



CSI Technical Journal
July 2005
Volume XXIII, Number 7

In This Issue

How Data and Trading
Methodology are Linked to Profits

10 Fundamental
Influences to Watch

New Markets for
VantagePoint Intermarket
Analysis Software

Mini Tech Talk

Backup Server Notice

Holiday Schedule

CSI will be closed for voice communication on Monday, July 4th in observance of the U.S. Independence Day holiday. All U.S. exchanges will be closed. Data from other markets will be available at the normal posting times, and the CSI host computer will be accessible as usual throughout the holiday weekend.

How Data and Trading Methodology are Linked to Profits

Are you an imminent market guru, on the cusp of uncovering the secrets of the investment universe? Do you have dreams or even aspirations of producing analysis software that will reveal these mysteries for yourself and anyone who buys your software? Whatever your long-term ambitions, you should know that all market analysts need data of true substance, coupled with logic, to guide their

pursuits. As many before you have already learned, trading system development requires just the right kind of market data and logical interpretation of that data. Here are some points you should know before you begin developing that trading system you have always dreamed of writing:

Data Presentation Matters

The type of data you decide to use to emulate and define the futures markets is often key to a successful result. Many market enthusiasts and trading system developers fail to get the full picture when building their trading system methodology, not recognizing that their success or failure may depend upon how they choose to represent the markets decades into the past. The choices are many, and each has some merit. Among those that are popular with trading system developers are cash prices, nearest future contracts, back-adjusted and CSI Perpetual Contract(R) data. The choice an analyst adopts can be critical to the pursuit of sustained success. Which will you choose?

Cash Prices

Cash series are helpful, but when using them, you must be aware that they are disconnected from volume and open interest data that apply to the corresponding futures markets. These key values are very important when measuring the strength of the directional movement of a given market. Futures traders should also recognize that studying cash prices substitutes an imperfect proxy. Traders who deal in the cash markets do not benefit from margined transactions. Cash traders must put up the full value of the product, missing out on the important margin advantage which allows for a substantial (95%) discount in the funds invested. Cash markets also reflect the current-day value, without the uncertainties of future time built in. When watching cash markets, the futures trader draws conclusions based on the actions of a somewhat different animal.

In our work here at CSI, cash prices are viewed as zero-days-forward perpetual futures “contracts,” with which futures prices are likely to converge. There is definite value for the trader to know the direction of this important potential bias.

Nearest Futures Data

The nearest future contract is another popular choice, but it bears the disadvantage of repeatedly changing to emerging contracts as time marches forward. In the nearest-future case, simulations typically assume that traders roll their money forward to the next high-volume contract, thus elevating the commission expense, perhaps unrealistically. Discontinuities in price are constantly consuming more funds to handle the sale and purchase of the current contract with respect to the next contract in line. The contract switching requirements affect the cost of maintaining your market position.

Back-Adjusted Series

Back-adjusted contracts are somewhat helpful because the transition from one contract to the next is hidden during the analysis process. Back-adjusted series also require many splicing choices that consume "degrees of freedom" (and profit dollars) that must be allocated to the process. When using such series, recognize that to replicate the simulation, you must continually roll your investments forward. Those commission and slippage expenses should be deducted from perceived profit potential.

Users of the back-adjusted series and nearest-futures contracts must compensate for the oscillating time-to-delivery consequences. At any given time, you may be viewing the market three months from delivery, and then suddenly find yourself viewing the market six months to delivery as time marches on and contracts roll forward. However, with either of these, you can always time your trades based on unadjusted prices for the current contract, which many see as an advantage.

Perpetual Contract® Data

The CSI Perpetual Contract data series is, in our view, the most attractive alternative because of its constant time-to-delivery nature. Perpetual Contract data provide an identical parallel for all markets because every price observed is precisely N-months (actually measured in days) forward of today. Users of CSI Perpetual Contract data also receive cash prices, which have a zero-days-forward perspective. This allows you to see the reality of the future and the solid substance of the present. You can always know which contract is getting the most time-to-delivery weight, so you can place and time your trades on a "real" near contract.

Futures are inherently dependent on the supply situation a few months forward of today, but Perpetual Contract data enjoys the identity of a genuine futures contract subject to the rules of discounted margin (vs. cash), and they are simple to manage and conceptualize. Another very distinct advantage of the Perpetual Contract data series is that volume and open interest are reported as a weighted measure based on the delivery time of the pair of contracts that are viewed N-months forward, and the total volume and open interest for all contracts is reported each day for the given commodity. Volume and open interest reports are extremely important to many analysis methods.

No other type of market data is comparable to the CSI Perpetual Contract data series. The only vendor who is capable of producing this correctly is CSI, the inventor and owner of the trademark to this important trading product.

Accidental Association vs. Predictive Effect

Too often in the pursuit of profitable trading systems, developers confuse accidental association with predictive effect. In a recent newsletter we wrote about the connection between the Washington Redskins' performance on the football field with the outcome of the forthcoming Presidential Election. For 64 years in 16 successive presidential elections, the outcome of the Redskins football game on the Sunday before the election seemed to predict the presidential winner. If the Redskins won, the incumbent prevailed; if the Redskins lost, the incumbent lost. This was proven to be a flawed predictor when the Redskins lost and the incumbent, George W. Bush won the 2004 election.

We bring this up to make the point that unrelated coincidences possess absolutely no predictive value. Nevertheless, many gamblers saw this as an opportunity to bet against George Bush's second trip to the White House. When designing a trading system, be careful that you are not using unrelated coincidences to prove the merits of your trading algorithms. When searching for hindsight predictive situations that consistently predict a given result, you must be able to prove that there are predictive elements lingering within the trading decision logic. Hindsight optimizations or trading system simulation exercises that explore future events for their predictive prowess should only be chosen for their proven predictive effect through logical reasoning.

Searching for Causal Relationships

Software developers should constantly look for situations or opportunities that can reasonably be attributed to cause and effect, with or without a leading or lagging response. There are definitely many situations and circumstances that lead one to make intelligent choices that have substantial merit, but those that are based solely upon coincidence are not among them.

This should not be interpreted as a condemnation of technical analysis, as technical indicators can be quite helpful from a statistical viewpoint. Many technical indicators are actually numerical representations of market conditions and relationships that have proven predictive powers. If you consider the algorithms behind those studies, you'll see that the developer found a way to quantify and interpret the underlying cause- and-effect relationship. If your proposed trading algorithm advances a notion that two seemingly unrelated events converge to produce a consistent result, consider carefully if a true causal relationship can be found. If not, don't rely upon it when trading the markets. Coincidence has probably lost more money for uninformed traders than any other phenomenon.

Even the seasoned trader can be misled by coincidence, but every trader should understand that there are great risks in taking the advice of a trading algorithm or approach that ignores the base fundamentals. Without establishing a cause-and-effect relationship, the likelihood of sustained success is roughly 50:50. However, this break-even scenario quickly slips into losses with the inevitable expenses of

commissions **and** slippage. This type of trading has some similarities with Las Vegas-style gambling: the odds are roughly 50:50, but the house takes from one to 10% of every bet. In a trading environment where coincidence, rather than the fundamental substance is involved, chances are nearly 50:50 that you will move into profitable territory on your very first trade. Unfortunately, the added "tax" of commission and slippage will gradually and persistently absorb your capital until you are forced from the game.

Subjective Choices

There is no objectively correct way to view the markets, but your choice of data to feed your analysis and your methodology will undoubtedly affect your success as a trader or analyst. You must recognize that your choices have relevance, and you must avoid using coincidence or random selection in deciding which method to employ to express the history of the markets. We suggest that you experiment with the various long-term data preparation techniques and discover the one you find to be most valid, rather than oscillating from one approach to another without understanding the implications of your actions.

Many helpful and fruitful tools are available, and you should consider carefully those that you use. We strongly believe that fundamental approaches should be part of your methodology. Too many traders, overly anxious to increase their net worth, ignore the many cause-and-effect procedures that could help them to remain solvent in the pursuit of trading success. We here at CSI are committed in offering suggestions that will add to your wisdom as a trader and will help you prevail in the very complex market arena.

Happy Trading!

Bob Pelletier

10 Fundamental Influences to Watch

Trading systems that offer substantive predictive effects and systems that can be tied to strong fundamental influences are most likely to return consistent profits. The pages of the CSI Technical Journal have mentioned ways to find and create such systems. Here are a few more tips to help you to stay on the profit side of your balance sheet:

- 1) Examine the USDA's Commitments of trader data published every Tuesday by the C.F.T.C. Align yourself with the commercial interests and the large trader interests, and trade contrary to the smaller trader. This data is posted with CSI's data feed as captured from the USDA.

- 2) Be sure to examine the put vs. call ratio of the market you plan to trade and remain aligned with this excellent contrarian measure.
- 3) Find the futures markets most highly correlated with your market of interest, and follow the prevailing market direction.
- 4) Find the futures markets most negatively correlated with your market of interest and trade in the opposite direction.
- 5) Find the markets that lead the market you want to trade and follow along in the same direction.
- 6) Visit the CSI website to explore many of the above correlation possibilities.
- 7) Follow the seasonal forces of your proposed market by examining the CSI Seasonal Index for the market you plan to trade.
- 8) Follow the relevant volume and open interest movements for your markets of interest to uncover the strength of a given directional move.
- 9) Examine the cash market time series for your futures market of interest and anticipate convergence for your selected market. Similarly, track the rate of convergence of the contract you will be trading with the next further distant contract. These checks should help you to measure a potential tendency for reversal.
- 10) Employ stops and reversal points to find good opportunities to exit from your markets of choice.

New Markets for VantagePoint Intermarket Analysis Software

We are pleased to announce that Market Technologies, LLC has released VantagePoint Version 6.2, and our own Unfair Advantage version 2.8.3 has been tailored to accommodate this fresh new offering. VantagePoint Version 6.2 adds nine new markets and updates the neural network models of the other 43 markets in the VantagePoint suite of market modules. The additional markets include six Forex pairs (Canadian Dollar, Japanese Yen, Swiss Franc, Australian Dollar, Euro Currency and British Pound) and three Exchange Traded Funds (Diamonds, Spydors and QQQQ). With the updated Unfair Advantage portfolios, VantagePoint customers using CSI data will have the opportunity to explore all 52 of the exciting markets covered by VantagePoint.

VantagePoint software is by far the most popular choice of CSI customers for market analysis and we are dedicated to maintaining the quality of service that has fostered a decades-long relationship with Market Technologies and their clients. Lou Mendelsohn (creator of VantagePoint software and founder of Market Technologies) first visited me back in the early '80s when he was one of a handful of pioneers working on innovative software for market analysis using microcomputers. I was impressed with Lou's use of intermarket analysis to uncover investment opportunities, an approach that I, too, have long advocated.

Through the years, Lou earned my respect by demonstrating a high degree of integrity and a strong commitment to developing logical technical analysis software, particularly with the integration of neural networks in the VantagePoint series of products. These techniques are especially important today, given the highly globalized and interconnected nature of the markets. CSI was the first data provider to support Market Technologies' software and now, more than 25 years later, VantagePoint continues to thrive on the depth and scope of CSI's immaculate database of domestic and world data. We are happy to continue the tradition.*

Bob Pelletier

The Market Technologies website offers free VantagePoint forecasts for the markets of your choice, plus information on intermarket analysis using VantagePoint. If you would like to learn more, visit their website at www.TraderTech.com or call them directly at (813) 973-0496 or (800) 732-5407.

*CSI enjoys sharing topics of interest about innovative trading products and trading systems that may be of interest to our customers, but we cannot stand behind or endorse the products of any outside firm.

Mini Tech Talk

Q. Is it possible to view futures data through Unfair Advantage without manipulations that blend markets, adjust for changes in specifications or add history?

A. Yes. These changes represent discretionary adjustments that are designed to enhance analysis. If you do not wish to have adjustments applied to your data, turn the adjustment feature off using the "Historical Adjustments," "Futures Adjustments" option under "Edit Portfolio" or in your Charting Preferences. You can view all the adjustments in UA by accessing the ua/archives/cdbadjust.adm file.

###

Backup Server Notice

Our Boca Raton offices will be closed during an upcoming weekend for building maintenance. The CSI database will be accessible through our backup server for the two-day period, so we anticipate no interruption of service. In the unlikely

event that you are unable to retrieve data from the backup site, which should occur automatically, please try again the following Monday morning after the building maintenance is completed, and the CSI staff has returned to their regular duties in support of customer interests and questions.