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Strategy for global hedge funds and alternative investment
Is the trend your friend or foe?

25 Jan 2005


Is it best to be a trend-follower or counter-trendist in managed futures?

With the beginning of 2005 we get a dose of new data as every stock index, hedge fund index, and commodity index wraps up their 2004 and reports for duty for a new year. Hedge funds in general had a tough 2004 but managed to close out the year with a nice 9.4 per cent gain, according to the CSFB/ Tremont hedge fund index (www.hedgeindex.com).

One of the sub-indices that managed to eke out a gain towards the end of the year is the CSFB Managed Futures Index, which finished the year with a 6 per cent gain after suffering a rough mid-2004 with six straight down months in a row, the worst being April with -6.4 per cent.

I don't like the idea of looking at the category of managed futures via an index, however. The problem is that managed futures is really comprised of two opposite strategies. Proponents of these two strategies are often religious about their beliefs and passionately argue the eventual demise of their opposite. The two strategies are those of the trend-followers and the counter-trendists.

Trend-following is often summed up by the simple phrase, "the trend is your friend". The idea being that if a market is hitting new highs, then it's a good idea to go long that market. Or if it's hitting new lows, then better start selling. The typical trend follower will follow 20 or more markets and commodities. At any point, the trend follower will say, somewhere in the world there's a bull market. If they manage to tread water in the choppy markets and go long and strong the bull markets, the returns will be massive.

Trend-following is the strategy of a well-known group of traders called the turtles. The turtles got their start in the 1980s when traders Richard Dennis and William Eckhardt made a bet. Dennis said that he could take people off the street and teach them trading. Eckhardt bet that he couldn't. Dennis won the bet when his students, the turtles, consistently scored higher than average returns over the next several years.

The counter trend guys take a different approach. Their basic idea is that most markets are mean reverting. If a market is hitting new lows, chances are its going to at least have a short-term bounce. If a market is hitting new highs, it might be time to scale out of a position rather than scale into a position. In other words, right when the trend followers are taking on their biggest positions, the counter-trend guys are scaling out. An example of the type of mean reverting market that counter-trend guys love to play is the Nasdaq 100, as represented by the exchange-traded fund QQQQ. When the QQQQ goes down 2 per cent for two days in a row everyone is starting to panic and the media pundits are talking about "broken trendlines". This is precisely when the counter-trendists dive in. That particular scenario has happened on 71 occasions. On average, the QQQQ has been up 0.7 per cent the next day. Counter-trendists catalogue thousands of these patterns across many different markets and often play these patterns on a systematic basis.

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Perhaps the most famous trend follower right now is John Henry, owner of the Boston Red Sox. Just as his team demonstrated a dramatic comeback and success this year, so did Henry's main fund, his Global Diversified Fund.

Starting in March 2004, things went from bad to worse for Henry. In March he was down 2 per cent, April 12 per cent, May down 5 per cent, June down 13 per cent, and July down 2 per cent. Personally, I can't handle volatility like that. If I were managing a fund with those numbers I'd probably have a stroke. Managing money is never easy, even if you are disciplined and systematic. To have to report to your investors that you are down 12 per cent, 5 per cent, 12 per cent, each month is not pleasant. But

Henry stuck to his guns and closed out the year with some strong months: September up 12 per cent, October 16 per cent, November 12 per cent, and December 3 per cent, closing out the year at positive 27.66 per cent, significantly better than all the market indices. Henry's worst drawdown in all of the funds he manages is over 50 per cent. Again, that's volatility I can't handle, but Henry has been a great success and his investors trust him.

On the counter-trend side, perhaps the most well-known is Toby Crabel. He manages more than \$1.6bn and has written the book *Day Trading with Short-term Price Patterns*, which can be found on eBay for upwards of \$1,000 a copy. Despite the volatility in the markets, Crabel only had two down months in 2004: March was down 0.79 per cent and June was down 0.39 per cent. Such volatility lets one sleep at night. He finished the year with a 3.36 per cent return, less than the yield on a 10-year treasury. His average return per year has been 9.48 per cent and his worst drawdown is only 4.23 per cent. While some don't mind the roller-coaster ride of John Henry, other institutional investors are willing to pay a 3 per cent management fee and 20 per cent incentive fee to have the sleepy volatility of a Crabel.

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