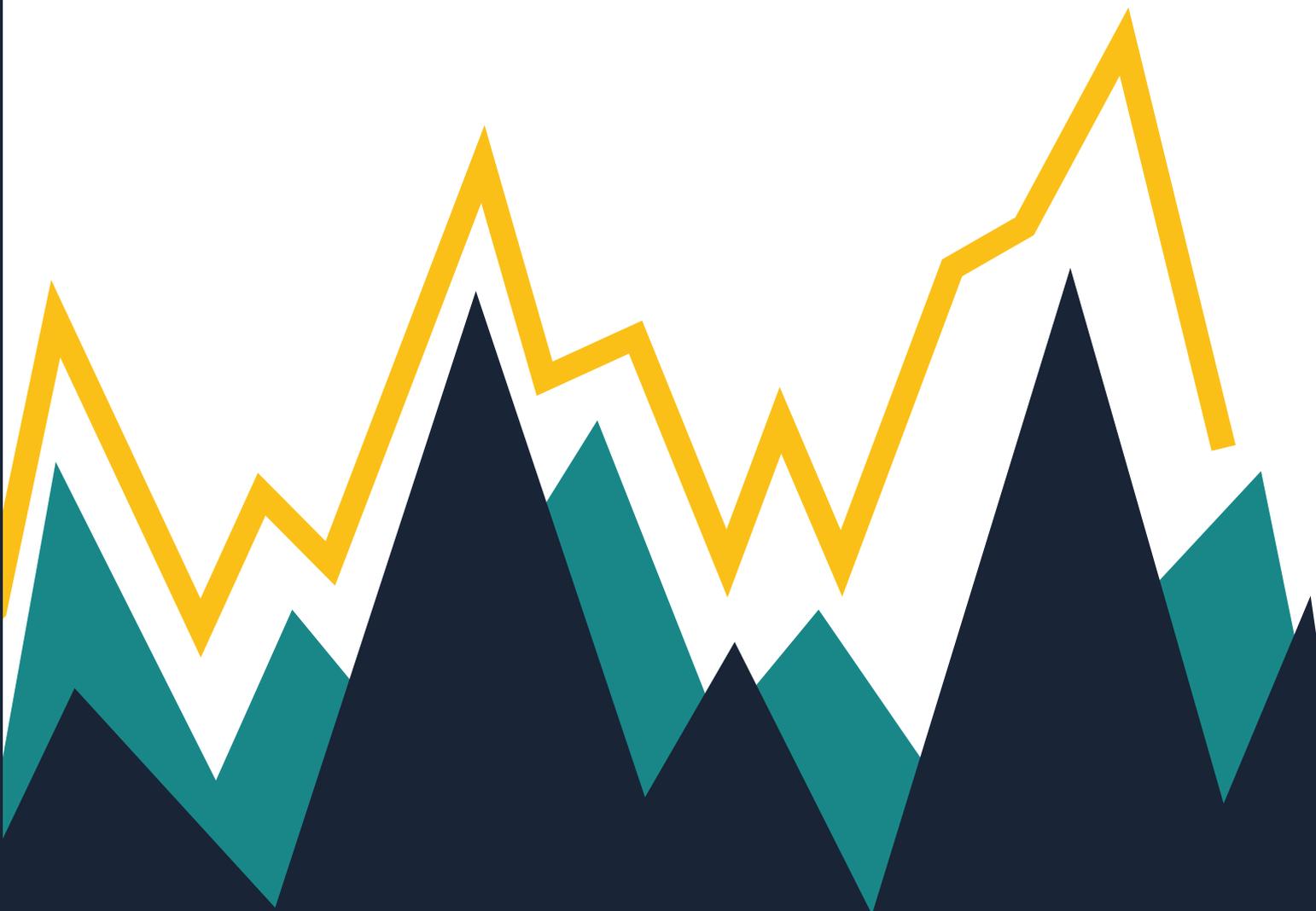# THE SYSTEMATIC TREND FILTER

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Building A Trader Company

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Happy trading and stay safe,

Building A Trader Team

Hello friend,

I'm so glad you decided to download this resource. I know it will help you on multiple levels. The systematic trend filter you will be learning about in these pages will help you:

- Avoid trading against an established trend;
- Know when the trend is in place and when it is instead pulling back or stalling;
- Know when to trade and when to remain flat;
- Know where the trend turns from Long to Flat to Short;

And thus:

- Become extremely selective where and why you are risking your hard-earned money.

This trend filter is based on the work that I did sending trading signals and analysis to institutional clients at 3CAnalysis.com. It is simple and effective and I know your account will thank you if you stick with it.

Don't Follow the Herd

Let's get right into the rationale behind this filter. In my work as a trading coach, I constantly see people that miss the forest for the trees. Most traders are obsessed about trading tactics and entries, completely ignoring or bypassing the initial steps that are required in order to create a consistent trading model:

- Instrument Selection (what to trade, and why);
- Instrument Watchlist (what to keep a close eye on each day/week);
- Trade Setup (the behavioural trait that inspires action);
- Trade Trigger (how/where/why you get in the market);
- Trade Management.

As such, most traders attempt to deploy their entry tactics anytime, anywhere. And by doing so, over 70% of traders lose money (based on the risk disclaimers that all brokers are required to keep on their websites and promotional material nowadays).

My exhortation is this: **do not follow the herd**! If you want to become a consistent trader you must do what most people will not, in order to obtain results that most people cannot.

This trend filter will help you, if you have the patience to wait for the filter to deal you in.

Here is a chart of EURUSD from August 2019 to October 2020. Take note of the places where the filter was "active" (white shaded areas). This means you would NOT be trading AT ALL unless the filter is active.
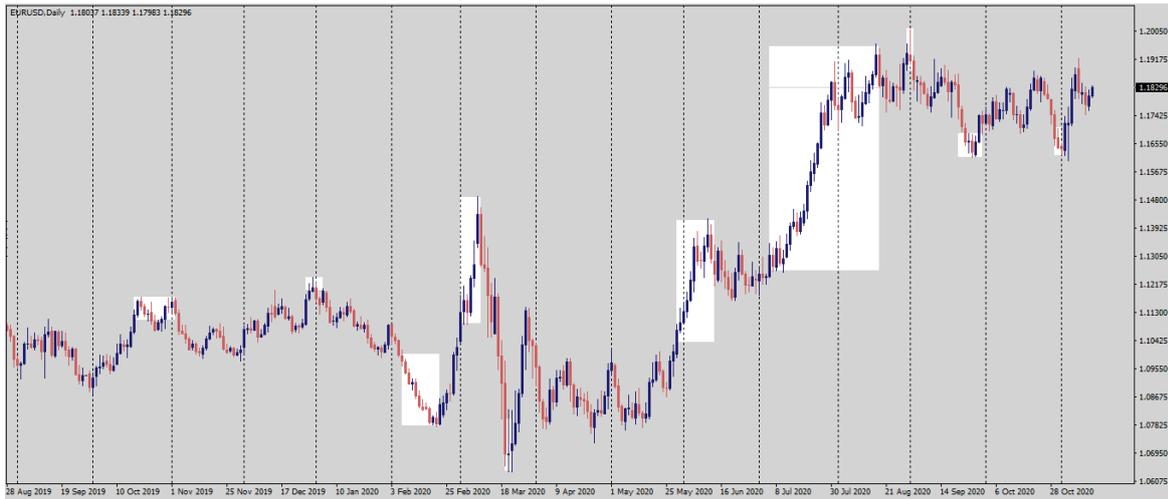
EURUSD Daily Chart from Aug 2019 to Oct 2020. Shaded areas are where the filter was allowing trades to be taken (long on the way up, short on the way down).

This may not mean that much to you right now. You might be looking at all the other movement in prices saying "look how much action I'm missing!". Fine. Perhaps the following evidence will help you understand the importance of being selective, being patient and picking your spots carefully.
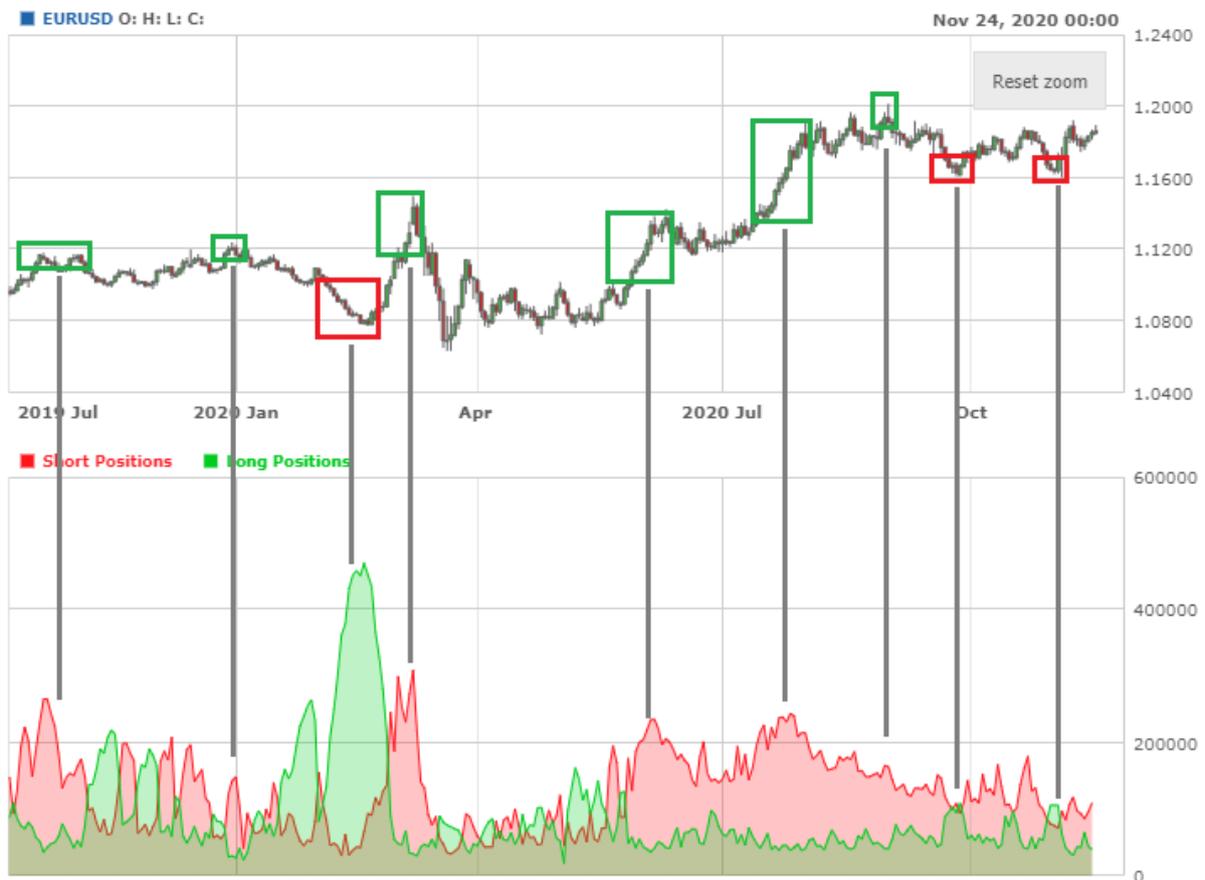
Source: MyFXBook Outlook

The chart above is a snapshot of retail positioning (represented by all live accounts on MyFXBook) on EURUSD from August 2019 to October 2020. But you can scroll back in time on any instrument: the behavioural trait is consistent over time.

Notice where the filter is "long" or "short". How are most traders positioned?

I think you'll notice how most traders are actually positioned opposite the trend filter! Most traders are attempting to buy during downwards moves, and sell during upwards moves.

By adopting the trend filter presented here, you will not only be filtering potential trends, but you will also know that you are going against the herd! You will be legging into trends at precisely the time that most people are trying to catch tops or bottoms.

Learn to Trade Trends

Here's my point: while it is fair to say there are multiple ways to trade profitably and there are multiple niches to be exploited, my experience with retail traders has taught me that most (if not all) not only fail to find their niche, they rarely find any consistency at all.

Here's why:

- most people who attempt trading for a living to evade the "normal 9-to-5 job" do not consider learning how to trade and becoming consistent year after year requires more passion, energy and resilience than a normal job. Trading is more akin to performance discipline. I've seen this again and again - one example stands out: After one of our initial training sessions I requested my student "back test" a setup we had worked on and keep detailed results of it. This trader not only never kept records of any kind but said "I've never really back tested anything…I just thought I could take what you tell me and apply it from here on in".

- Even if they are interested, most people who want to be retail traders rarely have the time to find their niche. To find your niche in the trading world you need to do a few things. First and foremost, know yourself. Know what gives you enjoyment, what comes naturally to you and what other people see in you. For example, if you naturally enjoy social context, interacting with people or speaking in public, staring at screens for 8 hours a day alone in your home office may not suit your temperament. First you do need to know yourself and your predisposition. Then you need to experiment with various approaches to trading to see which one suits you best. Long-term value investing in stocks? Systematic trading in FX and Commodities? Intraday momentum? Intraday mean-reversion? There are many styles and to create a best-fit you will need to act like a scientist: test, observe your own reactions, make notes and adjust your trading approach based on evidence. This takes time and dedication and if you are trying to master the art of trading at the end of a long working day, what are the odds of success?

- Even if aspiring traders do commit to take the time and make the effort, the pressure to perform and "escape the day job" hinders their progress and keeps them focused on the money and not the process. Many find some decent information on the internet or in some good trading books that suit their style but as soon as they hit their first drawdown (a string of consecutive losses) consistency and discipline get thrown out of the window and the "perpetual tweaking" starts.

- Left to their own devices, most aspiring traders seem to be drawn to mean-reversion trading, which ties into their psychological need to be right. What happens is most aspiring traders tend to battle the current trend, they look for "turning points", they try to identify the market top or bottom and look to "fade" the prevailing trend -instead of trying to enter the market in line with the existing trend on a pullback.

So while I strongly believe that aspiring traders are much better off getting help sooner rather than later, I am happy to leave you with this systematic trend filter which will keep you on the right side of the market, and even more importantly, keep you out of the market most of the time when there is no clear directional movement.

Systematic Trend Filter Rules

Here are the rules. They are extremely simple, but need to be understood well.

1. It starts at the Monthly Level. The macro direction is "long" if we post a Daily close above a prior Month's high. The macro direction is "short" if we post a Daily close below a prior Month's low. Once we break higher (or lower), the macro direction remains long (or short) until we break the prior month's low (or high).

2. Once the Macro direction is established, we shift to the Weekly level which we will call the Momentum direction. We remain positioned "long" (or short) so long as the prior week closed in the top 50% of it's range (or in the bottom 50% for short).

3. If the Macro direction and the Momentum direction are both in sync, we turn to the Trading direction which is decided by the prior day's close. If yesterday closed in the top 50% of it's range, we can continue to seek "long" entries today. Vice versa for shorts.

That's it! Unambiguous information from the Monthly, Weekly and Daily levels can help us identify the potential start of trends, the resumption of trends after pullbacks, and keep us out of the market when the 3 directions are not in sync.

Worked Example #1: EURUSD

Now it's time to see the filter in action, so you can understand it for yourself. A picture paints a thousand words!

We're going to start in April 2020 because April was an "inside month" and as such, is a good starting point to understand the filter.

So, the first thing we need is a daily close above the prior month's high (for a long bias) or the prior month's low (for a short bias). In this case, near the end of May, prices close above the April highs.

A potential new trend had started.
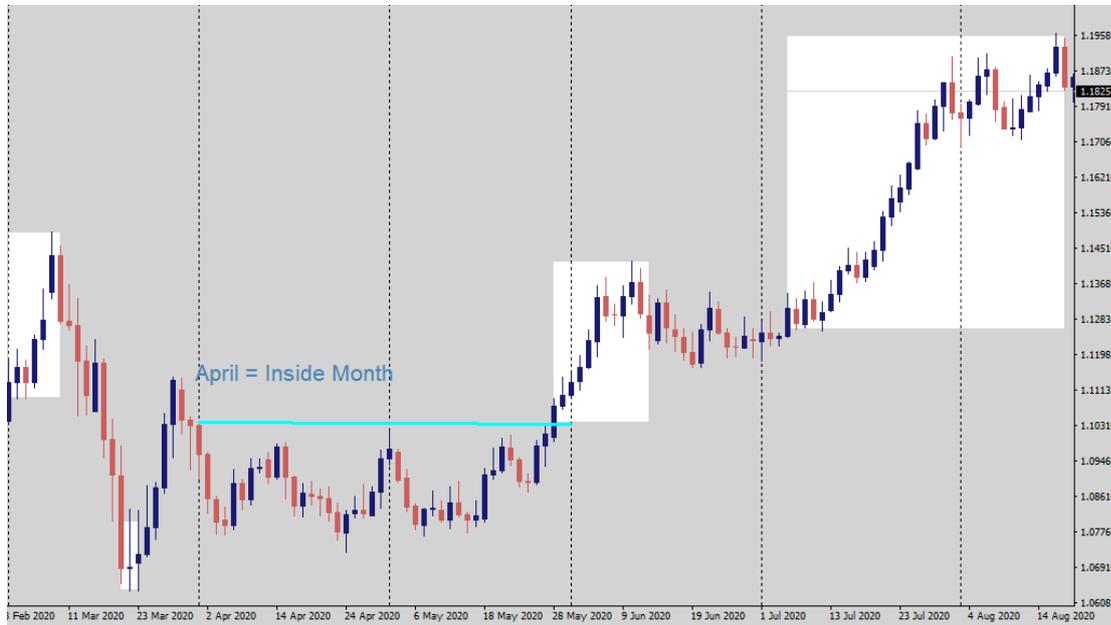
If we now move to the 4H level, at the time the Macro direction was established, we were also moving beyond prior week highs, so the Momentum requirement was also fulfilled.
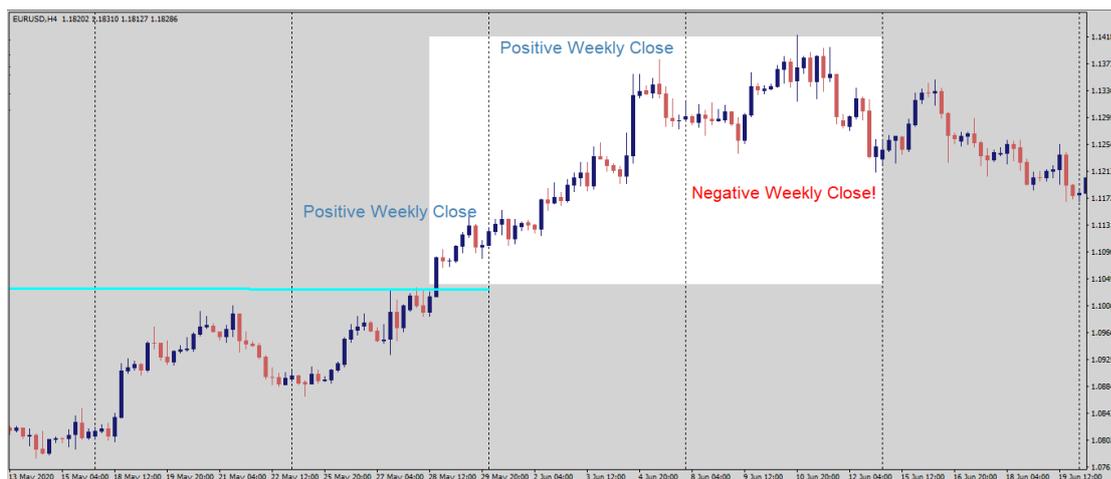
The Momentum direction remains "long" until the close of June 12th. The negative weekly close is in opposition to the Macro direction and as such, before the filter will allow us to trade again, prices need to post a weekly close in the top 50% of it's range. Alternatively, prices can close above a prior week high (and in that case we do not need to wait for the weekly close).

Now let's cascade the Macro and Momentum layers down to the daily level.
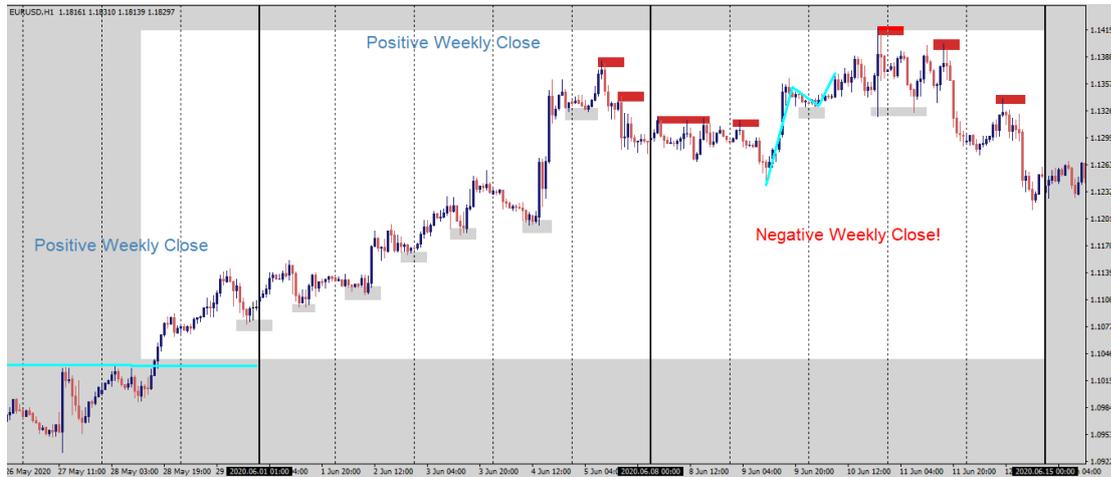
In the chart above, we see the final step: the Trading layer. With the Macro and Momentum layers pointing up, we simply need each day to close in the top 50% of it's range in order to keep the filter "on".

That condition is met until June 5th. June 5th closes negative and as such, we need to wait until we get a positive daily close in order to resume trading.

The market posts the first positive close on June 9th and "longs" are hence allowed on the 10th and 11th. But then, on the 11th, the market closes negative and the filter turns off. So we would be flat on Friday June 12th, waiting for a positive daily close. However, on the 12th, the week also closes and a negative weekly close is posted.

As such, before the Trading layer can become active, we need the Momentum layer to click back in line with the Macro layer.

But that doesn't happen for some time. 3 Weeks go by with no positive closes. As such, we pay no attention to the Trading layer because we are still waiting for a week to close in the top 50% of it's range, or to break the prior week's top.
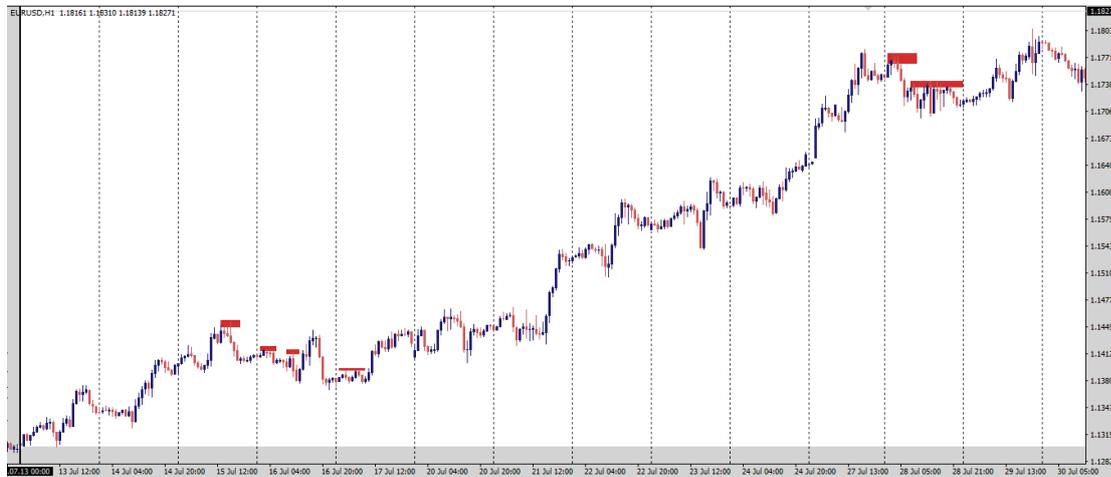

That happens on the 13th of July, and is the start of a multi-week trend. The Trading layer kicks out of gear on the 16th of July, but on the 20th allows us to trade "long" again until the 28th of July.

Then conditions start getting choppy and the you will learn just how powerful this simple filter can be.

The Momentum layer remains "long" until the close of August 7th. But the Trading layer is more active and allows us to trade "long" only on July 27th, then on July 30th into the 31st; then on July 5th and 6th.

The rest of the time, the Trading layer is reacting to the choppy conditions in the short-term, keeping us "flat" and keeping our capital safe.
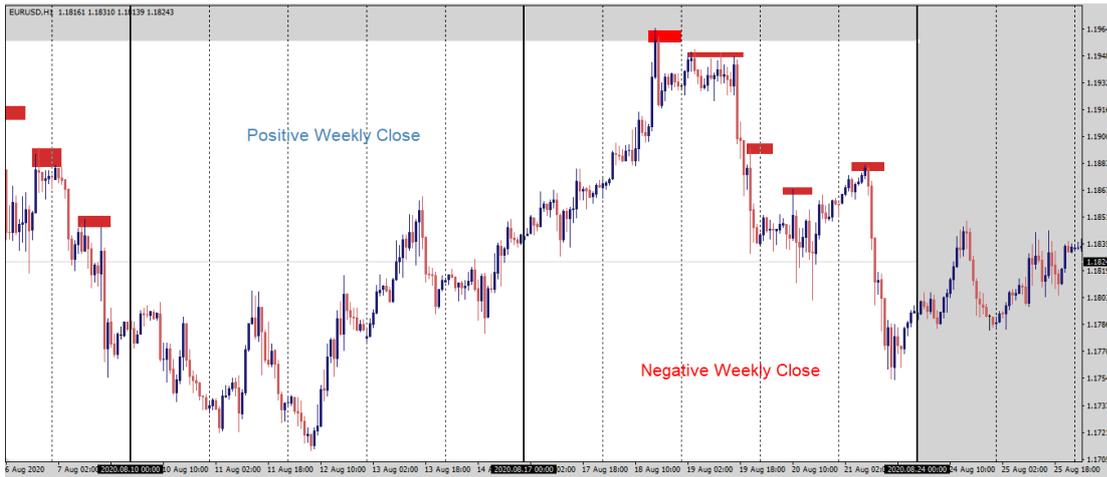
The Momentum layer gets active again on the close of August 14th 2020. So we can seek "longs" as of the 17th (Monday). The Trading layer flattens us out on the 19th and keeps us flat all the way until the end of the week (which closes negative and kicks the Momentum layer out of gear).

Worked Example #2: DAX

Robust trading rules should work across all instruments and this trend filter is no different: it can be applied to any liquid instrument (FX, Indices, Stocks, Bonds, Metals, Commodities, etc.).

Let's work through some examples on the Dax.

First, the big picture of where the Macro layer was shifting to "long" or "short".
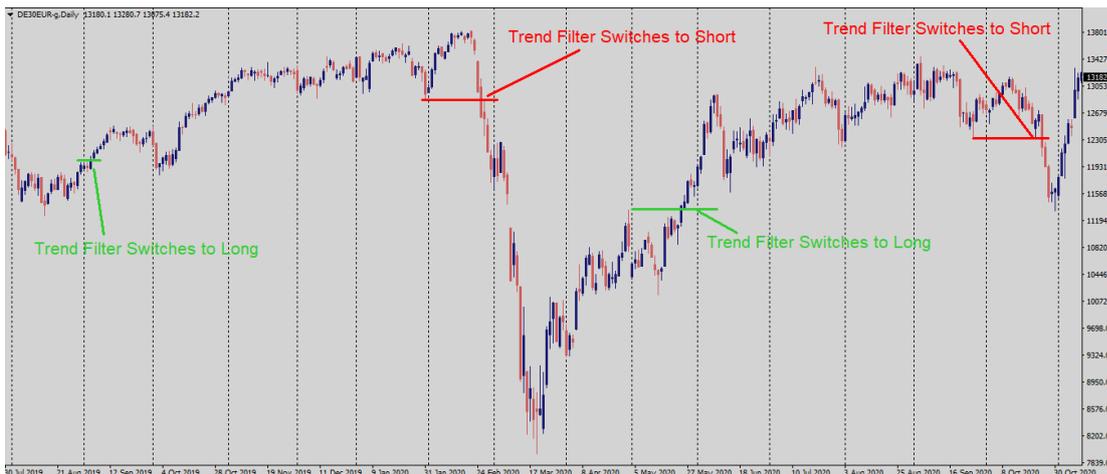
And here is the breakdown of where the Macro, Momentum and Trading layers were in sync, allowing us to trade. I have used this example to show how the filter was acting during the Coronavirus crisis, and the subsequent recovery period in 2020.
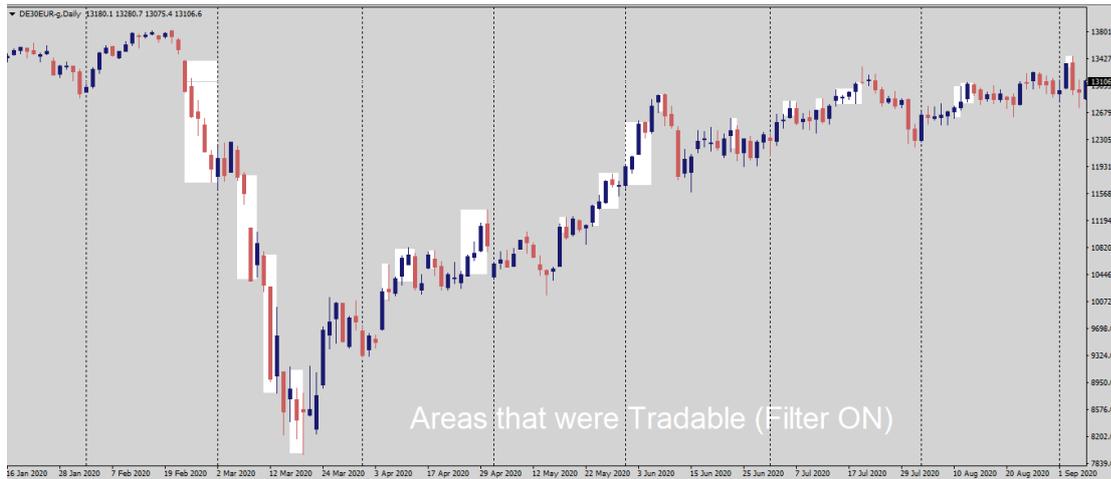
Now compare the image above, which goes from the middle of May 2020 all the way into November 2020, with the retail positioning report issued by Dailyfx:

Germany 30 Client Positioning

IG Client Sentiment

Notice anything? When the filter is allowing "long trades", retail folk are positioned "short". While the filter is allowing "short trades", retail folk are positioned "long". As stated previously, the natural inclination of most traders to sell into rallies and buy into dips is present on all instruments. Vice-versa, the trend filter keeps you positioned in line with the market.

You are following trends. Following momentum. Never fading. And never guessing.

We will start the observation period in May 2020, going straight to the Trading layer since the Macro and Momentum layers were both evidently positive.

Then into the weekly close of June 12th the Momentum layer turned neutral. We awaited a positive weekly close. We got one into June 19th, but the Trading layer was still flat because despite closing positive on the week, June 19th was a negative day.
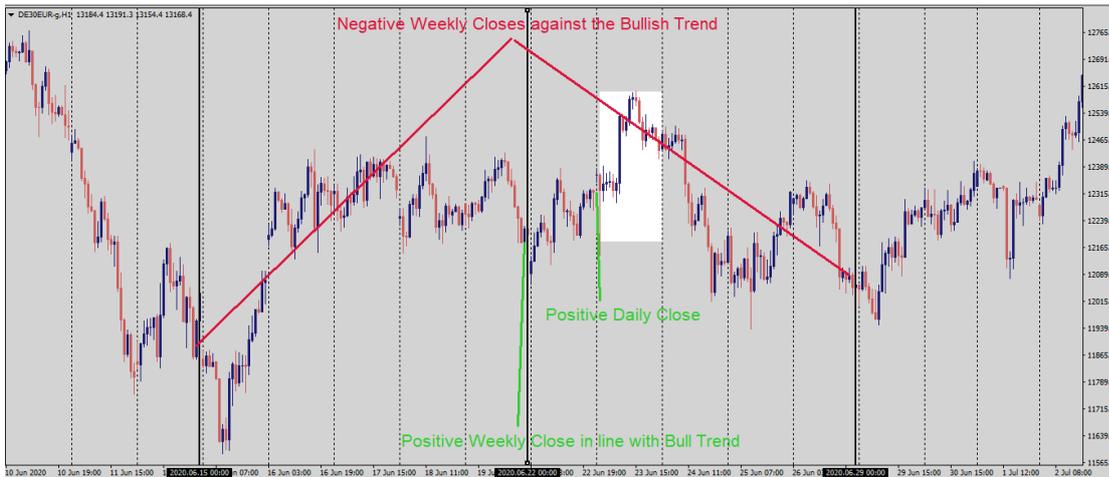
So on Monday June 22ⁿᵈ we're flat, but with the positive close we are again trading long on Tuesday and into Wednesday the 24ᵗʰ. Then the Trading layer flattens us out, and the Momentum layer flattens out as well into the weekly close.


The Momentum and Trading layers turn back "long" in sync with the Macro layer into July 6ᵗʰ. But the markets get choppy and it's on/off until we get an extended bull run from July 15ᵗʰ through the 21ˢᵗ.

Then the Trading layer flattens out, and the Momentum layer flattens out also into the 24th of July. We remain flat until the 10th of August 2020.

After a few days of positive momentum, the markets get choppy once again and the filters turn off.
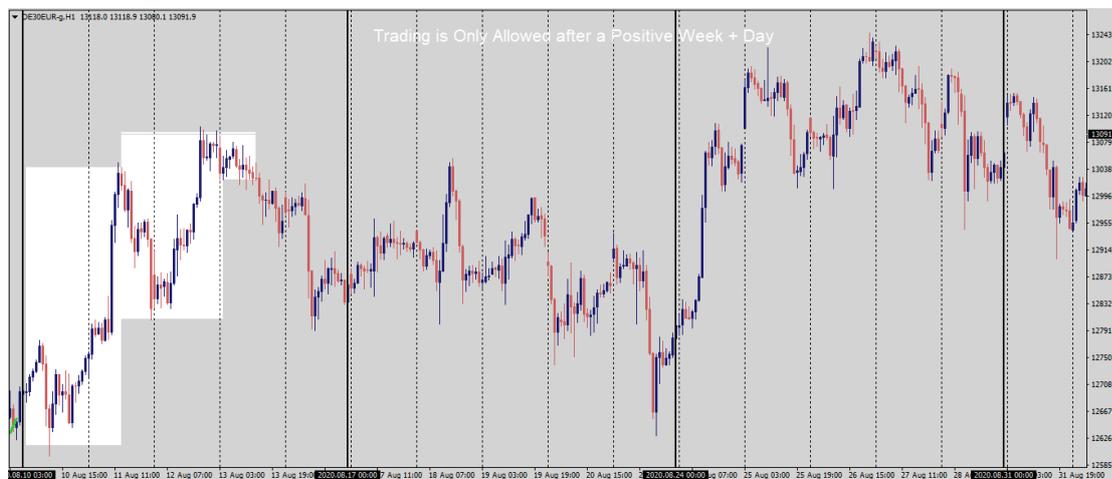
All through the rest of August and September 2020, there are only a few instances when all 3 filters were in sync. This requires much patience, but your account will thank you for not getting chopped up in non-directional markets.

The Trend Filter was active during early and mid-October 2020 as well.
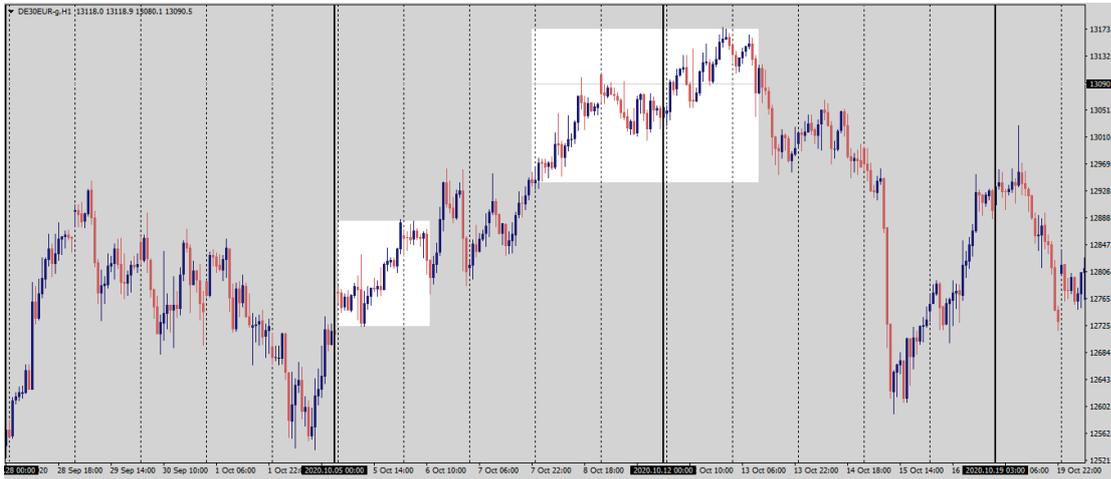
Until finally the Macro direction changed in late October, shifting to a "short" stance and capturing the decline from the 23rd into the 30th.
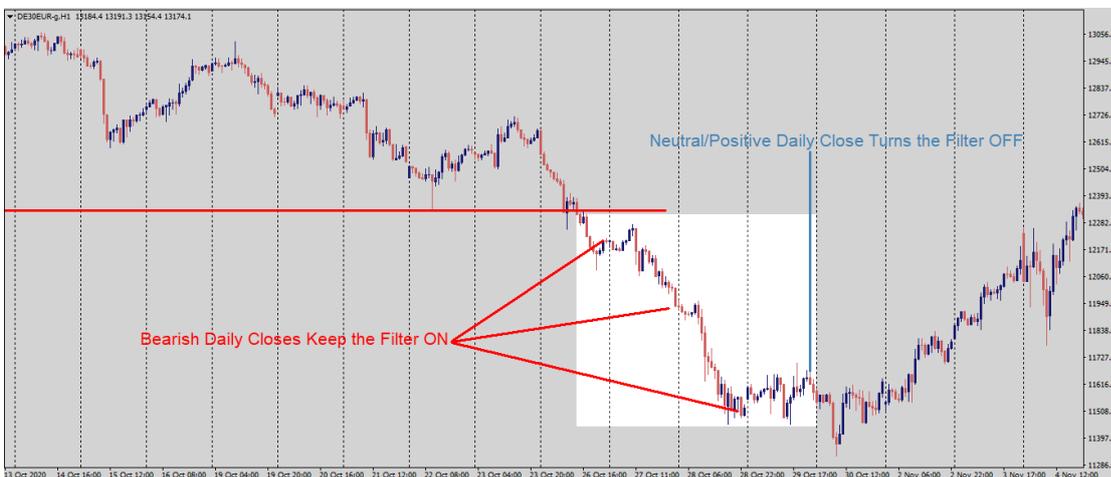
Parting Thoughts

Once I had a coachee that, just like you, was trying to generate enough income from his trading to substitute his day job.

This trader had gone through a few months of great performance, but then gave almost everything back to the market and just couldn't understand what was wrong.

Here are the trader's statistics during his profitable run (on real money).

Gross Profit:	15 799.84	Gross Loss:	9 248.92	Total Net Profit:	6 550.92
Profit Factor:	1.71	Expected Payoff:	31.80		
Absolute Drawdown:	285.87	Maximal Drawdown:	2 778.32 (38.36%)	Relative Drawdown:	38.36% (2 778.32)
Total Trades:	206	Short Positions (won %):	107 (54.21%)	Long Positions (won %):	99 (52.53%)
		Profit Trades (% of total):	110 (53.40%)	Loss trades (% of total):	96 (46.60%)
Largest		profit trade:	1 124.33	loss trade:	-402.48
Average		profit trade:	143.63	loss trade:	-96.34
Maximum		consecutive wins ($):	6 (2 369.79)	consecutive losses ($):	12 (-2 101.88)
Maximal		consecutive profit (count):	2 369.79 (6)	consecutive loss (count):	-2 101.88 (12)
Average		consecutive wins:	3	consecutive losses:	2

And here is the same trader's performance, just 2 months after that:

Gross Profit:	2 294.42	Gross Loss:	3 042.64	Total Net Profit:	-748.22
Profit Factor:	0.75	Expected Payoff:	-25.80		
Absolute Drawdown:	748.22	Maximal Drawdown:	2 636.15 (91.28%)	Relative Drawdown:	91.28% (2 636.15)
Total Trades:	29	Short Positions (won %):	7 (85.71%)	Long Positions (won %):	22 (77.27%)
		Profit Trades (% of total):	23 (79.31%)	Loss trades (% of total):	6 (20.69%)
Largest		profit trade:	1 087.65	loss trade:	-2 393.37
Average		profit trade:	99.76	loss trade:	-507.11
Maximum		consecutive wins ($):	10 (694.44)	consecutive losses ($):	2 (-2 636.15)
Maximal		consecutive profit (count):	1 219.22 (4)	consecutive loss (count):	-2 636.15 (2)
Average		consecutive wins:	6	consecutive losses:	2

Houston, we have a problem!

I had to work with this trader on more than one area, but let me just show you the kind of market conditions that allowed him to produce his good returns.

Quite simply, the trader had been trading in the context of a strong upwards move on the Dax.

But when the market started to flatten out and go sideways, the trader started having problems.

The lesson is simple: if you can just sit still and wait for those instances when the market is actually breaking into a trending motion, all your entry techniques will have a higher probability of working.

Over to You

I know you may be excited to take this trend filter and apply it to your own trading immediately. However, I want you to do some homework first.

Pick your favourite instrument. It might be GBPUSD, it might be Gold, it might be Amazon.

Overlay the trend filter rules on your instrument of choice going back to the start of 2020. Study the filter day by day, week by week. Highlight the areas where Macro + Momentum + Trading layers were all in agreement.

Then step back and see where you would have been trading.

Compare that to where you traded yourself.

Take notes on:

- Trade frequency
- Trade profitability

And ask yourself how useful the filter might have been in reducing the number of unforced errors, conserving your trading capital, and allowing you to trade only when the probability of having a decent run was enhanced.

I'm here to Help

I would gladly look at your homework if you're interested in a second opinion. Just send your homework to hello@buildingatrader.com and I'll get back to you within 24/48 hours.

And as usual, if you have any questions at all just get in touch.

The only dumb question is the one you keep to yourself.

I wish you all the best in your trading career,

Justin

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