Michael Covel

Price Is the Best Indicator in the World

Long time readers of TRADERS´ will remember that as early as the March issue of 2006, we published an interview with Michael Covel that was devoted entirely to the subject of trend following. More than eight years have passed since then, during which time a lot has changed. That is why we are publishing a second interview where we will be showing new aspects of Michael Covel's trading philosophy. The world has moved on for him, too, and he has been able to learn many new things. Marko Graenitz interviewed him in early May, and you can look forward to some exciting reading.

» TRADERS´: Hello Mr. Covel, or should we rather say, "Good evening?" It is afternoon here though, and what time of day is it in your part of the world?

Covel: Good evening. I am currently in Ho Chi Minh City, Vietnam, where it is 10 pm now.

TRADERS´: Your company is based in the US and you have staff there as well. What made you decide to go to Asia on a permanent basis?

Covel: In 2013, I gave 40 plus presentations for various funds in China, Japan, Singapore, Malaysia and Vietnam, doing a lot of travelling in the process. And somehow I got stuck there. It is now one of my goals to spread trend following in regions across Asia. In the US, the concept has long been known, but I can see there is some catching up to do here in Asia.

TRADERS´: Which brings us to what we would like to discuss with you. Could you briefly summarise the main idea behind the trend-following approach?

Covel: The basic approach is that nothing is predictable. I will reiterate because this is absolutely crucial and it is regularly disregarded by most market participants: There is absolutely nothing that can be predicted!

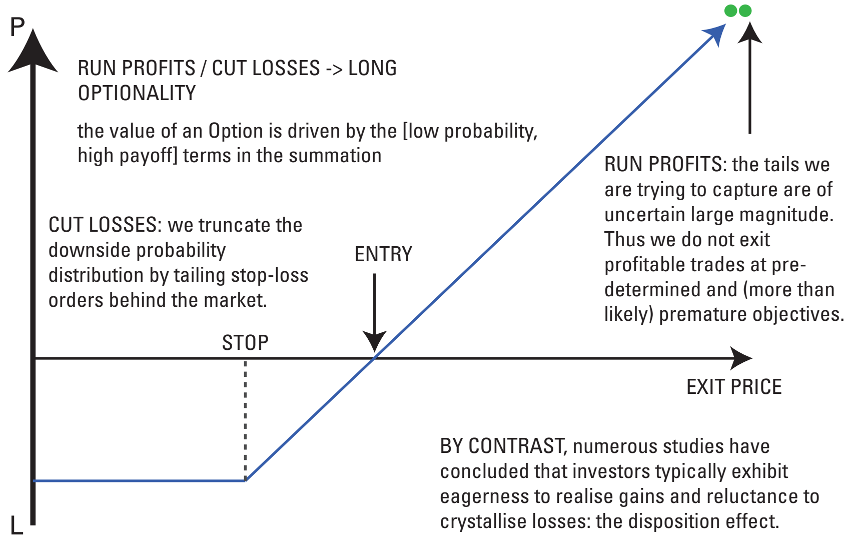
TRADERS´: This is indeed in contrast to all we are offered every day on the stock market...

Covel: And for a good reason: A lot of people make money by claiming that they can predict something.

TRADERS´: Is that a claim false even for long term predictions? Say in terms of several years?

Covel: Yes, even for that. Just look at the last 20 years. The market kept going up and down all the time. How the hell is anyone supposed to have predicted that ahead of time? Anyone claiming that is a liar. Reality is so complex that no one can tell what is going to happen in a few years' time.

F1) Let Your Profits Run, Cut Your Losses Short



The graphic shows the basic idea of trend following. By cutting losses short and letting profits run, an asymmetric payoff profile will develop over the long term with small losses and profits that are few in number but much larger in magnitude. This is also referred to as optionality.

Source: Mulvaney Capital Management

TRADERS´: If trend following defies prognostication, how does it work then?

Covel: It works by way of the price, "the best indicator in the world". If the price of any stock goes up, then that is a clear indication of market participants willing to buy at higher prices. Analogously, this is true of prices falling. All of this is based on the idea of a pro-cyclical momentum or trend: If something goes up (or down), it will likely continue to go up (or down).

TRADERS´: Aren't you oversimplifying things a little bit here? How do you know these trends exist, if forecasts are impossible?

Covel: This is what the stats tell us. And they are pretty reliable. You see, studies have shown that there have always been trends in the markets – in fact for more than 100, 200 and 800 years (across three studies). I think that is a pretty valid basis for a trading strategy. But if investors proceed classically by using a buy-and-hold strategy, which on closer inspection is no real strategy at all, they need to cope with significant drawdowns when the markets tumble. A good trend-following strategy, however, will benefit from bear markets by using short positions to bet on downward trends.

TRADERS´: Still, there are many sideways phases and erratic movements, in which case a trend following strategy can make losses over a longer period of time.

Covel: Yes, sure. Like any other strategy, this one also includes certain drawdown phases caused by many losses accumulating when there are no clear trends in the markets. Historically, however, such phases are of a temporary nature. Surviving drawdowns as well as you can requires good risk management and building up a smart portfolio, some of which will always be following current trends, compensating for the small losses that occur as a result of false signals.

TRADERS´: If trend following works so well, why is the strategy used by so few market participants?

Covel: For a long time the consensus among academics was that the markets were efficient and profits made by using simple trend-following strategies were more a product of chance than anything else. Meanwhile, the mindset of some academics has changed. Increasingly, academic studies are being published that show that trend following works. The problem is the "experts" in the financial industry cannot sell this approach as well because people would much rather hear predictions backed by great fundamental analysis and projections. Such "stories" will appeal to investors more than a statement saying to just follow the trend.

TRADERS´: What does your own trading style look like – is there anything you can let us know about that?

F2) Trend-Following Trade Scheme

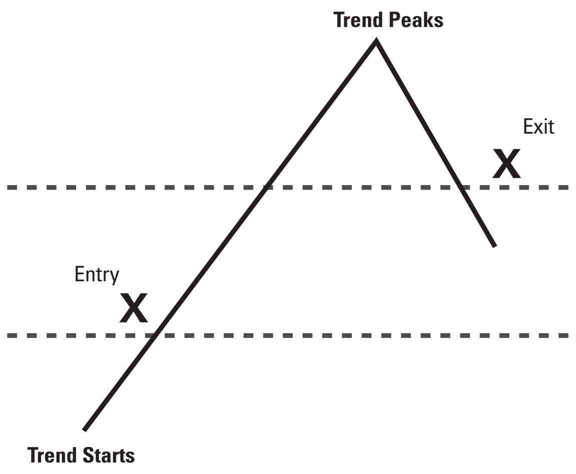


Figure 2 shows a simple scheme indicating what typical trend-following trades look like. In the case of an upward trend entry is made significantly later than the actual low point when the trend direction is deemed to be confirmed based on the respective criteria (moving average, breakout or the like). Similarly, exit will not be made until the trend is considered to have ended based on the same or similar criteria – depending on the exact trading strategy. As a result, trend-following traders "cut out" the "centrepiece" of the overall movement. Since no trading is ever done directly on the low or in close proximity to it, a false signal will basically cause losses to occur but these will be significantly smaller than any profits that are made when your trades are successful.

Source: www.trendfollowing.com

Covel: I use trend following when trading futures and ETFs. In order to achieve a good diversification of risk, I use a basket of various markets and asset classes. I keep entries and exits simple, for example, long term moving averages (MAs) such as the 100-day MA and in the case of exits sometimes on the basis of slightly less long term MAs. Breakouts above or below certain levels may also trigger an entry or exit. My rules are such that they are precisely defined, so I make no discretionary decisions, but always know exactly what to do.

TRADERS´: How did you make these rules?

Covel: The whole strategy is based on extensive backtests. I have programmers testing the ideas for me.

TRADERS´: What time frame do you trade in?

Covel: My investment horizon is long term, because in the end it is there that the largest movements occur. In addition, you can enjoy a much better quality of life when you are a long term trader. A lot of short term traders will dream of enjoying great freedom, but then spend the entire day sitting slavishly in front of the screen. Besides, the more short term your time horizon is, the more difficult things tend to become: The general level of stress will increase, you will need to watch your trades more often, and the impact of algorithmic high frequency trading is also increasing. I know that many traders will find trend-following wise, but then want to "optimise" it: better entries, better exits, and so on. However, this will only work to a certain degree without destroying the basic idea. Strategies should be evaluated at most on a daily basis, or even better on a weekly basis – no intraday trading. Experience suggests that the latter, weekly signals, works best.

TRADERS´: What are the essential standards that traders should adhere to when creating a trend-following trading strategy?

Covel: There are numerous ways of implementing a trend-following strategy, so every trader or investor needs to find their own criteria depending on the time horizon chosen,

Trend-Following Strategy

There are several ways of implementing a trend-following strategy. Basically, the strategy goes long in markets that have gone up, and short in markets that have gone down (so-called "Time-Series Momentum"). Specifically, it is in particular the exact parameters that can be varied individually. Since some graphics on the following pages show the simulation results of AQR Capital, we would like to use that as an example to explain their trend-following approach. The investment universe comprises a total of 59 markets from four different asset classes: 24 commodities, eleven equity indices, 15 bond markets, and nine currency pairs. Based on these data, three trend-following strategies were simulated where trade direction (long or short) was selected on the basis of returns achieved over periods of one, three and twelve months.

This will be illustrated by the following two examples: When a market had been up over the last three months, a long position was opened as part of the 3-month strategy. If a market had been down over the past twelve months, a short position was opened in the 12-month strategy. From the three strategies an equally weighted combination was calculated on a monthly basis. This was then adjusted in such a way that the overall portfolio had an annual volatility of ten per cent (hereinafter referred to as "trend-following strategy"). Adjusting the volatility ensures that the risk incurred by the strategy will remain constant over time – regardless of how many markets were tradable at each point in time in the backtest. The period of time studied ranges from 1903 to 2012 with those times when some markets were not available being simulated by each of the remaining number of markets.

their backtest results, and their personal preferences. However, the basic concept is always the same (Figure 1 and 2). In the final analysis, the process of devising a strategy starts with five questions, which to some extent represent the basis for a trend trading approach:

1. Which markets are traded?
2. What are the position sizes?
3. Where will the entry be made?
4. When will the exit be made in case of loss?
5. When will the exit be made in the event of a profit?

TRADERS´: Do you look at charts?

Covel: Look at them I do, but charts should not be overestimated. You use the price to trade, and that means sheer numbers, not the chart. You do not need charts to trade, but people love them nonetheless.

TRADERS´: Have you ever thought about starting your own fund?

Covel: I have indeed, but so far I am comfortable with my success. At some point, there may be the proper constellation of stars aligning where the general conditions are right. But managing a fund definitely has its drawbacks, too. You need to meet regulatory requirements, take care of a lot of paperwork, look after customers, and so on and so forth. It is especially the customers and the fee structure that can bring a lot of pressure to bear on the manager. And if the fund does not collect enough money, the project may soon turn into a loss-making bureaucratic nightmare.

TRADERS´: How did you actually become aware of the trend-following idea yourself?

Covel: That was in 1994 when I read about the turtle trader Jerry Parker in a magazine. He had made $30 million in one year, which made me curious, of course. I was not only driven by the prospect of large sums of money, but rather by the question of how he had acquired the skills required to achieve such a feat. I found it fascinating that it was apparently possible to learn how to trade. Before that, I used to think that, like Warren Buffett, I would first have to master “value”, work at Goldman Sachs and trade on the basis of fundamentals.

TRADERS´: What are the advantages that trend-following investors have over those who trade on the basis of fundamentals?

Covel: The difference is quite simple. As a trend follower I can say: ”I can do that. These are the rules

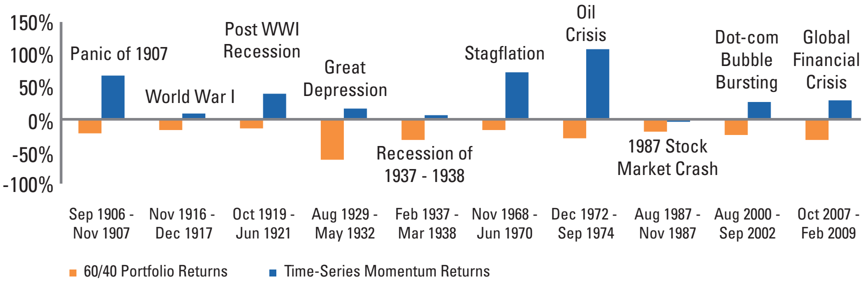
T1) Trend-Following Backtest

Period	Before Fees (annualised)	After 2/20 Fees* (annualised)
Total:		
Jan 1903 - June 2012	20.0%	14.3%
by Decade:		
Jan 1903 - Dec 1912	18.8%	13.4%
Jan 1913 - Dec 1922	17.1%	11.9%
Jan 1923 - Dec 1932	17.1%	11.9%
Jan 1933 - Dec 1942	9.7%	6.0%
Jan 1943 - Dec 1952	19.4%	13.7%
Jan 1953 - Dec 1962	24.8%	18.4%
Jan 1963 - Dec 1972	26.9%	19.6%
Jan 1973 - Dec 1982	40.3%	30.3%
Jan 1983 - Dec 1992	17.8%	12.5%
Jan 1993 - Dec 2002	19.3%	13.6%
Jan 2003 - Dec 2012	11.4%	7.5%

This shows the hypothetical backtest of the trend-following strategy which in the backtest was scaled for a volatility target of ten per cent a year. As far as the returns achieved both before and after fees are concerned, transaction costs have already been taken into account. *2/20 means that a management fee of two per cent and a performance fee of 20 per cent are paid (standard hedge fund fee structure).

Source: Hurst et al, "A Century of Evidence on Trend-Following Investing", AQR Capital Management, 2012

F3) Trend Following vs 60/40 Portfolio



The graphic shows the ten largest drawdowns of a classic 60/40 strategy on the US markets (orange bars) where 60 per cent of the portfolio in the S&P 500 and 40 per cent in 10-year US Treasuries were invested (rebalancing at the end of each month). The blue bars show which returns were achieved by the trend-following strategy during these phases. With the exception of the crash in 1987 when the trend-following strategy recorded a small loss, there were positive returns in all other times of crisis.

Source: Hurst et al, "A Century of Evidence on Trend-Following Investing", AQR Capital Management, 2012

that I have tested and found to be good, so I am going to apply them." But it would be presumptuous of me to claim that I could emulate Warren Buffett's style. His success story is very much linked to the market performance of the last few decades and some fortunate decisions of his, so you can see him as a good example of survivorship bias. Where are the other Warren Buffett's?

TRADERS´: Once you had understood how the Turtles came to be successful, how did you go from there? Were you able to use the trend-following approach for your own benefit?

Covel: I continued to study the subject and learn more along the way, for example from other well known traders like Bill Dunn, who was not one of the Turtles. To this day, I continue learning new things, and enjoy understanding how everything works and is interconnected. Ultimately, trend following is nothing but a concept in order to benefit from the effects triggered by the behaviour of market participants – fear, greed, and other emotions emanating from people and causing markets to be impacted. The markets are, as it were, behavioural economics in action. And that is what you benefit from as a trend follower.

TRADERS´: Did you learn from anybody else?

Covel: Sure, many! A few years ago I started regular podcasts with interesting people from the financial industry or related fields. Among them are many well-known names such as Nobel Prize winner Harry Markowitz (portfolio theory founder), Jack Schwager (author of Market Wizards book series), and Mark Faber (fund manager and author) as well as many famous and successful traders such as Larry Williams, Mark Minervini, Ed Seykota, Jerry Parker, Howard Lindzon, and John Bollinger, but also lesser-known interviewees, such as Nobel winner Vernon Smith and his bubble studies providing very interesting insights into specific areas of expertise. There are more than 240 episodes available on my website with a total of more than two million listens. I continually learn new things not only for myself, but I can also help others develop an understanding of the markets. My podcast allows that.

T2) The 10 Largest Drawdowns

Start of Drawdown (Previous High)	Depth of Drawdown (from High to Low)	Duration of Drawdown (Months High to Low)	Duration of Recovery (Months Low to High)
Mar 1947	-26.3%	21	63
May 1939	-20.7%	13	13
Oct 1913	-15.2%	5	7
Feb 1937	-14.4%	2	8
Oct 1916	-13.8%	6	7
Feb 2009	-13.5%	4	25
Jul 1910	-11.3%	10	19
Nov 1956	-11.2%	4	4
Oct 2001	-10.8%	6	3
Dec 1907	-10.4%	17	14

This shows the ten largest historic drawdowns of the trend-following strategy.

Source: Hurst et al, "A Century of Evidence on Trend-Following Investing", AQR Capital Management, 2012

TRADERS´: One of your podcasts includes an interview with Jack Horner, a US palaeontologist who also worked on the dinosaur film "Jurassic Park". Is there a connection to the markets there?

Covel: Yes, that is arguably the most extraordinary of all my interviews. And there is a bit you can learn from his episode about trading. After all, aren't traders and investors all predators to some extent? Eat or be eaten. So why not study the largest and most dangerous predators of all time? After all, there is something impressive about the skull of a Tyrannosaurus Rex, which is why I have a replica of it in my office.

TRADERS´: Eat or be eaten, that sounds tough for neophyte traders. What do you recommend to someone just trying their hand at trading?

Covel: At the very beginning, their best bet is reading good books that lay the right foundation. Jack Schwager's first two books, "Market Wizards" and "New Market Wizards", are definitely recommended. In addition, there is the work published of Daniel Kahneman and Vernon Smith as well as Jesse Livermore's book "Reminiscences of a Stock Operator". I am also happy to recommend my own book "Trend Following", my numerous podcasts as well as studies available on my website. If you are still confused after reading all that and executing your first few trades, then trading the markets may not be the right thing for you to do. Not everyone is meant to be a trader even though trading is a skill that can be learnt.

TRADERS´: What career would you like to have pursued, if things hadn't moved in the direction of trading?

Covel: The US celebrity chef Anthony Bourdain has had an enviable career. He is constantly invited to travel, cook and eat, which must be a great life. Given the necessary talent and interest, that is something I could well have imagined doing myself.

TRADERS´: Thank you very much for the interview! «

The interview was conducted by Marko Graenitz.

F4) Strong Trends

The figure shows three futures (corn, yen, and coffee) that exhibited strong trends during the period of September/October 2012 to September 2013. It is such movements that favour the trend-following strategy and allow big profits to be made.

Source: www.tradestation.com