

Three Faces of the Macro-Trend Analyzer

Richard "Doc" Ahrens

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The objective of using the MTA is not to improve our returns by taking on more risk. The objective is to improve returns by taking on less risk .
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Trader and author Bill Williams introduced an indicator called the Alligator in 1995 that used three averages: a 5-day, an 8-day, and a 13-day. 5, 8, and 13 are consecutive numbers in the Fibonacci sequence, which is often used to create non-harmonic averages. When I was searching for a reliable, long-term indicator it occurred to me that the Alligator might work on a longer time frame, so I changed the time scale from days to weeks and shifted the periods to three larger Fibonacci numbers, 13, 21, and 34. So the Macro-Trend Analyzer (MTA) is similar to a very large Alligator.

This paper details three different "tests" (i.e., ways to interpret what the MTA is telling us).

The original Alligator was bullish when the fast average was on top, the medium average was in the middle, and the slow average was on the bottom. And it was bearish when the fast average was on the bottom, the medium average was in the middle, and the slow average was on top. If the averages were not in bullish or bearish order, then it was a good idea to sit on the sidelines and wait until the market picked a direction. I used that same approach for what I called the "strict" test.

The Strict Test is somewhat slow to identify emerging trends. A second way to detect trend shifts is by using the slopes of the three averages. This method signals an advance when all three averages are rising and it signals a decline when all three averages are declining. It is referred to as the "3-Slope Test".

A third way of identifying emerging trends is when the closing price is above the slow average and middle average is rising, it is a signal that the trend has turned up. When the closing price is below the slow average and the middle average is falling, it is a signal that the trend has turned down. This method is simpler and more responsive than the other two tests. It is called the "Simple Test".

In order to compare the three methods, a program was developed to see how the Strict Test, the 3-slope Test, and the Simple Test would have performed over the last 20 years. In the last two decades we have had two serious bear market declines and a couple of long-term advances so these two decades provide us with a variety of market types and conditions.

The sections of this paper that showed the historical charts and performance statistics have been removed because they were based on Version 1 which used weekly data. Those results became obsolete with the introduction of Version 2 of the MTA which uses daily market data. When I have time I will rewrite the test program and generate updated charts and tables.

CAVEATS

The results shown are hypothetical. Whether they will continue in the future depends on the operation of the financial markets continuing in essentially the same way as they have in the past. While this is likely in principle, one should keep in mind that the markets are always evolving.

The results shown depend on perfect execution: no missed signals, no data delays, no kibitzing, no hesitation. Further, the results do not include the costs of commissions or slippage.

The primary value of the results shown here is to demonstrate the relative performance of the three MTA tests. These results should not be used to assume future returns.

Finally, these charts only show one security, SPY. Results with other securities will undoubtedly vary, and they may vary dramatically. I will be running the three MTA Tests against other securities in the future. I surmise the best results will come from heavily-traded ETFs like QQQ, IWM, VTI, and XLF, or relatively sedate ETF's like USMV and TLT. However, this is just speculation and no testing has been done yet.

Conclusions

Investing with the Simple Test offers to increase your return 5.5 times more than buying and holding SPY. While the thought is tantalizing, it is not practical for most investors. In order to implement trading with the Simple Test, you would have to check the indicator every market day without fail. With a average holding period of 35 days, being one day late to enter or exit could might turn a winning trade into a losing trade. Since the results are compounded, losses (or even reduced returns) on 2 or 3 of the 86 total trades could seriously reduce your final outcome.

Considering these factors, I don't believe that trading with the Simple Test is actually practical for any one person, regardless of their dedication to following the system. In order to implement trading with the Simple test, it would require a team of three traders. With a team of three, two could always be watching the market and communicating with each other. That would leave time for one of the three to miss a day for personal reasons, recover from an illness, or go on a vacation.

The 3-Slope Test has an average holding period of 207 days, which is much more forgiving. If you are a day or even two days late taking action, it's not a calamity. If you occasionally miss a day, it's probably not going to hurt you too much. Also, when displayed with the status of all three averages, the 3-Slope Test gives you warning when the market may be starting to turn. You know when you need pay more careful attention to the market and when a quick glance at the chart is enough. As such, I think the 3-Slope Test is much more practical for the individual investor.