To: S&C

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Using Automated Spot Forex Systems like Options

Options offer traders a unique way to take a position in the market not offered by traditional markets[i]. Options have certain features such as static cost of the option, which quant's and portfolio managers appreciate greatly, although options are not popular in the retail market or with individual investors. They are considered sophisticated and in many ways they are. Although it is easy for anyone to open an options account and trade, strategies involving options can quickly become complex.
Some exotic options are customized to meet the demands of traders who want to take specific views of the markets, such as the Double no-Touch[ii], which pays off if the market does not touch 2 outlying prices. This is betting that the market will stay in a range. During short periods of time this can be highly successful, such as during a week where the market is waiting for news announcements and lacks volatility and volume. However, it is sometimes difficult to find liquidity for such short term options, which is where an automated spot system would be valuable. It is more difficult to win using this strategy over a longer period of time, such as months. However, there are many reasons that traders may want to bet that the market will be in a defined trading range so all possibilities should be explored.

A Grid trading system, as referred to by Forex traders[iii], is a system that places orders above and below the market every 20 pips (this value can be adjusted according to the pair traded), Sell above the market and Buy below the market. As long as the market is in a trading range, the strategy will never lose. Once the pair starts trending in either direction, the strategy will begin to open more and more losing positions until the total drawdown of the system becomes unmanageable or wipes out the account balances. Horror stories about accounts being wiped out, and other personal experiences, have allowed traders to brush off these systems as useless.

It is the thesis of this article that these systems can be useful with proper risk controls, and can be used like options to take a position on the market.

The most important feature is an account protection, or global stop loss, that will close all trades if the open drawdown of the system is greater than what the value is set to. Let's say it is set to 1% - the strategy will trade and win as long as the pair is in the range. The trader knows he is risking only 1% of his account, which is similar to a vanilla long call option, which would have limited risk (limited to the premium of the option) and unlimited reward[iv].

If a trader has $100,000 in his account, he would be paying $1,000 to earn an unlimited profit. Of course, unlimited is theoretical, the trade will come to an end when the pair resumes trending. But theoretically, there is no limit to the profit as long as the pair stays in the trading range. This is why options have such a high pay-out for in the money options. In this example, the trader will make $200 per trade (100,000 standard lot size x 20 pips x $10 per pip). Once 5 trades have closed, if there is no open drawdown, the trader has paid for his trade and all remaining trades are pure profit. The value of this strategy is that once 1% is made, the rest is pure alpha. The total loss is limited to 1%, but it could be .25% or .5% in the case that the trend forms before the trade pays for itself.

As long as the market stays in the range, the strategy continually profits. This can be compared to an options time-value[v]. Since this is a new type of trading, terminology does not exist to describe this for automated spot Forex systems.

One reason why this is better – while it is 'similar' to options, the trader isn't actually 'paying' a premium, it's simply the acceptable loss he is willing to accept to get into the trade. He is 'paying' 1% to gain 3% or 10%.

Commercial hedgers may have barriers to their hedges irrespective of market movements. If a portfolio manager has existing positions that will become valuable if the market reaches certain levels, but has no way to capitalize on a ranging market, this strategy would be appropriate.

Two factors will determine the profitability of this strategy; 1) the definition of the range and 2) the number of times that the market moves up and down within this range. 2) is not volatility, which is measured by the total amount the market goes up and down.

When playing options, we suggest playing both extreme ends of the curve.

1) low risk very low yield trades, such as 'delta neutral' options strategies that may take advantage of certain types of volatility.

2) low risk low probability high return 'black swan' trades

Grid trading systems are just one example of using automated spot Forex algorithms to trade options-style strategies.

Live Trade Example

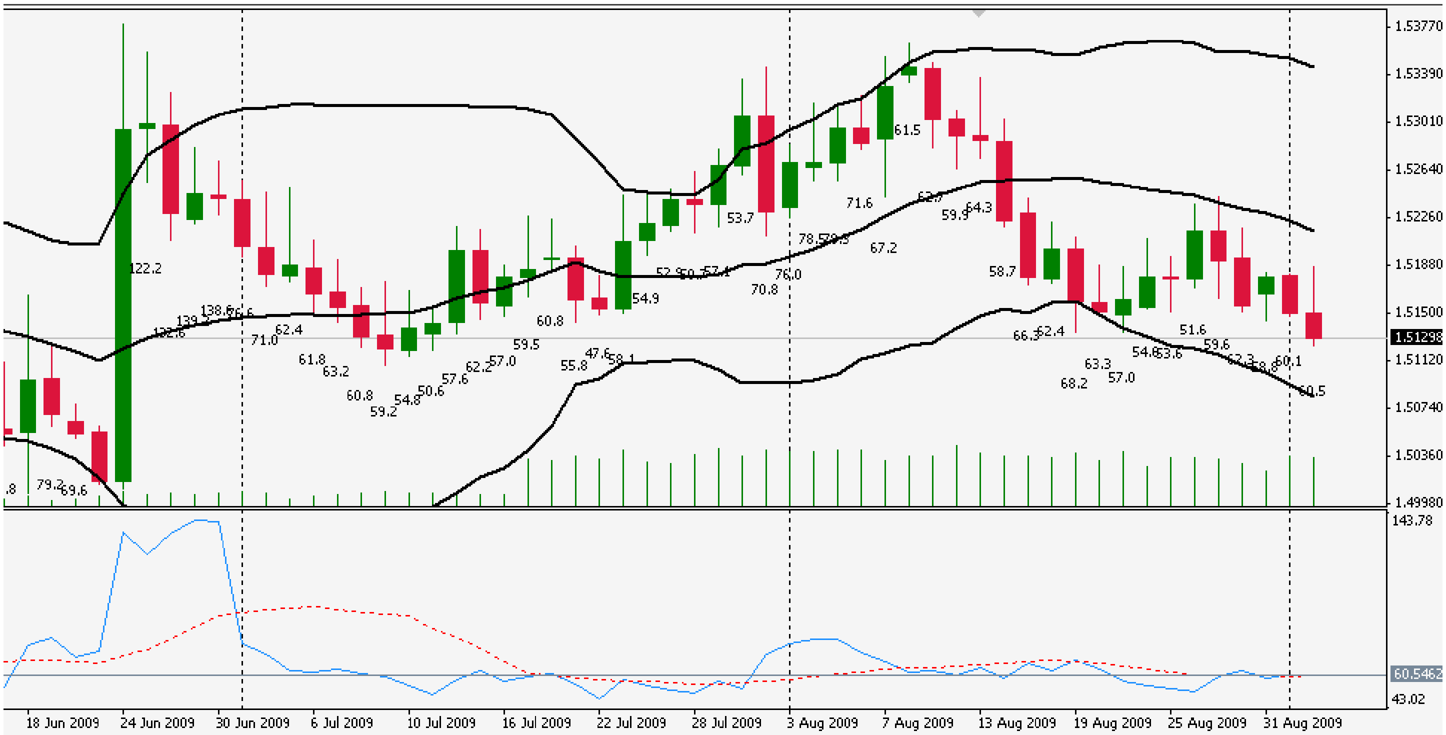
A customer who has leased a grid trading system called "PH3" applied it on the EUR/CHF pair on August 24th, 2009, with a strategy stop loss set to $25 or .25% (the account has $10,000 USD). The strategy placed 24 trades until it was stopped out on September 2nd for a total profit of $7. The profit includes the $25 in booked losses, so the gross profit was roughly $32. The average profit per trade was $1.85, or 20 pips. Due to the account size, Micro lots were used which have a 1,000 size, which is roughly .10 per pip.

This is a proof that it is possible to execute this strategy successfully. This is a good trade with a good outcome, which could be better. A wider stop loss would have allowed the strategy to continue trading, but it served the account well by limiting the losses. While a $7 or .07% profit is not much, it happened in a period of 2 weeks using a low trade size for the purposes of testing. This is just one example of how to use a system like this, and of course, a larger size would have achieved a larger profit. Using a 10k mini contract instead of a micro, a $70 profit would have been achieved with a total $250 in risk. It is the conclusion of this article that the math involved in calculating risk is similar to options, in that the trader is risking $25 to gain back the $25 and have in this case a $7 profit with the potential to have $100 in profit or more.

[In above picture, red arrows represent sells and green arrows represent buys. See bottom right where the strategy is stopped out.]

Of course, this strategy could not be applied to any currency pair under any conditions to get the same result. The pair chosen, and the market conditions, was highly dependent in achieving this result. However, the same is true for options. Randomly picking options strategies will not achieve a good result.

A trader using this system must identify a flat or 'ranging' market, by looking at the average volatility over the past 5 trading sessions, and calculating what he expects in the next 5 trading sessions in terms of volatility. This can be done either by experience, or by using indicators such as the V Speed, pictured here:



This indicator displays the high-low (range) of each bar. Determining what is a range can depend on the pair. It should be compared to its historical behavior; any pair is always in a historical 'range' even if the width of the range is 4,000 pips. A range that wide would not provide ample opportunity for a grid trading system. In the case of EUR/CHF, since June 18th 2009 it trades between 1.5365 and 1.5105, a 350 pip range. Knowing the 350 pip range, the grid levels and account stop loss can be set accordingly.

Strategy Use

This strategy can be used as an 'overlay' strategy combined with other strategies. It can have an extremely short term time horizon, in comparison to the above example. For example, if the market is quiet due an upcoming data release, a system such as this would trade well until the release is announced and the market starts moving. It's difficult to trade when the market is not moving. Some managers may be pressured to trade even if a good trade is not clear. A strategy like this will serve this situation well.

Additional Thoughts

Sometimes guessing what the market isn't going to do is a lot easier than guessing what the market will do. This can be done with options and the above referenced specific types of spot forex automated systems.

Resources

Register for a free account at http://eesfx.com for more detail about this strategy, including the automated system itself, including manual and instruction.

http://ph5.eesfx.com

For a free demo of MT4 to run this system on, please click below:

http://demo.eesfx.com

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[i] http://en.wikipedia.org/wiki/Option_(finance)

[ii] http://www.investopedia.com/terms/d/doublenotouch.asp

[iii] http://www2.oanda.com/cgi-bin/msgboard/ultimatebb.cgi?ubb=get_topic;f=15;t=003696;p=1

[iv] http://en.wikipedia.org/wiki/Call_option

[v] http://en.wikipedia.org/wiki/Option_time_value