# Trend-following winners are not lucky monkeys

*Trend following gets a bad rap in some circles, but there's no denying the profits some trend traders have reaped over the years.*

BY MICHAEL COVEL

Famed Stanford University psychologist Leon Festinger once said, "A man with a conviction is a hard man to change. Tell him you disagree and he turns away. Show him facts or figures and he questions your sources. Appeal to logic and he fails to see your point."

Although trend following has been one of the most successful trading strategies for decades, some critics downplay the massive profits accumulated by trend followers, arguing there are just a few chance winners — "lucky monkeys," they claim.

Not true. Large numbers of trend followers have found a way to outpace market averages. They have done so with hard work and the ability to stick with a trading plan — usually for a very long time. However, some detractors seem happy to snub their nose at success, perhaps even until they have wasted a lifetime on sub-par trading strategies. Others, however, choose to test, accept proof, and build toward a profitable life. Who are some inspirational winners? The list of successful trend-following traders includes:

The purpose of trading is to make money, not to be right — a distinction that separates trend-following from other trading philosophies.

- John W. Henry, who bought the Red Sox through trend following.
- Bruce Kovner, who is worth more than $4 billion.
- Bill Dunn, who made $80 million in 2008.
- Michael Marcus, who turned an initial $30,000 into $80 million.
- David Harding, who is worth more than $690 million.
- Ed Seykota, who turned $5,000 into $15 million in 12 years.
- Kenneth Tropin, who made $120 million in 2008.

Most of these traders did not come from privileged backgrounds; many did not learn trend trading in college. They came from different disciplines, worked disparate jobs, and saved a nest egg to begin trading with trend-following rules. They are proof that anyone can rise to the top if ambitious enough.

Some people don't buy it, however. They gripe, "I can't be a trend follower because you need a huge portfolio, which requires lots of capital." First, part of that argument is correct. You can't trade if you are broke. However, trading as a trend follower doesn't necessarily mean massive capital. Micro and mini futures contracts, ETFs, or LEAPs give just about everyone the opportunity to use trend-following techniques.

Then there's the argument that noting the achievements of

*continued on p. 18*

successful trend followers ignores the reality of the losing traders: "This trend-following firm failed, which means the winners are just lucky survivors." The problem with this analysis is that it only looks at the *end*. After-the-fact statistical analysis is not a substitute for direct observation. There are usually many reasons for failure, and if you don't look at the exact cause of failure — assuming some traders were just the unlucky losers makes little sense.

How does one go about ensuring success? Interestingly, the performance data of trend-following traders offers fantastic insights on how to become a more successful trader. One of the keys to trading success is learning how to extrapolate from a professional trader's track record.

Let's start with a cold, hard truth: All traders suffer drawdowns at some time. No matter the trading style or duration, all traders have times when they lose. Long periods of losses, accumulated into drawdowns, are often the trigger that forces traders out. However, analyzing a system's "breakeven percent," which is the minimum percentage of profitable trades needed to produce profits for a given average winning trade/losing trade ratio, can show how wrong you can be before actually losing a substantial amount of money. For example, Table 1 shows statistics for a hypothetical trading system.

At first glance, the 65-percent winning statistic looks promising. However, if you look closer at the data you will find possible issues. The system has a positive mathematical expectation of $67.50, meaning it will generate profits at these levels at 65 percent accuracy.

Expectation = (avg. win trade * win pct.) - (avg. losing trade * (1-win pct.))
= (400 * 0.65) - (550 * (1-.65))
= (400 * 0.65) - (550 * 0.35)
= 260 - 192.50
= $67.50

The winning percentage here is just an aggregate statistic

| TABLE 1: EXAMPLE SYSTEM A | |
|---|---|
| Average winning trade | $400 |
| Average losing trade | $550 |
| Ratio | 0.73 |
| Winning percentage | 65% |

representing overall results. Of course, there will be runs where nearly every trade is profitable, and there will be runs where nearly every trade is a loser. This is the nature of trading. You cannot expect 6.5 winners for every 10 trades taken. Trading is random and there will be deviations from the mean.

Turning back to our example system, if the winning percentage drops to 50 percent you should expect losses:

Expectation = (400 * 0.50) - (550 * 0.50)
= 200 - 275
= -$75

Solving for the breakeven percent shows the system breaks even at 58 percent; below this threshold the system will generate losses.

Now consider the hypothetical trading system in Table 2. At first glance the idea of being right only 45 percent of the time might be difficult to handle. After all, who wants to be wrong 55 percent of the time? However, the system's mathematical expectation is larger than System A's:

Expectation = (650 * 0.45) - (325 * 0.55)
= 292.50 – 178.75
= $113.75

Solving for the breakeven percent shows the system must have a winning percentage of 33.34 percent to break even. The system allows you to be wrong 66.65 percent and still breakeven. It is easier to produce profits when a system allows one to be wrong more than half the time.

Using a randomly distributed performance result to project the two systems' equity curves highlights their differences. System A has a win/loss ratio of 0.73, while System B has a win/loss ratio of 2.00. The effects of a larger win/loss ratio are obvious in Figure 1. System B produces an approximately $11,300 gain while System A produces an approximately $6,800 gain.

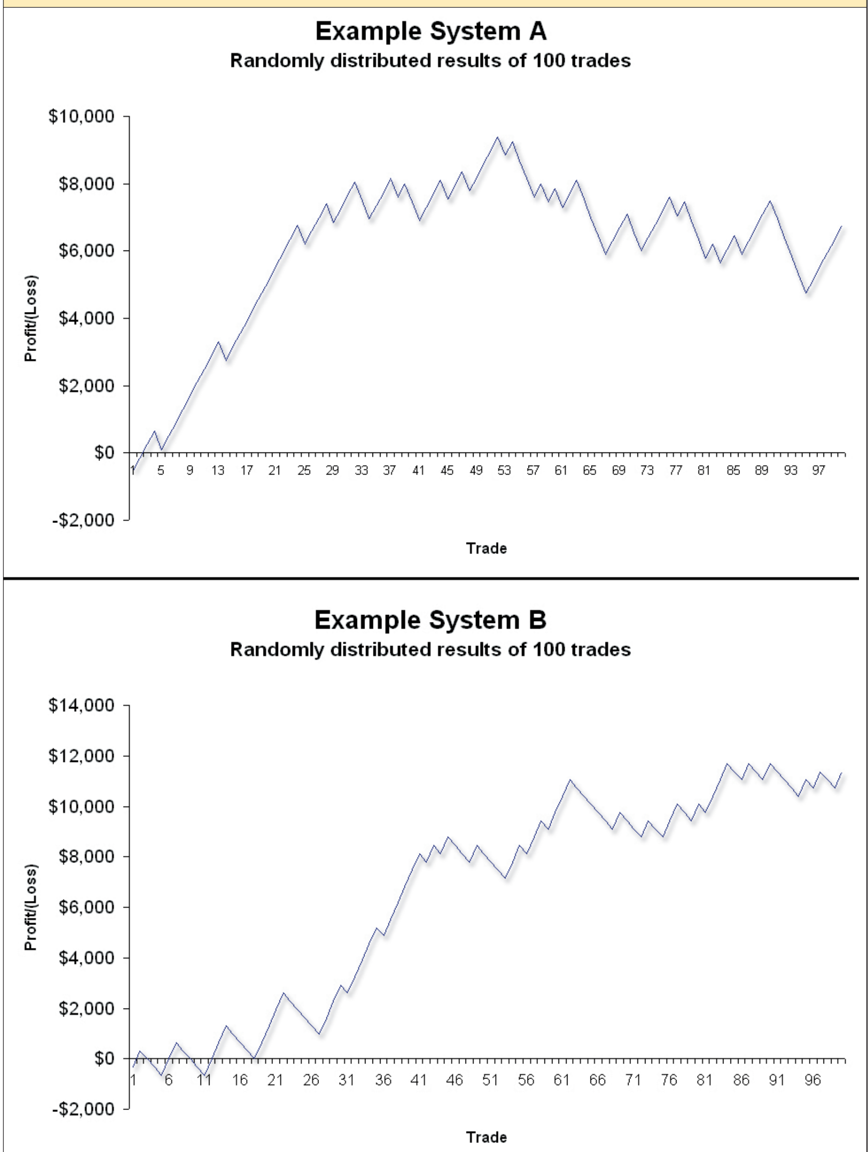
We all want to be right and have that "magic method that produces big winners. That's human nature. However, the purpose of trading is to make money, not to be right. The ability to make this distinction separates the trend-following mind-set from other types of trading philosophies and techniques.

Using our breakeven insights begins the process of evaluating why trend following wins and why it seems to have greater longevity than other trading styles. Consider performance data from the six trend-following programs in Table 3 (Jan. 1, 2006 to Sept. 2011). The higher the average win/loss ratio on a monthly basis, the lower the breakeven percent. They programs can afford to be wrong more than 50 percent of the time and still earn profits.

The same lesson applies to individual traders looking to go down the trend-following path: Larger win/loss ratios have one of two sources — small losses or outsized gains. Why? Trend followers tend to

*continued on p. 20*

**FIGURE 1: LOWER WINNING PERCENTAGE, BETTER RESULTS**




System B has a much lower winning percentage than System A, but because its average winning trade/losing trade is so much higher than System A's — typical of a trend-following strategy — it is much more profitable.

have large and unpredictable months because they are constantly in position to profit whenever markets move substantially higher or lower. The hunt for those "black swans" — outlier events — begins with answering a handful of key questions.

## The questions

What is the foundation of trend-following success? Profitable trend-following traders ask five critical questions before putting capital at risk:

1. What market do you buy or sell at any time?
2. How much of a market do you buy or sell at any time?
3. When do you buy or sell a market?
4. When do you get out of a losing position?
5. When do you get out of a winning position?

Stated another way:

1. What is the state of the market?
2. What is the volatility of the market?
3. What is the equity being traded?
4. What is the system or trading orientation?
5. What is the risk aversion of the trader or investor?

| TABLE 2: EXAMPLE SYSTEM B | |
|---|---|
| Average winning trade | $650 |
| Average losing trade | $325 |
| Ratio | 2.0 |
| Winning percentage | 45% |

During these very uncertain times — times so perfectly suited for a black swan to swim in and surprise — "tail risk" can hit. Tail risk, or the possibility that an investment will move beyond three standard deviations, should be the only discussion today. However, this discussion is usually broached without mentioning the only true tail-risk hedge: trend following.

Consider analysis from noted market pro James Montier from his report "A Value Investor's Perspective on Tail Risk Protection: An Ode to the Joy of Cash" (GMO, June 2011): "When considering tail risk protection, investors must start by defining the tail risk they are seeking to protect themselves against . . . The hardest element of tail risk protection is likely to be *timing*. It is clear that a permanent allocation is likely to do more harm than good in many situations. When it comes to timing tail risk protection,

*continued on p. 21*

**TABLE 3: TREND-FOLLOWING PROGRAM BREAKEVEN PERCENT**

| Program | Average win (monthly) | Average loss (monthly) | Average win/ loss ratio | Monthly breakeven percentage |
|---|---|---|---|---|
| Dunn | 8.48% | -7.04% | 1.20 | 45.36% |
| EMC Classic | 4.12% | -3.61% | 1.14 | 46.70% |
| Fall River Global HL | 4.60% | -3.34% | 1.38 | 42.06% |
| Hawksbill | 8.50% | -5.28% | 1.61 | 38.31% |
| Saxon Aggressive | 4.08% | -2.80% | 1.46 | 40.70% |
| Winton | 3.05% | -2.13% | 1.43 | 41.12% |

These trend-following programs illustrate the higher the average winning trade/losing trade ratio, the lower the winning percentage the system requires to break even.

a long-term value-based approach and an emphasis on absolute standards of value, coupled with a broad mandate (a wide opportunity set, or, investment flexibility, if you prefer) seems to offer the best hope."

Value investing is the solution to tail risk? No. That is a tired argument considering buy-and-hold/value philosophies have languished for 13 years. News flash: Buy-and-hold forever is not a strategy. Further, Montier argues that timing is the hardest part? Recall the five questions — timing is but one part of an overall trading plan.

Remember, trend followers have no idea if there is a current bubble in stocks, bonds, commodities, or any other market. They don't know when the next tail risk event will appear, but they are ready to act, and prosper no matter when the event or trend unfolds. On the flip side, it is truly amazing how some people try to convince others that they *know,* and offer value investing as the solution. Has there ever been a time when the majority knew it was in the middle of a bubble and acted accordingly? Bubbles are never clear until the dust settles and they are popped. That's why trend following works well — it doesn't require advance knowledge of a future surprise event to profit.

In short, a proven path to profits is having a trend-following mind-set ingrained in your psyche before a big dip or rise in the markets, having predefined entry and exits rules to your trade, and having that rigid process in place. Don't forget for a second the ugly alternatives. On average, according to the *Wall Street Journal*, 95 percent of Wall Street's recommendations are to buy. No sell strategy? That equals trouble — big trouble.

In the end, you have to decide what you want. Do you want the exciting feeling of listening to some guru stock picker attempting to predict what will happen tomorrow, or do you want to control how much you can lose of your limited capital and ride unpredictable trends for possible lifelong profits? ◆

*For information on the author, see p. 8.*

## Related Reading

**Books by Michael Covel:**

***Trend Commandments: Trading for Exceptional Returns*** (FT Press, 2011).

***The Little Book of Trading: Trend Following Strategy for Big Winnings*** (Wiley, 2011).

***The Complete TurtleTrader*** (HarperCollins, 2009).

***Trend Following*** (FT Press, 2009).