Questions for the first lecture of the Diploma course and the exam with some model answers...

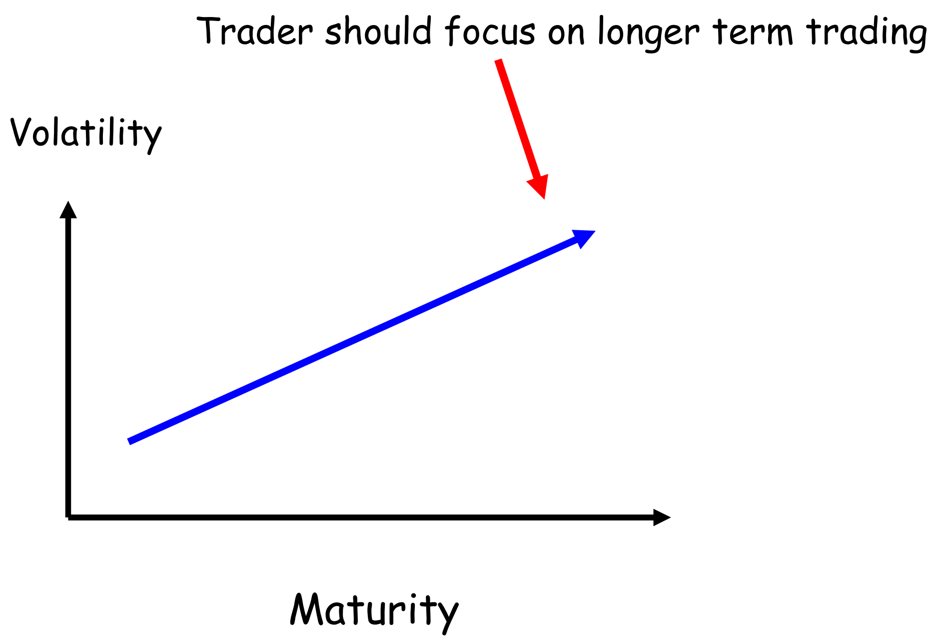
Following on from the presentation I have included a number of short questions and answers rather than one long essay question.

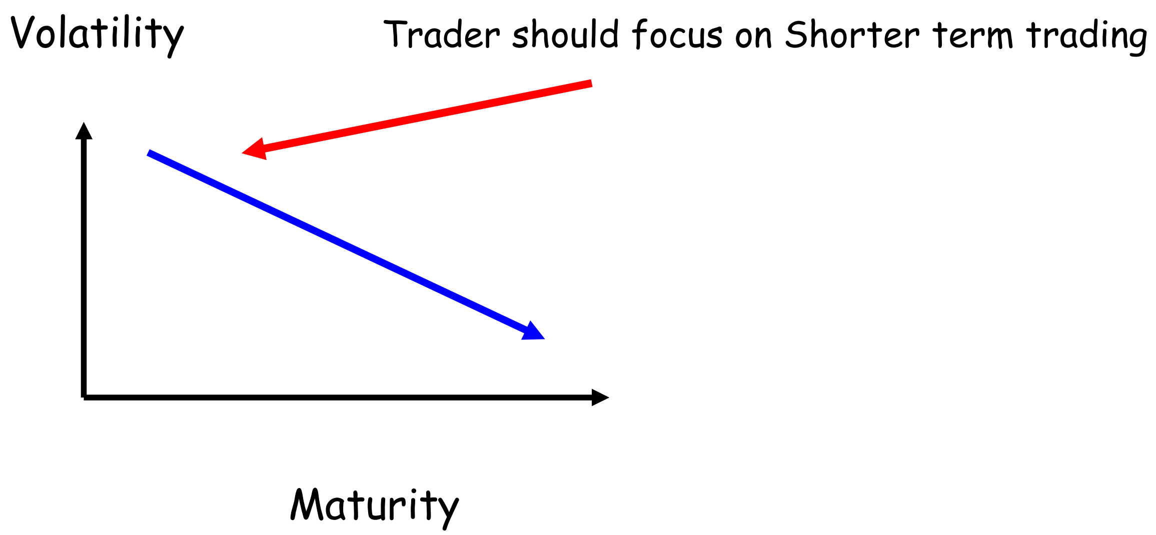
1. Explain how the shape of the term structure of volatility in a market determines the preferred style of trading?

<u>Model Answer:</u>

Where the volatility curve term structure is positively sloped then the trader should prefer longer term trading. When the curve is negatively sloped then the trader should prefer shorter term trading. The higher the volatility then the greater the expected returns. The trader should gravitate towards the higher period of volatility.

Illustrate with a chart…





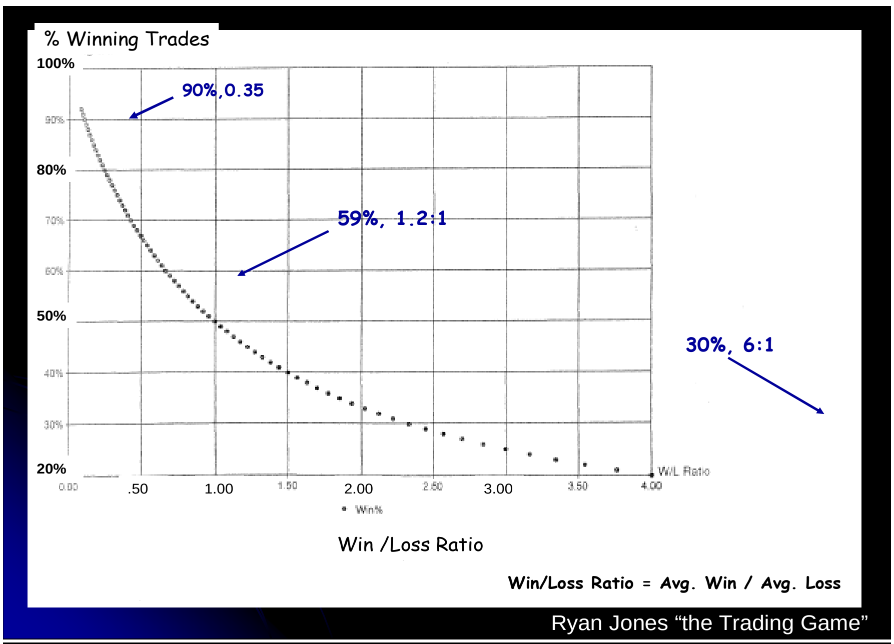
2. Identify and explain diagrammatically which combination of the following trading systems will lead to the most optimal equity return outcome.

Success rate	**Average Win/ Average Loss**
85%	**.40**
55%	**1.5**
25%	**6**

<u>Model Answer</u>

The trader should use the two systems at the extremes of the chart. The systems at the extremes offer a diversification edge as the combination offers stability of equity returns over both the short and long term. The "high success rate, low avg win:avg loss ratio" system offers lots of small profits with an occasional large loss and the " low success rate, high avg win:avg loss ratio" system offers the opposite. The combined outcome compliments each other and leads to an optimal solution

The middle of the road system – 59% 1.2 to 1 avg win/avg loss – should not be used UNLESS the stability of the results is compelling. The risk is that the volatility of the returns with such a low avg win to avg loss ratio and success ratio could lead to a heightened chance of risk of ruin in the short term.



3. Outline the main differences between Martingale and Anti-Martingale money management techniques?

Model answer

Martingale

In a martingale betting style, traders will increase their bets after each loss in hopes that an eventual win will recover all previous losses.

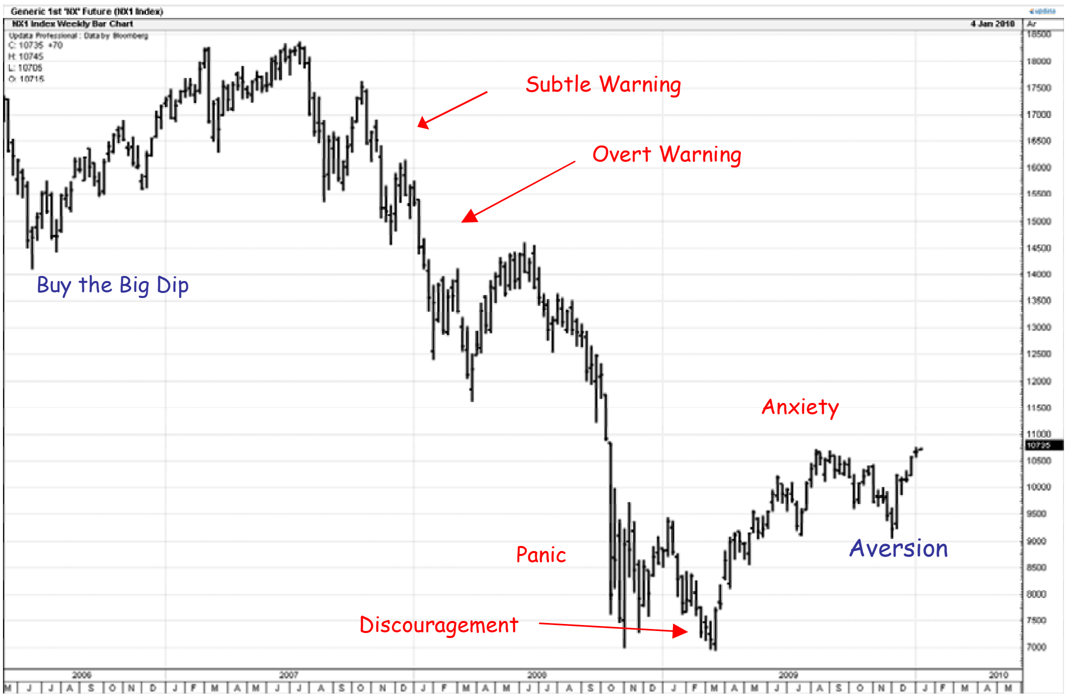
Anti-Martingale

The **anti-martingale** betting strategy is the opposite of the martingale approach. The anti-martingale approach instead increases bets after wins, while reducing them after a loss. The perception is that in this manner the trader will benefit from a winning streak or a "hot hand", while reducing losses while "cold" or otherwise having a losing streak. Many financial markets have some cyclical component to them, and the approach of a trader may only be appropriate for one portion of that cycle. Using an anti-martingale risk management scheme will increase profits during time periods when a trading approach is working well, while automatically decreasing exposure during portions of the cycle where trading is unprofitable. This method reduces the risk of ruin.

The anti martingale method is the ONLY method to use if the system or style of trading has a positive outcome.

4. Examine the following chart and illustrate some major points of the sentiment cycle.

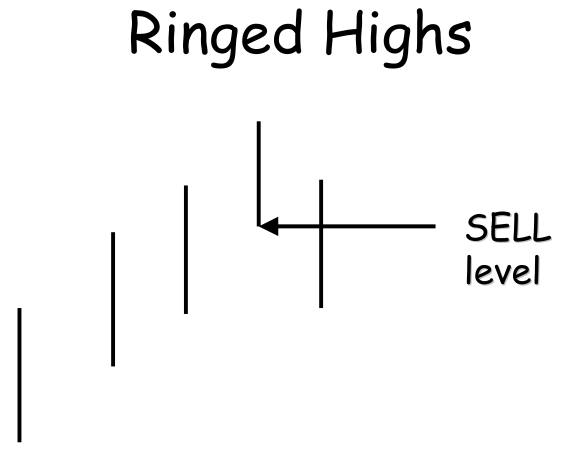
Model Answer



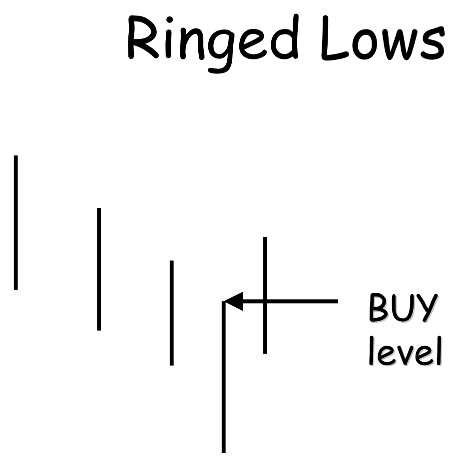
5. Explain the pattern of ringed highs and ringed lows?

Model Answer

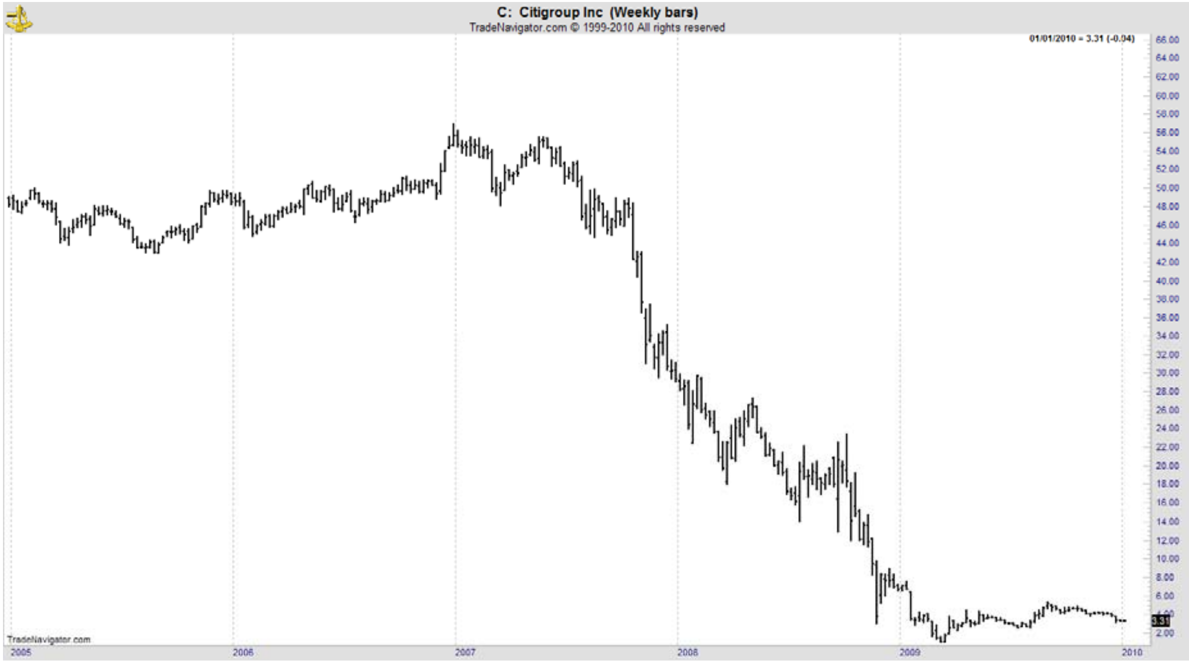
Ringed high - 3 bar pattern where the market forms a high. Applicable across all timeframes and is often signals the end of a move. Trade entry for the reversal is indicated. See illustration below…



Ringed Low - 3 bar pattern where the market forms a low. Applicable across all timeframes and is often signals the end of a move. Trade entry for the reversal trade is indicated. See illustration below…



6. Examine the following chart and illustrate some major points of the sentiment cycle.



Model Answer