

# Evaluating Computerised Trading Systems

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Computerised trading systems are often aggressively marketed in Australia, especially during strong bull markets and I am frequently asked about them. I do not use computerised trading systems and I have not tested any of these systems. I am therefore not in a position to make a recommendation about any of them. Likewise, I am not in a position to understand the financial requirements of potential buyers, so I am unable to make specific recommendations as to their suitability for a specific person. However, I am able to suggest guidelines for potential buyers who want to evaluate trading systems before buying them.

## Types of Software

There are three basic types of technical analysis software:

### Toolboxes

These are generally described as 'charting software'. They are used to draw charts from a database of market prices, volumes, open interest and other specialised data series. They also calculate indicators from the database and draw charts of them. The database may be supplied and updated as part of the software package, or the data may be purchased separately. To be classified as a toolbox, the software must either fully disclose the algorithm for any indicator, or provide reference to its calculation in a textbook on technical analysis. They do not create trading suggestions. The user does the analysis and makes his or her own decisions.

Good software packages are relatively inexpensive.

Before buying a toolbox, get a demonstration disk. If one is not available, ask for a demonstration of the software. Make sure it does everything you want, as the features vary. Also find out what help is available when you have problems and whether there is an active user group.

### Black Boxes

These are generally described as 'trading systems' and are easily identified because they run on proprietary algorithms that are not disclosed. They run these algorithms over a database and give you trading recommendations or suggestions. It is my understanding of the law that the person selling such software to you must be licensed as an investment adviser by the Australian Securities and Investment Commission.

These software packages are always expensive. They are sometimes thinly disguised as toolboxes or grey boxes. There is a good discussion of software types in *The New Trading for a Living* by Dr Alexander Elder (Wiley), a book every prospective trader should read. His view is that "Most black boxes are sold by hustlers to gullible or insecure traders. .... The only way to make money from a black box is to sell one." Also see below under the heading Evaluating Black Boxes.

### Grey Boxes

These are like a black box in that they generate trade suggestions from proprietary algorithms. However, they provide a general idea of how the formula works and sometimes allow the user to modify the settings or parameters. They may also have an associated tool box component. If they

are expensive, they are probably disguised black boxes. They should be evaluated the same way as a black box.

## Types of Black Box

It is my experience that there are three types of black box, categorised by the motives of the people behind them:

### Real Experts

There are very few of these. They have been developed after long periods of testing both on past data and in actual trading. They are almost never for sale; because the owner knows their value is enormous and is best realised by using it to trade their own funds and/or managed funds. They are never advertised to the public or sold by high-pressure means.

### Naive Developers

There are some of these about. The developers have learned a little about technical analysis and mistakenly think they have found 'the secret'. They often say that they are selling the system so they can make some money to continue development. So, you are being offered the opportunity to pay for them to learn. These people will usually have no experience in the securities industry, no industry specific qualifications and no license. You would be better to just give your money to charity. If you believe their story, you must take the time to test the system before using it to trade real money.

### Marketers

These are the ones widely advertised and sold by high-pressure means. They are always expensive, to pay for the marketing organisation and enrich the promoters. Wild claims are made about the performance of these systems, almost always based on theoretical testing rather than actual trading. Maybe some of them will make you wealthy. Unless you are hell-bent on enriching the promoters, you must evaluate them before you buy. If you buy on the basis of a money-back or other guarantee, get legal/financial advice as to whether the promoting company is likely to honour the guarantee.

## Evaluating Black Boxes

I would never buy a black or grey box trading system, but if I were contemplating the purchase of a black box or grey box trading system, these are the steps I would take before handing over any money:

- I would deal only with a licensed person. I would check that person's licence with the Australian Securities and Investment Commission.
- I would want anything that I am told to be given to me in writing, or I would make complete diary notes of all conversations. I would consider tape recording any presentations. No honest promoter should object to this.
- I would ask for an audited track record of all actual trades over a reasonable period made using the system. I would contact the auditor and verify his or her report.
- If I were unable to get an audited track record of all actual trades, I would ask to see the complete details of testing done on historical data using the system. I would require that:
  - The system test be over several different markets and over periods long enough to cover bull, bear and sideways markets.

- The system testing be done in front of me or verified by an independent person, such as an auditor. I would contact that independent person and verify his or her report.
- I be allowed to paper trade the system on several markets before finalising my agreement to purchase it.

After buying it, I would carry out my own testing on historical data. I would then paper trade it for some months before using real money.

Testing computerised trading systems is a big subject and is beyond the scope of this article and my experience and expertise. I recommend that anyone who wants to evaluate a system should first study:

*Computer Analysis of the Futures Market* by Charles Le Beau and David W Lucas (Business One Irwin).

*Schwager on Futures – Technical Analysis* by Jack D Schwager (Wiley).

*Trade Your Way to Financial Freedom* by Van K Thanp (McGraw-Hill).

They all have excellent discussions of the process of designing and testing systems.

Each person must do his or her own evaluation of the testing, because everyone is different. Unless you are comfortable with a system, you will not succeed with it.

Nothing that I have said or implied in this article is a recommendation to buy a computerised trading system. Nor should it be construed as comment upon any system currently on the market.

## To read more of my work

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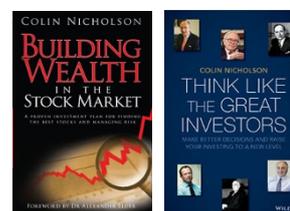
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