Some years ago, my wife and I owned a vacation cottage situated on the slight swell of a crescent dune in Amagansett, N.Y. Purchased for investment purposes, we rented it out during most of the high-income summer months. Four neighbors with similar properties shared the same dune as well as a tennis court and swimming pool.

One day, shortly after Halloween in 1991, I received a telephone call from one of my neighbors, an Amagansett resident for nearly all the summer and fall months. "Richard," he blurted breathless describing a Nor'easter which had recklessly swept through the area. "if the center of the storm would have been just 40 miles closer, it would have devastated our community, flattened the panorama and perhaps even flattened our little dune!"

A catalyst, the late October Nor'easter gave rise to the idiom, *perfect storm.* Six years later, a book on the event was published, followed by a movie hitting the big screens in 2000.

Today, *Perfect Storm* refers to the simultaneous occurrence of meteorological events which, if taken individually would be less powerful then the storm resulting from their chance combination.

A meteorologist described the *perfect storm* as the confluence of three different weather-related phenomena—warm air from a low pressure system coming from one direction, a flow of cool and dry air generated by high-pressure from another direction, and tropical moisture provided by Hurricane Grace.

Like natural phenomena influenced by unpredictable variables, my *Perfect Storm Trading Strategy* is based upon several different and seemingly unrelated market forces, which when taken together generate extraordinary low risk entry points for short term

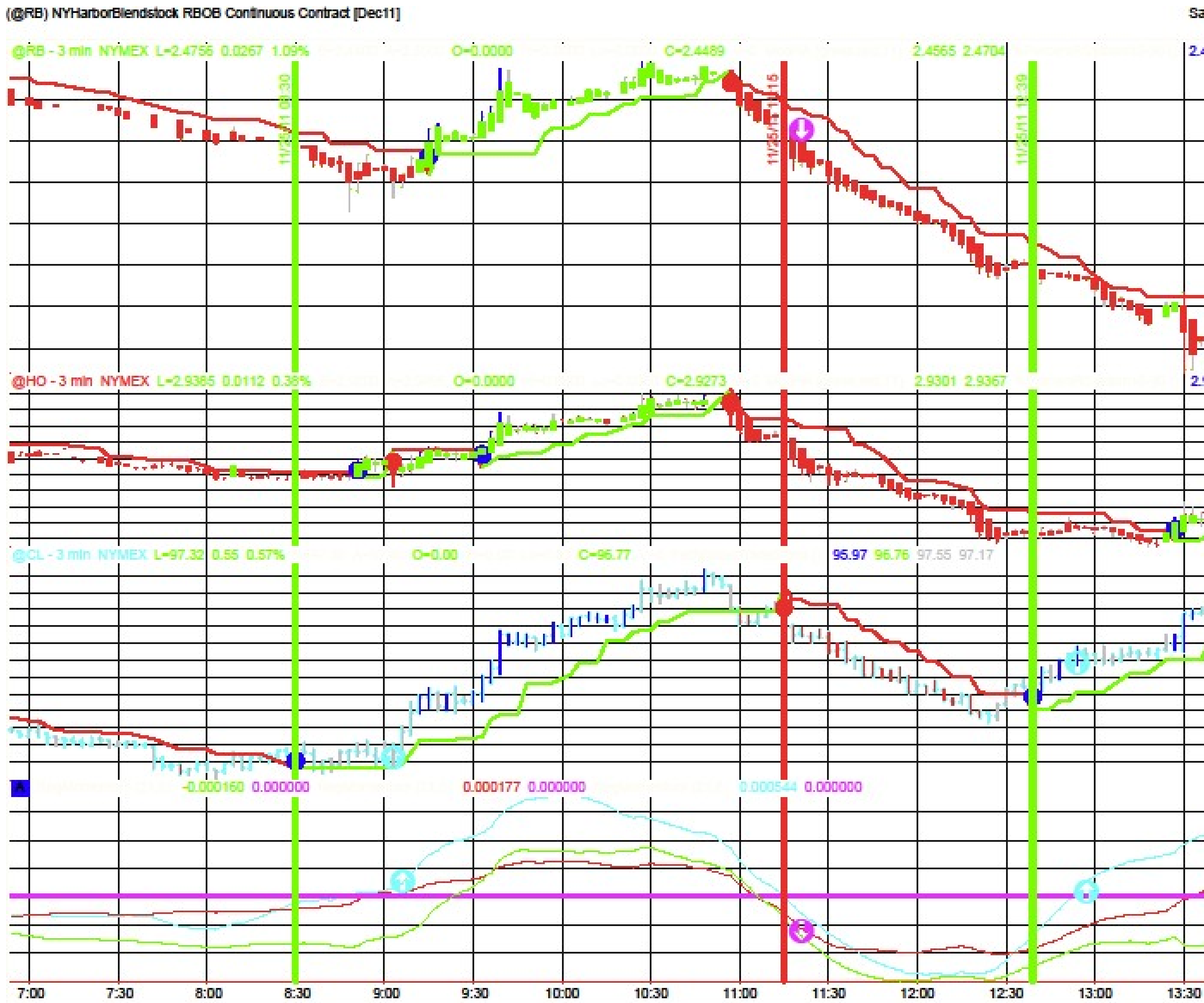
bursts of profitable trend trading.

World renowned Russian novelist Leo Tolstoy authored a wonderful short story titled:" How Much Land Does A Man Need," in which Pahom, the protagonist is given the opportunity to purchase a sizable piece of land for a very reasonable price. The burning question was—what is the price? The answer was, "As much as you can go round on your feet in one day is yours, and the price is one thousand rubles a day. But there is one condition: If you don't return on the same day to the spot whence you started, your money is lost."

Like all investors Pahom was up for the challenge, empowered by the possibility to close a profitable deal. However, blind sighted with greed, at the end of the story, Pahom is unable to return to the starting point. Although tenacious and persistent, he dies trying to meet his objective.

Tolstoy's literary genius aside, *The Perfect Storm Trading Strategy* bares no resemblance to the story's final outcome. Why?—because at the core of the strategy is the observation that all profits are fleeting. Consequently the trader is forced to take defined earnings, thereby reducing the risk of loss. This is often referred to as "the rebalancing bonus." Constantly taking profits and limiting losses while sometimes giving away some extra profit potential has the result of reducing volatility.

A balanced profit oriented system, the *Perfect Storm Trading Strategy*, originally developed for the inter-day FX market, both future and spot, can be adapted to almost all tradable markets.



The above illustration of the oil market on the NYMEX shows the *Perfect Storm Strategy* at work. The Green and Red horizontal lines indicate a positive (green) or negative(red) trend change in the crude trading market. Another indicator tells the trader which component of the market is the better place to take that signal. Sometimes it is in the main crude contract, often times it is better to trade one of the refinery outputs, either gasoline or heating oil. *Perfect Storm* will try and keep the trader in the better place.

The Perfect Storm Trading Strategy, although developed for the futures market, can be used in the equity markets as well. As you will discover in my story which follows, it is the result of the search for the perfect pairs trading system.

I started my journey of discovery in the equity and equity derivative market as they say ‘a long long time ago.’

Young, adventuresome, ambitious, motivated and with life-size dreams of earning big bucks, I began my Wall Street career at Weeden & Company in 1966. Exclusively a family launched trading firm, Weeden ‘made markets’ in Corporate Bonds and listed equity securities.

Not a member of the New York Stock Exchange, the company made what was called a ‘Third Market’ in NYSE listed securities, creating an over- the- counter market in over 500 NYSE listed shares. Their goal was to ‘democratize’ the securities market.

Lucky to be in the right place at the right time, I landed a job, as a rookie trader in training, in an era of non-negotiated commissions. The process was innovative and promising.

In possession of a commission book, every member firm salesperson was equipped to calculate the commission rate for buying and selling listed shares through a NYSE member. An additional quarter-point was charged for an odd lot-- less than 100 shares. However, the commission rate was not linked to the number of shares purchased. In fact, IBM, trading at over $200, had the highest commission rate at the time, approximately seventy-five cents per share.

The Weeden strategy was devised to 'make a market' in listed shares, net of commissions. This meant that an Institutional buyer of IBM would have options. They could go either to a NYSE member and pay the price offered on the NYSE plus the seventy-five cents commission, or do business through Weeden, get a market for IBM and deal at the offered price without payment of a commission. Weeden made a profit by buying at the bid side of the market and selling at the offered side of the market as often as possible.

For instance-- if the last sale on the NYSE was $212, the price would be $212 plus seventy-five cents commission or $212.75. On the other hand, if a buyer called Weeden and asked for a market and the trader made a market $211.75-$212.25, the customer would fare better because the net price would be $ 212.25, a saving of fifty cents per share.

Weeden conducted business with most of the large financial institutions and mutual fund managers in the world. These clients included large money center banks and smaller fund advisors from Boston to Los Angeles with stops in between, like Omaha to speak with high end investors.

Now in the 21st Century and it is amazing to note how technology has revolutionized the world. Computers, cell phones, Ipods and a vast array of other high tech toys and gadgets have moved into the business world.

Times have certainly changed. In my initial days, we answered calls on telephones with sliding switches, similar to the antiquated switchboards featured in the movies of the 1930's and 40's. The holes were numbered, and when a client called, a

trader identified him/her by yelling the hole number in lieu of a name. I still remember callers ‘42’ and ‘50’-- respectively First National City and Morgan Banks.

In the day of 10:00 to 3:30 trading and seven day settlements I started, as a trainee, in the so called back office, learning how securities were handled. It was still the era of paper. Securities were delivered to the broker/dealer at a selected time in the morning and payments were procured at a designated hour in the afternoon.

When I moved on to the trading floor, I discovered it was rather helpful to know not only how the system worked, but whose assistance I could solicit if a client conveyed a problem through their trader.

The trainee position was multi-faceted. First, the rookies were responsible for maintaining the ‘position pad’ of the trader to whom they were assigned. How did this work? Every few minutes during the trading day, to make sure the trader knew his/her net position, the trainee/assistant would put all the trader’s tickets in order, sum up the number of shares in each security purchased by the trader, and subtract the number of shares the trader had sold.

Next, the trainee would scrutinize the trader’s presumed position, and adjust it to reflect the actual number. But it did not end here. Second, the trainee would go for coffee, change the ticker tape, and more importantly, make sure that the ‘trading turrets’ were protected from coffee spills. Every 30 minutes, one of the trainees would rush over to the Dow Jones News Ticker and copy the Dow averages onto the blackboard in the front of the room.

A trainee's job was to listen and learn: listen to how the markets worked, and learn the symbols and the clients' numbers. We were expected to pick up phones and yell out to the traders the orders we received from clients.

Furthermore, we were required to learn that 'in' was a client sell and 'out' was a client purchase—it was in to us, and out to them. Once again this was not the end of it. We still had to master the names and symbols of every stock we traded. Since most stocks had nicknames, this was quite a challenging task.

IBM was 'I-Beem,' Coca Cola with its KO symbol was 'knock-out,' and Anaconda Copper was 'snake.' Included in the training process was learning how to define and differentiate between a proper and improper market.

Nonetheless, despite it all, it was the best of times. I had the opportunity to study and work together with the most generous, knowledgeable and empowering people in the profession. Eventually I did get a trading pad; an event that was exciting even if the pad was not exclusively my own.

During the administration of President John F. Kennedy, the U.S. balance of payments was moving in the wrong direction. An interest equalization tax, which basically halted U.S. companies from financing their overseas expansion with U.S. domestic debt, was levied. Simultaneously the Eurodollar market was born. A U.S. company could now expand outside the U.S. if they were willing and able to raise the money from U.S. Dollars already held overseas.

In addition to its many offices in the United States, Weeden had a branch office in London from which they reached the large overseas market in U.S. shares. To gain additional entry to that market, the London office started to make markets in Eurodollar

debt. There was a supplementary Eurodollar client market in Canada, as well as the offshore Bermuda and Nassau banks. Many large U.S. institutions active in the Eurodollar market also managed large investment portfolios for foreign international clients.

Eventually, Weeden made the decision to engage a trader in New York to handle the North American market and to take over the Euro pad from London at their closing bell. During the overlap, both desks would share position responsibilities. At the time, most of the trading was in Convertibles, a hybrid of debt and equity.

Weeden took the lead and became not only the most important market maker in Europe during that period, but the sole market maker in the United States. It was an exciting moment!

The Euro Convert market was exploding, three to five new issues every week. To communicate with London, I used a quarter-speed teletype and learned how to type using a trader's shorthand. In the days before direct dialing, transatlantic calls were costly, almost prohibitive, and to phone abroad it was necessary to set an appointment for a telephone line.

Always on our feet, we were constantly apprehensive about getting 'picked-off' by a large order hitting both our desks simultaneously. But the experience at Weeden was phenomenal. Almost by default, so to speak, I gained expertise in convertible securities and used the knowledge profitably during a career spanning three and a half decades.

The marker-making success at Weeden, a NASD member, forced us to discontinue trading in Eurobonds. The NASD, in the midst of a very larger increase in trading volumes and settlement difficulties put in trading holidays and, fearful of

financial problems within its membership, proposed to impose a capital penalty on trades that would settle outside of seven days. The Eurobond market, extremely fragmented, settled trades physically in the place of the issuers domicile. US denominated issues settled physically in New York. Great Britain in London, and so on. Often times, trades done in London between Weeden and firms located in London and on the continent would not settle in New York for months. The capital charge would have put Weeden in serious financial condition. The firm discontinued its Eurobond business to protect its capital. I was immediately hired by Kidder Peabody, whose Eurobond business was headquartered in Zug, Switzerland.

Working in both London and New York, Kidder's Eurobond business was outside the NASD capital provisions. Kidder Peabody London was not a US company. It was Swiss. I started the New York business for the London/Swiss company. I had an office a little bit separated from the New York equity trading desk. It was a desk in transition. The domestic convertible desk included Jay Regan who left to start Convertible Hedge Associates which changed its name a few years later to Princeton/Newport Partners, and Tom Taylor who left to go back to Texas and run the trading desk at the Bass Brothers, who had just started to change from a small oil and gas developer to one of the largest investment firms in generations.

While at Kidder Peabody, I started to entertain the idea of formulating a system to predict convertible bond change from the actual variation in the price of the underlying shares. Although it was far from easy, I knew that a challenge conquered is a vital and valuable lesson learned. The challenge was intricate—instead of PC's, with almost effortless access to information, we had large IBM mainframe computers.

I asked the Service Bureau Corporation (SBC), a subsidiary of IBM, to help me develop a model of convertible security behavior. Concurrently, Charles Lard, doing business on the trading desk of Bear Stearns had a similar goal. Mr. Lard had engaged Service Bureau Corp to assist him with the development of a similar program.

SBC took the initiative to introduce us, and we agreed to combine our efforts. This would be a strategic alliance to find a model. Convertible Arbitrage Security Holdings was born, a pioneer partnership, trading in convertibles. Charlie formulated the abbreviation "CASH," perhaps believing it would live up to its name. Unfortunately the initiative did not enjoy longevity-- no one believed in the concept.

However, not easily discouraged, Charlie and I stayed together and became General Partners in the NYSE member firm Hamershlag, Borg & Co, trading convertibles and brainstorming to get a proprietary convertible hedge account off the ground. It was another challenging experience.

The margin requirements were not what they are today. Consequently, we had to put up margin on both sides of the trade. In return we received no interest rebate on the short side. Nevertheless, prior to quitting and calling it a day, we had the opportunity to talk to and 'help out' J. Paul Getty, at the time winner of the prestigious title "richest man in the world!"

Hamershlag employed an oil analyst who had compiled a comprehensive and detailed research report on Getty Oil. In fact, Carl Kempner, one of the firm's Senior Partners, phoned Mr. Getty in London and asked if he would be willing to comment. Responding affirmatively and following some additional dialogues, he opened an account with Hamershlag, Borg & Co.

Carl’s secretary filled out the New Account form, and in the box “Net Worth” wrote ‘*are you kidding*!’ I wish we would have made copies of that document.

Mr. Getty, an active trader of oil shares, would receive a call from our trading desk just before the opening of trading on the NYSE and would give us some orders from time to time.

One day, I picked up his call and introduced myself. “Mr. Feit, he said, “what do you do at the firm?” I cleared my throat and described my dealings in Convertible Arbitrage, perhaps hoping I could stir up enough interest to get him to fund my operation. He listened attentively. “Mr. Feit,” he replied, “could you prepare a spreadsheet on the oil stocks and get it to me on a regular basis?” Beyond excited I responded: “Sure Mr. Getty, I’ll get on it right away”—and I kept my word.

A few weeks later, I had another conversation with him. “Mr. Getty, was the spreadsheet I sent you helpful?” I inquired. He made it known he had reviewed the information and requested some modifications. I took the opportunity to ask some more questions in my quest to discern exactly what investment path he was interested in pursuing.

Although Mr. Getty was somewhat reticent in revealing what he was really after, I had some pretty precise ideas. We discussed price changes and dividend dates and the homogeneous nature of the oil from the Arabian Peninsula. Having calculated the relative value of most of the large oil companies, he was swapping in and out of them for his investment account. A clever investor, our spreadsheet was just an additional arrow in his quiver, though he continued his relationship with Hamershlag, Borg & Co.

I continued to trade Convertibles and in the early 70's was hired by Sandy Weill to start a convertible department at CBWL-Hayden Stone. It was a position with a dual job description-- educating the retail arm and speaking with institutional investors from the institutional desk.

Eventually an article in the August 1974 edition of *Business Week* detailing what I was doing at now, Shearson Hayden Stone, netted me a call from Dick Tierney, the head institutional trader and senior partner of Blyth Eastman Dillon.

Mr. Tierney lured me over, offering me the opportunity to make markets in stocks on the block desk against the offsetting positions of convertible bonds and the newly created listed options market in Chicago. Thrilled, I seized the moment. It was an empowering experience.

In addition to being on the block desk, I was also part of the investment banking department. My position entailed not only making rounds after the close but went further. I also had the task to convince the investment bankers to offer an equity linked product to their banking clients.

Although somewhat challenging, my effort was very successful. In fact that year Blyth Eastman Dillon was number one in the category. Pleased with my performance, Mr. Tierney promoted me to Vice President. I liked where my career path was heading. I loved my work. I had nothing but respect from my peers. What could possible go wrong?

In October of 1979, Insurance Company of North America (INA), with a majority interest in Blyth Eastman Dillon, sold the company to Paine Webber. We were instructed 'to stay in place' because in due time we would be presented with an interesting proposition, and if, after a six month paid hold, we were not offered a comparable

position at Paine Webber, we would get a severance package of an additional six months' pay in addition to an extra bonus.

For the next six months I sat in an office at Paine Webber and played hearts while waiting for their decision regarding my professional future. Paine Webber, the purchaser, was plagued with a dilemma. Blyth Eastman Dillon had a capital structure totaling one-third of Paine Webber, but did twice the business in equity related businesses and reaped more than twice the profits.

However, they discovered it too late. Six months thereafter, all the solid figures of Blyth Eastman Dillon opted to go with Jay Perry, a former partner of Salomon Brothers. Mr. Perry had been hired to run investment banking and institutional sales and trading at Blyth. He was going to take most of the business to Dean Witter.

Jay had made a deal for me to start, along with Jesse Gerstel, the computer whiz originally from Salomon Brothers, a proprietary convertible trading department. Jesse while at Salomon working with Jay had developed the trading system that Michael Bloomberg's equity department was using. Promised a percentage of the profits, we were delirious!

Our returns on capital were over 100%. After five years we had only four losing months and the average losing month was only one-fifth of our typical profitable month. We were riding the big waves. Thoroughly disciplined and exceptionally focused, we had no obstacles on our path to slow our course.

Dean Witter was acquired by Sears, setting in motion two major changes. One, Sears started to demand budget projections. Our budget projection for that particular year

was Five million dollars or One and a quarter million dollars per quarter. It was a budget for PROFITS, not expenses.

In fact, one quarter we made One and three quarter million dollars, which was Five hundred thousand dollars over budget. This created panic in the Sears Tower. An accountant was sent to investigate why we had exceeded the budget by such a large figure.

We couldn't control our laughter when the accountant finally came to the conclusion that it was acceptable to make more money than budgeted.

The second change factor occurred when Sears selected as President and Chairman apparent, Phil Purcell—a man with absolutely no Wall Street experience. When we asked Mr. Purcell for additional capital, instead of inquiring:" How much capital can you run at a return in excess of 100 %," he agreed to give us the extra capital if we in turn would concur to take only half the profit percentage on the additional capital.

After thanking him for his consideration, I went directly to my boss. Even though I was a Senior Vice President, I reported to one of the three Executive Vice Presidents, Jay Perry. I told Mr. Perry I thought it was a worthless response. Jay saw an opportunity and immediately phoned Jeff Cohen, who ran the incredibly profitable Risk Arbitrage department at Dean Witter. Jeff and I, friends since our Blyth Eastman Dillon days, had arranged for our departments to be situated in adjoining spaces at Dean Witter because many merger transactions at that time involved the issuance of convertible preferred securities and I was able to judge the value quite quickly and position and hedge the paper in house.

Jay proposed that we seriously consider leaving Dean Witter and start a hedge fund built around the synergy of risk and convertible arbitrage. Jay would raise the money and assume the role of managing partner. Jeff and I were in full agreement.

Certain Jay was a superstar we felt he could pull it off. Our intuitions were unfaltering--in just a few days, Jay had raised a substantial sum of money from solid investors, including Dean Witter. Immediately we made the decision to resign from Dean Witter and start Perry, Cohen and Feit & Co. Our goal was to be NYSE members and do Risk and Convertible Arbitrage.

Unfortunately several weeks later, Jay was diagnosed with medically unresponsive terminal Leukemia and passed away shortly thereafter. Jeff and I continued with the formation and development of the firm, changing the name to Cohen Feit and Co. Most of the gang from Blyth and Dean Witter came with us. Jesse, however opted to remain at Dean Witter and brilliantly continued to run the convertible effort there.

Not long after, Cohen Feit & Co gained a reputation as the absolute best place to work on Wall Street. Whenever the firm had a job opening or an expansion plan, the number of applicants soared. The working environment was fun and easy going, and morale was high.

Convertible Arbitrage was a new concept for investors to grasp. With the exception of our former employer Dean Witter, none of our potential investors had ever invested in the strategy. The offering memorandum for Cohen Feit outlined in some detail the actual transaction set-up. Within 20 years, a strategy that had only about $100 Million invested in 1980 had over $20 Billion invested in 2000.

The returns suffered in conjunction with the increase in those employing the strategy. What happened? A strategy that threw off returns well in excess of 30 % net per year started to have periods of negative returns. There was too much money chasing after the few lucrative opportunities. New issues were designed exclusively for the 'arbs.' Investment bankers started to persuade client companies to issue equity- linked securities with increasing new complex terms and too attractive to resist tax avoidance schemes. The day of the 'plain vanilla' convertible was over.

After my retirement from Cohen Feit & Co, APT, the developers of STAR, one of the first statistical arbitrage quant strategies, inquired if I would be agreeable to starting a joint venture. In the past, while at Cohen Feit & Co., I had used their services to develop an index trading strategy.

We traded the physical shares of the S&P 500 against the S&P futures with a great deal less than the 500 different component parts which lowered our trading costs. The quant strategy traded was like a sub-manager for large French Bank. Additionally, I traded the Japanese Warrant market against the underlying shares using their 'factor' models.

The idea was to balance out the risk in the uncontrollable, huge and volatile Forex market to insure that our returns were 'plain vanilla,' and not because the currency moved in our favor.

It was a long day. The Japanese Warrant market started at approximately 8:00 PM EST time and peaked in the early morning in London. We were spared the time disconnect when the French Bank was merged and the new owners decided not to pursue the business.

Of course we missed out on some major profits since the Japanese equity market was taking a nosedive. Undoubtedly, our strategy would have been a 'home run." Fortunately for me, the convertible arbitrage strategy was still very strong, and I started another hedge fund as a General Partner. Although I was not certain how long the convertible market could continue offering the kinds of returns that I was generating, I tried very hard to develop another strategy that would.

I had been, while trading the Japanese Warrants, looking at the new pairs trading strategy being developed with the help of my joint venture partners. APT Ltd. was the purveyors of the statistical data for this new strategy and had most of the new quant arbitrage traders as clients. Sensing an opportunity, I drafted an idea using some of the tools I had at my hands and sent off a letter to an old friend, Izzy Englander, who was the founder of Millennium Partners. Izzy had been, in my and others opinion, the best options broker on the AMEX floor and I had used him to my advantage while at Blyth Eastman Dillon, where at the time I was the head of the Institutional Options Department. Izzy had been, before Millennium, one of the main partners of Jamie Securities, a hedge fund with many of the same limited partners and structure as Cohen Feit. Izzy answered my letter within a few days and I started at Millennium about a week later.

Whatever could go wrong went wrong. My data provider was not able to provide accurate and timely trade data, and my plan, while at the inception looked well, did not work. After a few weeks of trying to get the data to be accurate and get a better trade plan, we parted ways.

I always thought that I was on a correct path and over the next few years I continued to work on the pairs trading problem. I was very stubborn. 10,000 hours sped bye and then some.

One day I had what I called my "Lost Chord" event. I still remember the first chorus:

Seated one day at the organ,
I was weary and ill at ease.
And my fingers wandered idly
Over the noisy keys;
I know not what I was playing
Or what I was dreaming then,
But I struck one chord of music,
Like the sound of a great Amen,
Like the sound of a great Amen.

I had finally, after all the years and trials, had developed what I know call *The Perfect Storm Trading Strategy*. Like most traders, I had investigated, analyzed and studied everything publicly available and had come to the conclusion that no public indicator works for long periods of time. If that were not true, every trader would be successful.

The Perfect Storm Trading Strategy is neither a 'Nickel' strategy that earns small positive returns most of the time but occasionally has a dramatic loss, nor a 'Black Swan' strategy that generates small losses most of the time but occasionally has a large profit. It is a strategy that looks at the trading environment in a different way. Small profits

become large profits with very small levels of risk and low capital requirements.

The following chart is an example of a pairs trade between AMP and AXP which took place on January 4, 2011.

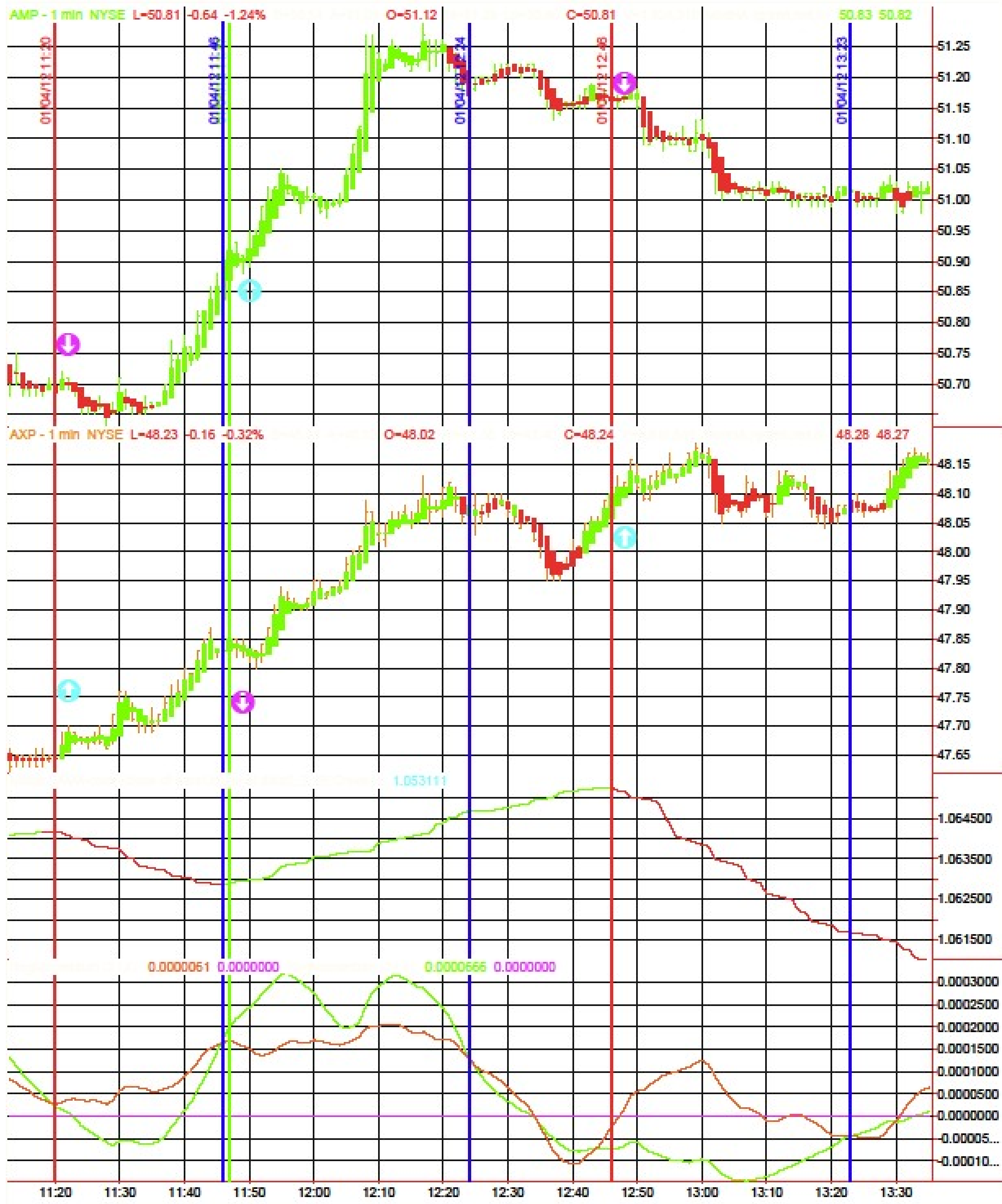
The red line indicates a buy of AMP, the red colored security, the blue line is the closing out of a position. The green line is a purchase of AXP, the green security. A corresponding short sale of the other security is also part of the pairs trading strategy. The middle solid line represents the value of the pair itself. Changing colors as the pair increases or decreases in value. Green when the value is moving up, red when the value is moving down.

The example is typical of the pairs trading system that has been derived by *The Perfect Storm Trading Strategy*. Equal dollars on both sides generates small profits in almost every case.

The strategy is never 100% correct in all the trades it indicates, but the vast majority of trades are profitable. The system reverses at the first sign of weakness in the trend. There are hundreds of pairs that are available for trading within the system.

The Perfect Storm Trading Strategy can be used in a traditional pairs trading strategy or as a stand-alone stock trading strategy. The uses are only limited by the imagination of the user. The CVX-XOM graph is an example.

The Perfect Storm Trading Strategy has no relationship and has not shared any indicators with the website PerfectStormTrading. The indicators are currently written for TradeStation in Easy Language and can be migrated to a Complex Event Processor.



(AMP) Ameriprise Financial Inc
Wednesday, January 4, 2012
AMP - 1 min NYSE L=50.81 -0.64 -1.24% O=51.12 C=50.81 50.83 50.82
AXP - 1 min NYSE L=48.23 -0.16 -0.32% O=48.02 C=48.24 48.28 48.27
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11:20 11:30 11:40 11:50 12:00 12:10 12:20 12:30 12:40 12:50 13:00 13:10 13:20 13:30
1 of 1
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(CVX) Chevron Corporation

Friday, January 6, 2012

1 of 1

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