Part II

3 Performance Data

"The criterion of truth is that it works even if nobody is prepared to acknowledge it."—Ludwig von Mises

What we've got here is failure to communicate. Some men you just can't reach, so you get what we had here last week which is the way he wants it. Well, he gets it. And I don't like it any more than you men."
—*Cool Hand Luke* (Movie)

It is a capital mistake to theorize before one has data.

Sir Arthur Conan Doyle[1]

Anyone can tell you they have a successful trading method or system, but ultimately the only objective measurement that matters at the end of the day is raw performance. Consider all of the presented data to be scientific proof of Trend Following. If a claim is to be made it must supported, The numbers in this chapter and at our Web site, *www.trendfollowing.com* don't lie.

In reviewing the performance histories from the trend followers profiled in Chapter 2, we zeroed in on five key concepts that help explain the data:

1. Absolute Returns
2. Volatility
3. Drawdown
4. Correlation
5. Zero-Sum

Absolute Returns

An absolute return trading strategy means you are trying to make the most money possible without being limited to comparison to with a typical index such as the S&P:

"An absolute return manager is essentially an asset manager without a benchmark. . .Bench marking can be viewed as a method of restricting investment managers so as to limit the potential for surprises, either positive or negative."—Alexander M. Ineichen[2]

Trend followers never attempt to track any particular index—ever. If trend followers like Bill Dunn, John W. Henry, and Ed Seykota had a coat of arms, "Absolute Returns" would be emblazoned upon it. They thrive and profit off the "surprises" that benchmarking so forcefully and artificially tries stop.

Are all trend followers shooting for absolute returns? No, not all play the game full tilt. Jerry Parker, an exceptionally gifted trend follower, purposefully aims for lower returns to cater to a different client base. Although today Parker does trade some of his portfolios for absolute return as well.

This ain't clipping coupons. No risk, no return.

Anonymous

John W. Henry articulates the strong case for an absolute return strategy:

"JWH's overall objective is to provide absolute returns. JWH is an absolute return manager, insofar as it does not manage against a natural benchmark. Relative return managers, such as most traditional equity or fixed income managers, are measured on how they perform relative to some pre-determined benchmark. JWH has no such investment benchmark, so its aim is to achieve returns in all market conditions, and is thus considered an absolute return manager."[3]

Shoot for a benchmark in return, and you run with the crowd. The benchmark is a crutch for those who do not want to ponder alternatives. Benchmarks like the S&P make people feel safe, even if that feeling is artificial. Trend followers understand that trading for absolute return sand not from blind adherence to benchmarks is the best way to handle uncertainty:

"The concept of indexing and benchmarking is very useful in the world of traditional, long-only investing, but we believe that it has limited usefulness for absolute return investing. Again, it gets back to the notion of what it takes to achieve an absolute return—

portfolio managers need to have an enormous amount of latitude and freedom in the execution of their trading strategy to ensure capital preservation and achieve a positive return. At its core, this concept of absolute return investing is almost antithetical to benchmarking, which encourages traditional managers to have similarly structured portfolios and look at their performance on a relative basis. Frankly, the reason many hedge fund managers became hedge fund managers was to get away from the institutionally-driven, relative performance world, and into an environment where they could be judged by—and prosper from—their investing talents and profitability."[4]

If your trading strategy is based on benchmark comparisons, it won't matter whether you are a talented trader, since your decisions are limited to boundaries defined and set by the averages. Why would any trading skill be relevant?

The class of those who have the ability to think their own thoughts is separated by an unbridgeable gulf from the class of those who cannot.
Ludwig Von Mises[6]

Fear of Volatility; Confusion with Risk

There are organizations that rank and track trend follower's monthly performance numbers. One organization, International Traders Research (ITR), gives them a 'star ranking' (not unlike the more famous Morningstar):

"The quantitative rating system employed by ITR to rank and rate the performance of all commodity trading advisors (CTAs) rated in the database relative to the performance of all other CTAs. Ratings are given in four categories: a) Equity, b) Performance, c) Risk exposure, and d) Risk-adjusted returns. In each category, the highest possible rating is five stars and the lowest possible rating is one star. The actual statistics on which the percentiles are based are as follows:

1. Performance: ROR
2. Risk: Standard Deviation
3. RiskAdj: Sharpe Ratio
4. Equity: Assets"[5]

Dunn Capital receives one star for "Risk," the implication being that an investment with Bill Dunn is risky. However, do these kinds of rankings really give us accurate information on Dunn Capital

Volatility is the tendency for prices to change unexpectedly. [7]

Management's risk? ITR uses standard deviation as their measure for "Risk." This is a measure of volatility and not risk. High volatility alone does not necessarily mean higher risk as a percent of equity traded.

It's doubtful that Bill Dunn is concerned about being unfairly penalized with such a measurement, but for someone who is accustomed to comparing traders by using standard deviation as a risk measurement, the story is inaccurate.

A great example of the star system weakness is demonstrated by the ranking of infamous former trader Victor Niederhoffer. At the time of Victor Niederhoffer's public trading demise in 1997 (more on Victor Niederhoffer's dance with the Asian Contagion in Chapter 4), he was rated as four stars for "Risk." Based on the past performance of Niederhoffer, the rankings were saying that he was a much "safer bet" than Dunn Capital Management. Obviously, the star system failed for people who believed Niederhoffer was less "risky." Standard deviation as a risk measure has done trend followers and anyone who wishes to learn about them or from them an injustice. One of our goals is to dispel the simplistic notion that Trend Following is "just risky" or that they "all have high standard deviations" which means they are "bad."

Where does proper analysis begin? Examine the following chart of various trend following performances from January 1993 to June 2003 (Chart 3.1):

CHART 3.1: Absolute Return: Annualized ROR (Jan. '93–Jun. '03)

Trading Managers		Annualized ROR	Compounded ROR
1	Eckhardt Trading Co. (Higher Leverage)	31.14%	1622.80%
2	Dunn Capital Management, Inc. (World Monetary Asset)	27.55%	1186.82%
3	Dolphin Capital Management Inc. (Global Diversified I)	23.47%	815.33%
4	Eckhardt Trading Co. (Standard)	22.46%	739.10%
5	KMJ Capital Management, Inc. (Currency)	21.95%	703.59%
6	Beach Capital Management Ltd (Discretionary)	21.54%	675.29%

CHART 3.1: Absolute Return: Annualized ROR (Jan. '93–Jun. '03) Continued

Trading Managers		Annualized ROR	Compounded ROR
7	Mark J. Walsh & Company (Standard)	20.67%	618.88%
8	Saxon Investment Corp. (Diversified)	19.25%	534.83%
9	Man Inv. Products, Ltd (AHL Composite Pro Forma)	17.66%	451.77%
10	John W. Henry & Company, Inc. (Global Diversified)	17.14%	426.40%
11	John W. Henry & Company, Inc. (Financial & Metals)	17.07%	423.08%
12	Dreiss Research Corporation (Diversified)	16.47%	395.71%
13	Abraham Trading Co. (Diversified)	15.91%	371.08%
14	Dunn Capital Management, Inc. (Targets of Opportunity System)	14.43%	311.66%
15	Rabar Market Research (Diversified)	14.09%	299.15%
16	John W. Henry & Company, Inc. (International Foreign Exchange)	13.89%	291.82%
17	Hyman Beck & Company, Inc. (Global Portfolio)	12.98%	260.18%
18	Campbell & Company (Fin. Met. & Energy—Large)	12.73%	251.92%
19	Chesapeake Capital Corporation (Diversified)	12.70%	250.92%
20	Millburn Ridgefield Corporation (Diversified)	11.84%	223.88%
21	Campbell & Company (Global Diversified—Large)	11.64%	217.75%
22	Tamiso & Co., LLC (Original Currency Account)	11.42%	211.29%
23	JPD Enterprises, Inc. (Global Diversified)	11.14%	203.03%

At some point, just saying a trader is volatile makes no sense if you look at the absolute return performance of Bill Dunn or John W. Henry (Chart 3.1). Raw absolute return of must count for something.

However, volatility (what standard deviation really measures) is a four-letter word for most market participants. Volatility scares them silly, even though a freshman algebra student could quickly analyze any historical data series of any market or trend follower and see that volatility is to be expected, plenty of investors run away from even a hint of volatility. Of course, some markets and traders are more volatile than others, but degrees of volatility are a

basic fact of life. To trend followers, volatility is the precursor to profit. No volatility equals no profit.

The press is also usually confused by the concept of volatility as seen in this excerpt from *Business Week*:

"Trend followers are trying to make sense out of their dismal recent returns. 'When you look past the superficial question of how we did, you look under the hood and see immense change in the global markets,' says John W. Henry's president. 'Volatility is just a harbinger of new trends to come.' Maybe. But futures traders are supposed to make money by exploiting volatility. Performance isn't a 'superficial question' if you were among the thousands of commodity-fund customers who lost money when the currency markets went bonkers."[8]

Unfortunately, this reporter is confused about volatility. High volatility doesn't necessarily mean high risk. Additionally, focusing on one time period in isolation while ignoring a complete performance history does not present the full picture. We wondered if he had written a follow-up article correcting his observations about Trend Following since the following year Bill Dunn produced a 60.25 percent return and Jerry Parker produced a 61.82 percent return. It didn't surprise us when our search of all *Business Week* articles revealed nothing remotely resembling a follow-up article or correction.

What Is Volatility for Trend Followers?

Some people suggested a few years ago that Trend Following had been marginalized. The answer is we haven't been marginalized—[Trend Following] has played a key role in helping protect a lot of people's wealth this year.

Mark Rzepczynski,
President and Chief Investment Officer
of John W. Henry & Co, 2003[9]

Nicola Meaden, a hedge fund researcher, compared monthly standard deviations (volatility as measured from the mean) and semi-standard deviations (volatility measured on the downside only) and found that while trend followers experience a lot of volatility, it is concentrated on the upside, not the downside.

Because, generally speaking, trend followers' volatility is consistently on the plus side, they are unfairly penalized by Sharpe Ratio aficionados. The Sharpe Ratio does not show whether volatility is on the plus or the minus side because it does not account for the difference between the standard deviation and the semi-standard deviation. The actual formula for calculating them is identical, with one exception: The semi-standard deviation looks only at observations below the mean. If the semi-standard deviation is lower than the standard deviation, the historical pull away from

the mean has to be on the plus side. If it is higher, the pull away from the mean is on the minus side. Meaden points out the huge difference that puts Trend Following volatility on the upside if you compare monthly standard (12.51) and semi-standard (5.79) deviation.[10]

Here is another way of understanding upside volatility: Think about a market that is going up. You enter at $100 and the market goes to $150. But then the market drops down to $125. Should you panic? No. Because after going from $100 to $150, then dropping back to $125, the market then zooms up to $175. This is Trend Following volatility in action.

You entered at $100. Why are you feeling bad about yourself when your position is at $125, even though you got up to a high of $150? You are still up $25, right? Far too many investors get tied up in knots trying to control or constrain how your profits move forward. Everybody wants a trade that allows you to enter at $100 and be at $120 at the end of a year. Ideally, at the end of the second year it would be at $140. Then at the end of the next year it would be at $160; the next year at $180, and so on. The real world doesn't work like that. Your position may go from $100 to $150 to $125 to $175 to $225.

Trading is a zero-sum game in an important accounting sense. In a zero-sum game, the total gains of the winners are exactly equal to the total losses of the losers.[12]

Trend followers have greater upside volatility and less downside volatility than traditional equity indices such as the S&P, because they exit their losing trades quickly. This results in many small loses. On the other hand, trend followers stay with profitable trends for a long time, even if there is upside volatility. When trend followers do well, they make money in sudden bursts, hence the high upside volatility.

Michael Rulle, President of Graham Capital, adds:

"A trend follower achieves positive returns by correctly targeting market direction and minimizing the cost of this portfolio. Thus, while Trend Following is sometimes referred to as being 'long volatility,' trend followers technically do not trade volatility, although they often benefit from it."[11]

Invariably, the best trend followers are high volatility traders. High rewards come with high volatility. If you can stay price driven and react to the moment with a precise set of rules, there is no need to obsess on preserving open profits or engineering new ways to lower volatility. The question, then, is not how to reduce volatility,

but how to manage it through proper investment size or money management.

That being said you must be accustomed to never seeing a smooth growth curve for your money. You will have to get used to riding the bucking bronco. Jerry Parker, John W. Henry, and Bill Dunn don't see straight up equity curves in their accounts either, so you are in good company.

John W. Henry makes the clear distinction between volatility and risk:

". . . Risk is very different from volatility. A lot of people believe there is no difference, but there's a huge difference and I can spend an hour on that topic. Suffice it to say that we embrace both volatility and risk and, for us, risk is that we're going to lose if we risk two tenths of one percent on a particular trade. That is, to us, real risk. Giving back a profit to you probably seems like risk, to us it seems like volatility."

Some people seem to like to lose, so they win by losing money.

Ed Seykota[14]

Henry's long-term world-view doesn't avoid high volatility. He patiently sits though it. The last thing he wants to experience is volatility forcing him out of a major trend before he can garner the big profits. Dinesh Desai, a trend follower from the 1980s who is now retired, was fond of saying that he loved volatility. He was clear that being on the right side of a moving market was the source of his profits.

But the skeptics mistakenly view high volatility, the engine that drives Trend Following's spectacular returns, as negative. For example, in the May 2001 *Managed Accounts Reports*, a fund manager who manages about $1.5 billion in assets remains on the sidelines refusing to believe in trend following:

"My biggest source of hesitancy about the asset class [Trend Following] is its reliance on technical analysis. Trading advisors do seem to profit, but since they rarely incorporate economic data, they simply ride price trends until they reverse. The end result of this crude approach is a subpar return to risk ratio." Another manager opines, "Why should I give money to a AA baseball player when I can hire someone in the major leagues?"[13]

How can one look at the absolute performance of Bill Dunn or John W. Henry and call it AA baseball? If you can get beyond the majority's irrational fear of volatility, you can learn when volatility really matters. Trend follower, Jason Russell, President of Hedgehog

Capital and student of Ed Seykota's, knows when volatility kicks in for him:

"Volatility matters when you feel it. All the charts, ratios and advanced math in the world mean nothing when you break down, vomit or cry due to the volatility in your portfolio. I call this the vomitility threshold. Understanding your threshold is important, for it is at this point that you lose all confidence and throw in the towel. Traders, portfolio managers and mathematicians seem well equipped to describe risk with a battery of formulas and ratios they use to measure volatility. However, even if you can easily handle the math, it can be a challenge to truly conceptualize it. The simple fact is that for the investor, the act of truly working through the thoughts and feelings that accompany losing money is hard. It is about as enjoyable as working through the thoughts and feelings associated with your death when preparing a will. There is no mathematical formula for vomitility because it is different for each person . . . For the [trader] who wants anything other than an interest-paying deposit at the bank, I think I can sum it up as follows: Surrender to the reality that volatility exists or volatility will introduce you to the reality that surrender exists."

If you were to put all the Trend Following models side by side, you would probably find that most made profits and incurred losses in the same markets. They were all looking at the same charts and obtaining the same perception of opportunity.

Marc Goodman
Kenmar Asset Allocation[16]

Drawdowns

With volatility comes the inevitable drawdown. "A Drawdown is any losing period during an investment record. It is defined as the percent retrenchment from an equity peak to an equity valley. A Drawdown is in effect from the time an equity retrenchment begins until a new equity high is reached. (i.e., In terms of time, a drawdown encompasses both the period from equity peak to equity valley (Length) and the time from the equity valley to a new equity high (Recovery).)"[15]

For example, if you start from $100,000 and drop to $50,000, then you are in a 50 percent drawdown. (You can also say that you have lost 50 percent.) Thus drawdown is a reduction in account equity.

Unfortunately, poorly educated clients and regulators have made drawdown a dirty word similar to how they vilify volatility. Traders are often forced to talk about their drawdowns in a highly negative manner, as if they must make excuses for these losses. Take this excerpt from Bill Dunn's marketing materials for example:

Dunn Capital Management's documents include a "summary of serious past losses." The summary explains that the firm has suffered through seven difficult periods of losses of 25% or more. Every potential investor receives a copy. Dunn says the summary communicates that this is what happened before and it will happen again. "If the investor is not willing to live through this, they are not the right investor for the portfolio," Dunn says."[18]

"Investors should be aware of the volatility inherent to DUNN's trading programs. Because the same portfolio risk profile is intrinsic to all DUNN programs, investors in any DUNN program can be expected to experience volatility similar to DUNN's composite record. During 26+ years of trading, the composite record, on a month-to-month basis, has experienced eight serious losses exceeding 25%. The eighth such loss equaled 40%, beginning in September 1999 and extending through September 2000. This loss was recovered in the three-month period ending in December 2000. The most serious loss in DUNN's entire history occurred over a four-month period which ended in February 1976 and equaled 52%. Clients should be prepared to endure similar or worse periods in the future. The inability (or unwillingness) to do so will probably result in serious loss, without the opportunity for subsequent recovery."[17]

Unless you truly understand how Dunn Capital Management trades, you might refuse to even consider investing with them, even though their 28-year track record is spectacular on an absolute return basis.

Examine the Dunn drawdown history (Chart 3.2):

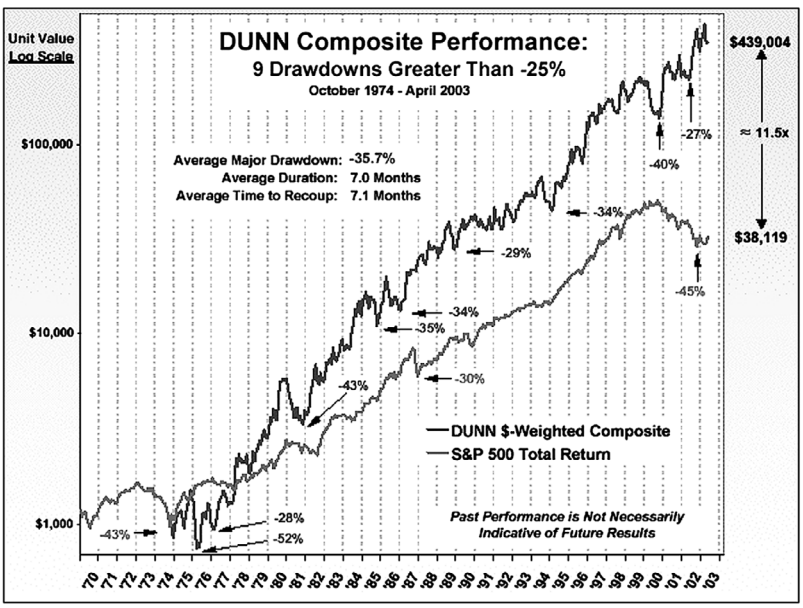

CHART 3.2: Dunn Drawdown Chart. *Source:* Dunn Capital Management

Imagine that the valleys between the peaks are filled with water. First, place a piece of paper over the chart and then very slowly move the paper to the right and uncover the chart. Imagine that you have made a very large investment in the fund. How do you feel as you move the page? How long can you remain underwater? How deep can you dive? Do you pull out the calculator and figure out what you could have earned at the bank? Do you figure out that you lost enough to buy a vacation, car, house, castle or perhaps solve the hunger crisis in a small country?

To the smart investor, the Dunn drawdown chart (Chart 3.2) is entirely acceptable because of his absolute returns over the long term, but of course that doesn't make these numbers necessarily easy to live with.

A proper discussion of drawdown and Trend Following must lead to the recovery process (which means bringing your capital to the point where your drawdown first started). Historically, trend followers quickly make money back during their recovery from drawdown.

The 25 or 50 biggest trend followers are essentially going to make money in the same places. What differentiates them from one another are portfolio and risk management.[19]

However, we must not neglect the math associated with losing money and then making it back. What if you start with $100 and it drops to $50. You are now in a 50 percent drawdown. How much do you have to make just to get back to break-even (Chart 3.3)? 100 percent. That's right, when you go down 50 percent, you need to make 100 percent to get back to break-even.

Notice that as your drawdown increases (Chart 3.3), the percent gain necessary to recover to the breakeven point increases at a much faster rate. Trend followers live with this chart day in and day out. Their strategy is designed with these numbers in mind.

CHART 3.3: Drawdown Recovery Chart

Size of drawdown	Percent gain to recover
5%	5.3%
10%	11.1%
15%	17.6%
20%	25.0%
25%	33.3%
30%	42.9%

CHART 3.3: Drawdown Recovery Chart Continued

Size of drawdown	Percent gain to recover
40%	66.7%
50%	100%
60%	150%
70%	233%
80%	400%
90%	900%
100%	Ruin

We have not made any changes because of a drawdown. While we have made minor changes since the program started trading in 1974, over the course of the years the basic concepts have never changed. The majority of the trading parameters and the buy and sell signals largely have remained the same.

Bill Dunn[21]

Unfortunately, the investment community uses drawdown numbers to paint an incomplete and unfair picture of Trend Following. David Harding of Winton Capital offered us insight.

"A key measure of track record quality and strategy "riskiness" in the managed futures industry is drawdown, which measures the decline in net asset value from the historic high point. Under the Commodity Futures Trading Commission's mandatory disclosure regime, managed futures advisors are obliged to disclose as part of their capsule performance record their 'worst peak-to-valley drawdown.' As a description of an aspect of historical performance, drawdown has one key positive attribute: it refers to a physical reality, and as such it is less abstract than concepts such as volatility. It represents the amount by which you are less well off than you were; or, put differently, it measures the magnitude of the loss an investor could have incurred by investing with the manager in the past. Managers are obliged to wear their worst historical drawdown like a scarlet letter for the rest of their lives."[20]

We recognize that traders must wear their worst drawdowns like a scarlet letter, but if the entire story of an absolute return trading strategy such as Trend Following is revealed, no one need ever fear a drawdown. For example, here is John W. Henry's drawdown and recovery in action (Chart 3.4):

CHART 3.4: JWH Financial and Metals Portfolio, Jan. 1, 1989 through Oct. 31, 1999
Source: John W. Henry and Company[22]

	-10% or More	-15% or More	-20% or More	-25% or More	-30% or More
# Month-End Occurrences	28	18	10	7	3
Average Drawdown	-19.7%	-24.0%	-29.2%	-31.7%	-37.5%
# Profitable 12 Months Later	25	17	All	All	All
Average Profit 12 Months Later	+52.4%	+58.6%	+73.5%	+74.8%	+96.1%
Average Time to New Peak through Trough	4 months	4 months	4 months	4 months	4 months

Henry's historical recovery bolsters our words with cold, hard numbers. But there is no getting around it: You can't eliminate catastrophic risk, much less drawdowns, from your trading. But you can manage drawdowns with Trend Following techniques.

Interestingly, there is another perspective on drawdowns that few people consider. When you look at Trend Following performance data—for example, Bill Dunn's track record—you can't help but notice that some times for becoming an investor in Dunn Capital Management are better than others.

Smart clients of Bill Dunn will look at the performance chart of Dunn Capital Management and buy in when the fund is experiencing a drawdown. Why? Because if Dunn is down 30 percent, and you know from your analysis of his past performance data that his recovery from drawdowns is typically quick and impressive, then why not "buy" Bill Dunn while he is on sale? This is commonly referred to as equity curve trading. Tom Basso makes the case:

"I haven't met a trader a yet that wouldn't say privately that he would tend to buy his program on a drawdown, particularly systematic traders. But, investors seem to not add money when, to traders, it seems to be most logical to do so . . . Why don't investors

You have to keep trading the way you were before the drawdown and also be patient. There's always part of a trader's psyche that wants to make losses back tomorrow. But traders need to remember you lose it really fast, but you make it up slowly. You may think you can make it up fast, but it doesn't work that way.

David Druz[23]

"Correlation coefficient: A statistical measure of the interdependence of two or more random variables. Fundamentally, the value indicates how much of a change in one variable is explained by a change in another."[25]

Maryland-based Campbell & Company, a trend-following managed futures firm with almost $3 billion in assets under management, has returned 17.65% since its inception in 1972, proving that performance can be sustainable over the long-term.[26]

The Millburn Diversified Portfolio has a 10% allocation which has historically exhibited superior performance characteristics coupled with an almost zero correlation of monthly returns to those of traditional investments. If an investor had invested 10% of his or her portfolio in the Millburn Diversified Portfolio from February 1977 through August 2003 he or she would have increased the return on his or her traditional portfolio by 73 basis points (a 6.2% increase) and decreased risk (as measured by standard deviation) by 0.26 of a percent (an 8.2% decrease).

www.millburncorp.com

invest on drawdowns? I believe the answer to that question lies in the investing psychology of buying a drawdown. The human mind can easily extrapolate 3 months of negative returns into 'how long at this rate will it take to lose 50% or everything?' Rather than seeing the bargain and the positive return to risk, they see only the negative and forecast more of the same into the future."[24]

Not only do trend followers tell clients to buy into their funds during a drawdown, they buy into their own funds with their own capital during their drawdowns. We know of employees at top trend followers that are almost giddy when they are in a drawdown since they know what is around the corner. This is a strong indication of the faith they have in their ability to recover.

Correlation

Correlation comparisons not only prove that Trend Following is a legitimate style, but also demonstrate the similarity of performances among trend followers. Correlation is not only important in assembling the portfolio you trade (see Chapter 9), but it is your critical tool to analyze and compare performance histories of trend followers. Unlike misguided comparisons using standard deviations, we find correlation comparisons of performance data extremely useful.

Julius A. Staniewicz, of John W. Henry and Co, in *Learning to Love Non-Correlation*, defines correlation as "a statistical term giving the strength of linear relationship between two random variables. It is the historical tendency of one thing to move in tandem with another." The correlation coefficient is a number from -1 to +1, with -1 being the perfectly opposite behavior of two investments (e.g., up 5% every time the other is down 5%). +1 reflects identical investment results (up or down the same amount each period). The further away from +1 one gets (and thus closer to -1), the better a diversifier one investment is for the other. But since John W. Henry's firm is keenly aware of keeping things simple, they also provide us with another description of correlation: The tendency for one investment to "zig" while another "zags."[27]

We took the monthly performance numbers of trend followers and computed their correlation coefficients. Comparing correlations

provided the evidence that trend followers trade typically the same markets in basically the same way at the same time.

Look at the correlation chart (Chart 3.5) and ask yourself why two trend followers who don't work in the same office—who are on opposite sides of the continent—have the same three losing months in a row with very similar percentage losses. Then ask why they have the same winning month, then the same two losing months, and then the same three winning months in a row. The relationship is there because these trend followers can only respond to what the market offers. The market offers trends to everyone equally. They're all looking at the same market aiming for the same target of opportunity.

Does this chart (Chart 3.5) mean trend followers are using similar techniques? Absolutely.

CHART 3.5: Correlation among Trend Followers

	AbrDiv	CamFin	CheDiv	DUNWor	EckSta	JohFin	ManAHL	MarSta	RabDiv
AbrDiv	1.00	0.56	0.81	0.33	0.57	0.55	0.56	0.75	0.75
CamFin	0.56	1.00	0.59	0.62	0.60	0.56	0.51	0.57	0.55
CheDiv	0.81	0.59	1.00	0.41	0.53	0.55	0.60	0.72	0.75
DUNWor	0.33	0.62	0.41	1.00	0.57	0.62	0.61	0.51	0.45
EckSta	0.57	0.60	0.53	0.57	1.00	0.57	0.58	0.74	0.71
JohFin	0.55	0.56	0.55	0.62	0.57	1.00	0.53	0.55	0.50
ManAHL	0.56	0.51	0.60	0.61	0.58	0.53	1.00	0.57	0.59
MarSta	0.75	0.57	0.72	0.51	0.74	0.55	0.57	1.00	0.68
RabDiv	0.75	0.55	0.75	0.45	0.71	0.50	0.59	0.68	1.00

AbrDiv: Abraham Trading Co.
CamFin: Campbell & Company
CheDiv: Chesapeake Capital Corporation
DUNWor: DUNN Capital Management, Inc.
EckSta: Eckhardt Trading Co.
JohFin: John W. Henry & Company, Inc.
ManAHL: Man Inv. Products, Ltd
MarSta: Mark J. Walsh & Company
RabDiv: Rabar Market Research

Surprisingly, correlation can be a touchy subject for some trend followers. The Turtles (Chapter 2) were all grateful to Richard Dennis for his inspiration and mentoring, but some seemed to become ambivalent over time, obviously indebted to Dennis but struggling to achieve their own identity:

"[Hawksbill] says his system is 95% Dennis' system and the rest his 'own flair . . . I'm a long way from someone who follows the system mechanically . . . but by far, the structure of what I do is based on Richard's systems, and certainly, philosophically, everything I do in terms of trading is based on what I learned from Richard.'"[28]

Even when correlation data still shows similar patterns of trading among many of Dennis' students, the desire of some to differentiate themselves from each other is stronger than their need to address the obvious similarity in Turtle return streams:

"There no longer is a turtle trading style in my mind. We've all evolved and developed systems that are very different from those we were taught, and that independent evolution suggests that the dissimilarities to trading between turtles are always increasing."[29]

The correlation chart comparing Hawksbill to other Turtle trend followers paints a clear picture. The relationship is solid. The data (Chart 3.6) is the real judge:

CHART 3.6: Correlation among Turtle Traders

	Chesapeake	Eckhardt	Hawksbill	JPD	Rabar
Chesapeake	1	0.53	0.62	0.75	0.75
Eckhardt	0.53	1	0.7	0.7	0.71
Hawksbill	0.62	0.7	1	0.73	0.76
JPD	0.75	0.7	0.73	1	0.87
Rabar	0.75	0.71	0.76	0.87	1

Correlation coefficients gauge how closely an advisor's performance resembles another advisor. Values exceeding 0.66 may be viewed as having significant positive performance correlation. And consequently, values exceeding -0.66 may be viewed as having significant negative performance correlation.

Chesapeake Capital Corporation
Eckhardt Trading Co.
Hawksbill Capital Management
JPD Enterprises Inc.
Rabar Market Research

Of course, there is more to the story than just correlation. While correlations show the Turtles still trade in similar ways, their returns can also differ because of their individual leverage choices. Some traders use a lot of leverage while others, like Jerry Parker, use less in order increase the comfort level of some institutional investors. Parker explains, "The bigger the trade, the greater the returns and the greater the drawdowns. It's a double-edged sword."[30]

The Zero-Sum Nature of the Markets

"Zero-sum" or "zero-sum trading" is arguably the most important concept in this chapter. Larry Harris, the Chair in Finance at the Marshall School of Business at University of Southern California and the current Chief Economist of The Securities and Exchange Commission, gets to the crux of the matter:

"Trading is a zero-sum game when gains and losses are measured relative to the market average. In a zero-sum game, someone can win only if somebody else loses."[31]

If you get people asking the wrong questions, you don't have to worry about the answers.

Hunter S. Thompson

Another good explanation of the zero-sum concept is found in "The Winners and Losers of the Zero-Sum Game: The Origins of Trading Profits, Price Efficiency and Market Liquidity," a white paper also authored by Larry Harris. In speaking with Harris he told us he was amazed at how many people came from the TurtleTrader.com Web site seeking to download his white paper and or find more information on the topics it addressed.

In brief, Harris examines what factors determine who wins and who loses when trading. He does this by categorizing traders by type and then evaluating their trading styles to determine whether the styles lead to profits or losses. Harris was direct in his analysis:

"Winning traders can only profit to the extent that other traders are willing to lose. Traders are willing to lose when they obtain external benefits from trading. The most important external benefits are expected returns from holding risky securities that represent deferred consumption. Hedging and gambling provide other external benefits. Markets would not exist without utilitarian traders. Their trading losses fund the winning traders who make prices efficient and provide liquidity."[32]

There are individuals who absolutely will not accept that there must a loser for them to be a winner. They cannot live with the idea that life is unfair and they can't have it both ways with everyone winning. Although they want to win, they do not want to live with the guilt that by their winning, someone else had to lose. This is a poorly thought out, yet all too common, view of the situation.

What separates winners from losers? Harris offers: "On any given transaction, the chances of winning or losing may be near even. In the long run, however, winners profit from trading because they have some persistent advantages that allow them to win slightly more often (or occasionally much bigger) than losers win."[33]

For anyone who has ever played blackjack or poker, or read about "edges" in gambling, Harris' words will ring a bell:

"To trade profitably in the long run, you must know your edge, you must know when it exists, and you must focus your trading to exploit it when you can. If you have no edge, you should not trade for profit. If you know you have no edge, but you must trade for other reasons, you should organize your trading to minimize your losses to those who do have an edge. Recognizing your edge is a prerequisite to predicting whether trading will be profitable."[34]

These observations will save your skin if you're willing to accept the zero-sum game, but as you will see throughout this chapter and the next, many traders are either ignorant of zero-sum thinking or choose to ignore it.

George Soros Refutes Zero-Sum

The success of famed trader George Soros is well-known:

"Soros is the best-known [of the] hedge fund investors. In 1992 he was called 'the man who broke the pound' for placing $10 billion in bets against the British pound that netted him at least $1 billion in profit."[35]

George Soros appeared on *Nightline*, the ABC news program, a few years ago. The following exchange between Soros and host Ted Koppel goes straight to the core of zero-sum:

Ted Koppel:. . . as you describe it, it [the market] is, of course, a game in which there are real consequences. When you bet and you win, that's good for you, it's bad for those against whom you have bet. There are always losers in this kind of a game.

George Soros: No. See, it's not a zero-sum game. It's very important to realize . . .

Ted Koppel: Well, it's not zero-sum in terms of investors. But, for example, when you bet against the British pound, that was not good for the British economy.

George Soros: Well, it happened to be quite good for the British economy. It was not, let's say, good for the British treasury because they were on the other side of the trade . . . It's not—your gain is not necessarily somebody else's loss.

Ted Koppel: Because—I mean put it in easily understandable terms—I mean if you could have profited by destroying Malaysia's currency, would you have shrunk from that?

George Soros: Not necessarily because that would have been an unintended consequence of my action. And it's not my job as a participant to calculate the consequences. This is what a market is. That's the nature of a market. So I'm a participant in the market.

Soros opens his own personal can of worms here with his view on zero-sum. Here's an online weblog post that incorrectly analyzes the importance of Soros' interview. The poster argues:

"Cosmetically, Koppel wipes the floor with Soros. He's able to portray Soros as a person who destroys lives and economies without a second thought, as well as simplify, beyond belief, something that should not be simplified."[36]

This is nonsense. The fact that Soros is a player in the market does not establish him as a destroyer of lives. You may disagree with Soros' ever-changing political ideology, but you can't question his morality for participation in the market. Do you have a 401k plan designed to generate profits from the market? Of course you do, just like Soros.

Others, such as Lawrence Parks, a union activist, correctly state that Soros is in a zero-sum game, but then get sidetracked by bias such as deeming the concept of zero-sum unfair and harsh for the "working man":

What objectivity and the study of philosophy requires is not an "open mind," but an active mind—a mind able and eagerly willing to examine ideas, but to examine them critically.

Ayn Rand[37]

"Since currency and derivative trading are zero-sum games, every dollar "won" requires that a dollar was "lost." But who are the losers that not only sustain but continue to tolerate these enormous losses year after year? Who could be so wealthy or so ignorant that $50 billion each year doesn't matter? Haven't they realized what a losing proposition this has been? What's more, why do they keep playing at a losing game? The answer is that the losers are all of us. And, while neither rich nor stupid, we've been given no choice but to continue to lose. Every time we, on behalf of our businesses or ourselves, change one currency into another, we lose transaction costs. Every time we hedge a payment from or to a foreign land, the cost of that hedge represents a loss of wealth. And every time one of these fiat currencies cannot be "defended," the workers, seniors, and business owners of that country—folks like us—suffer big time. Indeed, as their currencies are devalued, workers' savings and future payments, such as their pensions, denominated in those currencies lose purchasing power. Interest rates increase. Commercial relationships predicated upon lower interest rates unravel, and businesses go out of business. Through no fault of their own, working people lose their jobs in addition to their savings. There have been press reports that, after a lifetime of working and saving, people in Indonesia are eating bark off the trees and boiling grass soup. While not a secret, it is astonishing to learn how sanguine the beneficiaries have become of their advantage over the rest of us. For example, famed financier George Soros in his recent The Crisis of Global Capitalism plainly divulges: 'The Bank of England was on the other side of my transactions and I was taking money out of the pockets of British taxpayers.' To me, the results of this wealth transfer are inescapable."[38]

Parks argues that the only choice he has been given is to lose. He loses; his union loses; everyone apparently loses in the zero-sum game. Of course there are winners and he knows that. The zero-sum game is, indeed, a wealth transfer. The winners profit from the losers. Parks correctly describes the nature of the zero-sum game but then positions the game in terms of morality. Life is not fair. If you don't like being a loser in the zero-sum game, perhaps it is time to consider how the winners (trend followers) play the game.

While it may appear that we are defending Soros, we're not. The market is a zero-sum game. Trying to fathom Soros' reasons for denying this would be pure speculation on our part. Soros is not always a zero-sum winner either. Soros was on the losing side of the

zero-sum game during the Long Term Capital Management fiasco in 1998. He lost $2 billion dollars. (We discuss this in more detail in Chapter 4). He also had severe trouble in the 2000 tech meltdown:

"With bets that went sour on technology stocks and on Europe's new currency, the five funds run by Soros Fund Management have suffered a 20 percent decline this year and, at $14.4 billion, are down roughly a third from a peak of $22 billion in August 1998."[39]

These wins and losses seem to have taken a toll on Soros: "Maybe I don't understand the market. Maybe the music has stopped but people are still dancing. I am anxious to reduce my market exposure and be more conservative. We will accept lower returns because we will cut the risk profile."[40]

We don't see evidence that the market has changed. Nor has the zero-sum game changed. However, something may have changed within George Soros.

It's all a matter of perspective. What some consider a catastrophic flood, others deem a cleansing bath.

Gregory J. Millman[42]

Dot-Com Mees Zero-Sum

Judge Milton Pollack's 2003 ruling dismissing class action suits against Merrill Lynch clearly illustrates the concept of zero-sum again. He minces no words in warning whiners about the zero-sum game they are playing:

"Seeking to lay the blame for the enormous Internet Bubble solely at the feet of a single actor, Merrill Lynch, plaintiffs would have this Court conclude that the federal securities laws were meant to underwrite, subsidize, and encourage their rash speculation in joining a freewheeling casino that lured thousands obsessed with the fantasy of Olympian riches, but which delivered such riches to only a scant handful of lucky winners. Those few lucky winners, who are not before the Court, now hold the monies that the unlucky plaintiffs have lost, fair and square, and they will never return those monies to plaintiffs. Had plaintiffs themselves won the game instead of losing, they would have owed not a single penny of their winnings to those they left to hold the bag (or to defendants)."[41]

A 96-year-old judge bluntly telling the plaintiffs to take responsibility for their own actions may have been painful reading for investors who were following the case. Pollack chastises the losers for trying to circumvent the zero-sum market process by

using the legal process basically telling them this time there would be no free lunch.

The harsh reality of the markets is that, if you are a trader or investor, ultimately, you have only yourself to blame for the decisions you make with regard to your money. You can make losing decisions or winning decisions. It's your choice.

David Druz, a student of Ed Seykota and a longtime trend follower, takes the Judge Pollack's ruling a step further and spells out the practical effects of the market's zero-sum nature:

If all it took to beat the markets was a Ph.D. in mathematics, there'd be a hell of a lot of rich mathematicians out there.

Bill Dries[43]

"Everyone who enters the market thinks they will win, but obviously there are losers as well. Somebody has to be losing to you if you are winning, so we always like to stress that you should know from whom you're going to take profits, because if you're buying, the guy that's selling thinks he's going to be right, too."

The market is a brutal place. Forget trying to be liked. Need a friend, get a dog. The market doesn't know you and never will. If you are going to win, then someone else has to lose. You don't like these "survival of the fittest" rules? Stay out of the zero-sum game.

Key Points

- Trend followers always prepare for drawdowns after strong periods of performance.
- An absolute return strategy means you are trying to make the most money possible.
- The fact that markets are volatile (go up and down) is not a problem. The problem is you if that volatility scares you.
- Trading is a zero-sum game in an important accounting sense. In a zero-sum game, the total gains of the winners are exactly equal to the total losses of the losers.