



StreetWatch
brought to you by:



imagination at work

**BEFORE
AND AFTER
THE BELL**

**EXPERT MARKET COMMENTARY
FROM THESTREET.COM'S TOP ANALYSTS**

see today's videocast now →

James Altucher

No Bull Market in Trend-Following

By [James Altucher](#)

RealMoney.com Contributor

5/23/2005 1:05 PM EDT

URL: <http://www.thestreet.com/p/rmoney/jamesaltucher/10224829.html>

Market Commentary

- Trend-following hedge funds have struggled thus far this year.
- John Henry's funds have reached a new maximum drawdown, according to iasg.com.
- Dunn Capital has had four losing months on the heels of two losing years.

While everyone has been proclaiming the death of convertible arbitrage, trend-following, another popular hedge fund strategy, has brought losses that make the convertible blowups pale in comparison.

Consider: Convertible arb funds, which buy convertible debt and short the underlying stock to lock in a high yield without much risk, typically have shown extremely low volatility and have enjoyed 10%-20% annual returns or more in their good years. This year, depending on which hedge fund index you look at, these funds are down anywhere from 3% to 10%. That's a horrible beating for this low-volatile strategy but nothing that's going to shake up the global economy.

Meanwhile, the flashier trend-following strategy is perhaps on its last legs, just four full months into the year. (I call it "flashy" because retail traders everywhere have adopted the marketing slogan of the trend-following hedge funds: "The trend is your friend.")

The basic philosophy of trend-following is that somewhere in the world, among all the stock and commodity indices, there are markets that are trending upward. If you catch those trends, you can make many multiples of 100% -- a great example being those who caught the **Nasdaq** trend early in the '90s and rode it.

Trend-followers like to say they "ride their winners and cut their losers." Using price and volume data, a trend-following fund will enter into a position when some metric confirms that a trend has started. For instance, a possible metric is when the 50-day moving average of a market closes higher than the 200-day moving average. Then, at various points along the way, they will use leverage to expand the size of their position whenever more trend-confirming metrics occur.

For instance, they start if the market reaches a three-month high, then add if it hits a six-month high, and again at a nine-month high, etc. Then, when the trend really picks up steam, the trend-follower is ideally in his max position.

The strategy works if they can cut losses quickly and stay out of the way of trendless, "choppy" markets. Some of the well-known trend-following funds are John Henry's funds and Dunn Capital Management.

John Henry, owner of the World Champion Boston Red Sox, is having a rough start this year. Iasg.com has the results of Henry's Original program, which he started in 1982. So far in 2005, the program is down 36%, putting him in his worst drawdown ever, a drawdown of 54%.

John W. Henry Original Invest Program

His team's a winner, but recent results for his fund are less cheery

	Monthly Performance												YEAR
	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	
2005	(19.00)	0.59	3.88	(25.11)E									(36.61)
2004	8.01	14.11	(2.94)	(9.24)	(7.85)	(15.05)	(1.29)	(0.10)	10.22	22.25	5.25	(16.09)	(0.26)
2003	22.39	8.21	(9.27)	0.53	0.83	(14.08)	4.36	5.63	(14.56)	(15.69)	8.60	4.71	(5.50)
2002	(0.04)	0.02	(9.20)	1.81	5.11	14.73	10.74	6.30	11.08	(7.82)	(8.10)	(1.59)	21.50
2001	(3.18)	(4.41)	17.44	(14.34)	0.69	(9.23)	(3.31)	3.69	6.35	2.49	(12.36)	2.10	(16.79)
2000	5.96	1.44	(4.90)	(6.68)	(5.13)	(2.73)	(3.31)	5.37	(10.15)	1.57	17.29	7.74	3.43
1999	(3.88)	5.11	(2.22)	5.98	(2.84)	2.14	(2.27)	0.59	(3.78)	(11.36)	4.63	(2.06)	(10.73)
1998	(1.30)	2.22	(4.10)	(0.52)	4.41	1.68	(3.97)	3.96	2.65	5.21	(12.82)	15.37	10.81
1997	3.42	0.21	1.63	0.50	1.10	(4.43)	2.05	(0.80)	(5.99)	3.59	0.00	4.86	5.73
1996	5.28	(7.35)	1.02	3.84	(6.48)	7.99	(4.36)	(2.33)	8.24	10.37	5.19	1.11	22.65
1995	2.16	17.87	16.58	9.09	(4.43)	1.65	(0.03)	(3.89)	(3.93)	3.25	1.15	6.84	53.23
1994	(2.95)	1.53	4.36	0.21	5.53	6.64	(7.15)	(4.73)	(2.83)	(14.11)	10.21	(0.04)	(5.68)
1993	(0.75)	9.54	(3.50)	10.36	0.12	(4.05)	14.92	(3.65)	0.63	(1.53)	3.45	11.40	40.64
1992	(6.12)	(8.79)	0.72	(0.84)	(4.46)	8.27	9.09	9.12	(2.75)	2.24	3.61	2.19	10.86
1991	(0.48)	0.30	(2.07)	(5.76)	4.40	(0.73)	(7.38)	(3.60)	10.74	(3.91)	(1.26)	17.71	5.43
1990	7.12	(2.04)	18.42	12.37	(10.93)	7.17	10.94	19.11	(2.12)	(1.90)	0.98	(2.32)	66.82
1989	0.80	(19.91)	11.70	(5.09)	28.97	(3.86)	8.08	(13.66)	(13.25)	(11.97)	7.35	9.82	(10.85)
1988	(6.90)	4.65	(16.05)	(5.10)	3.60	13.90	(19.80)	(4.30)	6.35	(2.45)	1.64	(12.53)	(35.16)
1987	8.99	3.65	2.66	21.91	0.75	(3.54)	8.84	(3.13)	(10.40)	35.80	16.48	11.93	129.81
1986	(4.39)	22.22	15.44	(5.83)	(2.78)	(2.13)	11.51	7.19	(2.86)	(10.25)	(1.94)	(2.98)	19.83
1985	2.43	0.88	(8.81)	(17.11)	11.00	4.37	16.80	1.74	(15.51)	9.57	7.36	18.62	26.77
1984	5.53	(4.81)	(7.54)	(2.09)	16.55	(10.30)	28.69	(9.03)	15.98	(5.24)	(2.18)	12.54	34.66
1983	14.36	(28.56)	1.63	4.86	8.27	(9.61)	10.91	13.41	(7.31)	(3.28)	(6.40)	(2.54)	(12.35)
1982										7.11	(16.85)	2.71	(8.52)

E = Estimated
Source: iasg.com

Dunn Capital is also having a rough patch: down 27% year to date, with losses in all four months. The fund has seen assets for its original WMA program go from a peak of about \$1.2 billion to around \$600 million currently,

Dunn Capital Management WMA

The rough start to 2005 comes after double-digit losses the preceding two years

	Monthly Performance												YEAR
	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC	
2005	(4.09)	(6.72)	(4.04)	(15.01)E									(27.04)
2004	(2.86)	8.38	2.90	(18.35)	(6.84)	(9.86)	(5.16)	9.29	1.58	7.93	5.32	(0.69)	(11.71)
2003	6.94	13.83	(22.44)	1.57	9.45	(8.07)	(4.75)	16.70	(7.63)	(4.23)	(4.45)	(4.47)	(13.40)
2002	3.03	(8.07)	2.39	(5.71)	5.41	24.24	14.82	10.50	9.10	(12.27)	(12.70)	21.34	54.05
2001	7.72	0.55	6.26	(8.96)	(0.91)	(8.31)	0.09	6.47	1.13	20.74	(23.52)	6.73	1.12
2000	6.90	(2.90)	(17.30)	(12.40)	(7.60)	(3.90)	0.56	3.29	(9.70)	9.12	28.04	29.39	13.22
1999	(13.20)	3.90	4.20	4.10	7.60	9.60	0.50	5.80	3.60	(7.00)	1.30	(5.50)	13.14
1998	4.20	(5.30)	4.00	(11.00)	(4.80)	(0.40)	(1.40)	27.50	16.20	3.80	(13.70)	0.30	13.67
1997	17.80	(0.20)	2.20	(6.50)	(5.90)	10.40	16.80	(10.20)	6.50	(0.60)	9.80	1.50	44.42
1996	15.80	(13.30)	9.60	9.20	(1.20)	0.60	(12.40)	(5.20)	12.60	20.30	26.90	(7.10)	58.38
1995	0.50	13.70	24.40	3.80	(2.60)	(3.60)	0.60	18.50	(6.50)	10.80	11.20	4.40	98.63
1994	(1.70)	(5.30)	14.90	7.00	5.20	3.30	(13.40)	(17.70)	(4.70)	(1.00)	0.70	(4.20)	(19.32)
1993	3.00	14.00	(3.30)	12.40	3.40	0.90	7.30	8.40	(5.00)	1.60	1.00	6.00	60.04
1992	(14.50)	(0.90)	4.00	(15.10)	(0.40)	13.00	11.40	9.20	(8.20)	(5.40)	(4.30)	(8.10)	(21.77)
1991	(7.00)	(4.50)	10.30	(4.50)	(5.00)	(0.50)	(2.50)	9.90	9.20	(14.90)	1.20	31.20	16.92
1990	23.50	5.30	6.10	6.80	(11.20)	4.00	1.40	2.10	3.80	(0.40)	5.40	(1.20)	51.69
1989	21.10	(4.20)	9.30	6.10	20.00	3.20	8.20	(13.00)	(1.60)	(16.70)	7.30	(5.40)	30.49
1988	0.70	4.30	(6.50)	(2.50)	3.90	(0.60)	(1.80)	(2.70)	2.00	1.90	(0.70)	(16.70)	(18.77)
1987	8.80	(1.80)	7.20	31.60	(2.70)	(4.60)	6.00	(3.00)	5.50	(5.60)	17.80	2.00	72.15
1986	(1.50)	24.50	11.90	(5.60)	(6.00)	(14.00)	(4.20)	12.50	0.60	(2.80)	(6.20)	(0.10)	3.42
1985	6.20	10.00	(7.30)	(13.10)	21.70	(6.80)	(8.40)	(13.50)	(30.70)	6.70	13.60	10.00	(21.85)
1984											(11.00)	18.00	5.02

E = Estimated
Source: Iasg.com

While I agree and understand that one has to risk money to make money, and that drawdowns do occur, the consistent volatility of these systems makes it an untenable strategy, at least for me. These problems are occurring for several reasons:

- The fact that trend-following systems survived the worst years of 2000-2002 made them viable additions to funds-of-funds or institutions looking to hedge themselves in bear markets with an uncorrelated strategy. Consequently, billions got thrown into these strategies, but the underlying capacity of the markets they trade is not

increasing. When \$10 billion worth of hedge funds are trying to change direction quickly in the corn markets, trouble can result.

- It's not entirely clear to me that markets trend. If anything, I'm a believer, and many studies have shown, that markets tend to mean revert. In other words, if they go too much in one direction, eventually they return to their average.

So it seems the trend traders' catch phrases, "Don't fight the trend" and "Add to your winners, cut your losers," could ultimately be the path to volatility, declining P&L and much financial heartache.

James Altucher is a managing partner at Formula Capital, an alternative asset management firm that runs several quantitative-based hedge funds as well as a fund of hedge funds. He is also the author of [Trade Like a Hedge Fund](#) and [Trade Like Warren Buffett](#). At the time of publication, neither Altucher nor his fund had a position in any of the securities mentioned in this column, although positions may change at any time. Under no circumstances does the information in this column represent a recommendation to buy or sell stocks. Altucher appreciates your feedback; [click here](#) to send him an email.

TheStreet.com has a revenue-sharing relationship with Amazon.com under which it receives a portion of the revenue from Amazon purchases by customers directed there from TheStreet.com.
