## Trading Rule

## Mardjokic.com

A copy of this article is available in PDF format here.

Hello again everyone. Since I got back to the States, I've been developing a number of trading strategies.  This first strategy looks at technical screens and follows a 'contrarian' view. This means that I buy when others are selling and sell when others are buying.

Now most traders employ what is known as trend following or momentum trading. When certain SMA's cross one another or a stock breaks through resistance or support they pile on the band wagon. Whichever way the wind blows they follow, and its served them well. One of the cardinal rules (and its not lost on me) is not to 'fight the tape'. Trying to buck a trend is like walking through an oncoming crowd. You get knocked over, stepped on, and left for ruin.

But being a contrarian has its rewards. Some of the most successful investors are contrarian. Warren Buffet is one of the most famous. He buys when when there is blood in the streets; likewise I buy when the markets have satisfied their blood-lust and I pile on shorts when markets have become overzealous with a new flavor de jour. Wall street tends to overshoot the mark (on the upside and the downside). Take a look at a LR chart of the SPX Price-to-earnings or Price-to-book. What people are willing to pay for equity in a company is a function of the Earnings Yield or the value of the underlying net assets in a company. This multiple fluctuate over time. Before the run up that started in March 2009, P/E was approx 9X earnings.

*See Appendix 1*

What I look to capture is the dead cat bounce off a low or the retracement as investors take profits or get hit by a case of buyer's remorse.

I won't divulge the actual techniques I am using to screen for buy/sell candidates but I will share with you the backtesting results. I performed my screen on the broad based S&P 500 index. I've used daily trading returns going back to 2000. For comparative purposes I have put up returns for the S&P 500 itself and US large cap mutual funds & fund of funds. (More on these money managers later).

I have optimized the entry and exit points and since I am betting against the markets I have set a rather tight stop loss at +/- 2.5%. If my exit triggers aren't met I implemented a hard sell for these trades after 3-5 BD's for book keeping purposes. In the real world I will cut my losers and let my winner's run.

*See Appendix 2*

So now on to the simulated results on the SPX. Investing in my long book would have earned you 45% returns over the last 10 years; on the short side -21% over the same period. (Just as a reminder, its good to see a negative in front of a short return!).

You will notice a few things, first I tend to make money when the markets are losing. This fits with the contrarian nature of my screens. Second, there is substantially less risk (7% SD vs. market SD of 20%) with only 2 down years: the biggest loss in 2002. In '02 my long book was down -12% and the short up +5%. At least you know I am not Madoff!

*See Appendix 3*

Comparatively, passively investing in the S&P 500 over the same period would have netted you -14% over the investment period. I've also displayed the median mutual fund and FoF returns, a common benchmark. They faired even more poorly.

This brings me to a side tangent: a lot of studies have shown that active investment is not worth it. Mutual funds have been a favored example in these studies; you will notice their returns are often in lock step with the S&P 500. When the markets are down, so are they. Exacerbating the problem, the 'active' component increases trading costs and their management fees often make such investments inferior to ETFs.

But the cards are usually stacked against these poor money managers. They are long-only meaning even if they were to turn bearish the only way they can express this view is by liquidating their portfolio and sitting in cash. They can underweight a particular stock with a 0% allocation but that's it. Yet PM's would never abstain from the market completely, else they can not justify their fees! I've touched on this subject before as it relates to retirement accounts; please refer to the article in PDF format.

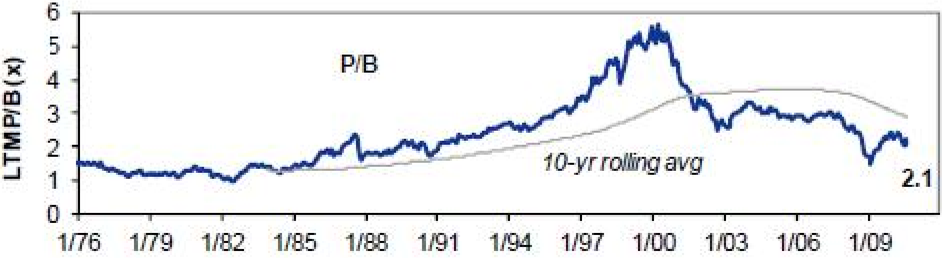
So why are my returns so splendid? - I don't trade for the sack of trading; I only trade when the odds are in my favor. And I buy at bargain basement prices or sell at exaggerate ones! Buy low, sell high? Pretty sensible no? According to my model, the markets have gotten out of whack 350 times over the last 10 years. But make no mistake, traders are right in following momentum. You could get steam rolled otherwise and for this I have those tight stop losses. Live to fight another day!

I intend on trading this model using the S&P 500 components. I will post my returns here on a monthly basis along with some commentary. I hope to make a battle tested model and of course some pocket change.

Regards,

Appendix 1

**Exhibit 22: Historical NTM P/E and LTM P/B values for the S&P 500**
aggregate bottom-up consensus valuation, as of August 19, 2010


*Source: Compustat, FactSet, and Goldman Sachs Global ECS Research.*

Appendix 2

| | Long Book | | Short Book[1] | | Combined Portfolio | | S&P 500 | Mutual Fund Universe[3] | | Fund of Fund Universe[4] | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Summary | Count of Longs | HPR W/Sell Trigger[2] | Count of Shorts | HPR W/Sell Trigger[2] | Count of Long/Short Opportunities | HPR W/Sell Trigger[2] | YoY Return | Median Mutual Fund Return | Dispersion b/t 2nd & 3rd Quartiles | Median FoF Return | Dispersion b/t 2nd & 3rd Quartiles |
| 2000 | 19 | 5% | 7 | -3.5% | 26 | 8.3% | 7% | -7.7% | 10.6% | -6.7% | 5% |
| 2001 | 37 | 5% | 16 | -1.4% | 53 | 6.8% | -13% | -13.2% | 4.5% | -13.0% | 2% |
| 2002 | 32 | -12% | 9 | -5.3% | 41 | -7.0% | -23% | -23.1% | 4.1% | -20.8% | 5% |
| 2003 | 10 | 1% | 14 | -4.7% | 24 | 5.9% | 26% | 26.4% | 2.6% | 29.1% | 7% |
| 2004 | 19 | 7% | 19 | -1.4% | 38 | 8.4% | 9% | 9.1% | 3.0% | 11.3% | 3% |
| 2005 | 13 | 3% | 12 | -3.1% | 25 | 6.1% | 3% | 4.9% | 3.0% | 6.2% | 4% |
| 2006 | 7 | 0% | 11 | -3.6% | 18 | 3.4% | 14% | 13.6% | 2.7% | 13.8% | 4% |
| 2007 | 9 | -1% | 23 | -0.1% | 32 | -0.5% | 4% | 6.1% | 6.2% | 6.7% | 4% |
| 2008 | 26 | 17% | 3 | -1.1% | 29 | 18.1% | -38% | -38.7% | 2.0% | -41.4% | 3% |
| 2009 | 15 | 8% | 18 | -4.0% | 33 | 12.5% | 23% | 25.8% | 7.3% | 30.8% | 3% |
| 2010 | 11 | 7% | 20 | 4.9% | 31 | 2.0% | -5% | -4.4% | 1.1% | -3.5% | 1% |
| **Compound Return:** | | **45.1%** | **-** | **-21.4%** | **350** | **82.4%** | **-13.7%** | **-20.7%** | - | **-12.0%** | **-** |
| | **Stdev** | **7%** | **Stdev** | **3%** | **Stdev** | **7%** | **20%** | **20%** | **-** | **21%** | **-** |
| | **RSF** | **6.3** | **RSF** | **-7.5** | **RSF** | **12.5** | **-0.7** | **-1.0** | **-** | **-0.6** | **-** |

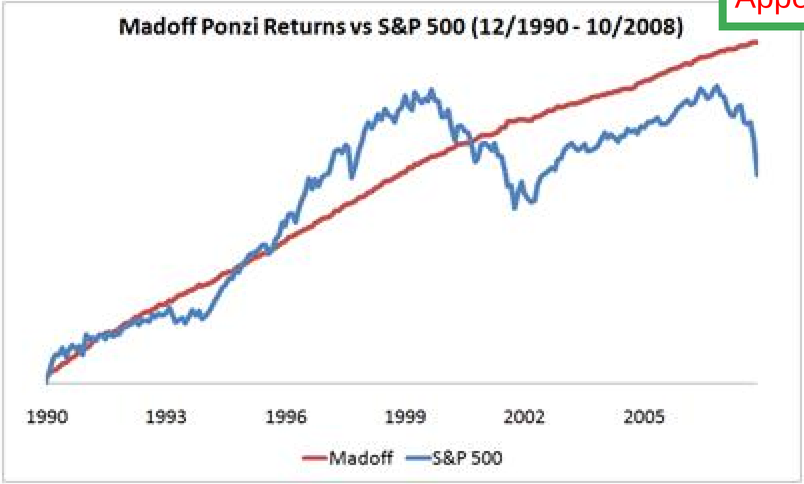
*1. Negative Returns displayed as calculated. Profit from Short = Displayed Return * -1*

*2. Optimized Sell Trigger; Stop Loss set @ -2.5%*

*3. Fund Universe Count = 1,653 Funds; Large Cap Focus; Exchange Traded*

*4. Returns calculated on YoY reported NAVs*

Appendix 3


Madoff Ponzi Returns vs S&P 500 (12/1990 - 10/2008)
1990
1993
1996
1999
2002
2005
Madoff
S&P 500