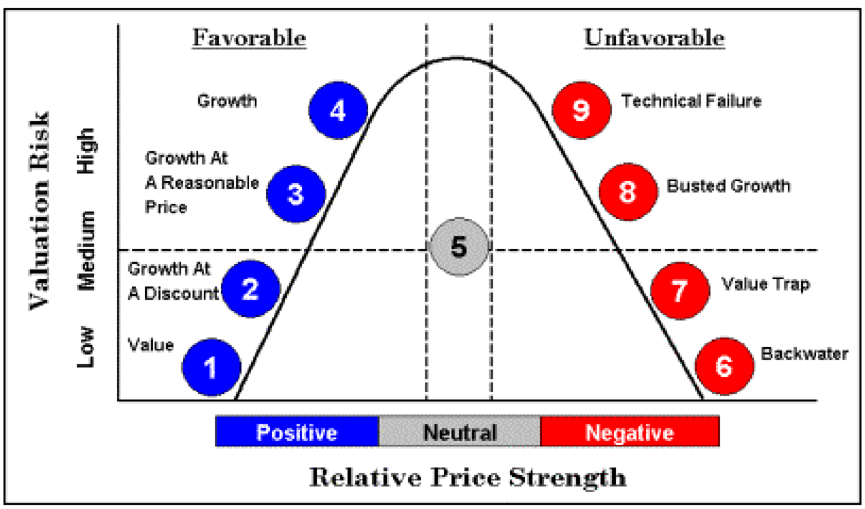
Trend Following

The latest book making the rounds of investment theorists is *Trend Following,* by Michael Covel.[1] For investors willing to engage in some insightful discussion of their core investment philosophy, the book will challenge long-held beliefs. Perhaps the most controversial argument is that Wall Street's great effort of analysis and projections of the future are of little or no use to the serious investor. According to Covel, if the objective is to have a defined strategy to put capital to work for a profit, then investors are traders and the difference is more than a parsing of semantics.

Trend Following is not an endorsement of day-trading and technical analysis. The basic premise is that the most profit is gained when a trader is harmonized to an enduring trend. To do this, traders need to adopt a strict discipline that minimizes behavioral bias (i.e., intuitive or "gut" feel), does not anticipate a trend beginning or end, and acts when the trend changes. This approach is diametrically opposed to long-term "buy and hold," which is viewed as a strategy that is best suited for passive indexing.

The "how-to" portion of Covel's book is more vague on the mechanics of trend following than his conceptual logic and extraordinary examples portray. However, we can't help but see similarities in approach to trend following in our Performance Probability Score (PPS) model. PPS incorporates analysis of relative valuation and relative price performance to produce risk and reward expectations for individual stocks. The core of the model is a binary separation of whether long-term relative price performance is positive or negative. Trend following is doing the same.



Source: Legg Mason

We have three years of performance data for PPS that are consistent with the concept of trend following. PPS ratings with a definable positive trend of relative price strength (PPS 1–4) have outperformed the S&P 500 handily while stocks with a long-term negative price trend (PPS 6–9) generally have underperformed. While we would argue that an overlay of relative valuation provides an important consideration, the basic rule of PPS is to stay with a positive or negative rating until a definable change has occurred. In other words, PPS does not anticipate changes in trends.

[1] Covel, Michael, *Trend Following: How Great Traders Make Millions in Up or Down Markets*, Financial Times Prentice Hall Books, 2004.

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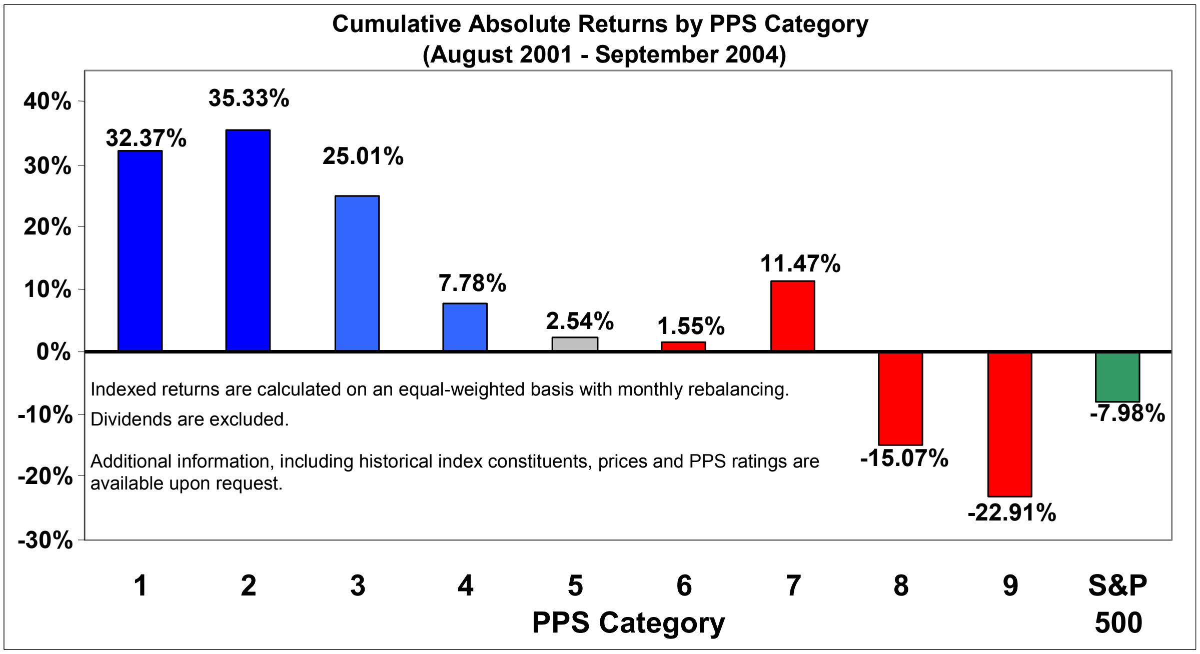
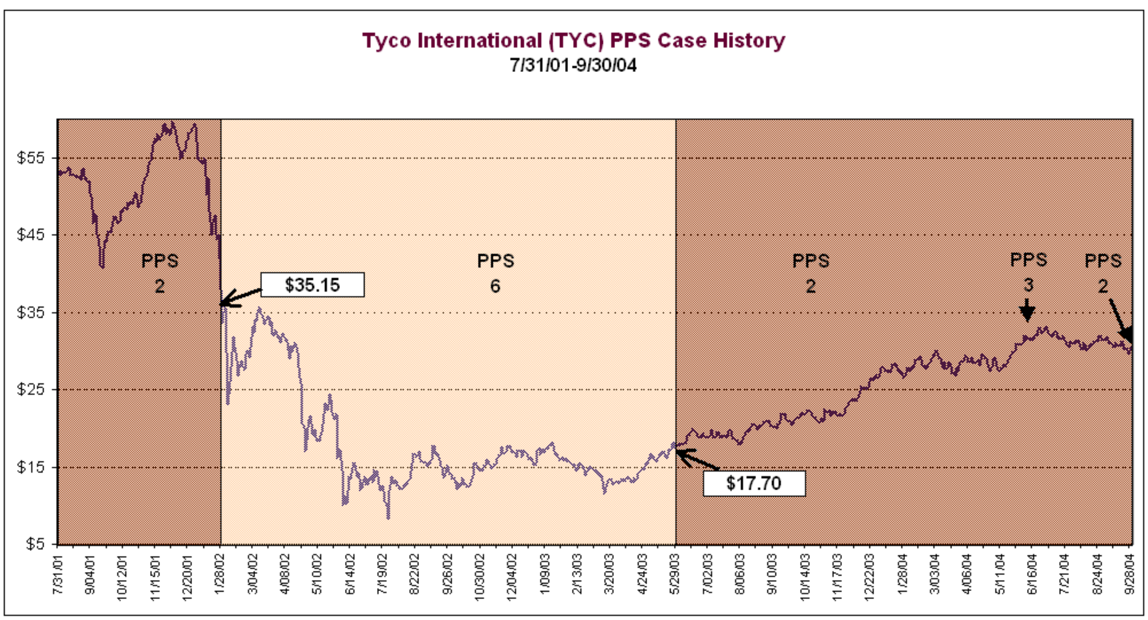


Source: Legg Mason

An example of trend following and PPS is the performance of Tyco International (TYC). The chart below shows a price graph of TYC from July 31, 2001 (inception of the PPS model), through September 30, 2004. The long-term relative price portion of PPS turned negative on TYC in January 2002 as the stock was declining sharply. Trend following makes no claim of getting investors out at a price peak. In reality, there is usually a period of negative relative performance before a change in the longer-term trend becomes definitive. At the time of the negative change in PPS rating, there was no doubt skepticism that the model was too late and the price weakness represented an attractive buying opportunity, given the extremely low valuation of the stock.



Source: Legg Mason

As it turned out, Tyco was to be front-page news and a "poster child" of corporate malfeasance for most of 2002. The stock bottomed at around $8 in July 2002 and began to move steadily higher. As with a market peak, trend following is unlikely to have a definitive change at the price bottom. From a perspective of trend following, there needed to be a period of positive relative performance before there was a confirmed change. This did not occur for the PPS model on Tyco until May 2003 at about $16. Again, there was no doubt skepticism that the model was too late in recognizing the improvement in TYC and the stock was approaching full valuation.

The purpose of this case history is to illustrate the methodology underlying the PPS model. This security was chosen because it demonstrates the characteristics the model attempts to justify. This illustration is not an indication that all stocks will perform similarly. There are securities in the PPS model that do not justify this investing approach.

Other than using consensus estimates for determining relative valuation, PPS provides an opinion that is independent of analysts' recommendations. The model is mechanical, unemotional, adaptive to change, and confirms rather than anticipates. Each of these characteristics is consistent with Covel's definition of successful trend following.

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. Importantly, Covel makes the case that investors are likely to benefit from having a portion of their portfolio invested in a non-traditional approach that adapts to whatever stock or asset class is exhibiting definable trends. While this "trader" mentality may strike some as inappropriate, this approach is becoming *modus operandi* for some of the most sophisticated and successful long-term investors.

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