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Can you tell me which is better – mechanical or discretionary trading? Discussions I have had don't seem to yield much balance. Nicholas, Perth

This is one question that I can give you a little bit of personal experience on how the argument can polarize traders. Once when discussing the issue at a seminar I received quite an aggressive dressing down from a person who said that it was impossible to make money using a discretionary method. When I argued that this was not essentially the case, I was told to produce statistics to prove my argument. And herein lies the real crux of difference between the two.

A mechanical system requires you to have a series of signals that tell you what to buy, how much to buy, where to place your stops, and when to sell. The way in which this type of system is developed comes from 'backtesting' where you test your system on historic data with the plan of extrapolating the results into the future. The backtesting essentially develops for the trader a statistical probability that any given trade will be successful. Part of it also hinges on the trades requiring no input from the trader themselves once the system has been devised. It tells you to buy – you buy.

The discretionary system allows you to make alterations to those factors I described in the previous paragraph. Buy; don't buy. Sell; don't sell.



Here's the thing though. Many of the best traders I know fall into the category of discretionary traders but in many ways, when you watch the way in which they operate, you can see quite a part of them that is almost mechanical. By this, I mean that they have a very clear picture in mind in terms of what they are looking for when they are determining what things to buy or sell.

This type of behaviour would suggest to me that these are people who have been trading for such a long time that they know what works and what doesn't and they trade according to what experience tells them to do which in one way means that they are acting on their own inbuilt 'mechanical system'. In some ways you could almost short cut this experience element through backtesting which would allow you to let your computer tell you what works and what doesn't.

So does this mean that system trading takes out the fuss and boils everything down to a simple set of rules? Perhaps – but it isn't without its own particular type of discipline.

The one drawback that I see of system trading is that it requires complete trust in the system that you are using. Remember – buy when it says buy. Sell when it says sell. This is really easy in principle but much harder to practically apply when money is on the line. The system requires you to take every trade to be successful – but what happens if you have taken 8 or 9 losing trades in a row. All of a sudden a system may seem a lot more difficult to stomach.

So where does this leave us at the end of the day? I think it will be difficult for any individual to simply pick up and run with the methods of any other person.