Daily Speculations

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Book Review by Victor Niederhoffer:

Trend Following: How Great Traders Make Millions in Up or Down Markets, by Michael Covel

I bought *Trend Following* because I like to see new developments in the investment field, and cutting-edge methods for defining trends. It did have one system, on p. 257, involving buying 89-day breakout for entries and selling 13-day breakdown for exit. The author reports that a 10-year in-sample test for 15 markets shows a 21% compounded return before commissions and slippage.

The second reason I bought the book was to get an update on the reasoning and decision-making of trend followers, as I find such a great aid in the study of the psychology of mass behavior and the philosophy of science. I get the same sort of value from these books as I do from studying the Keech cult, supernatural operators such as Uri Geller and horoscope readers. The book is a treasure trove in this regard, typified by the first chart in the book, which shows that if you created a hypothetical index of the three long-time trend-following firms -- Dunn, Campbell and John Henry -- that an investment of $1,000 in 1985 would have grown by 2003 to some $48,000, versus $6,000 for the S&P.

The author apparently has no understanding that if you select from among the top funds from the top traders in a group that the results will appear to be strong. Nor does he seem to appreciate the importance of randomness in explaining the results of the selected trend followers: trends they caught, selected funds reported, money under management and years started and stopped.

The level of analysis in that first chart of the book is in my opinion superior to anything else that follows.

My third reason for buying the book was that I wanted to find some great insights about the trend followers. The books is fantastic here. I learned, for example, that when Seykota "looks at a market that everyone thinks has exhausted its up trend, this is often when he likes to get in .... He just puts the chart on the other side of the room and if it looked like it was going up, then he would buy it."

And:

- "Trend followers generate phenomenal returns because their decisions are ultimately based on one piece of core information: price."
- "We are trend followers, not trend generators. At the beginning or end of a major trend, we may provide a little bump or a minor goose, but it will be an extremely superficial temporary effect."
- "The strategy of buy and hold is bad. Hold for what? A key of successful traders is their ability to leverage investments."
- "Obviously you can't know what happens before it happens. Maybe the rate cut is the start of a major trend, and maybe it's OK to go in after. That's our approach -- no bias short or long."
- "Trend following hasn't changed, even though a single trend follower has."

The book consists of 10 chapters: Trend Following, Great Trend Followers, Performance Data, Big Events in Trend Following, Baseball: Thinking Outside the Batter's Box, Human Behavior, Decision-Making, Science of Trading, Holy Grails and Trading Systems.

An unexpected benefit of the book was the wealth of adulatory anecdotes about the great trend-followers. For example, Bill Dunn received a doctorate in theoretical physics from Northwestern University in Chicago in 1966 and he subsequently developed and tested logistic and operational systems for the Department of Defense. Bottom line: "Dunn enjoyed the R&D side of things but also understood the real world."

John Henry manages over $2 billion in client assets. He's "a trend follower cut from similar cloth to Bill Dunn." He was born to a farming family and loved baseball from the time he was 9 years old. He has described himself as having average intelligence ... and attended community colleges and took numerous night courses but never received his college degree."

Ed Seykota's achievements "rank him as one of the best trend followers of our time. ... his monthly performance data for the 1990s is eye-popping. ... He enjoys debunking market ignorance with terse, Zen-like statements that force the hearer to look inward." An example from Seykota.com: "Today or yesterday, skeptics abound. They sound like broken records in their desire to see trend following debunked."

The book gave us a lagniappe by quoting some of the people on our SpecList. Gibbons Burke, in perhaps the most sensible thing in the book, offered some philosophical thoughts about randomness: "You may know that out of the next 20 trades, 12 will be winners. What you don't know is the sequence."

Dr. Brett, the market shrink, contributes a self-assessment questionnaire, the result of which "is likely to influence the degree of success traders are likely to have in adopting a trend following approach."

As I often tell Dr. Brett, the likelihood of success in using a system is determined much more by the randomness of prices, and the grind and rake, than their affinity for childhood thrill rides or their level of moodiness.

John Hoenig, proprietor of the Capitalistpig hedge fund, is quoted on the front cover: "*Trend Following* will replace *Market Wizards* as the must-read bible for a new generation of traders."

Yes, and let us hope that others will follow in an endless succession, believing that following fixed mechanical rules and eyeballing chart from across the rooms are the road to riches, as this will help absorb the massive infrastructure and frictional upkeep that the market needs for it to function.

P.S. Before I had a chance to read all of the golden nuggets of the book, I was delighted to learn from Laurel that five pages were devoted to recounting the mistakes of my 1997 debacle and revealing how trend following would have saved me from them, and to ridiculing our book, *Practical Speculation,* on the grounds that we still don't get it. This brought back pleasant memories of similar denigratory remarks about my ability to come back in squash after I quit the game in the late '60s.