

Trend Following Algorithms in Automated Stock Market Trading

by

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Master of Science in E-Commerce Technology



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A thesis submitted in partial fulfillment of the
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Supervisor

Date _____



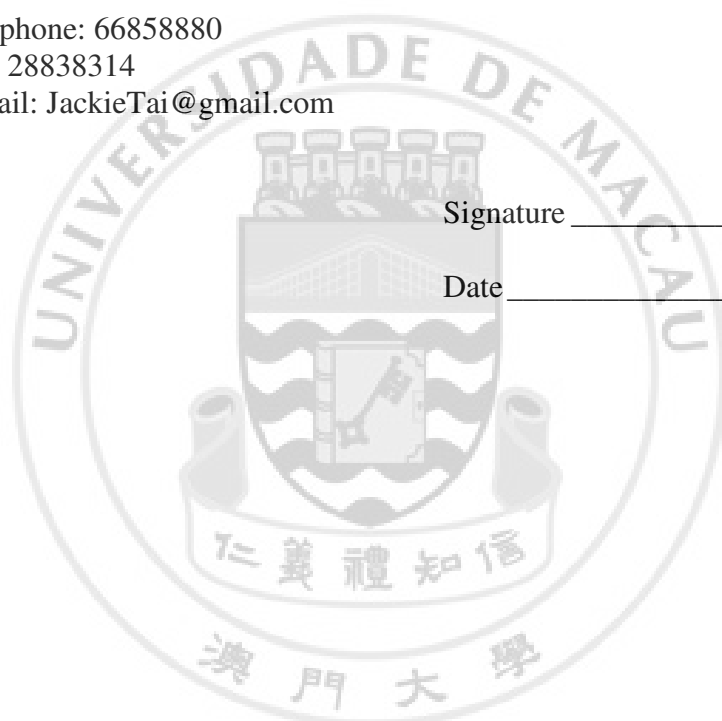
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Abstract

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Unlike financial forecasting, trend following[1] does not predict market movement, instead of prediction, it follows market trend. Once a trend is recognized, just jumps in and rides on it, taking benefit from both sides, enjoying the profits from ups and downs of the markets. Trend following trade has a long and successful history[2], it has been wildly used by professional traders, and can be applied to various markets. There are many forms of trend following, the traditional trading method is by human judgment and following trade strategies rules. That is the human spots out a trend, identifies the trade signal and places an order accordingly. Beyond rules and strategies, human judgment becomes the core element, it requires rational discipline and emotional control to stick with a trend, following precise rules through the market movements of upward and downward. However, as emotions are part of the human nature, this self-discipline is not always carried out. Therefore many trend traders failed to make profit. Today with the growth of computer power and Internet technology, trend following trade can be programmed and automated. Transaction executions that used to be performed by human could be replaced and automated by an automated trading system. Trade decisions that used to be made by human judgment, now are replaced by algorithms. Algorithms are free from human emotions, they execute precisely as how the codes instruct to trade so.

Financial forecasting is always a hot topic in academic research, there many scholars who work on this field, plenty of research works are carried out. In general, there are two domains, one is the financial field, using economics models that rely on mathematical, statistical, time series forecasting to address the problem; this one belongs to the economics finance, models from this area use little of computer

algorithm. The other is computational field, using scientific models that base on intelligent algorithms such as machine learning, artificial neural network, expert system...etc[3], that attempt to find an optimal solution for the problem. This is the area that researcher have been studying on. Among this computational domain, the adoption of this kind of algorithm or model somehow is not particularly popular in today financial market place. But on the other hand, there are very few academic researcher studies about trend following, yet the use of this technique is everywhere, and is widely applied on various of financial markets. So there must be some reasons behind this. In my opinion, models or algorithms that base on machine learning or neural network...etc, are something I refer as black-box processing (e.g. tuning some internal weights), which means that we know what data input to the black-box, and what outcome will be the output, but how it produces, is not transparent and parameters setting is difficult to control. Perhaps these uncertainties are not favorable in financial trading practice.

Most of the researchers, who work on this topic, tend to focus on predictive model because of intellectual endeavour. In this thesis study of major in e-commerce, we propose five trading algorithms that are based on a different type of model; we call it "Reactive Model". The first one is derived from the concept of basic trade strategy, in which all trend followers try to systematize their trades. The basic premise is that the most profit is gained when a trade is synchronized to an enduring trend. The rules of this algorithm are statically formulated as the trade parameters remain unchanged once they have been defined.

Based upon this initial concept of trading algorithm, some variants are introduced with incorporation of technical analysis concept. Technical analysis makes trade decision through technical indicators such as RSI, STC, and EMA ...etc, these indicators are changing dynamically according to the market situation. By adopting one or more of these indicators and by studying how they react to the market, we can form rules that are able to inherit this dynamic nature. By following these rules during

trade session, we update the trade parameters with the latest dynamic values attribute too.

For improving the performance, we introduce fuzzy logic into our trade system, which forms our third and fourth versions of trading algorithms. The properties of these trading algorithms are generally built upon the experiences of previous trading algorithms, such as the membership definition and fuzzy sets generation. All these trading algorithms are later verified on Hang Sang Index futures market in a simulated environment, and the result is encouraging.

These trading algorithms showing an outstanding performance in the wild bullish and bearish markets between the years of 2007 to 2009. However, during the year of 2010, they seem to be under performing, as they are no longer generating great profits. This is due to the large flip-flop changes of the market. It was observed that frequent market trend fluctuations deter trend following algorithms.

To resolve this limitation, we present our last trading algorithm, namely "Trend Recalling", it is considered to be adaptable to market behavioral changes. The concept of financial cycle was taken into account of our algorithm. This trading algorithm is also verified on Hang Sang Index futures contracts in simulated environment, and the result is inspiring.

In this thesis we discuss on the design of an automated trading system, which incorporates these trend following algorithms, which is a core element of the system, and the application of this type of system in financial market. We also investigate how the market fluctuation can affect the overall performance, and bring new perspective to handling the financial cycles.

One of our goals is to build up this automated trading system, which primarily operates on financial derivative market[4], such as the Hang Sang Index Futures Contract that trade on HKFE (Hong Kong Future Exchange) or the Dow Jones Industrial Average Index Futures Contract that trade on CBOT (Chicago Board of

Trade). In this thesis “Hang Sang Index Futures” is selected as the primary simulation market, although the system can be applied on any market theoretically.

By using only historical market data, the system is able to react according to real-time market state, and make trade decision on its own. To reduce the overnight risk and cost-of-carry, trade will be performed on a daily basic only, which means no contracts will be carried overnight. The P&L (Profit and Loss) on each trade will be recorded and accumulated as the total of ROI (Return on Investment), which is a common indication for the performance of an investment in financial world.

Contributions of this thesis research are summarized as follow:

- Developed an automated trading system prototype, which provides a cornerstone for future development, and experimental platform for evaluating trading algorithms and programmed.
- Proposed some innovative trading algorithms based on trend following concepts.
- Provided an alternative view and comparative of two kinds of trading algorithms (Predictive model vs. Reactive model).

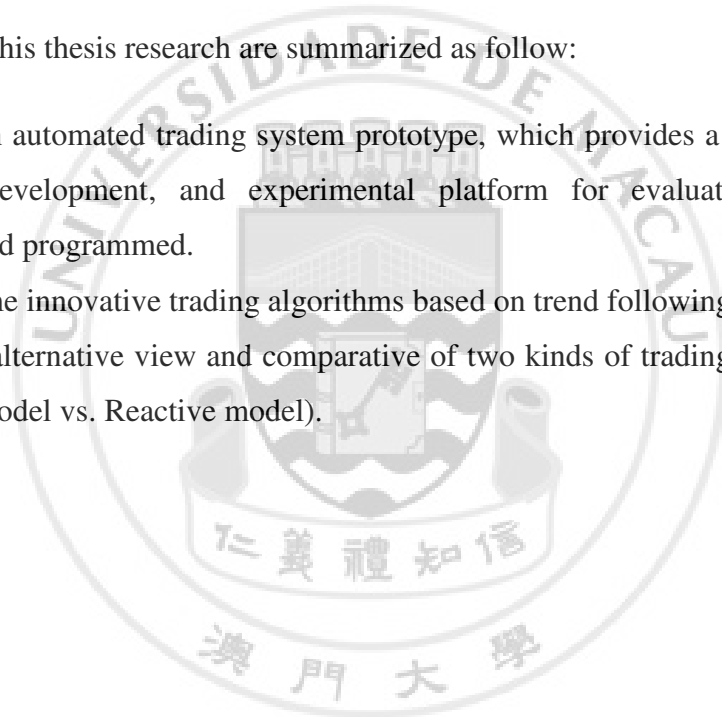






TABLE OF CONTENTS

List of Figures	iii
List of Tables	vi
List of Abbreviations	vii
Chapter 1: Introduction	1
1.1 Derivatives Market.....	4
1.2 Futures Contract.....	5
1.3 Technical Analysis.....	6
1.3.1 Moving Average.....	7
1.3.1.1 Simple Moving Average	7
1.3.1.2 Exponential Moving Average	8
1.3.2 Relative Strength Index.....	9
1.3.3 Momentum Oscillator	10
1.3.4 Stochastic Oscillator.....	11
Chapter 2: System Design.....	12
2.1 System Overview	12
2.2 Use Cases	14
2.3 Class Diagram.....	16
2.4 State Diagram.....	18
2.5 Sequence Diagram	21
2.6 Database Design.....	22
2.7 External Rationale.....	33
2.8 Interface Design	34
Chapter 3: Trend Following	38
3.1 Static Trend Following (algorithm 1)	38
3.2 Experimental Simulation 1	43
3.3 Dynamic Trend Following (algorithm 2).....	44
3.4 Experimental Simulation 2	46
Chapter 4: Fuzzy Trend Following.....	48

4.1 Fuzzy Logic Trend Following (Algorithm 3)	48
4.2 Experimental Simulation 3	51
4.3 Fluctuation Examination.....	52
4.4 Fuzzy Logic Trend Following with Volatility (Algorithm 4).....	55
4.5 Experimental Simulation 4	59
Chapter 5: Trend Recalling.....	62
5.1 Financial Cycle	64
5.2 Trend Recalling Past Strategies Algorithm (Algorithm 5)	66
5.2.1 Preprocessing.....	67
5.2.2 Selection	69
5.2.3 Verification.....	71
5.2.4 Confirmation.....	72
5.3 Experimental Simulation 5	75
Chapter 6: Conclusion.....	78
6.1 Summary of Results.....	80
6.2 Verification By Other Data Set.....	82
6.3 Comparison with Predictive Models.....	84
6.4 Evaluation of System Response Time	90
6.5 Summary of Contributions.....	91
References.....	93

LIST OF FIGURES

<i>Number</i>	<i>Page</i>
Figure 1: An idea of automated trading system	2
Figure 2: Example of simple moving average	8
Figure 3: Example of exponential moving average	9
Figure 4: Example of Relative Strength Index	10
Figure 5: Example of momentum index	10
Figure 6: Example of Stochastic Oscillator Index	11
Figure 7: System overview of the designed ATS	13
Figure 8: General functions of the automated trading system	15
Figure 9: Classes design of the automated trading system	17
Figure 10: General system state flow	18
Figure 11: Decision-making and ordering state flow	20
Figure 12: Typical system operations sequence	22
Figure 13: Database conceptual design ER diagram	23
Figure 14: Database design detail ER diagram	24
Figure 15: External linkage of the ATS to third party system	33
Figure 16: ATS main interface design	34
Figure 17: Example of the main user interface design	35
Figure 18: Manual trade UI design	35
Figure 19: Manual trade UI example	35
Figure 20: Example of real-time chart user interface	36
Figure 21: Example of historical chart user interface	37
Figure 22: Illustration of P and Q applied on trend T	39
Figure 23: P and Q applied on smoothed trend EMA(T)	40
Figure 24: P and Q value range determination	41
Figure 25: By holding the other value constant, it is possible to have multiple values of P and Q that generate good profits	42
Figure 26: Simulation trade of Algorithm 1 verifies on Hang Seng Index Futures	43

Figure 27: Daily profit and loss distribution of Algorithm 1 simulation.....	43
Figure 28: Illustration of dynamic P & Q rules and criteria	45
Figure 29: Simulation of Algorithm 2 compare with Algorithm 1 on HSI Future	47
Figure 30: Daily profit and loss distribution of Algorithm 2 simulation.....	47
Figure 31: First input variable membership definition	49
Figure 32: Second input variable membership definition.....	49
Figure 33: Center of gravity defuzzification output membership definition	49
Figure 34: Simulation of Algorithm 3 compared with Algorithms 1 and 2.....	51
Figure 35: Daily profit and loss distribution of Algorithm 3 simulation.....	52
Figure 36: Example of simulated market trend with fluctuation control.....	54
Figure 37: Fluctuation test result	54
Figure 38: First input variable membership definition	56
Figure 39: Second input variable membership definition.....	57
Figure 40: Third input variable membership definition.....	57
Figure 41: Center of gravity defuzzification output membership definition	57
Figure 42: Simulation result of Algorithm 4 compares with Algorithm 3	59
Figure 43: Daily profit and loss distribution of Algorithm 4 simulation.....	59
Figure 44: Result of all Algorithms compare with Hang Seng Index performance	61
Figure 45: Performance update of pervious trading algorithms	63
Figure 46: Financial Cycle.....	64
Figure 47: Market trend movement	65
Figure 48: Chart of 2009-12-07 and 2008-01-31 intra-day price trend	65
Figure 49: Trend recalling algorithm processes illustration	67
Figure 50: Example of EDM and preprocessing applied on 2009-12-17 day trend	68
Figure 51: Example of selection in 2009-12-07 with best fitness sample	70
Figure 52: Fitness test applied on 2009-12-07 during the middle of trade session	71
Figure 53: Fuzzy volatility membership definition summary.....	73
Figure 54: Simulation trade of Algorithm 5 during the year of 2010.....	75
Figure 55: Daily profit and loss distribution of this simulation.....	76
Figure 56: Performance comparison to CTAs/Managed futures funds.	76
Figure 57: Simulation of first four algorithms during the year of 2007 to 2009	80


Figure 58: Simulation results of all trading algorithms during the year of 2010.....	81
Figure 59: Simulation of first four algorithms on H-Share during 2007 to 2009	82
Figure 60: Simulation result of all trading algorithms on H-Share in 2010	83
Figure 61: Predictive model simulation trade result on HSI futures in 2010	86
Figure 62: Daily profit and loss distribution of predictive model simulation trade.....	87
Figure 63: Predictive model overnight contract simulation trading	88
Figure 64: Daily profit and loss distribution of predictive model overnight contract	88
Figure 65: Predictive model compare with Reactive model (trend recalling).....	89



LIST OF TABLES

<i>Number</i>	<i>Page</i>
Table 1: Fluctuation test result data	55
Table 2: Simulation result data of all trading algorithms	60
Table 3: Average error ratio of these trading algorithms.....	61
Table 4: Summary of this trading algorithm performance.....	75
Table 5: CTAs/Managed funds performance data in the year of 2010.....	77
Table 6: Simulation result data of first four trading algorithms from 2007 to 2009	80
Table 7: Average error ratio of first four trading algorithms during the simulation.....	81
Table 8: Simulation results data of all trading algorithms in the year of 2010.....	81
Table 9: Average error ratio of all trading algorithms during simulation.....	82
Table 10: Result data of first four algorithms on H-Share from 2007 to 2009.....	83
Table 11: Average error ratio of first four trading algorithms in H-Share	83
Table 12: Simulation result data of all trading algorithms on H- Share in 2010.....	84
Table 13: Average error ratio of all trading algorithms in H-Share	84
Table 14: Accuracy of predictive model generate by Oracle Crystal Ball.	85
Table 15: Simulation trade result data of predictive and reactive model	89
Table 16: System response time evaluation data	90

LIST OF ABBREVIATIONS



HKFE	Hong Kong Futures Exchange
CBOT	Chicago Board of Trade
HSI	Hang Seng Index
P&L	Profit and Loss
ROI	Return on Investment
SMA	Simple Moving Average
EMA	Exponential Moving Average
RSI	Relative Strength Index
MTM	Momentum Oscillator
STC	Stochastic Oscillator
MACD	Moving Average Convergence Divergence
ETF	Exchange Traded Funds
ATS	Automated Trading System
API	Application Programming Interface
ER	Entity Relationship
UI	User Interface
FCL	Fuzzy Control Language
IB	Interactive Brokers

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