"How I Achieved Over 100% Annually In the Futures Market 4 Years Running"

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The performance data in this article is based on live trading in funded accounts. All results are shown as net of commissions. Please remember that trading futures and involves substantial risk of loss and is not suitable for everyone. Past performance is not necessarily indicative of future results.

Overnight success. I've heard that term quite a few times in the last year, as people learn that I achieved a 148% return and a second place finish in a world renowned, real time, real money futures trading contest in 2005. If that wasn't enough, I won first place in 2006 with a 107% return, and second place again in 2007 with a 112% return. To top it off, through Feb 2008, I have a 125% return. Since you've probably never heard my name before, you might be inclined to think the same thing. But you'd be dead wrong. The fact is, the futures markets are littered with overnight failures, with overnight successes scattered few and far between.

I've been speculating in futures for 17 years, and it took me most of that time to become an "overnight success." Even though achieving over 100% return four years running entailed some luck, I know I could not have gotten there without following certain steps. In this series of articles, I'll detail these steps, steps that worked so well for me. My guess is that they'll work for you, too.

Step 1: Have a Plan
I've never seen someone build a house from scratch without drawings, sketches or architect's renderings, and I bet you haven't either. To build a house, you need a set of plans. The same holds true for speculating in the futures market – without a plan you are destined to fail. Trust me – I tried to succeed without a plan in the wheat market of 1997. It turns out I

did have an unwritten plan, which was to meet margin call after margin call, until I ran out of money. The market obviously had a better plan, namely to take all my money, and it succeeded.

So what makes for a good plan? I think there are 3 major pieces to it. First, you must know what you want. Second, you must determine what you are willing to invest to get it. Finally, you have to know what you'll risk to get what you want, as nothing worth having comes free. I'd like to elaborate below on each of these pieces.

The first step in a good plan is to know what you want. Are you satisfied with a 4% return per year, or are you aiming for 150%? Certainly, your objective will determine your strategy (which I discuss in step 2). For example, if your goal is 4%, you can find many CDs that yield 4%, but CDs won't do the trick if your objective is 150%. So, knowing what you want upfront is paramount to later success. In my case, I knew what I wanted – I wanted to win the trading contest. So, I looked at what previous winners had done, and determined that if I achieved their median return, I'd have roughly a 50/50 shot at winning. I then knew exactly what I wanted – a 200% return in one year.

The second portion of a solid plan is knowing what you are willing to invest to reach your goal. In the investment arena, this takes the form of time and money. How much time will you spend researching, studying, programming, going to seminars, buying "black box" systems, talking to advisors, etc. to achieve your goal? How much money are you willing to spend upfront doing all these things? Obviously, the more you invest, the better your chances of reaching your goal. For me, I decided reaching my goal was worth a few thousand dollars in computer hardware, software and books and tapes (such as Van Tharp's "Trade Your Way To Financial Freedom" book and the "Developing a Winning Trading System that Fits You" tapes), and 15 hours a week of my free time in the months before the contest started (my wife, however, only grudgingly accepted this part of my investment!). The point is, realize that your objective will take an investment, and if you are not willing to make that investment, it is best to not even try.

The last piece of the plan puzzle is to determine what you are willing to risk to get what you want. How much money are you willing to put at risk to achieve your goal? If it is less than 10%, you can't realistically expect returns of 100%, although I'm sure some people have done that well. Part of this is knowing your "walk away point," the point at which your losses cause you to quit. Back in 1997, I didn't have a walk away point, so since I couldn't walk away, my money walked away for me! For the contest, I determined that if I lost two thirds of my starting capital, I'd walk away. My upfront work (which I'll discuss in step 2) told me there was a 20% chance of this happening within a year. Pretty steep, I know, but it was a risk I felt comfortable with.

In step 1, I discussed the need for a solid plan, with a clear objective, a pre-determined investment level and a definitive risk amount before the plan was abandoned. For my 2005 second place, 148% return contest finish, I had an objective of a 200% return, $3,000 for trading equipment, 15 hours per week of investment time, and a walk away point of a loss of two thirds of my capital. As tough as those things were to determine, formulating my plan was the easy part. The hard part was finding a system that could help me reach all pieces of my plan. I did that in step 2.

Step 2: Find a Strategy

Finding a viable strategy is the most difficult part of developing a trading system. You might not think that's true, based on ads and infomercials you see, which show you how easy picking a strategy is. Alas, if it were only as easy as picking up a phone, going to a free seminar in a hotel or visiting a website! In reality, finding a good strategy involves 3 main areas: a skill assessment, research and detailed development.

The first part of determining how to reach your plan is to do an accurate, let's-be-honest-with-yourself skill assessment. What are you good at, trading wise? Is it following a system from an advisor or system vendor, trading from your gut, or programming your own system? Will your personality allow for large drawdowns, or do you need a system that has many little wins which protect profits, at the expense of some profit?   This assessment, if done right, will point you in the right direction.   If you don't do this assessment, you'll be doomed to wander the "land of the losers." When I reached a 148% in 2005, I took a long hard look at my abilities BEFORE I started trading. I determined that creating my own system was the only way to go, both from a psychological standpoint and an ability standpoint.

The second component of your strategy is research. Before you settle in on a strategy, you need to see what is out there, what is working today, etc. Books, magazines, and websites are a great way to see what is "state of the art." If you aren't subscribing currently to magazines such as Futures Magazine or Technical Analysis of Stocks and Commodities, you may be researching old, tired ideas in books, ideas that don't even work anymore. That doesn't mean that books are useless – in fact, books such as the Market Wizard series are great research tools. General information books by Kauffman and Bernstein are also perfect to learn about the markets. Finally, numerous websites give free advice, teach technical and fundamental concepts and give trading tips, usually all for free. It is best to hear what opposing viewpoints are out there, before you leap into trading.

Once you know your skills, and you've done the research, it's time to get your hands dirty by doing detailed development. Of course, the level of detail depends on the trading route you chosen. Since I decided to do my own strategy development, I'll share some of the major areas of my strategy design.

My first step in strategy development was determining the basic type of system I wanted. After doing a lot of research, I found a basic system that fit me – trend following. Such a system could be updated at night (not interfering with my day job), and it fit my personality. Some people, however, might like swing trading, or scalping, or one of a host of other techniques. The key, I've found, isn't necessarily the basic type of system you choose, as long as it fits your needs and desires. Even given how successful my system has been, I know it wouldn't fit certain people, and they would lose money if they tried to trade it. But I can trade it, and I know it makes money!

The second step to developing a strategy was selecting the proper indicators for my basic system. For example, moving averages might be best for trend systems, while oscillators might work fine for swing systems. This step was a lot of trial and error, since sometimes combinations of indicators worked well together, and other times they didn't. My experience was that all indicators work some of the time, but none work all of the time. The trick is to find the balance between the two extremes. For my system, I ended up with one primary indicator, with a second confirmation indicator. That's all I needed to get good performance. Sometimes, less means more!

Step three for me was back optimizing results. Since I was using Tradestation software to develop my 100%+ systems, this step was relatively easy. I won't go into details of how to optimize, as there are many excellent books and articles on the topic. Suffice it to say that the biggest danger is in over-optimizing. Running a system with 2 parameters with 10,000 variable levels is definitely over-optimizing. The easiest thing to remember is to keep it simple. If you are optimizing on moving average, for example, use an increment of every 5 days, for example, not an increment of every hour. Good systems don't need exact optimization.

The fourth step in my strategy development was forward walking. Again, this topic can be very complex, but the general idea is that you want to see how your optimized system performs on data it has never seen. A robust system will perform almost as well for optimized and non-optimized data. I should point out that this step is not critical, but if you ignore it, you greatly increase the chances of developing a system optimized on the past, which crashes and burns in the future.

The fifth step in developing my strategy was Monte Carlo testing. I took all my trades, throw them in a hat, and start pulling them out one at a time, simulating trade by trade results. By doing this numerous times, you simulate what could happen with your system. Most people get surprised when they do this. For example, you could have a system which makes money in the long run, but has a 90% drawdown in the short run. Your actual results may be totally different than your optimized results (and your walk forward results), just due to trade sequence!

For my award winning 2005 performance, Monte Carlo simulation told me I had a 50% chance of doubling my money in a year, but also a 20% of losing two thirds of my starting equity. These were favorable odds, in my opinion. But, without Monte Carlo testing, I'd have no idea what my chances of victory and defeat even were. I highly, highly recommend Monte Carlo testing. It can be done in Excel, and there are good off-the-shelf programs also. Because of my programming ability, I decided to create a customized Excel spreadsheet, which perfectly suits my purposes. Check out my Store link on www.kjtradingsystems.com, since one day I may offer it for sale.

Once I had all these strategic development pieces in place, I was almost ready to turn my strategy on. Before I did that, however, I wanted to make absolutely, positively sure that my strategy and system was good. That led to step 3, "Check and Double Check."

Step 3: Check and Double Check

Remember when you were in school and the teacher always said "remember to check your work?" If you were like me, you thought doing the work was the hard part, and checking it was something you didn't need. Well, if you avoid checking your work before trading a strategy, you can easily fall into trouble. In fact, I think checking and double checking is so important that I made it a separate step!

The degree and type of double checking you do depends on the strategy you determined in step 2. Below are some double checking steps to consider if you selected an advisor, a black box system or built your own system.

If you selected an advisor to provide your trade signals, make sure you get an independent source to vouch for the advisor. The best advisors will have plenty of customer references to share with you, which you should contact. These references will give you insight into the advisor and the system. If your advisor is a Commodity Trading Advisor, you can check out their compliance record at http://www.nfa.futures.org/. Remember, it is your money, so don't feel guilty about challenging your potential advisor.

Double checking an advisor worked very well for me early in my trading career. I once found an advisor with 100% profitable trades. Before I gave him money, though, I did a little investigation, and found out that this advisor did indeed have 100% profitable closed trades, but had many open trades (which we did not include in his results), most of which were tremendous losers! Obviously, I did not invest in his system.

If you bought an off the shelf system, or trade off of daily signals from an advisor, ask for a real time results history. Most people that sell systems can show a fabulous past history, but it likely did not occur with real money. The best of the group have nothing to hide, and will willingly share such information. Websites such as worldcupadvisor.com and collective2.com publish actual track records for their advisors and systems, and do not include optimized backtested results. Look for actual track records as your double check of their profitability. All results on my website, www.kjtradingsystems.com, are from actual accounts I have. I show only REAL MONEY results!

For systems you develop yourself, double checking a strategy you developed yourself might be the most important thing you do. It is also probably the hardest thing to double check, since you might tend to overlook the same items the second time that you overlooked the first time! Since I developed my own system on my way to my award winning returns, I'll share how I double checked my system.

My first rule in checking my system was "if it is too good to be true, it probably is." An early version of my system had superb results, over 90% trade accuracy and very little drawdown. But based on the research of top systems I had done, I knew this performance was a little TOO good. So, I double checked my results, and low and behold, I found I had programmed my systems to use tomorrow's close for today's calculations – no wonder it was so good!

Another rule I use in checking my own systems is to create a mirror system of the original. For example, every time my system says buy, I sell, and vice versa. Common sense would say that this reverse system should be the exact opposite (minus commissions) of the original system, since trading is a zero sum game, with someone losing every dollar you win. I know that if both systems show excellent results, I probably programmed something wrong.

The last important point in checking and double checking is paper trading. No matter how you came up with a trading strategy, it is a good idea to paper trade it first. While paper trading won't give you the emotions associated with winning and losing money, it can help you set up your basic trading structure. For example, one of my trading strategies works automatically, without ongoing human intervention. But before flipping the "on" switch, I acted out what the system would do in several scenarios, such as computer failure and internet access being down. I also followed the system in real time, to see if orders would be placed when and how they should be placed.

Your paper trading might uncover that your system trades the daytime hours, but your backtested results are for the 24 hour market. Obviously, such a system won't work in real life as you intended. Or, your stop loss might depend on the entry fill price, which during fast markets you might not receive from your broker for an hour. How do you, and how does your system, respond to this very real possibility?

In short, paper trading is a good way to get the kinks out of placing and monitoring actual trades. You'll discover potential pitfalls, and be able to correct them, before trading with actual money.

Once you have found a strategy that matches your abilities and your personal situation, it is time to trade with real money. Executing your strategy is the most exciting, and simultaneously the most frightening, part of trading.

Step 4: Execute Your Strategy
At this point, you are ready to pull the trigger, and trade your strategy with real money. In my experience, there are five areas to concentrate on that will help you execute your strategy.

The first area is to determine your level of involvement. If your strategy requires you to enter trades during the day, you better make sure you work schedule can support it. If you are relying on a broker to pick trades for you, you better make sure he can reach you when he needs to. If you are auto trading on a home PC, make sure you have the support infrastructure in place.

The second key to executing your strategy is finding a broker, if you haven't already. The choice of broker (full service, discount) will depend on your strategy, and the amount of help you need entering trades. Most of the bigger brokers have 24 hour desks, and excellent order entry software. Of course, commission rates vary widely between brokers, so it pays to shop around a bit. I highly recommend all the brokers I use, and you can see them by going to the Links page on my website www.kjtradingsystems.com.

The third execution key, and possibly the toughest, is to pull the trigger when your strategy signals "trade." From my personal experience, this is one of the toughest things to do. Frequently, you'll be confronted with signals that make you cringe, and you'll want to avoid the trade. My experience has shown that the most painful trades at the beginning are the trades that are the most profitable in the end. For example, as of this writing I am long Copper. My strategy went long AFTER Copper was at new highs, when it felt much easier to go short. After all, how high could it go? That single trade has so far increased my account equity by 30%! A little uncomfortableness at the start may be a VERY good thing.

The fourth key to good execution is "don't be the Emperor." What this means is do not overrule your system, even when it hurts. If your system has been proven to give you an edge, it does not make sense to overrule it, since you will inevitably do worse on your own than the system would have done. This is another rule which sounds easy, but is EXTREMELY difficult to follow. I know this from personal experience. In November 2004, I was in 2nd place in the same contest I finished in 2nd place in 2005. In a futile attempt to boost my return, I overruled my system with a misguided crude oil trade. Approximately $10,000 in losses later, I threw in the towel on the trade, and second place in the contest was a distant memory. Overruling your system, as I have experienced, will hurt you eventually!

The last key to executing your strategy is proper money management. Money management is an enormous topic, and certainly this short article cannot do it justice. I can tell you that money management will not make an unprofitable system suddenly profitable, but it can make a profitable system HUGELY unprofitable. The key money management technique early on is to stay in the game – don't overtrade. Profits will come for a good system, but only if you have the capital to trade the opportunities. You can't win in the long run if bad money management takes you out of the game in the short run.

Once you have started to execute your strategy, your job is far from done. Now comes the monitoring phase…

Step 5: Monitor and Adjust as Necessary
I come from an engineering and manufacturing background, and an essential part of any robust manufacturing process is statistical process control, or SPC. SPC tells you at a glance whether or not your process is in control, and when corrective action is necessary. This process control

concept can be adapted to your trading, and is crucial to keeping your system on the right path.

Every year, I monitor each and every trade, comparing fill prices, etc. to my theoretical system. When discrepancies came up, I determined the reason, and put the proper controls in place to fix the problem. In any trading situation, mistakes will happen, and it is important to fix them as soon as possible to prevent recurrence in the future.

Another monitoring system you might find useful is keeping a trading log. Recording the details of trades, along with your thoughts and feelings, can be very helpful when you review your system performance. This log is especially powerful when you violate your system, as you likely will at some point. Reviewing why you violated your system, and what the end result was, may help you refine your signals to more closely match your psychology.

A final way to monitor your results is to complete a year end review of your performance, compared to how the ideal execution of your strategy should have performed. You might find, for example, that you consistently traded one or two markets poorly, because of slippage during trade entry and exit. This analysis might lead you to eliminate certain markets, trade them with limit orders instead of market orders, etc. The point is to look at your results both from a big picture point of view (how did I do overall, compared with the ideal results?) and from a small picture (why are certain trades better or worse than what they should have been?).

Even though I have had excellent performances each year, I still do a full year end review. Based on that review, I made a few minor enhancements that should improve my performance in the next year. So, now matter how well you do, monitoring and adjusting has to be part of your overall game plan.

Conclusion

So there you have it - the five steps to trading that I used to achieve 100%+ performance from 2005 to 2008:

Step 1: Have a Plan
Step 2: Find a Strategy
Step 3: Check and Double Check
Step 4: Execute Your Strategy
Step 5: Monitor and Adjust as Necessary

For your situation, some of these steps will be more involved than I have described, and don't be surprised if it takes a year or so for you to progress from determining your objective to actual trading. My advice is to not rush any of the steps, and revisit the steps as necessary, until you feel totally comfortable. I obviously can't guarantee that you'll have the results I had, but I can tell you the steps work, and work well.

Don't forget that I have done a lot of this dirty work, and I still have a number of limited subscriptions available to my systems. Visit www.kjtradingsystems.com for complete details.

I offer you best wishes in your trading endeavors!

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Kevin Davey finished in 1st place in a worldwide, real money, year long trading contest in 2006, with a 107% return. In 2005 and 2007, he finished in 2nd place in the same contest with returns of 148% and 112%, respectively. Through February 2008, he has a 125% return in the same contest. Kevin can be reached at kdavey@kjtradingsystems.com or via his website http://www.kjtradingsystems.com.

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