A Brief History of Trend Following

Speculation has a Multi -century history, perhaps even a multi-millennium traceable record. From Roman coin shortages and those who stockpiled and benefited, through Tulip Mania in Holland in the early to mid 1600's, speculation has existed. It's only really when we get to the great industrial age of the 19th Century that we really start to see speculation as a widely pursued activity and where we get to see well documented evidence of the speculators of the day plying their trade. Much was written of the art of speculation in the 1800's, but unfortunately, much of it related to the great plungers and manipulation pools that existed during that period as these made for great stories – we don't see much written on those who were truly successful and their rules and methods.

In trying to write a brief history of trend following I was trying to look back through several centuries (at least), when I suddenly put things in perspective and realised that most of today's "Wall Streeters" probably consider a trading strategy with a long track record to be 2 years at most. There's me thinking – well I can only really dig out evidence of trend following going back 250 years! Therein lies a great lesson in trend following –history goes back a long time!!!! One should always be very aware of what has happened over the centuries so one does not believe that what has occurred in the last 20 years in financial markets is likely to continue into the future. Most modern day Wall Street participants probably believe a trading strategy with a 2 year track record must always work, or market conditions that have, perhaps, prevailed for a decade mark "the new way". They don't, plain and simple and history is littered with those foolish enough to believe things really ever change where money is concerned.

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The simple reason is that financial markets are driven by primal human nature – i.e. fear and greed – and that has never and will never change.

So back to the history of trend following.

Evidence does exist of early trend following practitioners, but it's hard to really dig into the details when looking back centuries. However a couple of interesting quotes from speculators demonstrating trend following type styles do exist. Consider the trader David Ricardo who made a lot of money in London markets (bonds and stocks) around 1800. Considered a highly successful trader, one of his recorded sayings was “Cut short your losses and let your profits run on” – this being one of the most important rules in trend following. Similarly around 90 years later we get a great quote from Arthur W.Cutten, a Chicago grain trader who famously made spectacular profits, “Most of my success has been due to my hanging on while my profits mounted. There is the big secret. Do with it what you will”.

Hanging on to large profits is, strangely, quite possibly the single hardest part of trading – harder perhaps than taking many small losses. As large profits mount, the emotions play havoc and give seemingly endless reasons to the profiteer as to why he should take the money now!!! In my experience most traders do cut out of winning trades too early and end up letting their losses run – this is perhaps the single biggest reason so many fail in the arena of speculation. Hanging onto large profits is also so hard that it is why so many modern day trend followers systemize their trading rules and take the emotion out of what they are doing. Perhaps Arthur W.Cutten was in fact an iron disciplined 1890 systematic trend follower?

It's not until the early 20th century that we get our first heavily documented and well understood trend follower – Jesse Livermore. Much has been written about the man including many books such as the modern day classic “Reminiscences of a Stock Operator” by Edwin Lefebvre. A similar book – “Jesse Livermore, Worlds Greatest Stock Trader” (Wiley Investment) by Richard Smitten, actually goes some way to listing out his trading rules – astonishingly similar to those used by modern day trend followers, demonstrating how very little has changed over the last 120 years. Here we have clear evidence of one of the most successful speculators in Wall Street history following rules that are used heavily in the trend following community today.

Moving on into the mid-1900 is where things start to become much more documented and modern day trend following systems seem also to have derived much of their roots.

Dow Theory is perhaps the earliest modern day expression of a basic trend following system. The theory, based on the concepts of Charles Dow was articulated in a series of articles in the Wall Street Journal between 1899 and 1902. Dow Theory defines a bull market as a series of higher highs and a bear market as a series of lower lows – what we now call a trend. Further proponents of Dow Theory such as William Hamilton (1903-1929) and Robert Rhea (1932) take things further forwards and we see the concept of buying on new highs and selling on new lows – one type of rudimentary trend following system.

Technical Analysis and Stock Market Profits (Schabacker, 1932), Profits in Stock Markets (Gartley, 1935) and Technical Analysis of Stock Trends (Edwards and Magee, 1948) all herald milestones in the development of trend following systems. Edwards said “profits are made by capitalising on up or down trends, by following them until they are reversed” and all three of these books looked at the concepts of trend lines and buy and sell signals.

Through Dunnigans’ methodologies in the 1950’s we come to Richard Donchian in 1957 and his article “Trend Following Methods in Commodity Price Analysis” which first appeared in the Commodity yearbook of 1957.

Donchian is perceived by many of today’s trend followers as the Godfather of modern day trend following techniques with many of the systems used by money managers in the 21st Century actually carrying his name. Donchian actually laid bare simple rules about buying break-outs such as his 20 day trading rule system and he also developed basic moving average crossover systems – again many fairly unchanged from what are used by many investment managers in today’s markets.

Not only this but Richard Donchian is credited with operating the first real "managed futures / trend following" fund – Futures Inc – in 1948.

We finally end the history of trend following with the "by now" globally famous story of the turtles – a group of students enlisted by Richard Dennis and William Eckhart (2 great futures traders operating trend following trading systems in the 1970's and early 1980's). In a story reminiscent of the film Trading Places with Edie Murphy and eerily, in the same year, 1983, Dennis and Eckhart enlisted a group of novice traders – some with no trading experience at all - via an advert placed in the New York Times. After a two-week training course on using a rudimentary trend following system, each of these novice recruits were given $1 Million in trading capital and told simply to follow the rules of what they had been taught. The Turtles, as they became known (due to Dennis's synopsis that a group of traders could be taught and reared in the same way turtle farms breed and rear baby turtles), went on to make millions in profits before leaving the training program in the late 1980's and going on to become some of the most successful money managers in history – Liz Cheval, Tom Shanks, David Druz, etc. For a full and detailed history of the whole turtle story perhaps read Curtis Faith's (an original Turtle) book – "The Way of the Turtle"- (McGraw Hill 2007) or Michael W.Covel's "The Complete Turtle Trader" (HarperCollins, 2007,2009)

Conclusion:-

The important piece of information to be gleaned and preserved from the above brief history of trend following is very simple but very the reader should be sure to grasp onto it.

Trend following has a history – it goes back centuries – it's the only trading/ investing strategy with such longevity and history and the reason is simple – it's based on human nature- that never changes and it never can. Hence when contemplating investing your hard earned cash in Wall Street's latest "Hottest" Fund – be sure and kick yourself and remember that it is worth investing in a strategy with a multi – century history of success – not an overnight "fad" which will probably only work for a year of two or until recent market characteristics change.