

A trading strategy with a 90% success rate?

Everyone wants the holy grail of trading and investing. Unfortunately there is no such thing, but there are certain strategies that can deliver pretty impressive results, providing you can cope with drawdown on your account for a while.....

Generally, the higher the win rate of any strategy, the lower the return and you can't say fairer than that. Consequently, you can have a strategy that is only right 40% of the time, but the gains are very high and thus easily compensate for the higher number of losing trades.

For example, the gap strategy that I have used for a number of years has an excellent win rate of over 70%, but to compensate for this high percentage, the returns are good, but won't turn you into an overnight millionaire. Instead, they deliver consistent small profits which accumulate over time.

However, you could use a momentum strategy such as a triangle formation, that can lead to an explosion in a stock's price, but has a much lower probability of working every time it forms.

To the majority of intermediate term traders and investors, a strategy that only succeeds 40 or 50% of the time becomes a psychological battle. It's very difficult to stick with a strategy with that win rate, purely because of controlling our emotions.

So what if you could find a strategy that when back-tested gave annualized returns of around 100% a year but still had a high win rate? Well, it looks like we have found one—providing you can cope with a bit of drawdown on your trades.

We can't take any credit for this strategy as it was discovered by a trader on Worden Brothers TeleChart's package. It was so good, we felt it worth writing about and commenting on here.

A KEY REVERSAL

This strategy is centered around 'key reversal days'. We have written about these in the past as they can often signal a change of trend in a stock or main index. For the purpose of this exercise, we are going to be applying this to key Exchange Traded Funds that track the main US indices. These are; the 'QQQQ' the NASDAQ ETF; 'SPY' the S&P 500 ETF; and 'DIA' the Dow Jones ETF.

A key reversal day occurs when an index or

stock makes a new intra-day high or low but then closes below the previous days close and preferably near the lows of that day. So, following an uptrend, any day that makes a new high and yet then closes near the lows of that day would be considered a key reversal day. The opposite is true for a downtrend—it makes new lows but then closes near the highs of the day (and higher than the previous days close). The wider the price range on that day, and the heavier the volume, the greater the odds of a reversal taking place.

THE SETUP

This has been back tested over the past 10 years and delivers the following results;

The QQQQ's were most profitable (100% success rate) with an average gain of 1.6% after commission, and an average holding period of 3 days to give an annualized gain of 140%.

The SPY's were profitable 90% of the time with an average gain of 0.5% and a holding period of 5 days.

The DIA were profitable 95% of the time with an average gain of 0.40%.

So the QQQQ's gave the best hit rate and percentage return, it's up to you if you wanted to solely trade with this index.

The criteria is simple, buy at the close; sell on the first profitable close above the entry price. This could probably be further refined to eek out greater profits. Below are the formula;

Low today < previous 10 day low.
Today's range > average range of the last 20 days.

Close today in the top 50% of the day's range.

Close today > close yesterday

Volume today > highest volume of the previous 10 days.

These are pretty spectacular results once you compound them over a year. We are sure that this simple formula could be improved when it comes to exiting the position, but it's certainly well worth trading even in its current format....

Education

The average drawdown for this strategy is 3%. Thus, you would have to allow a stop loss of 6% on each trade to allow each one to work out.....

One way of improving on these returns is to look at the current exit strategy. If you are in front of your trading screen most days, I'm sure you could utilise an intra-day ext that improves your overall performance...

Kevin Burton