



A Counter Trend Concept

There are many ways to approach counter trend models. They are just not as coherent and simple as trend models. In this demo sheet, I want to show a concept. A method of approaching counter trend modeling.

There are two main types of counter trend models. The one getting the most attention goes against the main trend. It waits for overheated trends and fades it. This is, in my view, not the most interesting type of counter trend model. My preferred style is the one that enters in the direction of trends, just as many short term trend followers are stopping out. This model bets on a snap back.

The underlying idea of this concept is to enter into situations where the trend followers are feeling a lot of pain. We enter in the direction of the main trend, but only after strong short term moves.

A model based on such a concept can greatly enhanced the volatility adjusted returns for a portfolio otherwise dominated by trend following strategies. It makes for a good portfolio component.

We already know more or less how trend followers trade. All we need to do is to find their logical stops, and enter soon after. In this sheet, I'll show you a basic indicator that can help us identify trend following pain. Next month I'll build on this and show you a complete trading model based on this concept.

A good indicator is simple in nature. It should be straight forward and simply quantify or visualize something that's easily understandable and that makes sense. Complexity is rarely a good idea in an indicator.

This particular indicator shows how many ATR units away we are from a recent peak. If you read my book, you may remember that my core strategy stopped out after three ATR units move against the trend,



from the highest reading. This indicator can help you identify where many trend followers exit and when the price comes under pressure because of this. Often the exits of the trend followers propel the price too far, too fast. After that, we often see a snapback, towards the trending direction.

Sometimes this snapback lasts, sometimes it does not. Counter trend models normally take the money and runs, not caring about if it continues or not.

Bear in mind that counter trend models, the way they are traded by CTA professionals, are usually designed to be volatility smoothers. They tend to be profitable, but over time trend following is much more profitable. These models still hold great value, for their negative correlation to trend following. As long as the gains and losses have different timings from trend following, the profitability is of less concern.

If it has this negative correlation, then you can increase allocation to your trend model for higher profits at the same risk level. Basic level portfolio logic.

So what is this indicator called? Regular readers know my general feeling about naming indicators after yourself to get famous, so I'll pick a name that surely won't stick. How about the Clenow Plunger? That ought to do it.

First, here's a visualization of the Clenow Plunger, to give you an idea of what it does.



The bottom pane is the indicator, while the top shows the price chart and trade signals based on the indicator.

Note that when the price pulls back, this indicator moves up. Here's in detail what the indicator does:

- Check overall trend direction. This is done here with a dual EMA. If the 50 day is higher than 100 day, the trend is up.
- Check the 20 day ATR value.
- Check the 20 day extreme price. That is, highest high in the past 20 days if trend is up, or 20 day lowest low if the trend is down. We want to know what the best reading was.
- Check how many ATR units we are away from that latest peak. Take the absolute difference between the current price and the 20 day extreme, and divide it by the current ATR.
- Now you've got the current pullback expressed in context.



If someone is running a trend model on a medium term basis, their stop will likely be around a reading of 3 to 4 on this indicator.

So let's say that you see a reading in that region, and the price comes under obvious pressure as trend followers exit, the probabilities are quite good for a near term rebound.

Summarized logic:(pseudo code) $\text{Value} = \text{abs}(\text{currentPrice} - \text{bestReading}(20)) / \text{atr}(20)$

Start by plotting this indicator. It should be possible in all decent simulation or TA packages. It's a very simple calculation but it can give you very valuable information. It doesn't generate trade signals on its own, but it's an important piece of the puzzle.

I'll return next month with ideas and trading models for how to implement this indicator in a systematic manner.