UPDATED EDITION

The Strategy that MADE MILLIONS in the 2008 Market Crash

TREND FOLLOWING

LEARN TO MAKE MILLIONS IN UP OR DOWN MARKETS

MICHAEL W. COVEL

"We don't make market predictions. We just ride the bucking bronco."
—Bill Dunn, Dunn Capital Management, Inc.

Praise for *Trend Following*

"Michael Covel's Trend Following*: essential."*

—Ed Seykota, trend follower and original market wizard

"Trend Following *by Michael Covel? I'm 'long' this book."*

—Bob Spear, developer of Trading Recipes Software

"Michael Covel's Trend Following *is a breakthrough book that captures the essence of what really makes markets tick. Diligently researched and comprehensive in scope, it will replace* The Market Wizards *as the must-read bible for a new generation of traders."*

—Jonathan Hoenig, portfolio manager, Capitalistpig Hedge Fund LLC and Fox News contributor

"Investment books that have a lasting appeal offer insight that resonates with a large number of investors. We believe Michael Covel's Trend Following *will be such a book."*

—Richard E. Cripps, Legg Mason chief market strategist

*"Please read [*Trend Following*] whether you think you have an interest in trend following or are not sure…Covel has hit a home run with it."*

—Gail Osten, editor-in-chief, *Stocks, Futures, & Options* magazine

"Michael Covel has written the definitive book on trend following. With careful research and clear insight, he has captured the essence of the most successful of all trading strategies. Michael knows his subject matter and he writes about it with passion, conviction, and enthusiasm. This enjoyable and well written book is destined to become a classic."

—Charles LeBeau, author of *Technical Traders Guide to Computer Analysis of the Futures Markets*

"Trend Following *is an engrossing and educational journey through the principles, pitfalls, players, and psychology of aggressive technical trading of the investment markets. [It is] rich in its wisdom and historical study."*

—Gerald Appel, president of Signalert Corporation and publisher of *Systems and Forecasts* newsletter

"Conventional wisdom says buy low and sell high, but what do you do now that your favorite market—be it a stock, bond, or commodity—is at an all-time high or low? For a completely different perspective, from people who actually make money at this business, take a look inside. Michael Covel has written a timely and entertaining account of trend following—how it works, how to do it, and who can do it. While it's not for everybody, it might be for you."

—Charles Faulkner, NLP modeler and trading coach, featured in numerous books including *The New Market Wizards*

"I think the book did a superb job of covering the philosophy and thinking behind trend following (basically, why it works). You might call it the Market Wizards of Trend Following."

—Van K. Tharp, Ph.D., president, International Institute of Trading Mastery, Inc. Van was originally profiled in *The Market Wizards* by Jack Schwager.

"I think that this book documents a great deal of what has made trend following managers a successful part of the money management landscape (how they manage risk and investment psychology). It serves as a strong educational justification on why investors should consider using trend following managers as a part of an overall portfolio strategy."

—Tom Basso, retired CEO, Trendstat Capital Management, Inc. Tom was originally profiled in *The New Market Wizards* by Jack Schwager.

"Michael Covel mixes a unique blend of trend following matters with the thoughts and quotes of successful traders, investors and society's leaders. This is a valuable contribution and some of the best writing on trend following I've seen."

—Robert (Bucky) Isaacson, managed money and trend following pioneer for more than 30 years

"Trend Following*: Definitely required reading for the aspiring trader."*

—David S. Druz, tactical investment management and trend follower for 25 years

"Michael Covel reveals the real secret about trading—that there is no secret. His points are peppered with wisdom from experts across the industry."

—John Ehlers, president, MESA Software

Trend Following
(Updated Edition)

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Publishing as FT Press
Upper Saddle River, New Jersey 07458

Printed in the United States of America

Eighth Printing: March 2011

ISBN-10: 0-13-702018-X
ISBN-13: 978-0-13-702018-8

Pearson Education Ltd.

Pearson Education Australia PTY, Limited.
Pearson Education Singapore, Pte. Ltd.
Pearson Education North Asia, Ltd.
Pearson Education Canada, Ltd.
Pearson Educación de Mexico, S.A. de C.V.
Pearson Education—Japan
Pearson Education Malaysia, Pte. Ltd.

The Library of Congress Cataloging-in-Publication data is on file.

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Foreword

> **"No good decision was ever made in a swivel chair."**
> **—General George S. Patton, Jr.**

Larry Hite

When I started trading in the commodity futures markets over 35 years ago, the industry didn't even have a name. Today, the business has grown to the point where there are a myriad of ways to describe the funds that operate and their many styles of investing. The particular discipline of trading that I practiced, even before the nomenclature existed, is now plainly and aptly termed "trend following." In fact, while I have seen many strategies come and go, most of the other managers that I have known to survive and thrive over the past few decades in global futures markets are also trend followers. For having made my living as a trend follower, I've yet to come across a more compelling study, so clearly distilled, than has been offered by Michael Covel in *Trend Following*.

I first met Michael Covel when he was working on this book. I was a little hesitant at first about sharing some of the rather simple secrets of my trade. And, I didn't make it easy on Covel. I started interviewing *him* on his investments and how he managed his risk. He quickly made me realize that he not only understood trend following, but that he embraced it much like me. We delved into the roots of trend following and my investment strategies to explore why they work rather than just accepting the results. In reading *Trend Following*, I now see how well he was able to translate his knowledge, and the perspectives of many of my colleagues, to paper.

A large fraction of traffic accidents are of the type "driver looked but failed to see." Here, drivers collide with pedestrians in plain view, with cars directly in front of them, and even run into trains. That's right—run into trains, not the other way around. In such cases, information from the world is entering the driver's eyes. But at some point along the way, this information is lost, causing the driver to lose connection with reality. They are looking, but they are not seeing.

Ronald A. Rensink

It's important to have a plan, remain disciplined in executing that plan, and pay attention to what is actually happening rather than what you expect to happen. We try to be as objective as possible in our analyses…It's not always easy for people who are involved every day to stay with a plan when misfortune occurs for a time. You always encounter the unexpected and this can push discipline right out of the way in the name of prudence. But prudence almost always dictates staying with the approach that has made you successful. I see that as one of my primary roles. I often encourage everyone during difficult days to remain patient. I don't blame people for the unexpected.

John W. Henry
CME Magazine, Premier Issue

Back in the 1970s, most of the guys I knew traded individual markets. The ones who traded wheat did not talk to the guys who traded sugar. And, the guys who invested stocks did not care to talk to either one, because commodities were for "speculators" and not "investors." Further, the bond crowd thought the stock guys were cowboys. Each group had developed its own superiority complexes and fundamentally believed that only industry experts like them could understand the subtle dynamics of their markets. I guess that's part of the reason that no one cared much for trend followers like me—I viewed every market the same way and each represented nothing more than a trade to me. Today, for all the different facets, I believe everyone has come to speak the same language. It's the language of risk.

In my early days, there was only one guy I knew who seemed to have a winning track record year after year. This fellow's name was Jack Boyd. Jack was also the only guy I knew who traded lots of different markets. If you followed any *one* of Jack's trades, you never really knew how you were going to do. But, if you were like me and actually counted *all* of his trades, you would have made about 20 percent a year. So, that got me more than a little curious about the idea of trading futures markets "across the board." Although each individual market seemed risky, when you put them together, they tended to balance each other out and you were left with a nice return with less volatility.

I could always see, after I got to Wall Street, how, for all the confusion, markets were driven by people and their emotions. That was what all of these markets had in common—people—and people just don't change. So, I set out to understand similarities in the way that markets moved. When I added up Jack's trades, only a few big trades made him all the money. For each of these big winners, I was there when "experts" told Jack that these markets couldn't go any higher, but they did. Then, when I looked at Jack's losses, they tended to be relatively small. Although it took me many years to put it all together—remember, there were no books like this back then—these seemingly small observations became the foundation for me of two important, intertwined investment themes: trend following and risk management. Jack was not so much a trend follower, but he did practice the first rule of trend following: Cut your losers and let your winners run.

Most of the guys that I knew who lost a lot of money actually tended to be more right than wrong. They just lost a lot on a few big losers. I believe that people put too much of a premium on being right. In some ways, it's one of the drawbacks for people who went to the best schools and always got straight As—they are too used to always being right. It gets back to people and emotions. Everyone is happy to take lots of little winners—it makes them feel good. When their trades go against them, on the other hand, they hold on because they don't want to accept being wrong. Many times, these trades come back and they are able to capture their small profit. To me, that kind of trading is a little bit like picking up nickels in front of a steamroller.

A prudent investor's best safeguard against risk is not retreat, but diversification. [And] true diversification is difficult to achieve by [simply] spreading an investment among different stocks (or different equity managers), or even by mixing stocks and bonds, because the two are not complementary.

David Harding
Winton Capital

Thankfully, the markets don't care about me or you or where we went to school. They don't care if you're short or tall. I was never very good in school and I wasn't a good athlete either. With my background, the way I saw it, I never had any problem with the idea that I could be wrong. So, I have always built in an assumption of wrongness to anything that I do. We now kindly refer to this practice as risk management, but I just wanted to answer the question: "What's the worst thing that could happen to me?" I never wanted to do anything that could kill me. Knowing that I was not likely to be right that often, I had to trade in a way that would make me a lot of money when I was right and not lose me a lot of money when I was wrong. If that wasn't enough, it also had to be simple enough for me to understand.

After many years of searching and learning things the hard way, I evolved my own version of trend following. The idea made sense and I had some good examples to follow. Still, I wanted to prove to myself that it worked without betting real money. I had to test what would have happened had I traded that way in the past. These were the early days of computers and we even had to "borrow" time on university computers to test and prove our theories. It was a painstaking task, but it gave me the comfort that I needed. Now, in reading *Trend Following*, the do-it-yourselfers might argue that having a book that illustrates these same basic principles takes some of the fun out of it.

Actually, Covel, like any good trend follower, has not focused solely on the endpoint. He gives you a deep understanding of the most important part: the path. Unlike so many other books that have been written about investing, *Trend Following* goes beyond the results to explore the journey of this outstanding group of traders.

For my staff at Hite Capital, Covel's *Trend Following* is required reading. For my daughters at home, it has finally settled the question I seemed never to have been able to clearly answer myself, "Daddy, what do you do for a living?" This book captures and conveys what so many traders have taken careers and large losses to learn. And lucky for all of us, you don't have to be Phi Beta Kappa to understand it.

We no longer live in that world of wheat guys, sugar guys, and stock guys. Trend following trading is an important force in every market and should be a part of any diverse investment portfolio. For me, the discipline of trend following goes beyond trading and money management. Trend following is a way of thinking that can be employed in many parts of life as we all tend to continue to do the things that work for us and stop doing those activities that don't.

The way I see it, you have two choices—you can do what I did and work for 30-plus years, cobbling together scraps of information, seeking to create a money-making strategy, or you can spend a few days reading Covel's book and skip that three-decade learning curve.

[Trend following firm] Aspect Capital is aptly named. Its group of physics-trained leaders took it from the aspect ratio of plane design, that is, the wider the wing span, the more stable the plane. As such, Aspect trades not only futures of its early roots but European equities, bonds and currencies in various forms, covering a so-called wider wing span. The London-based hedge fund was the brainchild of Martin Lueck, Eugene Lambert and Anthony Todd. Founded in 1997, the principals were involved in the development of AHL (now owned by Man) with a track record stretching back to 1983. Aspect's disciplined approach has successfully generated returns from both longs and shorts in difficult markets environments.

Futures Magazine and Aspect Capital

About Larry Hite

Larry Hite founded Mint Investments in 1983. By 1990, Mint Investments had become the largest commodity trading advisor in the world in terms of assets under management. Mint's achievements won Hite and his team industry-wide acclaim, and in 1990, Jack Schwager dedicated an entire chapter of his bestselling book, Market Wizards*, to Hite's trading and risk management philosophy.*

Preface

"Men wanted for hazardous journey. Small wages. Bitter cold. Long months of complete darkness. Constant danger. Safe return doubtful. Honor and recognition in case of success."[1]

When it is a question of money, everyone is of the same religion.

Voltaire

This book is the result of a 14-year "hazardous journey" for the truth about trend following trading. It fills a void in a marketplace inundated with books about buying low and selling high, index investing, and all other types of fundamental analysis, but lacking any resource or, for that matter, practically any reference to what I believe is the single best strategy to consistently make money in the markets. That strategy is known as **trend following.** Author Van Tharp has described it succinctly:

> "Let's break down the term 'trend following' into its components. The first part is 'trend.' Every trader needs a trend to make money. If you think about it, no matter what the technique, if there is not a trend after you buy, then you will not be able to sell at higher prices … 'following' is the next part of the term. We use this word because trend followers always wait for the trend to shift first, then 'follow' it."[2]

Trend following trading seeks to capture the majority of a market trend, up or down, for profit. It aims for profits in all major asset classes—stocks, bonds, currencies, and commodities. Unfortunately, however simple the basic concepts about trend following are, they have been widely misunderstood by the public. My desire to correct this state of affairs is what, in part, launched my research.

I wanted to be as objective as possible, so I based my writing on all available data:

- Trend followers' month-by-month performance histories
- Trend followers' published words and comments over the last 30 years
- News accounts of financial disasters
- News accounts of the losers in those financial disasters
- Charts of markets traded by trend followers
- Charts of markets traded by losers in the financial disasters

Education rears disciples, imitators, and routinists, not pioneers of new ideas and creative geniuses. The schools are not nurseries of progress and improvement, but conservatories of tradition and unvarying modes of thought.

Ludwig von Mises

If I could have written a book comprising only numbers, charts, and graphs of trend following performance data, I would have. However, without any explanation, few readers would have appreciated the ramifications of what the data alone showed. Therefore, my approach to writing *Trend Following* became similar to the one Jim Collins describes in his book *Good to Great*, in which a team of researchers generated questions, accumulated data in their open-ended search for answers, and then energetically debated it.

However, unlike Collins who was writing about generally well known public companies, trend followers form a sort of underground network of relatively unknown traders who, except for an occasional article, the mainstream press has virtually ignored. What I have attempted to do is lift the veil, for the first time, on who these enormously successful traders are, how they trade, and what is to be learned from their approach to trading that we might all apply to our own portfolios.

Trend Following challenges much of the conventional wisdom about successful trading and traders. To avoid the influences of conventional wisdom, I was determined to avoid being influenced by institutionalized knowledge defined by Wall Street and was adamant about fighting "flat earth" thinking. During my research, starting with an assumption and then finding data to support it was avoided. Instead, questions were asked and then, objectively, doggedly, and slowly, answers were revealed.

If there was one factor that motivated me to work in this manner, it was simple curiosity. The more I uncovered about trend followers, the more I wanted to know. For example, one of the earliest questions (without an answer already) was learning who profited when Barings Bank collapsed. My research unearthed a connection between Barings Bank and trend follower John W. Henry (now the majority owner of the Boston Red Sox). Henry's track record generated new questions, such as, "How did he discover trend following in the first place?" and "Has his approach changed in any significant way in the past 30 years?"

I was also curious about who won the $1.9 billion hedge fund Long Term Capital Management lost during the summer of 1998. Why did the biggest banks on Wall Street invest $100 billion in an options pricing model with so much inherent risk? Further, considering what mutual fund and hedge fund managers lost during October 2008 and what successful trend followers earned during the same time, I could not understand why so few investors were oblivious to even the existence of trend following trading. Other questions quickly appeared:

The important thing in science is not so much to obtain new facts as to discover new ways of thinking about them.
Sir William Bragg

- How do trend followers win in the zero-sum game of trading?
- Why has trend following been the most profitable style of trading?
- What is the philosophical framework of trend followers' success?
- What are the timeless principles of trend following trading?
- What are trend followers' worldview of market behavior?
- What are the reasons why trend following is enduring?

Many of the trend followers studied are reclusive and extremely low key. Some discovered trend following on their own and used it to make their fortunes out of home offices. Bill Dunn, a successful trend follower who has beaten the markets for over 30 years, works out of a quiet, Spartan office in a Florida coastal town. For Wall Street, this approach to trading is tantamount to sacrilege. It goes against all the customs, rituals, trappings, and myths we have grown accustomed to with Wall Street success. In fact, it is my hope that my profiles of trend followers will correct the public's misconception of a successful trader as a harried, intense workaholic who spends 24/7 in the labyrinth of a Wall Street trading firm, surrounded by monitors and screaming into a phone.

When the first edition of *Trend Following* hit the streets in April 2004 I hoped to assemble the first comprehensive look at trend following trading. Almost five years since initial publication, that goal was realized. How do I know? Since the first edition of *Trend Following*, I have met literally dozens of trend following traders managing collectively billions upon billions of dollars. Their feedback has been the validation. I never would have expected that an obscure book put together five years ago would lead me to having conversations with the likes of Nobel Prize winner Harry Markowitz and hedge fund managers Boone Pickens and David Harding, but it did.

Validation aside, October and November 2008 made me want another bite at the apple, another chance to "work" on this book. And lucky for me, the 2008 market chaos gave me that window. There is no doubt that October and November 2008 were the most historic market months since the Great Depression. Most people, most mutual funds, and most hedge funds lost unimaginable sums of money. It has long been said that "genius is leverage in a rising market," and when the bubble popped in 2008 clearly people who had long been positioned as genius weren't that smart after all. Already guessed where I am headed with this rant? Yes, while the rest of the world got creamed in 2008, trend followers made fortunes. Performance numbers for top trend following traders for October 2008 alone ranged from +5 percent to +40 percent. Making that much in one month when much of the rest of the world was losing big time is noteworthy to say the least. My publisher Jim Boyd agreed with me.

Fish see the bait, but not the hook; men see the profit, but not the peril.

Chinese proverb

This new edition of *Trend Following* includes many new sections and insights, surrounding the same core timeless lessons from the first edition. I updated the book throughout and worked to make material accessible and interesting enough so it might give an occasional "aha" experience. However, if you're looking for trading "secrets," you need to look elsewhere. There is no such thing. If you're in the mood for stories about what it's like inside a typical Wall Street firm (at least in those firms before they all went under in 2008!) or how greedy traders sow the seeds of their own destruction, your needs will not be met with my writing. But if you are looking for something different, looking for something to fill a void in your understanding of how big returns are actually made year after year, but didn't know where to turn for honest information, I hope my insights give you the confidence that ultimately helps you to make some big money.

To be aware how fruitful the playful mood can be is to be immune to the propaganda of the alienated, which extols resentment as a fuel of achievement.

Eric Hoffer

Acknowledgments

It is a pleasure to recognize the traders, colleagues, mentors, writers, and friends who contributed directly and indirectly to *Trend Following*.

Justin Vandergrift and William W. Noel, III must be singled out for special mention. This book would not have come together without their hard work.

I am particularly grateful to those traders—Ed Seykota, Bill Dunn, Daniel Dunn, Mark Rzepczynski, Jason Russell, Easan Katir, Jonathan Hoenig, Cole Wilcox, Eric Crittenden, Michael Martin, Salem Abraham, Ajay Jani, and Paul Mulvaney—who were generous with their feedback under tight writing deadlines. Thanks also to Martin Bergin for the initial introduction to Bill Dunn.

The support of Charles Faulkner must be acknowledged as well. He shared his intellect, enthusiasm, and most of all, his time, reading and critiquing various drafts. Additionally, John O'Donnell of Online Trading Academy was gracious with his time and energy.

I also want to thank Peter Borish, Bill Miller of Legg Mason, Michael Mauboussin of Legg Mason, Richard Cripps of Legg Mason, David Harding of Winton Capital, William Fung, Toby Crabel of Crabel Capital, Grant Smith of Millburn Corporation, Mark Abraham, Bernard Drury of Drury Capital, Larry Hite of Hite Capital Management, Michael Clarke of Clarke Capital Management, Mark Rosenberg of SSARIS Advisors, LLC, Jon Sundt of Altegris, Christian Baja of Superfund, David Beach of Beach Capital, and Alejandro Knoepffler of Cipher Investment Management for their generous personal time and consideration. I want to especially thank Jerry Parker of Chesapeake Capital for answering questions early on.

Additionally, Celia Straus, Jeff Kopiwoda, Chris Koomey, Jerry Mullins, Molly Alton Mullins, Beneva Schulte, Withers Hurley, Elizabeth Ellen, Justice Litle, Barry Ritholtz, Mark Rostenko, Arthur Maddock, Brett Steenbarger, Austin Guu, and Bob Spear all made valuable contributions.

Throughout years of research, I've benefited repeatedly from the trading wisdom and experience of John W. Henry, Jonathan Craven, Mark Hawley, John Hoade, Shaun Jordan, Carol Kaufman, Jane Martin, Leo Melamed, Larry Mollner, Kim Hunter, Gibbons Burke, Chuck LeBeau, and Leon Rose. A sincere thank you also goes out to Oliver Alliker, James Altucher, Gerald Appel, Aspect Capital, Hunter Baldwin, Tom Basso, John Boik, Bob Brooks, Wade Brorsen, Ursula Burger, Jake Carriker, Celeste Cave, Art Collins, Cory Colvin, Allan Como, Larry Connors, Chip Dempsey, Tim Dempsey, Rolf Dobelli, Edward Dobson, David Dolak, Woody Dorsey, David Druz, Patrick Dyess, Stephen Eckett, William Eckhardt, Marc Faber, Mark Fitzsimmons, Ed Foster, Nelson Freeburg, Mitsuru Furukawa, Dave Goodboy, Jayanthi Gopalakrishnan, Stephanie Haase, Scott Hicks, James Holter, Scott A. Houdek, Robert (Bucky) Isaacson, Christian Jund, MaryAnn Kiely, Eddie Kwong, Pete Kyle, Eric Laing, Elina Manevich, Bill Mann, Jon Markman, Michael Martin, John Mauldin, Timothy M. McCann, Lizzie McLoughlin, James Montier, Georgia Nakou, Peter Navarro, Gail Osten, Michael Panzner, Bob Pardo, Baron Robertson, Jim Rogers, Murray Ruggiero, Michael Seneadza, Takaaki Sera, Tom Shanks, Howard Simons, Barry Sims, Aaron Smith, Michael Stephani, Richard Straus, Nassim Nicholas Taleb, Stephen Taub, Ken Tower, Ken Tropin, Tomoko Uchiyama, Thomas Vician, Jr., Robert Webb, Kate Welling, Gabriel Wisdom, Brent Wood, and Patrick L. Young for all of their efforts and support.

And thank you to the following publications and writers who generously allowed me to quote from their work: Sol Waksman and Barclay Managed Futures Report, *Futures Magazine*, Managed Account Reports, Michael Rulle of Graham Capital Management, and *Technical Analysis of Stocks and Commodities Magazine*.

I am also indebted to the following authors whose works continue to be treasure troves of information and insight: Morton Baratz, Peter Bernstein, Clayton Christensen, Jim Collins, Jay Forrester, Tom Friedman, Gerd Gigerenzer, Daniel Goleman, Stephen Jay Gould, Alan Greenberg, Larry Harris, Robert Koppel, Edwin Lefevere, Michael Lewis, Jesse Livermore, Roger Lowenstein, Ludwig von Mises, Lois Peltz, Ayn Rand, Jack Schwager, Denise Shekerjian, Robert Shiller, Van Tharp, Edward Thorp, Peter Todd, Brenda Ueland, and Dickson Watts.

This book could only have come to fruition with the editorial guidance of Jim Boyd at FT Press, as well as the able assistance and attention to detail of Dennis Higbee. I also want to thank Donna Cullen-Dolce, Lisa Iarkowski, Stephen Crane, John Pierce, and Lucy Petermark. To Paul Donnelly at Oxford University Press, I owe a special debt of gratitude for seeing potential in my initial proposal—even though he passed!

—Michael W. Covel

About the Author

Michael Covel is a highly respected author, director, and entrepreneur who founded the internationally known website TurtleTrader.com in 1996. Covel's first book was the best selling *Trend Following: How Great Traders Make Millions in Up or Down Markets* (FT Press April 2004 and November 2005 Expanded Edition). The book profiles great trend following traders who have won millions, if not billions, in the market. The original edition, expanded edition, and paperback edition have sold 100,000 plus copies. It is also available in German, Japanese, Chinese (complex and simplified), Korean, French, Arabic, Turkish, and Russian.

Covel's second book *The Complete TurtleTrader: The Legend, the Lessons, the Results* (Collins, October 2007) is the definitive inside look at the legendary trader Richard Dennis and his student traders, 'The Turtles.' The book has received wide acclaim and is headed toward bestseller status. It is also available in German, Korean, and Chinese (complex and simplified).

Building off his book success, Covel wrote, directed, and produced a theatrical release documentary titled *Broke: The New American Dream*, built around the subject of behavioral finance, specifically investigating the 2007–2008 market crisis and crash. Face-to-face interviews with Nobel Prize winners Dr. Harry Markowitz and Dr. Vernon Smith, famed mutual fund investor Bill Miller of Legg Mason, David Harding of hedge fund Winton Capital, plus dozens of other Wall Street pros, along with average investors were conducted over 2007 and 2008. The film was shot in New York, DC, Miami, Dallas, San Diego, Baltimore, Las Vegas, Richmond, London, Tokyo, Singapore, Macau, and on a sheep farm outside of Harrisonburg, Virginia.

Fear touches everyone—even the successful people, the golden boys, the people who give the appearance of passing through life with their hands deep in their pockets, a whistle on their lips. To take on risk, you need to conquer fear, at least temporarily, at least occasionally. It can be done, especially if you look outside yourself for a strong ledge to stand on.

Denise Shekerjian[1]

Michael Covel has had unparalleled face-to-face access with the great traders of our time. Interviewing dozens of fund managers managing collectively well over $10 billion USD has given Covel a unique understanding.

Not afraid of a crowd or controversy, Covel is known for engaging and provocative speeches presented to audiences from Tokyo to Paris to Macau (China) to Vienna (Austria) to Hong Kong to Dallas (US). His writings have appeared in *Trader Monthly Magazine*, *Stocks, Futures and Options Magazine*, *Futures Magazine*, *Technical Analysis of Stocks and Commodities Magazine*, TradingMarkets.com, Yahoo Finance, *Market Technicians Association Newsletter*, and *Futures Japan Magazine*. Covel has been quoted and interviewed by likes of Bloomberg Radio, *Technical Analysis Magazine*, Barrons, and dozens of radio programs.

Covel can be reached directly at www.michaelcovel.com.

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Trend Following

1

"Speculation is dealing with the uncertain conditions of the unknown future. Every human action is a speculation in that it is embedded in the flux of time."—Ludwig von Mises[1]

The Market

A market is simply a place where buyers and sellers gather to trade and exchange goods, buying and selling for any number of reasons across all types of instruments (for instance, stocks, currencies, commodities, and so on). Markets perform the essential role of exchange. The New York Stock Exchange and the National Association of Securities Dealers Automated Quotation System (NASDAQ) are two exchanges. There are also futures exchanges, such as the Chicago Mercantile Exchange. All of these exchanges have many markets where traders can buy and sell whatever they want. They are the place where organized speculation takes place.

The people that I know who are the most successful at trading are passionate about it. They fulfill what I think is the first requirement: developing intuitions about something they care about deeply, in this case, trading. They are the people who study years of charts, or commodity annuals… They develop a deep knowledge of whatever form of analysis they use. Out of that passion and knowledge, their trading ideas, insights, and intuitions emerge.

Charles Faulkner[2]

Although this might sound simple and might sound as if I am focusing on a minor point, I am not. The markets' capability to provide a "price" for buyers and sellers to rely on as fact in the course of speculation is crucial. Ludwig von Mises, the noted Austrian economist, puts it into perspective:

> "It is the very essence of prices that they are the offshoot of the actions of individuals and groups of individuals acting on their own behalf. The catallactic concept of exchange ratios and prices precludes anything that is the effect of actions of a central authority, of people resorting to violence and threats in the name of society or the state or of an armed pressure group. In declaring that it is not the business of the government to determine prices, we do not step beyond the borders of logical thinking. A government can no more determine prices than a goose can lay hen's eggs."[3]

Although government can't determine prices in the long run, in the short term as we have all seen with the popping of the credit bubble, the government can greatly affect the market system. However, at the end of the day, all we have are prices and speculation. Because that is the case, finding out how to best "speculate" using market prices is a worthy endeavor.

The joy of winning and the pain of losing are right up there with the pain of winning and the joy of losing. Also to consider are the joy and pain of not participating. The relative strengths of these feelings tend to increase with the distance of the trader from his commitment to being a trader.

Ed Seykota[4]

Winning Versus Losing

Because of the corporate and market scandals of the last decade, it is understandable that the general public equates "winning" with simply abusing the financial market system. October and November 2008 are the latest to leave the public feeling abused and on the outside looking in. However, there are disciplined men and women trading in the markets with the utmost integrity who achieve spectacular returns year after year. Examine their beliefs and self-perceptions so you understand what keeps their earnings honest. However, before you examine others' perspectives, take a moment to consider your own. How do you approach investing?

For example, does this describe you? At the end of the 1990s, just when you were feeling good about yourself because you were more secure financially, the dot-com bubble burst, and by the time it was over, you had lost a significant amount of money. The same thing happened again in October and November 2008. You found yourself angry with the analysts, experts, brokers, or money managers whose advice you had taken. You didn't do anything wrong except follow their advice. Now you doubt that you will meet your investment goals or retire. You've held on to your remaining investments believing that they will eventually turn around, but deciding how to invest your 401k monies is paralyzing. You still believe that buying and holding is the way to go. You've now begun to think that winning in the markets is just plain dumb luck.

If you think education is expensive, try ignorance.
Derek Bok

Or, maybe you view your money world like this: Sure, you lost some cash in the bear market and sure you lost more in October and November 2008, but, win or lose, you enjoy the thrill of investing in stock in the hopes of making a profit. Investing is entertainment for you. Plus, you like to boast about your investments for the admiration of others. You know you can be depressed and angry when you lose, but you also know that when you win you feel terrific. It's a great high. Because your main goal is to invest for quick profits, you're going to keep on doing what you've always done. After all, there was one time a few years ago when trading off a "hot tip" made you a nice profit.

There is a much better way to think about making money. How would you feel about embracing this perspective? Your approach is objective and rational. You have enough confidence in your own decision making that you don't seek out investment recommendations from others. You're content to wait patiently until the right opportunity comes along. Yet, you're never too proud to buy a stock that is making new highs. For you, buying opportunities are usually market breakouts. Conversely, when you recognize that you are wrong, you exit immediately. You view a loss as an opportunity to learn, move on, and save your money for another day. What good is obsessing on the past going to do for you? You approach your trading as a business, making note of what you buy or sell and why in the same matter-of-fact way that you balance your checkbook. By not personalizing your trading decisions, you can make them without emotional indecision.

The perfect speculator must know when to get in; more important, he must know when to stay out; and most important, he must know when to get out once he's in.

That is a stark contrast in perspectives. The first is that of a generally a market loser; the latter is that of a potential market winner. Don't be in such a hurry to choose the winning approach until you've found out just what making such a choice entails. On the other hand, I hope you'll find in *trend following trading* the inspiration to step up to the plate and go for it without fear or reservation. And don't be shy about it. You have to want to make money. You have to want to get ahead and be successful, the critics' condemnation be damned. Speculation, as von Mises has noted, is not only honorable, but a lifeblood. Profit-seeking speculation is *the* driving force of the market.[5]

Investor Versus Trader

Do you consider yourself an investor or a trader? Most people think of themselves as investors. However, if you knew that the biggest winners in the markets call themselves traders, wouldn't you want to know why? Simply put, they don't invest; they trade.

Investors put their money, or capital, into a market, such as stocks or real estate, under the assumption that the value will always increase over time. As the value increases, so does the person's "investment." Investors typically do not have a plan for when their investment value decreases. They usually hold on to their investment, hoping that the value will reverse itself and go back up. Investors typically succeed in bull markets and lose in bear markets.

Nothing has changed during the 21 years we've been managing money. Government regulation and intervention have been, are, and will continue to be present for as long as society needs rules by which to live. Today's governmental intervention or decree is tomorrow's opportunity. For example, governments often act in the same way that cartels act. Easily the most dominant and effective cartel has been OPEC, and even OPEC has been unable to create an ideal world from the standpoint of pricing its product. Free markets will always find their own means of price discovery.

Keith Campbell[6]

This is because investors anticipate bear (down) markets with fear and trepidation, and therefore, they are unable to plan how to respond when they start to lose. They choose to "hang tight," and they continue to lose. They have an idea that a different approach to their losing involves more complicated trading techniques such as "selling short," of which they know little and don't care to learn. If the mainstream press continually positions investing as "good" or "safe" and trading as "bad" or "risky," people are reluctant to align themselves with traders or even seek to understand what trading is about.

A trader has a defined plan or strategy to put capital into a market to achieve a single goal: profit. Traders don't care what they own or what they sell as long as they end up with more money than they started with. They are not investing in anything. They are trading. It is a critical distinction.

Tom Basso, a longtime trader, has said that a person is a trader whether or not he is actually trading. Some people think they must be in and out of the markets every day to call themselves traders. What makes someone a trader has more to do with his perspective on life more so than making a given trade. For example, a great trader's perspective includes extreme patience. Like the African lion waiting for days for the right moment to strike its unsuspecting prey, a trend follower can wait weeks or months for the right trade that puts the odds on his side.

Trend followers are traders, so I generally use the word "trader" instead of "investor" throughout.

Additionally, and ideally, traders go short as often as they go long, enabling them to make money in both up and down markets. However, a majority of traders won't or can't go short. They struggle with the concept of making money when a market declines. I hope that after reading *Trend Following*, the confusion and hesitation associated with making money in down markets, markets that are dropping or crashing, will dissipate.

Fundamental Versus Technical

There are two basic theories that are used to trade in the markets. The first theory is fundamental analysis. It is the study of external factors that affect the supply and demand of a particular market. Fundamental analysis uses factors such as weather, government policy, domestic and foreign political and economic events, price-earnings ratios, and balance sheets to make buy and sell decisions. By monitoring "fundamentals" for a particular market, one can supposedly predict a change in market direction before that change has been reflected in the price of the market with the belief that you can then make money from that knowledge.

Whenever we get a period of poor performance, most investors conclude something must be fixed. They ask if the markets have changed. But trend following presupposes change.

John W. Henry[7]

The vast majority of Wall Street uses fundamental analysis alone. They are the academics, brokers, and analysts who spoke highly of the new economy during the dot-com craze. These same Wall Street players brought millions of players into the real estate and credit bubbles of 2008. Millions bought into their rosy fundamental projections and rode bubbles straight up with no clue how to exit when those bubbles finally burst. Consider an exchange between a questioner and President Bush at a December 17, 2007 press conference:

> Q: "I wanted to ask you [Mr. President]—I'm a financial advisor here in Fredericksburg [Virginia], and I wanted to ask you what your thoughts are on the market going forward for '08, and if any of your policies would make any difference?"
>
> The President: "No (laughter), I'm not going to answer your question. If I were an investor, I would be looking at the basic fundamentals of the economy. Early on in my

presidency, somebody asked me about the stock market, and I thought I was a financial genius, and it was a mistake (laughter). The fundamentals of this nation are strong. One of the interesting developments has been the role of exports in overall GDP growth. When you open up markets for goods and services, and we're treated fairly, we can compete just about with anybody, anywhere. And exports have been an integral part, at least of the 3rd quarter growth. But far be it for me—I apologize—for not being in the position to answer your question. But I don't think you want your President opining on whether the Dow Jones is going to—(laughter)—be going up or down."

One of our basic philosophical tendencies is that change is constant, change is random, and trends will reappear if we go through a period of non-trending markets. It's only a precursor to future trends and we feel if there is an extended period of non-trending markets, this really does set up a base for very dynamic trends in the future.

Former Head of Research at John W. Henry[8]

The President's view is a typical fundamental view shared by the vast majority of market participants. Consider further an excerpt found in Yahoo! Finance's commentary; it outlines a single market day:

> "It started off decent, but ended up the fourth straight down day for stocks…early on, the indices were in the green, mostly as a continuation from the bounce Monday afternoon…but as the day wore on and the markets failed to show any upward momentum, the breakdown finally occurred…The impetus this time was attributed to the weakness in the dollar, even though the dollar was down early in the day while stocks were up…also, oil prices popped higher on wishful thinking statements from a Venezuelan official about OPEC cutting production… whether or not these factors were simply excuses for selling, or truly perceived as fundamental factors hardly matters…."

Millions of readers read this type of drivel every day. Worse, thousands watch Jim Cramer of *Mad Money* fame promote similar nonsensical beliefs every day. Predictions based off of fundamental analysis don't work for the vast majority of market participants. Great example? Not many predicted the October/November 2008 market crash! On top of not being able to predict, fundamental analysis leaves many with trying to pick bottoms or trust that conditions will always improve. One of the great traders of the twentieth century, Ed Seykota, nailed the problem with fundamental analysis:

> "One evening, while having dinner with a fundamentalist, I accidentally knocked a sharp knife off the edge of the table. He watched the knife twirl through the air, as it came to rest with the pointed end sticking into his shoe. 'Why didn't you move your foot?' I exclaimed. 'I was waiting for it to come back up,' he replied."[9]

But I think our ace in the hole is that the governments usually screw things up and don't maintain their sound money and policy coordination. And about the time we're ready to give up on what usually has worked, and proclaim that the world has now changed, the governments help us out by creating unwise policy that helps produce dislocations and trends.

Jerry Parker[11]

Don't we all know an investor who is waiting for "his" market to come back? The financial website marketer Motley Fool has a backstory, a narrative behind how it started, that reflects the folly of literally banking on fundamental analysis as a solution for making money:

> "It all started with chocolate pudding. When they were young, brothers David and Tom Gardner learned about stocks and the business world from their father at the supermarket. Dad, a lawyer and economist, would tell them, 'See that pudding? We own the company that makes it! Every time someone buys that pudding, it's good for our company. So go get some more!' The lesson stuck."[10]

The Motley Fools' David and Tom Gardner's pudding story might be cute, but it is *Forrest Gump*-like simplistic (and wrong). Their plan gets you in, but it doesn't tell you when to get out or how much of the pudding stock you must buy. Unfortunately, many people believe that simple story is a good strategy for making money. That is a sad state of affairs.

While a fundamental analyst may be able to properly evaluate the economics underlying a stock, I do not believe they can predict how the masses will process this same information. Ultimately, it is the dollar-weighted collective opinion of all market participants that determines whether a stock goes up or down. This consensus is revealed by analyzing price.

Mark Abraham
Quantitative Capital Management, L.P.

A second market theory, technical analysis, operates in stark contrast to fundamental analysis. This approach is based on the belief that at any given point in time market prices reflect all known factors affecting supply and demand for that particular market. Instead of evaluating fundamental factors, technical analysis looks at the market prices themselves. Technical traders believe that a careful analysis of daily price action is an effective means of trading for profit.

Now here is where an understanding of technical analysis becomes complicated. There are essentially two forms of technical analysis. One form is based on an ability to "read" charts and use "indicators" to predict market direction. Here is an example of the mentality behind a predictive view of technical analysis:

> "I often hear people swear they make money with technical analysis. Do they really? The answer, of course, is that they do. People make money using all sorts of strategies, including some involving tea leaves and sunspots. The real question is: Do they make more money than they would investing in a blind index fund that mimics the performance of the market as a whole? Most academic financial experts believe in some form of the random-walk theory and consider technical analysis almost indistinguishable from a pseudoscience whose predictions are either worthless or, at best, so barely discernibly better than chance as to be unexploitable because of transaction costs."[12]

Markets aren't chaotic, just as the seasons follow a series of predictable trends, so does price action.
Stocks are like everything else in the world: They move in trends, and trends tend to persist.
Jonathan Hoenig
Portfolio Manager,
Capitalistpig Hedge Fund LLC

This is the view of technical analysis held by most people who know of technical analysis—that it is some form of mysterious chart reading technique, such as astrology. Equity research from a major bank furthers my prediction distinction point:

> "The question of whether technical analysis works has been a topic of contention for over three decades. Can past prices forecast future performance?"[13]

However, there is another type of technical analysis that neither tries to predict nor forecast. This type is based on reacting to price action. Trend followers are the group of technical traders who use reactive technical analysis. Instead of trying to predict a market direction, their strategy is to react to the market's movements whenever they occur. This enables them to focus on the market's actual moves and not get emotionally involved with trying to predict direction or duration.

It is not the strongest of the species that survive, nor the most intelligent, but the ones most responsive to change.
Charles Darwin

However, this type of price analysis never allows trend followers to enter at the exact bottom of a trend or exit at the exact top of the trend. Second, with price analysis, they don't necessarily trade every day. Instead, trend followers wait patiently for the right market conditions instead of forcing the market. Third, there should be no performance goals with price analysis. Some traders might embrace a strategy that dictates, for example, "I must make $400 dollars a day." Trend followers would counter with, "Sure, but what if the markets don't move on a given day?"

One trend follower summarized the conundrum:

> "I could not analyze 20 markets fundamentally and make money. One of the reasons [trend following] works is because you don't try to outthink it. You are a trend follower, not a trend predictor."[14]

Discretionary Versus Mechanical

I have established the concept that you can be an investor or trader. I have established that trading can be fundamentally or technically based. Further, technical trading can be predictive or reactive. And I've explained how trend followers are traders who use a reactive technical approach based on price. However, there is even more distinction. Traders can also be discretionary or mechanical.

It is when the unimaginable occurs that the systematic trader remains calm, presciently knowing when to buy, sell, or adjust their exposure.

Mark Abraham
Quantitative Capital Management, L.P.

John W. Henry, one of the best trend followers over the last 25 years, makes a clear distinction between the two strategies: "[I] believe that an investment strategy can only be as successful as the discipline of the manager to adhere to the requirements in the face of market adversity. Unlike discretionary traders, whose decisions may be subject to behavioral biases, [I] practice a disciplined investment process."[15]

When Henry speaks of decisions that may be subject to behavioral biases, he is referring to the legions of traders who make their buy and sell decisions based on the sum of their market knowledge, their view of the current market environment, or any number of other factors. In other words, they use their discretion—hence, the use of discretionary to describe their approach to trading.

Decisions made at the "discretion" of the trader are subjective and can be changed or second-guessed. There are no ironclad assurances that these discretionary trading decisions are not colored by personal bias. Of course, a trader's initial choice to launch a trading system is discretionary. You must make discretionary decisions such as choosing a system, selecting your portfolio, and determining a risk percentage. However, after you've decided on the basics, you can choose to systematize these discretionary decisions and from that point forward, make them systematic.

The trend is your friend except at the end when it bends.

Ed Seykota[18]

Mechanical trading systems, generally used by trend followers, are based on an objective and automated set of rules. Traders rigidly follow these trading rules (often putting them into computer programs) to get themselves in (buy) and out (sell) of a market. A mechanical trading system can make life easier by eliminating emotion from trading decisions. It forces discipline. If you break your mechanical trading system rules, you will go broke.

Henry puts into perspective the downsides of discretionary trading:

> "Unlike discretionary traders, whose decisions may be subject to behavioral biases, JWH practices a disciplined investment process. By quantifying the circumstances under which key investment decisions are made, the JWH methodology offers investors a consistent approach to markets, unswayed by judgmental bias."[16]

I feel sorry for the traders who watch CNBC all day, every day. They hope to eek out some competitive advantage from the comments of some guy who has never traded an S&P contract in his life. Even if the media happened to have something relevant to say, the news is already reflected in the open, high, low, close, open interest and daily volume.

Christian Baha
CEO Superfund

It seems a bit rigid to say you can't even use just a little discretion when faced with a trading decision, doesn't it? After all, where's the fun if all you ever do is follow a mechanical model? But then trend following isn't supposed to be about fun. It's supposed to be about winning profits. A researcher at Campbell and Company, one of the oldest and most successful trend following firms, is adamant about avoiding discretion:

> "One of our strengths is to follow our models and not use discretion. This rule is written in stone at Campbell."[17]

You can see throughout this book that trend followers choose their words carefully and deliberately. It was encouraging to me to find that there are few, if any, instances when their words are not reflected in their philosophies and ultimately their performance data.

In Plain Sight

Trend following is not something new. It goes back decades. The strategy is simply discovered by new generations of traders at different times:

> "Salem Abraham, a trend following trader, began researching the markets by asking a simple question: Who is making money? The answer was trend followers and his journey began."[19]

But few people have made the journey with Abraham. During the dot-com era of the late 1990s, during the 2008 real estate and credit bubbles, so many investors and traders with so little strategy were making so much money that trend followers disappeared from the radar screen, even though they kept right on making money.

Since trend following has nothing to do with short-term trading, cutting edge technologies, or Wall Street Holy Grails, its appeal is always negligible during market bubbles. It's not sexy. If investors can jump on the bandwagon of practically any "long only" mutual or hedge fund manager or turn a profit trading themselves by simply buying Internet, energy, or real estate stocks and holding on to them, what need would there ever be to adopt a strategy such as trend following?

However, if we look at how much money trend followers have made since assorted stock market bubbles have popped, trend following becomes far more relevant to the bottom line. The following chart (Chart 1.1) shows a hypothetical index of three longtime trend following firms compared against the S&P stock index. The chart combines Dunn Capital Management, Campbell and Co., and John W. Henry and Co. into an equally weighted index:

Defining a trend is like defining love. We know it when we see it, but we are rarely sure exactly what it is. Fung and Hsieh's paper goes a long way to doing for trends what poets have been trying to do for love since time immemorial. They give us a working model that quantitatively defines their value for us. Traders will not be surprised to learn that trend following advisors performed best during extreme market moves, especially during bad months for equities.[20]

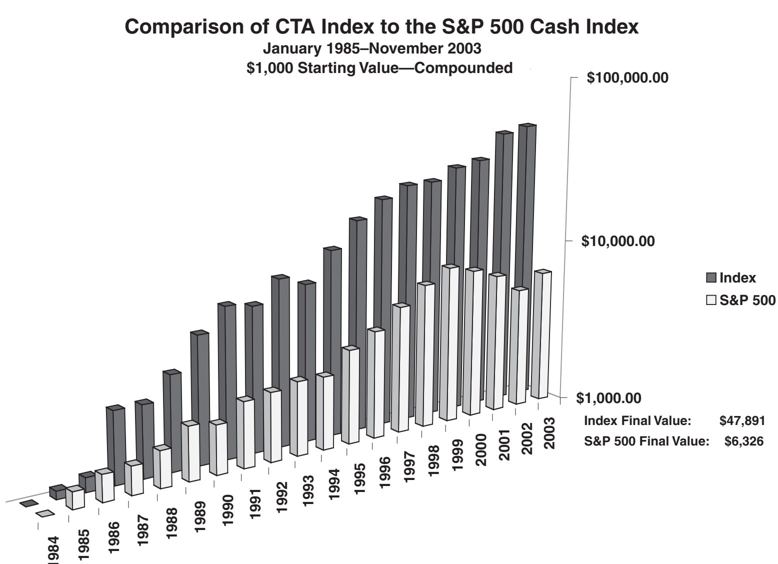

CHART 1.1: Trend Following Index Compared to S&P and NASDAQ

Change is not merely necessary to life—it is life.

Alvin Toffler

Yet, even when trend following success is brought to their attention, investors are often skeptical. They say the markets have changed and that trend following no longer works. Their concerns usually stem from a random press story of a trend follower who supposedly “blew up” and lost all of his clients’ money. But the truth is that trend following hasn’t changed, even though a single trend follower may make a mistake.

Let’s put change in perspective. Markets behave the same as they did 300 years ago. In other words, markets are the same today because they always change. This is the philosophical underpinning of trend following trading. A few years ago, for example, German mark trading had significant trading volume. Now the Euro has replaced the German mark. This was a huge, yet typical, change. If you are flexible, market changes, like changes in life, don’t have to impact you negatively. Trend traders traded the mark; now they trade the Euro.

Accepting the inevitability of change is the first step to understanding trend following philosophy. One trend follower describes the benefits of understanding change:

> “But what won’t change? Change. When a period of difficult performance continues, however, most investors’ natural conclusion is that something must be done to fix the problem. Having been through these draw downs before, we know that they are unpleasant, but they do not signal that something is necessarily wrong with the future. During these periods, almost everyone asks the same question in these exact words: ‘Have the markets changed?’ I always tell them the truth: ‘Yes.’ Not only have they changed, but they will continue to change as they have throughout history and certainly throughout our 19 years. Trend following presupposes change. It is based on change.”[21]

Markets go up, down, and sideways. They trend. They flow. They surprise. No one can forecast a trend’s beginning or end until it becomes a matter of record, just like the weather. However, if your trading strategy is designed to adapt to change, you can take advantage of the changes to make money as John W. Henry noted:

> “If you have a valid basic philosophy, the fact that things change turns out to be a benefit. At least you can survive. At the very least, you will survive over the long term. But if

> you don't have a valid basic philosophy, you won't be successful because change will eventually kill you. I knew I could not predict anything, and that is why we decided to follow trends, and that is why we've been so successful. We simply follow trends. No matter how ridiculous those trends appear to be at the beginning, and no matter how extended or how irrational they seem at the end, we follow trends."[22]

The people who excel in any field are people who realize that the moment is there to be seized—that there are opportunities at every turn. They are more alive to the moment.

Charles Faulkner[23]

What does Henry mean by "a valid basic philosophy?" He is talking about a trading strategy that can be defined, quantified, written down, and measured in terms of numbers—as a way to track trends. Do you have one of those? Does your broker have one? Does your mutual fund manager have one? Does your high-flying hedge fund have one? Trend followers do not guess if they must buy or sell. They know what to do because they have their "valid basic philosophy" codified in a specific plan. What is behind the source of those trends, those profits? The Man Group, one of the largest trend following traders, sees "trends as a persistent price phenomenon that stem[s] from changes in risk premiums—the amount of return investors demand to compensate the risks they are taking. Risk premiums vary massively over time in response to new market information, changes in economic environment, or even intangible factors such as shifts in investor sentiment. When risk premiums decrease or increase, underlying assets have to be priced again. Because investors typically have different expectations, large shifts in markets result over several months or even years as expectations are gradually adjusted. As long as there is uncertainty about the future, there will be trends for [trend followers] to capture."

The four most expensive words in the English language are "this time it's different."

Sir John Templeton

Change

There are plenty of people who ignore trend following's tremendous track record and argue that it is outdated, inferior, or it plain doesn't work.

"Has Trend Following Changed?" was the topic of a panel at a Managed Fund Association's conference. Patrick Welton saw that there is no evidence that trend following has changed. To prove this fact, he constructed 120 trend following models. Some were reversal-based, and others were not. Some were breakout style trading systems based on price action with others relying on

While conceding tacitly or explicitly that over the long run daily price movements are serially independent (move randomly) technical analysts focus on recurring short term patterns and trends. They are like surfboard riders, who study the movements of the waves, not in order to understand why they behave as they do, but simply in order to be on hand whenever they surge, to catch them at their crest, or as soon thereafter as possible to ride them as far as they possible can, and to dissemble before they change direction.

Morton S. Baratz[25]

By honest I don't mean that you only tell what's true. But you make clear the entire situation. You make clear all the information that is required for somebody else who is intelligent to make up their mind.

Richard Feynman

volatility and band-style breakouts. The average holding periods ranged from two weeks to one year. The results gave almost identical performance characteristics in periods covering the late 1980s, early 1990s, and late 1990s.

Welton also addressed the misconception that the sources of return for trend following had changed. He pointed out that starting from first principles, it was a fact that the source of return for trend following resulted from sustained market price movements. Human reaction to such events, and the stream of information describing them, takes time and runs its course unpredictably. The resulting magnitude and rate of price change could not be reliably forecast. This is the precise reason why trend following works.[24]

Burt Kozloff, a consultant in the fund industry, also confronted trend-trading skeptics head on two decades before trend followers' fantastic October 2008 returns:

> "In February, 1985, on a tour of Germany sponsored by the Deutsche Terminborse, several advisors and pool operators were making a presentation to a group of German institutional investors. Among them were two trend-based traders, Campbell & Co. and John W. Henry & Co. During the question-and-answer period, one man stood and proclaimed: 'But isn't it true that Trend Following is dead?' At this point, the moderator asked that slides displaying the performance histories for Campbell and Henry be displayed again. The moderator marched through the declines, saying: 'Here's the first obituary for trend-based trading. Here's the next one…and the next but these traders today are at new highs, and they consistently decline to honor the tombstones that skeptics keep erecting every time there's a losing period.' Campbell and JWH have made their investors hundreds of millions of dollars since that time. It might, therefore, be a mistake to write yet another series of obituaries."[26]

A new trend following obituary, often oblivious to real facts, and often rooted in ignorance, will be written every few years by mutual fund defenders, player haters, and cranks despite the incredible amounts of money made by trend following practitioners. Perplexed at Wall Street's lack of acceptance, one trend follower responded:

> "How can someone buy high and short low and be successful for two decades unless the underlying nature of markets is to trend? On the other hand, I've seen year-after-year, brilliant men buying low and selling high for a while successfully and then going broke because they thought they understood why a certain investment instrument had to perform in accordance with their personal logic."[27]

I have found though that trend followers generally seem to be oblivious to those who question their strategies. Why spend massive energy constantly defending yourself when you are producing monster returns year after year? That said, I do enjoy spending time to make the defense for them. The subject is too important and too valuable for the average investor to let it go under the radar.

Modus Operandi: Price

In an increasingly uncertain and, these days, downright unfriendly world, it is extremely efficient and effective if our decision making is based on this single, simple, reliable truth. The constant barrage of fundamental data, such as price-earnings ratios, crop reports, and economic studies, plays into traders' tendencies to make trading more complicated than it needs to be. Yet, factoring in every possible fundamental still does not tell a trader how much and when to buy, or how much and when to sell. The truth of "price" always seems to win out over all of these other analytical methods.

But even if you digest price as the key trading variable, it is not unusual for many traders to become familiar with and focus on only one market (usually stocks in their home countries) to the exclusion of all other global opportunities. Seeking to maintain a maximum degree of comfort, they follow this one familiar market's movements faithfully. If they specialize in stocks, they wouldn't dream of branching out into currencies or futures. How can a stock trader know anything about currencies? That's the fear. The idea that you could know enough about Cisco and soybeans to trade them both seems unfathomable to many. But think about what cotton, crude oil, Cisco, GE, the U.S. dollar, the Australian dollar, wheat, Apple, Google, and Berkshire Hathaway all have in common. The answer? Price.

[Trend following] is motivated by a very broad interpretation of the universe. The underlying belief is that economic systems adjust to changes in fundamentals gradually and over long periods of time, and that the consequent trends are evident everywhere in human history and commerce. Political, economic, and social regime changes trigger price adjustments in markets that don't happen instantaneously. For example, the growth and decline of the Roman Empire took place, not in a day, but over hundreds of years. A major problem, of course, is that markets don't move from one state to another in a straight line: There are periods of countertrend shock and volatility. We spend most of our time trying to find ways to deal with those unsettling but inevitable events. That being said, it is really not difficult to put together a simple trend following system that can generate positive returns over a realistic holding period and there are many, many commercial systems that have been generating strong, albeit volatile, returns for a long time. So there are definitely firm grounds for believing in Santa Claus.

Paul Mulvaney
CIO of
Mulvaney Capital Management Ltd.

Market prices are the objective data. Accepting that truth allows you to compare and study prices and measure their movements, even if you know nothing about those markets themselves. You can look at individual price histories and charts without knowing which market is which and trade them successfully. Think about that. That is not what they teach at Wharton, but it is the foundation of making millions.

Follow the Trend

Don't try to guess how far a trend will go. You can't. Peter Borish, former second-in-command with Paul Tudor Jones, lays bare the only concern a trader must have:

> "Price makes news, not the other way around. A market is going to go where a market is going to go."[28]

The concept of price as the trading cue is just too darn simple for people to accept. This is seen in the mainstream press that always emphasizes the *wrong* numbers. Bill Griffith, an anchor at CNBC, once pondered:

> "At some point, investing is an act of faith. If you can't believe the numbers, annual reports, etc., what numbers can you believe?"

Griffith misses the point when he asks what numbers you can believe if you can't believe a company's annual report. It doesn't matter whether you can or cannot believe the earnings statement. All of these numbers can be doctored, fixed, or cooked. The traded market price can't be fixed. It's the only number to believe. You can see it every day in the paper or online. However, this simple fact does not diminish the confusion. Alan Sloan, by all accounts a fine finance reporter, searches for numbers to trust without ever understanding how futile his search will be:

> "If some of the smartest people on Wall Street can't trust the numbers, you wonder who can trust the numbers."

What numbers is Sloan talking about? Balance sheets? Price-earnings ratios? You can't ever trust those numbers. Someone can always alter them. Beyond that, even if you knew accurate balance sheet numbers, how can they can help you determine when or how much to buy or sell? A critical lesson from John W. Henry:

> "…Political uncertainty is one reason why investment decisions are not driven by discretionary judgments. How, for example, do you measure the impact of statements from Messrs. Greenspan, Rubin, Summers, Miyazawa, or Sakakibara? Even if [we] knew all the linkages between fundamentals and prices, unclear policy comments would limit our ability to generate returns…trying to interpret the tea leaves in Humphreys-Hawkins testimony or the minds of Japanese policy authorities does not lend itself to disciplined systematic investing. Instead of trying to play a loser's game of handicapping policy statements, our models let market prices do the talking. Prices may be volatile, but they do not cloud the truth in market reactions. Our job is to systematically sift price data to find trends and act on them and not let the latest news flashes sway our market opinions."[29]

You can't read tea leaves. Nobody can. William Eckhardt, a longtime trend follower and former partner of trend follower Richard Dennis (the father of the 'Turtles'), builds off Henry's wisdom by describing how price is what traders live and die by:

> "An important feature of our approach is that we work almost exclusively with price, past and current…Price is definitely the variable traders live and die by, so it is the obvious candidate for investigation…Pure price systems are close enough to the North Pole that any departure tends to bring you farther south."[30]

How does a trend follower implement Dennis' philosophy? Trend trader Ed Seykota told me a story about trading sugar. He had been buying sugar—thousands of sugar contracts [futures]. Every day, the market was closing limit up. Every day, the market was going higher and higher. He just kept buying more and more sugar each day limit up. A broker was watching all this. One day, the broker called Seykota after the market was closed, because he had extra contracts of sugar that were not balanced out, and he said to Seykota, "I bet you want to buy these other 5,000 contracts of sugar." Seykota replied, "Sold."

Think about that: After the market has closed limit up for days in a row, Seykota says, "Sure, I'll buy more sugar contracts at the absolute top of the market." Why is this an important lesson?

Ed Seykota is a genius and a great trader who has been phenomenally successful. When I first met Ed he had recently graduated from MIT and had developed some of the first computer programs for testing and trading technical systems…Ed provided an excellent role model. For example, one time, he was short silver and the market just kept eking down, a half penny a day. Everyone else seemed to be bullish, talking about why silver had to go up because it was so cheap, but Ed just stayed short. Ed said, "The trend is down, and I'm going to stay short until the trend changes." I learned patience from him in the way he followed the trend.

Michael Marcus[31]

Be less curious about people and more curious about ideas.

Marie Curie

The wisest trend follower I know has said that every 5 years some famous trader blows up and everyone declares trend following to be dead. Then, 5 years later, some famous trader blows up and everyone declares trend following to be dead. Then, 5 years later…well, was the problem trend following or the trader?

[Trend following] is similar to being long options because the stop loss creates a limited downside, and the continuation of the trend creates the large upside. This is why the phrase for this approach to trading is to "cut losses" and to "let profits run." Of course, if trends continually fail to materialize, these limited losses can accumulate to large losses. This is also true for any option purchase strategy. For trend followers, the "option premium" is "paid" for after an unsuccessful trade is closed when a stop loss has been reached. The premium can also be "paid" after markets have moved a great deal, profits have been made, and a reversal causes a trailing stop to be hit, and some of the profits reversed.

Michael S. Rulle, President, Graham Capital Management[34]

Everybody instinctively wants to buy sugar on the dip. Let it come down low. Get a bargain. Trend following works by doing the opposite: by buying higher prices.

Even Good Traders Confuse Price

The trading histories of Julian Robertson and Louis Bacon, two famous hedge fund managers, underscore the importance of price for decision making.

A few years back, Julian Robertson shut his long running hedge fund down. He was a global macro trader who relied on fundamentals for decision making. He had a close relationship with another global macro trader, Louis Bacon. Bacon is extremely secretive to the extent that it's nearly impossible to find out his performance numbers unless you are a client. I do know from the little bit of writing available on Bacon that he's pulled hundreds of millions, if not billions, of profit from the marketplace. Although Bacon does not advertise himself as a trend follower, the following excerpt leaves no doubt that he is focused on price action just as much as a trend followers:

"If a stock goes from 100 to 90, an investor who looks at fundamentals will think maybe it's a better buy," explains one source. "But with Louis [Bacon], he will figure he must have been wrong about something and get out." Contrast that, say, with [Julian] Robertson, who, even after shutting down his firm, was doggedly holding on to massive positions in such stocks as U.S. Airways Group and United Asset Management Corp… [Bacon made the comment] in an investor letter that 'those traders with a futures background [trend trading] are more sensitive to market action, whereas value-based equity traders are trained to react less to the market and focus much more on their assessment of a company's or situation's viability.'"[32]

Today, Louis Bacon is still trading and following price.

Trend followers know that attempting to pinpoint the beginning of a trending market is futile. When trends begin, they often arise from a flat market that doesn't appear to be trending in any direction. The idea is to take small bets early on in a market to see if the trend does, indeed, mature and get big enough to make big money. How do trend following strategies succeed? Michael Rulle of Graham Capital Management offers:

> "The ability of trend following strategies to succeed depends on two obvious but important assumptions about markets. First, it assumes that price trends occur regularly in markets. Secondly, it assumes that trading systems can be created to profit from these trends. The basic trading strategy that all trend followers try to systematize is to 'cut losses' and 'let profits run.'"[33]

I asked Charles Faulkner, a modeler of top traders, to expand upon what at first glance appears to be a simple idea:

> "…the first rule of trading is to, 'Cut your losses, and let your profits run.' And then, that it's the hardest thing to do. Seldom do any of them wonder why, and yet this is exactly where the efficient market hypothesis breaks down, and the psychological nature of the markets shows through. When we lose or misplace something, we expect to find it later. The cat comes back. We find our car keys. But we know a dollar on the street will not be there with the next person who passes by. So experience teaches us that losses are unlikely and gains are hard. 'A bird in the hand is worth two in the bush.' This is when I tell them that they earn their trading profits by doing the hard thing—by going against human nature. This is where the discipline comes in, the psychological preparation, the months of system testing that give the trader the confidence to actually trade against his natural tendencies."

In Patton*, my favorite scene is when U.S. General George S. Patton has just spent weeks studying the writing of his German adversary Field Marshall Erwin Rommel and is crushing him in an epic tank battle in Tunisia. Patton, sensing victory as he peers onto the battle field from his command post, growls, "Rommel, you magnificent bastard. I read your book!"*

Paul Tudor Jones as quoted in the Foreword to *The Alchemy of Finance*

If cutting losses and letting profits run is the trend follower's mantra, it is because harsh reality dictates that you can't play the game if you run out of money. Nor can you predict the trend direction, as trend trader Christopher Cruden points out:

> "I would prefer to finish with a certain currency forecast, based upon my own fundamental reading of the market and one that underpins my personal investment philosophy… The only problem is I can't tell you when this will happen or which event will be first. On that basis alone, it seems best to stay with our systematic approach."[35]

Are you a bull market baby? Can you survive in any situation?

A good example of not letting profits run can be seen in trading strategies that take profits off the table before a trend is over. For example, one broker told me that one of his strategies was to ride a stock up for a 30 percent gain and then exit. That was his strategy. Let it go up 30 percent and get out. Sounds reasonable. However, a strategy that uses profit targets is problematic. The biggest problem is that it goes against the math of getting rich, which is to let your profits run. If you can't predict the end or top of a trend, why get out early and risk leaving profits on the table?

For example, you start with $50,000. The market takes off and your account swells to $80,000. You could, at that point, quickly pull your $30,000 profit off the table. Your misconception is that if you don't take those profits immediately, they will be gone.

Trend followers know that a $50,000 account may go to $80,000, back to $55,000, back up to $90,000, and from there, perhaps, all the way up to $200,000. The person who took profits at $80,000 is not around to take the ride up to $200,000. Letting your profits run is tough psychologically. But understand that in trying to protect every penny of your profit, you actually prevent yourself from making the big profits.

Loss

I began to realize that the big money must necessarily be in the big swing.

Jesse Livermore

You are going to have ups and downs in your trading account. Losses are a part of the trading game. You say you want no losses? You want positive returns every month? Well, you could have had your money with the Ponzi-scheme of Bernard Madoff, but we all know how that turned out! Life equals having losses and you're going to have losses with trend following. "You can't make money if you are not willing to lose. It's like breathing in, but not being willing to breathe out."[36]

If you don't have losses, you are not taking risks. If you don't risk, you won't ever win big. Losses aren't the problem. It's how you deal with them. Ignore losses with no plan and they will come back to haunt you and your account size. Consider:

> "Theoretically, really big losses rarely befall a trend follower because he eliminates or reverses his position as soon as the market goes against him. A lot of little losses are

inevitable…The rationale for hanging in is that any price move could be the beginning of a trend, and the occasional big breakout justifies a string of small losses."[37]

Conclusion

Ed Seykota once told me a story about being in Bermuda with a new trader who wanted to learn the "secrets." "Just give me the quick-and-dirty version of your magical trading secrets," the neophyte said. Seykota took the new trader out to the beach. They stood there watching the waves break against the shoreline. The neophyte asked, "What's your point?" Seykota said, "Go down to the shoreline where the waves break. Now begin to time them. Run out with the waves as they recede and run in as the waves come in. Can you see how you could get into rhythm with the waves? You follow the waves out and you follow them in. You just follow their lead."

In my search for the facts about trend following, it became clear that its basic tenets, its philosophical underpinnings, are relevant not only to trading, but to our lives in general, from business to personal relationships. I also found in my conversations with the old pro trend followers that trend following works best when pursued with unbridled passion.

How important is passion? Author Brett Steenbarger puts passion into perspective:

Many people would sooner die than think; in fact, they do so.

Bertrand Russell

"Find your passion: the work that stimulates, fascinates, and endlessly challenges you. Identify what you find meaningful and rewarding, and pour yourself into it. If your passion happens to be the markets, you will find the fortitude to outlast your learning curve and to develop the mastery needed to become a professional. If your passion is not the markets, then invest your funds with someone who possesses an objective track record and whose investment aims match your own. Then go forth and pour yourself into those facets of life that will keep you springing out of bed each morning, eager to face each day."[38]

While assembling *Trend Following*, it became clear that when used within the context of passion, the term "trend following" could

Among people who take the trouble to understand what the business is about instead of assuming it involves speculating on live cattle, it is readily understood.

Bruce Cleland, Campbell and Co.[40]

also be substituted throughout for other activities in life. This insight crystallized with me while rereading a passage from a 1938 book on creative writing by Brenda Ueland:

> "Whenever I say writing in this book, I also mean anything that you love and want to do or to make. It may be a six-act tragedy in blank verse, it may be dressmaking or acrobatics, or inventing a new system of double entry accounting…but you must be sure that your imagination and love are behind it, that you are not working just from grim resolution, i.e., to impress people."[39]

Trend followers I met don't seem to trade with grim resolve or with an intention to impress others. They are playing the game to win and enjoying every moment of it. Like other high-level performers, such as professional athletes and world-class musicians, they understand how critical it is to maintain a winning attitude for success. And as Larry Hite reminded, good trend traders ask themselves straightforward questions:

> "The first question you have to ask yourself: 'who are you?' I'm not kidding. And don't look at your driver's license! But what you got to say to yourself: 'what am I comfortable doing?' Am I an arbitrager? Am I a short-term trader? …it is really important that you understand who you are and what you want to do. The next thing you have to ask yourself, one of the real details, 'what are you going to do?' What are you going to do exactly? What has to be done? Is it hard to you? Is it easy? Do you have the materials to do it? One of the great things about the market is the markets don't care about you. The market doesn't care what color you are. The markets don't care if you are short or tall. They don't care about anything. They don't care whether you leave or stay. The last question you have to ask yourself: 'what follows?' You have to ask yourself, 'if I do this and it works, where am I? What have I got?' Now what I've said may really sound like it's pretty simple and common sense, [but think about the failed hedge fund Long Term Capital Management]…those were some very, very smart people [Nobel Prize winners] who did some pretty stupid things. And they did it because they didn't ask themselves the basic questions."

Key Points

- Seykota: "All profitable systems trade trends; the difference in price necessary to create the profit implies a trend."
- Trend following is based on simple universal laws we can all learn.
- No one knows how high or how low a market will go. No one knows when a market will move. You can't undo the past, and you can't predict the future. Prices, not traders, predict the future.
- Trend followers buy high and sell short low. This is counterintuitive for most.
- Using "common sense" is not a good way to judge or trade markets.
- Losses are a cost of doing business. No one can be right all the time. No one can make money all the time. Trend followers expect and handle losses with objectivity and detachment. If you don't have losses, you are not taking risks. If you don't risk, you won't win.
- Price goes either up, down, or sideways. No advances in technology, leaps of modern science, or radical shifts in perception will alter this fact.
- What if they told you that the best way to get to point B, without bumping into walls, would be to bump into the walls and not worry about it? Don't worry about getting to point B, but just enjoy bumping into the walls.[43]
- "If you take emotion—would be, could be, should be—out of it, and look at what is, and quantify it," says John W. Henry, reflecting from the owner's box at Fenway Park, "I think you have a big advantage over most human beings."

If you take emotion—would be, could be, should be—out of it, and look at what is, and quantify it, I think you have a big advantage over most human beings.

John W. Henry[41]

A trend is a trend is a trend, Gertrude Stein would have said if she were a trader…Once you have a game plan, the differences are pretty idiosyncratic.

Richard Dennis[42]

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