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Methodology

[TradingEdge.Pro's](#) methodology describes a multi-step process for building and validating trading strategies, structured into two parts: strategy development and testing, and practical use. In the testing phase, a strategy is defined as a set of objective rules, validated through initial tests, optimised, and assessed for stability (robustness), and then evaluated using Walk-Forward Analysis. The detailed testing assumptions (including the instrument universe, in-sample/out-of-sample periods, data sources, transaction costs, and execution rules) are described in the "[Testing Specification](#)" document. The full methodology and metric definitions are available on the TradingEdge.Pro "[Methodology](#)" page.



Crash v.2

Investment Strategy Testing Summary

Crash Strategy is a **trend reversal investment technique** that uses the **RSI** (Relative Strength Index) indicator. Strength Index) and **Average True Range (ATR)** to identify market situations where **prices are rising very strongly in a short period of time, causing a herd rush among many market participants**. Despite the prevailing bullish trend in the market, this strategy aims to **identify moments where the price is driven by irrational investor enthusiasm**, which often leads to rapid price declines.

Although the strategy is based on **rational assumptions** and tries to use **the sheep-mover effect**, its **effectiveness in real transactions remains questionable**. It has not even passed preliminary tests, which means that it is not recommended for use in real trading.

Our goal is to have a strategy that remains **profitable and effective over a wide range of parameters**, because the market is a changing organism and the optimal parameters can change over different periods. **I cannot emphasize enough that for a strategy to work in real conditions, it must also work on suboptimal parameters and in suboptimal conditions.** In a word - **it must be stable** to changing market conditions.

I don't know who said these words, but they perfectly reflect the problem of many optimizations:

"I've never seen a strategy that didn't work in backtests."

We don't know the future, we don't know future market conditions, but if we know that our strategy **has historically generated acceptable results** in various market conditions and across various parameter ranges, then we are **one step ahead of other** market participants.



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Step 1: Formulate an investment strategy

Crash Strategy is a **short -selling strategy** invented by Larry Connors that aims **to take advantage of extreme states of greed in the market**. It involves identifying instruments that are **overbought and are likely to reverse their uptrend soon**. Despite the prevailing uptrend in the market, this strategy aims to **identify the moment when the price is driven by irrational investor enthusiasm**, which often leads to rapid price declines.

For the purposes of this test, **short positions on stock indices, bonds, gold and the US dollar index were used**, which allows us to assess the strategy's effectiveness across a broad spectrum of asset classes.

Compared to **the assumptions presented by Larry Connors** and tested in **Crash v.1**, in this version **we have slightly modified the basic rules of the strategy**:

- **Historical volatility** – is calculated based on **the Average True Range (ATR)**.
- **RSI indicator** – we use the classic **RSI indicator** (Relative Strength Index).
- **Entering a short position** – we place an order at **the opening price of the next day**, when the conditions for opening a position are met.
- **Exiting a position** – we close the position when the closing RSI falls below a specified level.
- **Pyramiding a position** – adding a second position if the market continues to rise after opening the first long position.

The strategy is simple and is based on specific, defined rules. However, it requires **a lot of discipline and mental toughness**, because it involves selling instruments that are in a strong upward trend and often enjoy great interest from the media and individual investors.

Characteristics of the strategy and its strengths and weaknesses:

- **Leveraging Market Psychology** – the strategy relies on investor behaviors such as greed and fear, which can create a market advantage.
- **Clearly Defined Rules** – Specific entry and exit criteria make it easier to implement and automate strategies.
- **High Profit Potential** – short positions in extremely overbought instruments can yield significant profits in a short period of time.
- **High Risk** – Short selling a stock that is rising parabolic carries the risk of potentially unlimited losses if the price continues to rise.
- **Psychological Difficulties** – trading against a strong upward trend and dominant market sentiment requires a lot of mental resilience.
- **Volatility and Liquidity** – high volatility can lead to price slippage and difficulties in executing orders at expected prices.
- **No Unlimited Loss Protection** – potential losses are theoretically unlimited if the price of the instrument continues to rise.

Crash Strategy is a tool for traders **wanting to take advantage of irrational market behavior** and extreme states of investor greed. Although it is **simple in concept, it requires a lot of discipline, experience and**



effective risk management. Due to the high risk and potentially unlimited losses, **this strategy is recommended mainly for advanced investors** who are aware of its specifics and ready for the psychological challenges associated with trading against the dominant trend.



Step 2: Define investment principles

Below is the **pseudocode** for the **Crash strategy** on daily charts:

1. **Calculation of Indicators and Criteria:**
 - a. **Historical Volatility:** 10-day volatility (as measured by ATR) must be at least 130% of 50-day volatility (as measured by ATR).
 - b. **RSI Indicator:** 3-day closing RSI must be 70 or above, indicating an overbought market.
2. **Generating Short Entry Signals:**
 - a. **First Short Position:**
 - i. A position is opened at the opening of the next day on which the above conditions are met.
 - b. **Adding a Second Unit:**
 - i. If, during an open position, the closing price rises above the opening level of the first unit, the position opening conditions from step 1 are valid, an additional unit is opened, which increases the involvement in the position.
 - ii. This is intended to take advantage of a further overbought market.
3. **Generating Output Signals:**
 - a. The position is closed when the closing RSI indicator falls below 30.
 - b. The position is closed at the opening price of the next day.
4. **Loss Management:** The strategy does not specify a specific Stop Loss level.
 - a. **Daily Position Monitoring:** If a position is open, monitor the RSI indicator daily to see if the exit condition is met. If the exit condition is met, close the position the next day at the open.
5. **Additional Notes:**
 - a. **No Long Positions:** The strategy focuses only on short positions in an uptrend.
 - b. **Financial Instruments:** For the purposes of this test, **short positions on stock indices, bonds, gold and the dollar index were used.**

The above rules have been described in a way that allows them to be directly converted into a script in the chosen testing platform, which ensures the accuracy of the historical simulation and the reliability of the test results.

Tests are performed assuming that **the risk of one position is 1.0% of the total capital, with a hypothetical stop loss order located 2 x ATR (40 days) away from the position opening point.**



Step 3: Conduct a preliminary test of the investment strategy

Below are some purchase and sale transactions that allow you to verify the following aspects:

- **Correctness of generated signals;**
- **Direction of opening position;**
- **Moment of opening a position;**
- **Position opening price;**
- **Moment of closing the position;**
- **Closing price of the position;**
- **Compliance of the transaction with the theoretical assumptions of the investment strategy.**

At this stage **it does not matter** whether the transactions are **profitable**, what **instrument was used** or whether they took place **recently** or **in the distant past**. The key is **to check whether the transactions are generated correctly** and in accordance with the assumptions described in the previous step.

The first transaction is on a **Gilt bond futures contract**. In mid-March 2013, **bond prices rose significantly**, meeting the conditions for opening a position (first candle in the rectangle on the left; **RSI > 70; ATR (10)/ATR (50) > 130%**). The next day (second candle in the rectangle on the left), **a short position was opened at the opening price**. For the next three days, prices rose slightly, after which they recorded three more downward sessions. This resulted in **the RSI indicator dropping below 30** (first candle in the rectangle on the right). This is therefore **a signal to close the position**, so we close it the next day at the opening (second candle in the rectangle on the right). **The system worked correctly.**



According to **the strategy's assumptions**, a position is **pyramided** when **the conditions for opening a position remain met** and **the market closes above the opening level of the first unit**.

An experienced observer will have noticed that **such a situation occurred above and is highlighted in the graphic below**.



The first candle in **the rectangle on the left** represents a candle whose close falls above the open of the first unit and the conditions for opening a position – **RSI > 70** and **ATR (10)/ATR (50) > 130%** – remain met.

Therefore, **the next day** (second candle in the rectangle on the left) a **short position was opened at the opening price**. For the next three days, the quotes **continued to rise slightly**, followed by **three more falling sessions**.

This resulted in **the RSI indicator falling below 30** (the first candle in the rectangle on the right), which is a **signal to close the position**. According to the strategy rules, **the position was closed the next day at the opening** (the second candle in the rectangle on the right). **The system worked correctly**.



Once we are sure that the transactions are generated correctly, we can proceed to the first test of the strategy on the full **in-sample data set**. These tests are performed on **the basic parameters**, which – according to my assessment – should correspond to the assumed goals of the strategy.

First of all, **we reject strategies that linearly lose capital**. If a strategy exhibits such a pattern, it is a clear signal that any parameter optimization does not make sense.

Our basic expectation is that the strategy generates **positive results**, even if they are at a low level.

Tested base parameters:

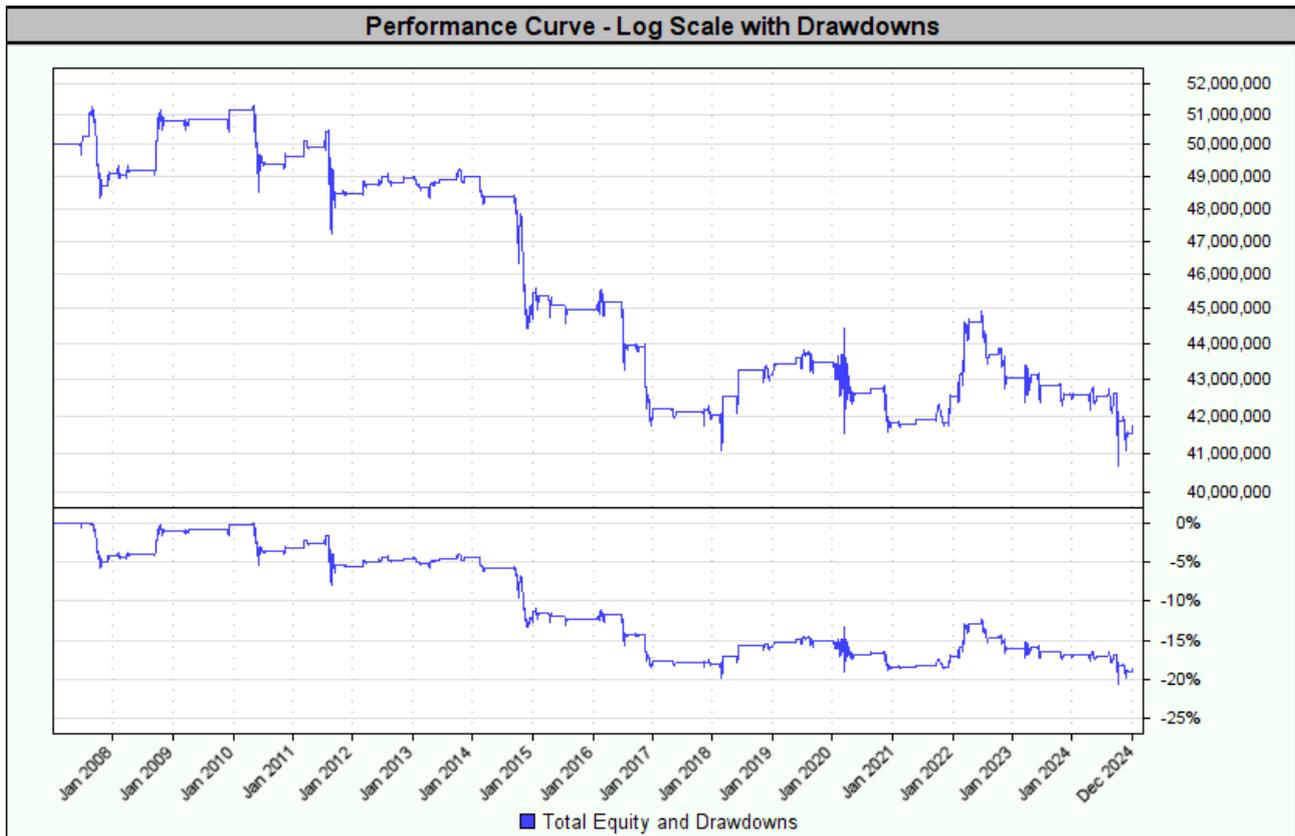
- **Short Term Volatility Period (ATR):** 10 days;
- **Long Term Volatility Period (ATR):** 50 days;
- **Short Term Volatility to Long Term Volatility Ratio:** min. 130%;
- **RSI Lengths:** 3 days;
- **RSI Entry Threshold:** 70;
- **RSI Exit Threshold (take profit):** 30;
- **Stop loss:** none;
- **Position size:** corresponding to the risk of 1.0% of the total capital, with a hypothetical stop loss order placed 2 x ATR (40 days) away from the position opening position;
- **Method of opening a position:** at the opening price of the next day;



- **Size of 1 unit:** 50%;
- **Size 2 units:** 50%;
- **Position direction:** short positions (sell) only.

The test result is shown below.

Historical or simulated results do not guarantee that similar outcomes will be achieved in the future.



Indicators/Measures	Concluding a transaction at the opening price
CAGR%	-1.00%
MAR Ratio	-0.05
RAR%	-1.23%
R-Cubed	-0.06
Robust Sharpe Ratio	-0.45
Max Drawdown	20.6%
Wins	52.4%
Losses	47.6%
Average Win%	0.33%
Average Loss %	0.51%
Win/ Loss Ratio	0.65
Average Trade Duration (days)	18
Percent Profit Factor	0.71
SQN	-



Number of transactions	248
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In summary, the system works properly and generates signals as expected. However, **tests on basic parameters have yielded poor results.** Therefore, **further testing of the strategy is not justified**, because its use in real transactions is **highly questionable.**



Step 4: Optimization and assessment of investment strategy stability

1. **Stability across a wide range of optimized parameters**

The step was skipped due to failure of previous tests.

2. **Monte Carlo simulation**

The step was skipped due to failure of previous tests.

3. **Stability over a moving time window**

The step was skipped due to failure of previous tests.

4. **Stability long/short**

The step was skipped due to failure of previous tests.

5. **Stability in the portfolio of financial instruments**

The step was skipped due to failure of previous tests.

6. **Money Management (Position Sizing)**

The step was skipped due to failure of previous tests.

7. **Strategy Risk Management**

The step was skipped due to failure of previous tests.



Step 5: Walk Forward Analysis

The step was skipped due to failure of previous tests.



Step 6: Using the strategy in real time

The step was skipped due to failure of previous tests.