After several tough years, trend followers again are earning outsized returns. Is this just a prelude to a massive letdown, or will trend following enter another golden age?

Meet the new boss, same as...

BY DANIEL P. COLLINS

It is an argument that has been going on as long as there have been trend followers and as long as there have been drawdowns. Does trend following really work? Have markets changed, making trend following a less effective strategy to manage money?

The answers invariably come back "yes" and "yes" and "so what?" Long-term trend following is the heart and soul of managed futures, started by such pioneers as John W. Henry, Keith Campbell and William Dunn. Since then hundreds of managers have followed, copying it, attempting to improve it and/or going in a different direction.

But markets go through cycles and certain strategies perform better or worse in these various market cycles. Every time one of these tough periods occurs, people ask if trend following is dead. These questions are legitimate because markets do change.

Trend followers were in the midst of their fourth subpar year in the summer of 2007 when the subprime crisis exploded, causing massive dislocations in financial markets, usually a good sign for managed futures in general and trend followers in particular.

Prior to the turnaround, the Barclay CTA Index was near an all-time low based on a rolling three-year return (see "A rough patch," right). It has recovered and is now showing one of its stronger performance stretches (see "Impressive recovery," right). But the index, which in the past had been a solid proxy for long-term trend following, now has many more diverse strategies. Looking at pure trend followers indicates a more impressive pop. John W. Henry's Financial & Metals program has returned 28.4% since September, and the Dunn Capital Management's (DCM) WMA program has earned 93% since September, even with a -10% March.

Charlie Wright, principal of Fall River Capital, believes markets have changed. "It goes in cycles. Trend following comes in and out of favor," he says.

Wright says he got a lot of flack within the industry when he suggested that there was a fundamental shift over the last few years. "I am convinced that between 2003 and 2005 there was a fundamental shift. The methods used in 1980 with a big portfolio of non-correlated markets were no longer working as well," Wright says.

He sees it as more than just a period without trends. "It was a major fundamental shift. You could see it in the performances. Our research shows that there has been a progressive increase in correlation of volatility."

Wright says that in the past, long-term trend followers could do well with a couple of huge trends in non-correlated markets, but what had happened is that volatility itself was correlating, making it difficult for trend followers to produce consistent returns. "There are volatility correlations between markets more so than before, which is a huge problem for trend followers," Wright says. He says there are three ways to deal with that correlation: use multiple models, develop additional price streams and use mathematical algorithms.

MULTIPLE MODELS

One of the changes we have seen in managed futures is the growth of managers using different models and time frames. This occurred in earnest earlier in the decade following the last poor performance period for trend followers.

Multiple models allowed for CTAs to profit in different market environments and to match some of the strong returns of trend following with lower volatility. Managers were adopting more counter-trend techniques and using multiple time frames.

Still, some of the solid trend followers stuck to their guns and when the difficult period from 1999 to 2001 ended these managers produced some of their best years.

Bill Dunn built his successful CTA on the belief in long-term trend following. But after his worst performance stretch, Dunn initiated changes in his program. Those changes, he insists, were not in reaction to recent performance as much as a long-term approach to the markets.

"We looked at ourselves when [markets weren't trending]. We decided to look at the way we did things. In the past we were able to enjoy long-term trends to offset the periods of churning [markets]. We found that there were relatively few trends from 2004 to 2006. There weren't a lot of long-term trends as opposed to 10 or 15 years earlier," Dunn says.

"Now we are seeing some significant trends that are lasting and being a long-term trend follower, we get to keep the profits."

DCM added grain and softs markets to its portfolio and added trading models. "Softs are getting quite liquid. We trade 52 markets instead of just 26, that gives us a lot more diversification. We changed from trading three different models to over 20 different models," Dunn says.

Dunn, however, did not change the underlying long-term trend-following approach. While some managers mix short-term and medium-term models and include countertrend methodologies, Dunn's various models still fall in the long-term trend-following camp.

"We are fine tuning," says Dunn, who notes the length of their trades still range from six to eight months. "Each model is independent of the other; some indicators have different parameters to determine entries and exits. They are all cousins," he adds.

One key is the additional markets. We have noted here that diversified trend followers with allocations across the full spectrum of futures markets have outperformed the larger managers with concentration in financial futures.

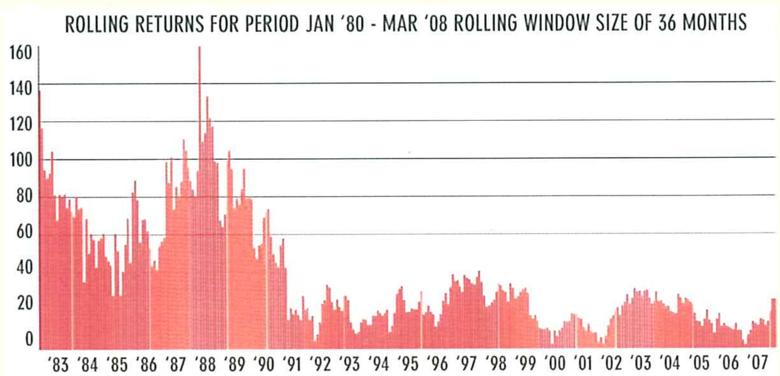
Dunn was able to add markets for two reasons, one good and one bad. Their money under management dropped after the difficult performance period, opening up markets that the program had grown too large to trade. Also, the onset of electronic markets and the commodities boom dramatically increased the capacity of many physical commodity markets.

At one point, the program only allocated to financial futures and energies, but now there is roughly 30% allocated to physical commodities.

Richard Bornhoft is chairman and chief investment officer of Equinox Fund Management, which operates the Frontier funds. He says multiple model CTAs tend to perform better and that

A ROUGH PATCH

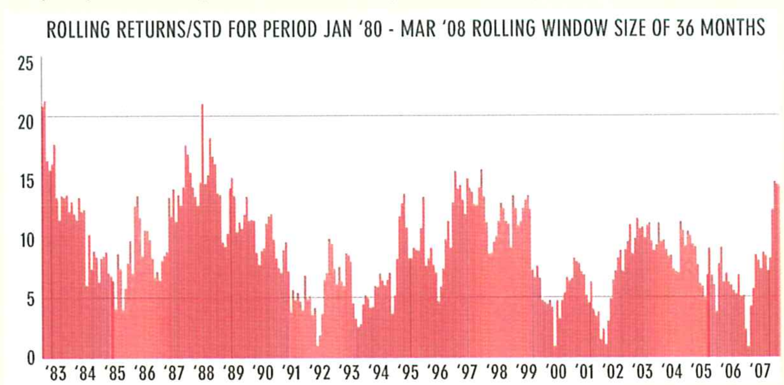
The period ending in the latter half of 2007 was the worst three-year period for the Barclay CTA index in its nearly 30-year history.



Source: Barclay

IMPRESSIVE RECOVERY

When looking at the same period and considering standard deviation, it still shows the end of a poor performance period, but also an impressive recovery.



Source: Barclay

SMOOTHER RIDE

Changes initiated by Abraham Trading Co. provided a smoother return stream.

	Compound annual return	Annualized STD	Sharpe ratio
Jan. 1988 to Dec. 2005	22.40%	36.61	0.49
Jan. 2006 to present	19.74%	12.87	1.18

diversification is an important reason.

Frontier offers individual and multiple advisor public pools. An advantage to his multi-manager approach is that they can gain a greater diversification across markets. If Frontier allocates to a larger trend follower with a high concentration in financial futures, they can add several smaller ag-based managers to cover their bases.

While Bornhoft sees the value in long-term trend following, he says that systems with multiple models tend to outperform others. "A common denominator among successful managers is multiple models. They are looking for trends, different models, different time frames — they may even mix in some other [strategies] if that evolution continues," he says.

One of the long-term trend-following stalwarts that performed well during the mid 2000s thanks largely to a significant allocation to physical commodities was Abraham Trading Company. But at the beginning of 2006, Abraham added multiple models and he wasn't just fiddling around the edges, as they added countertrend methods as well.

Shaun Jordan, director of marketing for Abraham, says, "We have become a multi-strategy CTA. Trend following is still a significant portion of what we do, but we have added mean reversion, countertrend and multiple time frame strategies that have allowed us to profit in areas we had not before."

Abraham's target returns are the same but they are attempting to do it at half of the standard deviation (see "Smoother ride," above)."We have seen dramatic improvement in that area," Jordan says. "It is not that we feel trend following is dead, it still is a significant portion of what we do. However it is a strategy that, when it is traded alone, is harder to sell."

Salem Abraham is on the investment committee of the St. Jude Children's Research Hospital and this gave him a perspective as to what asset allocators said about him when he was not in the room. He learned that many allocators simply look at Sharpe ratios and standard deviations and run from long-term trend followers.

"We did this because it is a way to generate the same returns with lower volatility," Jordan says.

Michael Stivala, a portfolio manager for MKP Global Futures, has spent a decade in managed futures and has built trend-oriented strategies.

His current strategy incorporates trend following with other approaches. "We are grounded in it," Stivala says.

Stivala began his career in managed futures working for Commodity Corp. and believes in the trend following concept. Stivala points out that different market environments provide better and worse environments. "You have tough cycles and people who manage these tough cycles better are the ones who outperform. What allows you to stay in this business is how you perform in difficult periods."

And that seems to be universal. Trend followers whose risk management procedures allow them to limit drawdowns during tough periods tend to survive.

"I am a big believer in CTA programs of all types," Stivala adds.

Dunn always has taken a long-term approach to markets. For those people who say that there has been a fundamental change in the markets that makes trend following no longer viable, he says, "it is possible that they are right but I haven't seen any evidence of it. What we are doing is the best thing I know how to do based on the past. A great deal of what will happen in the future will look like the past but there is no way to know the future."

WHAT NEXT

While the short answer to explain bad performance periods for trend followers is always the lack of long-term trends, many trend followers had strong recoveries in 2007, while others still struggled. Trend followers need trends. Often they will earn huge returns in a couple of markets. So the more markets they trade, the better their chances of success are. As one trend follower put it, "we throw a lot of nets out hoping to get one or two big hauls."

During the 1990s, some of the more successful trend followers took in huge amounts of money causing them to eliminate less liquid markets, making them less diversified.

The growth of liquidity in physical commodity markets allows for sustained diversification and the success of alternative strategies means that CTAs will not be trying to enter markets at the same time.

Trend following is no longer sexy and perhaps it never was. In a sense it is a matter of taking what the market gives you and earning extra around the edges: getting in a little earlier, getting out before the correction and taking profits off the table before a reversal, as opposed to predicting where the market will go, which is more difficult.

Most CTAs we talk to, particularly in the trend following space, say that their entry models are pretty basic and not a matter of huge proprietary pride. It is the risk management imbedded in a program that allows them to ultimately succeed. That figures to remain true in the future, or as Dunn concludes, "Trend following is not dead. I am having a good time and so are my clients." FM