Trend Following: An Alternative to Buy and Hold

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Buy and Hold Nation

Trend following can be a good alternative to the "Buy and Hold" phenomenon that is currently being shown to investors. Many in the financial services industry will tell you that over the long term, Buy and Hold investing will provide you with index-like returns and can beat most active managers. Their philosophy is essentially that there are three steps you should take as an investor: 1) build an asset allocation to manage your risk, meaning deciding what percent to put into the growth portion of your portfolio like stocks or stock funds, and what percent to put into the more stable piece of the portfolio like bonds/fixed income; 2) pick the investments; 3) set it and forget it. This model was built in a lab by academics and neglects to take into account one very important variable: **humans.**

Buy and Hold strategies all assume a rational decision-making process by humans and their ability to stay invested no matter what is happening in the market. It also assumes a time frame of forever. These are two of the fatal flaws of the Buy and Hold approach. Humans have emotions, are afraid of losses, have time horizons a lot shorter than forever, and realistically shouldn't be asked to sit idly by while their nest egg may get cut in half like the S&P 500® Index did in 2000-2002 or 2007-2009.

Finally, ignoring emotions and timeframes becomes even more unrealistic as people pass age 50, and their portfolios are likely growing larger. As investors inch toward retirement, their investing window becomes shorter and they can't afford the risk of starting off their retirement right in front of or even during a 2000-2002 or 2007-2009 type market. The industry calls this "sequence-of-returns" risk. This unfortunate timing would leave an investor watching their retirement dreams get delayed (or worse) if their investments take a large hit. That would literally be a life-changing event.

Fear and Hope

There is a segment of the population that avoids investing altogether because of the gripping fear of a potential bear market on the horizon. Peter Lynch famously said, "People have lost more money waiting for corrections than has ever been lost in a correction". The Buy and Hold model makes no allowance for this fear. Again, because humans have emotions, it's not fair for academics and advisors to dismiss this fear as irrational. Back in the days of "normal" interest rates where an investor could earn ~5% or more in high quality bonds, this was not as big an issue. But in today's low rate environment, having this fear of a future loss can prove to be a real impediment to reaching your goals while investing with such low returns.

Then there is another type of investor who will never let go of hope and chooses Buy and Hold because they refuse to sell at a loss. They think, "If I sell my investments now, I will miss the next big bull market when prices move higher." The Buy and Hold community has driven in the mantra that if you sell now, you will miss the eventual bull market, despite the fact that the losses keep mounting on your holdings. I guess I missed the fine print where it says that if you sell, you can't buy back in. You just need an unemotional re-entry buy rule to get back into the market.

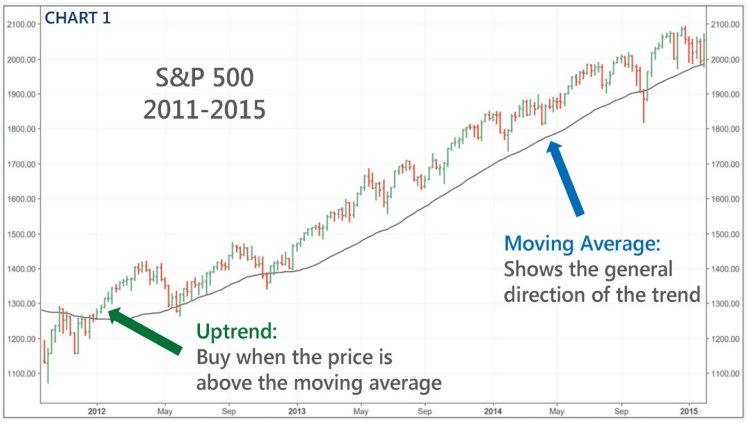
The Trend Following Approach

A better alternative to Buy and Hold is the rules-based, unemotional process of trend following. Trend following takes the approach of staying invested in uptrends when there is less risk present, and getting out of the market in a downtrend when there is more risk. Trend following systems come with built in risk management that includes rules for both the buy and the sell decisions. The rest of this article will break down some components of a trend following strategy, walk through an example of how trend following works and how it could fare in both good and bad markets.

Determine the Trend's Direction

The first step in trend following is to establish the direction of the trend. For purposes of this article, we will be looking at the medium- to longer-term trend. At the core of most trend following models is the use of moving averages. Moving averages are used to smooth out prices and help reveal the direction of the trend. For example, a commonly used moving

average is the 200-day moving average. This simply takes the closing prices of the last 200 trading days, adds them up and divides by 200. This gives you a single data point. The next day you take the newest closing price, drop off the oldest price and you get a new data point. Over time this gives you a smooth moving average line like the ones we see in charts 1 and 2 below.

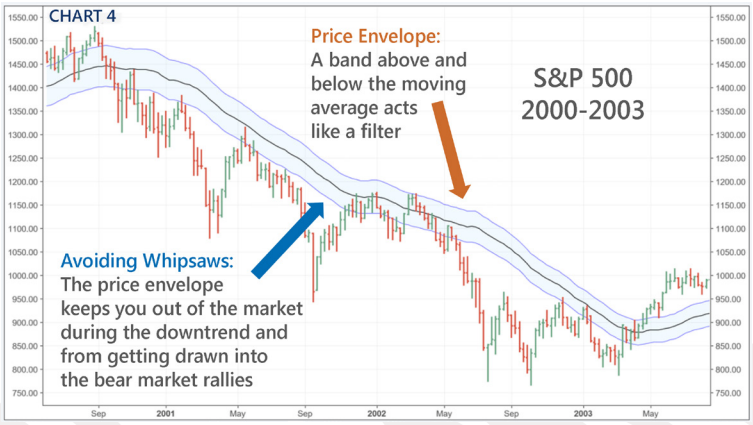


The trend direction becomes fairly obvious by looking at the slope of the moving average, showing if the trend is moving up, down or sideways. But more importantly, a trend following system applies the idea that if current prices are *above* the moving average then we are in a long-term uptrend, or if current prices are *below* the moving average then we are in long-term downtrend. These cross-over points, visible in charts 1 and 2 above, indicate when we are in an uptrend, meaning there is less risk and you should buy or stay invested, or when we are in a downtrend, meaning more risk is present and you should sell into cash.

You may not realize it, but with that one step you have left the emotional world of investing driven by TV pundits and hunches from a neighbor, and entered a rational rules-based investment model.

Minimize Whipsaws

A common issue with this simplistic model is that there are times where prices briefly close below the moving average (triggering a sell) and then quickly move back above the moving average (triggering a buy) in a very short period of time. These unprofitable trades are called "whipsaws" and are frustrating to deal with. You can see examples of this shown in charts 1 and 2 above. One way to help alleviate some of the whipsaws is to put a filter around the moving average. If you take a look at charts 3 and 4, you will see the blue bands or "envelope" around the moving average. In this example, this is just a filter using a percentage above and below the moving average. With this filter in place, the buy and sell rules now dictate that prices must close above the envelope to buy and below the envelope to sell. As charts 3 and 4 show, this helps eliminate most of the whipsaws and helps to keep you invested during normal "pullbacks" within an uptrend. It also helps to keep you out of the market in a downtrend and not get drawn back into bear market rallies.



An ordinary "pullback" is defined as a 5-10% loss and is considered healthy in sustaining longer-term market cycles. Since World War II, on average, there have been about three ordinary pullbacks a year, so they're common. An investor must be willing to stomach this amount of loss when investing in any equity strategy because not reacting to these small pullbacks will help avoid whipsaws.

Even if you do experience whipsaw events, this reveals the tradeoff between Buy and Hold and trend following investing. Buy and Hold equity investing, by design, will suffer large drawdowns as we saw in 2000-2002 and 2007-2009 when investors incurred losses of over 50%. Buy and Hold also has the unknown variable of time: it takes years for a bear market to lose the money and often even longer periods to recover, or return an investor to breakeven. Trend following is designed to avoid large losses and drawdowns, but has the potential setback of whipsaws that will happen now and again.

While a good trend following manager will have additional rules to help avoid these whipsaw events, there is no perfect system. However, in my experience, the average retail investor would rather deal with the small frustrations of occasional whipsaws than the life changing events of bear markets and large losses that can delay or even eliminate an investor's goals.

Please keep in mind that these indicators are illustrations of trend following concepts and are for informational purposes only. Beaumont Capital Management's (BCM) Sector Rotation system uses different short, intermediate and long-term averages, additional data inputs, as well as various smoothing mechanisms.

Avoiding Large Losses is the Key to Success

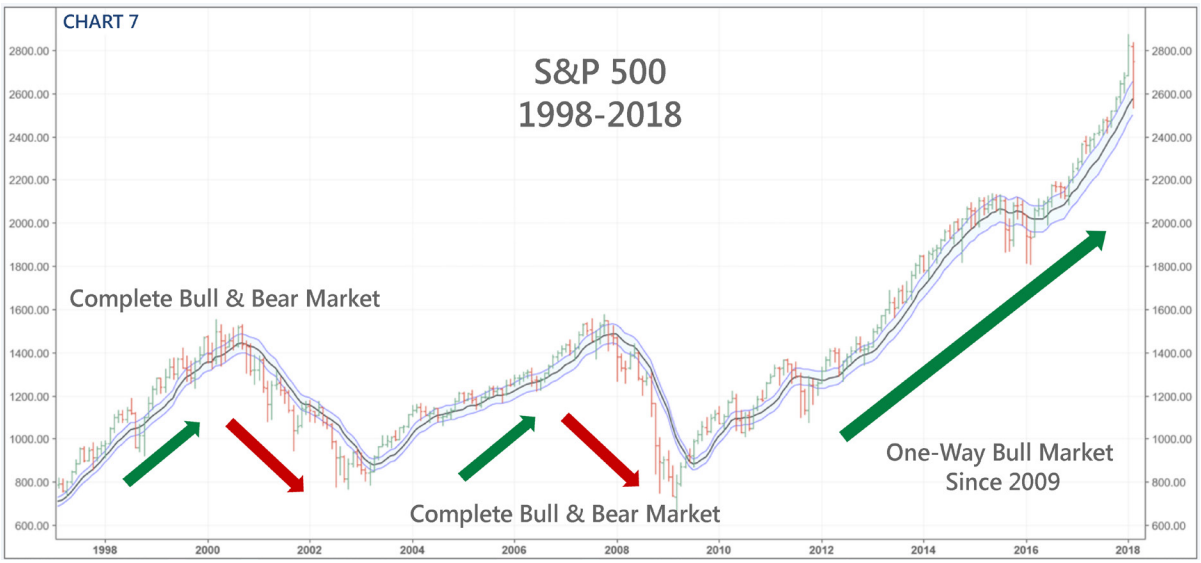
Avoiding *large* losses is the key to successful investing and risk management is the basis of any successful investment plan. An important part of trend following is that it comes with built in risk management. Historically, the large losses of bear markets happen after the trend has been broken. As you can see in charts 5 and 6 below, the major damage of the last two, and indeed most, bear markets happened after the trend was broken. The circle in each chart shows the drawdown you would have incurred from the market high if you used a trend following strategy that was able to sell before the bear market (indicated by the red arrow). The large blue arrow shows the devastating losses that would have been avoided.

Please note that in this example strategy you didn't sell at "the" high of the market, nor did you buy at "the" low. Trend following is not trying to predict the end or beginning of a trend but rather waits for confirmation of a trend change and then acts.

Bear in mind that trends typically last longer than you expect. As you can see, trend following gives you the sell signals, and also provides the buy signals for re-entry once a new uptrend is re-established, as shown on the right side of charts 5 and 6 above. Put simply, a well-designed trend following system will be engineered to keep you invested in bull and sideways markets, and to sell after ordinary market pullbacks (but before the loss becomes too damaging) to help avoid whipsaw and the large loss.

It's Not a One Way Trip

Trend following is not designed to "beat the market" during a one-way uptrend. The goal is to try to "beat the market" through a full market cycle that includes both an uptrend and a downtrend. Chart 7 below shows the last 20 years of U.S. Equity market performance including two complete market cycles.



The current one-way bull market started in March of 2009 and investors have been trying to sell at the top of this market for several years. This current bull market phase is over nine years old and one of the longest bull markets in history. It is easy to see why investors are being lured into the Buy and Hold camp. This time is different…right?

Trend Following with Sectors

At BCM, we take the trend following concept and apply it to ETFs that track the individual sectors of the S&P 500. Sectors are just a section of the market. For example, technology stocks, energy stocks and health care stocks are each sectors that reflect a specific segment of the market. People often ask "would a sector model have worked during 2000-2002 or 2007-2009?"

Below are the same trend following illustrations showing the biggest losing sector during the last two bear markets. The chart shows the technology sector in 2000-2002 during the "dotcom" bubble, and the financial sector during the 2007-2009 financial crisis. In both cases, prior to the bear market, these sectors had grown to over 20% of the S&P 500. Owning a Buy and Hold Index fund meant that at least 20% of your investment was committed to staying in a sector that was failing. If individual, multiple, or all of the sectors are falling in a negative trend, where is it written that you must stay invested? When the trend turns positive again, why not reinvest then with the majority of your capital still intact?

There Are More Important Things In Life

No system or model is perfect. Yogi Berra said "In theory there's no difference between theory and practice, but in practice there is". While Buy and Hold may make rational sense in a laboratory, real life is much messier. People have emotions and as we get older, we can't afford to risk a life-changing event of a bear market. There is no guarantee that the market will come back quickly. As the charts illustrate, if you stay invested for a full cycle, it often takes four or five years to break even.

Trend following systems, including the BCM Sector Rotation strategies, are based on rules. Having a rules-based system to give you buy and sell signals can take away all of the fears discussed above. Instead of making big "hire and fire your manager" type decisions, often at the worst times, why not invest in a system that uses rules to make smaller, more timely buy and sell decisions for you?

Trend following is objective. Trend following does not involve the emotions of watching the news or seeing what is trending on Twitter to decide what to do. It is built on the belief that after all the news and global events happen, investors will decide to either buy or sell. That decision becomes a trade, and these trades then become a price on a chart. Therefore, the price on a chart reflects the headlines of the day and people's reactions to them. Trend following bases its decision on one core piece of information: price. Yes, there will be some whipsaws and there will be times this type of strategy will lag the market. But, at the end of the day, trend following can give the investor a real opportunity to take part in the upside of the market while avoiding the major losses that come with a bear market. Isn't this what we all want?

We all invest because we have future aspirations, goals, and dreams. Bear markets threaten these dreams and human emotions tend to make us do the worst things at the worst times—buy high and sell low. There is no mystery that there are more important things in life than investing. With this in mind, trend following strategies can grow your wealth, will seek to play defense for you, help free you from the emotional grip of investing, and allow you to pursue the other things in life that really matter.

For more insights like these, visit BCM's blog at blog.investbcm.com

Sources and Disclosures:

Chart 1: TradingView S&P 500 Index – Weekly Chart 9/26/2011 – 2/2/2015
Chart 2: TradingView S&P 500 Index – Weekly Chart 6/5/2000 – 8/11/2003
Chart 3: TradingView S&P 500 Index – Weekly Chart 9/26/2011 – 2/2/2015
Chart 4: TradingView S&P 500 Index – Weekly Chart 6/5/2000 – 8/11/2003
Chart 5: TradingView S&P 500 Index – Weekly Chart 11/1/1999 – 7/14/2003
Chart 6: TradingView S&P 500 Index – Weekly Chart 12/11/2006 – 9/7/2009
Chart 7: TradingView S&P 500 Index – Monthly Chart 2/1997 – 2/2018
Chart 8: TradingView SPDR Technology ETF – Symbol XLK – Weekly Chart 6/5/2000 – 7/14/2003
Chart 9: TradingView SPDR Financial ETF – Symbol XLF – Weekly Chart 10/30/2006 – 10/5/2009

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As with all investments, there are associated inherent risks including loss of principal. Stock markets, especially foreign markets, are volatile and can decline significantly in response to adverse issuer, political, regulatory, market, or economic developments. Sector investments concentrate in a particular industry, and the investments' performance could depend heavily on the performance of that industry and be more volatile than the performance of less-concentrated investment options. Foreign securities are subject to interest rate, currency exchange rate, economic, and political risks, all of which are magnified in emerging markets. The risks are particularly significant for ETFs that focus on a single country or region. The ETF may have additional volatility because it may be comprised significantly of assets in securities of a small number of individual issuers.

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Performance data shown represents past performance and is no guarantee of future results.

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