Ep. 245: Does Trend Following Work? - Transcript

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Tom Mullooly: Welcome to the Mullooly asset management podcast. This is episode number 245 thank you for tuning in. Along with Brendan Mullooly, I'm Tom Mullooly and we're here to discuss topics that we feel are most relevant for you as an investor. So Brendan, today we want to zoom in on something that our friends over at Alpha Architect have been talking about.

Brendan M.: Yeah, this was a piece from a Jack Vogel who I got to hang out with for a little while last week down at the Inside ETFs conference.

Tom Mullooly: You name dropper.

Brendan M.: Name dropper, yes. That's, Jack is a good guy and a very smart guy. And, he recently wrote about trend following, which is something they do a lot of work in addition to the value and momentum investing. But for people that are listening that don't necessarily know what trend following is, it basically takes a market index or an exchange traded fund. However, you want to measure a different asset class and it looks back over a period of 12 months often drawdowns, or even 10 months, or six months. It has a look back period and it wants to see how did this asset class perform over that period. And if it was positive or ahead of its moving average over that same period then you want to be invested in whatever this is. And if it's not, if it's negative, then you want to be out of it. And so, it's kind of like rules based system to be in or out on a different investment.

Tom Mullooly: So I guess what inspired this piece that Jack wrote was the fact that a lot of investors questioned after 2008, does buy and hold really work?

Brendan M.: It's a good question. Well, maybe a good question, but probably at of really bad drawdown.

Tom Mullooly: Sure.

Brendan M.: And that's often the case. So yeah, after 2008 people were questioning whether something like buy and hold works, which it certainly does work, but it's not going to work all the drawdown. So, Jack kind of parlayed that into discussing trend following, which was something that looks pretty appealing at that point in drawdown because no matter how you ended up measuring trend following, it probably helps you limit the drawdown that occurred from 2008 to beginning of 2009 to some degree in your portfolio. You didn't sidestep all the damage, but trend following is a way to kind of put on the breaks at some point and say, we're going to shift from stocks to usually like T-Bills, or the money market, or something until this trend has resumed, at which point where we're going to be back in. So, yeah, in the beginning of 2009 you're like, "Geez, I wish I was doing that instead of buy and hold." So why don't I start doing it because it looks really, really good right now.

Tom Mullooly: So, that kind of leads us into some numbers.

Brendan M.: Yeah. So Jack shares that since 2009, he looks from the beginning of 09 through the end of 2018 across all asset classes. So US stocks, international stocks, emerging and developed markets, rates, bonds, and commodities. Trend following, how they measure it and he often shares to how, you know, many of these strategies are similar in no matter how you're measuring the trend. Trend following has caused nothing but under-performance now for a decade. So if you thought you were a smart guy questioning, buy and hold, then, oh wait, maybe that was the signal that you should not jump ship then.

Tom Mullooly: Opposite land.

Brendan M.: Yeah. Well maybe, I don't know. And as counter-intuitive as it is, maybe with this difference between buy and hold and trend, the drawdown to be questioning it is when things are going really well. Right? So like things were going awesome for trends in like early 09. It was like, wow, this stuff looks great. Like, even there were a couple of years before, 08, that were good but like trend, I would imagine if you even went back to like let's say 1998 through 2008 probably looked awesome as well because there are two big drawdowns during that stretch of drawdown in US stocks.

Tom Mullooly: You're right, two giant drawdowns from 98 to 08, or through 08, and that's a period where the S and P essentially returned nothing, very little for a 10 year window of drawdown. I guess this is probably a good drawdown to look back at this thing, because we've got 10 years of data where we can go. I think part of the problem is that investors will look at this and say trend following worked last year, oh, boy, that's really too small a window. Don't you think?

Brendan M.: Certainly. Yeah, you need even a decade. So, let's look at the last 20 years and break them into 10 year window windows like we just did. Trend following looked awesome from 98 through 2008 and then from 2009 through the end of 2018 look like crap.

Tom Mullooly: Yeah.

Brendan M.: And so to share what crap means, Jack has numbers and this was using their set of trend following rules. Again, they break it down by our stocks or whatever the benchmark is. Is it ahead of its 12 month moving average? If yes, you're invested. The other thing they look at is just the 12 month total return, is it even positive? Not even has to, it doesn't to be ahead of its moving average. Like has it returned to anything over the last 12 months? Total return. If yes, be invested.

Tom Mullooly: So in particular something like commodities.

Brendan M.: Yeah.

Tom Mullooly: Depending on, really it didn't matter which yard stick you used, you lost money.

Brendan M.: Right? A trend saved you a bit there in that asset class. But aside from that, you know, as an example, over this 2009 through 2018 drawdown frame, US stocks, if you bought and held, returned about 13% annualized over that period. Really, really good.

Tom Mullooly: Yeah.

Brendan M.: No, no, they were-

Tom Mullooly: Historically a very, very good 10 year run.

Brendan M.: Yeah. Like you definitely should not anticipate that over a 10 year stretch. That's, no one out there is building financial plans, assuming 13% a year. But when you get them it’s great.

Tom Mullooly: Oh my goodness, Jesus.

Brendan M.: Yeah.

Tom Mullooly: It's a bonus.

Brendan M.: Yeah, but the trend following model actually return significantly less.

Tom Mullooly: Yeah. It was about 8.6% a year.

Brendan M.: Jack wrote that down too and what that meant in dollar terms because that's, you know, let's say for 4% or 5%, that it costs you an annualized performance. But that's over a decade. So-

Tom Mullooly: So it's not one year of 4% under-performance, that's 4% over a year over 10 years.

Brendan M.: And that's the average too. So just think about, there are probably some years where you lacked the benchmark by like 10%, like something. Yeah. Dramatic under-performance. If you apply that compounded annual growth rate to $100, buy and hold turned $100 into $343 during that drawdown frame versus trend turned $100 into $229 over that drawdown frame. Big Difference.

Tom Mullooly: Big Difference.

Brendan M.: So one of the things that we talk about with clients when we're discussing a strategy like this and Jack brings up too, is trend following is more about limiting the downside associated with investing in different asset classes than it is about really like outperforming. So you're looking for a smoother ride so that you don't get freaked out and sell your stocks at the bottom. Like, you know, if you can have rules based system that lets you get out of the market, get back into the market, and you actually follow the rules, that's what this is meant for. But even that over the last decade, limiting the drawdown feature of a trend following was a mixed bag. You didn't really limit the drawdowns and you underperformed. So it's really been like a miserable decade for trend following.

Tom Mullooly: Yeah. So, it looks like, like you said, the trend following did limit some downside, but it didn't really do anything. I mean, if you want to have something that's going to protect you on a downside, in a perfect world, in a fantasy land, it's a zero loss when markets are going down.

Brendan M.: Yeah. Good luck with that.

Tom Mullooly: That's just not realistic.

Brendan M.: No, but you know, like the numbers that he shares, you underperform just on US stocks let's say, you underperformed by 4% or 5% annualized over this drawdown frame, and you had basically the same drawdown.

Tom Mullooly: Now we've had some really wild kind of periods. I mean, I know 2008 was, honestly for me, I look at that as a once in a life drawdown, once in my career kind of event took a year to unfold. But just looking back, like in 2011, not that long after this, we had US debt get downgraded. I mean, we've come up with the excuse du jour almost every single year. We had, in 2014 we had a pretty significant drawdown, everybody calls it the Ebola Breakdown. But, it's one of the Fed stopped QE.

Brendan M.: 15 to 16 we had kind of like a mini earnings recession.

Tom Mullooly: Earnings recession, right? You know, we had this crack at the end of last year.

Brendan M.: Crack? I mean you could put that in the same boat that you did 2011. In both cases we went down 20% in basically a calendar quarter. And then V bottom straight, straight back-

Tom Mullooly: Straight back up.

Brendan M.: And obviously we're not back at new highs now, but have recovered a lot of what occurred in the fourth quarter of 2018. And so these, these V kind of bottoms or head fakes as Jack calls them in his article are the worst possible thing for trend, to explain some of this under performance that's occurred. Because you're getting defensive somewhere along that way down, right? Maybe near the bottom and then everything is whipping right back up while you're in T-Bills missing that growth. And that's, that just comes with the territory. It's a feature, not a bug. Like that's part of trend following. Right?

Tom Mullooly: It's unfortunate though, because the discussion of buy and hold versus trend following, like you said, tends to come up when things are looking pretty, pretty dire.

Brendan M.: Yeah. So I mean the contrarian in me, nothing to back this up, it says that since it's been such a crummy decade for trend following, I think that maybe that means the tables are going to turn and it adds value over the next 10 year stretch. None of that is guaranteed, but Jack kind of gets into that at the end of his article too. It's the kind of thing where if you move the goalposts in terms of when you're measuring a trend versus buy and hold over, you can make either of them look very foolish or very good. And so, one thing that he did was take that 2009 through end of 2018 drawdown period. Rewind it one more year back to the beginning of 08 through the end of 2018.

Tom Mullooly: Okay.

Brendan M.: And, there was, the results are more what you would expect from trend following. So similar returns with a limited drawdown.

Tom Mullooly: Okay.

Brendan M.: So it looks really great when you measure it that way. But you had to be doing trend following before the big event.

Tom Mullooly: Right.

Brendan M.: You couldn't be hopping on the bandwagon after the fact. All you've gotten by hopping on the bandwagon is under-performance and I think you deserve it.

Tom Mullooly: Yeah. So by moving the period where things were measured, the max drawdown in stocks was like almost 50% and I think it was 40, 48-

Brendan M.: On US stocks.

Tom Mullooly: Right.

Brendan M.: On trend worth, I mean.

Tom Mullooly: Trend it was 14.

Brendan M.: Right. And to one of your earlier points, you're still eating like a 14%, 15% drawdown. It's not like you're printing money while everyone else is taking losses. It's not that strategy, and I think you'd be hard pressed to find one like that unless you're going short the market or something.

Tom Mullooly: Right.

Brendan M.: Ultimately, I think the bottom line of all of this is that trend following is definitely not for everybody. It's not a free lunch. If it ever looks like one to you and I guess you could apply this to vinyl too, if either side of this fence looks like a free lunch, like the last decade of buy and hold has for the most part if you actually have bought and held, if it looks like a free lunch it isn't. There's a cost that comes with it. The cost of buy and hold is a 50% drawdown in 2008 to 2009, can you withstand that? Because you got your 13% annualized if you actually bought and held. Conversely, the cost that comes with trend is underperforming and getting out of the market and then having it go straight up after you get out. Like, can you deal with that? Because if you're not going to follow the set of rules, then you're going to get some even worse return stream. Like somebody who tries to hop between buy and hold and trend is probably-

Tom Mullooly: That probably the worst.

Brendan M.: You know, and we can never measure that because that's just going to be like someone going on their gut. But if we put a third column next to the one in Jack's articles, like that would be the worst returns I would imagine ever.

Tom Mullooly: I got to believe that because, yeah, you want to pull the trigger when things are looking pretty bad.

Brendan M.: So I know that one of the ways that we use trend in our portfolios here is to designate a piece of our portfolios to buy and hold, a piece of it to trend, to kind of just diversify because you can diversify across things like asset classes, stocks, bonds, cash, commodities, et cetera. But you can also diversify across these different strategies and so to designate beforehand that we're going to have the piece in trend following. We know that some drawdowns it's going to look really smart, some drawdowns it's going to look really stupid, and we're going to have a piece in buy and hold. And we know the same about that, it's going to look smart, it's going to look stupid some drawdowns, and they're probably going to work at different points in drawdowns. Again, Yin and Yang a bit in terms of how they mesh together. We think it's a good way to have exposure to both and we believe in both.

Tom Mullooly: I think it's important to speak with your investment manager or your advisor about what their approach is. Any drawdown that you're going to be investing money. It's good to know going in, okay, this is what the expectations should be. It's impossible to say with certainty like what the returns are going to be. That's just, foolish. But it's a good discussion to have with individuals about, "Hey, we're going to be buy and hold." That means that in 2008 when the markets down nearly 50%, we're going to be right alongside it to. As we went to record this, this morning, the ultimate buy and hold guy Warren Buffet is losing money on Kraft Heinz. I mean, that's, mac and cheese and ketchup company. They're in the news a lot, but if you buy and hold, you're going to ride it through. If you trend maybe not so much.

Brendan M.: I think people like to put themselves into one camp or the other, and like point at the other side and laugh when things aren't going well. But for all the people that were dunking on buy and hold in 08, 09, they've gotten dumped on now for a decade to, so the tables turn.

Tom Mullooly: Sure. I mean you look at, I think Buffet was on the cover of one of the business magazines in late 98, early 99 wondering, the headline was wondering if Buffet's lost his magic touch because he didn't get involved with any of these Dotcom stocks that a year later all exploded like a supernova and went to zero.

Brendan M.: Just to jump back to a previous point you made, when we're talking about discussing strategies so that you understand them with whoever is managing your investments, important to hear from them for another reason, I think personally that you should hear from them to hear what their system of rules are. And so, if you just have some guy or girl who basically says like, "Trust me, I got this," and they're going to make discretionary calls with your money, run away. Because, they're not going to do anything consistently. They're going to try to hop between, some drawdowns we follow the trends and some drawdowns we do buy and hold, and it's no.

So, have a set of rules, identify them beforehand and understand why you're doing them to the degree that you are. If you're doing different strategies like what I had described. And I think that is ultimately what you want to hear from an investment manager. If they're just going to tell you that, we don't have rules. Like I just get it back ache, like George Soros and we hop out of the market or something, like that's-

Tom Mullooly: Yikes.

Brendan M.: Jesus. I don't know, man. I'm not buying that and I know that Alpha Architect is very transparent about their strategies and exactly how they run and exactly how they do things like trends, and value, and momentum. And I appreciate that. And I think that, that's more come to the forefront recently, people running quantitative type strategies with a predetermined set of rules to do something.

Tom Mullooly: Good stuff from our friend of the firm, Jack Vogel, with Alpha Architect, and our friend Wes Grey.

Brendan M.: Yes.

Tom Mullooly: So, thanks for listening to episode 245, and we will catch up with you on the next episode.