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Here Are The Three Best Technical Indicators

By Michael Covel

TradingMarkets.com

August 12, 2005 7:00 PM ET

[I received an email comment today from a respected market observer:](#) "Obviously, with the plummet we had yesterday, everybody's wondering what the trend is...you might want to consider mentioning something like this." I emailed back that trend followers don't predict. My associate responded with: "I would venture to guess that you look at long-term weekly and month charts and that some longer term up-trends are still in place...(and that is worth mentioning.)" Of course the "plummet" yesterday was replaced with a gain today!

This interchange got me thinking that no matter how many times trend following is explained, the basic concepts can still be hard for many people, even experts, to "get". For example, trend followers are not chart readers. They don't use charts to project into the future. Consider this good trend following definition from Van Tharp: "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." Christopher Cruden, a technical trader, took the definition a step further when he spoke at the Alternative Investment Management Association: "...as many investors and a number of members of the press know to their chagrin, a technically driven investment approach inevitably leaves the manager without a quotable view. His (or her) belief/expectation/notion that the euro, for example, will rise or fall against the Swiss franc may or may not be interesting cocktail party conversation but has no impact upon the way the computer will react...I would prefer to finish with a certain currency forecast, based upon my own fundamental reading of the market and one which underpins my personal investment philosophy. This is that the dollar will inevitably trade at 0.5 euros and at 2.0 euros. 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."

Sounds easy enough, but some people either can't or won't accept trend following for what it is. And there is a smaller minority who continue to question trend following's validity, vehement in their belief that prediction is an absolute necessity: "So, in other words, you trade according to a system the signals of which are not associated with whether price will move both in the right direction

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and to a certain minimum extent after the trader has committed to a prospective entry? Good luck. You're going to need it."

That is correct. Trend followers never have knowledge of some minimum extent move after an entry. How could anyone know the a minimum? In my book, Trend Following, I address the misconception that you can predict anything head on. A recent discussion post also frames the issue correctly: "Technical Analysis is attacked for what people wish it could do. Trend following like any form of technical analysis is a risk management tool, not a price prediction tool. Once again, this is why (anyone's) demand for a predictive model using trends is downright silly. There is no such model and that is not inconsistent with the fact that trend following is a valid form of technical analysis."

In discussing the downsides of the prediction mindset, another trader offers: "Although I'm sure there are folks making money by predicting price (perhaps you are one of them), I've never actually met one. All the good traders I know use probability instead. Personally I didn't start turning regular profits until I got rid of the prediction framework. Also, there was a long time where I thought I surely wasn't predicting price, but in fact I was (attempting to do so). These things are part of the long and painful growing process (to overcome). The only way to avoid it...(is to think in terms of a)...probability framework from the beginning."

However the logic of these posters is lost on this reader who recently wrote me: "Suppose your trend following system suggests you buy a stock today. Your system uses daily data -- it is a short to intermediate trend trading system that often holds positions for days or weeks if they remain profitable. But also suppose, you have 100 percent certainty that the opening price tomorrow will be more favorable for entry than the current price (say the stock is going ex-dividend). It just so happens, that this decline would stop you out of the stock, causing a loss. Are you really going to tell me you would still buy the stock, even though you KNOW that the price will be more favorable tomorrow?"

To say there is 100% certainty about tomorrow is an extremely slippery slope. No Trend Follower believes tomorrow is more certain than today. You can only operate in the here and now. Forecasting the future is great for cocktail conversation, but bad for trading. Other people have written me where their confusion about core differences between fundamental analysis and trend following is stark: "There is nothing incompatible with fundamental analysis and Trend Following, nor Elliott Wave and Trend Following. So it is on you to demonstrate any contradictions."

Life is about choices. You can't be a trend follower and base your decisions on fundamental analysis or Elliott Wave (whatever Elliott Wave is exactly is a debate in of itself). Trend Followers (Dunn, Seykota, Henry, Harding, Tropin, etc.) trade very similar and objective methods. Where are the Elliott traders? Where are their performance numbers? When you say fundamental what do you mean exactly? Think about it this way: Losing traders forecast where the market will be tomorrow. Winning traders react to what the market is doing right now. Ask a great trader where he thinks a market will go and he will probably shrug and say the market will go wherever it wants to go. Reaction is about the business of making money, prediction is all ego (and delusion). Trend Following success is ultimately a measure of market psychology. Trends, like epidemics, build in geometric progressions. Some people jump on the bandwagon; some get in early either by chance or luck. Finally there is a critical mass that makes it possible for even more people to simply hear about the trend and get on board. If you design a strategy to take advantage of this basic human behavior, you can apply it to a broad range of markets from cotton to currencies to stocks, and win. So for all of those expecting the magical grail or some secret sauce to explain market behavior or offer predictions for tomorrow, consider what the 3 best technical indicators in order are:

1. Price
2. Price
3. Price

Michael W. Covel is the founder and President of Trend Following™. A researcher

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*of the most successful Trend Following investment managers, he has been in the alternative investments industry consulting on Trend Following to individual traders, hedge funds and banks for ten years. His best selling book, **Trend Following: How Great Traders Make Millions in Up or Down Markets** (Prentice Hall, May, 2004) is a complete and concise guide to trend following. It includes interviews with great trend followers who have won millions if not billions in the market. The trading world has embraced the book with endorsements from Van K. Tharp, John Mauldin, Ed Seykota and many more. Trend Following is now in its fifth printing, and is currently available in a Japanese translation with Chinese, German, French, Korean and Russian translations soon to follow. Teaching and sharing unique insights about Trend Following trading and alternative investments has earned Mr. Covell respect as a rational and logical voice in uncertain times. Mr. Covell also writes for numerous industry publications including *Your Trading Edge*, *Stocks, Futures and Options Magazine* and *International Petroleum Finance* and is consistently quoted and interviewed by a variety of financial publications.*


Mr. Covell is also Managing Editor at TurtleTrader.com®, the leading Trend Following news and commentary resource since 1996. Thousands of visitors from more than 70 countries as well as hundreds of trading professionals engaged in years of debate and interchange making the site the rich archive of trading information, data and opinion that it continues to be today. TurtleTrader, one of the largest & strongest trading community on the web with over 7.5 million unique visitors since its inception, also functions as a resource center for the Trend Following Educational Course.

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