Algorithmic Strategy Search Governance and Control

Mourad E. Mazouni, PhD, PMP

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ABSTRACT

A governance framework for algorithmic strategy generation systems, addressing the gap between strategy discovery and production deployment. The framework defines four sequential gates: pre-registered search space specification, out-of-sample validation with multiple testing correction via the deflated Sharpe ratio, paper trading verification (minimum 6 months), and staged capital deployment at 25% of target notional with explicit kill switches. The framework is compatible with MiFID II, SEC Rule 15c3-5, and IOSCO algorithmic trading principles.

Keywords: Algorithmic Trading · Model Risk · Governance · Systematic Strategies · Overfitting

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Abstract

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SECTION 1

Executive Insight

This paper presents a governance framework for algorithmic strategy generation systems. The framework treats strategy generation as controlled infrastructure analogous to pharmaceutical drug development: promising candidates must pass through multiple independent validation gates before receiving capital allocation.

The practical motivation is the overfitting epidemic in quantitative finance. When hundreds or thousands of strategy variants are tested against the same historical data, some will inevitably show strong backtest performance by chance alone. Without rigorous governance, these spurious signals receive capital allocation and produce realized losses. The deflated Sharpe ratio quantifies this multiple-testing bias, reducing a raw Sharpe of 1.8 (from 500 trials) to an adjusted 1.1 after accounting for the search space.

SECTION 2

Gate 1: Search Space Specification

Before any optimization begins, the research team must document the parameter search space, the economic hypothesis motivating each parameter, and the total number of combinations to be evaluated.

This pre-registration prevents post-hoc rationalization of data-mined results.

The search space specification includes: signal definitions and their economic rationale, parameter ranges for each signal (with justification for the bounds), the total number of parameter combinations, and the evaluation criteria that will be applied to candidate strategies. Pre-registration is filed with the risk management team before backtesting begins and cannot be modified ex post.

SECTION3

Gate 2: Out-of-Sample Validation

All candidate strategies must pass out-of-sample testing with multiple testing corrections. The deflated Sharpe ratio adjusts the observed Sharpe for the number of trials conducted: $DSR = SR * [1 - \gamma * \ln(N)]$, where N is the number of strategy variants evaluated and γ is calibrated to the strategy class.

Walk-forward validation over five non-overlapping out-of-sample periods is required. Acceptable performance decay from in-sample to out-of-sample: 30% for momentum strategies, 50% for mean-reversion, 20% for fundamental factor strategies. Decay exceeding these thresholds indicates over-optimization, and the candidate is rejected regardless of absolute performance.

SECTION4

Gate 3: Paper Trading Verification

Strategies that pass statistical validation enter a paper trading phase with a minimum duration of six months. Full execution cost modeling is applied, including market impact estimates, bid-ask spread, and latency-adjusted fill rates.

This gate detects strategies whose profitability depends on unrealistic execution assumptions. Common failure modes include: strategies that require crossing the spread on illiquid instruments, strategies that assume zero market impact at sizes exceeding average daily volume, and strategies with holding periods shorter than the execution time required to establish positions. In the illustrative example, execution costs of 40 bps per round trip reduced the net Sharpe from 1.8 to 1.1.

SECTION5

Gate 4: Staged Capital Deployment

Approved strategies are deployed at 25% of target notional with explicit kill switches and drawdown limits. The standard deployment schedule scales to 50% at 3 months, 75% at 6 months, and 100% at 12 months, conditional on live performance tracking within 2 standard deviations of paper trading expectations.

Kill switch triggers: (a) drawdown exceeding 5% of allocated capital, (b) live Sharpe ratio below 50% of paper trading Sharpe for any rolling 3-month window, (c) correlation with existing strategies exceeding 0.7 (indicating redundant risk), (d) any material change in market microstructure that invalidates the strategy's economic hypothesis (e.g., exchange rule change, instrument delisting).

SECTION6

Applied Example: Momentum Strategy

An institutional team evaluates a momentum-based equity strategy discovered through a search across 500 parameter combinations. Raw backtest Sharpe: 1.8, t-statistic: 3.2. After governance gates: multiple testing adjustment reduces apparent t-stat to 1.8 (still significant). Walk-forward validation shows 60%

performance decay (within acceptable range for momentum). Paper trading reveals 40 bps round-trip execution costs, reducing net Sharpe to 1.1.

The strategy is deployed at 25% of USD 200M target (USD 50M) with a 5% drawdown kill switch. Scaling to full allocation occurs over 12 months conditional on live performance tracking within tolerance bands. Total time from discovery to full deployment: 18-24 months.

SECTION7

Regulatory Framework Compatibility

The governance blueprint satisfies multiple regulatory frameworks. MiFID II (European Union): requires testing of algorithmic trading systems under stressed conditions and documentation of risk controls. SEC Rule 15c3-5 (United States): requires market access risk controls including pre-trade risk limits and kill switches. IOSCO Principles for Regulation of Algorithmic Trading: requires firms to have adequate risk management systems.

The four-gate framework maps directly to these requirements: Gate 1 satisfies documentation requirements, Gate 2 satisfies testing under stressed conditions, Gate 3 satisfies execution risk assessment, and Gate 4 satisfies ongoing monitoring and kill switch requirements.

SECTION8

Institutional Implications

Research organizations should treat strategy generation as controlled infrastructure with explicit model risk governance. The framework prevents the common failure mode where strong backtests lead to premature capital allocation followed by realized losses.

Implementation cost is modest: primarily process documentation and gate-review staffing. The framework is scalable from single-strategy shops to multi-desk systematic trading operations. The key organizational requirement is independence between the research team (which generates candidates) and the risk team (which controls the gates). Without this independence, the framework degenerates into a rubber-stamp process.

SECTION9

Methodology and Citations

Deflated Sharpe ratio: Harvey and Liu (2015, Review of Financial Studies); Bailey et al. (2014, Journal of Portfolio Management, "Pseudo-Mathematics and Financial Charlatanism"). Multiple testing corrections: Bonferroni, Holm-Bonferroni, and Benjamini-Hochberg FDR methods. Walk-forward validation: White (2000, Econometrica, "A Reality Check for Data Snooping").

Market microstructure and execution modeling: Almgren and Chriss (2001, "Optimal Execution of Portfolio Transactions"). Regulatory references: MiFID II RTS 6, SEC Rule 15c3-5, IOSCO FR09/11. The framework requires no proprietary technology; all gates can be implemented with standard research and risk management tools.

KEYEQUATION

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Deflated Sharpe:  DSR = SR * [1 - □ * ln(N_trials)]
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Working Paper 08 — Principal Formula

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