Forex Forensics Can Make You Rich!

> **Forensic science** is the scientific method of gathering and examining information about the past. This is especially important in law enforcement where forensics is done in relation to criminal or civil law,[1] but forensics are also carried out in other fields, such as astronomy, archaeology, biology and geology to investigate ancient times.
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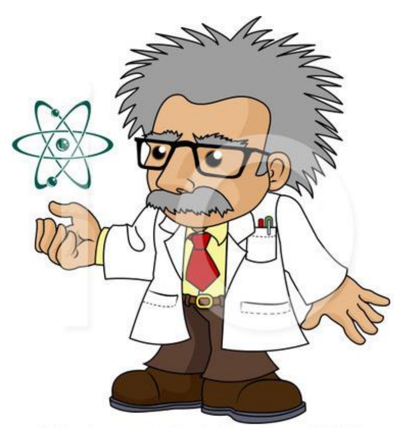
> The word *forensic* comes from the Latin *forēnsis*, meaning "of or before the forum."[3] In Roman times, a criminal charge meant presenting the case before a group of public individuals in the forum. Both the person accused of the crime and the accuser would give speeches based on their sides of the story. The individual with the best argument and delivery would determine the outcome of the case. Wikipedia

Forensics per se has become synonymous with crime investigations thanks to Hollywood tapping a macabre interest that author Patricia Cornwell and then others found had a special interest to the great unwashed who live vicariously through the lives, misfortunes and sometimes the death of others. In our case we are thankfully not required to delve into these murky depths, but it is undoubtedly true that if you don't understand how markets work you will either a) lose money and probably quite a lot of money, or b) lose the opportunity of making a lot of money from your Forex trading. Both of these instances rank as serious misfortunes in my book, so to enhance your trading education I would like to share some of the more important forensic analysis of how Forex markets work and how you can use this knowledge to propel or hasten you along the longed for track of trading success. You may be new to trading Forex and just starting on this great journey to fame, fortune and financial independence or for all I know you may already be well along that path. In either event an understanding of the evidence adduced from a forensic examination of markets will speed you along the desired path.

Let's define that path as the first step in our examination, as different folks harbor vastly different aims and often the answer to a question is influenced by how the question is framed. Some traders seek high winning percentage answers whilst others are concerned with risk/reward ratios. I suggest to you that these standard variables are really more psychology than trading with the standard analytical output of Win%, average win/loss, drawdown etc really being supplied to salve the traders' angst problem. One of the most sought of these measures is the biggest consecutive losing streak. All of these common outputs speak to the human desire to know how deep the water is before jumping in. That is a sensible and laudable emotion but it plays no part in the design of trading systems which is what we do at the Danielcode.



From a system design perspective it is easy to create a trading system with a huge win/loss ratio. Similarly it is easy to create systems with no big run of losses, but all these optimizations/adaptions come at the expense of the one performance metric that should overshadow all else and the first question you should ask; "how much money does the system make?" For traders it's all about the money. We measure our performance in money, and whilst we may adjust risk to enhance earnings (the money again!), the bottom line remains unchanged.

There are some variables in trading that we can control; what markets we trade, when we trade and the risk that we are prepared to take on each trade. We can compound those variables with profit targets and staking systems into which much labor and ingenuity has been invested, but I suggest to you that none of these will do much to enhance an empirically poor trading program, and a much more satisfactory and rewarding approach is to start with something good and make it better. For this we need to see the forensic details of markets.

Now for any market research there are a number of "must have" characteristics, without which our data will be flawed and hence any conclusions that we may draw will be tainted. Essentially we need to use a computer generated program so we can cover large swathes of data and we need to have thoroughly tested the program for detail, execution and validity before we embark on this examination. In this case we are using the research program from our short term trading model dubbed "FractZen". This is a proprietary study that cuts up daily data into various sizes with the object of determining the most important market characteristic that likely you have never heard of….Speed!!

Speed Kills….

We need to express our data output against a fixed base and that inevitably leads us to margin. Unlike Futures that trade through central exchanges, Forex does not have universally set margins or even set leverage. Different platforms offer traders variants of both and some of the pure day trading platforms will offer you quite miniscule margins. Remember that these rules on margins, stops and order types are drawn by brokers for the benefit of brokers and we have no input, but to test day trading strategies in Forex is to deny their basic ambit as 24 hour markets, so for this we needs establish acceptable margins as our reporting base. I use a common margin calculator for this purpose and find that their required margin for a 1 lot of AUD-USD which will be our first subject, at 1:50 leverage is USD $1890. That will suffice for our examination.

To start we take the average daily true range ("true" meaning we account for any gaps) and divide it into smaller lots. These are called "Fractals" meaning a portion of previous market moves. All markets are fractal based and although the ratios of fractals to the whole vary constantly and theoretically at least there are an infinite number of possible fractals, the good news is that markets are creatures of habit and all employ the same five fractals almost constantly. To this we add a simple momentum entry signal which we will apply constantly. Rising momentum in either direction will create buy and sell signals and our ongoing trade management will be by way of a fixed stop which becomes a variable in our output. If this sounds a bit too prosaic and simple, I urge you to stay with me. All of this is in direct pursuit of getting you closer to the traders nirvana of optimum trading, or in the colloquial "Show me the Money!!"

Let's start by running the AUD-USD pair from 01/01/2014 to 05/31/2014 just to be current and grab your interest as to what your recent trading should have returned. This is not enough data to form reliable conclusions and we always use an out of sample data test of at least 12 months when making this examination, but keeping to current or recent data is more likely to focus your attention on the possibilities of where your trading should be.

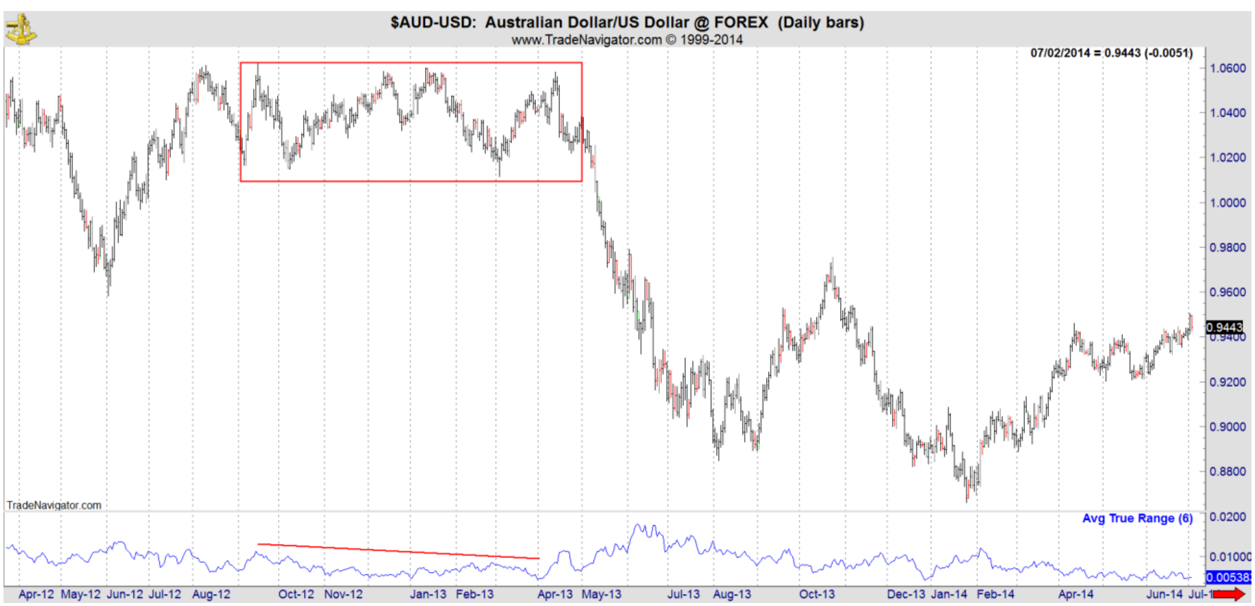
To start our analysis let's run the common speeds of 4, 5, 6 and 7. This means we are dividing our average daily ranges into fractions (or fractals) to give us more signals and direct us to the profitable paths if any. We will start by using a 2 bar trailing stop so that we are not making external judgments yet.

That returns the following:

1:4 Fractals = ($1810); 1:5 Fractals = ($900); 1:6 Fractals = $2610; 1:7 Fractals = ($3140)

Just one of our common speeds (more fractals = faster market) returned a profit. Wow!! Is market speed really so important? Indeed it is the alpha and omega of trading, both the beginning and the end. Now the 1:6 speed returned + $2610 for the 5 months we tested. And that's on a margin requirement of USD $1890, so that is 138% on margin. Better still, that's just for 5 months so if we keep trading for a full year we can expect $6264 or 331% on an annualized basis. And now we are getting scores that would be credible in any trading championship. We haven't allowed for slippage or brokerage and we have 41 trades in this sample so figure the brokerage and 5% slippage. Still very nice.

For this run we have used a 2 bar trailing stop. If we use a smaller stop, say the Danielcode ratio of 1.296, our 5 month profit jumps to $3210 or an additional $600 or thereabouts on our previous enquiry. This implies $7704 for a full year but running our program for the 12 month period to 05/31/14 actually returns $10,550. And that my friends is a return in the stratosphere. Not to be seduced by merely one year's figures, let's ask the question what our 2 year return on these same settings and speed would be? The answer is $4440 which implies some worse than lackluster trading in 2012 and significant drawdowns. And here it is:



The multi month consolidation accompanied by a constant reduction in average daily range…truly anathema to a momentum based program.

The Secret…

There are many secrets in trading. If you survive long enough in this game which few do, and you find someone who really understands the business to teach you, the true glories of high class trading will be yours. Of course many purport to know "The Secret" but their inability to actually prove these mysteries suggests that these worthies may be extracting money from you under false pretenses, always a risk in this business. An historic example of this is the celebrated WD Gann a Chicago broker of renown. Mr Gann left this world in 1955 and was famous as a teacher and inventor of the arcane. His chameleon like qualities enabled him to be hailed for one quality, whilst actually being something else entirely. In the 30s Gann's teaching aids were selling for the

equivalent price of a new Buick automobile. Quite a feat. His greatest "gift" was a marvelous marketing come on: "If you are worthy I will tell you the number"; and once you became "worthy" presumably by buying enough of his products, he would tell you the number was 7, which of course it isn't. In fact the number of all trading markets is 6 and to prove that proposition I suggest you read "Master Class-It's About Time" under the Articles tab at www.thedanielcode.com or just use this link in your browser:

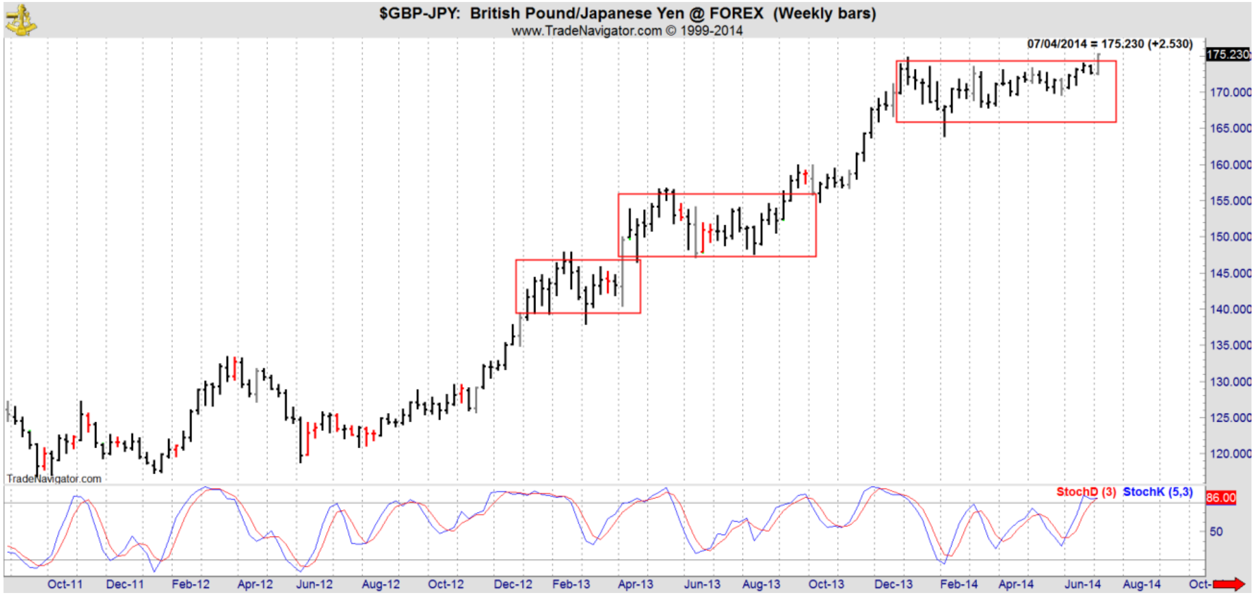
http://www.financialsensearchive.com/fsu/editorials/danielcode/2009/0515.html to prove this proposition for yourself. And you got that secret without necessarily being worthy. Simple enough?

However that's not the secret I want to talk about here. This secret has to do with what we call volatility which is nothing like the VIX which expresses volatility in a directional format. Here we use volatility to mean the strength of the multitude of fractals that make up all market moves and in particular the market's ability to trend, that is go in one direction long enough to create profitable trading for us. And the secret comes in two parts: a) Volatility comes in waves. It waxes and wanes like the moon and often follows lunar cycles for long periods which is why you should be interested in the Jews and Daniel. The Jews because old testament Jews used a lunar calendar and Daniel because he lays out in his book (it's in the Bible folks) the whole of the solar calendar and its relationship to the then used lunar model. And all of this amazingly accurate to about 120 minutes a year or a 0.02% variance in an age when water clocks were considered the epitome of technological swish, and b) There is always volatility in 59.3% of markets. Thus volatility not only waxes and wanes within markets, it also ebbs and flows between markets.

Our task as traders is to catch that volatility which is the life blood of profits and unless you can forecast impending volatility in advance (I can't) the logical solution is to trade multiple markets. Let's add the GBP-JPY pair to our trading portfolio. It's Fractals show the following 5 month return:

1:4 Fractals = ($20,111); 1:5 Fractals = $412; 1:6 Fractals = $2856; 1:7 Fractals = $5833

You see how dramatic these variances are? Get the fractal wrong and you are destined for poverty. Get it right and riches flow readily. On our 12 month run of data to 05/31/2014 it returns just $32 on the same program, not enough to pay the electricity it cost to run your computer let alone those avaricious developer and brokerage fees, but that's not the point. The point is that Shakespeare's apt description of volatility as "The Slings and Arrows of Outrageous Fortune", Hamlet Act III, were against this market for large chunks of 2013/2014, see the chart below:



But, but, but, it made a ton of money on this program for our 2 year test specifically $14,759 on a margin of USD $3431 so about 215% on an annualized gross basis. Not too shoddy at all, but more importantly to buffer the primacy of the volatility swings argument the GBP-JPY pair returned a staggering $19,272 for the period from 06/01/2012 to 04/25/2013. Just the time that our first contestant AUD-USD was in the doldrums. There is always volatility somewhere and trading a wide enough spread of markets to capture thrilling speed will buffer your equity curve from the damnation of killing speed.

Speed Thrills…

To the above we can add GBP-USD at +$8364 or NZD-USD at +$4830 for the base testing 5 month period. They have margins of $3311 and $1130 respectively and either projects excellent returns, whilst having periods of dormancy and diminishing ranges. So if you can handle the unavoidable peaks and valleys of real time trading, and you understand the necessity of finding the elusive sweet spot for each market, then you will see how thrilling trading with the right speeds can be.

To wrap up this journey let's take a step into the real world of trading. What I have discussed above is the result of decades of research and enquiry. To duplicate this type of research you need a computer driven program that can process large amounts of data in a reasonable time. I use software, charts and data exclusively supplied by my partner Genesis Trade Navigator at http://www.tradenavigator.com . And you will need grunty hardware as well, and the resources to plough through all the alternate settings of speed, range, stops and other variables. It is a labor of love for those who seek knowledge but not even I could describe this sort of research as a fun time. It has its highs with "Eureka" moments when that magic fractal reveals itself but conservatively there are a minimum of 50 combinations to test for each Forex pair. Few have the ability to undertake these projects, but many want to trade without this knowledge. Most of you will have small accounts and just want to trade one market or perhaps two at most. The most important point I can make to you is that unless you are trading a reasonable spread of markets, the volatility surge and withdrawal will beat you. I would rather see you trading 2 or 3 mini contracts than 1 biggie. A very senior Australian businessman who is a household name in the retail space Down Under opined to me that of all the good operators he had seen in a long and varied life, the one constant was that the top operators all found the one good thing and stuck with it. I have taught thousands of people who wanted to learn to trade over the past quarter century. Some got it; most don't. The ones who went on to be really good at this game were the ones who put in the work and persevered, and that regrettably is the atypical model.

I trust that I have set the grey matter wondering for some of you. Trading is a worthwhile and rewarding enterprise and perhaps in this article you have found some new, exciting and very different lines of enquiry to think on. Please send your questions and comments to me at jneedham@thedanielcode.com and I will respond as soon as possible. There is more for you to learn about market timing and much is available under the articles and videos tab at the Danielcode website, www.thedanielcode.com .

"The game of speculation is the most uniformly fascinating game in the world. But it is not a game for the stupid, the mentally lazy, the person of inferior emotional balance, or the get-rich-quick adventurer. They will die poor". Jesse Livermore

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...still working after 25 centuries!

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> The fox knows many things, but the hedgehog knows one big thing. A Hedgehog Concept is not a goal, intention or strategy to be the best. It is an understanding of what you can be best at. The distinction is absolutely crucial. ~ Isaiah Berlin, The Hedgehog and the Fox

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NOTE: The results cited in this article are computer generated. They are hypothetical and do not account for liquidity and price availability in markets nor for brokerage and other expenses. Please read the risk and disclosure statements at the Danielcode website.
