

Form ADV Part 2A

Submitted to FINRA

August 26, 2013

for

www.KaufmanSignals.com

Website Documents

The website to serve as a brochure for
The company's online market reports

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KaufmanSignals.com
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TRADING PHILOSOPHY

**The more data the better
Apply consistent rules
Choose unique markets
Diversify your strategies
Equalize risk across markets
Hedge with a broader index
Use natural exits**

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How the Programs Work

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QUESTIONS & ANSWERS

**How to get started?
Can I start small?
What size positions?
What about stops?
Which Products?**

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ABOUT KAUFMAN

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There are many different ways to trade, as we all know from Mr. Kaufman's books, *Trading Systems and Methods* and *Alpha Trading*. But finding the best ideas, then taking them from a concept to a practical trading method is a long road and there are important lessons along the way.

- Be prepared for the unexpected price shock, the Black Swan.
- Diversify across trading methods and not just into sectors.
- Favor algorithmic trading to remove emotion and add stability to your returns.

No matter what you are holding, an extreme market move can produce losses such as the ones we saw in 2008. There may not be a way to eliminate those losses, but there is a way to minimize them and position you for the next big move. That's where **KaufmanSignals.com** comes in.

Taking Control. The last 30 years has been filled with opportunity and risk. But it's your money and your responsibility. You need to see that the positions in your account are aligned with the way you want to trade and the amount of risk you're willing to accept.

- If you're a trend follower watching Fed policy, then you wanted to be long interest rates through 2011 and lightly short since late 2012.
- If you're picking stocks, you want to buy when they are cheap relative to the overall market and sell when they are overbought. And, you want to protect yourself when the whole market turns down.
- If you prefer patterns, you look for divergence, where a stock, ETF, or futures product is moving higher but at a slower rate, a key place to enter a new trade.

You want to understand why there is a buy or sell signal, how risk is controlled, and why it's best to trade a certain position size.

KaufmanSignals.com provides the management tools you need. The programs offered here represent many years of developing systems that perform under different market conditions. These are trading

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Here's what you get

3 Exceptional Programs
Stocks – ETFs – Futures
Historical NAVs or P&Ls
Model Portfolios
Daily Trading Signals

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How the Programs Work

*It's Free! Just register to view the full articles on this page
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TREND

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This is a *macrotrend* program which tries to capture the long-term price trends that relate to economic policy or significant shifts in supply/demand. The concept is the basis for most of the hedge funds and managed account programs and has been a stabilizing and profitable component for the past thirty years...

Unique Features. Our trend program scales in and out of positions as the trend strengthens and changes direction. It has multiple risk controls, beginning with risk-adjusting each position. It does not enter immediately, but waits for...

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DIVERGENCE

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Divergence is a well-known concept that recognizes when two related markets are moving apart. We often see this in the major index markets, such as the S&P and NASDAQ, or in two related stocks such as Dell and Hewlett-Packard.

Our method is called *technical divergence*, and it occurs when the price moves higher but a momentum indicator moves lower, or when the opposite pattern occurs. Prices rising and momentum falling sets up uncertainty where the final price resolution can often be predicted...

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TIMING

<Document 1.16>

This strategy is based on *relative value arbitrage*, the basis for high-frequency trading and the subject of Mr. Kaufman's book, *Alpha Trading*. Using the *Stress Indicator*, the program seeks opportunities when a stock or ETF is cheap relative to its broader index.

Unique Features. Unlike typical pairs trading, which produces frequent but very small profits, this program uses the same timing method but is long-only stocks. Instead of hedging each trade with the index, it waits for a downtrend in the overall market. In that way it significantly increases the profits per share...

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*Its application as an Investment Advisor (FINRA) is pending approval.

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Here's what you get

3 Exceptional Programs
 Stocks – ETFs – Futures
 Historical NAVs or P&Ls
 Model Portfolios
 Daily Trading Signals

There are many different ways to trade, as we all know from Mr. Kaufman's books, *Trading Systems and Methods* and *Alpha Trading*. But finding the best ideas, then taking them from a concept to a practical trading method is a long road and there are important lessons along the way.

- Be prepared for the unexpected price shock, the Black Swan.
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You want to understand why there is a buy or sell signal, how risk is controlled, and why it's best to trade a certain position size.

KaufmanSignals.com provides the management tools you need. The programs offered here represent many years of developing systems that perform under different market conditions. These are trading methods that retain their uniqueness regardless of the extreme moves in the market. It doesn't mean that they can't all lose money at the same time, but it's far less likely. When a price shock hits the market these programs will continue to provide diversification; that means less risk.

Three Exceptional Trading Programs. These trading methods are robust, that is, they work equally well for individual equities, ETFs, and futures, using the same specifications. With that in mind, **KaufmanSignals.com** offers three high-performance trading strategies that are fundamentally different.

TREND, the most popular of all concepts, has a history of success over the past 30 years. Our method uses multiple risk management techniques, multiple signals, and multiple time frames to produce a superior product. It takes advantage of sustained prices moves linked to economic and government policy.

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DIVERGENCE, a short-term strategy based on the concept that when prices move higher while the momentum of prices is falling, prices direction is uncertain. This program takes a position at the point of indecision looking for a short-term profit when prices resolve themselves in a predictable way.

TIMING, with signals based on the concept of pairs trading presented in *Alpha Trading* (Wiley, 2011), but with larger returns per share than are typical of this technique. This method is long-only individual stocks and uses the S&P as a hedge when there is an expectation of an overall downturn in the market. It also has a small SPDR ETF portfolio that gives signals for sector rotation.

While these trading methods all offer diversification across markets, an investor will find that the uniqueness of the three approaches, when used together, offer far more risk control than a single strategy.

Stocks, ETFs, and Futures, with Model Portfolios. The Divergence and Trend programs are provided for about 150 popular stocks, 50 ETFs, and 50 futures markets. The Timing program applies only to stocks and ETFs. Along with individual trading signals we have simulated model portfolios for investors of different levels. Both long and short signals are given, but the model stock and ETF portfolios track only the long trades. Sample results can be found on the individual tabs on this website.

What You Get. The tools required for applying a systematic method to your trading are now available from **KaufmanSignals.com**. It takes more than working with a limited number of charts and studies to formulate a method that tells you which stock or market is likely to perform, when to enter and exit, and how much to commit. Few traders are able to devote full time to the effort, so it is important to remember that larger portfolios require equally large commitments to manage them.

We give you daily trading recommendations, and a choice of portfolios that would only be available to a professional manager, and will fit the needs for most individual investors, but we give you enough information to create your own portfolio. The updated performance tracking of the algorithmic strategies for all stocks, futures, and ETFs, are available monthly, as are the performance of the model portfolios and the historic simulated results. Register now to read "How the Programs Work".

<Sidebar>

Trading Philosophy**The more data the better****Apply consistent rules****Choose unique markets****Diversify your strategies****Equalize risk across markets****Hedge with a broader index****Use natural exits****TRADING PHILOSOPHY AND STRATEGY OVERVIEW****Understanding Systems and Markets**

Algorithmic trading systems bring the investor good returns and increased predictability. Compared to discretionary trading it is analogous to the turtle and the hare. You can't rush a system or make it do anything other than what it was intended for. Each strategy has a particular profile: trend systems have many small losses and fewer large profits, and mean reverting systems have many small profits and a few large losses. While you can alter these numbers somewhat, you cannot change the big picture, nor should you, and you cannot force a market to produce a profit on demand. It's a matter of accepting the way a system performs, and the way prices move, and working with them.

Of course, among the many trending and mean-reverting methods there are better ones. The best always have a sound premise. They are not created by scouring the computer for combinations of indicators and stop-losses. They are the results of observing the markets and understanding what makes them move.

Using trend-following as an example, we have seen that the most persistent trends are in the interest rates. That has been the result of Fed policy, effectively lowering rates over the past 25 years. Until recently many young Wall Street analysts have never seen a market where interest rates have risen. Those interest rate trends directly affect FX prices. Money flows to the countries with the highest returns net of inflation (and other political risks); therefore, lower rates create a trend towards lower currency value.

Then long-term trend following is really trying to be on the same side of the market as government policy. It is a sound premise. On the other hand, we know why there are short-term trends – changes in supply and demand, a natural disaster, seasonality – but in most cases these trends are erratic and of unknown length. They can be profitable, but they are far less consistent than long-term trends. Based on this reasoning, many hedge funds and Commodity Trading Advisors (CTAs) have adopted macro trends as a large part of their portfolio with great success.

The Research and Development Process

Having decided on a method, the next step is to develop the rules for trading and controlling risk. Some of the important steps that we follow are:

The more data the better. More data contain more patterns and a chance to see how the strategy works in many different conditions. Although some would say that the old data is no longer representative of that market, we don't believe that. The market is full of uncertainty, and a system is robust only if it can deal with bull and bear markets, price shocks, and doldrums.

Apply consistent rules across all markets. We know that markets have their own personality. Apple and Amazon are not the same as a utility or even Bank of America. Corn is not the same as crude

oil. What makes these markets similar are the investors, the way they react to news, both macro and micro. A successful trading strategy must consider the differences, such as volatility, and the similarities, such as the trend or arbitrage, but account for them in a systematic way, using a common set of simple rules and formulas that adapt each market. The alternative is to have very specific rules for every situation and every market. Using the same rules is a robust solution. Using different rules tends to overfit the data and has little predictive value. We subscribe to the approach that “loose pants fit everyone.”

Control the risk. Risk management is equally as important as a sound premise and a good strategy. Traders that focus their resources on a single market may reap huge returns -- or huge losses. Concentration of capital increases risk. One aspect of risk control is *diversification*. Proper diversification should include:

- Markets that are unique from one another
- Multiple strategies that are unique in the way they see price movement
- Equalizing risk across markets, sectors, and strategies

There is also *individual trade risk*. Use a strategy that takes you out of the market rather than a stop. Some traders limit risk using a stop-loss order; however, it is better to have a “natural” stop that conforms to the rules of the strategy. It is also possible to control risk by varying leverage, most common for portfolios of futures markets.

Finally, there is *portfolio risk*. We rightfully expect that daily portfolio returns will be less volatile than individual stock or futures market risk; however, that doesn’t mean that the risk won’t be large during periods of stress. For futures, a method called “volatility stabilization” alters the leverage to attempt to keep daily volatility near a target level, often about 14%. Because stocks are not normally leveraged, portfolio risk is a combination of:

- Trading equal value of each stock
- Hedging with a broader index when necessary
- Diversifying into unique strategies
- Using a stop-loss when there is no “natural” system exit

Specific risk controls are discussed in more detail in the description of the individual strategies. For more detail and an in-depth discussion of risk, see Chapters 23 and 24 of *Trading Systems and Methods, Fifth Edition* (Wiley, 2013).

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<sidebar>

QUESTIONS**How do I get started?****Can I start small?****What size positions?****What about stops?****Which products?****QUESTIONS AND ANSWERS**

How do I get started? You'll need to have a brokerage account or retirement account where you can place orders. If you are trading in a retirement account, remember that you cannot take short positions. And, when you hedge your positions in the *Stock Timing* program, you can use the ETF SH (the inverse SPY) or SDS (the double-leveraged inverse SPY), so that instead of selling short SPY, you'll be buying $\frac{1}{2}$ the position in SDS.

Each morning you'll get a link to the trading signals for the subscribed programs. Trading signals are generated based on the previous closing prices but are executed the following morning when the markets open. We suggest that you use a *price-limit order* because the opening range can be quite large. With a small amount of practice, you should be able to beat the previous closing price and improve your results. You'll only need to trade once each day, and not at all if the positions in the portfolio don't change.

On the first day, we recommend getting into all the stocks in the portfolio you choose. We can't know if this is a good or bad time to enter, but overall the programs are more likely to be successful on any one day. You may prefer to enter only new trades, and build to a full portfolio.

You may choose to trade specific stocks. One of the links will give you the trading signals on all the stocks that we follow, so you can create your own portfolio for the program you choose. The position size will always be based on a \$5000 investment, so dividing or multiplying all positions sizes by the same value will keep the risk the same.

Can I start small? It's always best to start small. It will help you get used to the way signals are generated, how to enter the orders, and the size of the profits and losses. Because the stock market allows you to trade any size position, you can change the nominal investment size for each stock from the current \$5000 to as low as \$500.

You can start with the *Sector Rotation* portfolio, which trades only 5 SPDR ETFs, the most liquid of the ETFs. Each morning there will be trading signals with positions based on \$5000 for each ETF. We should point out that commission costs of, for example, \$7.95, will have a larger impact on a smaller position size, but you still have the comfort of getting used to the program with little risk.

The next level up would be trading a portfolio of 10 stocks using the *Timing* program. That offers more diversification into individual equities and recommends hedging with the SPY or SDS when the overall market turns down. Or, you can trade the 10-stock portfolio in the *Divergence* program, which is also short-term. Both programs assume trading the long side only, although the Divergence program shows the short sale trades. In both cases, position sizing is based on \$5000 per stock, so you can change that to your investment size.

When trading futures, the dollar value of our portfolios are higher. You may divide the number of contracts in any sample portfolio to accommodate a smaller account. Keep in mind that when trading

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futures we prefer to commit no more than one-fourth of our capital to initial margin with the remaining capital to cover variation margin and to keep the performance risk to about 14% annualized. That means you have a 16% chance of losing more than 14% in any one year. By taking positions of $\frac{1}{2}$ the size you reduce that risk (and potential returns) by $\frac{1}{2}$. If you are not an experienced futures trader it would be prudent just to begin by trading one contract in one market from each of the major sectors, interest rates, equity index, currencies, energy, and metals.

How do you decide the position size?

For stocks, we simply divide a fixed amount, usually \$5000, by the stock price to determine the position size. A better way would be to divide the \$5000 by the 20-day stock volatility as we do in futures, so that each stock has the same risk. We would always have smaller positions in the more volatile stocks and most often we wouldn't be using all the investment that is available. That means the returns will be smaller. We've decided that higher returns are more desirable. Because higher prices stocks are generally more volatile than lower prices stocks, we still get some degree of risk equalization and good diversification.

For futures markets, which allow a high degree of leverage, we volatility-adjust the position sizes, so that every trade is expected to have equal risk. We then risk-adjust at the sector level and finally target a specific level of risk for the recommended portfolios. This multi-level process is intended to maximize diversification and minimize risk.

What about stops? Stops are important for many different strategies, but for some methods they fight with the underlying concept. For example, in our *Timing* and *Sector Rotation* programs, we use a "crisis" stop based on a drop in value from our entry. However, we use natural stops in the *Trend* program because a reversal in the trend is the best way to take us out of the market.

Long-term trends need to capture profits from extremely long price moves, called the *fat tail*, to succeed over time. If you get stopped out while the trend is still intact, then you can miss the biggest profits and severely reduce your chance of success. If you get out on a stop then you need a way to reenter if you're wrong. Our experience and research show that getting in and out of a trade is rarely as good as just staying in until the trend changes.

Most programs use a natural stop. For example, the *Divergence* program enters at a turning point in prices, when the direction of the price move conflicts with its momentum. If we are right or wrong about the position, the price and momentum will move in the same direction within a few days and the program will exit. The exit is consistent with the underlying strategy and we have not found that setting a stop loss can improve results.

How are stocks picked for the portfolios? We track about 150 stocks and 50 ETFs for the *Timing* and *Divergence* programs. From those we select 10, 20, or 40 stocks for the sample portfolios, with the expectation that these choices will outperform the market as a combination of return and risk.

Our selection process looks at recent performance and activity. We want stocks that are active so that we don't add a stock that has no position. We also want stocks that have higher than average returns or more volatility, which is another indication of activity. Don't forget that we will divide the investment of \$1000 by the stock price to try to equalize the risk. Simply by avoiding those stocks that are quiet we can select a portfolio that is expected to outperform the overall market, which is an average of active and inactive stocks.

For futures markets we trade preset portfolios. These choices span all sectors: interest rates, currencies, and equity index, for financial portfolios, and also energy, metals, and agricultural products

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for fully-diversified portfolios. The financial portfolio will include the most active world markets. For futures it is most important to have diversified positions in all sectors, rather than allowing concentration in one sector, which could happen if, for example, crude oil started to climb to \$200/barrel.

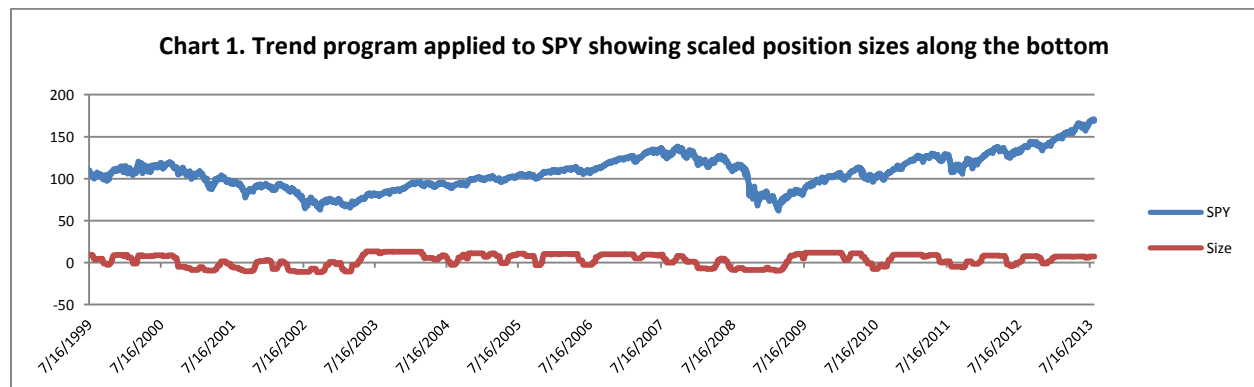
TREND is a *macrotrend* program, which tries to capture the long-term price trends that relate to economic policy, or structural shifts in supply/demand. The concept is the basis for most of the hedge funds and managed account programs and has been a stabilizing and profitable component for consistency.

Recently, macrotrend strategies have smaller than average returns and have fallen out of favor with some investors. Yet, in 2008, those programs returned from 20% to 70%, offsetting the losses in equities and other assets caused by the subprime crisis. For a long-only stock application, the program exited nearly all long positions, avoiding the worst of the losses, then reentered when the uptrend resumed, moving to new performance highs in the following years. Macrotrend programs are most valuable when stocks are in a bear market, and they are always an important guideline for other trading, which benefits from knowing both the direction and the strength of the trend.

A Unique Feature of our macrotrend program is that it scales in and out of positions as the trend increases in strength and changes direction. Other features are:

- All positions are risk adjusted (also called *risk parity*) for increased diversification
- Multiple trends are used based on a range of non-linear calculation periods to avoid a program that is biased toward faster or slower choices.
- Entries require a price reversal, which avoids chasing the market, clustering with other macrotrend orders, improving results.

Chart 1 is an example of the varying position size of the Trend program applied to SPY. Note that the position size is above zero during an uptrend and below during a downtrend, yet it quickly turns from down to up in 2002 when the new bull market begins.



Risk-Adjusted Positions and long-term trends are best suited for futures markets, which span a wide range of products. In order to create a stable portfolio, it is necessary to equalize the risk of each sector before combining them in the designated weights. The energy markets have had periods of very high volatility compared to recent price movement in interest rates. Trading equal dollar amounts, or an equal number of contracts in each group, would put far greater risk in energy and overwhelm any gains from interest rates.

Applied to Equities and ETFs, because futures markets have low margin and high leverage, allow for varying that leverage to equalize risk and stabilize returns. However, that is not possible for most investors in equities. There is some ability to duplicate the diversification of futures using ETFs, such as GLD (physical gold) and TBT (20-year bonds), but that still doesn't allow for investors to change the leverage. For equities there is less diversification because many stocks are highly correlated to one another, more so because of arbitrage to the major indexes, such as S&P futures or SPY (SPDRs). When the average of actual stock prices fall below the index by enough to be profitable, professional trades will

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buy all stocks in the S&P and sell the index to capture the arbitrage. This increases the similarity of price movement.

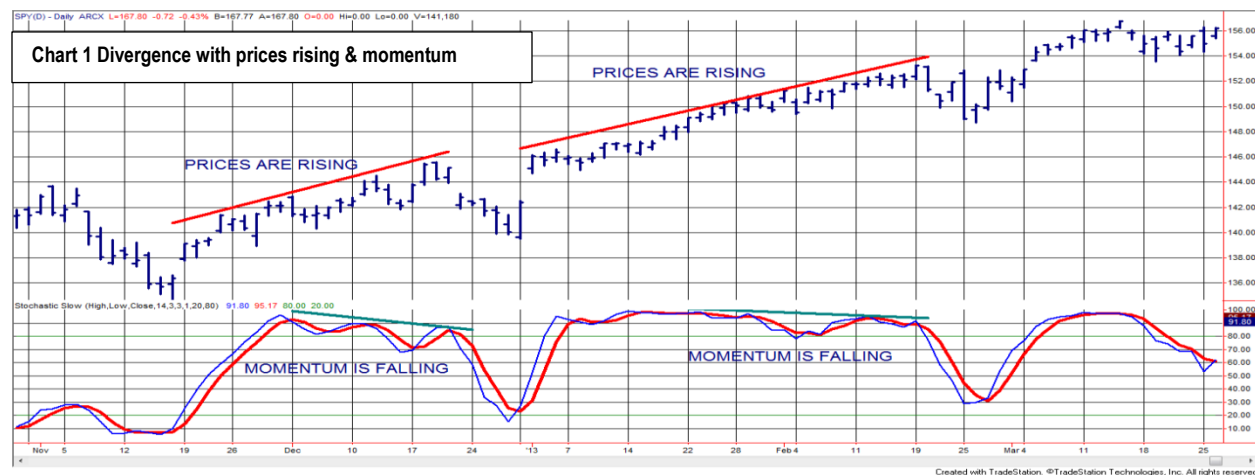
Portfolios vary considerably when using futures or stocks. For stocks and ETFs, the stocks are selected in much the same way as the *Timing* and *Divergence* programs, favoring those with long-term success and short-term volatility. Portfolios of 10, 20, and 40 stocks are given.

Futures portfolios are all fixed, that is, the markets to be traded, and their percentage allocation in the portfolio, are determined in advance. That assures diversification and stability. If selected by short-term performance, a portfolio might only have interest rates one year, equity index the next, and crude oil in another. Narrowing the holdings greatly increases the risk.

Fixed portfolios in futures allow us to accommodate specific investment sizes and set a *target volatility*. The target volatility, nominally 14%, is used as a guideline for stabilizing returns. When the portfolio shows sustained volatility below 14%, position sizes are increased; when it is above 14%, sizes are decreased. The advantage comes mostly in the low volatility periods, which are most frequent, although reducing size in markets with extreme volatility effectively reduces risk and may take profits off the table. A specific portfolio, say \$100,000, can be scaled up or down simply by multiplying all positions by the same factor; however, scaling down may eliminate some smaller positions and alter the results.

DIVERGENCE is a well-known concept that recognizes when two related markets are moving away from each other. We often see this in the major index markets, the S&P and NASDAQ, or in two related stocks such as Dell and Hewlett-Packard.

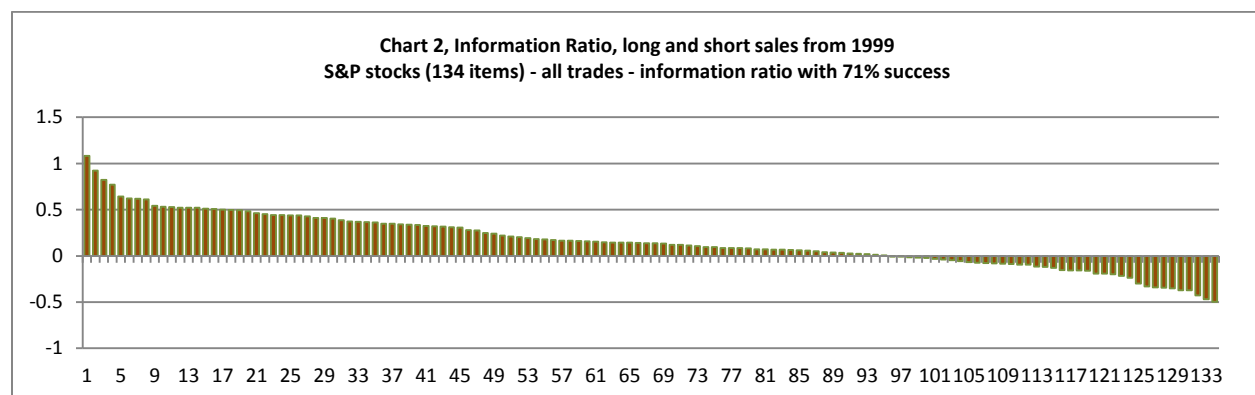
Our method is called *technical divergence*, and it occurs when the price moves higher but a momentum indicator moves lower, or when the opposite pattern happens. "Momentum falling" really means that prices are moving higher at a slower rate, a situation that most often predicts change. Chart 1 gives two examples of *stochastic divergence*, both with prices rising and momentum falling. In both cases this pattern is followed by a drop in prices, then a continuation of the trend. Our Divergence strategy will trade the reaction following the divergence pattern.

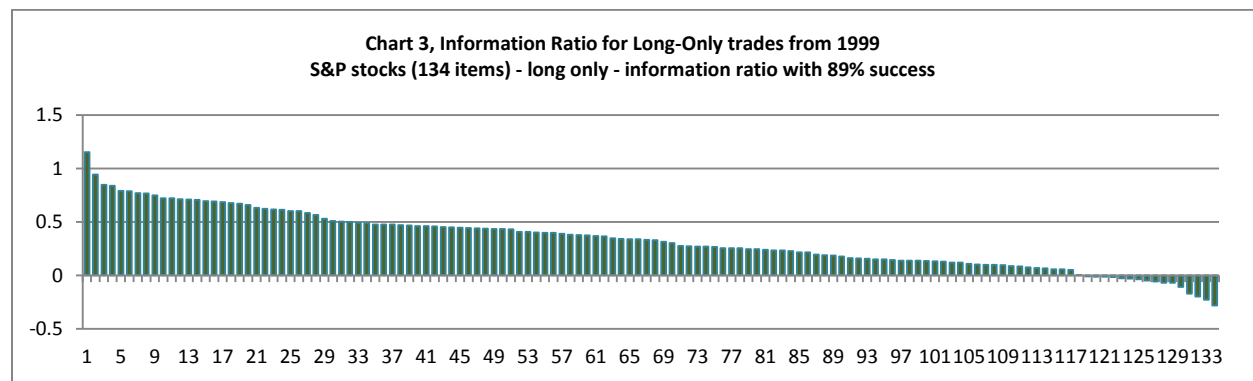


Performance Characteristics

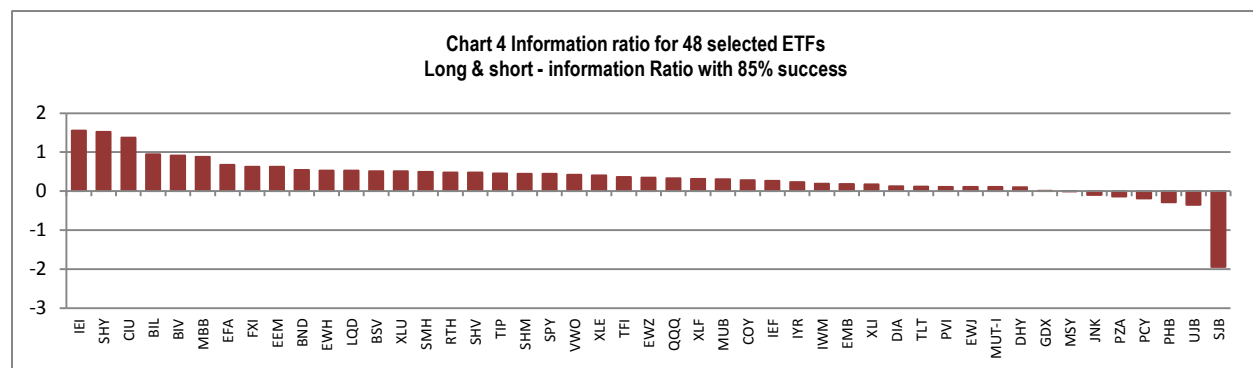
- This is a short-term strategy, holding a position for an average of 5 to 8 days.
- It has a low correlation to trend-following because it is taking positions either opposite to the direction of the trend, or at a time when prices are moving.
- It has a high likelihood of success on individual trades.
- Profits per trade are smaller than trend-following because trades are held for less time.

Performance of Individual Stocks We use the *information ratio* (annualized rate of return divided by annualized standard deviation) to show which stocks, ETFs, or futures markets have the best return for the risk taken. A higher value shows more return for risk. Chart 2 shows the ratio for the historic simulated performance of 134 stocks selected based on a combination of high liquidity and above average volatility. The actual daily signals are posted for about 150 stocks, including those of particular interest in the current market but with lower capitalization. We add and remove stocks as market activity warrants.

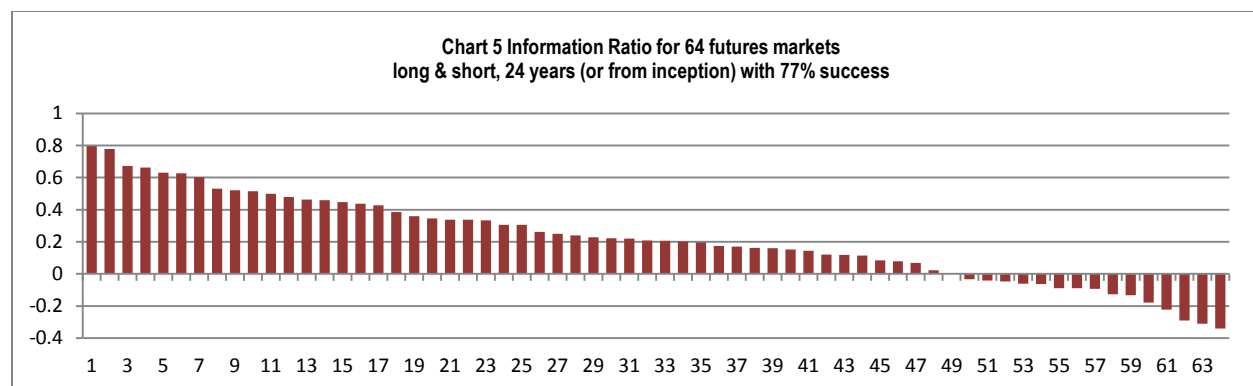


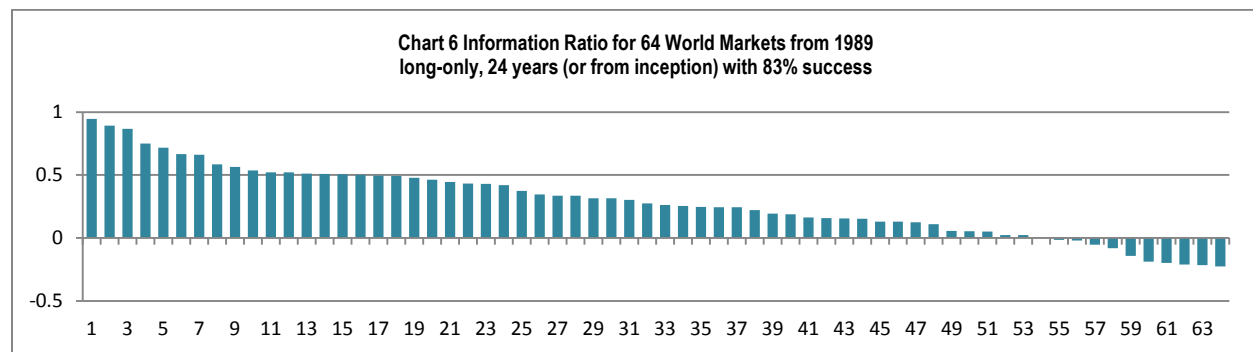


ETFs We recognize the importance of ETFs and provide Divergence trading signals on the most popular and liquid. Because many are a composite of stocks, the price patterns tend to be smoother and the trading results somewhat different although equally as reliable as individual stocks. ETFs offer greater diversification than individual stocks, which can move together or reverse together, during times of stress. An ETF can reflect the price of either physical gold or gold shares, with two very different performance characteristics. Chart 4 shows the information ratio, based on our simulations, for 48 selected ETFs going back 14 years or from inception of trading. Symbols are along the bottom.



Futures Markets Futures are the venue of professional traders because of the high cost and high leverage. They offer access to all aspects of the economy, from interest rates to grain, and include markets throughout the world. Charts 5 and 6 show the simulated results of the Divergence program on 64 of the world's most liquid futures markets, including most of the U.S. and European contracts.





Selecting What to Trade Few investors trade all markets, in stocks, ETFs, or futures, nor would they want to. But which ones do you choose and how many? There is an important trade-off when making this decision:

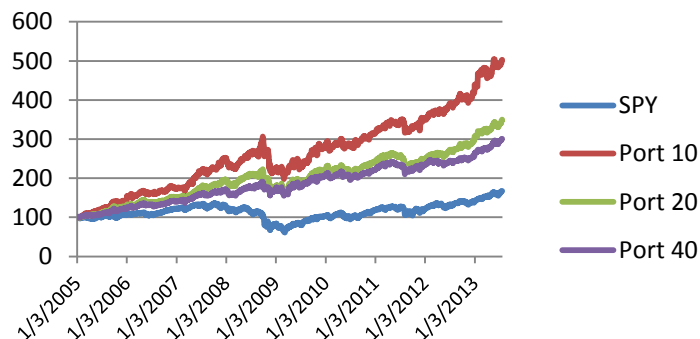
- *Trading more products gives more stable, less volatile performance, but lower returns.*
- *Trading fewer products increases volatility but gives the opportunity for higher returns.*

That is, if you select the best performing stocks, you would have far better returns than the average of all stocks. Kaufman Signals has developed a selection method that has consistently beat the average and reduces risk well below that seen in a broad market, such as the S&P; however, along with the greater chance of higher returns, trading only a few stocks will always have unseen risks.

Portfolios Based on the Number of Stocks Traded *KaufmanSignals.com* assumes an investment of \$5000 in each stock; however, this can be scaled up or down to meet your needs. Position size is simply the investment divided by the share price. Then Bank of America (BAC), now trading at \$14.50, would have a position of 344 shares while Apple (AAPL) at \$435 would only have 11 shares. In this way we trade equal exposure (although not always equal risk) in stock. This goes a long way towards stabilizing the portfolio.

Model portfolios are based on trading 10, 20, or 40 out of the total stocks followed. Then a portfolio of 10 stocks would require an investment of \$50,000 (10 stocks times \$5000 each), and a portfolio of 30 stocks would need \$150,000. You can always choose to trade a portfolio of 10 stocks with \$25,000 by dividing all positions by 2; however, commission costs have a greater effect as the value of your position gets smaller. We also recommend never trading a position larger than 3% of the stock's average daily volume, a number provided by the daily signals. Looking at Chart 7, we can see the trade-off between portfolios of fewer and more stocks. The portfolio of 10 stocks outperforms all others, but has a larger drawdown in 2008. The larger portfolio of 40 stocks is much smoother but returns only 2/3 of the 10-stock portfolio. The SPY (S&P SPDRS ETF) lags along the bottom.

Chart 7. NAV comparison of 10, 20, and 40 stock portfolios with SPY



Risk Return Comparison	SPY	Model Portfolio Table 1		
		10	20	40
AROR	6.2%	20.8%	15.8%	13.8%
Volatility	21.6%	17.0%	14.4%	12.6%
Ratio	0.287	1.223	1.098	1.093

Table 1 gives the supporting numbers. In the simulated results from January 2005 through July 2013, SPY returned 6.2% annualized with an annualized volatility of 21.6%. That means it had a 16% chance of losing more than 21.6% in any one year. The *KaufmanSignals.com* portfolio of 10, the best performer, shows annualized returns of 20.8% and a comparable risk of 17.0% for an information ratio of 1.22. Note that, as the number of stocks in the portfolio increases, both the returns and risk decline; however, all simulated portfolios show a far better result than a passive investment in the S&P.

Model Portfolio of 10 Stocks During the first part of July, 2013, a portfolio of 10 stocks would have had the allocations shown in Table 2. Positions are assumed to be entered on the open of the day following a new signal, and closed out on the open following an exit signal. The NAV, daily returns, and current exposure are shown in columns 2, 3, and 4.

TABLE 2 A Model Portfolio with 10 Stocks													
Date	NAV	Return	Exp	SBL 1	SBL 2	SBL 3	SBL 4	SBL 5	SBL 6	SBL 7	SBL 8	SBL 9	SBL 10
7/1/2013	487.482	0.210%	4715	GMCR	AET	HYMTF	MS	INTC	MU	SCHW	WAG	AMAT	KEY
7/2/2013	487.822	0.070%	3752	GMCR	AET	HYMTF	MS	INTC	MU	SCHW	WAG	AMAT	KEY
7/3/2013	487.733	-0.020%	3833	GMCR	AET	HYMTF	MS	INTC	MU	SCHW	WAG	AMAT	KEY
7/5/2013	492.740	1.030%	4842	GMCR	AET	HYMTF	MS	MU	SCHW	WAG	AMAT	KEY	SBUX
7/8/2013	493.101	0.070%	5989	GMCR	AET	HYMTF	MS	MU	SCHW	WAG	AMAT	KEY	SBUX
7/9/2013	490.929	-0.440%	4806	GMCR	AET	HYMTF	MS	MU	SCHW	WAG	KEY	SBUX	DAL
7/10/2013	489.096	-0.370%	4939	GMCR	AET	HYMTF	MS	MU	SCHW	KEY	SBUX	DAL	HUM
7/11/2013	490.455	0.280%	1857	GMCR	AET	HYMTF	MS	MU	SCHW	KEY	SBUX	DAL	HUM
7/12/2013	494.187	0.760%	4810	GMCR	AET	HYMTF	MS	MU	SCHW	KEY	SBUX	DAL	HUM
7/15/2013	496.657	0.500%	5915	AET	HYMTF	MS	MU	SCHW	KEY	SBUX	DAL	HUM	WFC
7/16/2013	494.540	-0.430%	4934	AET	HYMTF	MS	MU	SCHW	KEY	SBUX	DAL	HUM	WFC
7/17/2013	494.785	0.050%	4847	AET	HYMTF	MS	MU	SCHW	KEY	SBUX	DAL	HUM	WFC
7/18/2013	500.617	1.180%	5794	AET	HYMTF	MS	MU	SCHW	KEY	SBUX	DAL	HUM	WFC
7/19/2013	502.030	0.280%	6871	AET	HYMTF	MS	MU	SCHW	KEY	SBUX	DAL	HUM	WFC
7/22/2013	503.307	0.250%	5938	AET	HYMTF	MS	MU	SCHW	KEY	SBUX	DAL	HUM	WFC
7/23/2013	501.075	-0.440%	2958	AET	HYMTF	MS	MU	SCHW	KEY	SBUX	DAL	HUM	WFC

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Sample Report Each morning, *KaufmanSignals.com* will deliver a link to the daily signals. Table 3 shows an example of the “All Signals” Divergence report for the Stocks and ETFs.

Table 3 Sample Divergence report for stocks													
Market	SBL	L/S Ratio	Long Ratio	Trend Strength	Closing Price	Action	Entry Date	Entry Price	Qty	Qty Chg	Trade PL	Exposure	Today PL
Dow	DJIAA-I	0.778	0.243	64	15542.24			0	0	0	0	0	0
Nasdaq	NDX-I	0.442	0.33	18	3041.16	Long	7/19/2013	0	32	0	557.44	97317	931
Russell	RUT-I	0.693	0.635	45	1043.83	Buy	On Open	0	95	0	0	0	0
VIX	VIX-I	-0.211	-0.161	50	13.18			0	0	0	0	0	0
ETFs													
Dow	DIA	0.453	0.345	68	155.10			0	0	0	0	0	0
Emerging	EEM	-0.126	0.069	77	39.69	Exited Long		0	0	-1615	80.75	0	0
Gold	GLD	0.234	0.294	82	127.48	Buy	On Open	0	487	0	0	0	0
High-Yield	HYG	-0.429	0.071	59	92.95	Buy	On Open	0	1075	0	0	0	0
Russell	IWM	0.248	0.18	45	103.59	Buy	On Open	0	965	0	0	0	0
Real	IYR	-0.05	0.019	55	68.04	Buy	On Open	0	1193	0	0	0	0
Nasdaq	QQQ	0.555	0.455	18	74.50	Long	7/19/2013	0	1326	0	358.02	98787	968
Silver	SLV	-0.015	-0.128	95	19.47			0	0	0	0	0	0
SPDRs	SPY	0.592	0.417	55	168.52	Buy	On Open	0	593	0	0	0	0
Material	XLB	0.034	0.137	73	40.26	New Short	7/24/2013	0	2369	2369	0	95376	-1303
Energy	XLE	0.57	0.315	59	82.66			0	0	0	0	0	0
Financials	XLF	0.791	0.693	50	20.64	Buy	On Open	0	4844	0	0	0	0
Utilities	XLU	0.188	0.44	50	38.85	Buy	On Open	0	2159	0	0	0	0
Retail	XRT	0.898	0.595	18	80.35	Long	7/17/2013	0	1137	0	159.18	91358	478
STOCKS													
Amazon	AMZN	1.093	1.281	23	298.94	Long	7/19/2013	0	186	0	-254.82	55603	365
Apply	AAPL	0.586	0.567	59	440.51	Buy	On Open	0	119	0	0	0	0
Barrick Gold	ABX	0.277	0.307	95	17.17			0	0	0	0	0	0
AmerInt Gp	AIG	0.037	0.134	27	45.96	Buy	On Open	0	1264	0	0	0	0
Boeing	BA	0.919	0.921	77	106.95	Buy	On Open	0	341	0	0	0	0
Boeing	BA	0.919	0.921	77	106.95	Buy	On Open	0	341	0	0	0	0
BIDU	BIDU	-0.091	-0.137	86	113.37	New Short	7/24/2013	0	275	275	0	31177	993
Citibank	C	0.429	0.438	59	52.19	Buy	On Open	0	1127	0	0	0	0
Cisco	CSCO	0.605	1.048	18	25.59	Long	7/19/2013	0	2469	0	-49.38	63182	691
EBAY	EBAY	-0.356	-0.167	0	52.10	Long	7/19/2013	0	783	0	-1675.62	40794	-23
Ford	F	0.596	0.65	64	17.37	New Short	7/24/2013	0	3472	3472	0	60309	-382
Facebook	FB	0	0.65	45	26.51	Exit Long	On Open	0	1736	0	-746.48	46021	330
Green Mountain	GMCR	0.501	1.038	100	74.56			0	0	0	0	0	0

Explanation of Columns	
Market	Name of the stock
SBL	Stock symbol
L/S Ratio	The information ratio, a measure of performance, for all long and short sales
Long Ratio	The information ratio for long-only trades
Trend strength	An indication of the strength of the trend, where 100 is the strongest and zero the weakest.
Closing Price	The most recent closing price
Action	Trade signal, note that on the day after a new position is entered, the action will state <i>New Long</i> or <i>New Short</i> position in the portfolio table.uy (enter new long) <ul style="list-style-type: none"> Buy (enter new long) Sell (exit existing long) Sell Short (enter new short) Buy to Cover (exit a short sale)
Entry Date	The date of the entry or the addition action <i>On Open</i> , indicating, for example, <i>Buy On Open</i>
Quantity	The number of shares to buy or sell
Quantity Change	The change in the number of shares from yesterday's position
Trade PL	The profit or loss in the current trade
Exposure	The total value of the open position, equal to the number of shares times the price
Today PL	The profit or loss on the current position as of the previous closing

SELECT TIMING AND SECTOR ROTATION is a strategy based on pairs trading logic, also called *relative value arbitrage*, as written in Mr. Kaufman's book, *Alpha Trading* (Wiley, 2010). Opportunities in pairs are based on identifying when two related stocks are moving apart, and enter and exit at extreme divergence using the *Stress Indicator*. A position is then taken expecting the two stock prices to move back together. It is a high-probability strategy because similar stocks, such as airlines, home builders, or health care providers, all share common customers who respond to the same economic conditions. Typically one stock moves first and the others catch up soon after.

This strategy can also be applied to sector ETFs, which can be compared to the major market index, the S&P. Those ETFs that lag the index have a tendency to catch up. If we look as a small set of SPDR ETFs, we can create a strategy similar to *sector rotation*. More information on this can be found at the end of this section.

Unique Features of the KaufmanSignals.com Timing Program bring to our attention a number of issues that make pairs trading difficult for most investors.

- The large number of stocks that have to be scanned looking for opportunities.
- The need to sell short one stock against another. Short sales may not be possible in every stock. They require "borrowing" the stock and paying the dividend as well as interest on the cost of the stock, reducing the potential gain.
- The arbitrage between two similar stocks yields frequent but often small profits.

To avoid these issues and make the strategy more profitable, our *Timing* program:

1. Only buys the undervalued stock when a pairs signal occurs. It does not sell any stock short.
2. Measures all stock signals against the S&P, rather than another stock, which opens up a much broader set of opportunities.
3. Hedges a percentage of the risk of all positions when the trend of the S&P is down. This trend is assessed over multiple time periods, and entered in phases, to make the process smoother.
4. May hedge by shorting the SPY or buying SDS (the inverted, double-leveraged SPY) for trading in accounts with short-sale restrictions.

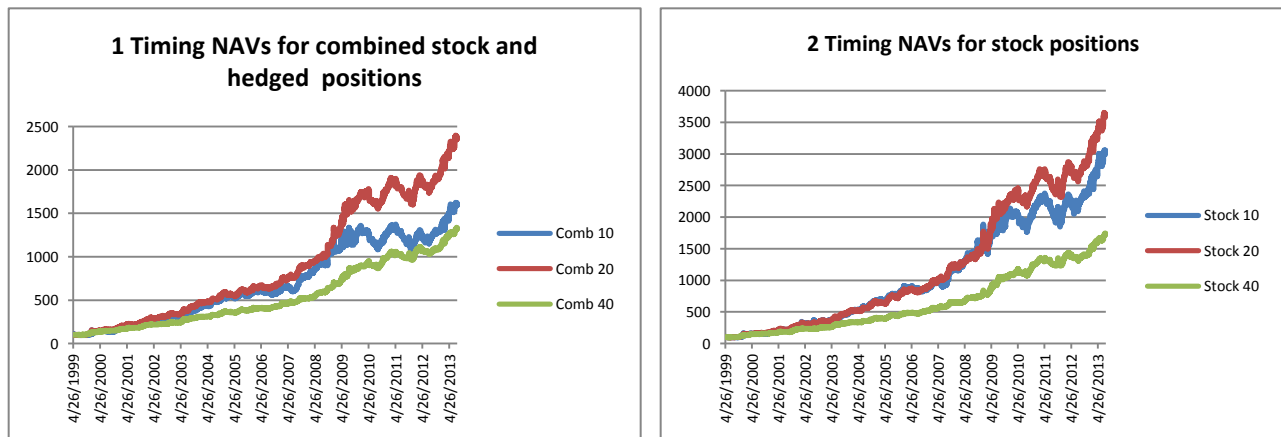
Simple Portfolios show that even with these simplified rules there are about 150 stocks from which buy signals might be generated on any one day. Choosing which to trade is always difficult. To make that easier, we provide a choice of portfolios based on 10, 20, and 40 stocks, each stock position having an initial value of \$5000, which can be scaled up or down. These portfolios have historically outperformed the market. You will see in Table 1 that the smaller portfolio has high returns but the highest risk.

Stock selection is based on two criteria, (1) the stock must have a trading signal, and (2) it must have higher volatility than the average stock. By eliminating those stocks that have low volatility, and therefore low returns, we greatly increase our expectation of higher returns. Because these trades typically last for only 5 to 8 days, and must satisfy strict entry criteria, there may not always be enough trades to fill the portfolio. On average, a portfolio will be filled to about 75% of its capacity. Then an account size of \$50,000 will, on average, hold positions worth \$37,500.

The table shows the returns, risk, and performance ratios of *Timing* portfolios of 10, 20, and 40 stocks.

Table 1	Stock			Stock & Hedge		
	10	20	40	10	20	40
AROR	26.8%	28.5%	22.1%	21.5%	24.8%	19.9%
Risk	22.9%	17.1%	11.4%	19.2%	14.3%	9.6%
Ratios	1.17	1.67	1.94	1.12	1.74	2.07
%Filled	72	65	48	72	65	48

Charts 1 and 2 show sample portfolios of 10, 20, and 40 stocks, each allocated \$5,000, with ("Combined") and without ("Stock only") the hedged position. Simulated trades go back to April, 1999 where possible.



Note that, as the size of the portfolio increases, the returns (AROR) decrease but the ratio increases, showing that more stocks generate smoother returns. The "%Filled" row shows the average percentage investment used by the portfolio.

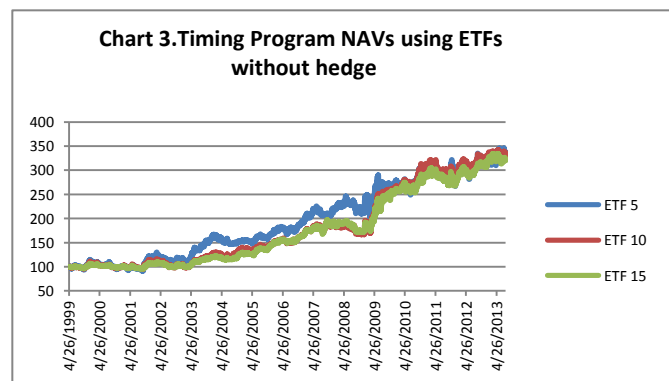
You can then choose which portfolio you prefer, for example 20 stocks with a nominal investment of \$100,000. You can also reduce that size by trading \$1000 per stock, but then commission costs will have a greater impact on your returns. We have used a charge of \$8 per trade, a lower fee will significantly improve the returns. We have found that it's best to commit \$5,000 to each stock.

Signals for all stocks are provided daily as are signals for each portfolio. Orders are expected to be executed on the following open, and we strongly recommend using limit orders. The opening range for any stock can be quite wide. Without using limit orders you will often get a disappointing price. You will also note that opening prices for most data providers may be different. Some use the average of the first minute of trading, and others use the first trade. Our performance record will vary from yours on specific trades, either better or worse, but should even out over time.

ETFs and Sector Rotation

Many ETFs are actively traded and we have chosen about 50 to track daily. Portfolios are available for 5, 10, and 15 ETFs using the same method just described. Simulated performance is shown in Table 3 and Chart 3 (without the hedge). Results are lower than portfolios of individual stocks because ETFs are an index; therefore, they have less volatility than many stocks.

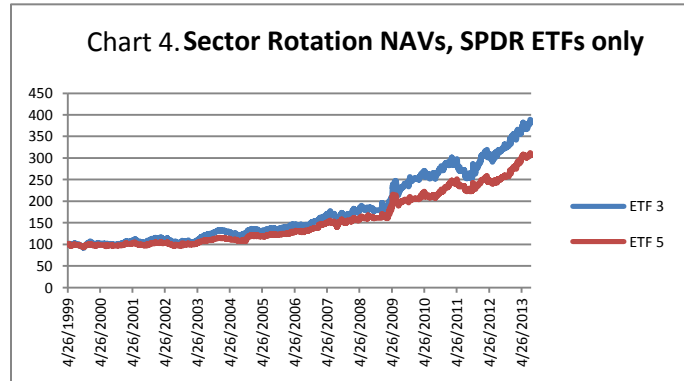
Table 3	ETFs Not Hedged			ETFs Hedged		
	5	10	15	5	10	15
AROR	8.77%	8.80%	8.52%	4.68%	6.18%	6.43%
Risk	15.90%	13.00%	11.25%	13.05%	10.69%	9.36%
Ratios	0.552	0.676	0.758	0.359	0.579	0.687
%Filled	75	67	58	75	67	58



Among the most liquid ETFs are *sector SPDRs*. By applying the same *Timing* strategy and portfolio selection to these ETFs, we create a portfolio of 5 that replicates what we would call *sector rotation*. It is another way of seeking diversification. Expected results are somewhat better than the larger set of ETFs because all of these ETFs correlate positively with the major index, SPY. In addition, fewer portfolio items means a smaller investment is possible.

Table 4

	ETF		Combo	
	3	5	3	5
AROR	9.73%	8.08%	7.58%	6.53%
Risk	12.85%	9.68%	10.81%	8.26%
Ratios	0.757	0.835	0.701	0.791
%Filled	62	44	62	44



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The Company

KaufmanSignals.com provides fully systematic strategies, on a subscription basis, for institutions and individual investors. These algorithmic methods are applied to stocks, ETFs, and exchange-traded futures.

Perry J Kaufman

The company President, Perry Kaufman, writes extensively on markets and strategies, and has 40 years of trading experience. His seminal book, *Trading Systems and Methods*, in its fifth edition, has been called “remarkably insightful - the most authoritative and comprehensive work in the industry; it puts the process of research and development into a cohesive framework.” His books have been translated into Chinese, Russian, Italian, Spanish, and Japanese, and he continues to lecture to economic forums, investor groups, and graduate students.

Mr. Kaufman began his career as a “rocket scientist,” first working on the Orbiting Astronomical Observatory (OAO-1), the predecessor of the Hubble Observatory, and then on the navigation for Gemini, later used for Apollo missions, and subsequently in military reconnaissance. In 1971 he became involved in the futures markets and has remained there. The earliest systematic programs used exponential smoothing and moving average trends, a technique developed in Aerospace for estimating the path of missiles.

For the balance of the 1970s, Mr. Kaufman was a partner in an Illinois agribusiness company, developing and marketing commercial hedging services. Throughout the 1980s he headed systematic trading for Transworld Oil, Limited (Bermuda), at that time it was the largest proprietary account in futures markets in the world. In the 1990s, he was a principal and Head of Research for Drapeau Advisors, a U.S. CTA focused on short-term trading. After accumulating a nearly 3.0 information ratio in 1998, the company was sold to ED&F Man to become Man-Drapeau Research, Pte (Singapore). Since 2000, Mr. Kaufman’s has served clients such as Cinergy’s proprietary trading group, Graham Capital Management, and Mizuho’s Alternative Investments.

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PERRY J KAUFMAN

International Financial Markets and Risk
Author & Speaker



Perry Kaufman is a world recognized expert in the financial markets industry. For more than 40 years he has written extensively on financial markets and strategies. He is a welcome and entertaining speaker at economic forums at home, and in Asia and Europe.

A prolific writer, his seminal book, *Trading Systems and Methods*, in its fifth edition, has been called “remarkably insightful – the most authoritative and comprehensive work in the industry; it puts the process of research and development into a cohesive frame work.” His books have been translated into Chinese, Russian, Italian, Spanish, and Japanese. He is realistic and clear on today’s business environment.

As a “rocket scientist,” he was an early participant in the space program. He first worked on the Orbiting Astronomical Observatory (OAO-1), the predecessor of the Hubble Observatory, and subsequently on the navigation for Gemini, later used for Apollo missions.

Perry transferred his skills to the agricultural markets of the ‘70s with one of the earliest systematic trading programs, applying techniques developed in Aerospace for estimating the path of missiles. His approach was then applied to the fast moving interest rate, currency, and energy markets as he managed one of the largest proprietary trading accounts in the world.

Kaufman’s books, published by Wiley, are available at popular bookshops and online.

- **KaufmanSignals.com** is a subscription service available to institutions and individuals.
- **Trading Systems and Methods, Fifth Edition**, a comprehensive discussion of the practical application of systems and realistic risk control parameters and limitations.
- **Alpha Trading** addresses algorithmic programs and systematic risk using pairs, or spread trading, which for years has been the basis of his practical market applications.
- **A Short course in Technical Trading** was developed as a primer for graduate students at Baruch University in New York, where Perry enjoyed their enthusiasm and energy.

Perry Kaufman lives in Connecticut. He accepts speaking engagements worldwide. Contact him by email, KaufmanSignals@gmail.com.

