TRADERS´ Interview

Michael Covel

Profit with Trend Following

In an age of instant execution, instant quotes, instant news, squawk boxes, matrixes, minute Elliott Wave analysis, Gann Analysis, CNBC and Bloomberg and whatever else you digest during a trading day, on your TV, on your monitor, in your news paper, or your mobile phone and Blackberry, you sometimes find something or someone that makes you stop in your tracks and prompts you to take a step back. The following article is about trend following, BUT before you skip to the next page, ask yourself this question: Am I successful as a trader? Now read the small paragraph below and ask yourself again:

Life is about choices. You cannot be a trend follower and base your decisions on fundamental analysis or Elliott Wave Theory or some other Holy Grail trading technique. The great trend followers trade objective methods. Where are the great Elliott Wave traders? Where are their performance numbers? Or when you say you use fundamentals such as interest rates or economic growth forecasts what do you mean exactly? Think about it this way: Losing traders forecast where the market will be tomorrow. Winning traders, like trend followers, react to what the market is doing right now.

It is a thought provoking interview with Michael Covel, but we will let him introduce himself

TRADERS´: Trend followers must be doing well in this market; how long will it last?
Michael Covel: How long will what last, trend following as a viable trading style? There is no reason why trend following should stop. If markets were to go sideways forever, there would be trends and then trend following would cease to work.

Trend following goes against all the customs, rituals, trappings, and myths we have grown accustomed to associating with Wall Street trading success. Trend following traders respond to what is happening in the market rather than anticipating what will happen. They base their trading decisions on one piece of core information: The market price. That makes them different from the vast majority of traders and investors who rely on fundamental data to make their trading decisions. They think the only way to beat the market is to gather all of the information you can find. They want news, they want CNBC, they want The Wall Street Journal, they want crop reports, they want OPEC rumours, they want Greenspan's shoe size - they believe all of this extraneous information will help them to make profitable trading decisions. And when they make a decision, 99 times out of a 100 it is to buy and hold, hoping that the market will go one way if they just hang in there. Hope is not a good trading strategy!

Trend followers, on the other hand, who are technical traders by nature, say enough! The market price is the best source of information about the market direction because the market price is the aggregate vote of everyone. It does not matter if the market goes up or down, because all you should care about is the price. All markets, from stocks and bonds to metals, currencies and commodities can be traded the same because all you need to know is the market price. Trend followers see the world in trends. Trend followers know that trends will arrive in unpredictable ways, going either up or down. Trend followers simply want to be on board to ride those unpredictable trends for profit. Think about it - what else can you really believe in beside the market price? Or, to quote John W. Henry, "The greatest action, the wisest, the best action that you can take in almost any situation is to stay with what is, instead of jumping to conclusions or trying to come up with conclusions. Just pay attention to what is."

TRADERS´: Any comments about the market we are seeing now?
Covel: No. Trying to look at some one month, 6 month or year period as a trend follower is pointless. Trying to examine the market from a short-term time frame is trying to make the market make money when you want it to. It does not work that way. You have to take what the market gives you.

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:

TRADERS´: How did you view the markets before you took up trading?
Covel: Like most everyone, I was exposed to fundamentals first. I remember all of my college professors saying it was impossible to make money from the markets. When you are young and don't know any better - you believe them - until you learn better and learn how wrong they were.

TRADERS': What motivated you to start trading?
Covel: All entrepreneurial ventures I have been involved in were

motivated by finding a way to make money through my own hard work, not just 'working for the man'. I am not cut out to be someone's employee... that is unless they pay more than I make now!

What led me to trend-following was curiosity. I was looking at performance data and what all those who played the trends made. Occasionally, I would read an article in some magazine, but I did not find much about these traders and I could not figure out why Main Street and Wall Street were not preoccupied with them. How could they be? If you just look at their performance numbers, you can see how much money they have pulled out of the market.

So I had this insatiable curiosity to figure out the puzzle.

TRADERS´: Figuring out the puzzle is obviously a huge task. Where did you begin?

Covel: Performance data; Meaning looking in depth at the performance data of professional trend followers which showed that a) they were trading similar methods and b) that meant anyone could do it.

Also, of course, the Turtle experiment where novices were taught to trade was motivating. The Turtles were and are trend followers.

TRADERS´: Have you always been a trend follower?

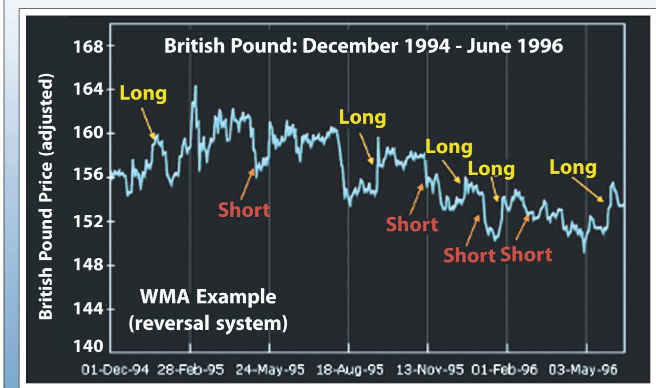
Covel: No.

TRADERS´: What other trading methods did you try out before deciding to stick to trend following?

Covel: An assortment of Warren Buffett style approaches - all fundamental. But I learned over time, you still have to decide when exactly do you enter, when do you exit, how much do you bet, and what will your total portfolio consist of. Those kinds of questions do not get answered just by having all the fundamental facts in the world. I asked my readers the other day:

"Is it easier for the average person to wrap their arms around the idea of "financing the operations of a business" or simply trading based on daily price action? Is it more realistic for the average person to be an "investor" or "trader"?"

F1) A Horror Market for Trend Followers



This chart is conceivably most unsuitable for a trend following trader. After nearly every signal in one direction, an opposite signal comes practically by return mail in the opposite direction. What we have here is called a whipsaw market, feared by all trend followers. This is where the many small losses occur that must be compensated by an unusually big winner.

TRADERS´: What is the answer you received?

Covel: The answer will be different for people. Some want to believe in the Warren Buffett way, some want to believe in the trend following way.

The biggest difference is still that so few people, relatively speaking, are aware of trend following trading as a viable means to pull money from the markets.

TRADERS´: Were you successful at the beginning?

Covel: I think it is rare a person is successful immediately. All ventures in life take hard work.

TRADERS´: Most new traders hear the "trend is your friend" speech early, but the majority of them never last more than six months. Is trend following really so difficult?

Covel: I think most people fail in entrepreneurial ventures, including trend following trading, due to a lack of will and lack of patience. Is trend following difficult? Conceptually, no it is not. But if you cannot stick with it, it will be difficult. However, what in life that results in great rewards is easy?

The harsh reality of today's markets is no different from yesterday or 10 years ago. Whether you are a trader or an investor, ultimately you have only yourself to blame for the decisions you make regarding your money. You can make winning decisions or losing decisions – it is up to you. If you are a trend follower, you make your decisions based on the market price. If the trend is up, it is a buying opportunity. If the trend is down, it is a selling opportunity or a time to go short opportunity. The market is a brutal place and you must be prepared for ups and downs in your account, including drawdowns and recoveries. You never bet against the trend. Sound hard? Well, great trading is hard!

Why do people have such a hard time just accepting a trend and just riding it? Why do people feel the need to explain "why" the move happened? One of my readers summed it up nicely:

He said "I believe that most people prefer to think that a 'business approach to investing' just makes sense - plain and simple. Though if you bring the discussion further, and really delve into what that means, and specifically, how it is reliant upon prediction, then you get a lot of blank stares. People have told me that they might not know the ins and outs of how their money manager is making decisions, but they know he is using 'sound investment principals' and they feel safe with that. When I bring up price being the real-time determinant of value, when I bring up money management and systematic trading decisions, as a clear way to be actively involved in your chance of turning your nest egg into an eagle, I get a lot of negative responses. The feedback I get is that people want to think that you need to be a hard working detective to really dissect these companies, understand the businesses, know the management, read the economy and then make an investment based on these 'facts'. They really would rather have that, and pay for that, and buy into that - than work on themselves and take responsibility. I certainly do not think everyone is that way, but it seems that the majority is."

TRADERS´: What makes a good trend follower?

Covel: This answer is best answered by my book "Trend Following". The book gives me a chance to answer this question in the detail needed. In simplistic terms, a good trend follower has a trading system with rules and the emotional/psychological temperament to stick with his trading system rules.

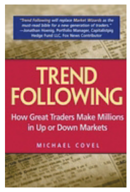
Life is about choices. You cannot be a trend follower and base your decisions on fundamental analysis or Elliott Wave Theory or some other Holy Grail trading technique. The great trend followers trade objective methods. Where are the great Elliott Wave traders? Where are their performance numbers? Or when you say you use fundamentals such as interest rates or economic growth forecasts what do you mean exactly? Think about it this way: Losing traders forecast where the market will be tomorrow. Winning traders, like trend followers, react to what the market is doing right now.

TRADERS´: Is a good trader automatically a good trend follower?
Covel: Yes, I believe that is a fair assessment.

TRADERS´: Explain some of your market concepts and trading ideas.
Covel: So many people get into arcane technical analysis. The great traders do not do that and neither do I. The bottom line is all traders need to answer these questions:

* How do you determine what market to buy or sell at any time?
* How much of a market do you buy or sell at any time?
* How do you determine when you buy or sell a market?
* How do you determine when you get out of a losing position?
* How do you determine when you get out of a winning position?

Book Info



Trend Following
How Great Traders Make Millions
in Up or Down Markets by Michael Covel
Price: £19.99
ISBN: 0131446037, 311 pages, hardback,
published by Prentice Hall, 1st edition, 2004

http://www.global-investor.com/traders

Trading - the way you enter and exit a market - could really be anything. The trend followers I write about in my book have a fairly specific strategy. First, they select a portfolio and the markets they are going to track. Then they wait to see if a market starts to move and if it does, either up or down, then a trend follower will take an initial long or short position, depending on the direction of the market.

The age-old market wisdom is that you are going to run with that position for as long as it goes in your favour. You are not going to guess, or predict, or forecast the direction. You do not know why the market is going up and frankly, I have not met a great trend follower yet who really cares why the market is moving. He just says, "My #1 goal is to get on these moving markets and have risk management so I know that if the market goes against me, I know where and when to exit."

That frame of thinking might be the big difference. Trend traders always know what their loss point is. They do not know what the upside is going to be, but they know what the downside is. They are risk managers.

TRADERS´: What are the essential qualities of a new forming trend?
Covel: I keep getting asked that question. I think it is phrased incorrectly, because what you are really looking for is more like wildcatting for oil. You drill a bunch of oil wells, and seven out of 10 of them are going to be failures, but three of them will be gushers. The idea is not really about picking or measuring a trend, it is to know the markets that you are following, and know when you are going to enter and exit.

A good example of entry is the age-old break-out. You are looking for a market that has momentum, or a market that is moving up or down. When you find it, you are going to get in. But when do you want to get out? Trend followers never get in at the exact bottom if they are going long, and they will never get out at the exact top. A typical trend follower will get in late and get out after the market has peaked. He rides that trend straight up and does not know he is going to get out until it is going the other way. That is the confirming signal to a trend follower. He is not trying to fight the process, or over think it or over rationalise it. The trend follower just says, "If it's going up, I'm long and when it starts to go down, I'm getting out. Perhaps I'll go short."

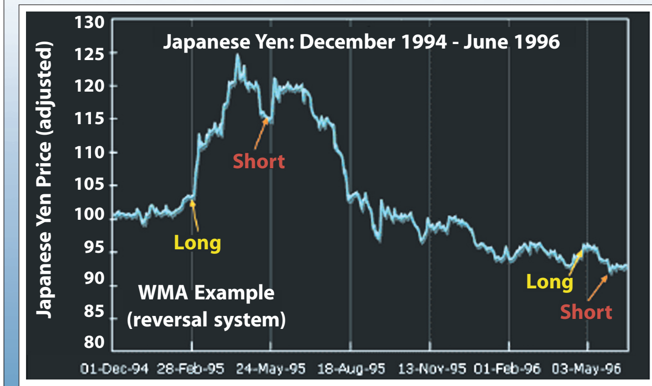
Even more specifically, strong breakouts to new highs or lows; do not make it much more complicated than that. Of course, a breakout alone does not mean the trend will continue. You can never know you have had a great trend until it is over.

TRADERS´: Often when you think of a trend following method you think of a trader who watches a slew of indicators to determine trend. Is it safe to say that the entry techniques of the successful traders you follow are fairly simple straight forward approaches?
Covel: They are indeed simple. Breakouts, moving average crossovers. The only people that think a whole slew of indicators are useful are traders who do not yet get what trend following trading actually encompasses.

TRADERS´: One of the most difficult things for many traders who have actually been able to capture a trend is to stay with it. How do you know when to get out?
Covel: You need rules. You need to know when you will get out before you ever get in. If the rule is to enter on X day breakout, then perhaps the rule is to exit on X day breakout in the opposite direction of entry. Trend followers never time the top and never get out before the top. Trend followers always exit after the peak on the way down (or way up if you had been short).

TRADERS´: How do you handle sideways markets?
Covel: Trend followers lose money in sideways markets. No trend means no trend following. You handle sideways markets by cutting losses short. You handle them by knowing they are possible and knowing they will happen. Sideways markets are all about having great risk management.

F2) Trend Followers Love This



This chart shows favourable price development for trend followers. The entries and exits do not occur at the most opportune point in time, rather the trader tries to cut out the middle third of a move.

TRADERS´: Do you use more than one system at a time i.e. a portfolio of mechanical trading systems generating various signals at various times, in an effort to smooth the equity curve of an account?
Covel: Some trend traders will do this to smooth their equity curves as you say and some accept the volatility head on as they are comfortable with their approaches in the long run.

Meaning, if you have a more volatile trend following trading approach does the short term volatility really matter if you are making the big absolute returns?

TRADERS´: When do you throw in the towel on a trend following system?
Covel: Over the years, I have found that for most trend followers - 50% is a number that causes them to pause. But then again, if someone truly knows trend following, they know from a profit peak (and especially if you are very aggressive trend follower), -50% is possible.

TRADERS´: A lack of volatility has been a disadvantage for many traders recently. Is it also a problem for trend followers?
Covel: Trend followers need volatility too. It is not so much a problem, just reality. Meaning trend followers need trends to make money and volatility is part of that.

TRADERS´: How long are your typical trades?
Covel: Trend following trading will see winners lasting months and maybe catch the occasional trend going over a year. Losers are often cut within days or weeks.

TRADERS´: Does being a trend follower mean a totally systematic approach, or is there room for discretionary elements?
Covel: The great ones are systematic. Never say never to any "new" way of doing things, but the great ones take their discretionary elements and make them systematic.

TRADERS´: Do you mix time frames?
Covel: In general, trend following trading is longer term. The great traders make their serious trend following profits over the months

and years, not day or week trends. Do some trend followers mix time frames - sure.

TRADERS´: Does volume play a role in your trading approach?
Covel: In the sense you do not want to be controlling 100% of the volume yourself in some illiquid market. Other than that, no, trend following is predicated on price action not volume analysis.

TRADERS´: How do you test your trading ideas?
Covel: I work with two programmers using custom testing platforms.

I do find these days for the testing software market two commercial products keep coming to the top: *www.wealth-lab.com* and *www.tradingrecipes.com*.

TRADERS´: How many different set-ups do you use for your trading?
Covel: For all of those expecting the magical grail or some secret sauce to explain market behaviour or offer predictions for tomorrow, consider what the 3 best technical indicators in order are:

1. Price
2. Price
3. Price

TRADERS´: Can you demonstrate briefly how price is used?
Covel: How about a price breakout? A new high of 100 days is a good example.

Of course, this does not tell you the trend will continue, it is just a trigger for entry. There is no way to predict how long a trend will go. Hence, that is why you just "follow" it.

You can't read tea leaves. John W. Henry can't. Ed Seykota can't. Nobody can. William Eckhardt, a long-time trend follower and former partner of trend follower Richard Dennis, builds off Henry's wisdom by describing how price is what traders live and die by.

The moment you add any other variables to the decision-making process, you have diluted price. 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.

TRADERS´: How do you manage your risk?
Covel: You have to find that balance of reward and drawdown comfortable for you.

Risk management is counterintuitive for most folks. Most want to pretend that you can enter the market and never have losses. If you look at the track record of a great trend follower like John Henry, Bill Dunn or Mark Rosenberg, and you look at two decades of their monthly performance, you are going to see as many down months as up months. Most people just want to believe it is always going to be up. Even when something like the dotcom bubble happens - and the Nasdaq is still down 60% - they want to imagine that it is not really happening. Trend followers accept that losses are happening. They know it is part of the game and they have a plan to deal with them.

TRADERS´: How do you determine when you are wrong in a trade?
Covel: The price will tell you. If you get in at 100 and the market goes to 75, you are wrong.

TRADERS´: Is money management an independent topic?
Covel: Money management is perhaps the most important topic, but as I make the case in Chapter 10 of my book, it is one of the 5 questions here you must answer:

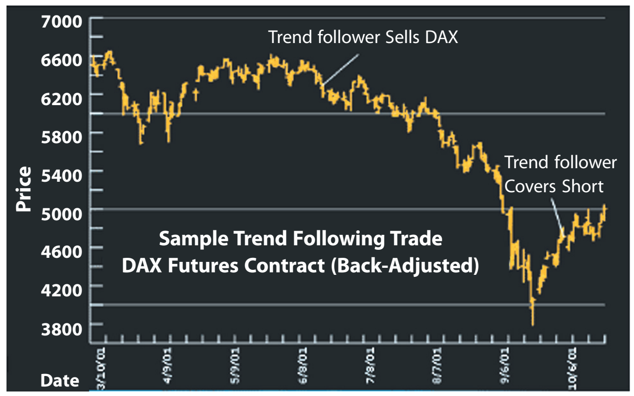
- How do you determine what market to buy or sell at any time?
- How much of a market do you buy or sell at any time?
- How do you determine when you buy or sell a market?
- How do you determine when you get out of a losing position?
- How do you determine when you get out of a winning position?

Money management is ultimately a defensive concept. It keeps you in the game. For example, money management tells you whether you have enough new money to trade additional positions. Trend followers all realise that you need to make small bets initially to simply stay alive and play another day. So, if you start at $100,000, and you are going to risk 2 percent, that will be $2,000. You say to yourself, "Why am I only risking $2,000. That is nothing compared to what I have got to bet." But that is not the point. First things first, you cannot predict where the trend is going to go, so you cannot afford to risk all of your capital out of the gate. Trend follower Craig Pauley points out: "There are traders who are unwilling to risk more than 1% but I would find it surprising to hear of any trader who risks more than 5% of assets per trace. Bear in mind that risking too little does not give the market the opportunity to allow your profitable trade to occur."

Think about money management as you would about getting into physical shape. You cannot lift weights six times a day for hours each day for 30 straight days without hurting yourself. There is an optimum amount of lifting you can do per day that gets you ahead without setting you back. You want to be at that optimal point, just as you want to get to an optimal point with money management. Trend follower, Ed Seykota *www.seykota.com*, author of The Trading Tribe book, describes this optimal point with his concept of "heat". "Placing a trade with a predetermined stop-loss point can be compared to placing a bet. The more money risked, the larger the bet. Conservative betting produces conservative performance, while bold betting leads to spectacular ruin. A bold trader placing large bets feels pressure - or heat - from the volatility of the portfolio. A hot portfolio keeps more at risk than a cold one. In portfolio management, we call the distributed bet size the heat of the portfolio."

Trading correctly is 90% money management, a fact that most people want

F3) The Perfect Trade



A typical trend following trade; the signal is generated after the downtrend has set in. The trade is closed after the market has turned upward. The profit on this trade amounted to 1600 points in the DAX future. This is the kind of trade necessary to make up for the many small losses that inevitably occur with this type of method.

to avoid or do not understand. However, once you have money management down, your personal psychology will be 100% of your trading success. Once you have the rules, you still need to follow them! Why then do traders have such trouble keeping their trading proportional? Why is it so hard for them to find that optimal point? Fear. Trend follower Tom Basso points out that traders usually begin trading small and then as they get more confident increase their trading size. Once they get to a certain comfort level of say, 1000 contracts, they often stay there, suddenly fearful that turning up the "heat", to use Seykota's term, will increase their risk. For trend followers like Basso, the goal is to keep things on a constant leverage. Few traders make the move to a proactive posture in which risks are actively managed for a more efficient use of capital.

How do you avoid trading less instead of trading the optimal amount of whatever capital you have? You need to create an abstract money world. Do not think about what money can buy. Just look at the numbers like you would when playing a board game like monopoly or risk and since your capital is always changing, it is important to continually rebalance your portfolio. Trend follower Paul Mulvaney points out that, "Trend following is implicitly clear about dynamic re-balancing, which is why I think successful traders appear to be fearless. Many hedge fund methodologies make risk management a separate endeavour. In trend following it is part of the internal logic of the investment process."

TRADERS´: How much of your equity do you risk per trade?
Covel: 1-2% is a typical risk percent.

TRADERS´: How do you manage your open trades?
Covel: Great trend following traders base their capital risked using open trade capital. Meaning, if you have open trade profit, you determine your money management, your position size... using all capital including open trade capital.

TRADERS´: What kind of stops and/or profit targets to you use?
Covel: The great trend following traders I have interviewed, and in my own trading/testing, profit targets are not part of the trend following trading game.

TRADERS´: As far as executing trades is concerned, is that a subjective process or do you do that mechanically?
Covel: Trend following is about rules. It is about putting those rules into a form that you can objectively follow. Subjective entry/exit rules or subjective money management rules would defeat the purpose.

TRADERS´: What is the relation between your winning and your losing trades?
Covel: 30-50% winners would be typical. Losers will always outweigh winners, but the hope is that the size of the winners will outweigh the size of the losers. Or said another way, you need big winners to make up for the small losers.

TRADERS´: What was your worst drawdown?
Covel: Trend following drawdowns can range. It depends on what you risk. It depends on how aggressive you are, but drawdowns ranging from -25 to -50% are seen.

Unfortunately many people criticise trend following by focusing only on their drawdowns or losses. These critics conveniently ignore the long-term absolute returns - the monster profits. In speaking with a large-money-managing trend follower recently, we both wondered why so many criticise trend following for drawdowns (from which they typically recover very quickly), but seem to purposely ignore the Nasdaq drawdown of -60 percent that has extended for five years.

TRADERS´: What do you find most frustrating with trading?
Covel: That so many people don't get "it". That so many people are seduced into wrong behaviours trying to get rich quick.

TRADERS´: When did you realise that trading was not going to be a just an attempt in the markets, but was going to be a full-time career for you? Or did you sense that from the beginning?
Covel: I do not walk around touting the label of "full-time trader". To me, for what I do in my life, that would seem odd. I have always been involved in a wide assortment of entrepreneurial ventures – trading is but one of them.

TRADERS´: You are a book author, you run a research company, are Managing Editor of TurtleTrader.com. How do you combine your busy schedule with the demands of trading?
Covel: All good things in life take time. Beyond my own trading, I also maintain investments with trend following traders and in real estate. I make my schedule busy - if I was not busy I would be bored!

One reason I am so passionate about trend following trading is that it is anchored in reality. Reality is unpredictable and uncertain. For example, trend followers know that if you do not cut your losses short, there is a good chance the losses will get larger. The more you struggle with your small loss, the larger it may become and the harder it may be to deal with if your decision-making is delayed. By holding themselves accountable and accepting a loss, trend followers are able to cope with uncertainty. They avoid behaviours that almost guarantee losses in the market such as lack of discipline, impatience, greed, self-delusion and subjectivity. If you are a trend following trader, you do not attach emotional baggage to the concept of money. Charles Faulkner, an expert on behavioural finance elaborates: “Some problems run deeper, springing from limiting, unconscious beliefs. For instance, a trader who has labelled himself one-for-trader, or who learned as a child the biblical story that it is easier for a camel to pass through the eye of a needle than for a rich man to enter the kingdom of God, may subconsciously sabotage his trading to respect his beliefs. They are deeply engrained in us, but if all the ethical people think money is bad, who is going to get the money?”

TRADERS´: Where does the psychological element come into play?
Covel: It is not the genius of a trend following system that makes them wealthy. It is their self-discipline, willingness to be responsible for what they do, and their hard work. Trend following rules are the easy part. It is playing by them that is so difficult for many. Frankly it all comes down to defining what you really want. Most people do not want to become rich; they just want to be rich. That is no definition. That is a dream. To become anything you need entrepreneurial zeal, you need passion. But I believe there are a number of key determinants:

- Lack of discipline - Traders are often lazy when it comes to the education needed to trade successfully.
- Impatience - Traders often have an insatiable need for action.
- No objectivity - Traders tend not to cut their losses fast enough. They marry their positions.
- Greed - Traders often want quick profits.
- Refusal to accept the truth - Traders often do not want to believe that the only truth is price.
- Impulsive behaviour - Traders often jump into the markets based on a story in the morning paper or on CNBC.
- Inability to stay in the present - Traders often spend time thinking about how they are going to spend their profits or regretting mistakes they made in the past
- Avoiding false parallels - Traders often look for patterns from the past that will enable them to predict what will happen in the future.

The quote by Carl Sagan, “It is far better to grasp the universe as it really is than to persist in the delusion, however satisfying and reassuring”, is a great reminder of what it takes for trend following success.

TRADERS´: Any words about fear, greed and self esteem?
Covel: Too much fear - you can’t win. Too much greed - you can’t win. Low self esteem – what, if anything, will you do in life that is productive?

TRADERS´: What do think is the difference between successful traders and unsuccessful traders?
Covel: Well, for most people quitting is far easier. In fact much research today shows people are more comfortable staying with what they have than exerting the extra effort to break out to new heights of success.

TRADERS´: You are archaeology enthusiast and even have you own collection of dinosaur skull replicas. An interesting past time for a trader; tell us a little about it. Does it relate to trading in any way?
Covel: As a teenager, my uncle and I discovered the hind quarters of a whale on a river cliff. We found 10 or so vertebrate all connected. The vertebrate were all the size of basketballs. This started my fascination with dinosaurs. And so after some business success, buying a scale skull of a T-Rex seemed only natural!

Seriously though, it seems that the general public wants the sizzle and excitement of CNBC stock picks and day trading cocktail banter. Why do people look past great performances for cheap thrills? Isn’t making absolute return big money your true desire? Isn’t that what we all really want? Don’t you ever feel like just taking the gloves off and start acting like a predator? Meaning; are not all great traders, great athletes, etc. to some degree “predators”? Maybe my dinosaur skulls act as a gentle reminder: “eat or be eaten”.