



System Traders Charge through Bear Markets

August 2009

By Michael Covel

The vast majority of investors use fundamental analysis for their investing decisions. They are the academics, brokers, bankers, analysts, college students, weekend warriors and Jim Cramers of the world who failed to plan for the stock market, real estate and credit bubbles of 2008 and 2009. Millions felt confident of so many rosy fundamental projections that they rode bubbles straight up and straight down with no clue when to exit as those bubbles finally burst. Many today still hang on, hoping everything will come back to “normal.”

One of the great traders of the 20th century, Ed Seykota, nailed the problem with that wishful thinking: “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.”

Don’t we all know an investor who is waiting for his or her market to come back? Don’t we all know an investor hooked to Ben Graham’s dollar cost averaging advice? And now we all know in our guts how wrong it was to invest based on forecasts, predictions and fundamentals. That stuff only works if you live forever.

IT’S DIFFERENT NOW

Look, the world changed in October 2008. Trillions of dollars were lost through a long-held belief in buy and hold. The Dow, NASDAQ and S&P 500 indexes fell like stones, and some of the biggest fundamental names crashed and burned. Nearly everyone has felt the ramifications: retirement accounts wiped out, jobs lost, firms going under and fear all around. Consider, for example, these panicked investors buried in GM investments, as reported by The Wall Street Journal, April 11:

- Marjorie Holden paid about \$40,000 for General Motors Corp. bonds, with interest ranging from 7.4 percent to 8.4 percent. Now the bonds are worth just under \$10,000.
- Bob Pandolfi, 68, a retired stockbroker from Staten Island, N.Y., saw his 1999 \$50,000 investment in GM bonds plunge to one-tenth of that.
- Harley VanDeloo, 69 bought \$20,000 in GM bonds a year ago. These are now valued at less than \$3,000. VanDeloo said, “I thought GM was too big to fail.”

Worse? FundAnalyze.com reports that in the past 10 years, for the largest 10 mutual funds (i.e., Fidelity and all the biggies), investors spent \$21 billion in mutual fund fees only to see stocks go up and then right back down. The mutual funds were paid all this money to perform, but failed to deliver when these baby boomers were ready to retire (see Figure 1).

FIGURE 1: Stock Funds with the Largest Advisor Fees

STOCK FUND	10-YEAR PERIOD	STOCK-PRICING FEES (BILLIONS)
FIDELITY MAGELLAN	1999-2008	\$3.70
FIDELITY CONTRAFUND	1998-2007	\$3.00
AMERICAN CENTURY ULTRA	1999-2008	\$2.30
PIMCO TOTAL RETURN	1999-2008	\$3.00
AMERICAN FUNDS INV CO AMER	1998-2007	\$1.54
FIDELITY GROWTH AND INCOME	1999-2008	\$1.56
AMERICAN FUNDS GROWTH FND AMER	1999-2008	\$2.10
FIDELITY LOW-PRICED STOCK FUND	1999-2008	\$1.66
AMERICAN FUNDS EURO-PACIFIC	1998-2007	\$1.74
FIDELITY DIVIDEND-GROWTH	1999-2008	\$0.80
TOTAL		\$21.40

Source: FundRazr.com

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WHO WERE THE WINNERS?

The press is always fascinated with the losers, those horrible stories of grandma losing her life savings or some random nonprofit firm getting mixed up in a Bernard Madoff scam. One would assume no one made money during this awful time. But there were some big winners in 2008, and they made money in a unique, honorable and fair manner.

How well did the winners do? During October 2008, for example, some traders made fortunes ranging from 5 percent to 40 percent. Many made more than 100 percent overall in 2008. The winners were systematic traders. Take a look at these results from the April 2009 article "The Top 25 Highest Earning Hedge Fund Managers" from Institutional Investor:

- David Harding's \$5.5 billion flagship Winton Futures Fund increased 21 percent.
- Most of Ken Tropin's and Graham Capital Management's funds earned double-digit returns, ranging from 20 percent to 52 percent.
- "Last year [Christian] Baha's Quadriga Superfund U.S. portfolios generated 30 percent average returns. ... [Superfund] was generally short global equity indexes and long many bond markets. In the first half of the year, it was long corn, gold, oil, soybeans and wheat and then shifted strategy, shorting many of those commodities."
- "Bill Dunn ... generated a 19.4 percent net annualized composite return since he launched his original trading program in October 1974. ... His \$168 million World Monetary and Agriculture program, founded in 1984, was up 51.5 percent last year."

HOW DID THEY DO IT?

First, let me state how they and other traders did not make money:

1. They did not know stock markets would crash in October 2008.
2. The traders did not make all of their money from shorting stocks in 2008.

What did they do? They made big money in many different markets from oil and bonds to currencies, stocks and commodities by systematically following trends up and down without using fundamental analysis to guide their buy and sell decisions.

Unfortunately for most people, the markets have long been positioned as action oriented. Do something. React to the latest news. Call one's broker. Listen to an analyst. All of these discretionary activities hinge on short-term human judgments for what to do next all at the expense of any cohesive, long-term plan to make money.

The need to exercise some type of human judgment drives the majority of market players. But what does all this action do for traders if their No. 1 goal is to profit from the market and avoid losing their life savings right before they are ready to retire? The short answer: not much. But there is hope.

TRADING SYSTEMS

The best traders are systematic traders. Their rules of buying and selling are written. Once they establish their rules, assuming they are based on sound trading rationale, traders follow them religiously.

What happens if a news story or some new economic numbers break? If the news is not part of the trading system, the trader does nothing. What happens if he or she loses 5 percent in one day? If the rules say to exit, the trader takes the loss and gets out—no questions asked. Consider these bits of wisdom from noted old pros:

- “We have a pretty strict definition of a systematic trader,” Michael Garfinkle of Commodities Corp. says. “They basically follow a set series of rules, established in a computer program, that tell you when to buy or sell, how many, as well as when to get out.”
- “Well, it may sound odd for someone who has written books about trading to say this, but I really don’t enjoy the process of trading,” Jack Schwager, money manager, says. “And by that I mean the actual decision making while the markets are active. Do I buy? Do I sell? Do I add to my position if it’s going against me? Do I get out? Do I double up? All that churning turmoil, emotional turmoil is something that I don’t particularly enjoy. What I do like is the puzzle element of it. Trying to solve the market puzzle. How can you come up with a set of rules that can ... ‘beat the market’? And that’s what I find fun. So I decided a while ago that the best course for me was to get out of the decision-making process and automate the whole procedure through system trading.”

The American Heritage Dictionary defines a system as “a set of interrelated ideas, principles, rules, procedures, laws or the like.” Systematic trader Bob Pardo has noted that the key words are “interrelated” and “rules.”

A trading system is a set of interconnected, mathematical formulae that can range from the simple to the extremely complex. The express purpose of these formulae is to provide buy and sell entry and exit points—or signals—for the purposes of automatic or mechanical trading. That is, trading without human judgment or intervention.

SYSTEMS ARE BETTER

Trading systems are superior to fundamental investing for several reasons. Here are a few:

- The elimination of human emotion and failure of judgment.
- Consistency.
- They greatly extend the number of markets that can be effectively traded.
- Predictability of performance: their profit expectancy and risk can be calculated and anticipated with a reasonable degree of confidence, according to Pardo Capital Limited.

THE REAL GOAL

“The purpose of trading is to produce profits, not to be ‘right,’” Robert Pardo writes in *The Design, Testing and Optimization of Trading Systems*. “The main reason a trading system helps to achieve that goal is due to systems’ quantifiability, verifiability, consistency, and objectivity.”

Writing rules is a key part of a good trading system, but the automated way of investing has a strong philosophical backbone. Systems traders understand deep down that life is a balance of risk and reward.

I have long saved an excerpt from the 1989 University of Georgia commencement address from Charles S. Sanford Jr. that echoes a credo of systematic traders:

“In the conventional wisdom, risk is asymmetrical: It has only one side, the bad side. ... This conventional view of risk is shortsighted and often simply mistaken. ... Successful people understand that risk, properly conceived, is often highly productive rather than something to avoid. They appreciate that risk is an advantage to be used rather than a pitfall to be

skirted. Such people understand that taking calculated risks is quite different from being rash.

“This view of risk is not only unorthodox, it is paradoxical—the first of several paradoxes that I’m going to present to you today. This one might be encapsulated as follows: Playing it safe is dangerous. Far more often than you would realize, the real risk in life turns out to be the refusal to take a risk.”

DEAL WITH RISK

Life is fraught with risk. No one can get away from it. However one tries to control the direction of his or her life, an individual will fail at times. And believe me, failure is part of great trading.

Systematic traders, for example, deal with failure every day by having precise rules to either stay on board a profitable trend or exit a trade with a loss. Bottom line, traders cannot avoid losses, but they can deal with them effectively through the use of trading systems by allowing traders not only to win but to preserve capital during trendless periods.

If traders do not want to think and act like this, what other options do they really have? Money under a mattress does a trader no good. Buy a house? The house could burn down or the real estate market might tank like it did in 2007-'09. One could invest in one's company stock, but if the company fails, the investor loses a job and a nest egg all at the same time. An investor could buy mutual funds and then pray that the empty mantra of “buy and hold” will start working again and that he or she won't face a bear market at age 65. But 2008 fried that idea!

How should one proceed in the face of risk? Begin by accepting the fact that markets do not reward stupidity and/or ignorance in the long run. They reward those with the brains, guts and determination to find opportunity where others have overlooked it. The winners press on and succeed where others have fallen short and failed. This is not easy, but the choices as I have outlined are stark.

How can traders begin to put themselves in the world of systems trading? They should start by asking these core questions:

- What is the market opportunity in the market niche?
- How big is the opportunity?
- How does one make money?
- How does one reach the market and sell?
- What is the competition?
- How is one better than the competition?
- How will one execute and manage the business?
- What are the risks?
- Why will one succeed?

It is important to answer these questions precisely to assess the risk of a business venture, and it is equally important to answer them if one is going to trade using systems.

FOLLOW THE PATH

At the end of the day, systematic trend followers do not worry about what the markets are going to do tomorrow. They don't concern themselves with forecasts, fundamental factors or technological breakthroughs. Systematic traders cannot undo the past or predict the future. Does a 50 percent drop in stocks mean the bull has finally run its course? No one knows, and that is why traders need rules every day that spell out which steps they will take before

they ever enter a market.

For me, the most striking lesson I have learned about systematic trend following during the past decade is that so many people have simply never heard of it, or if they have, they either can't or won't wrap their arms around it. I can understand that.

For 25 years, Wall Street has plowed millions upon millions of investors into buy-and-hold mutual fund nonsense. When that bubble burst, fear and confusion should be expected. Sadly, financial literacy is at a low point.

However, people have the ability to change how they think and act. The early developers of systematic trading have laid the foundation for all of us to see through the lens of their wisdom and performance. Traders just need to act to take advantage of that trail blazing.

Michael Covel is the author of two books, Trend Following and The Complete Turtle Trader. Both books cover the subject of systematic trend-following trading. Covel's new documentary film "Broke: The New American Dream" was released in June 2009 and features top systematic traders.

SFO Magazine Article from:

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