Inside the Counterintuitive World of Trend Followers

It's Not What You Think. It's What You Know.

By Charles Faulkner

In his book, ***Trend Following***, Michael Covel states that trend followers have a philosophy that informs their trading. What is all too easy to miss is that these philosophies aren't after-dinner digressions. When trend followers say they have a philosophy, they are talking about how they know the world around them, and this knowledge is not from books. It is won from the world and is quite empirical.

The trend-following philosophy can be summarized in seven statements – taken in part from actual utterances of trend followers (and the rest used with poetic license as regards their principles). Each will be covered in detail in the ensuing paragraphs. They are:

- No one can predict the future;
- If you can take the would-be, could-be, should-be out of life and look at what actually is, you have a big advantage over most human beings;
- What matters can be measured, so keep refining your measurements;
- You don't need to know when something will happen to know that it will;
- Prices can only move up, down or sideways;
- Losses are a part of life; and
- There is only now.

The difference between trend followers and other types of traders isn't one of style. What trend followers do is outside the scope of normal human reactions. Frankly, their deeply counterintuitive strategy should alert other traders that something very different is going on.

Take the adage every trader knows: "Cut your losses, let your profits run." Clearly, every trader will agree that it is the hardest thing to do. Why? Is it because "a bird in the hand is worth two in the bush" (or in the account)? Or is it because when your dog runs away from home, he is usually back by dinner? Trend followers know about these experiences, and they know something else: They know that all of these examples are anecdotal. They are just personal experiences and beliefs that will bias their judgement. Trend followers know that these instances are not reliable guides to the nature of markets. All right then, what is?

No One Can Predict the Future

"There is no predicting anything," the very successful trend follower, John W. Henry, tells us. What this means is that all of your hunches, intuitions and beliefs about how the world works are steeped in self-deception. Thus, despite pronouncements of a bunch of experts on television or elsewhere, tech stocks are not trading because of anything; gold is not moving for anybody. The Fed rate is not changing for a particular reason. It's not that there are not market influences or market makers or reasons that markets change. There are. It's just that there are *so many* of them. But to quantify them and to make a judgment about their relative weights and influences is beyond the possibility of anyone.

Trend follower and president of Dunn Capital, Bill Dunn, has a doctorate in theoretical physics. No one gets a doctorate in that discipline without understanding, in a deep way, the "three-body" problem. In the celestial version, Sir Isaac Newton found a way to mathematically describe the interaction of two bodies – the earth and the moon. To do this, he ignored all the other influences in the heavens. Enough for a start, he assumed his two-body solution would lead to solutions being found for the interaction of three, four and more. Two centuries later, they hadn't. Finally, to speed things along, a prize was offered by the king of Sweden. It was won in 1889 by Henri Poincare, but not for solving it. He demonstrated that it could not be solved.

Professor Poincare found that with just three bodies, the behavior of each one affecting the other made it impossible to calculate directly what was going on, and therefore, how the bodies would affect each other. The same is true of the relationships between stocks, bonds and futures. Approximations are possible, but counterintuitively the more accurate that market participants try to make their models, the more these models cease to describe what is going on in the world.

The conclusion is, quite simply, that the world is much richer and more detailed than any model, and every model of complex behavior (starting with only three bodies) will fall short of a description that allows prediction. Was that too much detail? It turns out that trend followers are fascinated with the details of what is in the world and how it works. They live and work in the world of what is.

Ed Seykota's Trading Tribe

Trend followers tend to be careful observers who notice trends everywhere; those observations include their own emotions while trading. Ed Seykota's investigations of how trends in emotions affect trading first appeared in his now-famous interview in the original ***Market Wizards*** book. "Win or lose, everybody gets what they want from the market. Some people seem to like to lose, so they win by losing money."

Over the last decade, Seykota has extended these apparently paradoxical insights into trading and life with another set of assertions; that we need to feel our feelings – those we like and especially those we don't like. If we resist our feelings, we wind up creating "dramas" in our lives and in our trading so that we have to feel these feelings. As he puts it, "The feelings you are unwilling to feel are your real trading system."

In many emotionally charged situations, like trading, a full expression of our feelings is stifled by an inner judgment about these feelings. Seykota calls this a "k-not." Avoiding these k-nots becomes more important than any stated goal. The way to untie these k-nots is to experience the feelings, but because these are the feelings we are unwilling to feel, we need the support and acknowledgement of others. Seykota insists that traders need to band together in "Trading Tribes" where they can encourage each other to face, embrace and celebrate these feelings through a process known as the Trading Tribe Process (TTP®).

In TTP, a trader voluntarily takes the "hot seat" and other Tribe members encourage him. According to participants, when a trader feels his feelings fully, he often experiences an "a-ha" along with spontaneous insights and revisions of previously problematic trading behaviors.

Whether this sounds offbeat or on the money may depend on your attitude toward men's groups, warrior training or something similar. You can find out for yourself through Seykota's website www.tradingtribe.com.

Look at What Is

If you can take the would-be, could-be and should-be out of life and look at what actually is, you have a big advantage over most human beings. Take these remarks by John W. Henry when asked how he created and maintains his discipline: "Well, you create discipline by having a strategy you really believe in. If you haven't done your homework properly and haven't made assumptions that you can really live with when you're faced with difficult periods, then it won't work. It really doesn't take much discipline if you have tremendous confidence in what you're doing."

What are these assumptions? Henry is clear about them – "No one consistently can predict anything, especially investors…" and "…other investors are convinced that they can predict the future, and I believe that's where our profits come from."

Notice that Henry's assumptions are not social givens such as, "I assume you are joining us for dinner," or "I assume I'm going to be rich." They are not even beliefs in the psychological sense, that is, a feeling of certainty about something that cannot be determined for sure. Many traders and trading coaches will read Henry's statement and conclude that what they need is tremendous self-confidence, an indomitable belief in the likelihood their success. They will want to instill beliefs like, "I will be a great trader," or "I deserve to be rich." But these "success beliefs" miss the point when it comes to trend following. It isn't what trend followers think of themselves that matters, it's what they know about the world.

[Editor's note: For more information on John W. Henry's trading philosophy, please see his feature interview in July 2004 ***SFO****.]*

What Matters Can Be Measured

What kind of assumptions do you make if "there is no predicting anything?" If there is no predicting anything, what do trend followers do when they do their research? If they have already taken the would-be, could-be and should-be out of the scenario in order to look at what is, then what is?

All traders know that there are vast quantities of price data available. What trend followers measure is the likelihood of price patterns recurring – in other words, probabilities. With probabilities, the human feeling for a market, intuitions about price movements and the gratifying feedback of getting it right disappear.

Jerry Parker, top trend follower and president of Chesapeake Capital, reminds us that trend-following metrics and measurements are "…not intuitive, not natural, too long term, not exciting enough." They are experienced as counterintuitive.

Market wizard Richard Dennis (whose hobbies include studying baseball statistics) is attributed with saying, "If your system makes a little money all year and loses a lot of money twice a year, reverse your system." This sounds crazy, but Dennis has run the numbers, and the couple of wins will outstrip all the losses the rest of the year by a wide margin.

Trend follower trader Ed Seykota adds, "If you can't measure it, you probably can't manage it." This certainly applies to Dennis' example.

"When" Doesn't Matter

You don't need to know when something will happen to know that it will. Trend followers know there is a statistically significant likelihood that a big payoff trade is coming, but they do not know in what market and they do not know when, so they must take every trade their systems generate. They know the vast majority of the trades the systems generate will result in a loss or a small gain. Richard Dennis is reported to have had an extraordinary number of winning trades for a trend trader, 55 percent, and it is said that he still made all of his "real money" on less than five percent of his trades.

To do this, trend followers must live at least part of life in this larger, abstract and statistical scope of time. For trend followers, the everyday moments of trading participate inside a "campaign" in a certain market or instrument where traders see each moment as the possibility of a statistical opportunity. This tends to reduce the importance of individual trades. The price will move – that's what is. There is a statistical probability for each outcome. One of the actual outcomes will happen.

Prices Only Move Up, Down or Sideways

Computerized trading software is so prevalent that traders can quickly create a trading system so complex that is it quite beyond their understanding. Meanwhile, clarity of thought and simplicity of design are the hallmarks of a good trend-following system. Trend followers know that however deep or complex their thinking is about trading, the input to their system is limited to one of three possible states – price increase, decrease or no change – and the final output of their system must be one of three actions, buy, sell or do nothing. This allows for fast heuristics.

Losses Are a Part of Life

In his classic, ***The Battle for Investment Survival***, Gerald Loeb writes, "Accepting losses is the most important single investment device to insure safety of capital. It is also the action people know the least about and that which they are least liable to execute." Though this statement should resonate with all traders, it has a special meaning for trend followers.

Trend followers tend to be more aware of the relationship between losses and gains than other types of traders. They realize that a large loss affects their trading gains over the lifetime of their portfolio. They realize that trading less frequently reduces the number of their losses as well as transaction costs and, so, is another effective means of preserving their capital.

According to Ed Seykota, elements of good trading include, "(1) cutting losses, (2) cutting losses and (3) cutting losses. If you can follow these three rules, you may have a chance." Few non-trend-following traders realize that Seykota is talking about three different kinds of losses. The first two of them are offered above – reducing the largest loss by strictly limiting position size and reducing the overall number of trades. Only trend followers know about the third. To quote John W. Henry again, "The desire to have close stops to preserve open trade equity has tremendous costs over decades." In essence, he is referring to cutting the exit stops that would turn trades into losses in volatile markets and greatly reduce eventual gains. This once again draws attention to the fact that trend followers, while trading in the same markets as everyone else, are living and working in profoundly different and more detailed worlds.

Does this make taking a loss easier? Yes and no. Yes, trend followers know they can't know the future, that there are statistical opportunities for those who know how to exploit them, that they must respond to every opportunity, and that they must preserve capital to continue trading. They backtest this until they are convinced it's the case. Then they set up their systems and take the trades that the system calls.

And no, trend followers are human and hate to part with something of value. The need for the adage "Cut your losses, let your profits run," is much like the need for the Ten Commandments. We do not have to be told what is in our nature. In going against our nature, instinct and a lifetime of cultural conditioning, trend followers really earn their money.

What About the Rest of Us?

Some people call economics the dismal science. But those people haven't talked to cognitive neuroscientists. According to their research, we humans have limited perceptual as well as information-processing abilities. When faced with decisions, whenever possible we tend to use simple rules and short-cuts, and we apply a criterion of sufficiency (good enough for now) – with little review of possible consequences and in a way that requires the least possible effort.

So, clearly, most of us will not measure up to the stiff requirements of successful trend following. On the other hand, these differences are due to the encouragement of some innate attitudes like curiosity about the world and some life-changing experiences like studying physics or learning about probabilities.

For example, Bill Dunn and Ed Seykota are graduates in physics and engineering. John W. Henry became convinced of his assumptions as a student when he collaborated with his college instructor on a strategy for beating the odds at blackjack. As any reader of Edward O. Thorp's famous book, ***Beat the Dealer***, can tell you, it's all about the probabilities. In fact, the number of outstanding traders mentioned in Jack Schwager's two ***Market Wizards*** books, some of whom started as gamblers, could fill a suit in a deck of cards. This makes sense. A trader who directly experiences the results of probabilities over and over again will become convinced that he doesn't need to know the future to win. He will recognize that the odds/probabilities shift over time. If this sounds like an encouragement to join the current poker craze, it's not. But if you do, keep in mind you are "at the table" to practice these odds-watching skills. The stakes need to be small enough that you are learning from your experience, not adding more traumas to your trading.

Another way to get started is to get more curious about the world of *what is*. Your children can help you with this, and even if you don't have any, you can still take a walk in the woods and notice that the shape of the leaves, branches and the trees are similar each other. Or go shopping and notice how you respond to closeouts and one-of-a-kind items. Or how people decide on what to order in a restaurant. Fractal market analysis, behavioral finance and heuristics all started with people noticing these kinds of things about the world everybody else thought they already knew. So do many trading ideas.

Trend followers can't trust their senses or their intuition or their better judgment. They deal in quantities and probabilities with bodies and minds designed for instincts and feelings. To paraphrase Woody Allen, their experience of the world may be untrustworthy, but it's the only place they can get a great steak. Us too.

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