The Short Victory of 2014

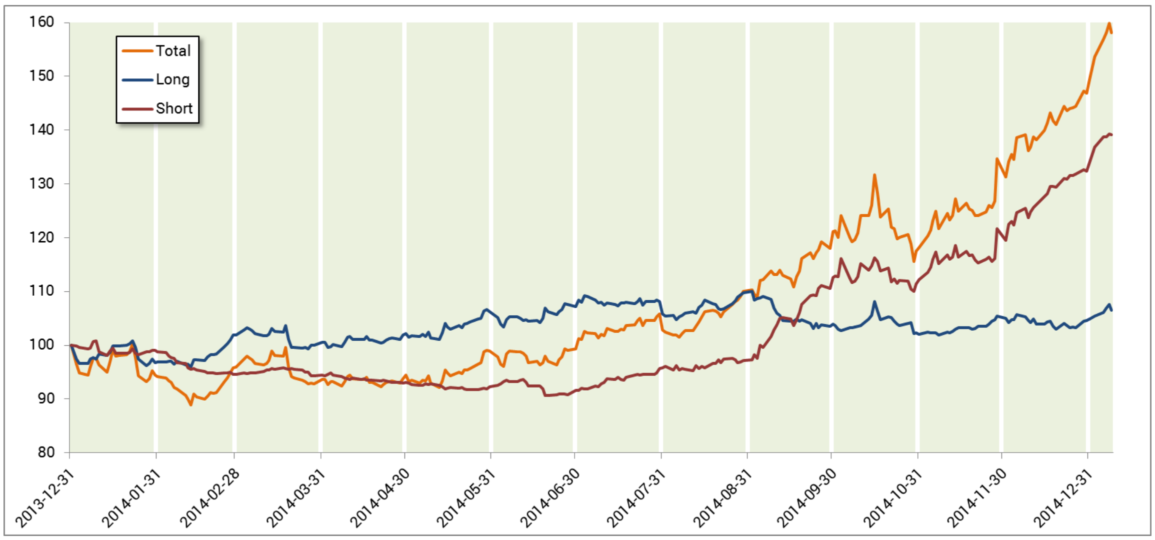
2015-01-09

In the long run, the short side of trend following doesn't provide much profits. Comparing the long and the short side returns usually shows that practically all long term gains come from the long side. The short side keeps losing slowly, only to suddenly spike up with massive short term profits from time to time. This begs the valid question of whether or not you should discard the short side all together.

It's a tricky question with no clear answer. It depends. For most retail traders, discarding the short side should be a valid option. If not discarding it, at least down-weighting it. In most years, such decision would have paid off. Last year however, was unusual.

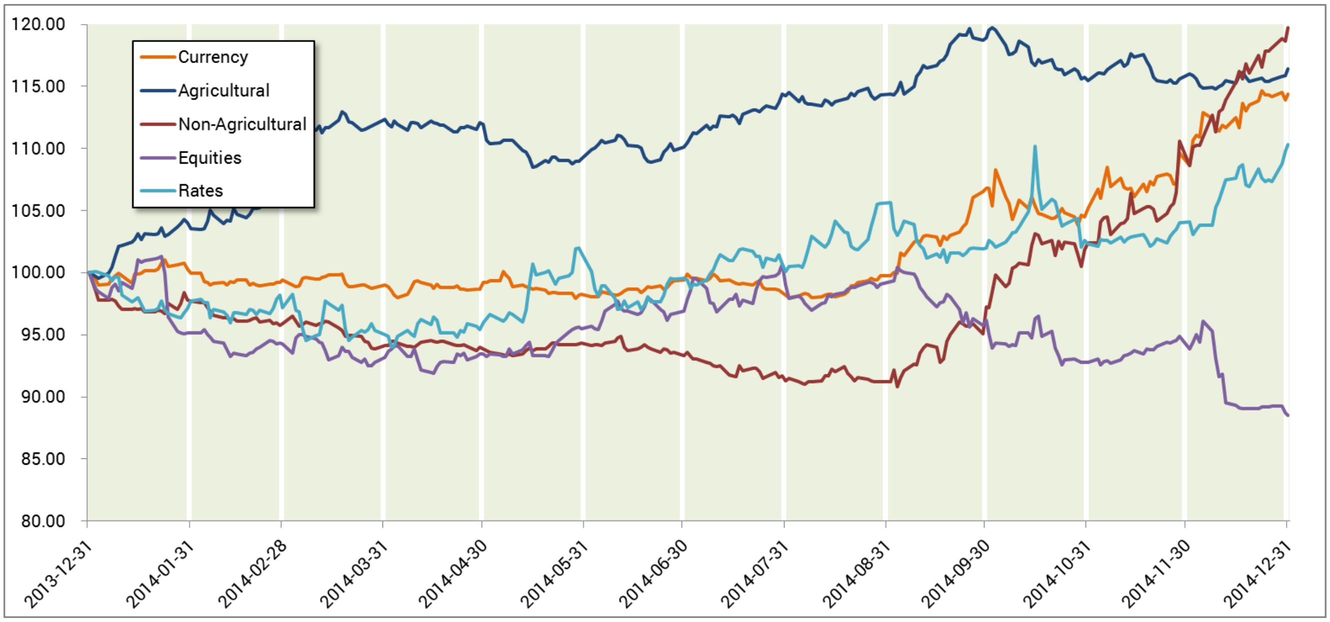
In 2014, the short side was massively profitable. It was one of those rare years where the shorts dominated. To illustrate what happened, I'll use the Core Strategy that I presented in my book. Keep in mind that this model is meant as an approximation of the trend following industry, not as a recommended trading model. It's easy to improve upon, but it was never built as a 'super strategy', just as an example.

Here's what that model did in 2014, using a broad set of around 60 futures markets covering all sectors.



Neat end of year results, isn't it? This very basic trend approach gained 60% in this stellar year. That's a very welcome gain after a couple of tough years for trend followers. Now, the interesting part comes when you break down the longs vs. the shorts. Note how the bulk of the profits come from the short side. The long side ended up gaining less than 10%.

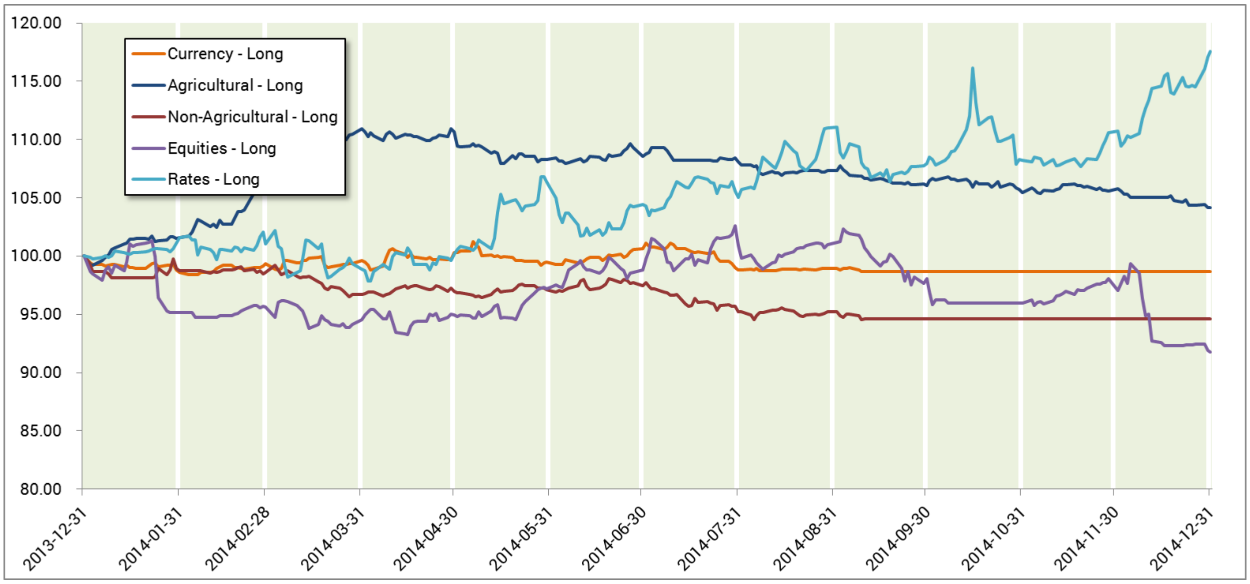
Let's dig one step further down to see where the trend followers really made their money in 2014. I'll break it down on individual sectors, using the same approximation model as above.



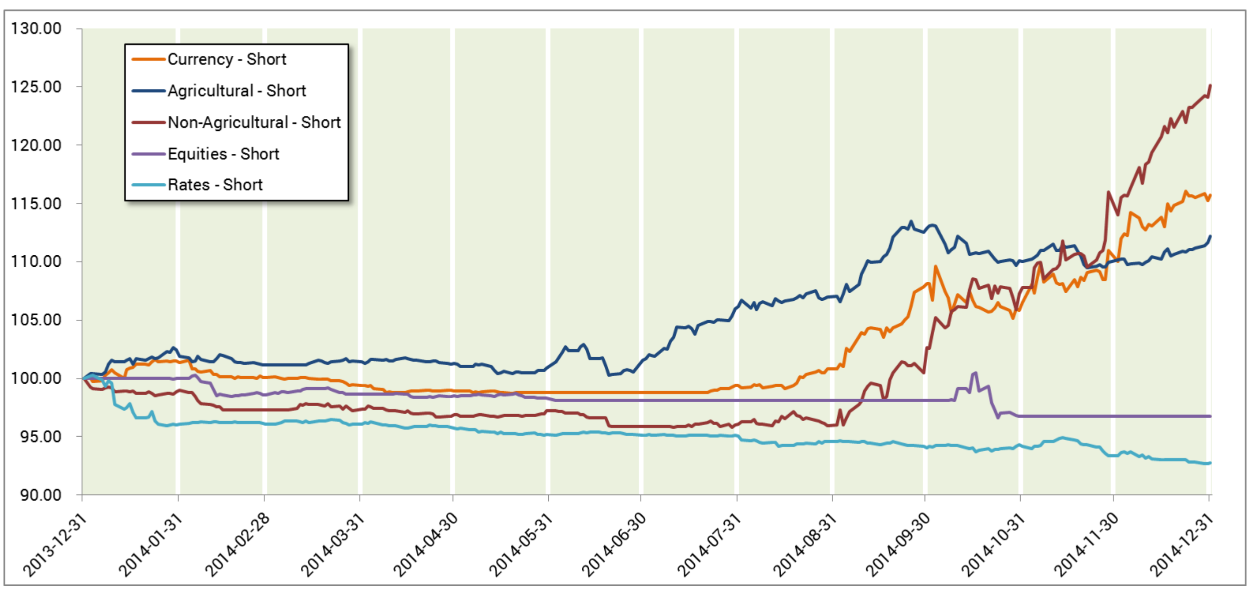
This picture looks fairly normal. At first, only the agricultural sector provided the profits early in the year, while all other were slowly losing. After Q1, everything more or less leveled out. No real action anywhere for half a year. But then by late summer, something started happening in the non-agricultural sector. We'll get back to that event in more detail soon.

What may surprise here is how difficult it was for trend followers to make money in stocks. Bear in mind that this is a medium term trend model, and as such it kept getting kicked out of the market every time there was a pullback. Besides, the only equity markets that really behaved well across the board were the American ones. Europe was quite terrible and Asia wasn't much better.

Looking at just the long side results, it looks quite mediocre. While we had double digit gains on the long rates positions, the other sectors didn't fair that well.



So what about the short side? Yep, this is where the action was, at least in the second part of the year. There were practically no short positions in equities, and the few taken all failed. The short rates positions, mostly in STIRs, also failed. But everything else on the short side did very well.



There are three interesting lines in the chart above. First, you'll see how the short agriculturals kicked in from mid-year. The grains and softs complex started falling quite hard and did so for a few months. That was an excellent trend to trade. This however died down during Q4 and leveled out again.

The second theme on the short side was in currencies. How do you short currencies? Against what? Well, this is a matter of semantics of course. In this context, going short a futures contract is what we're referring to. The gains in short currencies here are essentially bets on a long dollar. Short Euro, short CAD, short, Sterling etc, all against the US Dollar.

The third and overwhelmingly most successful theme of the year was short non-agricultural commodities. This sector is a compound of metals and energies. Guess which one provided the gains…

Below you see the individual results for each market. The correlation in the oil complex has been very high, but it's also been the most profitable. On top of the performance chart for 2014 were the short gasoil, crude, heating oil and gasoline.

The oil collapse of 2014 was surprising, but highly profitable for trend followers trading the short side. The trade chart below is again from the same model.

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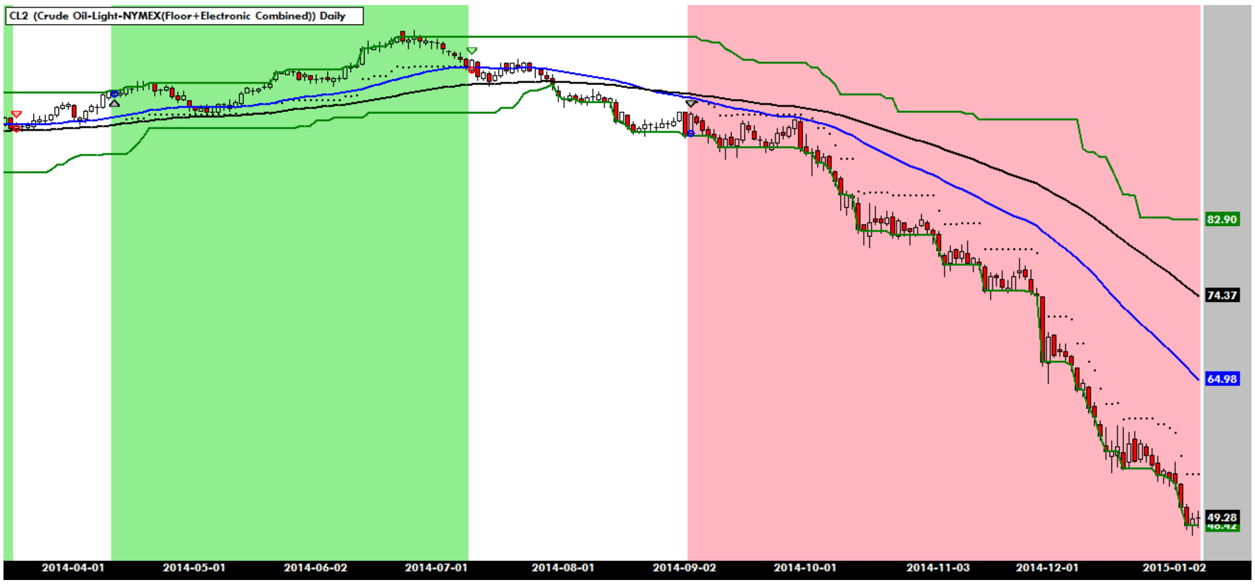


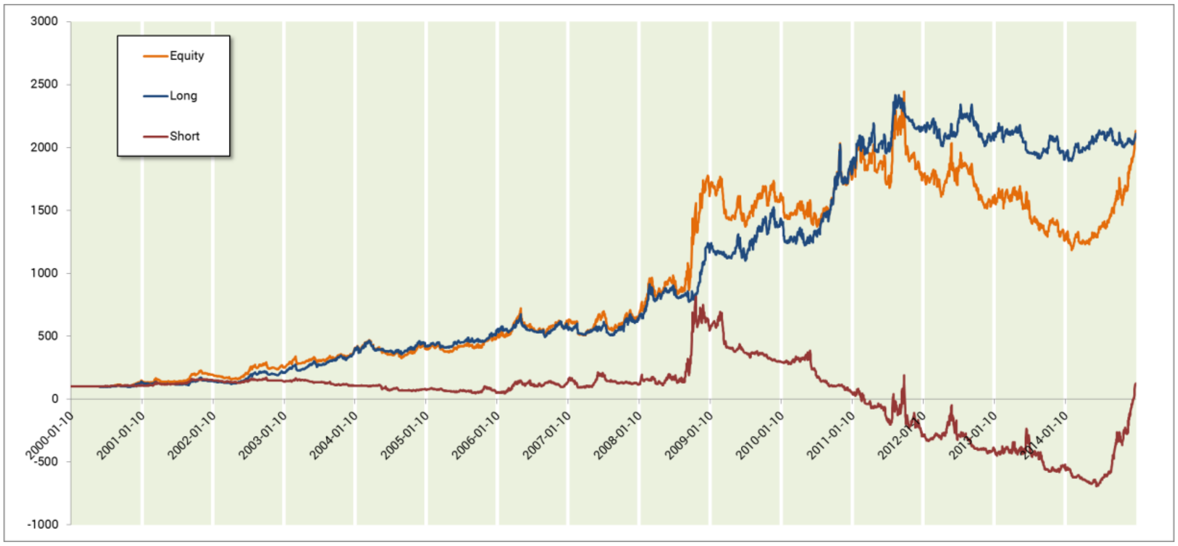
What does this mean, going forward?

Not much. This is really nothing new. Just unusual.

Last year, it would have paid off to trade the short side. In fact, last year would have paid off very well to only trade the short side and not bother with the long. But that's an anomaly. There's always a danger in modifying your strategy based on recent events. You'll most likely end up chasing performance like a cat chasing its tail.

Whether you want to trade the short side or not, of whether you want to treat it differently or not, shouldn't be dependent on this last quarter.

The chart below shows the longs vs. the shorts for a longer period of time. What you see is that the normal behavior of short trend following is a slow decline, followed by brief and very steep short term gains.



Going forward, the most likely development is that the short side goes back to doing what it usually does. That is, slowly moving downwards. If you didn't trade the short side before, you shouldn't start now.

And the oil? At this point, the oil is in the middle of a massive water fall decline. It's extremely oversold and just lost half its value. The probability that it loses another 50% is not terribly high. The short party is most likely coming to an end.