Jesse Livermore Trading System Step By Step.

In this lecture we will go over how to trade the Jesse Livermore trading system step by step.

I have chosen to provide this as a text document as it will be easier to follow and refer back to in the future.

As an overview, the Jesse Livermore system is a daily trend trading system for US large cap stocks.

The trading system has been backtested with a portfolio size of $100,000 but this figure is not important and can be replaced with any reasonable starting amount such as $1m, $50,000, $20,000 or $10,000.

Importantly, our backtest results included transaction costs of $0.01 per share and they were run on a database that is adjusted for historical/delisted stocks as well as splits and dividends.

NB: If you are an Amibroker user you can also use the code that I have provided to automatically generate your buy and sell signals.

The Jesse Livermore Trading system can be implemented by following the below steps:

Step 1: Bull market or bear market.

The first step is to decide whether or not we are in a bull market or a bear market as this will dictate the direction in which you can trade. All you have to do in this step is to check whether or not the S&P 500 is trading above or below it's 200-day moving average.

If above, then we will be ready to take long positions. If below, then we will only take short positions. Importantly, the position of the S&P 500 relative to its 200-day MA only impacts our entry rules not our exit rules.

Step 2: Scan for breakout signals.

If we are in a bull market the next step is to scan the S&P 100 for any stocks making new 150-day highs. There are numerous scanners available (free and paid) that can do this for you.

150-day highs should be calculated using the close price. In other words, a stock only makes a 150-day high if it closes at the highest close in the previous 150 daily closes. The actual high price is irrelevant, we are concerned only with the closing price.

If we are in a bear market we scan the S&P 100 for any stocks making new 100-day lows.

Again, 100-day lows should be calculated using the close price. In other words, a stock only makes a 100-day low if it closes at the lowest close price in the previous 100 daily closes.

Step 3: Rank duplicate trading signals.

Before we enter our long or short positions it is important to first take care of any duplicate trading signals.

Often, when we scan for 150-day highs in the S&P 100 we will encounter more than one stock making a breakout. To decide which stock to buy first we simply rank them by their 1-year percentage performance.

For long breakouts, we will buy the stocks with the highest 1-year percentage performance first.

For short breakouts, we will short the stocks with the lowest 1-year percentage performance first.

Step 4: Calculate position size and enter trades.

After scanning the market and ranking any breakout signals it is time to enter a position on those signals which we will do in order of rank.

Our initial position size is 10% of our equity so we will use that to determine how many shares to go long or short. We also have two additional scale-in entries of 10% for longs only.

For example:

If we have a starting capital of $100,000 and we get a buy signal for Apple at a price of $178 we will enter an order to buy 56 shares of Apple on the next market open.

100000 / 10 = 10000

10000 / 178 = 56.18 shares

If we have capital of $25,000 and we have a short signal for Microsoft at a price of $126 we will enter an order to short 19 shares (we always round down) of Microsoft on the next market open.

25000 / 10 = 2500

2500 / 126 = 19.84 shares

If it is a bull market we will enter long positions for all breakout signals on our list in order of 1-year highest performance and we do this until we either run out of capital or we reach the maximum portfolio size of 10 open positions.

We also have the option of 50% margin which will allow us to enter additional scale-in entries as they come up.

If it is a bear market we will enter short positions for all short signals on our list in order of 1-year lowest performance and we do this until we either run out of capital or we reach the maximum portfolio size of 10 open positions.

Importantly, position size is always calculated using the total equity not remaining funds in the account. So if you have 4 positions in your portfolio, remaining funds of $60,000 and your equity has dropped to $97,000 you use this figure to calculate position size. 10% of which would be $9,700.

Step 5: Enter stop loss.

When we send the orders to the broker to enter our trades we also include a 50% stop loss level. This can be entered as a bracket order or can be implemented shortly after the position is live.

For long positions the stop loss is put 50% below the entry price and for short positions the stop loss is put 50% above the entry price.

For example, if we have a long entry in Apple at $178 we will put our stop loss at $89.

Short positions are rarely hit but give some peace of mind when using margin.

Step 6: Scan for additional entry signals and new exit signals.

It is important to scan the market each day for entry and exit signals.

Entry Signals

Each day scan the market for new breakout signals.

If you find another stock making a 150-day high (in a bull market) and you have less than 10 open positions in your portfolio you can add that stock to your portfolio using the same position sizing method of 10% of total equity.

If you don't have enough available funds then you can shrink your position size to include that new entry. For example, if your total equity is $100,000 but you only have $5,000 left (5% of equity) then you can use that to enter your signal. Just be careful not to go lower than $500 as this will rarely be worthwhile after transaction costs..

The same goes for any additional short signals in a bear market. Portfolio size is always constrained to 10 total positions long and short.

Scale-in entries

Each day also check the stocks in your long portfolio for any new breakouts.

If a stock in your portfolio has made another new 150-day high (and we are still in a bull market) you can increase your position on that stock by an additional 10%.

Note that position size is calculated using your total equity (not remaining funds) and entries are still entered on the next market open.

In other words, if your equity has risen to $110,000 then you calculate 10% of that which is $11,000.

You can do this twice more on any breakout stock taking the total position size on that stock up to a maximum of 30%.

Sometimes you will find that even using 50% margin you will not have enough funds to enter additional scale-in or breakout signals. That's completely fine. Simply skip the trade and carry on following the system until you have more funds available.

Exit signals

Each day you must also scan the market for new exit signals.

If any long positions in your portfolio hit a new 50-day low close you must sell those positions in full on the next market open. This includes any additional scale-in entries.

If any short positions in your portfolio hit a new 25-day high close you must cover those positions in full on the next market open.

Be aware that as you sell down your existing positions space will open up for new entries or scale-in positions.

Step 7: Rinse and repeat.

When space opens up for new entries it is simply a case of going back through the steps. First decide if we are in a bull market or bear market and then scan for new signals.

You will find that sometimes you will be very active in the market, opening and exiting lots of trades whilst other times you will go for long stretches without needing to do anything.

Either way, it's crucial to check your portfolio every day so you don't miss out on any important exit signals or scale-in entries.

Missing just one signal can cause a nasty loss that the system would not have taken.

Conclusions

As I recommend with all systematic trading strategies it is wise to first trial the system on paper first before trading it with live money.

Mistakes, changes in market conditions and curve fitting can sometimes cause trading strategies to go off the rails and perform poorly so please be careful before going live with too much capital.

I usually advise to start small and only implement the strategy with a small portion of your capital until you build up more confidence with the strategy's performance.

For example, you could allocate 90% to index funds and 10% to this trading system and increase that mix as you become more confident.

If you are unsure about any of the above then please reach out to me for further explanation.