



Are There Optimum Indicator Parameters?

Are you seeking the optimum parameter to use for your indicators?

I have been training traders for around 17 years and perhaps the most frequently asked question of all goes something like: "What parameters do you use for your moving averages?"

My sincere and honest response is that I don't use any in my analysis and if I did there is no such thing as an optimum parameter ... except in hindsight. However, hindsight is not much worth to us right now.

Is there any such thing as an optimum parameter for any indicator?
Not as far as I am aware.

Are there any mystical powers about indicators which make them predict the market?

No.

Let's get this straight. All indicators are lagging. This is intrinsically so since they are all calculated from historic prices and there is categorically no argument to say that price develops in a linear fashion that implies indicators can be used to forecast price. I have not found one that predicts the market.

Let's take an RSI. The default in most platforms is 14. This is because it was considered by Welles Wilder who created RSI that there is a common 28 day cycle in the market and thus an indicator length of half the cycle length is a broad yardstick to use.

If you look back at price history and apply several different length RSIs over that history, at times you will find that (for example) an 8 period will work well during sharper oscillating markets while during broad swinging markets a 14 period may work better.

Well, now we have a game plan. We can use an 8 period RSI when the market is choppy and a 14 period when it's not... Now look at your chart and decide what will happen from now. There is always an element of judgment involved and no way of saying for certain which length you should use.

The next argument is to optimize the RSI and choose the most profitable periods. Well, it can be done but having written systems I have never found a parameter that works without substantial a drawdown, certainly not one I would care to trade through. In addition, developing a system is not as straightforward as it seems. What if the optimum period is 14 with a profit of 100 but parameters of 12, 13, 15 and 16 only have profits of 25? (This is not an uncommon occurrence.) Would you feel confident that the optimum period was not just an aberration? (In all probability it is.)

So after all that it seems that there is no safe parameter to use for indicators. Frankly I use the default in most cases – at least for momentum indicators – but the bigger issue here is not the indicator but **how you use it**.

Again let's take an RSI. Broadly it is commonly used as an overbought/oversold indicator. This is only true during consolidating markets and not trending. You should never use these types

of signals from momentum indicators while a trend is in place. Does this mean it is right that, as soon as RSI moves above 70 it is time to sell and below 30 is a time to buy?

No. Definitely not... Here is one of the best bits of advice I can give.

Never take a trade taking a signal from only one form of analysis.

The biggest piece of the puzzle that many (and probably most) traders fail to understand is price. For instance, why take a sell signal because RSI is above 70 but has not moved back below a strategic low. It could be beginning an uptrend and the lows and highs are still moving higher. It could be pausing in a flag formation which is a strong continuation pattern. Remember that many of the best profits come from long positions when momentum indicators are overbought (and short positions when momentum indicators are oversold.)

Always make sure that price is doing something to confirm your trade...

Maybe you see daily RSI above 70. Fine, move down into the hourly charts and see if:

- There is a price/momentum divergence, or
- A reversal pattern is developing – then confirmed, or
- A trend support has been broken.

If any of these occur then your short trade because daily RSI is overbought stands a much greater chance of success.

But what has this got to do with the parameter you choose for the RSI?

Nothing really, but as long as you are using one that is not an extreme and follows the market on the majority of occasions the actual parameter is not important – the combination of the RSI and price should be enough for the majority of trades in this way. Just understand that indicators have their limitations and do not expect them to magically tell you what trade to take. Study price. Understand price. Combine it with indicators and you will have taken a step forward to better profits.

Good luck

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