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# Forecasting Ability But No Profitability: An Empirical Evaluation of Genetic Algorithm-optimised Technical Trading Rules

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**Abstract.** This paper evaluates the performance of several popular technical trading rules applied to the Australian share market. The optimal trading rule parameter values over the in-sample period of 4/1/82 to 31/12/89 are found using a genetic algorithm. These optimal rules are then evaluated in terms of their forecasting ability and economic profitability during the out-of-sample period from 2/1/90 to the 31/12/97. The results indicate that the optimal rules outperform the benchmark given by a risk-adjusted buy and hold strategy. The rules display some evidence of forecasting ability and profitability over the entire test period. But an examination of the results for the sub-periods indicates that the excess returns decline over time and are negative during the last couple of years. Also, once an adjustment for non-synchronous trading bias is made, the rules display very little, if any, evidence of profitability.

## 1 Introduction

Forecasting the future direction of share market prices is an important, but difficult exercise. Both technical and fundamental analysis have been used for this purpose, with varying success. Initial studies of technical analysis by [2] and [16] were unable to find evidence of profitability and thus concluded that technical analysis is not useful. More recently, there has been a renewed interest in this topic; see [7,10,3].

Technical analysis uses only historical data, usually consisting of only past prices but sometimes also includes volume, to determine future movements in financial asset prices. This method of forecasting is commonly used by foreign exchange dealers, who are mostly interested in the short term movements of currencies; see the survey of the London foreign exchange market by [29]. However, technical analysis is also used to forecast share prices. A survey by [11] reveals that investment analysts consider technical analysis as an important tool for forecasting the returns to different classes of assets. This widespread use of technical analysis in financial markets is surprising to most academics, since this behavior is irrational given the implications of the efficient market and random walk hypotheses for investment and speculation.

Under an efficient market it is expected that prices follow a random walk and thus past prices cannot be used successfully to forecast future prices. Therefore, the most appropriate investment strategy is the buy and hold strategy which consists of holding the market portfolio. It is not expected that any other strategy can consistently beat or outperform the market.

Although criticized by economists, most notably [25], technical analysis has received an increasing amount of attention by academics. Numerous studies examining technical trading rules applied to various shares and share market indices, have uncovered evidence of predictive ability and profitability; see [28,8,6,19,27]. There are also studies which have found some evidence of predictive ability but no profitability once reasonable adjustments are made for risk and trading costs; see [12,20,7,10,3].

The majority of these studies have examined trading rules where both the rules and their parameter values were chosen arbitrarily. However this approach leaves these studies open to the criticisms of data-snooping and the possibility of a survivorship bias; see [23] and [9] respectively. By choosing trading rules based on an optimisation procedure utilising in-sample data and testing the performance of these rules out-of-sample, this bias can be avoided or at least reduced. This approach is taken by [26] and [3], by employing a genetic programming approach to discover optimal technical trading rules for the foreign exchange market and US share market respectively.

In this paper the forecasting ability and economic profitability of some popular technical trading rules applied to the Australian share market are investigated using a standard genetic algorithm optimisation procedure.<sup>1</sup> The approach adopted in this study differs from the genetic programming approach for two reasons. First, since the objective of this study is not to discover new trading rules but rather to examine popular, commonly used trading rules.<sup>2</sup> Second, there is a potential problem associated with the use of genetic programming, since this artificial intelligence technique was only recently developed by [21]. Therefore it is unrealistic to evaluate the performance of trading rules discovered by the genetic programming approach prior to the date of the development of this technique.

The next section of the paper describes the technical trading rules examined in this study. Section 3 develops the genetic algorithm methodology used in trading rule optimisation. Section 4 explains the performance measures that are used to evaluate trading rule forecasting ability and economic profitability. Section 5 considers an empirical investigation of the performance

<sup>1</sup> To the author's knowledge there is only one other study considering the performance of technical trading rules applied to the Australian share market. The performance of the filter rule applied to various individual Australian shares was examined by [4], who was unable to find any significant evidence of profitability.

<sup>2</sup> Focusing exclusively on the popular and commonly used rules, does introduce the possibility of a survivorship bias. But since it is difficult, if not impossible, to include the entire universe of all technical trading rules, there is always a danger of survivorship bias in any performance study.

of the genetic algorithm-optimised technical trading rules applied to the Australian share market. Finally, Section 6 provides some conclusions and directions for possible future research.

## 2 Technical Trading Rules

Trading rules are used by financial market traders to assist them in determining their investment or speculative decisions. These rules can be based on either technical or fundamental analysis. This study considers only rules based on technical indicators. A technical indicator is a mathematical formula that transforms historical data on price and/or volume into a single number. These indicators can be combined with price, volume or each other to form trading rules. Some of the more popular technical indicators used by traders include: channels, filters, momentum, moving averages and relative strength indices. Reference [1] provides an excellent description of the different technical indicators used in trading.

### 2.1 Determination of the investment position

Trading rules return either a buy or sell signal which together with a particular trading strategy determines the trading position that should be taken in a security or market. The trading strategy considered in this study is based on a simple market timing strategy, consisting of investing total funds in either the share market or a risk free security. If share market prices are expected to increase on the basis of a buy signal from a technical trading rule, then the risk free security is sold and shares are bought. However, if the rule returns a sell signal, it is expected that share market prices will fall in the near future. As a result, shares are sold and the proceeds from the sale invested in the risk free security.<sup>3</sup>

### 2.2 Different types of rules

Two general types of technical trading rules are considered - rules based on either moving averages or order statistics.

**Moving average rules** Moving averages are used to identify trends in prices. A moving average (*MA*) is simply an average of current and past prices over a specified period of time. An *MA* of length  $\theta$  is calculated as

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<sup>3</sup> This strategy excludes the possibility of short selling, which in general is difficult to conduct in the Australian share market due to certain legal restrictions. By using a stock index futures contract, the market portfolio can be sold short to establish a negative position in order to profit from a fall in prices. This is not considered here, but left for possible future work.

$$MA_t(\theta) = \frac{1}{\theta} \sum_{i=0}^{\theta-1} P_{t-i} \quad (1)$$

where

$$\forall \theta \in \{1, 2, 3, \dots\}.$$

By smoothing out the short-term fluctuations or noise in the price series, the *MA* is able to capture the underlying trend in the price series over a particular period of time. An *MA* can be used to formulate a simple trend-following rule also referred to as a momentum strategy.

A simple *MA* rule can be constructed by comparing price to its trend, as represented by the *MA*. If the price rises above the *MA*, then the security is bought and held until the price falls below the *MA* at which time the security is sold. This simple rule can be modified to create the filtered *MA* rule and the double *MA* rule. A filtered *MA* rule is similar to the simple *MA* rule, except it includes a filter which accounts for the percentage increase or decrease of the price relative to its *MA*. The purpose of this filter is an attempt to reduce the number of false buy and sell signals, which are issued by a simple *MA* rule when price movement is nondirectional. This rule operates by returning a buy signal if the price rises by  $X$  percent above the *MA* and then returning a sell signal only when the price falls by  $X$  percent below the *MA* at which time the security is sold. In contrast to the previous two rules, a double *MA* rule compares two *MAs* of different lengths. With this rule if the shorter length *MA* rises above the longer length *MA* from below then the security is bought and held until the shorter *MA* falls below the longer *MA* at which time the security is sold.

A more general *MA* rule can be specified by considering two moving averages and a filter.<sup>4</sup> This Generalised *MA* (*GMA*) rule can be represented by the binary indicator function

$$S(\Theta)_t = MA_t(\theta_1) - \left(1 + (1 - 2S_{t-1}) \frac{\theta_3}{10^4}\right) MA_t(\theta_2) \begin{cases} > 0, 1 \\ \leq 0, 0 \end{cases} \quad (2)$$

where

$$\begin{aligned} \forall \theta_1, \theta_2 \in \{1, 2, 3, 4, \dots\}, \theta_1 < \theta_2 \\ \forall \theta_3 \in \{0, 1, 2, \dots\} \end{aligned}$$

and the *MA* indicator is defined by Equation 1. This function returns either a one or zero, corresponding to a buy or sell signal respectively, which indicates

<sup>4</sup> Obviously, this general rule could be extended to include more *MAs*, filters and other technical indicators.

the trading position that should be taken at time  $t$ . The lengths of the short and long  $MAs$  are given by parameters  $\theta_1$  and  $\theta_2$ , which represent the number of days used to calculate the  $MAs$ . The parameter  $\theta_3$  represents the filter parameter in terms of basis points; where one hundred basis points equivalent to one percent.

The three different  $MA$  rules discussed above are nested within the GMA rule. These rules can be derived individually by imposing certain restrictions on Equation 2:

1. *Simple MA*:  $\theta_1 = 1, \theta_2 > 1$  and  $\theta_3 = 0$

$$S(\Theta)_t = P_t - MA_t(\theta_2) \begin{cases} > 0, 1 \\ \leq 0, 0 \end{cases}$$

2. *Filtered MA*:  $\theta_1 = 1, \theta_2 > 1$  and  $\theta_3 > 0$

$$S(\Theta)_t = P_t - \left( 1 + (1 - 2S_{t-1}) \frac{\theta_3}{10^4} \right) MA_t(\theta_2) \begin{cases} > 0, 1 \\ \leq 0, 0 \end{cases}$$

3. *Double MA*:  $1 < \theta_1 < \theta_2$  and  $\theta_3 = 0$

$$S(\Theta)_t = MA_t(\theta_1) - MA_t(\theta_2) \begin{cases} > 0, 1 \\ \leq 0, 0. \end{cases}$$

**Rules based on order statistics** Technical trading rules can also be based on order statistics, such as the maximum and minimum prices over a specified period of time. The filter and channel rules are two examples which use local maximum and minimum prices. Reference [8] refer to this rule as the trading range break-out rule. The maximum price  $P_t^{\max}(\phi)$  and the minimum price  $P_t^{\min}(\phi)$  at time  $t$  given a historical price series consisting of  $\phi$  observations are

$$P_t^{\max}(\phi) = \text{Max}[P_{t-1}, \dots, P_{t-\phi}] \tag{3}$$

$$P_t^{\min}(\phi) = \text{Min}[P_{t-1}, \dots, P_{t-\phi}] \tag{4}$$

where

$$\forall \phi \in \{1, 2, 3, \dots\}.$$

The channel rule is founded on the idea of support and resistance levels which are related to the market forces of demand and supply. The support level is achieved at a price where buying power dominates selling pressure, effectively placing a floor on the level of prices. The resistance level, which is the opposite of support, is defined as the price where selling pressure exceeds buying power forcing down the price and effectively creating an upper level or ceiling in prices. With the channel rule the resistance (or support level) is

defined using the maximum (or minimum) price over the most recent historical period of prices consisting of  $\phi$  observations as defined by Equations 3 and 4 respectively. This rule returns a buy (or sell) signal when price breaks through its current resistance (or support) level from below (or above) to above (or below) this level.

The filter rule is based on the idea that when price rises above (or drops below) a certain level, it will continue to rise (or fall) for some period of time. The filter rule operates by returning a buy signal when price increases by  $X$  percent above a previous low and a sell signal once the price falls by  $X$  percent below a previous high. The original filter rule of Alexander (1964) defines the previous low (or high) implicitly using the minimum (or maximum) price from a historical series commencing on the date of the most recent transaction.

The filter rule can be generalised by explicitly choosing the amount of data to use in order to determine the previous low or high. This can be done by introducing a parameter  $\phi$  which specifies a fixed length for the historical price series used to calculate the maximum or minimum price, similar to the channel rule. Furthermore the original channel rule as outlined above, can also be generalised by introducing a filter parameter. Similar to the filtered *MA* rule, this rule will only return a buy (or sell) signal if the price exceeds the maximum (or minimum) price by  $X$  percent.

Since both the channel and filter rules use order statistics, these two rules can be nested within a single decision rule. This Generalised Order Statistic (GOS) rule is represented by the indicator function

$$S(\Phi)_t = P_t - \left(1 + (1 - 2S_{t-1}) \frac{\phi_2}{10^{-4}}\right) (P_t^{\max}(\phi_1))^a (P_t^{\min}(\phi_1))^b \begin{cases} > 0, 1 \\ \leq 0, 0 \end{cases} \quad (5)$$

where

$$\begin{aligned} a &= \phi_3 S_{t-1} + (1 - \phi_3)(1 - S_{t-1}) \\ b &= \phi_3(1 - S_{t-1}) + (1 - \phi_3)S_{t-1} \end{aligned}$$

$$\forall \phi_1, \phi_2 \in \{1, 2, 3, \dots\}.$$

The parameter  $\phi_1$  represents the length of the historical price series used in determining either the maximum or minimum price,  $\phi_2$  is the filter parameter given in basis points and  $\phi_3$  is a binary parameter defined as

$$\phi_3 = \begin{cases} 1, & \text{Filter rule} \\ 0, & \text{Channel rule} \end{cases} \quad (6)$$

where the value one and zero represent the filter and channel rules respectively. The rule can be generalised further by allowing the parameter  $\phi_1$  to be derived either implicitly (as is the case with the channel rule) or explicitly (as is the case with the filter rule).

The filter and channel rules outlined above, can be derived from the GOS rule by imposing certain restrictions on Equation 5:

1. *Filter rule*;  $\phi_1 =$  number of days since last transaction,  $\phi_2 > 0$  and  $\phi_3 = 1$

$$S_t = P_t - \left(1 + (1 - 2S_{t-1}) \frac{\phi_2}{10^{-4}}\right) (P_t^{\max}(\phi_1))^{S_{t-1}} (P_t^{\min}(\phi_1))^{(1-S_{t-1})} \begin{cases} > 0, 1 \\ \leq 0, 0 \end{cases}$$

2. *Channel rule*;  $\phi_1 > 0$ ,  $\phi_2 = 0$  and  $\phi_3 = 0$

$$S_t = P_t - (P_t^{\max}(\phi_1))^{(1-S_{t-1})} (P_t^{\min}(\phi_1))^{S_{t-1}} \begin{cases} > 0, 1 \\ \leq 0, 0 \end{cases}$$

### 3 Genetic Algorithm Methodology

#### 3.1 Optimisation

The choice of technical trading rule parameter values has a profound impact on the profitability of these rules. In order to maximise trading rule profitability, parameter values must be chosen optimally. In this optimisation problem, it is important to be aware of two issues. First, there are a large number of possible parameter values. Second, the profit surface is characterised by multiple optima; see [26] and [3]. Genetic algorithms are a very efficient and effective approach to this type of problem.

Efficiency refers to the computational speed of the optimisation technique. Through a recombination procedure known as crossover and by maintaining a population of candidate solutions, the genetic algorithm is able to search quickly through the profitable areas of the solution space. Effectiveness refers to the global optimisation properties of the algorithm. Unlike other search or optimisation techniques based on gradient measures, a genetic algorithm avoids the possibility of being anchored at local optima due to its ability to introduce random shocks into the search process through mutations. Since a genetic algorithm is an appropriate global optimisation method, it can be used to search for the optimal parameter values for the GMA and GOS trading rules given by Equations 2 and 5 respectively.<sup>5</sup>

Genetic algorithms were originally developed by [18]. They are a class of adaptive search and optimisation techniques based on an evolutionary

<sup>5</sup> Another global optimisation technique is simulated annealing. However, this study focuses exclusively on a standard genetic algorithm.

process. By representing potential or candidate solutions to a problem using vectors consisting of binary digits or bits, mathematical operations known as crossover and mutation, can be performed. These operations are analogous to the genetic recombinations of the chromosomes in living organisms. By performing these operations, generations of new candidates can be created and evolved over time through an iterative procedure. However, there do exist restrictions on the process of crossover so as to ensure that better performing candidates are evolved over time. Similar to the theory of natural selection or survival of the fittest, the better performing candidates have a better than average probability of surviving and reproducing relative to the lower performing candidates which eventually get eliminated from the population. The performance of each candidate can be assessed using a suitable objective function. A selection process based on performance is applied to determine which of the candidates should participate in crossover, and thereby pass on their favourable traits to future generations. It is through this process of “survival of the fittest” that better solutions are developed over time. This evolutionary process continues until the best (or better) performing individual(s), consisting of hopefully the optimal or near optimal solutions, dominate the population.<sup>6</sup>

### 3.2 Problem representation

Potential solutions to the problem of optimisation of the parameters of the GMA rule defined in Equation 2 can be represented by the vector

$$\mathbf{y}_1 = [\theta_1, \theta_2, \theta_3]. \quad (7)$$

For the GOS rule given by Equation 5, candidates can be represented by the vector

$$\mathbf{y}_2 = [\phi_1, \phi_2, \phi_3, \phi_4] \quad (8)$$

where  $\phi_3$  is defined above given by Equation 6, while  $\phi_4$  is a dummy variable defined by

$$\phi_4 = \begin{cases} 1, & \phi_1 \text{ is determined implicitly} \\ 0, & \phi_1 \text{ is determined explicitly.} \end{cases} \quad (9)$$

In order to use a genetic algorithm to search for the optimal parameter values for the rules considered above, potential solutions to this optimisation

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<sup>6</sup> [17] provides a detailed description of the mathematical operations involved, the programming and applications of genetic algorithms.

problem are represented using vectors of binary digits. Binary representation is necessary in the standard genetic algorithm for the application of the recombination operations. These vectors also known as strings, are linear combinations of zeros and ones, for example  $[0\ 1\ 0\ 0\ 1]$ . A binary representation  $\mathbf{x} = [x_1, x_2, x_3, \dots, x_n]$  is based on the binary number system which has a corresponding equivalent decimal value given by  $\sum_{i=1}^n (2^{n-i})x_i$ . For example, the decimal equivalent of the vector  $[0\ 1\ 0\ 0\ 1] = (2^4 \times 0) + (2^3 \times 1) + (2^2 \times 0) + (2^1 \times 0) + (2^0 \times 1) = 8 + 1 = 9$ .

**Binary representation of the GMA rule** The periodicity of the two *MAs* have a range defined by  $1 < \theta_1 \leq L_1$  and  $2 < \theta_2 \leq L_1$ , where  $L_1$  represents the maximum length of the moving average. The filter parameter has a range given by  $0 \leq \theta_3 \leq L_2$ , where  $L_2$  represents the maximum filter value. For this study  $L_1 = 250$  days and  $L_2 = 100$  basis points.<sup>7</sup>

In order to satisfy the limiting values given above, the binary representations for  $\theta_1$  and  $\theta_2$  are each given by a vector consisting of eight elements. For the filter parameter ( $\theta_3$ ) a seven bit vector is required. Therefore, the binary representation for the GMA rule can be defined by a row vector consisting of twenty three elements stated as

$$\mathbf{x}_1 = [\mathbf{x}_{11}, \mathbf{x}_{12}, \mathbf{x}_{13}] \quad (10)$$

where

- $\mathbf{x}_{11}$  = subvector consisting of eight elements (binary representation of  $\theta_1$ )
- $\mathbf{x}_{12}$  = subvector consisting of eight elements (binary representation of  $\theta_2$ )
- $\mathbf{x}_{13}$  = subvector consisting of seven elements (binary representation of  $\theta_3$ ).

**Binary representation of the GOS rule** The parameter on the channel rule  $\phi_1$  represents the number of the most recent historical observations used to calculate either the maximum or minimum price. This parameter is restricted to the values  $1 \leq \phi_1 \leq 250$ . Therefore, the binary representation is given by a vector consisting of eight elements. The range for  $\phi_2$  is given by  $0 < \phi_2 \leq 1000$  basis points. Thus a vector consisting of ten elements is used and the decimal equivalent values are restricted to the desired range. Therefore, the binary representations for the order statistics based rule can be defined by a row vector consisting of twenty elements stated as

$$\mathbf{x}_2 = [\mathbf{x}_{21}, \mathbf{x}_{22}, \mathbf{x}_{23}, \mathbf{x}_{24}] \quad (11)$$

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<sup>7</sup> These limiting values are consistent with what is used in practice. Also, results from a preliminary investigation, indicated that higher parameter values generally produced losses.

where

- $\mathbf{x}_{21}$  = subvector consisting of eight elements (binary representation of  $\phi_1$ )
- $\mathbf{x}_{22}$  = subvector consisting of ten elements (binary representation of  $\phi_2$ )
- $\mathbf{x}_{23}$  = subvector consisting of one element (binary representation of  $\phi_3$ )
- $\mathbf{x}_{24}$  = subvector consisting of one element (binary representation of  $\phi_4$ ).

### 3.3 Objective function

The ultimate goal of the genetic algorithm is to find the combination of binary digits for the two vectors  $\mathbf{x}_1$  and  $\mathbf{x}_2$ , representing the parameter values given by  $\mathbf{y}_1$  and  $\mathbf{y}_2$ , which maximises an appropriate objective function. Each candidate's performance can be assessed in terms of this objective function, which can take numerous forms depending upon specific investor preferences. Given that individuals are generally risk averse, performance should be defined in terms of both risk and return. The Sharpe ratio is an example of a measure of risk-adjusted returns. The Sharpe ratio is given by

$$SR = \frac{\bar{r}}{\sigma\sqrt{Y}} \quad (12)$$

where  $\bar{r}$  is the average annualised trading rule return,  $\sigma$  is the standard deviation of daily trading rule returns, while  $Y$  is equal to the number of trading days per year. This formulation is actually a modified version of the original Sharpe ratio which uses average excess returns, defined as the difference between average market return and the risk-free rate.

Trading rules as defined by the indicator functions given in Equations 2 and 5, return either a buy or sell signal. These signals can be used to divide the total number of trading days ( $N$ ), into days either "in" the market (earning the market rate of return  $r_{mt}$ ) or "out" of the market (earning the risk-free rate of return  $r_{ft}$ ). Thus the trading rule return over the entire period of 0 to  $N$  can be calculated as

$$r_{tr} = \sum_{t=1}^N S_{t-1} r_{m,t} + \sum_{t=1}^N (1 - S_{t-1}) r_{f,t} - T(tc) \quad (13)$$

where

$$r_{m,t} = \ln\left(\frac{P_t}{P_{t-1}}\right)$$

which includes the summation of the daily market returns for days "in" the market and the daily returns on the risk-free security for days "out" of the

market. An adjustment for transaction costs is given by the last term on the right hand side of Equation 13 which consists of the product of the cost per transaction ( $tc$ ) and the number of transactions ( $T$ ). Transaction costs of 0.2 percent per trade are considered for the in-sample optimisation of the trading rules.

### 3.4 Operations

Selection, crossover and mutation are the three important mathematical operations in any genetic algorithm. It is through these operations that an initial population of randomly generated solutions to a problem can be evolved, through successive generations, into a final population consisting of a potentially optimal solution. The search process which ensues is highly efficient and effective because of these operations.

Selection involves the determination of the candidates for participation in crossover. The genitor selection method, a ranking-based procedure developed by [30], is used in the genetic algorithm employed in this study. This approach involves ranking all candidates according to performance and then replacing the worst performing candidates by copies of the better performing candidates. In the genetic algorithm developed in this paper a copy of the best candidate replaces the worst candidate.

The method by which promising (better performing) candidates are combined, is through a process of binary recombination known as crossover. This ensures that the search process is not random but consciously directed into promising regions of the solution space. As with selection there are a number of variations, however single point crossover is the most commonly used version and the one adopted in this study.

To illustrate the process of crossover, assume that two vectors  $A = [1\ 0\ 1\ 0\ 0]$  and  $B = [0\ 1\ 0\ 1\ 0]$  are chosen at random and that the position of partitioning is randomly chosen to be between the second and third elements of each vector. Vectors A and B can be represented as  $\left[ \begin{array}{c|ccc} 1 & 0 & 1 & 0 \\ \hline & & & \end{array} \right] = [A_1\ A_2]$  and  $\left[ \begin{array}{c|ccc} 0 & 1 & 0 & 1 \\ \hline & & & \end{array} \right] = [B_1\ B_2]$  respectively, in terms of their subvectors. Recombination occurs by switching subvector  $A_2$  with  $B_2$  and then unpartitioning both vectors  $A$  and  $B$ , producing two new candidates  $C = [1\ 0\ 0\ 1\ 0]$  and  $D = [0\ 1\ 1\ 0\ 0]$ .

In contrast to crossover, mutation involves the introduction of random shocks into the population, by slightly altering the binary representation of candidates. This increases the diversity in the population and unlike crossover, randomly re-directs the search procedure into new areas of the solution space which may or may not be beneficial. This action underpins the genetic algorithms ability to find novel inconspicuous solutions and avoid being anchored at local optimum solutions. Mathematically, this operation is represented by switching a binary digit from a one to a zero or vice versa. However, the

probability of this occurrence is normally very low, so as to not unnecessarily disrupt the search process.

This operation can be illustrated by an example. Assume that the third element in vector  $C = [1\ 0\ 0\ 1\ 0]$  undergoes mutation. The outcome of this operation changes the binary representation of vector  $C$  slightly, producing a new candidate represented by  $E = [1\ 0\ 1\ 1\ 0]$ .

### 3.5 Procedure

The genetic algorithm procedure can be summarised by the following steps:

1. Create an initial population of candidates randomly.
2. Evaluate the performance of each candidate.
3. Select the candidates for recombination.
4. Perform crossover and mutation.
5. Evaluate the performance of the new candidates.
6. Return to step 3, unless a termination criterion is satisfied.

The last step in the genetic algorithm involves checking a well-defined termination criterion. If this criterion is not satisfied, the genetic algorithm returns to the selection, crossover and mutation operations to develop further generations until this criterion is met, at which time the process of the creation of new generations is terminated. The termination criterion adopted, is satisfied when either one of the following conditions is met:

1. the population converges to a unique individual,
2. a predetermined maximum number of generations is reached,
3. there has been no improvement in the population for a certain number of generations.

This latter condition ensures that the genetic algorithm cannot continue indefinitely.

### 3.6 Parameter settings

The genetic algorithm has six parameters settings  $\{b, p, c, m, G_1^{\max}, G_2^{\max}\}$ , defined as:

- $b$  = number of elements in each vector,
- $p$  = number of vectors or candidates in the population,
- $c$  = probability associated with the occurrence of crossover,
- $m$  = probability associated with the occurrence of mutation,
- $G_1^{\max}$  = maximum number of generations allowed,
- $G_2^{\max}$  = maximum number of iterations without improvement.

These parameters can effect both the efficiency and effectiveness of the genetic algorithm search. Small (large) values for  $b, p, m, G_1^{\max}, G_2^{\max}$  and a large (small) value of  $c$  result in rapid (slow) convergence; see [17] or [5] for an

**Table 1.** Genetic Algorithm Parameters

Rule	$b$	$p$	$c$	$m$	$G_1^{\max}$	$G_2^{\max}$
GMA	23	150	0.6	0.005	250	150
GOS	20	150	0.6	0.005	250	150

explanation of these results. The greater the rate of convergence the lower the computational time that is required to reach the solution. However, if the rate of convergence is too rapid the solution space is not adequately searched, potentially missing the optimal solution (or better solutions to the one found).

Table 1 displays the parameter values that are used by the genetic algorithm for each of the trading rules. The choice of  $b$  values was discussed above in Section 3.1, while the choice of values for  $p$ ,  $c$ ,  $m$ ,  $G_1^{\max}$  and  $G_2^{\max}$  was guided by previous studies (see [5], Chapter 7) and experimentation with different values.

## 4 Performance evaluation

### 4.1 Economic profitability

The true profitability of technical trading rules is hard to measure given the difficulties in properly accounting for the risks and costs associated with trading. Trading costs include not only transaction costs and taxes, but also hidden costs involved in the collection and analysis of information. Transaction costs of 0.1 percent per trade are used to investigate trading rule performance. Since according to [28], large institutional investors are able to achieve one-way transaction costs in the range of 0.1 to 0.2 percent. However, given that different individuals face different levels of transaction costs, the break-even transaction cost is also reported in the results section; see [6]. This is the level of transaction costs which offsets trading rule revenue with costs, leading to zero trading profits.

To evaluate trading rule profitability, it is necessary to compare trading rule returns to an appropriate benchmark. Since the trading rules considered in this paper restrict short selling, they do not always lead to a position being held in the market and therefore are less risky than a passive buy and hold benchmark strategy, which always holds a long position in the market. Therefore, the appropriate benchmark is constructed by taking a weighted average of the return from being long in the market and the return from holding no position in the market and thus earning the risk free rate of return. The return on this risk-adjusted buy and hold strategy can be written as

$$r_{bh} = \alpha \sum_{t=1}^N r_{f,t} + (1 - \alpha) \sum_{t=1}^N r_{m,t} - 2(tc) \quad (14)$$

where  $\alpha$  is the proportion of trading days that the rule is out of the market. This return represents the expected return from investing in both the risk-free asset and the market according to the weights  $\alpha$  and  $(1 - \alpha)$  respectively. There is also an adjustment for transaction costs incurred due to purchasing the market portfolio on the first trading day and selling it on the last day of trading.

Therefore, trading rule performance relative to the benchmark can be measured by excess returns

$$XR = r - r_{bh} \quad (15)$$

where  $r$  represents the total return for a particular trading rule calculated from Equation 13 and  $r_{bh}$  is the return from the appropriate benchmark strategy given by Equation 14. Since investors and traders also care about the risk incurred in deriving these returns, a Sharpe ratio based on excess returns can be calculated using Equation 12, where  $\bar{r}$  represents annualised excess returns given by Equation 15 and  $\sigma$  is the standard deviation of the daily excess returns.

## 4.2 Predictive ability

To investigate the statistical significance of the forecasting power of the buy and sell signals, traditional t tests can be employed to examine whether the trading rules issue buy (or sell) signals on days when the return on the market is on average higher (or lower) than the unconditional mean return for the market.

The t-statistic used to test the predictive ability of the buy signals is

$$t_{buy} = \frac{\bar{r}_{buy} - \bar{r}_m}{\sigma \sqrt{\frac{1}{N_{buy}} + \frac{1}{N}}} \quad (16)$$

where  $\bar{r}_{buy}$  represents the average daily return following a buy signal and  $N_{buy}$  is the number of days that the trading rule returns a buy signal. The null and alternative hypotheses can be stated as

$$\begin{aligned} H_0 &: \bar{r}_{buy} \leq \bar{r}_m \\ H_1 &: \bar{r}_{buy} > \bar{r}_m. \end{aligned}$$

Similarly, a t-statistic can be developed to test the predictive ability of the sell signals. To test whether the difference between the mean return on the market following a buy signal and the mean return on the market following a sell signal is statistically significant, a t-test can be specified as

$$t_{buy-sell} = \frac{\bar{r}_{buy} - \bar{r}_{sell}}{\sigma \sqrt{\frac{1}{N_{buy}} + \frac{1}{N_{sell}}}} \quad (17)$$

where the null and alternative hypotheses are

$$\begin{aligned} H_0 : \bar{r}_{buy} - \bar{r}_{sell} &\leq 0 \\ H_1 : \bar{r}_{buy} - \bar{r}_{sell} &> 0. \end{aligned}$$

Another test of whether the rules have market timing or forecasting ability is based on an approach suggested by [13]. This test is based on the following regression

$$r_{m,t} - r_{f,t} = \alpha + \beta S_t + \varepsilon_t \quad (18)$$

where  $r_{m,t}$  and  $r_{f,t}$  are the return at time  $t$  for the risky asset or market portfolio and the risk-free security respectively,  $\varepsilon_t$  is a standard error term and  $S_t$  is the trading rule signal. To test whether a particular rule has market timing ability the regression given in Equation 18 is estimated using OLS and the following hypothesis test is conducted

$$\begin{aligned} H_0 : \beta &= 0, \text{ no market timing ability} \\ H_1 : \beta &> 0, \text{ positive market timing ability.} \end{aligned}$$

### 4.3 Statistical Significance

The bootstrap method proposed by [15] has been applied in finance for a wide variety of purposes; see [24]. Reference [22] use this method for the purpose of testing the significance of trading rule profitability, while [8] use trading rules on bootstrapped data as a test for model specification. In this study, a bootstrap approach similar to [22] is used to test the significance of both the predictive ability and the profitability of technical trading rules.

To use the bootstrap method a data generating process (DGP) for market prices or returns must be specified a priori. The DGP assumed for prices in this study is the simple random walk with drift

$$\begin{aligned} \ln P_{t+1} &= \mu + \ln P_t + \varepsilon_t \\ \varepsilon_t &\sim IID N(0, \sigma^2) \end{aligned} \quad (19)$$

where  $\mu$  represents the drift in the series,  $\ln P$  is the natural logarithm of the price and  $\varepsilon$  is the stochastic component of the DGP. Since continuously compounded returns are defined as the log first difference of prices, then the above DGP given in Equation 19 implies an IID normal process with a mean of zero for returns.

The bootstrap method can be used to generate many different return series by sampling with replacement from the original return series. The bootstrap samples created are pseudo return series that retain all the distributional properties of the original series, but are purged of any serial dependence. Each bootstrap sample also has the property that the DGP of prices is a random walk with drift. From each bootstrap a corresponding price series can be extracted, which can then be used to test the significance of the predictive ability or profitability of a particular rule. This is done by applying the rule to each of the pseudo price series and calculating the empirical distribution of the trading rule profits or the statistic of interest. P-values can then be calculated from this distribution.

To test the significance of the trading rule excess returns the following hypothesis can be stated

$$\begin{aligned} H_0 : XR &\leq \bar{XR}^* \\ H_1 : XR &> \bar{XR}^*. \end{aligned}$$

Under the null hypothesis, the trading rule excess return ( $XR$ ) calculated from the original series is less than or equal to the average trading rule return for the pseudo data samples ( $\bar{XR}^*$ ). The p-values from the bootstrap procedure are then used to determine whether the trading rule excess returns are significantly greater than the average trading rule return given that the true DGP is a random walk with drift. In a similar way, the market returns following buy and sell signals and the Sharpe ratio can also be bootstrapped to test the significance of the predictive ability and profitability of the trading rule studied.

The bootstrap procedure involves the following steps:

1. Create  $Z$  bootstrap samples, each consisting of  $N$  observations, by sampling with replacement from the original return series.
2. Calculate the corresponding price series for each bootstrap sample given that the price next period is  $P_{t+1} = \exp(r_{t+1})P_t$ .
3. Apply the trading rule to each of the  $Z$  pseudo price series.
4. Calculate the performance statistic of interest for each of the pseudo price series.
5. Determine the P-value by calculating the number of times the statistic from the pseudo series exceed the statistic from the original price series.

## 5 An empirical application

### 5.1 Data

The data consists of the daily closing All Ordinaries Accumulation index and the daily 90 day Reserve Bank of Australia bill dealer rate. The data is collected over the period 4/1/1982 to 31/12/97, consisting of 4065 observations.<sup>8</sup> For the purpose of avoiding the possibility of data-snooping, the total period is split into an in-sample optimisation period from 4/1/1982 to 31/12/89 and an out-of-sample test period from 2/1/1990 to 31/12/97.

Table 2 provides summary statistics for the continuously compounded daily returns ( $r_m$ ) on the All Ordinaries index.<sup>9</sup> The return series has characteristics common to most financial time series and the results are broadly consistent with previous studies. The autocorrelation coefficients are also reported for the first five lags. These coefficients show evidence of highly significant low-order positive autocorrelation.<sup>10</sup> Significant first-order serial correlation in share indices is a well known stylized fact due to the inclusion of thinly-traded small shares in share market indices. Therefore, this result is not surprising given that the All Ordinaries Accumulation index is comprised of over 300 shares, which includes a significant amount of small shares. There also appears to be significant higher order serial correlation as indicated by the heteroscedasticity-adjusted Box-Pierce Q statistic (ABP). These results seem to be consistent across the in-sample optimisation and out-of-sample test periods.

### 5.2 Trading rule parameter values

A genetic algorithm was programmed and then used to search for the optimal parameter values using the All Ordinaries Accumulation index data during the in-sample optimisation period.<sup>11</sup> The GA-optimal parameter values for the trading rules found during the in-sample period based on transaction costs of 10 basis points are reported in Table 3. The returns and the Sharpe ratios are high, even compared to the buy and hold return of 18.79 percent per annum and the corresponding Sharpe ratio of 0.86 percent per unit of standard deviation. The best GMA rule can be described as a 14 day MA rule with a 64 basis point filter, while the best GOS rule can be described as a 9 day channel rule with a 21 basis point filter.

<sup>8</sup> The data was obtained from the Equinet Pty Ltd data base.

<sup>9</sup> The continuously compounded daily returns are calculated as the natural logarithm of the first difference of the original price series.

<sup>10</sup> The 95% confidence interval is  $\pm 0.0314$ , which is calculated using the formula  $\pm \frac{2}{\sqrt{n}}$ , where  $n$  is the number of observations.

<sup>11</sup> All programs are written in GAUSS, version 3.2, which are available from the author upon request.

**Table 2.** Summary statistics for daily returns

	1982-97	1982-89	1990-97
Sample size	4064	2028	2035
Mean	0.0533	0.0676	0.0381
Std. dev.	1.0214	1.1956	0.8107
Skewness	-6.0385	-7.4628	-0.3231
Kurtosis	163.7916	173.2427	8.9921
Maximum	6.2228	5.5994	6.2228
Minimum	-28.7495	-28.7495	-7.4286
$\rho_1$	0.1114	0.1214	0.1222
$\rho_2$	-0.0400	-0.0413	-0.0413
$\rho_3$	0.0696	0.1119	0.1111
$\rho_4$	0.0869	0.1300	0.1295
$\rho_5$	0.0493	0.0751	0.0752
ABP(10)	22.7308	19.1460	19.2501
ABP(30)	53.8039	46.1164	46.3069

**Table 3.** Trading rule parameter values

Rule	Parameter values	$\bar{r}$	SR	No.	$\bar{r}$	SR	Best after	No. of Time	No. of Time
Best over ten trials					Average over 10 trials				
GMA	(1,14,64)	36.1	3.0	8	35.8	3.0	119	229.7	203.9
GOS	(9,21,0,0)	36.0	3.1	10	36.0	3.1	123	245.3	207.8

The Sharpe ratio (SR) is calculated as the ratio of annualised returns ( $\bar{r}$ ) to standard deviation. The number of times the best rule was found in 10 trials (No.) is given in the fifth column. The average number of iterations completed until the best rule was found (Best after) is reported in column 8. The average number of iterations completed for one trial (No. of iters) is reported in the second last column.

In order to investigate the important properties of effectiveness and efficiency, the genetic algorithm is run over ten trials for each rule. The effectiveness of the genetic algorithm's ability to search for the optimal parameter values is investigated by observing how many times the best rule is found over ten trials; given in the fifth column of Table 3. It appears that the genetic algorithm is reasonably efficient, since in 90 percent of the runs the genetic algorithm has found the same best rule.

Another measure of the effectiveness of the genetic algorithm is to find good rules in terms of the performance criteria used, not necessarily the best or optimal rule. This is evaluated by considering the average of the annualised returns and Sharpe ratios over the ten trials for each rule. The results indicate that the genetic algorithm may not have perfect accuracy, but on average finds rules very close to the best rule.

The efficiency of the genetic algorithm as a search or optimisation technique is measured by considering the time it takes to find good rules. On average the genetic algorithm took over three and half hours to run, whereas an exhaustive grid-search procedure would have taken many hours, if not days.<sup>12</sup> Obviously, a more efficient genetic algorithm could be developed, but this is not pursued in this study.

### 5.3 Performance evaluation

It should not be surprising to observe high in-sample performance for the genetic algorithm-optimised trading rules. Rather, it is more interesting and important to examine how these rules perform out-of-sample.

**Economic profitability** The out-of-sample performance statistics are reported in Table 4. In terms of the annualised excess returns ( $XR$ ) and the corresponding Sharpe ratio ( $SR$ ), both rules are able to outperform the appropriate benchmarks after allowing for transaction costs of 10 basis points per trade. These results remain positive, as long as transaction costs are below 0.53 and 0.62 percent per trade as indicated by the break-even costs ( $tc^*$ ). The rules trade roughly seven times per year and produce positive excess returns for approximately 45 percent of the trades. An indication of their riskiness is given by the maximum drawdown ( $Max D$ ), which measures the largest drop in the cumulative excess return series. In terms of this measure of risk, both rules are much less risky than the buy and hold, which has a maximum drawdown of -69 percent.

The robustness of the results is investigated across different non-overlapping sub-periods. Four 2 year sub-periods are investigated during the out-of-sample period from 1990 to 1997. A sub-period analysis of the performance results, show that this good performance deteriorates over time. In the last couple of years neither rule is able to outperform the benchmark.

**Predictive ability** To examine the forecasting ability of the rules, the signals are investigated both individually and together. The results for the predictive ability of the trading rules are reported in Table 5. Both rules display some evidence of significant predictive ability as indicated by the t-statistics in the second last column of Table 5. This result is confirmed by the final column in the table which reports the t-statistic based on the [13] market timing test. However, individually the buy and sell signals do not seem to have any significant predictive ability. In addition to this overall significant predictive ability, all the rules issue buy (or sell) signals when the excess returns on the market are on average less (or more) volatile as indicated by the volatility of returns following buy ( $\sigma_{buy}$ ) and sell ( $\sigma_{sell}$ ) signals respectively.

<sup>12</sup> All genetic algorithm runs were conducted on a Pentium 233 MHz desktop PC.

**Table 4.** Performance statistics for GA-optimised share market rules

Rule	$\bar{r}$	$XR$	$SR$	$tc^*$	$\bar{T}$	$T_w/T$	$\bar{r}_w$	$\bar{r}_L$	$Max D$
Panel A: Full Sample (1990-97)									
GMA	10.82	2.45	0.37	53	7.36	44.07	1.72	-0.88	-14.10
GOS	11.16	2.91	0.44	62	6.86	45.45	1.92	-0.98	-10.97
Panel B: Sub-period results for the GMA rule									
1990-91	12.48	5.91	0.82	99	7.53	40.00	1.87	-0.97	-6.11
1992-93	16.53	3.59	0.62	69	7.44	46.67	2.20	-0.81	-7.64
1994-95	8.02	2.83	0.45	58	7.50	46.67	1.27	-0.78	-5.40
1996-97	5.20	-3.37	-0.46	0	8.53	41.18	1.20	-0.82	-14.31
Panel C: Sub-period results for the GOS rule									
1990-91	11.27	4.64	0.65	87	7.03	35.71	2.58	-1.24	-9.35
1992-93	16.36	3.73	0.64	79	6.45	53.85	2.09	-0.87	-9.10
1994-95	8.35	3.16	0.51	64	7.00	42.86	1.50	-0.71	-5.67
1996-97	7.01	-1.39	-0.19	3	8.53	47.06	1.31	-0.94	-11.02

The Sharpe ratio ( $SR$ ) is the ratio of annualised excess returns ( $XR$ ) to standard deviation. The break-even level of transaction cost is given by  $tc^*$ . Trading frequency  $\bar{T}$  is measured by the average number of trades per year.  $T_w/T$  represents the proportion of trades that yield positive excess returns. The average excess return on winning and losing trades is given by  $\bar{r}_w$  and  $\bar{r}_L$  respectively. The maximum drawdown  $Max D$  represents the largest drop in cumulative excess returns.

**Table 5.** Predictive ability - share market rules

Rule	$N_{buy}$	$\bar{r}_{buy}$	$\sigma_{buy}$	$t_{buy}$	$N_{sell}$	$\bar{r}_{sell}$	$\sigma_{sell}$	$t_{sell}$	$t_{buy-sell}$	$t^*$
Panel A: Full Sample (1990-97)										
GMA	1159	0.065	0.729	0.922	876	0.003	0.906	-1.033	1.699	1.669
GOS	1097	0.069	0.731	1.037	938	0.002	0.894	-1.077	1.834	1.830
Panel B: Sub-period results for the GMA rule										
1990-91	284	0.065	0.793	0.796	222	-0.048	0.951	-0.883	1.458	1.455
1992-93	303	0.100	0.700	0.636	209	0.020	0.739	-0.799	1.245	1.248
1994-95	271	0.052	0.745	0.551	237	-0.016	0.804	-0.588	0.987	0.972
1996-97	298	0.033	0.680	-0.201	208	0.062	1.103	0.218	-0.364	-0.335
Panel C: Sub-period results for the GOS rule										
1990-91	271	0.058	0.813	0.658	235	-0.033	0.924	-0.693	1.171	1.199
1992-93	292	0.101	0.696	0.642	220	0.023	0.742	-0.758	1.214	1.223
1994-95	255	0.056	0.748	0.610	253	-0.016	0.798	-0.600	1.049	1.037
1996-97	275	0.047	0.665	0.031	231	0.043	1.079	-0.030	0.052	0.050

All the statistics reported in this table are defined and discussed in Section 4.

**Table 6.** Bootstrap p-values

Rule	$\bar{X}R$	$\bar{S}R$	$\bar{r}_{buy}$	$\sigma_{buy}$	$\bar{r}_{sell}$	$\sigma_{sell}$	$\bar{r}_{buy-sell}$	$\sigma_{buy-sell}$
Panel A: Full Sample (1990-97)								
GMA	0.000	0.000	0.000	1.000	0.000	1.000	0.000	0.998
GOS	0.016	0.018	0.018	0.996	0.018	0.960	0.044	0.946
Panel B: Sub-period results for the GMA rule								
1990-91	0.076	0.082	0.078	0.976	0.026	0.894	0.086	0.844
1992-93	0.104	0.110	0.130	0.746	0.238	0.892	0.112	0.842
1994-95	0.124	0.126	0.110	0.842	0.220	0.838	0.148	0.716
1996-97	0.592	0.570	0.596	0.986	0.046	0.390	0.582	0.118
Panel C: Sub-period results for the GOS rule								
1990-91	0.106	0.110	0.106	0.926	0.104	0.872	0.122	0.758
1992-93	0.094	0.098	0.108	0.806	0.208	0.892	0.114	0.836
1994-95	0.130	0.134	0.110	0.798	0.254	0.828	0.154	0.728
1996-97	0.464	0.462	0.458	0.984	0.048	0.542	0.480	0.108

The measures reported in this table are described in Tables 4 and 5

A sub-period analysis of these results indicates that the difference between the average return following buy signals and the average return following sell is no longer significant. This is also true for the market timing test. However, the ability of the rules to buy when volatility in the market is low and sell when volatility is high, appears to be robust across different time periods.

**Statistical significance** The bootstrap approach outlined in Section 4 is applied to both the trading rule performance and predictive ability results. The simulated p-values for the various measures of performance and predictive ability are given in Table 6. The results for the entire out-of-sample period provide evidence that the rules have significant forecasting power and profitability given that the return series are generated by a random walk process. However a sub-period analysis shows only weak evidence of significant predictive ability and profitability. In general, these results confirm those reported in Tables 4 and 5.

#### 5.4 Return measurement bias

It is important to evaluate the sensitivity of the results to the significant persistence in returns, which are reported in Table 2. Since the existence of thinly traded shares in the index can introduce a non-synchronous trading bias or return measurement error. Therefore, these returns might not be exploitable in practice. To investigate this issue, the performance of the trading rules is simulated based on trades occurring with a delay of one day. This should remove any first order autocorrelation bias due to non-synchronous trading.

**Table 7.** Return measurement sensitivity–share market rules

Rule	$XR$	$SR$	$tc^*$	$\bar{T}$	$MaxD$	$t^*$	Bootstrap p-values			
							$\bar{r}_{buy}$	$\sigma_{buy}$	$\bar{r}_{sell}$	$\sigma_{sell}$
GMA	0.57	0.09	28	7.36	-21.36	0.879	0.156	1.000	0.002	0.810
GOS	0.39	0.06	25	8.11	-23.91	0.866	0.158	1.000	0.002	0.790

The performance statistics contained in columns two to seven are described in the notes to Table 4. The last four columns contain bootstrap simulated p-values for the statistics described in Section 4.

As can be seen from Table 7, the rules are still profitable over the out-of-sample test period, although there has been a substantial reduction in performance. Furthermore, there appears to be weak, if any, evidence of predictive ability. However, both rules still retain the property of being in the market when return variability is low and out of the market when return variability is high.

The break-even transaction costs have been reduced to approximately 0.25 percent per trade. This probably lower than the costs faced by most financial institutions. Since stamp duty and taxes are also incurred on all trades, which have been ignored in this evaluation of trading rule performance.<sup>13</sup> Also during volatile periods liquidity costs, as reflected by the bid-ask spread, could increase substantially. Even for large shares this increase could be in the order of 0.5 to 1 percent. Thus, there does not appear to be sufficient evidence to conclude that the trading rules are economically profitable.

## 6 Conclusion

This paper has outlined how a genetic algorithm can be used to optimise technical trading rules and considered an application of this methodology to the Australian share market. The results indicate that there exists some evidence of overall market timing ability, but individual buy and sell signal have only, at best marginal forecasting power for the next days returns. Surprisingly, the rules appear to be able to distinguish between periods of low and high volatility. This is an interesting issue which was not investigated in this study, but is left for future research.

Both the GMA and GOS rules were able to outperform the benchmark strategy over the out-of-sample test period, taking into account both trading costs and risks. However, a sub-period analysis of the results indicates that the performance of both rules deteriorates over time. This performance is substantially reduced once the trading rule returns are adjusted for non-synchronous or thin trading.

<sup>13</sup> Stamp duty costs per trade in Australia are currently 0.15 percent. Taxation costs vary across institutions and different individuals.

In conclusion, there appears to be some evidence of forecasting ability, but probably little or no evidence of profitability once a reasonable level of trading costs has been considered. Since the break-even costs for these trading rules do not appear to be high enough to exceed realistic trading costs.

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