ODDS® Correlation Trader

Objective, Development History and Trading Method

Objective

ODDS® Correlation Trader deals with one of the oldest problems beleaguering traders since markets began:

No single indicator works well all the time. At times, a certain indicator may be in perfect harmony with the market. Every time it says buy, the market goes up. Every time it says sell, the market goes down. At other times, however, the indicator is just as perfect, only it's perfectly *wrong*. Whenever it says buy, the market collapses. And when it says sell, the market skyrockets upward.

Just think if you could know, in advance, when you should use the indicator, and when you shouldn't.

ODDS Correlation Trader (OCT) attempts to provide an answer to that quandary. OCT uses applied mathematics on a large number of broad-based, diversified market indicators, comparing the indicators to the subsequent performance of the stock market. It then looks for the best performing indicators, and follows only certain indicators that have shown a recent tendency to provide and accurate forecast of the market's direction. It ignores those indicators that have fallen out of synch.

OCT's objective is to use an adaptive process to improve forecasting power.

Development History

ODDS Correlation Trader is based on a principle I developed back in 1996. The principle was conceptualized when I was doing some research on probability theory and options. My work back then led me to the conclusion that there are better ways to analyze options strategies than by using a model with an overly simplistic probability assumption. The reason is that nearly every model out there uses a probability model based on a flawed hypothesis of the way markets behave. Option models fail to account for the likelihood of large moves, or in statistical parlance, fat tails. For years, I have used this knowledge in the options field to resounding success. But I had never used this outside of the options arena. I used it, and still do use it, to calculate true probabilities on options strategies.

In 2008, with the breakdown in the stock market, I realized that some prediction models would no longer work as they had in the past. Let's take a contrary opinion indicator, for instance. Previously, if too many people got too bearish, it was a good sign that, with pessimism at an extreme, a rally would develop. The usually wrong crowd would be wrong once again. But that didn't happen in 2008. Traders got bearish, then more bearish, and then even more bearish. Even though pessimism was at an extreme, the market never snapped back.

The same thing happened with monetary indicators. If there has been one iron-clad rule that has existed for more than 50 years, it's this: Don't fight the Fed. If the Fed wants to kill the economy to stop inflation, they can do it. By raising rates, they can put the brakes on the economy and the stock market. If the Fed wants to grow the economy, they can also do that. By cutting rates and supplying liquidity, they can get the economic engine and the stock market moving. At least, that's the way it's worked since World War II. But that's not what happened in 2008. The Fed started cutting rates in August 2007 and has been on a rate cutting regime ever since. Heck, the Fed isn't alone. China, Europe and central bankers globally have been cutting rates sharply for well over a year. But those rate cuts have not helped either the stock market or the economy. The usually-reliable monetary indicators fell out of synch.

On the other hand, technical indicators, such as moving average crossovers, have been on fire. Let's say you are monitoring two moving averages: the 50-day moving average and the 200-day moving average. When the market breaks below both of those moving averages, and then the 50-day m.a. drops below the 200-day m.a., you have what's called a crossover (some call it a "golden cross"). That's considered a bearish sign. But here's the thing. In a non-trending market, you can get whipsawed from bearish to bullish, back to bearish and back, again and again.

So what's a person to do? My research has shown is that you need to switch to the so-called "HOT" indicators. What's particularly interesting is that switching to what's hot is not a unique approach. Several academic studies[1] have shown that this "adaptive" concept works. What I've done is to utilize correlation analysis to tell the system how to adapt.

The ironic twist in all of this is that the indicators I am using in this system are pretty much the same as those I've used for decades. There are a few changes, but for the most part, they're the same. The key difference is, I don't judge whether that indicator is bullish or bearish anymore. For instance, I don't look at a particular overbought/oversold indicator, see that it's saying that the market is oversold, and then render a judgment that says, BULLISH. Instead, I let the correlations determine whether it's bullish or bearish. Even then, however, it's not enough. And here's why. I next look to see if that indicator has been accurate recently. If it has, then and only then, do I choose to utilize it.

The system goes through this process for each of the many indicators, and then ranks them based on accuracy, and then selects from the higher ranking indicators. The system then provides a single numerical evaluation of the market.

Trading Method

Because the time horizon of the system is so short, you can use the trading signals provided by *ODDS Correlation Trader* to trade the leveraged exchange-traded index funds: SSO (Ultra S&P 500 Proshares) and SDS (Ultrashort S&P 500 Proshares). That way, you get some leverage, but you're never at risk of a margin call.

You can also use options. These have a higher profit potential, but there is the tradeoff of increased risk. For liquidity reasons, I would suggest at-the-money, next month SPY options.

OCT uses end-of-day data to perform the analysis. Research is done overnight. OCT's market forecast is provided the following morning before the 9:30 a.m. Eastern Time market open.

To see how the system has performed, please see the *Performance Summary*.

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[1] Pesaran and Timmerman, 1995, "Predictability of Stock Returns: Robustnes and Economic Significance"
Bai, 2007, "Equity Premium Predictions with Adaptive Macro Indices"
Huang, 2008, "Real-Time Profitability of Published Anomalies: An Out-of-Sample Test"