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MICHAEL COVEL

TREND-FOLLOWING AND HIS NEW FILM

TALES FROM THE TRADING ROOM | **ACHIEVE TRADING CLARITY**

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COVER STORY



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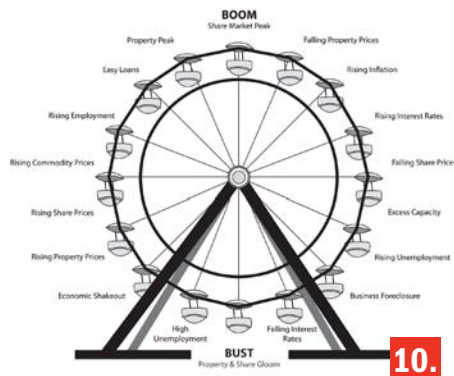
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I have recently returned from a holiday in Japan, where I was lucky enough to witness first hand the spectacle of sumo wrestling. I was surprised that after such extensive training (and eating) the actual bout itself is over in just a few seconds. Much like some trades, sumo appears to be all in the preparation and execution.

As we head to the end of the year, I trust that with YTE close at hand you will go into 2010 well prepared, no matter what the market throws at you. In this issue Garry Abeshouse concludes his look at Market Cycles (page 26); we welcome Kyle Waller and Casey T Smith who explore the world of opportunities created by Exchange Traded Funds (page 38); Gary Norden commences his series of real-life lessons learned from the trading room (page 22); in our cover story Akhilesh Kamkolkar looks at scale trading strategies for commodities markets; and as trend-following strategies come back into focus YTE's Ben Power catches up with Michael Covell to discuss trading strategies and his new film, 'Broke'.

From all at YTE we wish you a safe and enjoyable holiday period and look forward to continuing to give your trading the edge in 2010.

Until next year, happy reading and profitable trading. 

Chelsea Reid
Editor in Chief – YTE

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Michael COVEL

Ben Power speaks with high profile trader **Michael Covel** about trend-following and his new film 'Broke'.

Michael Covel is a passionate promoter of the trend-following trading strategy, which seeks to profit from big market moves. Covel first became interested in trend following after hearing the story of a group of traders, dubbed the 'Turtles', who were taught trading as part of an experiment by industry legend **Richard Dennis**. Covel began promoting and teaching trend following on his internet sites, turtletrader.com and michaelcovel.com. He has released two books on the subject, 'Trend Following', and 'The Complete Turtle Trader', which includes the story of the 'Turtles'.

Covel has been a strident critic of conventional financial methods, including the 'buy and hold' method. He recently turned his sights on the entire Wall Street system, directing a film, 'Broke: The New American Dream'. The film is unique in that it doesn't blame just big-time finance operators for bringing the world's financial system down; it also puts the blame squarely on regular people who – often driven by greed – handed their money to a variety of scam artists.

Covel grew up in Virginia and now shuttles between Virginia, San Diego and Las Vegas. He spoke with YTE about his new film, and trend following as a successful trading strategy.

We've just been through the worst financial crisis since the Great Depression. Your film, 'Broke: The New American Dream', is a hard-hitting critique of the finance industry. What went wrong?

America and much of the world came to believe stocks and real estate could only go up. That belief caused trillions of dollars to be lost by investors. In many ways the actions people were taking meant we'd end up with lots of people broke. Did everyone lose? No. People with a good strategy did not blow up. Many made money. I would argue that if you had no job and were speculating recklessly in stocks or real estate, and if you did not consider the 'odds' of making the money you sought, you really wanted to be broke. Controversial premise? You bet. True? In my opinion, yes.

There are signs of a recovery coming through. Do you think there's been enough pain? Are you seeing any signs that people have actually learned lessons from the crisis?

Pain? Many people made money! So who are we talking about? The people with no strategy who bet that everything would go up forever and had no plan for an exit? Those people? Have they had enough pain? I don't know if they have. Have people learned? Human nature doesn't change. Bubbles come and bubbles go. I am sure there will be another one soon. The question is: can government save markets from crashing every time by lowering rates to zero and printing money? Will that always work as a solution? I doubt it. The NASDAQ was at 5000 in the year 2000. Today it stands at roughly 2000. That's 3000 points less than nine years ago. The Nikkei was at 39,000 in 1989. Today it is roughly at 10,000. Do the Japanese believe in buy and hold

and 'recovery'? Lastly, think about the idea of 'recovery'. United States' unemployment is at a 26-year high. I can't predict the future, but that number is brutal.

One of the themes in 'Broke' appears to be that people should stop blaming others for their financial woes and take responsibility. Can trading be a good way to take control of personal finances?

Yes, as long as you have a sound strategy. If you don't put the time in to find a sound strategy, you are in trouble.

Can you tell us how you got interested in trading, and, more specifically, trend following?

I read an article on the 'Turtle' traders in 1994. It said a guy named Jerry Parker went to a 'school' and learned 'technical' trading strategies. That was it. I wanted to learn what he was taught.

What are the key principles behind trend following that make it different from other strategies? How do trend followers typically define a trend?

Trend following is simply an idea. It's a trading idea for making buy and sell decisions in any market. A trader takes an idea, turns it into a mathematical formula and tests it to see if it would have made money. A good trend-following trading system doesn't buy low and sell high; it rides trends. Trend followers don't get entry or exit signals and apply some extra layer of 'human judgment'. They don't try to be smarter than the system.

You can't know a trend until it is over. Famed trend follower Ed Seykota has said: "There is no such thing as the trend; there are countless trends, depending on the method we use to determine a trend... There is no way to determine the current trend, or even define what 'current trend' might mean; we can only determine historical trends."

The reality is that while the strategy is called trend following it is not about spotting or finding trends (an impossible task). Trend following is best executed in the form of a trading system. That trading system will answer these five questions:

- What market do you buy or sell at any time?
- How much of a market do you buy or sell at any time?
- When do you buy or sell a market?
- When do you get out of a losing position?
- When do you get out of a winning position?

If you have answers to those five questions, you have a trend-following trading strategy.

Once a trend 'appears' to be beginning, I assume trend followers just jump on board. What would be an example of a trend-following entry and exit?

A simple trend-following entry and exit is a breakout. For example, a 55-day breakout of the highest high (long entry) or lowest low (short entry) is a typical trend-following entry trigger. Conversely, a common exit would

Do you have any recent or historic examples of market moves that trend followers have successfully ridden?

Sure. On page 134 of the latest edition of 'Trend Following', I illustrate a Chadwick Investment Group trade where they shorted lean hogs in August 2008 and exited in November 2008 (figure 1).



be a 20-day lowest low (for long entry) or highest high (for short entry). Said another way: enter on a 55-day breakout and exit on a 20-day breakout in the opposite direction from your entry. Entry might be sexy, but exit and money management are the keys to long-term success.

I assume traders could be wrong quite a few times before catching a real trend?

Absolutely. I was once told a story about Paul Tudor Jones making more than ten entries on the same market, only to be stopped out each time with a small loss. The eleventh time was the charm and the market took off in his direction and gave him one of his biggest wins.

Are fundamental criteria used to determine entries?

No.

How did trend followers perform during the global financial crisis?

In 2008 most made fortunes. Often from 50 per cent to more than 100 per cent for the year.

Most trend followers trade futures, such as currencies and even hogs, as in the example above. Does the strategy work with equities as well?

Yes. People mistakenly get fixated on the instrument. Wrong move. It's the market. If you want to trade stocks as a trend follower, you can trade LEAPS, ETFs, many options, and so on.

One of the highest-profile trend followers, John W Henry, who owns the Boston Red Sox, has had a tough time, with his assets under management plummeting after a big drawdown. How is he doing now?

He did very well in 2008. His assets dropped due to Merrill Lynch pulling money right at the bottom of a drawdown. If Merrill had stayed on board, they would have been richly rewarded. But clearly Merrill had larger issues over a bad decision in their trend-following allocation. They no longer exist as an independent concern! They essentially imploded and were sold off to a bank.

Do you think trend following has been unfairly maligned because of big drawdowns like Henry recently suffered, when the drawdowns in stock markets can be just as big – and that's without leverage?

Great point – and my point exactly! Mutual funds clearly take massive drawdowns. Maybe people will talk of them now.

the Wall Street Journal looking for novices to train. His recruits, later known as the Turtles, had anything but traditional Wall Street backgrounds; they included a professional blackjack player, a pianist, and a fantasy-game designer. For two weeks, Dennis taught them his investment rules and philosophy, and set them loose to start trading, each with a million dollars of his money. By the time the

requires a certain psychological make up, including the ability to accept a lot of losing trades and patience to ride big trends. Are some just not suited to it as a method?

That is an interesting question. Is anyone suited to go through the fall of 2008 again as a buy-and-hold trader? I saw massive volatility and massive losses – all with a strategy (buy

A good trend-following trading system doesn't buy low and sell high; it rides trends. Trend followers don't get entry or exit signals and apply some extra layer of 'human judgment'. They don't try to be smarter than the system.

Trend following seems to attract some unique individuals, like Henry. Who are some of the other great characters you've met?

I have met quite a few trend traders who are characters – from David Harding to Salem Abraham, and Ed Seykota to Richard Dennis. Tops for me is Larry Hite. Hite is a living trend-following legend (profiled in the 'Market Wizards' book). Hite is the consummate New York guy, who just happens to love the 'betting' involved in trend following (along with a good joke or two!).

Another great character is Bill Dunn. He has a track record going back to the mid 1970s of nearly 20 per cent a year on average. That is just incredible. Do the compounding on those numbers. Dunn is a former Marine who works out of sleepy Stuart, Florida. For people who think of glass towers in New York, London and Tokyo as the 'place' to be for traders, Dunn's world is a culture shock. Working out of that town in Florida placed him in the top 10 of all traders for 2008. His earnings were north of \$60 million. He let me use a quotation of his on the front cover of my 2009 edition of 'Trend Following': "We don't make market predictions. We just ride the bucking bronco."

Central to the trend-following history is the story of a group of traders called the Turtles, which you outline in your most recent book, 'The Complete Turtle Trader'. Who were they?

Richard Dennis made a fortune on Wall Street by investing according to a few simple rules. Convinced that great trading was a skill that could be taught to anyone, he made a bet with his partner and ran a classified ad in

experiment ended in 1988, Dennis had made a hundred million dollars from his Turtles and created one killer Wall Street legend.

Are the Turtles still trading?

Six original Turtles still trade for clients. Some, like Jerry Parker, had the emotional and psychological discipline to keep at the system. He has arguably made a billion dollars, all from answering a want ad. The Turtles were taught rules, and those rules worked, but there was more to it. I spent a decade investigating that 'more'.

Are the Turtle rules available?

Sure, they are no secret. I put the Turtle rules, philosophy, psychology and their performance results in my book, 'The Complete TurtleTrader'. I caution readers though. The concept of 'Turtle' rules is misleading. In fact, several original Turtles, specifically ones who were long-term trading failures, have made the concept of Turtle 'secret rules' a business model. However, the psychology involved in successful Turtle trend following is clearly much more important than the nonsensical notion of 'secret rules'. The single biggest compliment I receive about my Turtle book is, "Wow, I thought I knew the Turtle story. I thought wrong!"

Do the Turtle rules still work?

Turtle trading is trend following. Yes, it still works. In fact, I recently sat in at a live panel comprising Richard Dennis and his four most successful students. They are all essentially doing the same thing two decades later.


You mentioned the importance of psychology. I assume trend following

and hold) that is predicated on believing markets always bounce back. Trend following is harder emotionally than that? I don't think so. People need to make choices. If they want to run with the herd, they can do so. If they want the chance for more money than their neighbour – trend following is an option.

Does executing a trend-following system require knowledge of programming?

Trading rules can be written down on a sheet of paper. The philosophy and rules of trend following should always be easily explainable in base form. Automating those rules, putting them into 'code', can be as diverse as who is the programmer at the task. No one size fits all. That said, there are programs out there that can make trend-following automation much easier.

Finally, I understand you're a trend-following purist, but are there any general principles that other traders can take from it?

Sure. Here is a big one. Before you ever enter a market on any trade using any trading approach – know exactly how much you are willing to lose. That might sound simple, but very few really do it. How much are you willing to lose? You can control that. It's a choice. 

Ben Power is a writer, journalist and trader. He has written on politics, economics and finance for numerous publications.