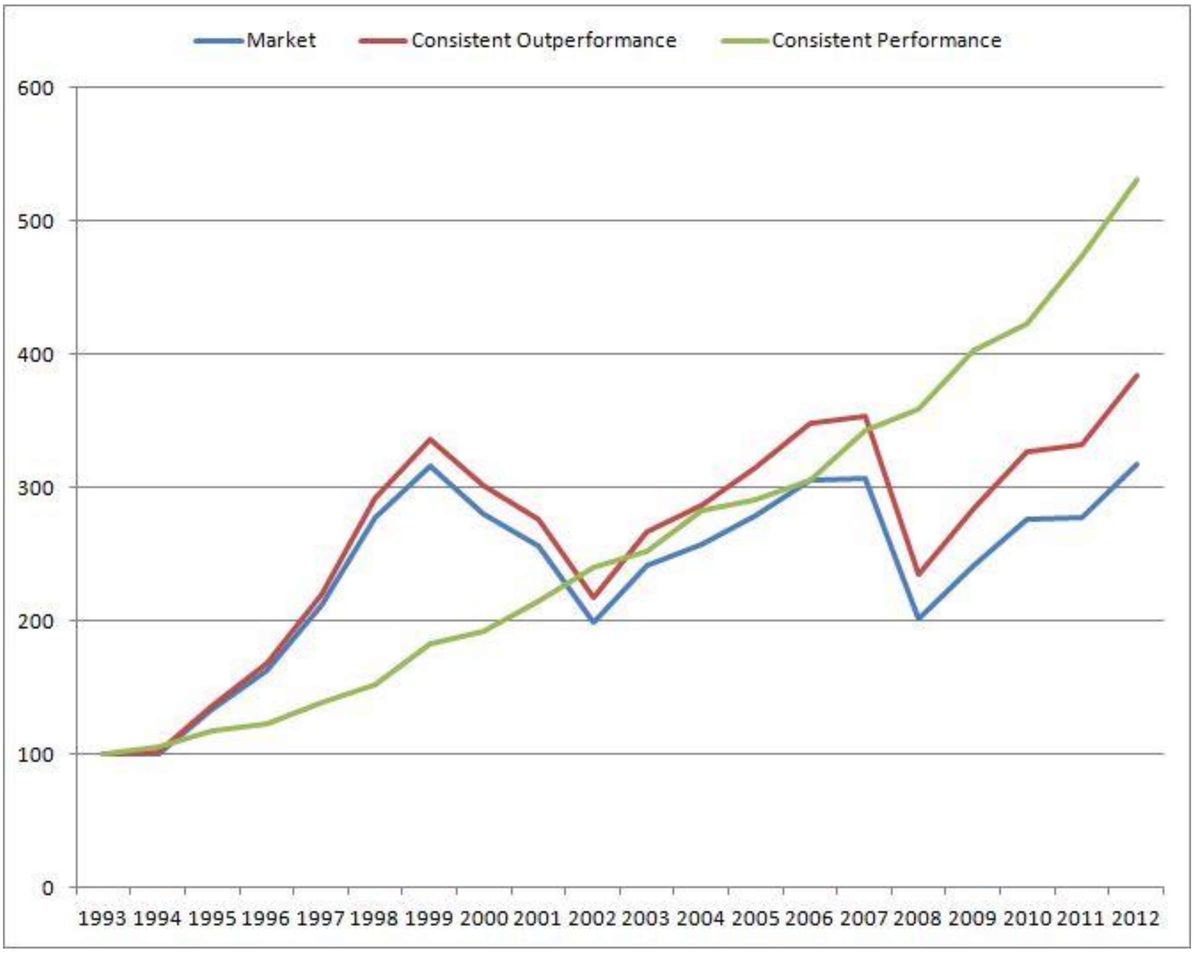
[Trading Basics: Measuring Performance]

Consistent Performance vs Outperformance

Success for a trader and/or investor can be defined in one of two ways: consistently outperforming the market, or consistently making money.

The two are not the same thing. The average fund manager whose performance is judged against the S&P500 will be delighted that his fund increased in value by 20% when the market was up only 10%. Similarly, he will be judged favorably if the fund lost 10% in value when the market lost 20%. The fund has consistently outperformed the market, but it has not consistently made money.



The typical independent trader is less interested in consistent outperformance as he is in consistent return. The individual who trades for a living, and needs to withdraw funds from his trading account on a regular basis, will need his account to increase in value just as regularly. So he will be happy to make 10% when the market has made 20%, provided he can also make 10% when the market has lost 20%.

Most traders seek consistent returns and therefore focus on the strategies that hold the promise of making money in both good times and bad. They accept that they are likely to underperform the S&P during strong bull markets, just as they embrace the fact that their capital will be protected in the event of a persistent bear market.

Both consistent performance and outperformance are legitimate objectives when building a trading system. <u>They key is to decide what one is striving for.</u> With that done, the relevant R&D can be undertaken, and the right time-frames and investment vehicles can be selected to achieve the desired goal.

Hedging

Hedging can be a very powerful component of a trading system. If used effectively, it can help convert a consistently outperforming strategy into a consistently performing strategy. Going long a stock while going short the market (and vice versa) allows the trader to capture the outperformance part of the trade, while in part protecting the trade should the market decide go against his position.

Many traders seek to protect their capital by creating “market neutral” systems. These usually entail going long and going short two groups of stocks in equal proportion. If strategy triggers favour the long side, then a short market hedge can be added to balance the position. If the system becomes predominantly short, then a long hedge can be added.

Pair trading is a form of hedged trade. It is not without risk however since it involves only two bets, both of which could prove disastrous. Adding diversification to the system by making many concurrent bets and using relatively low position size is the only way to control risk.

Hedging is not free. There is the cost of using options, or the opportunity costs of using leveraged ETFs. So these have to be factored in when determining the overall performance of a strategy.