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## What You Should Know About Alpha

Friday December 9, 3:31 pm ET

By [TradingMarkets Research](#)Expand your trading education--visit [www.tradingmarkets.com](http://www.tradingmarkets.com).

### Skill-Based Return, or Alpha

**There is a low rumble. It's starting to appear in more and more print articles. Alpha.** Everyone is talking about "alpha". Consider this excerpt from *The New York Times*:

*"While that (alpha) may just be Greek to people far removed from Wall Street, when money managers talk about alpha, they are referring to investments that make money even when markets are slumping. It is the opposite of beta, the term applied to investments whose returns tend to track the market.*

More important than simply making money "even when markets are slumping" (let's face it "slumping" can mean many different things to different people!), generating alpha is skill.

Skill-based return, or alpha (i.e. generate alpha) is what trend followers are aiming to achieve. It's what all great traders aim for, regardless of style. While many might argue over an exact definition, it makes sense to think of alpha as return a trader can generate up and above the index. However, many believe that a skill-based return is impossible. They believe the only return to be had is from following the "index". The New and Expanded Edition of *Trend Following* includes performance reports for numerous trend followers. It is quite clear, from the performance reports, that generating alpha is very doable.

All this said, you only have to look around for a few minutes to find mass confusion among the financial press. For example, I was forwarded the following interview request last week:

*"What to Do with 2005 Winners/Losers -- Wall Street Journal (US) I'm looking for investment strategists, money/portfolio managers, financial planners and professors to discuss what investors should do with the big stock winners and losers they hold from 2005 as 2006 approaches. This is for a Sunday Wall Street Journal article."*

I called this reporter, introduced myself and said that if you have winners, don't exit. Keep riding the trend. I said you don't get rich taking profits, so if the trend is still on, stay with the trend. My explanation at its base level was a simple story of how traders generate alpha.

She was not buying my message. There was a long pause. Silence. She then said that she could not write that since it was not true. She wanted to know how I could say such a thing. I tried to explain the basics of following the trend. She did not "get" it and did not want to get it. I was surprised for a moment that this reporter would not listen, but then again was it really a surprise? She of course wanted "predictions". Even if I made them up, giving this reporter predictions for the New Year would have made her happy. Getting the concept of alpha across to people can be hard!

Right after speaking with this *Wall Street Journal* reporter, I received a call from a key player at a trend following firm with a track record exceeding 15 years. They had a **great** November (up +15%) after a choppy most of 2005 (November recouped much of the year). We both agreed that is challenge. Meaning can you sit there in the midst of choppy markets waiting for the trend? Do you have the stomach? Can you tolerate the pain of loss for the potential of gain? That's the life of the great traders. That's the life of those who make the millions. For this man, being able to sit through choppy periods waiting for trends is their skill. It's their alpha.

Why mention both of these people? With so many mixed messages zooming into our living rooms, critically picking apart the good, the bad and ugly is sometimes the only way to learn!

#### Words into Actions

All great traders with great skill have a plan. They have trading plans or systems to generate their alpha. Van Tharp recently emailed me a white paper on trading systems, which included the following excerpt:

*"If you don't work out how you will make decisions ahead of time, then you will certainly have to sort it out at the time of the first difficult decision. If you make decisions on the spot, with no guidelines, you have two problems: 1) figuring out what to do and 2) how to do it. And these problems must be faced under great stress and limited time. It's better to calmly sort out the decision making process ahead of time so that the decision mechanism is agreed to before hand." In general system development then, we look for robust, simple plans that can cover a wide range of conditions. When you preplan like this, you don't try to force the world to adapt to your plan. If you fall in love with a strategy and become emotionally invested in making it work no matter what the market or the world says, you lose the ability to adapt and learn."*

All alpha generators follow these basic constructs. All traders with skill do this. Do you?

Michael W. Covel is the founder and President of [www.TrendFollowing.com](http://www.TrendFollowing.com). A researcher 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, New Expanded Edition (Prentice Hall, November 2005)** 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. Covel respect as a rational and logical voice in uncertain times. Mr. Covel 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. Covel is also Managing Editor at [www.TurtleTrader.com](http://www.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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