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The Reports Of My Death Have Been Greatly Exaggerated

by: Michael Covel

The contentious debate continues ad infinitum. What is the best strategy for locating enduring sources of returns over time? For one group of traders the answer is trend following. For them, 2004 was "business as usual," another 12-month period demonstrating their ability to be patient through the markets' ups and downs and still come out on top. However, there were some people on Wall Street who disagreed, misinterpreting trend followers' 2004 drawdowns as a sign that trend following was finally dead in the water. Once again, as has happened periodically over the past 30 years, these dire predictions, bred from confused, perhaps even wishful thinking and misconceptions about how trend following works, were wrong.

As the author of the book, Trend Following (Financial Times, 2004), in some senses I find myself point man for the controversy and confusion about the performance of trend-following traders. With each forecast of doom, usually in the form of a book review, column and/or interview, I try to set the record straight, starting with a look at the assumption that generates much of the confusion in the first place: the efficient market hypothesis. The hypothesis essentially says that you can't find an edge to beat the market, and simply sticking with a benchmark or index is the best path to take for profit. Proponents of the efficient market hypothesis argue that because markets are efficient and prices fully reflect all information, traders who consistently outperform the market do so out of luck, not skill. Their mantra is "the market knows best," so don't even attempt the impossible, beating a benchmark. Of course, in real-world terms, markets are both efficient and inefficient– some more than others. In the real world, traders do beat the market, some by a wide margin.

Returns Speak for Themselves

Trend followers like David Harding, Ken Tropin, Salem Abraham, John W. Henry and Keith Campbell dispute the efficient market hypothesis by beating market benchmarks. They beat the market and have done so for years and, in some cases, decades. They turn the efficient market hypothesis on its head and, instead, seek out market inefficiencies where they can make money. For these active trading managers, the more inefficient the market, the more opportunities it offers skilled traders to outperform the unskilled. True to form, trend followers successfully exploited market opportunities offered in 2004:

• John W. Henry & Co.: +13.71%
• Winton Capital: +22.62%
• DUNN TOPS: +11.47%
• Campbell Global Diversified: +8.61%
• Transtrend: +12.87%

Of course, this is just a small one-year sample, but over the long haul there are plenty of winning trend-following traders. What accounts for their patience and discipline and commitment to long-term success? For these traders, ultimately it may be about making a profit, but it's also an understanding and keen appreciation for the scientific method.

The sciences and trend following have much in common. For example, they both are grounded in numbers. Additionally, just as scientists start with a hypothesis, trend followers start with a view of the world. Their view sees the world in trends. Trend followers know that trends will arrive in unpredictable ways going either up or down and can never be predicted in advance. Trend followers simply want to be on board to ride those unpredictable trends for profit. From this worldview, they develop rules or models to best identify and then follow those trends.

But isn't the world simply too complex and too volatile to analyze comprehensively? What trading strategy can possibly capture all these changing market conditions? Trend followers understand that the best judge of a changing market condition is the market price. If a price suddenly races up from 20 to 40, it is a clear, strong and real signal that something has changed. Facing the reality of any and all market environments head-on is the philosophical foundation of trend following. Yet, if it's that simple (and profitable), then why does trend following continue to confuse bright and market-wise people?

Market Price Says It All

I have come to believe that the confusion is linked directly to a trading and investing culture familiar, and therefore comfortable, with only one approach to the markets: fundamental analysis. Fundamental traders and investors think the only way to beat the market is to gather all of the information they can find. They want news, they want CNBC, they want Jim Cramer, they want crop reports, they want OPEC rumors, they want Greenspan's shoe size, and some people believe all of this extraneous information will help them to make profitable trading decisions. 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. Think about it. What else can you really believe in besides the market price?

It may help to clear up some of the confusion about trend following by examining the viewpoints of some trend-following critics (because I'd like to attribute their criticism to confusion, I am not too hard on them). Peter Deoteris, in the Welling@Weeden newsletter, recently reviewed my book. In describing the trend-following community, Deoteris diminishes it by mistakenly referring to John W. Henry and Ed Seykota as "a couple of commodities traders." The universe of trend-following traders is hardly a party of two composed of Ed Seykota and John W. Henry alone. There are many successful trend followers, and the majority of them trade stocks, currencies, bonds and commodities. And what is the implication of the word "commodity?" People associate the term "commodity" with "risky," but forget that all trading methods are risky. The trick is to understand the risk and know what to do with it on a daily basis. Deoteris also assumes trend followers' success comes from "predicting" market direction:

"The Asian debt collapse, the Long-Term Capital Management debacle, the 9/11 terrorist disaster, etc.," he maintains, "were all predicted in some fashion by some super wizards."

In fact, any form of the word "predict" is stricken from the trend-following vocabulary, as trend followers make clear any time they are given the opportunity to do so. However, by attaching the term "revisionist history" to descriptions of how trend followers established positions, Deoteris perpetuates the myth that trend followers forecast significant market events:

"...There clearly is a strong element of revisionist history at work here... looking back and using subsequent events to justify various traders' positions. When those positions were established, however, they were based on logic and assumed risks that were often entirely different."

Trend Traders Follow the Markets

In fact, trend followers take trading positions with no knowledge that an event or crisis will occur. They take their positions as markets move. With price leading the way, they follow along. The fact that these particular small, initial price trends lead to big trends which lead to big events is not something anyone could predict.

Another source of confusion stems from trend following's use of technical analysis. For example, one form of technical analysis attempts to "read" charts to divine the market direction, something trend followers do not do. The second form of technical analysis, practiced by trend followers, is based on reacting to market movements whenever they occur. Trend followers are perfectly happy to accept the fact that this method of price analysis they employ never allows them to enter at the exact bottom or exit at the exact top of a trend. They know that using a trend-following strategy over a diverse group of markets will make money over time, and that fact should make all of our pulses jump with possibilities. In today's jaded world where so many investors are beaten down to believe that nothing is positive and no one can beat the market, an appreciation of what trend followers are accomplishing should be a light-bulb moment for all.

Look a Little Deeper

However, there is plenty of company when it comes to confusion about trend following. When Citigroup recently fired their entire technical analysis group as a cost-cutting measure, replacing it with more fundamental analysis, media coverage jumped all over the idea that technical analysis was dead. Immediately I started receiving e-mails asking if trend following was now dead! The real question with the Citigroup firings is not why they were replacing technical with fundamental analysis, but what kind of technical analysis were they using in the first place? It certainly wasn't the price-based analysis used by trend followers. Yet the only conclusion most people drew from Citigroup's actions was that technical analysis had been thoroughly discredited.

Unlike the fired group at Citigroup (and so many other banks and hedge funds), trend followers do not "project price trends in stocks." Trend followers are technical traders but they trade off price action or movement alone, an unfamiliar concept for most people. Perhaps the best way to become familiar with the concept is to think of trend following as a trading system based on scientifically proven ideas for making money. Trend followers know their trading systems must answer these five questions before they ever enter the market:

- How does the system determine what market to buy or sell at any time?
- How does the system determine how much of a market to buy or sell at any time?
- How does the system determine when to buy or sell a market?
- How does the system determine when to get out of a losing position?
- How does the system determine when to get out of a winning position?

Sleep Soundly at Night

Why are these five questions so important to trend followers? Simply, they allow market participants to measure and manage risk. These five questions, if answered before one ever enters the market, allow a market participant to sleep soundly. However, most people don't understand the questions – much less why they should be answered – and, therefore, doom themselves to repeating the same trading mistakes. Instead of appreciating the trend-following risk-management mindset, they are forever focused on the downside of risk and simply want to avoid it. Trend followers can always tell you exactly how much they risk; what they can't tell you is how much they will make. Great traders know return levels are not predictable!

That's not to say trend followers don't have periods when they lose money. They do. Unfortunately many people criticize 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 criticize 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.
Last year, for one, was filled with great examples showing the downs and ups of trend following. In fact, many trend followers saw 2004 drawdowns ranging from -25 percent to -50 percent at summer's end. But as is so typical of trend-following performance cycles, many trend followers rebounded from the summer lows during the fall and went on to post solid performances for the year.

Trend Following: Here to Stay?

Burt Kozloff, an old pro in the managed money community, debunked the supposed annual death ritual for trend followers at a presentation he moderated to German institutional investors in 1985. During the Q&A, a man stood and proclaimed, “But isn’t it true that trend following is dead?” Kozloff asked that the presentation slides showing performance histories be displayed again. He marched through the declines saying, “Here’s the first obituary for trend-based trading. Here’s the second one…and the next, but these traders today are at new highs, and they consistently decline to honor the tombstones that skeptics keep erecting every time there’s a losing period. [These traders] have made their investors hundreds of millions of dollars since that time. It might, therefore, be a mistake to write yet another series of obituaries.”

At the end of the day, you could argue that trading is all about drawdown and recovery. Those are the facts of life as all great trend-following traders demonstrate repeatedly. Do we all wish the rides were smoother? Sure, but you have to deal with the real world, and the real world is uncertain and volatile. Whether you trade your own account or let someone trade for you, trend following has decades of proven performance excellence that can easily be examined to build your confidence in the method. There are no free lunches. You can make money, and you can lose money. To get the big gains, there will be periods of pain and drawdown. No risk, no return.

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