As so often happens in my field, it's not the answer that is wrong, but the question. When people ask me how long will trend following trading last? There is no reason trend following should ever stop. Only if markets were to go sideways forever, would trends cease to exist and, therefore trend following cease to work.

Trend following traders respond to what *is* happening in the market rather than anticipating what will happen. One might say that they are aggressively reactive in that they avoid at all costs forecasting and prediction. They base their trading decisions on one piece of core information: The market price. Most traders, on the other hand want news, want CNBC, The Wall Street Journal, crop reports, OPEC rumors and daily doses of Jim Cramer. Why? Because they believe deep down in their gut that all of the "stories" and "data" will help them to make profitable trading decisions.

For trend followers all (and we do mean *all*) fundamental data is like white noise. It couldn't matter less if the market goes up or down because all trend followers care about is price action.

Think about it - what else can you really believe in beside the market price? Or, to quote John W. Henry, "The greatest action, the wisest, the best action that you can take in almost any situation is to stay with what is, instead of jumping to conclusions or trying to come up with conclusions. Just pay attention to what is."

Trend Following v. Systems Trading

Debate over what is and what might be doesn't stop there. Confusion over trend following and systems trading never seems to end. Here is an observation about my book Trend Following:

"A frequent (and valid) criticism of the book Trend Following is that its author often says the word "trend following" when in fact what he means is "mechanical systems trading" in general -- forgetting that there (are) several major classes of mechanical systems, only one of which is trend following."

No, that's not what "its author" means. Trend Following, the book, is about long-term trend following trading. Most trend followers are systematic, but their decision to systematically trade comes only after making the decision to trade as a trend follower. Trend following trading is a style. It is a method based on a philosophy. "Systems trading" on the other hand, means nothing in the abstract unless you define what kind of system it is.

Starting Out

Successful trading is not simply about entry and exit. Most traders spend countless hours working on detailed and specific entry criteria for all the different markets they track. For many of them the entry signal itself is the magical Holy Grail. If you take a sampling of the advertised "best" 'trading systems' you'll find that many simply advocate their own combinations of entry and exit techniques. Unfortunately in the real world life (and trading) is much more difficult.

If you have spent any time in the market then you realize just how hard it is to consistently make money. Reality is that periods of drawdown from trend-less markets, unexpected news releases and large unforeseen events push markets up and down, often violently. Trend following trader or not, your mental discipline is taxed daily.

And on top of that dose of reality, keep in mind that no one can guarantee your profits, whether you start trading with $5000, $500,000 or $5 million! Another wrong question? *What is the right amount of starting capital?* There is no dollar amount too little or too big that allows you to sit back and assume that your starting capital alone is the pivotal key to success. Rather than focusing on starting capital, we suggest you decide *how* you are going to trade. This decision requires answering what we believe to be the right questions, and there are five of them:

1.) How do you determine what market to buy or sell at any time?
2.) How much of a market do you buy or sell at any time?
3.) How do you determine when to buy or sell a market?
4.) How do you determine when you get out of a losing position?
5.) How do you determine when you get out of a winning position?

Most traders answer the third question only. They try to find a method to determine when to buy or sell a market (entry and exit). They leave the other four questions unanswered.. Let's examine just one of the four unasked questions - question two for example. We want to know what is the bet size. How much of our limited capital will we bet each time? It is most likely that this question, question two is the question that separates the Paul Tudor Jones and Bruce Kovners of the world from the weekend warriors and Jim Cramer Mad Money fans.

Most of the systems and methods you find on the market trade an entry and exit technique on a one lot basis. Each signal is traded using one contract. Even those which were ranked and evaluated by so called independent testing authorities only test on a one contract basis. So in theory a $10,000 account would trade the same as a $1,000,000 account – both would trade a single contract on each signal. However, if the million-dollar account traded only a single contract, it would be significantly de-leveraged. It would be risk averse to the point of being a different system all together!

While reading this you may say, "Well I would obviously trade more contracts if I started with more trading capital." Really – then how many? Ten times the amount used for a

$10,000 account? Maybe 100 times more? You are just guessing if you do not have a mechanical way to quantify the number of contracts.

For example, many trading systems use what is called a fixed dollar stop – meaning they use a similar dollar amount (i.e. $500) for each stop. More sophisticated trend following systems have a stop method calculation based on some parameter or trade pattern which could vary depending on market conditions. What they lack is a calculation routine that adjusts the number of contracts traded against the appropriate risk amount set for each market in the portfolio. Money management or bet sizing is not simply about your stop placement!

For example, assume your system signaled an entry into the markets below.

Market	Action	Risk in Dollars
Corn Futures	Buy	$500
Treasury Bond Futures	Sell Short	$1,500
Exxon Single Stock Futures	Buy	$325
Yahoo Single Stock Futures	Sell Short	$425
Euro Dollar Futures	Buy	$250

Assume you started trading with a hypothetical $50,000 account. Most people's definition of a trading system would assume a one-contract 'unit' size for each market. Taking one contract in each market leaves you favoring the Treasury Bonds more than any other market. You are willing to risk more dollars on this market than any other market in the portfolio. Is this what you want? Does this feel logical to you?

Consider this chart instead:

Market	Action	Risk in Dollars	Risk to equity
Corn Futures	Buy	$500	1%
Treasury Bond Futures	Sell Short	$1,500	3%
Exxon Single Stock Futures	Buy	$325	.65%
Yahoo Single Stock Futures	Sell Short	$425	.85%
Euro Dollar Futures	Buy	$250	.50%

A more sophisticated method of calculation would spread risk evenly across all markets so no one market is favored. How do you do this? First, set the maximum risk per unit equal to risk of the market with the largest dollar risk. (It is important in real time trading to maintain a dollar risk that is very small in portion to your trading capital – perhaps 2-5%. Doing so will ensure you will have enough capital to return to the market in a worst case scenario.) In our example it is the Treasury Bond Futures and the risk in dollars is $1,500. Then divide each of the other market's risk in dollars into the largest dollar risk. For example, Corn would be $1,500/$500 or 3 contracts. This calculation determines the number of contracts to trade and adjusts each market to equal the risk of the market with the largest risk. We recommend rounding down when determining contract size, i.e. 2.70 becomes two contracts not three. If you use three contracts then you've exceeded the risk of your largest market.

Consider a recalibrated bet sizing:

Market	Action	Single contract Risk in Dollars	Adjusted number of contracts	Adjusted risk	Adjusted Risk to equity
Corn Futures	Buy	$500	3	$1,500	3%
Treasury Bond Futures	Sell Short	$1,500	1	$1,500	3%
Exxon Single Stock Futures	Buy	$325	4	$1,300	2.6%
Yahoo Single Stock Futures	Sell Short	$425	3	$1,275	2.6%
Euro Dollar Futures	Buy	$250	6	$1,500	3%

Here you are not favoring any one market, instrument or stock. Risk is equally spread across all markets. Why does this matter? Let's hypothetically assume that your Corn, Exxon and Eurodollar positions made money while the Bond and Yahoo positions lost. Also, assume that each winner made 1.50 times your initial risk. When you compare the results of the two portfolios you see the dramatic importance of spreading risk across a portfolio.

Trade Results based on a single contract on each signal at 60% accurate

Market	No. Contracts	Winner/Loser	Profit/(Loss)
Corn Futures	1	Winner	$750.00
Bond Futures	1	Loser	($1,500.00)
Exxon Single Stock Futures	1	Winner	$487.50
Yahoo Single Stock Futures	1	Loser	($425.00)
Eurodollars Futures	1	Winner	$375.00
Total		**3/5 Winners**	**($312.50)**

Although the system was 60% accurate (3 of 5 markets won) the system still lost money.

Trade Results based on a risk adjusted number of contracts at 60% accurate

Market	No. Contracts	Winner/Loser	Profit/(Loss)
Corn Futures	3	Winner	$2,250.00
Bond Futures	1	Loser	($1,500.00)
Exxon Single Stock Futures	4	Winner	$1,950.00
Yahoo Single Stock Futures	3	Loser	($1,275.00)
Eurodollars Futures	6	Winner	$2,250.00
Total		**3/5 Winners**	**$3,675.00**

At 60% accurate the system made $3,675, a sharp contrast to a single contract allocation on each signal.

What would happen if the system was 40% accurate instead of 60% accurate? Instead of three markets winning out of five what would happen if three of five lost money?

Trade Results based on a single contract on each signal at 40% accurate

Market	No. Contracts	Winner/Loser	Profit/(Loss)

Corn Futures	1	Loser	($500.00)
Bond Futures	1	Loser	($1,500.00)
Exxon Single Stock Futures	1	Winner	$487.50
Yahoo Single Stock Futures	1	Loser	($425.00)
Eurodollars Futures	1	Winner	$375.00
Total		**3/5 losers**	**($1,562.50)**

As expected the system lost substantially more than the example above. Now, consider our system at a 40% accuracy clip:

Trade Results based on a risk adjusted number of contracts at 40% accurate

Market	No. Contracts	Winner/Loser	Profit/(Loss)
Corn Futures	3	Loser	($1,500.00)
Bonds Futures	1	Loser	($1,500.00)
Exxon Single Stock Futures	4	Winner	$1,950.00
Yahoo Single Stock Futures	3	Loser	($1,275.00)
Eurodollar Futures	6	Winner	$2,250.00
Total		**3/5 losers**	**($75.00)**

At 40% accurate the system suffered a small loss or basically broke even.

Although these examples are fictional they do demonstrate that if you spread the risk across your portfolio, or equalize risk among the markets that you are trading, your ability to manage drawdowns, or trend-less periods will be improved greatly. You will be better able to weather "bad" markets without blowing through your entire trading capital.

Conclusion

Whether you are a trader or investor, ultimately you have only yourself to blame for the decisions you make regarding your money. You have only yourself to blame for asking the wrong questions. You can make winning decisions or losing decisions - it's up to you.

Amazingly, the rules and discipline needed to be a great trend following system trader are still unrecognized by mainstream media and the public at large. If anything the great trend followers' exceptional performance over many decades continues to be misinterpreted, maligned or just plain ignored.

The market is a brutal place. You have to be prepared for ups and downs in your account. You have to ask the right questions. Sound hard? Well, great trading is hard!

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