11-1-2007

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# Enhancing existing stockmarket trading strategies using Artificial Neural Networks: A Case Study

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**Abstract.**

   *Developing financially viable stockmarket trading systems is a difficult, yet reasonably well understood process. Once an initial trading system has been built, the desire usually turns to finding ways to improve the system. Typically, this is done by adding and subtracting if-then style rules, which act as filters to the initial buy/sell signal. Each time a new set of rules are added, the system is retested, and, dependant on the effect of the added rules, they may be included into the system. Naturally, this style of data snooping leads to a curve-fitting approach, and the resultant system may not continue to perform well out-of-sample. The authors promote a different approach, using artificial neural networks, and following their previously published methodology, they demonstrate their approach using an existing medium-term trading strategy as an example.*

## Introduction

There is a long established history of applying Artificial Neural Networks (ANNs) to financial data sets, with the hope of discovering financially viable trading rules. Despite the large amount of published work in this area, it is still difficult to answer the simple question, "Can ANNs be used to develop financially viable stockmarket trading systems?" Vanstone and Finnie [1] have provided an empirical methodology which demonstrates the steps required to create ANNs which allow us to answer this question.

   In this paper, the authors demonstrate that the same methodology can be used to enhance already existing trading systems. This paper briefly reviews an existing medium-term long-only trading system, and then works through the authors methodology to create an ANN which will enhance this trading strategy.

The initial trading strategy and the ANN enhanced trading strategy are comprehensively benchmarked both in-sample and out-of-sample, and the superiority of the resulting ANN enhanced system is demonstrated. To prevent excessive duplication of effort, only the key points of the methodology outlined are repeated in this paper. The overall methodology is described in detail in 'An empirical methodology for developing stockmarket trading systems using artificial neural networks' by Vanstone and Finnie [1], and this methodology is referred to in this paper as 'the empirical methodology'.

## Review of Literature

There are two primary styles of stockmarket trader, namely Systems traders, and Discretionary traders. Systems traders use clearly defined rules to enter and exit positions, and to determine the amount of capital risked. The strategies created by systems traders can be rigorously tested, and clearly understood. The alternative, discretionary trading, is usually the eventual outcome of an individual's own experiences in trading. The rules used by discretionary traders are often difficult to describe precisely, and there is usually a large degree of intuition used. However, it is commonly accepted that discretionary traders produce better financial results [2].

For the purposes of this paper, it is appropriate to have a simple, clearly defined mathematical signal which allows us to enter or exit positions. This allows us to accurately benchmark and analyze systems.

This paper uses the GMMA as the signal generator. The GMMA is the Guppy Multiple Moving Average, as created and described by Daryl Guppy [3], a leading Australian trader. Readers should note that Guppy does not advocate the use of the GMMA indicator in isolation [4], rather it is appropriate as a guide. The GMMA is useful for this paper, as it is able to be implemented mechanically. In essence, any well defined signal generator could be used as the starting point for this paper.

The GMMA is defined as:

$$GMMA = \left( \begin{pmatrix} ema(3) + ema(5) \\ + ema(8) + ema(10) \\ + ema(12) + ema(15) \end{pmatrix} - \begin{pmatrix} ema(30) + ema(35) \\ + ema(40) + ema(45) \\ + ema(50) + ema(60) \end{pmatrix} \right) \tag{1}$$

Creation of the ANNs to enhance this strategy involves the selection of ANN inputs, outputs, and various architecture choices. The ANN inputs and outputs are selected as described in the authors PhD thesis [5], and, for the sake of brevity, are only briefly dealt with in this paper. Similarly, the choices of output and architecture are described in the empirical methodology paper. Again, these are only briefly dealt with here.

For each of the strategies created, an extensive in-sample and out-of-sample benchmarking process is used, which is described in the authors methodology paper.


## Methodology

This paper uses data for the ASX200 constituents of the Australian stockmarket. Data for this study was sourced from Norgate Investor Services [6]. For the in-sample data (start of trading 1994 to end of trading 2003), delisted stocks were included. For the out-of-sample data (start of trading 2004 to end of trading 2006) delisted stocks were not included. The ASX200 constituents were chosen primarily for the following reasons:

1. The ASX200 represents the major component of the Australian market, and has a high liquidity – a major issue with previous published work is that it may tend to focus on micro-cap stocks, many of which do not have enough trading volume to allow positions to be taken, and many of which have excessive bid-ask spreads,

2. This data is representative of the data which a trader will use to develop his/her own systems, and is typical of the kind of data the system will be used in for out-of-sample trading


Software tools used in this paper include Wealth-Lab Developer, and Neuro-Lab, both products of Wealth-Lab Inc (now Fidelity) [7]. For the neural network part of this study, the data is divided into 2 portions: data from 1994 up to and including 2003 (in-sample) is used to predict known results for the out-of-sample period (from 2004 up to the end of 2006). In this study, only ordinary shares are considered.

The development of an ANN to enhance the selected strategy is based on simple observation of the GMMA signals. Figure 1 show sample buy/sell signals using the points where the GMMA signal crosses above/below zero. One of the major problems of using the GMMA in isolation is the fact that it frequently whipsaws around the zero line, generating spurious buy/sell signals in quick succession.

One possible way of dealing with this problem is to introduce a threshold which the signal must exceed, rather than acquiring positions as the zero line is crossed. The method used in this paper, however, is to forecast which of the signals is most likely to result in a sustained price move. This approach has a major advantage over the threshold approach; namely, in a profitable position, the trader has entered earlier, and therefore, has an expectation of greater profit. By waiting for the threshold to be exceeded, the trader is late in entering the position, with subsequent decrease in profitability.

However, for the approach to work, the trader must have a good forecast of whether a position will be profitable or not. This is the ideal job for a neural network.

In figure 1 below, there are a cluster of trades taken between February 2007 and March 2007, each open for a very short period of time as the GMMA whipsaws around the zero line. Eventually, the security breaks out into a sustained up trend. What is required is an ANN which can provide a good quality short-term forecast of the return potential each time the zero line is crossed, to allow the trader to discard the signals which are more likely to become whipsaws, thus concentrating capital on those which are more likely to deliver quality returns.



**Figure 1 GMMA signals**

The neural networks built in this study were designed to produce an output signal, whose strength was proportional to expected returns in the 20 day timeframe. In essence, the stronger the signal from the neural network, the greater the expectation of return. Signal strength was normalized between 0 and 100.

The ANNs contained 13 data inputs. These are the technical variables deemed as significant from the review of both academic and practitioner publications, and details of their function profiles are provided in the author's PhD thesis. The formulas used to compute these variables are standard within technical analysis, except for LPR and HPR, which are also defined in the authors PhD thesis. The actual variables used as inputs were:

1. EMA(close,3) / EMA(close,30)
2. RSI(3)
3. EMA(close,15) / EMA(close,60)
4. HPR
5. LPR
6. SMA(volume,3) / SMA(volume,15)
7. ATR(3) / ATR(15)
8. ADX(3)
9. ADX(15)
10. STOCHK(3)
11. STOCHK(15)
12. RSI(15)
13. MACD

The basic statistical characteristics of the in-sample data are provided below:

| Variable | Min | Max | Mean | StdDev |
|----------|-----|-----|------|--------|
| 1 | 0.85 | 2.04 | 1.04 | 0.06 |
| 2 | 0.84 | 1.91 | 1.04 | 0.06 |
| 3 | 0.07 | 1.00 | 0.89 | 0.13 |
| 4 | 0.02 | 1.00 | 0.72 | 0.17 |
| 5 | 0.01 | 1.67 | 0.99 | 0.32 |
| 6 | 0.00 | 3.71 | 1.00 | 0.30 |
| 7 | 3.59 | 100.00 | 53.44 | 19.54 |
| 8 | 6.05 | 99.71 | 25.13 | 10.77 |
| 9 | 0.00 | 100.00 | 54.56 | 36.62 |
| 10 | 0.00 | 100.00 | 65.02 | 27.73 |
| 11 | 0.43 | 100.00 | 58.08 | 24.99 |
| 12 | 32.70 | 98.03 | 58.64 | 8.46 |
| 13 | -0.11 | 7.14 | 0.06 | 0.15 |

**Table 1.** Technical Variables: Statistical Properties

For completeness, the characteristics of the output target to be predicted, the 20 day return variable, are shown below. This target is the maximum percentage change in price over the next twenty days, computed for every element i in the input series as:

$$\left( \frac{\left( highest(close_{i+20...i+1}) - close_i \right)}{close_i} \right) \times 100 \qquad (2)$$

Effectively, this target allows the neural network to focus on the relationship between the input technical variables, and the expected forward price change.

| Variable | Min | Max | Mean | StdDev |
|----------|-----|-----|------|--------|
| Target | 0.00 | 100.00 | 10.48 | 24.84 |

**Table 2.** Target Variable: Statistical Properties

The calculation of the return variable allows the ANN to focus on the highest amount of change that occurs in the next 20 days, which may or may not be the 20-day forward return. For example, the price may spike up after 5 days, and then decrease again, in this case, the 5-day forward price would be used. Therefore, perhaps a better description of the output variable is that it is measuring the maximum amount of price change that occurs within the next 20 days.

As explained in the empirical methodology, a number of hidden node architectures need to be created, and each one benchmarked against the in-sample data.

The method used to determine the hidden number of nodes is described in the empirical methodology. After the initial number of hidden nodes is determined, the first ANN is created and benchmarked. The number of hidden nodes is increased by one for each new architecture created then created, until in-sample testing reveals which architecture has the most suitable in-sample metrics. A number of metrics are available for this purpose, in this paper, the architectures are benchmarked using the absolute profit per bar method. This method assumes unlimited capital, takes every trade signalled, and measures how much average profit is added by each trade over its lifetime. This figure is then refined to the amount of profit added by open trades on a daily basis. The empirical methodology uses the filter selectivity metric for longer-term systems, and Tharp's expectancy [8] for shorter term systems. This paper also introduces the idea of using absolute profit per bar for medium term systems.

## Results

A total of 362 securities had trading data during the test period (the ASX200 including delisted stocks), from which 11,790 input rows were used for training. These were selected by sampling the available datasets, and selecting every 25th row as an input row.

**Table 3** reports the profit per bar and average days held (per open trade) for the buy-and-hold naïve approach (1st row), the initial GMMA method (2nd row), and each of the in-sample ANN architectures created (subsequent rows). These figures include transaction costs of $20 each way and 5% slippage, and orders are implemented as day+1 market orders. There are no stops implemented in in-sample testing, as the objective is not to produce a trading system (yet), but to measure the quality of the ANN produced. Later, when an architecture has been selected, stops can be determined using ATR or Sweeney's[9] MAE technique.

The most important parameter to be chosen for in-sample testing is the signal threshold, that is, what level of forecast strength is enough to encourage the trader to open a position. This is a figure which needs to be chosen with respect to the individuals own risk appetite, and trading requirements. A low threshold will generate many signals, whilst a higher threshold will generate fewer. Setting the threshold too high will mean that trades will be signalled only rarely, too low and the traders' capital will be quickly invested, removing the opportunity to take high forecast positions as and when they occur.

For this benchmarking, an in-sample threshold of 20 is used. This figure is chosen by visual inspection of the in-sample graph in Figure 2, which shows a breakdown of the output values of the first neural network architecture (scaled from 0 to 100) versus the average percentage returns for each network output value. The percentage returns are related to the number of days that the security is held, and these are shown as the lines on the graph. Put simply, this graph visualizes the returns expected from each output value of the network and shows how these returns per output value vary with respect to the holding period. At the forecast value of 20, then return expectation be-

gins to steepen, so this value is used.  Higher values such as 25 or 30 would also be valid.
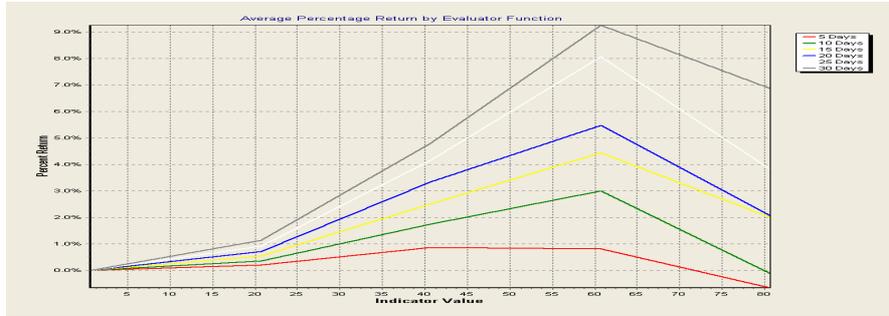


**Figure 2 In-sample ANN function profile**

| Strategy (In-Sample Data) | Avg. Profit / Day ($) | Avg. days held |
|---|---|---|
| Buy-and-hold naïve approach | 1.89 | 2,528.00 |
| GMMA alone | 1.46 | 34.26 |
| ANN – 6 hidden nodes + GMMA | 4.30 | 55.73 |
| ANN – 7 hidden nodes + GMMA | 5.07 | 61.22 |
| ANN – 8 hidden nodes + GMMA | 8.07 | 47.16 |
| ANN – 9 hidden nodes + GMMA | 4.38 | 52.36 |

**Table 3.** In Sample Characteristics

As described in the empirical methodology, it is necessary to choose which ANN is the 'best', and this ANN will be taken forward to out-of-sample testing.  It is for this reason that the trader must choose the in-sample benchmarking metrics with care.  If the ANN is properly trained, then it should continue to exhibit similar qualities out-of-sample which it already displays in-sample.

From the above table, it is clear that ANN – 8 hidden nodes should be selected.  It displays a number of desirable characteristics – it extracts the highest amount of profit per bar in the least amount of time.  Note that this will not necessarily make it the best ANN for a trading system.  Extracting good profits in a short time period is only a desirable trait if there are enough opportunities being presented to ensure the traders capital is working efficiently.

Therefore, it is also important to review the number of opportunities signalled over the 10-year in-sample period. This information is shown in **Table 4**.

| Strategy (In-Sample Data) | Number of trades signalled |
|---|---:|
| Buy-and-hold naïve approach | 362 |
| GMMA alone | 10,545 |
| ANN – 6 hidden nodes + GMMA | 3,252 |
| ANN – 7 hidden nodes + GMMA | 2,446 |
| ANN – 8 hidden nodes + GMMA | 1,646 |
| ANN – 9 hidden nodes + GMMA | 4,282 |

**Table 4.** Number of Trades signalled

Here the trader must decide whether the number of trades signalled meets the required trading frequency. In this case, there are likely to be enough trades to keep an end-of-day trader fully invested.

This testing so far covered data unseen by the ANN, and is a valid indication of how the ANN can be expected to perform in the future. In effect, the in-sample metrics provide a framework of the trading model this ANN should produce.

**Table 5** shows the effect of testing on the out-of-sample ASX200 data, which covers the period from the start of trading in 2004 to the end of trading in 2006. These figures include transaction costs and slippage, and orders are implemented as day+1 market orders.

This was a particularly strong bull period in the ASX200, hence the ANN figures are quite high. However, the strength of the bull market over the 2004 – 2006 period can also be seen in the buy-and-hold naïve approach.

| Strategy (Out-of-Sample Data) | Avg. Profit / Day ($) | Avg. days held |
|---|---:|---:|
| Buy-and-hold naïve approach | 13.66 | 758.00 |
| GMMA alone | 4.91 | 37.37 |
| ANN – 8 hidden nodes + GMMA | 21.40 | 50.99 |

**Table 5.** Out of Sample Performance

Although there appears a significant difference between the GMMA, and the ANN enhanced GMMA, it is important to quantify the differences statistically. The appropriate test to compare two distributions of this type is the ANOVA test (see supporting work in Vanstone [5]). The results for the ANOVA test are shown in **Table 6** below.

| ANOVA | GMMA | GMMA + 8 hidden nodes |
|---|---|---|
| Number of observations | 2,284 | 151 |
| Mean | 183.61 | 1091.24 |
| Std Dev | 1265.30 | 3588.84 |
| 95% Confidence Internal of the mean – lower bound | 131.69 | 514.46 |
| 95% Confidence Internal of the mean – upper bound | 235.53 | 1,668.31 |

**Table 6.** Anova Comparison

The figures above equate to an F-statistic of 50.81, (specifically, $F(1,2433) = 50.810$, $p=0.00$ ($p<0.05$)), which gives an extremely high level of significant difference between the two systems.

## Conclusions

The ANN out-of-sample performance is suitably close to the ANN in-sample performance, leading to the conclusion that the ANN is not curve fit, that is, it should continue to perform well into the future. The level of significance reported by the ANOVA test leads to the conclusion that the ANN filter is making a statistically significant improvement to the quality of the initial GMMA signals.

The trader now needs to make a decision as to whether this ANN should be implemented in real-life.

One of the main reasons for starting with an existing successful trading strategy is that it makes this decision much easier. If the trader is already using the signals from a system, and the ANN is used to filter these signals, then the trader is still only taking trades that would have been taken by the original system. The only difference in using the ANN enhanced system is that trades with low expected profitability should be skipped.

Often in trading, it is the psychological issues which undermine the traders success. By training ANNs to support existing systems, the trader can have additional confidence in the expected performance of the ANN.

Finally, Figure 3 shows the same security as Figure 1. The ANN has clearly met its purpose of reducing whipsaws considerably, which has resulted in the significant performance improvement shown in **Table 3** and **Table 5**.

Of course the result will not always be that all whipsaws are removed. Rather, only whipsaws which are predictable using the ANN inputs will be removed.



**Figure 3 GMMA signals filtered with ANN – 8 hidden nodes**

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