TREND FOLLOWING

A Note from Al Abaroa
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A Pragmatic View

Over the years I've spoken with countless people seeking trading solutions. I've reviewed many managers and trading programs with all different sorts of approaches and risk management disciplines. The one thing I've come to understand with a great degree of certainty is that you never know for sure what any market is going to do. The simple truth is that anything can and does happen in the market. We are all regularly surprised by what markets do at any given point in time. So, this begs the question; how is it possible to remain confident in the middle of constant uncertainty and potential adversity? The ability to concentrate and remain objective is a skill that successful traders have acquired. Top traders think differently than most of us do.

Inspired by a whitepaper titled "Performance Gap", written by well-known Trend Following trader and New Market Wizards contributor Tom Basso, we sought to expand upon his work. Specifically, we wanted to search for trend following model timing solutions and help investors think like top traders. In his work, Mr. Basso studied client returns vs. CTA returns. Surprisingly, despite the exceptional performance of managers, clients did not fare as well. How could this be?

To answer this question, our research took us through several schools of thought. We examined global volatility along with performance records within the Barclay's Systematic Index. We looked at money flows over a 13-year period. We studied win/loss ratios and even attempted to factor the human element into the mix.

The first element to understand about trend following models is that the return stream is not linear. Mr. Basso described it the best, referring to the return stream of trend following as asymmetrical. His description stems from the simple premise that markets trend the minority of the time. Simply put, a trader cannot follow a trend that is not. In the absence of market trends, gains will also be sharply absent. When looking at equity curves of some of the greatest trend following managers of all-time, it is not difficult to spot the common denominators amongst them. The long periods of sideways to negative performance is a particular standout. Interestingly, the other remarkable standout is that most of these track records illustrate periods of exceptional gains. Furthermore, return streams were not exclusively contingent on robust, bullish environments. Exceptional gains are achieved in both Up & Down periods of

overall market performance. Another common denominator amongst successful trend followers is that average annual compound growth returns reside in the double-digit category (low to mid-teens).

The latter of the common denominators grabs the interest levels for most. Yet, it leaves investors to puzzle over the extended periods of absent gains.

This puzzle remains unsolved for many trend followers and has presented a great enough of a barrier for others to keep them from ever attempting the approach. In order to break the barrier and help investors think like top traders, we will expound upon the process.

How does volatility influence return in trend following models?

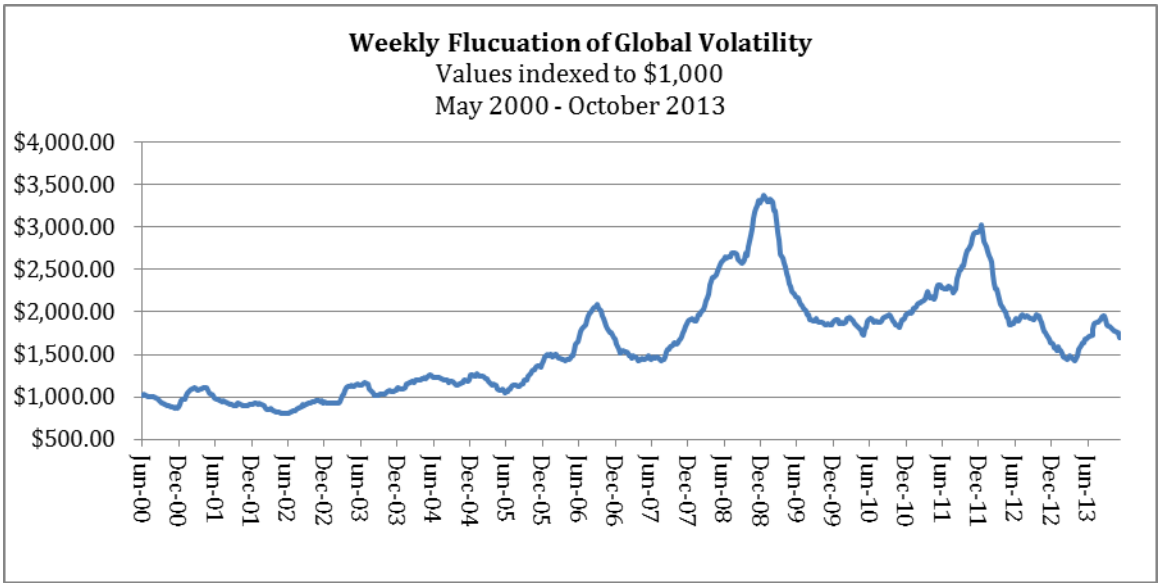
There is a long stated opinion that the payoff curve in a trend following model is reminiscent to that of a long option. It is easy to understand the basic premise. The characteristics of a long option are a defined risk coupled with unlimited profit potential. This loosely translates to many a trend following model in that per trade risk is defined with a stop placed (stops don't necessarily guarantee exact fills) and an unlimited reward.

In a buy side option model (long options), one of the greatest contributors to profit streams are volatility expansions. A large timely directional move, paired with a volatility increase, will handsomely reward the option holder.

As such, if we were to draw a comparison between the option buyer and the trend follower, we would be remiss to not explore the influences of volatility on the latter's performance.

When attempting to unearth a potential correlation between periods of exceptional gains and any volatility influences, we need to first identify market movement. To do this, a Global Volatility Index was created. The concept of this tracking measure was first introduced to me by Justin Vandergrift of Chadwick Investment Group.

Tracking global volatility allows for identification of shifts in price movement. The measure looks at 20 to 35 markets around the globe, ranging from multiple market sectors such as global stock indices, energies, and agricultural products to currencies. To avoid skew and maintain a fair balance, all prices are indexed to a starting point value of $1,000 and forward looking price changes are expressed as a percentage change from the first data point and averaged as a group. This offers an easy to follow graphical representation of price movement, corresponding volatility and shifts thereof.



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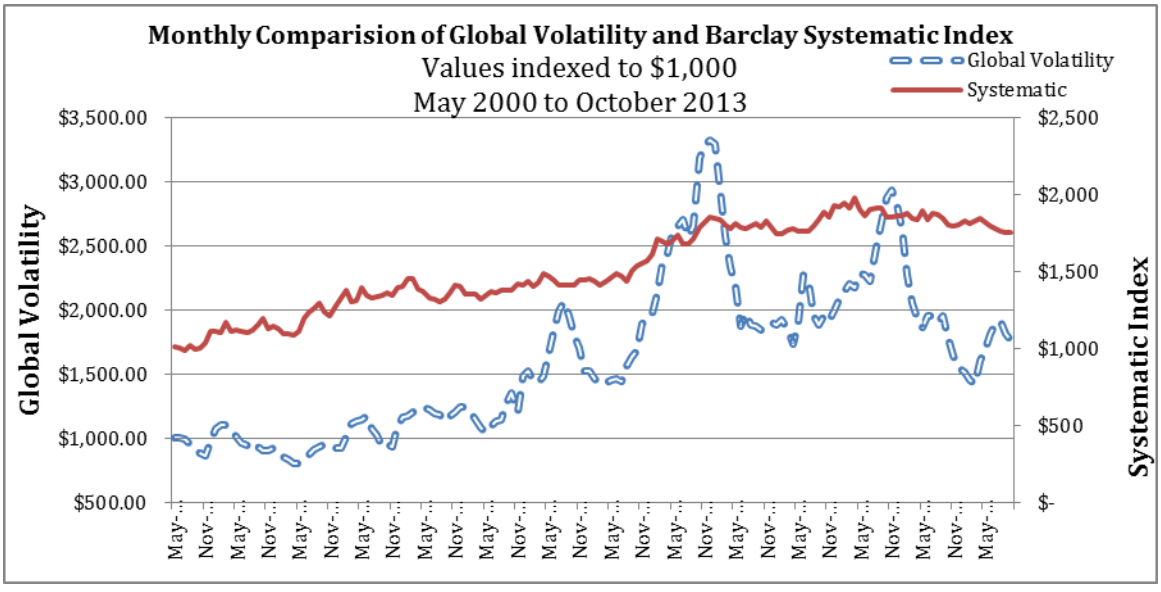
Encouraged by having this basic framework in place, we overlapped trend following performance and searched for a correlation. We looked for broad based correlation across the space as to lessen the odds that the coefficient of determination was being limited to just a few hand selected data sets. Furthermore, to avoid any existing biases, the Barclays Systematic Index was used.



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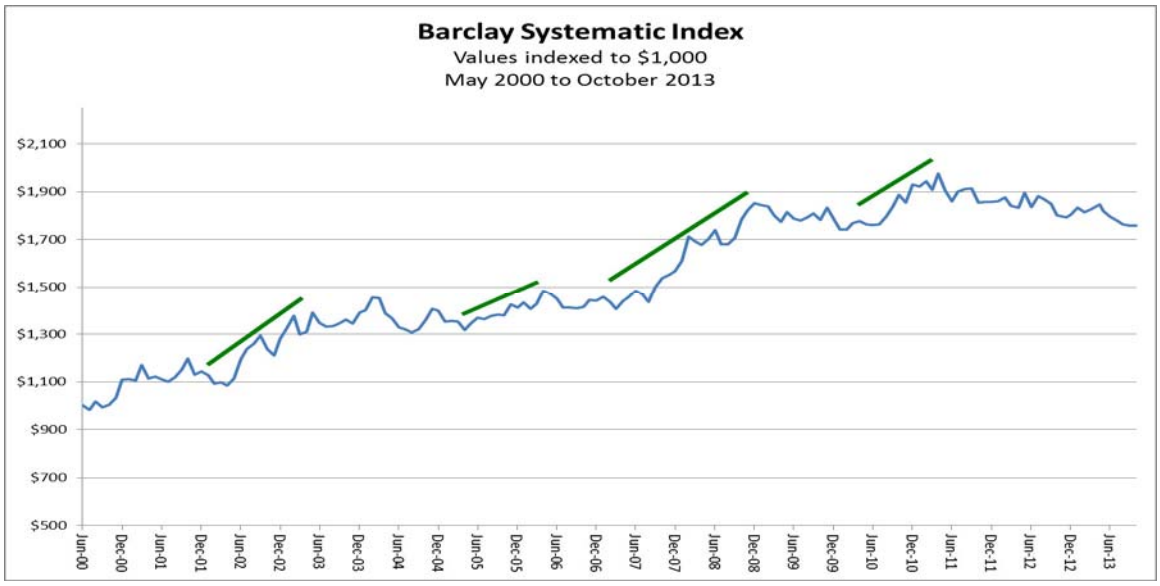
For us, it is here that encouragement turned to excitement. The green bars highlight periods of increased global volatility. It doesn't take long to see that exceptional performance gains are definitely showcased during these global volatility expansions.



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Root Cause

With a firm conviction that volatility is a key contributor to exceptional gains within trend following models, the question left to answer is simply: why?

In our opinion, price movement is the most obvious conclusion. Trend Followers do exactly that… follow trends. Remember, in the absence of trends, you cannot follow what is not.

A second, less obvious theory rests within the science behind position sizing and allocation structure. Profits are predicated on the number of contracts traded. As such, increased positions can potentially equate to increased profit dollars. Immediately, the flip side of that relationship should come to mind, which is an increased trade risk. While in most cases this could hold true, it does not necessarily apply in this context.

This is where we believe the trend follower has a formidable advantage. The structure that allows for such advantageous risk management is based on Fixed Fractional Contract allocation. Let's break down the aforementioned sizing method into two parts to better understand.

- Fixed
- Fractional Contract Allocation

Fixed

Per trade position risk is “fixed” as a set percentage of the total unit equity. Assume a $100,000 unit structure for the following illustration. If the risk mandate calls for a 2% exposure, any trade entry that called for the stop placement to carry risk in excess of $2,000 would be rejected. Conversely, under the 2% risk guidelines, trades with stop loss placements under $2,000 would be accepted.

Fractional Contract Allocation

Position sizing is determined on the risk expressed in actual dollars. In other words, if a particular trade required a stop loss placement accepting $1,000 in risk, the “fractional contract allocation” would call for two contracts to be traded. This would fall within the “fixed” risk mandate of 2% exposure on a per trade basis.

By comparison, if the same trade required a stop loss placement accepting $500 in risk, the “fractional contract allocation” would call for four contracts to be traded. In this case, despite the increased position size, the per-trade “fixed” risk mandate has been met, as exposure still fits neatly within the 2% exposure cap ($500 x 4 contracts = $2000).

Understanding this premise is critical when searching for correlation between performance and global volatility shifts. During periods of low volatility, two main points should be made clear.

First, price movement is sparse, presenting a challenge to the trend follower in that the sought after trend is absent. This period of consolidation leaves chart patterns spotted with false breakouts. In turn, equity curves prove to be flat or down.

The second point is expressed in terms of the average true range (ATR). The consolidation phase results in a contraction of the ATR. Here is where volatility has its greatest potential impact to the trend follower's outcome. The ATR typically dictates stop placement and position sizing. As a direct function of price movement, a narrow range allows for a tighter stop. The "fractional contract allocation" method explicitly takes advantage of this range and increases contract allocation (more contracts placed) yet dollar risk expressed on a per trade basis has not increased, respecting the "fixed" percentage mandate.

Now, when price movement occurs, expanding Global Volatility, trend followers are rewarded two-fold. The exceptional gains are not just derived from directional participation, but are compounded from increased position size.

Return Chasers – A Sucker's Game

No matter the duration of time surveyed, one thing seems to remain timeless. People love winners. The definition of winners in this context is broad based. It could be a winning stock market, think of the tech bubble in the 90's. It could be a Real Estate bubble, think of the housing market boom in mid-2000's. It could be related to a sports team and its fair weather fans. Whatever the context, the song remains the same; people love winners. As such, people chase return.

This love affair with winning is ruled by the emotional aspect of human nature. It is something we learned early in our lives. It feels good. Unfortunately, it is that level of human involvement that often wreaks havoc on investment returns. In Basso's piece he notes that investors' net results lagged those of the CTAs' return.

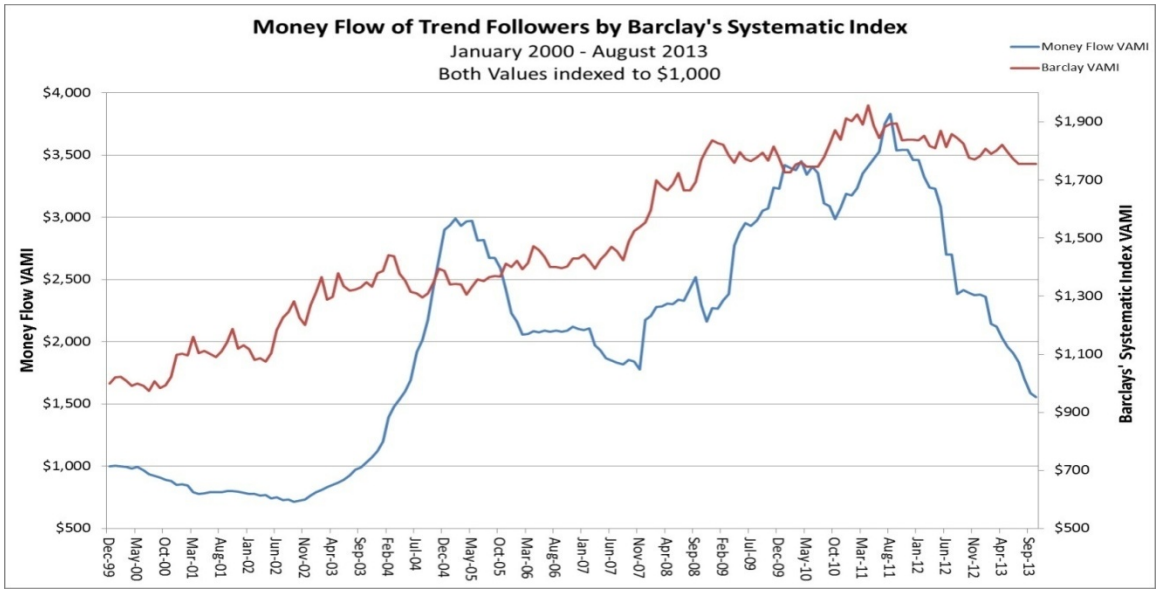
Money Flows

With such superior performance figures, why isn't everyone successful when allocating to previously proven trend following models? Perhaps, it is here the element of human nature enters. While it is natural to want to participate in gain, the discipline required to achieve it may not necessarily walk hand-in-hand.

Below, is a chart of the money flows in and out of futures funds covering the 13-year window between 2000 and 2013. There is a clear ebb and flow, which is illustrated graphically. To determine money flows, we selected eight household names in the space[iii]. We tracked ending month balances as reported by the manager, accounted for net monthly performance (gains and loss) and then compared total assets reported. We indexed money flow totals to a starting data point of $1,000 and tabulated an equally weighted VAMI over the sample time frame. This removed any performance skews to larger funded traders. This was done to highlight new additions and capital reductions to the traders while discounting any gains or losses in AUM due to performance.

We then looked at those money flows against the Barclay's Systematic Index and found a repetitive pattern. As return stream across the space proved positive, return chasers flooded managers with dollars. As return stream cooled, impatient dollars searched for gain elsewhere.

The unfortunate component in this pattern is that dollars moving into trend following programs came on the heels of gain, usually at the end of a cyclical upturn in a return stream. True to form, trend models then move flat and the fresh dollars sour. Instead of the exceptional gains those dollars chased, the subsequent result was draw-down and out flowed the dollars, only to miss the next run up in the equity curve.



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In September of 2000, the Barclays' Systematic Index began an impressive advance higher and peaked in February of 2004. The resulting yield was positive 46.7%. Reviewing the movement of money flow you can clearly see the flow of funds into Trend Following programs initially declined, even though profits were being earned. While the Systematic Index peaked in February 2004, the peak in money flow did not occur until May 2005. Investor funds continued to chase returns for more than a year after the peak.

The next major advance in the Barclays' Systematic Index occurred from March of 2007 until December of 2008. The resulting yield was positive 31.6%. We see the same pattern develop again, investor funds declined initially and then began to chase returns. The money flow peaked in April of 2010 while the peak in the Systematic Index occurred more than a year before. Parenthetically, Global Volatility too had a large expansion in each of the above referenced time frames, which is no strange coincidence.

Studying this simple money flow pattern would likely help investors change their train of thought, and start thinking like top traders. However, this goes against human nature and is especially difficult to digest by the uninformed.

Win Loss Ratios

It was noted earlier in this piece that return stream is asymmetrical. It should be highlighted that win/loss ratios are an important part of the puzzle. Many successful trend models will only showcase gains 35 to 45% of the time. Alternatively, it could be said that many successful trend models will suffer losses 55 to 65% of the time. Numerically, that translates into approximately six of every ten trades resulting in a draw of capital.

To fully understand the significance of these ratios it is best to look at data points of both winning and losing periods with varying tenures. Assume that a systematic algorithm boasts a 40% win ratio. While it is a true statistical measure that four of ten trades win, it is false to assume that four of *every* ten trades win. There will be times that the pendulum will swing to either side of the statistical mean. This simple fact speaks volumes for both draw-down and exceptional gain periods.

During phases of market consolidation, we will see sideways to negative equity curve formations. It is here that trade statistics will reveal the pendulum has swung to the left. These periods may have win ratios of just 20 to 30%.

During periods where markets are trending, we will likely see sharp upward spikes in equity curve formations. The trade statistics will then reveal the pendulum has swung to the right.

These periods may have win ratios north of 50%. In addition, not only will win ratios be more robust, but per trade gains tend to be larger as benchmarked to the series of smaller losses accepted along the way.

Understanding this piece of the puzzle is of paramount importance. The investor may take solace that weathering a sideways move was not from luck or from a market rebound, but rather a true testament to the strict adherence of a risk management discipline.

Human Element

Peter Lynch, the manager of the Magellan fund, one of the most successful funds of all time, estimated that approximately 50% of his investors lost money. How could that be? Simply put, return chasers. It is human nature to want to be part of a winning team. We seek out investments that have recently been winning, or are currently winning, because it is easier to stomach emotionally. Buying an asset when it is losing is counter intuitive.

Markets will move. They will move up, they will move down and most of the time they will move sideways. Top traders know this. More importantly, top traders will embrace this. Top traders will also embrace that the market price is always the right price. Therefore, in an environment where constant uncertainty and potential adversity thrives, top traders *must* think differently. They are not predictive, but rather reactive. They attempt to participate with what the market is doing. If the market is rising, then they attempt to be long. If the market is falling, they attempt to be short. When their expectations are wrong, they get out of a trade, as they don't expect to be right all of the time.

Understanding the trend following framework from every perspective can help in putting the pieces of the puzzle together. It can potentially assist in the understanding of timing capital additions and capital withdrawals that ultimately may play more of a role in the growing of money than relying on a robust bull market or prediction of future events. Understanding the framework may get the individual trader to start thinking like a top trader.

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[i] Abraham Trading Company – Abraham Diversified Program
Chesapeake Capital Corporation – Diversified Program
Dunn Capital Management – World Monetary and Agriculture Program
EMC Capital Advisors – Classic Program
Hawksbill Capital Management – Global Diversified Program
Milburn Ridgefield Corporation – Diversified Program
Rabar Market Research – Diversified Program
Sunrise Capital Partners LLC – Expanded Diversified

[ii] Money flow was calculated using end of month balances as reported by the advisor, not day to day deposits and withdrawals. As such the calculation of money flow, while close to actual movement, will not represent exact movement of dollars in and out of the programs sampled.

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