Understanding Testable Strategies: A Guide to Optimizing Your Trading Approach

At **Stratify**, we are dedicated to helping you make smarter, data-driven decisions through the effective back testing of trading strategies. However, not every strategy is suitable for back testing. This guide will clarify what types of strategies can be tested and why subjective or discretionary approaches may not provide reliable results.

What Makes a Strategy Testable?

For a strategy to be effectively tested, it needs to meet certain criteria. Specifically, it should be:

1. **Objective**: The strategy must have clearly defined, rule-based conditions that can be applied to historical data. These rules must be consistent and replicable, ensuring the same actions would be taken every time given the same conditions.
2. **Measurable**: Every aspect of the strategy must be quantifiable. This includes the entry and exit points, risk management rules (e.g., stop-loss and take-profit levels), and any other criteria like moving averages, support/resistance levels, or specific indicators.
3. **Historical Data Compatible**: Your strategy must be based on inputs that can be historically measured (e.g., price, volume, indicators). It should not depend on real-time subjective interpretations, such as "market sentiment" or "intuition."

Examples of Testable Strategies

Here are a few common types of strategies that are suitable for back testing:

- **Moving Average Crossovers**: A strategy based on the crossing of short-term and long-term moving averages (e.g., a 50-day MA crossing above a 200-day MA as a buy signal).
- **Breakout Strategies**: Buy or sell when the price breaks above or below a specified level (e.g., resistance or support levels).
- **RSI or MACD Indicators**: Entry and exit points based on overbought/oversold conditions indicated by technical indicators like RSI or MACD.
- **Trend Following**: Strategies that follow the overall trend of an asset, for instance, going long when a stock is in an upward trend according to specific criteria.
- **Mean Reversion**: Buying or selling based on the assumption that the price will revert to the mean (average) over time after reaching extreme highs or lows.

Why Subjective Strategies Are Not Suitable for Testing

Subjective strategies, also known as discretionary strategies, are based on personal judgment, intuition, or vague criteria like "feeling that the market will turn." These strategies might include:

- **Gut-feeling trades**: Buying or selling based on a hunch or market sentiment.
- **Discretionary risk management**: Deciding stop-loss or take-profit levels "in the moment" rather than following set rules.

- **News or event-driven decisions**: Trading based on how you interpret an unfolding event or news release.

Challenges with Subjective Strategies:

- **Inconsistency**: Since subjective strategies rely on human interpretation, it's impossible to replicate the same decision-making process over time.
- **Non-replicability**: Testing requires rules that can be applied repeatedly to historical data. With subjective strategies, there are no fixed rules to apply.
- **Lack of Data Compatibility**: Subjective factors like emotions or market rumors cannot be quantified or applied to historical data for testing purposes.

The Importance of Objectivity in Strategy Testing

For a back test to be reliable, the strategy must be objective and rule-based. This ensures that the strategy can be tested against historical data in an unbiased way, providing insights into its potential effectiveness in future markets. Objective strategies offer:

- **Consistency**: The ability to apply the same rules to past and future data.
- **Transparency**: The logic behind each trade is clear and can be reviewed.
- **Optimization**: You can tweak parameters (such as moving average periods or risk levels) to optimize the strategy, something that's not possible with subjective methods.

Final Thoughts: Building a Strong Strategy

When considering which strategy to test, ensure that it:

- Has clear, rule-based entry and exit criteria.
- Relies on measurable data that can be reviewed historically.
- Avoids subjective decision-making or interpretations.

At **Stratify**, we help traders and investors like you focus on what can be proven and measured. By testing only objective strategies, we provide you with reliable, data-driven insights to help you refine your approach and achieve better trading outcomes.

Need help defining your strategy?
Our platform allows you to input your strategy details, and we take care of the rest. Reach out to us if you have questions or need guidance on how to structure your strategy for testing.