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Secrets of Trend Following

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Trend Following was my eight-year "hazardous journey" for the truth about trend-following trading. This book was meant to fill a void in a marketplace inundated with books about finance and trading, but that lacked any resource or reference to the best strategy to make money in the markets: trend-following trading.

I have come to learn over time that trend following is a confusing term. The best definition I have seen comes from trading psychologist Van Tharp: "Let's break down the term 'trend following' into its components. The first part is 'trend.' Every trader needs a trend to make money. If you think about it, no matter what the technique, if there is not a trend after you buy, then you will not be able to sell at higher prices.

"'Following' is the next part of the term. We use this word because trend followers always wait for the trend to shift first, then follow it."

Trend following quite simply seeks to capture the majority of a trend, up or down, for profit. It trades for profits in the major asset classes of stocks, bonds, currencies and commodities.

That's the simple part. Now for the controversial part of trend following.

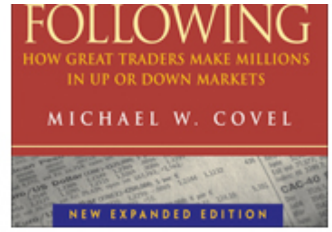
Lao Tzu, a philosopher from the 6th century B.C., once said, "Those who have knowledge don't predict, and those who predict do not have knowledge." Trend followers do not predict market direction. They can't predict the next big trend, and they can't predict their performance. People have a hard time accepting those simple truths in a world where *CNBC* makes it seem like the next bit of news will be crucial to your trading account.

Probably the most-asked question I get on the subject is not directly related to trend-following trading. People want to know, "Have the markets changed?" The short and sweet answer is, "No, the markets have not changed." Markets behave the same as they did 300 years ago. They are the same today because they always change.

Trend followers believe that if you have a trading system that's sound -- meaning its principles are designed to adapt -- you can take advantage of market changes and make money. Changes in markets are no different from changes in the business world or in other areas of life. They will not hurt you if your strategy for handling them is based on reality, flexibility and responsibility for making your own decisions.

Consider the wisdom of John W. Henry, owner of the Boston Red Sox and a legend in the field of trend following:

> If you have a valid basic philosophy, the fact that things change turns out to be a benefit. At least you can survive. At the very least, you will survive over the long term. But if you don't have a valid basic philosophy, you won't be successful because change will eventually kill



> you.
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> I knew I could not predict anything, and that is why we decided to follow trends, and that is why we've been so successful. We simply follow trends. No matter how ridiculous those trends appear to be at the beginning, and no matter how extended or how irrational they seem at the end, we follow trends.

Still others are unconvinced of Henry's logic. They argue that technology has erased any trading edge found by trend followers, thereby changing the markets. I disagree. Computers don't erase "edge." For every trader with a computer program saying "buy," there are nine other traders with computer programs saying "sell." No matter what you do, markets go through different stages: accumulation, runup, distribution and decline.

You need a plan to handle those stages with a positive expected value, just like the edge maintained by the Vegas casinos.

Look at it this way. You are just starting out. You are new to the game. Perhaps you have had some career success and saved a little money. Perhaps not. Maybe you are in college, maybe you are retired, or maybe you're just ready to trade. Whatever the reason, once you start the process of entering the markets, you will need money to play the game.

There is no stated minimum capital to trading as a trend follower. There is no magic number. There are many factors relating to your starting capital, not the least of which is your own personal discipline and ability to stick with a trading system or stick with a trading advisor. Anyone who gives you an exact figure for starting capital is either conning you, or more probably, dismissing your query with a mindless answer. A top trader was asked this same question. He responded, "I ask the trader who thinks he needs a certain amount before he can trade exactly what amount he would need to stop trading."

No one can guarantee you profits, whether you start trading with $5,000, $500,000 or $5 million. There is no dollar amount too little or too big that allows you to sit back and assume that your starting capital alone is some pivotal key to success. Rather than focusing on starting capital, decide how you are going to trade. What is your trading strategy going to be? Have you answered these five questions?

1. How do you determine what market to buy or sell at any time?
2. How much of a market do you buy or sell at any time?
3. How do you determine when you buy or sell a market?
4. How do you determine when you get out of a losing position?
5. How do you determine when you get out of a winning position?

A complete trend-trading system uses these five questions to establish rules for entry and exit, along with rules about how much to buy or sell at any given time. Trend followers have rules ready to answer those five questions regardless of the particular day, week, month, year or current market condition.

Still, people ask, "How do you determine a trending market?" Wrong question! The question is, "How do you make money?" The answer involves taking small bets early on in a market (that is, starting to move or trend) to see whether the move matures and ends as a big trend. Trend followers enter markets long before the nightly news is reporting new 13-year highs in whatever market.

When the financial news starts talking about high oil prices or a stock at record lows or highs, trend followers have long since established their positions (and profits) and may be exiting when the late-to-the-party amateurs start taking their positions.

At the end of the day, good trading is a game. It's all about odds. It's all about probabilities and payouts. Trend followers focus their energy there, not where 99% of the crowd fixates. It's their edge.

Michael Covel is the founder and president of Trend Following. 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 10 years. Passionately educating his clients in order to find that "edge," has made Covel a widely respected expert in the field. He writes for numerous industry publications and is continually quoted and interviewed by Barron's, Bloomberg and RobTV, among others. An experienced and successful entrepreneur, he is a frequent guest on national TV and radio shows and regularly gives presentations at international hedge fund conferences from Hong Kong to Tokyo, advising listeners on proper trading, decision-making, risk management and trend following. Covel is also managing editor at TurtleTrader.com, the leading trend-following news and commentary resource since 1996.