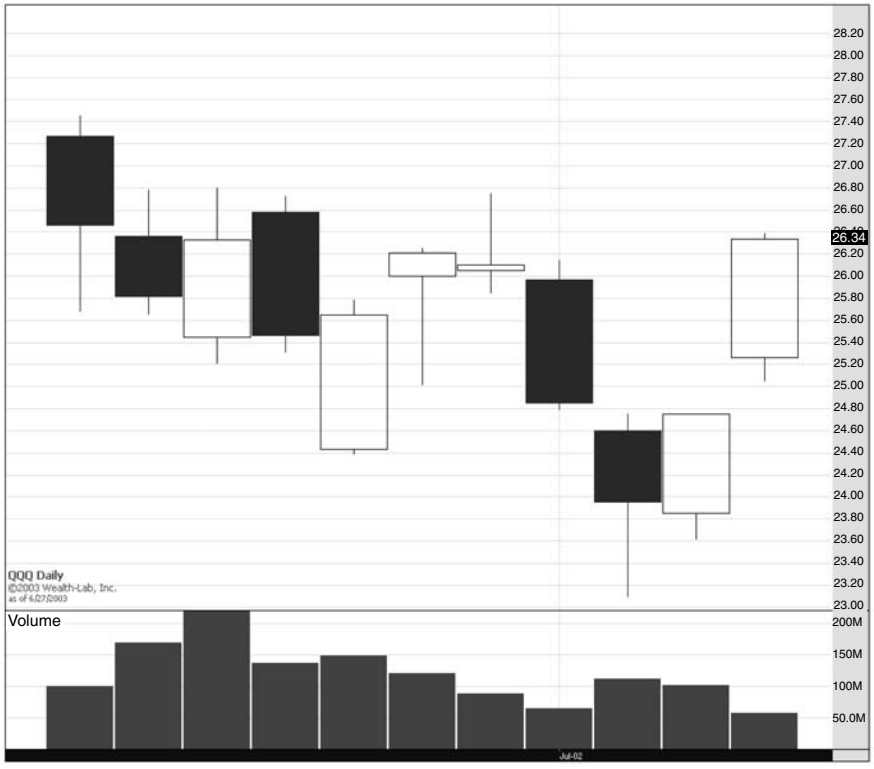

FIGURE 1.2 QQQ on June 26, 2002.

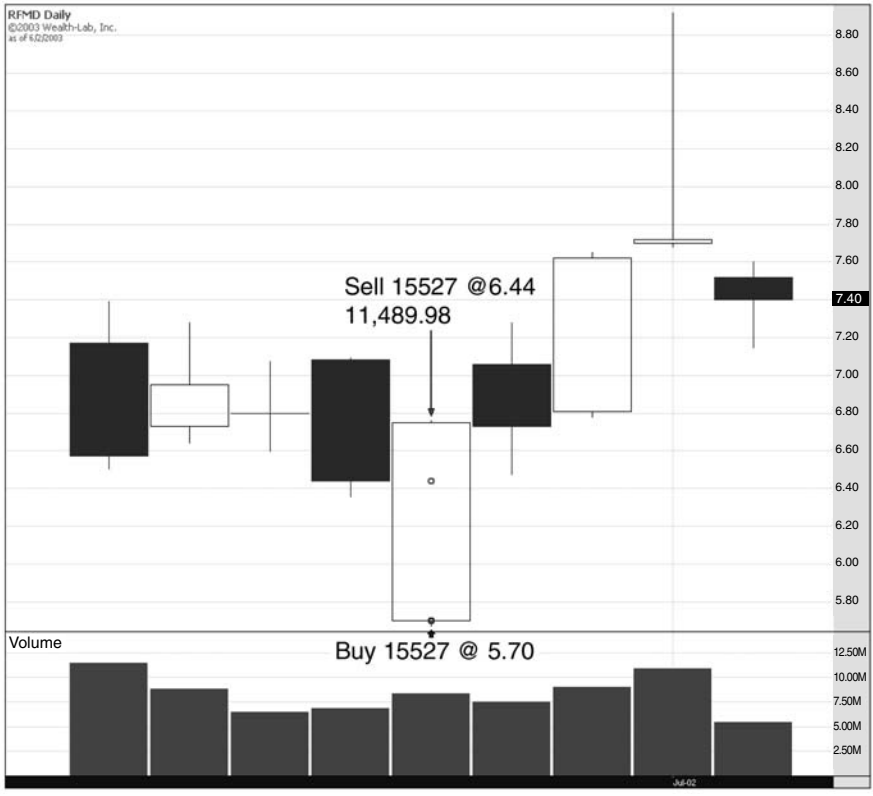

FIGURE 1.3 RFMD on June 26, 2002.

that the world was ending and the worst was yet to come. However, buying that open and selling when RFMD hits the price it had closed at the day before (i.e., it fills the gap), 6.44 would have resulted in a 12.98 percent profit.

Example: YHOO, 7/11/02

On July 11, 2002, the QQQs opened at 23.76 (see Figure 1.4). Having closed the afternoon before at 23.90, which was a gap down of slightly more than half a percent. YHOO opened at 11.15, down from 12.19 the night before. After the close on July 10, Yahoo beat earnings but did not guide up. The market was clearly disappointed in this, hoping for the second-half recovery in 2002, which did not look like it was going to happen.

As demonstrated in Figure 1.5, buying the open and closing out at the open the next day at 12.79 resulted in a profit of 14.71 percent. This was still in the middle of a steep market slide that lasted until July 24, but profits on the long side were still available to those looking for the right opportunity.

Simulation of 5% Gap

Starting with $1,000,000 and using 10 percent of equity per trade from March 10, 1999 (the inception of QQQ) to January 1, 2003, we get the result as shown in Table 1.4 (on all Nasdaq 100 stocks including deletions). As we can see from the equity curve of the simulation (Figure 1.6), there were very few trades generated in 1999. The interesting thing is that as the market had its most extreme falls (note the buy and hold line in Figure 1.6, the equity curve spikes upwards despite the fact that this is a long only strategy. The myth of a bear market is that only going short works. This strategy demonstrates the complete falsehood of that myth.

Figure 1.7 illustrates the annual return.

Average annual return of 28.32 percent with a Sharpe ratio of 1.29.

Many fund of funds take the view that the way to smooth out volatility of returns during both bull and bear markets is to have a long/short strategy. This way, during bull markets the longs will hopefully outperform the shorts and the market (the presumed alpha of the strategy), and during the bear market the shorts will greatly outperform the long positions. However, this strategy demonstrates it is possible to have a long/long strategy during both bull and bear markets by diversifying the method of going long. As an example, we can take the reverse approach of shorting gaps down and try shorting gap ups, as described in System #5.

TABLE 1.4 Simulation of 5% Gap with Market Gap System

	All Trades
Starting Capital	$1,000,000.00
Ending Capital	$2,593,543.00
Net Profit	$1,593,543.00
Net Profit %	159.35%
Exposure %	5.22%
Risk-Adjusted Return	3053.37%
All Trades	525
Average Profit/Loss	$3,035.32
Average Profit/Loss %	2.07%
Average Bars Held	1
Winning Trades	321 (61.14%)
Gross Profit	$2,875,406.00
Average Profit	$8,957.65
Average Profit %	5.89%
Average Bars Held	1
Maximum Consecutive Winning Trades	13
Losing Trades	204 (38.86%)
Gross Loss	($1,281,862.38)
Average Loss	($6,283.64)
Average Loss %	–4.07%
Average Bars Held	0.97
Maximum Consecutive Losing Trades	14
Maximum Drawdown	–8.26%
Maximum Drawdown $	($168,763.75)
Maximum Drawdown Date	9/6/2001
Recovery Factor	9.44
Profit Factor	2.24
Payoff Ratio	1.44
Risk Reward Ratio	3.37
Sharpe Ratio of Trades	6.59