CHAPTER 4

The Conqueror

This chapter discusses the Conqueror, which is a clever method that encourages some truly original thinking. I am a big fan of trading through multiple time frames (see Chapter 10 for more information on diversifying through time). This particular method looks at three different time frames before entering a trade.

Most methods use the same method for entering and exiting trades. For example, you buy when the 20-day moving average crosses above the 50-day moving average and sell when the 20-day moving average crosses below the 50-day moving average. However, the Conqueror actually uses a different exit technique from the entry technique. This is rare in the world of trading.

In previous chapters we've covered ways to exit a trade that are different from the entry point. This uncommon approach leads to much higher profits than the basic method that most people use to trade. The Conqueror uses one method to enter and another method to exit. They are related to each other but are separate. In addition, the stop loss is adaptive. That is, it looks at current market conditions and adapts to those conditions to create the exit strategy.

THE BEGINNINGS OF THE CONQUEROR

The idea originated back in 1991 when Bruce Babcock created a system called the Currency Conquistador. Bruce was one of the pioneers of futures trading. He was the founder of *Commodity Traders Consumer Report*

(CTCR, which is now Web-only at www.ctcr.investors.net), which I bought from him in 1996 when he was diagnosed with cancer. He was the author of one of the most popular books on trading, *Dow Jones-Irwin Guide to Trading Systems*, and designed many profitable systems.

Perhaps his greatest contribution to futures trading was a sense of integrity and cutting through the hype that fills the futures and forex world. CTCR allowed no advertising so Bruce could be totally honest in his reviews of products.

Bruce fiddled with the Currency Conquistador for a few years and then released Currency Conquistador II. This presented a more sensitive stop loss method than the first version.

At this point, ace researcher Nelson Freeburg enters the story. Nelson publishes an amazing newsletter called *Formula Research* (see Appendix: Suggested Reading for more information). Nelson develops trading methods and systems for trading most markets. He has a clever mind and has come up with some great systems. I highly recommend his publication.

Nelson published an enhancement for the Conquistador at the end of 1994. One key enhancement was that the original Currency Conquistador was only for trading currencies. Nelson broadened the testing to other futures contracts and found that his modifications made it profitable for a broad list of futures. We are only looking at forex in this book, but knowing that the method works on many more markets gives confidence that this is a strong method.

Nelson also simplified the system, which is almost always a good thing. In this case, it was a good thing because Nelson-simplified systems outperformed the basic Babcock system.

WHAT IS TRUE RANGE?

Before I get into the mechanics of the system, let me first discuss *true range* as we will be using this concept in the calculation of the Conqueror.

One of the advantages of the forex market is that the opening price is basically the same as the closing price of the previous day. We close at one price and the opening price is simply the next tick. The only exception is the close on Friday going over to the open on Monday. Here, it is possible for a gap to be created by the change in price occurring over the weekend. In this case, we need to adjust for the potential gap in figuring out the true range on Monday. We will know what the actual range is by simply looking at the chart or a table and seeing what your chart service tells you what the range is. Good enough. The problem comes in when there is a gap between the range on Friday and the range on Monday.

In this case, the reported range doesn't really represent the range of the day. Let's say that the price gapped down and the high on Monday is below the low of Friday. The range that is reported is not reflective of what implicitly happened. Although no trading occurred between the high of Monday and the close of Friday, it can be said that the true high for Monday should have been the close of Friday.

Here is how Nelson defined it in CTCR in 1995:

> *To begin with, a day's true high is the higher of today's high or yesterday's close. The true low is the lower of today's low or yesterday's close.*
>
> *The true range is simply the true high minus the true low. The true range is designed to better measure the totality of price movement in cases where yesterday's close lies beyond today's price range.*

Table 4.1, reproduced from *Commodity Traders Consumer Report*, shows the results of Nelson's final modification of the Conquistador.

As you can see, the method is very profitable. In fact, here is what Nelson stated in his issue of *Formula Research* devoted to the Conquistador:

> *The self-adjusting stop is perhaps the most innovative element in this versatile trading system. The wealth of applications inherent in the logic is a tribute to the analyst who designed it. We are in Bruce Babcock's debt for sharing Currency Conquistador, which, in terms of sheer dollars gained, is the most profitable futures system* Formula Research *has published thus far.* (Commodity Traders Consumer Report, *1991*)

ENHANCING THE CONQUISTADOR

Now I enter the story. I took Nelson's profitable modifications of the Conquistador and modified them. I've created two different versions. One is *very* long term and the other is short term. To differentiate the results from the excellent work of Bruce and Nelson, I changed the name to the Conqueror.

Let's now take a look at the rules. First, we define several conditions. A positive number is bullish and a negative number is bearish.

1. Today's close minus the 10-day moving average (MA) of the close
2. Today's 10-day MA minus the 10-day MA 10 days ago
3. Today's close minus the close 40 days ago

TABLE 4.1 Currency Conquistador Version by Nelson Freeburg (Study Shows Profits/Losses from August 1, 1972, to July 9, 1998)

	Swiss Franc	**British Pound**	**D-mark**	**Japanese Yen**	**Average**
Total Net Profit	$167,062	$177,688	$112,675	$212,437	$167,466
Total Number of Trades	97	124	104	102	107
Number Winning Trades	45	46	52	53	49
Number Losing Trades	52	78	52	49	58
Percent Profitable	46 percent	37 percent	50 percent	51 percent	46 percent
Largest Winning Trade	$19,450	$32,018	$20,187	$32,662	$26,079
Largest Losing Trade	$(2,787)	$(3,019)	$(3,987)	$(3,087)	$(3,220)
Average Winning Trade	$5,669	$7,140	$3,633	$5,327	$5,442
Average Losing Trade	$(1,693)	$(1,933)	$(1,467)	$(1,426)	$(1,630)
Ratio Average Win/Average Loss	3.34	3.69	2.47	3.73	3.31
Average Trade (Win & Loss)	$1,722	$1,433	$1,083	$2,082	$1,580
Maximum Consecutive Winners	5	4	7	4	5
Maximum Consecutive Losers	5	9	4	3	5
Average Number of Bars in Winners	110	104	94	99	102
Average Number of Bars in Losers	23	15	25	21	21
Max Closed-Out Drawdown	$(8,000)	$(26,468)	$(7,475)	$(8,162)	$(12,526)
Max Intra-Day Drawdown	$(8,162)	$(26,725)	$(8,175)	$(9,237)	$(13,075)
Profit Factor	2.89	2.17	2.47	4.03	2.89
Account Size Required	$11,162	$29,725	$11,175	$12,237	$16,075
Return on Account	1,496 percent	597 percent	1,008 percent	1,735 percent	1,209 percent

Source: Commodity Traders Consumer Report, 1991.

Go long if all three conditions are positive. Go short if all three conditions are negative. Stand aside on any other condition. I'll get to the protective stop in a minute.

Let's consider this entry situation. Basically, we are looking at three different time horizons. First, we are looking at the price action over the last 10 days when we look at condition one. Condition two is really looking at the price action of the last 20 days. Finally, condition three is looking at the last 40 days.

We do not go long or short until all three trends in the market are congruent. The concept of applying three different time frames is unusual in trading. I had kind of a "doh" moment when I first saw it because it is so obvious yet never really done.

Basically, we are making sure that whatever trend is in place is powerful enough to turn all three directions bullish or bearish. A sideways market will not trigger the three conditions and we will stand aside in those situations, which is perfect. Only when the market really starts to move in one direction or another will the three trends line up and we will enter the market. Otherwise, one or more of the three conditions will be positive or negative and we will look for opportunities in other markets.

It is, therefore, difficult to get a buy or sell signal from the Conqueror. Most of the time it sits out of the market. It stubbornly waits for the market to really get going in one direction or another before it jumps in with a long or short position. This is one of the most important features of the Conqueror. It sits out when the market is drifting sideways or has only a slight trend. This saves a lot of money in whipsaw losses. It is also a significant improvement over most trading methods!

Let's take a look at an example. Let's pick up the action in the middle of September. The three conditions are mixed at that point. Let's follow the flow of the trade to see how it develops.

I've marked three arrows in Figure 4.1. The first arrow shows that condition three is negative. The close that day is below the close of the market 40 days previously.

Three days later, the price closes below the 10-day moving average, turning this condition negative. That's two conditions that are negative. We still can't go short because we need to have all three conditions negative before we can go short.

Take a look at the chart. At this point, the market has had a down move from the upper left of the chart. There was a rally in mid-September. At this point, we don't know if this is the beginning of a new bull market or simply a countertrend rally in the down trend. The market should probably be considered as roughly neutral. At this point, we have two conditions negative and one positive.

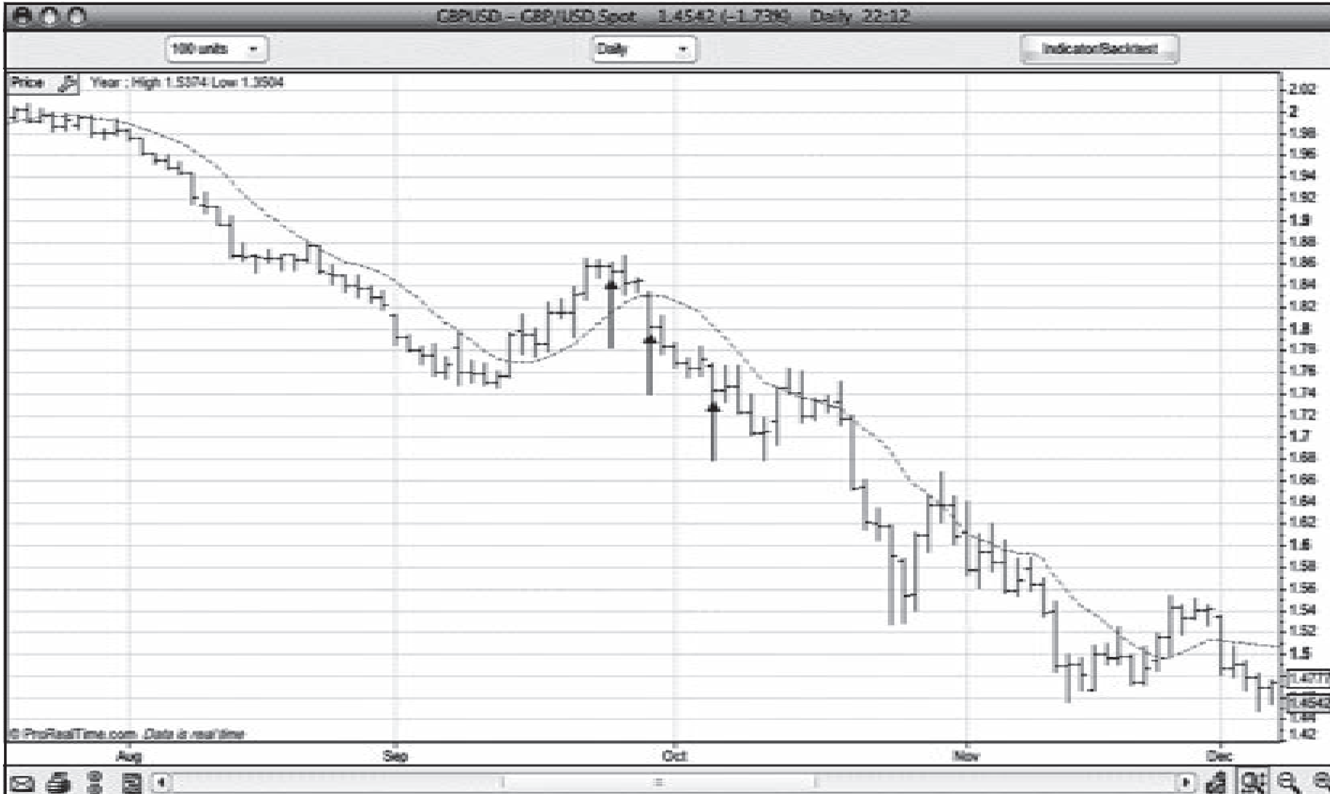

FIGURE 4.1 British Pound with Conditions Marked

The Conqueror sits back and waits until the trend is conclusively in one direction before entering. At this point, there are two negatives and one positive for only a net negative of one. This is not conclusive enough for the Conqueror.

The one condition that is not cooperating is the 10-day MA because it is still not below itself 10 days previously. It is not until early October before the 10-day MA drops enough. At that point, as the third arrow indicates, the third condition turns negative.

We go short on the close of trading on the day that the third condition triggers. If we don't know if the third condition has triggered until after the close of trading, then we go short on the open the following day. Okay, we are now short. All three conditions have been triggered. Where is our protective stop? Now it gets really interesting. We are going to use several different methods to determine the protective stop.

The first stop is a simple money management stop. For a standard contract, place a stop that would be a $2,000 loss. In other words, figure out how many pips represents $2,000 and place a stop that many pips away from the entry price. Fortunately, this stop will rarely be triggered. The other forms of stop will be triggered far more often. Still, we want some disaster insurance in place.

I've added another panel to the chart (see Figure 4.2). The new lower panel shows the average true range (ATR) over the past 40 days. This is simply the 40-day average of the ATR. You can see that the ATR was about 0.024 on the day we went short. That is really 240 pips. You can also see that the market was becoming more volatile from August through November. The ATR was slowly moving higher during this period showing that the average range for the day was increasing. In fact, it increased from about 150 pips per day to 350 pips per day.

This is the point where we create the two different versions of the Conqueror. Conqueror I will create a stop two times the ATR away from the current close while Conqueror II will create a stop 12 times the ATR away from the current close. Let's look closer at the current situation as an example.

Let's say that we get short at 1.7400. The ATR on that day is 0.0240, or 240 pips. Conqueror I will place a protective stop loss 480 pips above the lowest close in the move. On day one, the lowest close will be the close of the entry day. Every time the market makes a new lower close, you would change the stop.

In addition, you would also change the stop as the ATR changes. We started with an ATR of 240 pips but it eventually gets up to about 350 pips in November. That means that we would start by adding 480 pips to the lowest close but could be about 700 pips wide in November!

FIGURE 4.2 British Pound with ATR Added

I like this because it widens out the stop when the market is more volatile. That is perfect.

The day after the entry bar, which is marked with the third arrow, closes slightly up. We would keep the ATR stop at the same level. However, the next day shows a drop and a lower close. We would lower the stop to 480 above the new lower close. And so on.

Conqueror II uses the same idea except the stop is 12 times the ATR, or about 2,880 pips above the lowest close. That is a significant distance from the market so few traders will be able to trade it. I mention it here because it is a profitable method but challenging for anyone but the most highly capitalized to trade. I won't mention it again in this chapter. From now on, I'll only speak of the Conqueror as being Conqueror I.

ADJUSTING THE STOP

So far we have discussed two different stop loss techniques: the initial $2,000 money management stop and the two times ATR stop. Now comes the really interesting part.

We are going to adjust the ATR stop by how many conditions are in play. Remember that we went short when all three conditions were negative. Every time a factor changes sign (positive or negative), we will reduce the size of the ATR stop by a third. Let's work through an example.

We originally put on the trade in Figure 4.2 with a 480-pip stop. (I'm going to ignore subsequent changes in the ATR in our calculations but you shouldn't in the real world.) Note that all three conditions remain negative until the downward-pointing arrow in Figure 4.3. At that point, the price closes just barely above the 10-day MA, which turns that condition positive.

We take our 480-pip stop and deduct one-third of 480. One-third of 480 is 158 pips. We subtract 158 from 480, giving us a new trailing stop of 322. The lowest close occurs a couple of days before that at 1.7029. We place our new protective stop loss 322 pips above that at 1.7351. The price on that day does not stop us out but there is a spike higher two days after the down arrow and we are stopped out for a 24-pip loss.

We would not have been stopped out if we had continued with the original stop loss. It was wide enough to protect us from getting stopped out. Here, we got stopped out with a microscopic loss.

But the market turns down the next day and the market closes below the 10-day MA so all three conditions are negative again. We get short again on the close of that day at 1.7282. The ATR is exactly 250 on that day so our first stop is 500 pips above the close at 1.7282. So we now have a stop

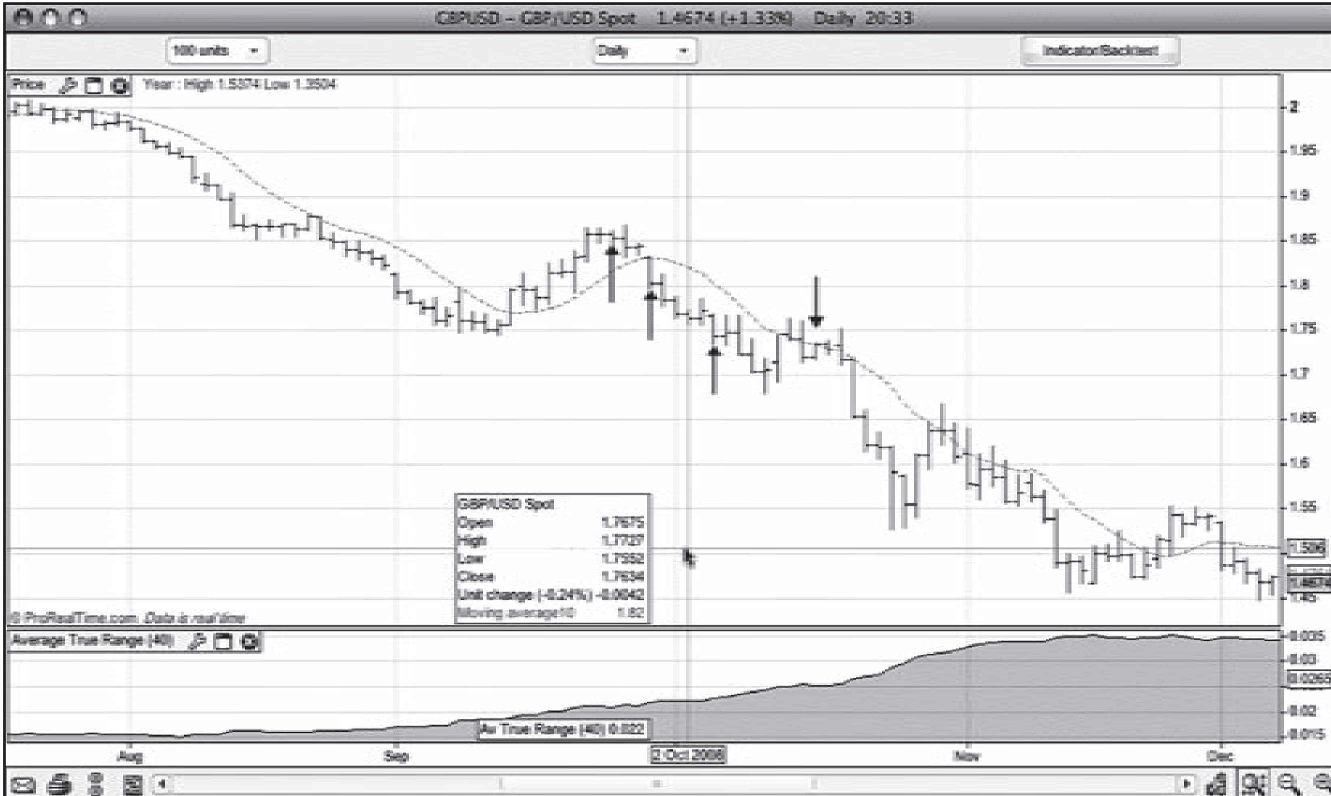

FIGURE 4.3 British Pound with Stop Adjustment Added

500 pips above the lowest close going forward until one or more of the conditions turn positive.

The market trades down to a low close four-fifths of the way through October at 1.5537. On that day, we lower the protective stop to 1.603 < 7, or 500 pips above the lowest close. We get stopped out the next day when the market moves up above 1.6057. We take a profit of over 1,200 pips.

At this point, all three conditions are still negative. That means that we could actually go short right away. However, I prefer to get a confirmation signal before reentering the short position. The best is that one of the conditions turns positive, then negative before we reenter the market. That occurs two days later when the market closes just above the 10-day MA, turning that condition positive. The market closes back below the 10-day MA the next day, turning this condition back to negative and all three conditions negative. Time to short the market again.

I won't carry the example along any further but you can see that the next trade was also profitable. One of the keys is that the Conqueror doesn't get involved in sideways markets. It sits patiently on the sidelines before getting involved. Also note that it moves the stop aggressively toward the current market price. Any significant retracement will stop out the Conqueror. It's a nervous system in that it leaps out of positions quickly when they go against the trade. It's hard to get into a Conqueror position but easy to get out.

It is also clear that the Conqueror loves a strong trend. It may get out quickly on a retracement but gets right back in if the three conditions reassert themselves. And they won't reassert themselves unless the three time frames are pointing in the same direction.

THE BOTTOM LINE

The Conqueror is a great technique that is being released to the general public in this book. This technique is based on systems designed by two of finest minds in this field, Bruce Babcock and Nelson Freeberg. That pedigree alone should make you want to try this method out.

This one-of-a-kind technique requires that a number of factors come to fruition before a long or short position is entered. At the same time, the Conqueror exits if the market hesitates just slightly. This means that the reward-to-risk ratio is superb.