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# Preface

“Men wanted for hazardous Journey. Small wages. Bitter cold. Long months of complete darkness. Constant danger. Safe return doubtful. Honor and recognition in case of success.”<sup>1</sup>

This book is the result of an eight-year “hazardous journey” for the truth about Trend Following. It fills a void in a marketplace inundated with books about finance and trading but lacking any resource or, for that matter, practically any reference to what we believe is the best strategy to consistently make money in the markets. That strategy is known as **Trend Following**:

*“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.”<sup>2</sup>*

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

*When it is a question of money, everyone is of the same religion.*

Voltaire

*Education rears disciples, imitators, and routinists, not pioneers of new ideas and creative geniuses. The schools are not nurseries of progress and improvement, but conservatories of tradition and unvarying modes of thought.*

Ludwig von Mises

basic concepts about Trend Following are, they have been widely misunderstood. Our desire to correct this state of affairs is what, in part, launched our research. We wanted to be as objective as possible, so we based our writing on the available data:

- Trend followers' month-by-month performance histories.
- Trend followers' published words and comments over the last 30 years.
- News accounts of financial disasters.
- News accounts of the losers in those financial disasters.
- Charts of markets traded by trend followers.
- Charts of markets traded by losers in the financial disasters.

If we could have developed a book comprised of only numbers, charts, and graphs of Trend Following performance data, we would have. However, without any explanation, few readers would have appreciated all of the ramifications of what the data showed. Therefore our approach to writing *Trend Following* became similar to the one Jim Collins describes in *Good to Great*, in which a team of researchers generated questions, accumulated data in their open-ended search for answers, and then energetically debated it.

Trend followers we studied form a sort of underground network of relatively unknown traders who, except for an occasional article, the mainstream press has virtually ignored. What we have attempted to do is lift the veil, for the first time, on who these enormously successful traders are, how they trade, and what is to be learned from their approach to trading that we might apply to our own portfolios.

*Trend Following* challenges much of the conventional wisdom about successful trading. We were determined to avoid being influenced by knowledge institutionalized and defined by Wall Street. We were adamant about fighting “flat earth” thinking. During our research, we tried to avoid starting with an assumption and then finding the data to support it. Instead we asked the question and then, objectively, doggedly, and slowly, let the answer reveal itself.

If there was one factor that motivated us to work in this manner, it was simple curiosity. The more we uncovered about

trend followers, the more we wanted to know. For example, one of our earliest questions was who profited when Barings Bank collapsed in 1995. Our search unearthed Barings Bank–related performance data including that of trend follower John W. Henry (now the majority owner of the Boston Red Sox). His track record generated new questions, such as, “How did he discover Trend Following in the first place?” and “Has his approach changed in any significant way in the past 20 years?”

We were also curious about who won the \$1.9 billion Long Term Capital Management lost during August and September 1998. We wanted to know why the biggest banks on Wall Street would invest \$100 billion in an options pricing model, Nobel prize–winning or not. Further, considering what mutual fund managers have lost in the past few years and what successful trend followers have earned during the same time period, we could not understand why so few investors know anything about Trend Following. We also became interested in:

- How trend followers win in the zero-sum game of trading.
- Why Trend Following has been the most profitable style of trading.
- The philosophical framework of trend followers’ success.
- Timeless principles of Trend Following.
- The Trend Following worldview of market behavior.
- Reasons why Trend Following is so enduring.

Many of the trend followers we studied are reclusive and extremely low key. Some discovered Trend Following on their own and used it to make their fortunes out of home offices. Bill Dunn, a successful trend follower who has beaten the markets for over 25 years, works out of a quiet, spartan office in a Florida coastal town. For Wall Street, this approach to trading is tantamount to sacrilege. It goes against all the customs, rituals, trappings, and myths we have grown accustomed to associating with Wall Street success. In fact, it is our hope that our profiles of trend followers will correct the public’s misconception of a successful trader as a harried, intense workaholic who spends 24/7 in the labyrinth of a Wall Street trading firm, surrounded by monitors and screaming into a phone.

*The important thing in science is not so much to obtain new facts as to discover new ways of thinking about them.*

Sir William Bragg



*Fish see the bait, but not  
the hook; men see the  
profit, but not the peril.*

Chinese Proverb

*To be aware how fruitful  
the playful mood can be is  
to be immune to the  
propaganda of the  
alienated, which extols  
resentment as a fuel of  
achievement.*

Eric Hoffer

We've assembled the first comprehensive look at Trend Following, but this is neither a course nor the only resource you will ever need. It is to be used in conjunction with our Web site at [www.trendfollowing.com](http://www.trendfollowing.com). We have tried to be comprehensive with our definitions. However, if we mention an unfamiliar word, name or reference a source you haven't heard of, please go to Google ([www.google.com](http://www.google.com)).

We have tried to make the material accessible and interesting enough so it might give you an occasional "aha" experience. However, if you're looking for trading "secrets," you need to look elsewhere. There are none. If you're in the mood for stories about what it's like inside a typical Wall Street firm or how greedy traders sow the seeds of their destruction, like in *Den of Thieves*, or *Barbarians at the Gate*, we will not meet your needs.

You may have noticed that I use "we" instead of "I" when describing the process of writing this book. That's because it could not have been written without the generosity of the traders, professors, investors, colleagues, and friends who graciously shared their wisdom and trading experiences with me. Without their support, hard work, long hours, and creativity, *Trend Following* would still be an ongoing hazardous journey. So if there is any "honor and recognition" to be given, it is to everyone who participated, not just the person whose name appears on the cover.

# Acknowledgments

It is a pleasure to recognize the colleagues, mentors, finance writers, traders, and friends who contributed directly and indirectly to this book.

William W. Noel, III and Justin Vandergrift must be singled out for special mention. They were the core members of our original Trend Following research team. The book would not have come together without their hard work.

I am particularly grateful to those traders—Ed Seykota, Bill Dunn, Daniel Dunn, Mark Rzepczynski, Pierre Tullier, Jason Russell, Easan Katir, Jonathan Hoenig, and Paul Mulvaney—who were generous with their feedback under tight writing deadlines. And thanks also to Martin Bergin of Dunn Capital Management for an initial introduction to Bill Dunn.

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Celia Straus, Jerry Mullins, Withers Hurley, Elizabeth Ellen, Justice Litle, Barry Ritholtz, Mark Rostenko, Tom Rollinger, Arthur Maddock and Bob Spear also made valuable contributions.

*Speculation [is] dealing with the uncertain conditions of the unknown future. Every human action is a speculation in that it is embedded in the flux of time.*

Ludwig von Mises

*There is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things.*

Machiavelli

Throughout years of research, I've benefited repeatedly from the trading wisdom and experience of John W. Henry, Salem Abraham, Peter Borish, Jonathan Craven, Mark Hawley, John Hoade, Shaun Jordan, Carol Kaufman, Jane Martin, Leo Melamed, Larry Mollner, Kim Hunter, Gibbons Burke, Chuck LeBeau, and Leon Rose. I want to especially thank Jerry Parker for answering questions early in my career.

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This book could only have come to fruition with the editorial guidance of Jim Boyd at Financial Times Prentice Hall, as well as the able assistance and attention to detail of Dennis Higbee, who copyedited. I also want to thank Donna Cullen-Dolce, Lisa Larkowski and John Pierce for their remarkable production and marketing skills. And to Paul Donnelly at Oxford University Press, I owe a special debt of gratitude for seeing the potential of our initial proposal.

—Michael Covel

# Part I



# Trend Following

# 1

“Speculation is dealing with the uncertain conditions of the unknown future. Every human action is a speculation in that it is embedded in the flux of time.”—Ludwig von Mises<sup>1</sup>

## The Market

A market is simply a place where buyers and sellers gather to trade and exchange goods, buying and selling for any number of reasons. The market performs the essential role of connecting financial and real economies. The New York Stock Exchange and the National Association of Securities Dealers Automated Quotation System (you hear it called NASDAQ on the news) are two markets. There are also futures exchanges like the Chicago Board of Trade or the Chicago Mercantile Exchange. All of these exchanges are markets where trend followers do their buying and selling.

It is the markets’ ability to give a “price” that buyers and sellers can rely on as fact. Ludwig von Mises, the great Austrian economist, offered:

“It is the very essence of prices that they are the offshoot of the actions of individuals and groups of individuals acting on their own behalf. The catallactic concept of exchange ratios and prices

*The people that I know who are the most successful at trading are passionate about it. They fulfill what I think is the first requirement: developing intuitions about something they care about deeply, in this case, trading. They are the people who study years of charts, or commodity annuals . . . They develop a deep knowledge of whatever form of analysis they use. Out of that passion and knowledge, their trading ideas, insights, and intuitions emerge.*

Charles Faulkner<sup>2</sup>

precludes anything that is the effect of actions of a central authority, of people resorting to violence and threats in the name of society or the state or of an armed pressure group. In declaring that it is not the business of the government to determine prices, we do not step beyond the borders of logical thinking. A government can no more determine prices than a goose can lay hen's eggs."<sup>3</sup>

## Winning and Losing

*The joy of winning and the pain of losing are right up there with the pain of winning and the joy of losing. Also to consider are the joy and pain of not participating. The relative strengths of these feelings tend to increase with the distance of the trader from his commitment to being a trader.*

Ed Seykota<sup>4</sup>

Between the corporate and market scandals of the past few years, it is understandable that the general public equates winning with abusing the market system. However, there are disciplined men and women trading in the markets with the utmost integrity who achieve spectacular returns year after year. We urge you to examine their market philosophies and strategies so that you will understand what makes them successful. We ask you to examine their beliefs and self-perceptions so you understand what keeps them honest. However, before we examine other's perspectives, we want you to take a moment to consider your own. How do you approach investing?

For example, does this describe you? At the end of the Nineties, just when you were feeling good about yourself because you were more secure financially, the dot-com bubble burst, and by the time it was over, you had lost a significant amount of money. You found yourself angry with the analysts, experts, brokers, or money managers whose advice you had taken. You didn't do anything wrong except follow their advice. Now you doubt that that you will ever meet your investment goals. You've held on to your remaining investments believing that the market will eventually turn around, but deciding what to do with your 401k money has become stressful. You still believe that buying at the bottom is the way to go. You've now begun to think that what winning in the markets really requires is just plain dumb luck.

*If you think education is expensive, try ignorance.*

Derek Bok

Or maybe you might view your financial world like this: Sure, you lost some money in the bear market but, win or lose, you enjoy the thrill of investing in a stock in the hopes of making a profit. Investing is entertainment for you. Plus, you like to boast about your investments to garner the admiration of others. You know you can be depressed and angry when you lose, but you also know that when you win, you feel terrific. It's a great high. Since your main

goal is to invest for quick profits, you're going to keep on doing what you've always done, bear or bull. After all, there was one time a few years ago when trading off a "hot tip" made you a nice profit.

There is a much better way to think about investing. How would you feel about embracing this perspective? Your approach is objective and rational. You have enough confidence in your own decision-making that you don't seek out investment recommendations from others. You're content to wait patiently until the right opportunity comes along. Yet, you're never too proud to buy a stock that is making new highs. For you, buying opportunities are usually market breakouts. Conversely, when you recognize that you are wrong, you exit immediately. You view a loss as an opportunity to learn and move on. What good is obsessing on the past going to do you? You approach your trading as a business, making note of what you buy or sell and why in the same matter-of-fact way that you balance your checkbook. By not personalizing your trading decisions, you're able to look forward to making them.

What a stark contrast in perspectives. The first is that of a potential loser; the latter is that of a potential winner. Don't be in such a hurry to choose the winning approach until you've found out just what making such a choice entails. On the other hand, we hope you'll find, in *Trend Following*, the inspiration to step up to the plate and go for it:

"Profit-seeking speculation is the driving force of the market."—Ludwig von Mises<sup>5</sup>

## Investor v. Trader: How Do You See the World?

Do you consider yourself an investor or a trader? Most people think of themselves as investors. However, if you knew that big winners in the markets call themselves traders, wouldn't you want to know why? Simply put, they don't invest, they trade.

Investors put their money, or capital, into a market, like stocks or real estate, under the assumption that the value of the entity they invest in will increase over time. As the value increases, so does the person's "investment." Investors typically do not have a plan for when their investment value decreases. They hold on to their investment, hoping that the value will reverse itself and go

*The perfect speculator must know when to get in; more important he must know when to stay out; and most important he must know when to get out once he's in.*



*Nothing has changed during the 21 years we've been managing money. Government regulation and intervention have been, are, and will continue to be present for as long as society needs rules by which to live. Today's governmental intervention or decree is tomorrow's opportunity. For example, governments often act in the same way that cartels act. Easily the most dominant and effective cartel has been OPEC, and even OPEC has been unable to create an ideal world from the standpoint of pricing its product. Free markets will always find their own means of price discovery.*

Keith Campbell<sup>6</sup>

*Trend followers are traders, so we generally use the word "trader" instead of "investor" throughout.*

back up. Investors typically succeed in bull markets and lose in bear markets.

This is because investors anticipate bear, or down, markets with fear and trepidation and therefore are unable to plan how to respond when they're losing. They chose to "hang tight," so they continue to lose. They have some idea that a different approach to losing involves more complicated trading transactions like "selling short," of which they know little and don't care to learn. If the mainstream press continually positions investing as "good" or "safe" and trading as "bad" or "risky," people are reluctant to align themselves with traders or even seek to understand what trading, as opposed to investing, is all about.

A trader has a defined plan or strategy to put capital into a market in order to achieve a single goal: profit. Traders don't care what they own or what they sell as long as they end up with more money than they started out with. They are not investing in anything. They are trading. It is an important distinction.

Tom Basso, a longtime trend follower, has often said that a person is a trader whether or not they are actually trading. Some people think they must be in and out of the markets every day to call themselves a trader. What makes someone a trader has more to do with their perspective on life than with making a given trade. For example, a trend follower's perspective includes patience. Like the African lion waiting for days for the right moment to strike its unsuspecting prey, a trend follower can wait weeks or months for a trend.

Ideally, traders go short as often as they go long, enabling them to make money in both up and down markets. However, a majority of "traders" won't or can't go short. They resemble investors in that they struggle with the concept of making money when a market declines. We hope that after reading *Trend Following*, the confusion and hesitation associated with making money in down markets will dissipate.

## Fundamental v. Technical: What Kind of Trader Are You?

There are two basic theories of trading. The first theory is fundamental analysis, the study of external factors that affect the supply and demand of a particular market. Fundamental analysis

pays attention to factors like weather, government policies, domestic and foreign political and economic events, price-earnings ratios, and balance sheets. By monitoring supply and demand factors, or “fundamentals” for a particular market, it is supposedly possible to predict a change in market conditions before that change has been reflected in the price of the market.

The vast majority of Wall Street are proponents of fundamental analysis. They are the academics, brokers, and analysts who spoke highly of the “new economy,” predicting that all dot-com stocks would rise forever due to an assortment of fundamental forecasts. Millions bought into their rosy projections and rode the dot-com bubble straight up with no clue how to exit when the bubble burst.

Has anyone changed their investment strategies, or do they still need their daily fix of fundamental headlines? Evidence that nothing has changed can be found in Yahoo! Finance’s commentary outlining a single day of trading in the fall of 2003:

“It started off decent, but ended up the fourth straight down day for stocks . . . early on, the indices were in the green, mostly as a continuation from the bounce Monday afternoon . . . but as the day wore on and the markets failed to show any upward momentum, the breakdown finally occurred . . . The impetus this time was attributed to the weakness in the dollar, even though the dollar was down early in the day while stocks were up . . . also, oil prices popped higher on wishful thinking statements from a Venezuelan official about OPEC cutting production . . . whether or not these factors were simply excuses for selling, or truly perceived as fundamental factors hardly matters . . . The tone is fragile and the chartists are becoming increasingly concerned about a more significant correction . . . the late, quick dip in the indices at the close didn’t help . . . the corporate news was generally good . . . Home Depot (HD 34.95 -0.52) had an excellent earnings report but lost early stock gains . . . Agilent (A 27.77) also had good earnings . . . General Electric (GE 28.44 +0.63) was upgraded to ‘buy’ at Merrill Lynch.”

Millions of readers still log on to Yahoo! Finance every day, so on their behalf we ask the following questions:

- Why aren’t four straight down days a good thing if you are short?
- Please define with a precise formula the term *bounce*.

*Whenever we get a period of poor performance, most investors conclude something must be fixed. They ask if the markets have changed. But trend-following presupposes change.*

John W. Henry<sup>7</sup>

*One of our basic philosophical tendencies is that change is constant, change is random, and trends will reappear if we go through a period of non-trending markets. It’s only a precursor to future trends and we feel if there is an extended period of non-trending markets, this really does set up a base for very dynamic trends in the future.*

Former Head of Research  
at John W. Henry<sup>8</sup>

- Please define with a precise formula the term *upward momentum*.
- Who attributed the impetus to weakness in the dollar? How did they do this?
- Please define with a precise formula the term *fragile tone*.
- What does *the corporate news was generally good* mean?
- What does it say for fundamental analysis that Home Depot reported good earnings, but the stock dropped?
- Merrill Lynch has issued a *buy* for GE. Will there ever be a *sell*? How much does Merrill Lynch say we should buy of GE?

Where are the facts in Yahoo!'s commentary? Where is the objectivity? One of the greatest trend followers Ed Seykota nails the problem of fundamental analysis with his typical good humor:

“One evening, while having dinner with a fundamentalist, I accidentally knocked a sharp knife off the edge of the table. He watched the knife twirl through the air, as it came to rest with the pointed end sticking into his shoe. ‘Why didn’t you move your foot?’ I exclaimed. ‘I was waiting for it to come back up,’ he replied.”<sup>9</sup>

Don’t we all know an investor who is waiting for “their” market to come back? Motley Fool’s home page reflects the folly of literally “banking on” fundamental analysis as a solution:

“It all started with chocolate pudding. When they were young, brothers David and Tom Gardner learned about stocks and the business world from their father at the supermarket. Dad, a lawyer and economist, would tell them, ‘See that pudding? We own the company that makes it! Every time someone buys that pudding, it’s good for our company. So go get some more!’ The lesson stuck.”<sup>10</sup>

David and Tom Gardner’s pudding story may be cute but it is not complete. Their plan gets you in, but it doesn’t tell you when to get out of the pudding stock or how much of the pudding stock you must buy. Unfortunately, many people believe their simple story is a good strategy for making money.

The second theory, technical analysis, operates in stark contrast to fundamental analysis. This approach is based on the belief that, at any given point in time, market prices reflect all

*But I think our ace in the hole is that the governments usually screw things up and don't maintain their sound money and policy coordination. And about the time we're ready to give up on what usually has worked, and proclaim that the world has now changed, the governments help us out by creating unwise policy that helps produce dislocations and trends.*

Jerry Parker<sup>11</sup>

known factors affecting supply and demand for that particular market. Instead of evaluating fundamental factors outside the market, technical analysis looks at the market prices themselves. Technical traders believe that a careful analysis of daily price action is an effective means of capitalizing on price trends.

Now here is where the understanding of technical analysis gets tricky. There are essentially two forms of technical analysis. One form is based on an ability to “read” charts and use “indicators” to divine the market direction. These so-called technical traders use methods designed to attempt to predict a market direction. Here is a great example of the predictive view of technical analysis:

“I often hear people swear they make money with technical analysis. Do they really? The answer, of course, is that they do. People make money using all sorts of strategies, including some involving tea leaves and sunspots. The real question is: Do they make more money than they would investing in a blind index fund that mimics the performance of the market as a whole? Most academic financial experts believe in some form of the random-walk theory and consider technical analysis almost indistinguishable from a pseudoscience whose predictions are either worthless or, at best, so barely discernably better than chance as to be unexploitable because of transaction costs.”<sup>12</sup>

This is the view of technical analysis held by the majority—that it is some form of superstition, like astrology. Technical prediction is the only application of technical analysis that the majority of Wall Streeters are aware of as evidenced by equity research from Credit Suisse First Boston:

“The question of whether technical analysis works has been a topic of contention for over three decades. Can past prices forecast future performance?”<sup>13</sup>

However there is another type of technical analysis that neither predicts nor forecasts. This type is based on price. Trend followers form the group of technical traders that use this type of analysis. Instead of trying to predict a market direction, their strategy is to react to the market’s movements whenever they occur. Trend followers respond to what has happened rather than anticipating what will happen. They strive to keep their strategies based on statistically validated trading rules. This enables them to focus on the market and not get emotionally involved.

*Markets aren't chaotic, just as the seasons follow a series of predictable trends, so does price action. Stocks are like everything else in the world: They move in trends, and trends tend to persist.*

Jonathan Hoenig  
Portfolio Manager,  
Capitalistpig Hedge Fund LLC

*It is not the strongest of the species that survive, nor the most intelligent, but the ones most responsive to change.*

Charles Darwin

However, price analysis never allows trend followers to enter at the exact bottom of a trend or exit at the exact top of the trend. Second, with price analysis they don't have to trade every day. Instead, trend followers wait patiently for the right market conditions instead of forcing the market. Third, there are no performance goals with price analysis. Some traders might embrace a strategy that dictates, for example, "I must make \$400 dollars a day." Trend followers would ask them, "Sure, but what if the markets don't move on a given day?"

One trend follower summarized the problem:

"I could not analyze 20 markets fundamentally and make money. One of the reasons [Trend Following] works is because you don't try to outthink it. You are a trend follower, not a trend predictor."<sup>14</sup>

## Discretionary v. Mechanical: How Do You Decide?

We have established the idea that you can be an investor or trader. We have established that trading can be fundamentally or technically based. Further, technical trading can be predictive or reactive. And we've explained how trend followers are traders who use a reactive technical approach based on price. However, there is one more distinction. Traders can be discretionary or mechanical.

John W. Henry, one of the best trend followers over the last 20 years, thinks it's important for clients to know his approach and he makes a clear distinction between the two strategies: "JWH believes that an investment strategy can only be as successful as the discipline of the manager to adhere to the requirements in the face of market adversity. Unlike discretionary traders, whose decisions may be subject to behavioral biases, JWH practices a disciplined investment process."<sup>15</sup>

When Henry speaks of decisions that may be subject to behavioral biases, he is referring to the legions of traders who make their buy and sell decisions based on the sum of their market knowledge, their view of the current market environment, or any number of other factors. In other words, they use their discretion—hence the use of "discretionary" to describe their approach to trading.

Decisions made at the “discretion” of the trader are subjective and therefore can be changed or second-guessed. There are no ironclad assurances that these discretionary trading decisions are based on reality, and not colored by personal bias. Of course, a trader’s initial choices to launch the system are discretionary. You must make discretionary decisions like choosing a system, selecting your portfolio, and determining a risk percentage. However, once you’ve decided on the basics, you can then choose to systematize these discretionary decisions and from that point on rely on a mechanical trading system.

Mechanical trading, used by trend followers, is based on an objective and automated set of rules. The rules are derived from their market view or philosophy. Traders rigidly follow these trading rules (often putting them into computer programs) to get themselves in and out of the market. A mechanical trading system makes life easier by working to eliminate emotion from trading decisions and forcing you stick to the rules. It enforces discipline. If you break your own rules with a mechanical trading system, you can go broke.

John W. Henry speaks to the downsides of discretionary trading:

“Unlike discretionary traders, whose decisions may be subject to behavioral biases, JWH practices a disciplined investment process. By quantifying the circumstances under which key investment decisions are made, the JWH methodology offers investors a consistent approach to markets, unswayed by judgmental bias.”<sup>16</sup>

It seems a bit rigid to say you can’t even use just a little discretion when faced with a trading decision, doesn’t it? After all, where’s the “fun” if all you ever do is follow a mechanical model? But then Trend Following isn’t about fun. It’s about winning. The Director of Research of Campbell and Company, one of oldest and most successful Trend Following firms, is adamant about avoiding discretion:

“One of our strengths is to follow our models and not use discretion. This rule is written in stone at Campbell.”<sup>17</sup>

You will see that, like Campbell’s Director of Research, trend followers use their words carefully and deliberately. It was encouraging to us to find that there are few if any instances when their words don’t reflect their performance data.

*The trend is your friend  
except at the end when it  
bends.*

Ed Seykota<sup>18</sup>

## Timeless

Trend Following is not new. The strategy is simply discovered by new generations of traders at different times:

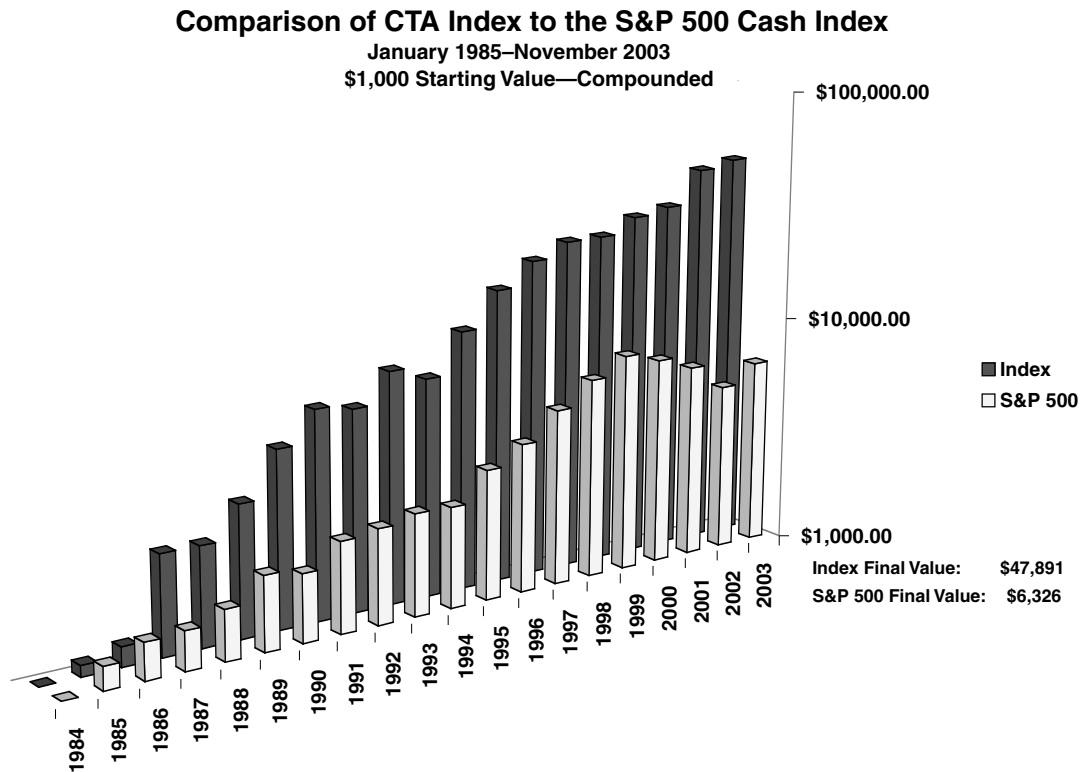
“[Salem Abraham, a trend follower,] began researching the markets by asking a simple question: Who is making money? The answer was trend followers and his journey began.”<sup>19</sup>

Few people have made the journey with Salem Abraham. During the dot-com era of the late 1990s, so many investors and traders with so little strategy were making so much money that trend followers disappeared from the radar screen even though they kept right on making money.

Since Trend Following has nothing to do with short-term trading, cutting edge technologies, or Wall Street Holy Grails, its appeal was negligible during the stock market bubble. If investors could jump on the bandwagon of practically any “long only” hedge fund manager or turn a profit trading themselves by simply buying internet stocks and holding on to them, what need was there to adopt a strategy such as Trend Following?

However, when we look at how much money trend followers have made since the bubble has popped, Trend Following becomes far more relevant. The following chart (Chart 1.1) shows a hypothetical index of three longtime Trend Following firms compared against the S&P stock index. The chart combines Dunn Capital Management, Campbell and Co., and John W. Henry and Co. into an equally-weighted index:

*Defining a trend is like defining love. We know it when we see it, but we are rarely sure exactly what it is. Fung and Hsieh’s paper goes a long way to doing for trends what poets have been trying to do for love since time immemorial. They give us a working model that quantitatively defines their value for us. Traders will not be surprised to learn that Trend Following advisors performed best during extreme market moves, especially during bad months for equities.<sup>20</sup>*



**CHART 1.1:** Trend Following Index Compared to S&P and NASDAQ

Yet even when Trend Following success is brought to their attention, investors are still often skeptical. They say the markets have changed and that Trend Following no longer works. Their concern usually stems from a random press story of a trend follower who “blew up” and lost all of his and his clients’ money. But the truth is that Trend Following hasn’t changed, even though a single trend follower may have. That is a big difference.

Let’s put change and Trend Following in perspective. Markets behave the same as they did 300 years ago. In other words, markets are the same today because they always change. This is a philosophical underpinning of Trend Following. A few years ago, for example, German mark trading had significant trading volume. Now the Euro has replaced the German mark. This was a huge, yet typical, change. If you are flexible, market changes, like changes in life, don’t have to impact you negatively.

*Change is not merely  
necessary to life—it is life.*

Alvin Toffler



Accepting the inevitability of change is the first step to understanding Trend Following philosophy. John W. Henry describes the benefits of understanding change:

“But what won’t change? Change. When a period of difficult performance continues, however, most investors’ natural conclusion is that something must be done to fix the problem. Having been through these drawdowns before, we know that they are unpleasant, but they do not signal that something is necessarily wrong with the future. During these periods almost everyone asks the same question in these exact words: ‘Have the markets changed?’ I always tell them the truth: ‘Yes.’ Not only have they changed, but they will continue to change as they have throughout history and certainly throughout our 19 years. Trend Following presupposes change. It is based on change.”<sup>21</sup>

Markets go up, down, and sideways. They trend. They flow, They surprise. No one can forecast a trend’s beginning or end until it becomes a matter of record, just like the weather. However, if your trading strategy is designed to adapt to change, you can take advantage of the changes to make money:

“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. 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.”—John W. Henry<sup>22</sup>

*The people who excel in any field are people who realize that the moment is there to be seized that there are opportunities at every turn. They are more alive to the moment.*

Charles Faulkner<sup>23</sup>

What does Henry mean by “a valid basic philosophy”? He is talking about a trading strategy that can be defined, quantified, written down, and measured in terms of numbers. Do you have one of those? Does your broker have one? Does your mutual fund manager have one? Does your high-flying hedge fund have one? Trend followers do not guess if they must buy or sell. They know what to do, because they have their “valid basic philosophy” set in a plan.

## Has Trend Following Changed?

There are plenty of people who ignore Trend Following's tremendous track record and argue that it is outdated or inferior or that it plain doesn't work.

"Has Trend Following changed?" was the topic of a panel at the Managed Fund Association's Network 2001 conference. Dr. Patrick L. Welton, CEO and Chairman of Welton Investment Corporation, said that there is no evidence that Trend Following has changed. In order to prove this fact, he constructed 120 trend-following models. Some were reversal-based, and others were not. Some were breakout-based on price with others on volatility and band-style breakouts. The average holding periods ranged from two weeks to one year. The results gave almost identical performance characteristics in periods covering the late 1980s, early 1990s, and late 1990s.

Welton also addressed the misconception that the sources of return for Trend Following had changed, saying that there was no evidence to support that perception. He pointed out that starting from first principles, it was a fact that the source of return for Trend Following resulted from sustained market price movements. Human reaction to such events, and the stream of information describing them, takes time and runs its course unpredictably. Welton went on to state that the resulting magnitude and rate of change of price could not be reliably forecast. This is the precise reason why Trend Following works.<sup>24</sup>

Burt Kozloff, a consultant in the hedge fund industry, also confronted skeptics. Here is an excerpt from a presentation he gave:

"In February 1985, on a tour of Germany sponsored by the Deutsche Terminborse, several advisors and pool operators were making a presentation to a group of German institutional investors. Among them were two trend-based traders, Campbell & Co. and John W. Henry & Co. During the question-and-answer period, one man stood and proclaimed: 'But isn't it true that Trend Following is dead?' At this point, the moderator asked that slides displaying the performance histories for Campbell and Henry be displayed again. The moderator marched through the declines, saying: 'Here's the

*The four most expensive words in the English language are "this time it's different."*

Sir John Templeton

*While conceding tacitly or explicitly that over the long run daily price movements are serially interdependent (move randomly) technical analysts focus on recurring short term patterns and trends. They are like surfboard riders, who study the movements of the waves, not in order to understand why they behave as they do, but simply in order to be on hand whenever they surge, to catch them at their crest, or as soon thereafter as possible to ride them as far as they possible can, and to dissemble before they change direction.*

Morton S. Baratz<sup>25</sup>

first obituary for trend-based trading. Here's the next 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.' Campbell and JWH 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."<sup>26</sup>

A new Trend Following obituary will be written every few years despite the incredible amounts of money made by its practitioners. Perplexed at Wall Street's lack of acceptance, John W. Henry once responded to Trend Following critics:

*By honest I don't mean that you only tell what's true. But you make clear the entire situation. You make clear all the information that is required for somebody else who is intelligent to make up their mind.*

Richard Feynman

"How can someone buy high and short low and be successful for two decades unless the underlying nature of markets is to trend? On the other hand, I've seen year-after-year, brilliant men buying low and selling high for a while successfully and then going broke because they thought they understood why a certain investment instrument had to perform in accordance with their personal logic."<sup>27</sup>

Trend followers generally seem to be oblivious to those who question the validity of their strategy. Why spend energy constantly defending yourself when you are producing monster returns year after year?

## Trend Following Modus Operandi: Follow Price

Trend followers generate phenomenal returns because their decisions are ultimately based on one piece of core information: price. In an increasingly uncertain and, these days, downright unfriendly world, it is extremely efficient and effective if our decision-making is based on this single, simple, reliable truth. The constant barrage of fundamental data, such as price-earnings ratios, crop reports, and economic studies, plays into traders' tendencies to make trading more complicated than it needs to be. Yet, factoring in every possible fundamental still does not tell a trader how much and when to buy, or how much and when to sell.

It is not unusual for many traders to become familiar with and focus on only one market (usually in their own country) to the exclusion of all other global opportunities. Seeking to maintain the

maximum degree of comfort, they follow this one familiar market's movements faithfully. If they specialize in stocks, they wouldn't dream of branching out into currencies or futures. How can a stock trader know anything about currencies? The idea that you could know enough about Cisco and soybeans to trade them both seems unfathomable to some. But think about what cotton, crude oil, Cisco, Sun, GE, the U.S. dollar, the Australian dollar, soybeans, wheat, Microsoft, EMC, and Oracle all have in common. Price.

Market prices are the objective data. You can compare and study prices and measure price movements, even if you know nothing about the markets themselves. You can look at individual price histories and charts without knowing which market is which and trade them successfully.

## Follow the Trend

Don't try to guess how far a trend will go. You can't. Peter Borish, former second-in-command for Paul Tudor Jones, lays bare the only concern a trader must have:

"Price makes news, not the other way around. A market is going to go where a market is going to go."<sup>28</sup>

The concept of price as the trading cue is just too darn simple for people to accept. This is demonstrated by the mainstream press, who always emphasize all the wrong numbers:

"At some point investing is an act of faith. If you can't believe the numbers, annual reports, etc., what numbers can you believe?"—Bill Griffith, Anchor, CNBC

Bill Griffith misses the point when he asks what numbers you can believe if you can't believe a company's annual report. It doesn't matter whether you can or cannot believe the earnings statement. All of these numbers can be doctored. The traded price can't be fixed. It's the only number to believe. However, this simple fact does not diminish the confusion. Alan Sloan, by all accounts a fine finance reporter, searches for numbers to trust:

"If some of the smartest people on Wall Street can't trust the numbers you wonder who can trust the numbers."

What numbers is Sloan talking about? Balance sheets? Price-earnings ratios? You can't ever trust those numbers. Someone can

*[Trend Following] is motivated by a very broad interpretation of the universe. The underlying belief is that economic systems adjust to changes in fundamentals gradually and over long periods of time, and that the consequent trends are evident everywhere in human history and commerce. Political, economic and social regime changes trigger price adjustments in markets that don't happen instantaneously. For example, the growth and decline of the Roman Empire took place, not in a day, but over hundreds of years. A major problem, of course, is that markets don't move from one state to another in a straight line: there are periods of countertrend shock and volatility. We spend most of our time trying to find ways to deal with those unsettling but inevitable events. That being said, it is really not difficult to put together a simple trend-following system that can generate positive returns over a realistic holding period  $n$  and there are many, many commercial systems that have been generating strong, albeit volatile, returns for a long time. So there are definitely firm grounds for believing in Santa Claus.*

Paul Mulvaney  
CIO of  
Mulvaney Capital Management Ltd.

*Ed Seykota is a genius and a great trader who has been phenomenally successful. When I first met Ed he had recently graduated from MIT and had developed some of the first computer programs for testing and trading technical systems. . . . Ed provided an excellent role model. For example, one time, he was short silver and the market just kept eking down, a half penny a day. Everyone else seemed to be bullish, talking about why silver had to go up because it was so cheap, but Ed just stayed short. Ed said, "The trend is down, and I'm going to stay short until the trend changes." I learned patience from him in the way he followed the trend."*

Michael Marcus<sup>31</sup>

always alter them. Beyond that, even if you knew accurate balance sheet numbers, they can never help you determine when or how much to buy or sell. John W. Henry drives home the critical lesson:

" . . . [P]olitical uncertainty is one reason why John W. Henry & Company, Inc. (JWH) investment decisions are not driven by discretionary judgements. How, for example, do you measure the impact of statements from Messrs. Greenspan, Rubin, Summers, Miyazawa, or Sakakibara? Even if JWH knew all the linkages between fundamentals and prices, unclear policy comments would limit our ability to generate returns...trying to interpret the tea leaves in Humphreys-Hawkins testimony or the minds of Japanese policy authorities does not lend itself to disciplined systematic investing. Instead of trying to play a losers game of handicapping policy statements our models let market prices do the talking. Prices may be volatile but they do not cloud the truth in market reactions. Our job is to systematically shift price data to find trends and act on them and not let the latest news flash sway our market opinions."<sup>29</sup>

You can't read tea leaves. John W. Henry can't. Ed Seykota can't. Nobody can. William Eckhardt, a longtime trend follower and former partner of trend follower Richard Dennis, builds off Henry's wisdom by describing how price is what "traders live and die by." The moment you add any other variables to the decision-making process, you've diluted price:

"An important feature of our approach is that we work almost exclusively with price, past and current . . . Price is definitely the variable traders live and die by, so it is the obvious candidate for investigation . . . Pure price systems are close enough to the North Pole that any departure tends to bring you farther south."<sup>30</sup>

How does a trend follower perceive the trading process? A well-known trend follower relates this story about trading sugar. He had been buying sugar—thousands of sugar contracts. Every day, the market was closing limit up. Every day, the market was going higher and higher. This trend follower just kept buying more and more sugar each day limit up. A broker was watching all this. One day the broker called after the market was closed because he had extra contracts of sugar that were not balanced out, and he said to this trend follower, "I bet you want to buy these other 5,000 contracts of sugar." The trend follower replied, "Sold."

Think about that: After the market has closed limit up for days in a row, this trader says, “Sure, I’ll buy more sugar contracts at the absolute top of the market.” Why is this an important lesson? Everybody instinctively wants to buy sugar on the dip. Let it come down low. Let me get a bargain. Trend Following works by doing the opposite, by buying higher prices.

Let’s say you saw a stock go from 5 to 100. When it was at 5, you didn’t know it was going to go to 100. And trend followers didn’t know it was going to go to 100 either. But they were buying all along, *knowing* that it could go to 100 even though it might not. So did it make sense to miss out on this trade that went to 100 because you did not enter at 5? Would you have avoided the trade if you had had the chance to get in at 20 instead of 5? If you got in at 20 and it went to 100, you made a great trade. You can’t time the trade. No one can pick a top or bottom.

*Be less curious about people and more curious about ideas.*

Marie Curie

### Even Good Traders Confuse Price

The trading histories of Julian Robertson and Louis Bacon, two famous hedge fund managers, underscore the importance of price for decision making.

In the last few years, Julian Robertson shut his long running hedge fund down. He was a global macro trader who relied on fundamentals for decision-making. He had a close relationship with another global macro trader, Louis Bacon. Bacon is extremely secretive to the extent that it’s nearly impossible to find out his performance numbers unless you are a client. We do know from the little bit of writing available on Bacon that he’s pulled hundreds of millions, if not billions, of profit from the marketplace. While Bacon does not advertise himself as a trend follower, the following excerpt leaves no doubt that he is focused on price action just as much as John W. Henry:

“If a stock goes from 100 to 90, an investor who looks at fundamentals will think maybe it’s a better buy,” explains one source. “But with Louis [Bacon], he will figure he must have been wrong about something and get out.” Contrast that, say, with [Julian] Robertson, who, even after shutting down his firm, was doggedly holding on to massive positions in such stocks as US Airways Group and United Asset Management Corp... [Bacon

*The wisest Trend Follower we know has said that every 5 years some famous trader blows up and everyone declares Trend Following to be dead. Then 5 years later some famous trader blows up and everyone declares Trend Following to be dead. Then 5 years later . . . well, was the problem Trend Following or the trader?*

*[Trend Following] is similar to being long options because the stop loss creates a limited downside, and the continuation of the trend creates the large upside. This is why the phrase for this approach to trading is to 'cut losses' and to 'let profits run.' Of course, if trends continually fail to materialize, these limited losses can accumulate to large losses. This is also true for any option purchase strategy. For trend followers, the 'option premium' is 'paid' for after an unsuccessful trade is closed when a stop loss has been reached. The premium can also be 'paid' after markets have moved a great deal, profits have been made, and a reversal causes a trailing stop to be hit, and some of the profits reversed.*

Michael S. Rulle,  
President,  
Graham Capital Management<sup>34</sup>

*You will also find additional research from Duke University on our Web site, [www.trendfollowing.com](http://www.trendfollowing.com), that takes Rulle's point to an academic proof.*

also offered] in a recent investor letter: Those traders with a futures background are more 'sensitive' to market action, whereas value-based equity traders are trained to react less to the market and focus much more on their assessment of a company's or situation's viability."<sup>32</sup>

Today, Louis Bacon is still trading and following the price. But Julian Robertson is out of the game, due in part, perhaps, to his refusal to accept "price" as his decision-making cue.

Trend followers are in the moment. They know that attempting to pinpoint the beginning of a trending market is futile. When trends begin, they often arise from a flat market that doesn't appear to be trending in any direction. The idea is to take small bets early on in a market to see if the trend does, indeed, mature and get big enough to make big money. How do Trend Following strategies succeed? Michael Rulle, President of Graham Capital Management and a trend follower, states:

"The ability of Trend Following strategies to succeed depends on two obvious but important assumptions about markets. First, it assumes that price trends occur regularly in markets. Secondly, it assumes that trading systems can be created to profit from these trends. The basic trading strategy that all trend followers try to systematize is to 'cut losses' and 'let profits run.'"<sup>33</sup>

We asked Charles Faulkner, a modeler of top traders and an expert in Neuro-Linguistic Programming, to expand upon this, at first glance, simple idea:

"Many traders have told me the first rule of trading is to, 'Cut your losses, and let your profits run.' And then, that it's the hardest thing to do. Seldom do any of them wonder why, and yet this exactly where the efficient market hypothesis breaks down, and the psychological nature of the markets shows through. When we lose or misplace something we expect to find it later. The cat comes back. We find our car keys. But we know a dollar on the street will not be there with the next person who passes by. So experience teaches us that losses are unlikely and gains are hard. 'A bird in the hand is worth two in the bush.' This is when I tell them that they earn their trading profits by doing the hard thing—by going against human nature. This is where the discipline comes in, the psychological preparation, the months of system testing that give

the trader the confidence to actually trade against his natural tendencies.”

If cutting losses and letting profits run is the trend follower’s mantra, it is because harsh reality dictates that you can’t play the game if you run out of money. Nor can you predict the trend direction, as Christopher Cruden, Managing Director of the trend follower Tamiso and Co., points out:

“I would prefer to finish with a certain currency forecast, based upon my own fundamental reading of the market and one which underpins my personal investment philosophy . . . The only problem is I can’t tell you when this will happen or which event will be first. On that basis alone, it seems best to stay with our systematic approach.”<sup>35</sup>

Cruden knows a potential forecast will give uncertain investors a feeling of confidence, but he also knows forecasting is impossible. Why pretend?

A good example of not letting profits run can be seen in trading strategies that take profits off the table before a trend is over. For example, a broker revealed to us that one of his strategies was to ride a stock up for a 30 percent gain and then exit. That was his strategy. Let it go up 30 percent and get out. Sounds reasonable. However, a strategy that uses profit targets is problematic. The biggest problem is that it goes against the math of getting rich, which is to let your profits run. Trend followers ride trends as far as they can instead of taking their profits as soon as they make them. If you can’t predict the end or top of a trend, why get out early and risk leaving profits on the table?

For example, you start with \$50,000. The market takes off and your account swells to \$80,000. You could, at that point, quickly pull your \$30,000 profit off the table. Your misconception is that if you don’t take those profits immediately, they will be gone. Refusing to risk those accumulated profits is a big mistake.

Trend followers realize that a \$50,000 account may go to \$80,000, back to \$55,000, back up to \$90,000, and from there, perhaps, all the way up to \$200,000. The person who took profits at \$80,000 is not around to take the ride up to \$200,000. Letting your profits run is tough psychologically. But understand that in trying to protect every penny of your profit, you actually prevent yourself from making big profits.

*In Patton my favorite scene is when U.S. General George S. Patton has just spent weeks studying the writing of his German adversary Field Marshall Erwin Rommel and is crushing him in an epic tank battle in Tunisia. Patton, sensing victory as he peers onto the battle field from his command post, growls, “Rommel, you magnificent bastard. I read your book!”*

**Paul Tudor Jones**  
as quoted in the Foreword to  
*The Alchemy of Finance*

*Are you a bull market baby? Can you survive in any situation?*



## Handling Losses

*I began to realize that the big money must necessarily be in the big swing.*

Jesse Livermore

You are going to have ups and downs in your trading account. Losses are a part of the trading game. You're going to have losses with Trend Following:

“You can't make money if you are not willing to lose. It's like breathing in, but not being willing to breathe out.”—Ed Seykota<sup>36</sup>

If you don't have losses, you are not taking risks. If you don't risk, you won't win big. Losses aren't the problem. It's how you deal with them. Ignore losses with no plan and they will come back to haunt you. Trend Following works to handle loss with stops. This sensible approach allows you to continue to trade:

“Theoretically, really big losses rarely befall a trend follower since he decides to eliminate or reverse his position as soon as the market goes against him. A lot of little losses are inevitable . . . The rationale for hanging in is that any price move could be the beginning of a trend, and the occasional big breakout justifies a string of small losses.”<sup>37</sup>

## Conclusion

A wise trend follower once told me a story about when he was in Bermuda, with a new trader who wanted to learn the “secrets.” “Just give me the quick and dirty version,” the neophyte said. The experienced trader took the newbie out to the beach. They stood there watching the waves break against the shoreline. The neophyte asked, “What's your point?” The old trader said, “Go down to the shoreline where the waves break. Now begin to time them. Run out with the waves as they recede and run in as the waves come in. Can you see how you could get into rhythm with the waves? You follow the waves out and you follow them in. You just follow their lead.

In our search for the facts about Trend Following, we learned that its basic tenets, its philosophical underpinnings, are relevant not only to trading, but also to our lives in general, from business to personal relationships. We also found in our conversations with the old pro trend followers that Trend Following works best when pursued with an unbridled passion.

How important is passion? Brett Steenbarger, Ph.D., an Associate Professor of Psychiatry and Behavioral Sciences at SUNY Upstate Medical University in Syracuse, NY, puts it in perspective:

“Find your passion: the work that stimulates, fascinates, and endlessly challenges you. Identify what you find meaningful and rewarding, and pour yourself into it. If your passion happens to be the markets, you will find the fortitude to outlast your learning curve and to develop the mastery needed to become a professional. If your passion is not the markets, then invest your funds with someone who possesses an objective track record and whose investment aims match your own. Then go forth and pour yourself into those facets of life that will keep you springing out of bed each morning, eager to face each day.”<sup>38</sup>

As we assembled *Trend Following*, we found that when used within the context of passion, the term “Trend Following” could also be substituted throughout for other activities in life. Our insight occurred when rereading this passage from a 1938 book on creative writing by Brenda Ueland:

“Whenever I say writing in this book I also mean anything that you love and want to do or to make. It may be a six act tragedy in blank verse, it may be dressmaking or acrobatics, or inventing a new system of double entry accounting . . . but you must be sure that your imagination and love are behind it, that you are not working just from grim resolution, i.e., to impress people.”<sup>39</sup>

Trend followers do not trade with grim resolve or with an intention to impress others. They are playing the game to win and enjoying every moment of it. Like other high level performers, such as professional athletes and musicians, they understand how critical it is to maintain a winning attitude if you want success.

*Many people would sooner die than think; in fact, they do so.*

Bertrand Russell

*Among people who take the trouble to understand what the business is about instead of assuming it involves speculating on live cattle, it is readily understood.*

Bruce Cleland,  
Campbell and Co.<sup>40</sup>

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## Key Points

- Ed Seykota: “All profitable systems trade trends; the difference in price necessary to create the profit implies a trend.”
- Trend Following is based on simple universal laws we can all learn.
- No one knows how high or how low a market will go. No one knows when a market will move. You can’t undo the past, and

*If you take emotion—would be, could be, should be—out of it, and look at what is, and quantify it, I think you have a big advantage over most human beings.*

John W. Henry<sup>41</sup>

*A trend is a trend is a trend, Gertrude Stein would have said if she were a trader . . . Once you have a game plan, the differences are pretty idiosyncratic.*

Richard Dennis<sup>42</sup>

you can't predict the future. Prices, not traders, predict the future.

- Trend followers buy high and sell low. This is counterintuitive for most people.
- Using “common sense” is not a good way to judge or trade markets.
- Losses are a cost of doing business. No one can be right all the time. No one can make money all the time. Trend followers expect and handle losses with objectivity and detachment. If you don't have losses, you are not taking risks. If you don't risk, you won't win.
- Trend Following is a classic targeting of an opportunity. Bill Dunn, a trend follower for over 25 years, named one of his funds “T.O.P.S.” for “targets of opportunity systems.” Don't mistake Dunn's terminology. He is not predicting.
- Price must go either up, down, or sideways. No advances in technology, leaps of modern science, or radical shifts in perception will alter this fact.
- What if they told you that the best way to get to point B, without bumping into walls, would be to bump into the walls and not worry about it. Don't worry about getting to point B, but just enjoy bumping into the walls.<sup>43</sup>