

Chapter One



Stick to Your Knitting



*Gary Davis, Jack Forrest,
and Rick Slaughter*

WHILE TODAY SUNRISE CAPITAL IS A VERY SUCCESSFUL money management firm, it did not start that way. It began with three visionary men who dared to be different. They saw opportunity and chased it. One of the founders put it this way: They stick to their knitting. They follow their trading rules. I said this in the Introduction, but it

bears repeating: To learn trend following trading, to make a great deal of money with this strategy, requires confidence. The best way to instill that confidence in you is to show you, start to finish, successful traders' paths. As you read this book you may find yourself asking why it is relevant when these traders started. You may be asking why it is relevant to learn about their performance in the 1970s, 1980s, 1990s, and so on. It's relevant because it shows consistency of strategy. This is not some "got lucky trading" method that works for one month, one year, or one decade. It has worked literally month by month for decades. In fact, by the time you finish this book I hope you look carefully at consistency of performance at all times for all strategies—not just trend following. If you find a strategy that doesn't have performance proof behind it, you're gambling. With that out of the way, let's jump in.

If you learn anything from this book, let it be the simple lesson: Stick with it. There will always be distractions: Breaking news banners, surprises, and unpredictable chaotic events are everywhere, but you can't let yourself be fazed. Here is one big secret: Top traders don't pay attention to that stuff. They have found, through hard work, diligent study, and perhaps a little luck—that their ability to stick with a trading plan is far more important than knowing or worrying about what their neighbor is doing.

Go back with me to the mid-1970s. Jack Forrest, a doctor practicing and teaching in San Diego, had built up his savings to begin trading his own account. It wasn't a lot of money, but it was enough to get going. He began investing in stocks, but it didn't take long for him to see that commodity futures, and their big up and down moves, would be much more lucrative.

Like many, Forrest got his start trading with fundamentals—understanding balance sheets, supply, demand, and so on. He realized that his ability to analyze markets was not very good. He talked to local brokers and they had no clue either. No one seemed to have a logical or systematic approach—a *trading system*. Many were just gamblers. Others chalked up their trading to having a feeling for what was going to happen. We have all had those experiences. That's how most everyone is initially exposed to the markets.

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**Some people say, “Boy, it really looks like
fundamental analysis has a lot of potential.”**

**If you ask why it has potential, the usual
response is “It just does.”**

But when you realize that a seat of the pants approach to the markets, otherwise known as using fundamentals,

doesn't work, what can you do? Head toward systematic techniques to trade the markets.

That means looking at what has happened historically. It starts with reading stories about famed investors such as Jesse Livermore, Dickson Watts, and Richard Donchian, and other great traders who have used systematic approaches throughout the years. There is no shortage of these kinds of books to check out. One major commonality from these authors and their decades ago wisdom: Get on the big move and stay with it.

The obvious questions: "Well how do you get on the big move?" "Try different things?" "What are those things?" "Buy a set of trading rules from someone else?"

Forrest started experimenting with technical trend trading ideas, and the idea of channel breakouts.

Channel breakouts occur when a stock or commodity is trading in a tight channel, then starts trading at a price higher than the top of the channel. What do I mean by tight channel? Apple is trading at 300, 305, 300, 305, 300 and then boom jumps to 325. It is breaking out of the "channel" of tight prices.

As Forrest went along experimenting, buying breakouts was working well, so Forrest began trading that way. Some traders take years to find a profitable system, but

Forrest had some luck on his side in that he found the right kind of approach—an approach very different from what most others were practicing.

With these kinds of trading rules you can become totally systematic. You can write your rules out and follow them with rigid discipline. Forrest's first system was very simple: buying weekly breakouts. It was a 12-week breakout system. Enter long or enter short when the market makes a 12-week high or low.

What markets can you trade like this? While the markets were different when Forrest started—all physical commodities—systematic trend following rules allow you to trade almost all markets today. That means stocks, currencies, gold, oil—you name it.

Night Class

While Forrest was doing his own research and trading, he had an interesting experience early on. He took a night class from legendary trader Ed Seykota, during the early 1980s. Seykota reinforced trend trading rules and trading psychology.

Seykota was teaching a four-week channel breakout system with a filter—only to be applied if the market was going up (from the long side). He did not apply the system if the market was decreasing (no short selling).

A filter is set up as a hurdle for taking a trade signal (your breakout). You would only trade from the long side if the most recent six-month breakout was up.



**Trend following can be simple, but sticking
with it is the hard part.**

It was more than just rules though. Because Seykota had been so successful with a systematic approach, it gave Forrest the confidence that he too had a shot at that type of success.

It's the same reason I want to introduce you to successful trend following traders throughout this book: to give you that same confidence.

Teaching Friends

Jack Forrest and Gary Davis were both doctors working in research at the University of California—San Diego. They were also tennis partners. Forrest desperately wanted someone to bounce trading ideas off of and who could trade his same systematic trend trading way, but he had no luck initially finding a trading comrade.

Forrest had about a five-year start on Davis before they even began discussing trading. Even though they

were good friends, Davis had no idea of Forrest's trading passion.

How did Davis finally learn of Forrest's passion? It all started with the mention of pork bellies while sitting on the beach after a tennis match. Yes, they were talking pork belly futures contracts—the type traded at the CME. Pork bellies? Just a fancy name for bacon.

While talking about pork bellies on the beach that day, Forrest said that he had “all of these books on trading” and told Davis that if he was interested in learning about the markets he was welcome to borrow them. Davis powered through almost 20 books in a week's time. It was the beginning of his trend following trading career.

Does this sound like an accident? Does this sound like Davis had no preset plan to be a trader? You would be correct. Davis enjoyed his faculty work, but never thought it was the perfect spot for him. He felt like a misfit among the rest of the faculty.

The First 17 Trades—Losers—or Don't Ask Around

Davis was just about to turn 34 as he started trading with a trend following program he had learned from author J. Welles Wilder, Jr. He lost on his first 17 trades, but once he made one tweak, which he believed is the only reason he is still trading now, he was back in the game.

What was Davis's Aha! moment? Dissect people who have been successful in almost any form of trading long-term and who have been trading some form of trend following or momentum trading.

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**Successful fundamental traders often
have great success because they've been
in the right place at the right time.**

After recovering from his first big losing streak, Davis realized that he had no idea what anybody else was doing—beyond his book reading. One thing he did know was that most traders last six months and lose all their money. Worse yet, it seemed successful traders lasted three years and then lost all of their money. He expected that his trading career would follow in a similar fashion.

More apt to be involved in independent study, Davis never did like talking to other traders much. He felt the key to his trend trading strategy was to stick with his plan, not changing rules around after looking at someone else and saying, "He has got this great idea. Oh, I'll try that."

As Forrest and Davis were each going down their separate, and growing trading paths, their future partner, Rick Slaughter, had already known for some time that the markets

were where he wanted to be. He could remember literally being at his grandfather's knee learning about stocks.

As a young man, corporate law was Slaughters' interest, but plans shifted. On his twenty-first birthday he placed his first trade. He was one of the first to program a trading system into a computer in the 1970s. Not long after, Slaughter set up shop and was trading trend following systems for clients.

Friends and Family Plan

Davis came to the conclusion, after a period of rigorous and profitable testing with his own money, that there was significant potential in scaling the size of his trading strategies. He sought the help of friends and family for capital to seed a larger pool of money.

Davis founded and launched what would come to be known as Sunrise Capital Partners (known as Sunrise Commodities at the time of inception) in 1980—with the gentle prodding of Ken Tropin (who then was with Dean Witter brokerage, but who today runs one of the most successful trend following firms in the world).

Davis was not super high tech at the time. He preferred handwritten charts and price quotes from the print version of the *Wall Street Journal*. That should be an inspiration for those of you who want to make excuses for not having the perfect this or that. Just do it, right?

However, there is an even larger lesson at play here. Today, many are at a disadvantage in testing their trading ideas. It is a computer-generated love affair now with commercials promoting 24/7. However, it takes experience to be able to recognize what's real and what's luck coming out of the data. Back in the days before the popularization of computers, testing was done by hand. You saw every trade on paper. Everything was obvious. Back then all you needed was to look at a chart, and the longer you looked at a chart, the more you realized how similar they were.

**The latest gizmo or hype is not the key
to your trading success.**

Davis continued on his trajectory of success with Sunrise, and by the mid-1990s was successfully managing over \$200 million and routinely delivering double-digit annual returns for investors. Forrest at this point had met and become partners with Rick Slaughter. The two were enjoying success as a team, albeit at a more modest level of assets under management than Davis. Acting on instinct in early 1995, the three industry pioneers merged to form Sunrise Capital Partners.

Markets Are Not Efficient

Many people think you can't beat the market. Markets are efficient they say. The academics believe it as religion. The story goes something like this: Even if you see a discrepancy in the markets, by the time you try to take advantage of it, it will be gone. So, instead buy a mutual fund and hold on until you are six feet under. Trend followers don't accept that jaded worldview.

Rick Slaughter may have been young, and a touch arrogant about some things in life and perhaps in the markets, but he never bought the *efficient market hypothesis*. When he was exposed to Eugene Fama, the founder of the efficient market hypothesis, he was in graduate school and the theory was just taking hold. Slaughter perceived a hole in it. He could not see how markets were efficient, when he and many of his peers were consistently making money. His thinking, then and now, is vastly different from that of almost all typical Wall Street views.

The reality? Markets are often in "tail" situations that can produce sizable profits—profits that, over time, will significantly outweigh losses that may occur when markets are not operating within tails. When I say *tail*, think back to that stats class you probably hated. The tail of the bell curve is what I mean: extreme events that are supposed to be very rare, but actually happen quite regularly in the markets.

Meaning, we all know the world is chaotic. We know surprises happen. We know that trying to explain the world with a perfectly symmetrical bell curve, a normal distribution, is not smart . . . so why not build a trading strategy to take advantage of that?

How do you do this? Once a potential trend signal is hit within a market, various filtering techniques take place (not exactly the early ones mentioned with Seykota, but in the same spirit). You need to look at the volatility of the market in question and determine whether the movement is simply noise or, instead, the onset of a price trend. Because it is impossible to know the difference in many instances, as a general rule, you should scale back the size of your initial trade in a situation where there is high volatility, placing relatively larger initial trades in times of lower volatility.

The key is to make sure you never miss a potential big trend. You always want to put some kind of trade on when your system says enter as your price trigger hits. If you are wrong, you have stops to protect your capital, to protect your downside.



Believe in the basics: The trend is your friend. It is a powerful tool and that means you can never miss a trade. After all, you never know which move is going to be the mother of all moves.

One of the lessons you can learn from the men at Sunrise: They jump on every trade; however, how much they risk on those trades changes over time, as well as how many pieces those trades are broken into.

Are most trades going to be profitable? No. But you don't know which ones are going to be winners or losers, so you have to move on every trade. Am I being redundant? Just a little! But this is so important to accept.

Just as you move on every trade, you must protect yourself on every trade. Protecting your downside is critical to trend following success, but sorely taken for granted by most investors—even by the so-called legendary fundamental investors who pollute TV regularly.

Follow the Leader

Logical rules are mission critical! So do like the leaders do. At the time a trade is placed, regardless of its size, assign it a pre-set stop loss so that in the event a perceived trend immediately reverses, only a very small amount of capital is lost. In addition to this predetermined money stop, all trades should be assigned a pre-set trailing stop that will activate, and then accelerate if a perceived price trend begins to fulfill itself. You do this so if a trend reverses after a

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run-up in price, at least some of the profits earned from the trade are realized. You want to try to have the highest exposures on when a trend is most likely to continue and the lowest exposures on when a trend is least likely to continue. Generally speaking, you want to trade all markets in a similar fashion. However, there are some markets and sector-specific rules that help differentiate them. It is not unusual to have money stops, trailing stops, and profit targets in a market such as wheat that are different from those used in the euro.

Expanding Your Horizons

A core theory of trend following is that when markets have a certain movement or momentum, and once they start in motion—they tend to stay in motion.

Have there been changes in the last 30 years to affect these basic beliefs? Sure. Market volatility over the last 30 years has been tremendous, but the change in opportunity has equally been tremendous. Today you have the opportunity to diversify into areas that wouldn't have been possible 30 years ago.

Now, diversification is great, but only if you have the rules set in place to control your moves. Most people just don't do what they're *supposed* to do. Jack Forrest was

blunt: “Your trading needs to boil down to rules, money management, and that is it. These are the logical rules, and we don’t change them unless we have a good reason to.”

Forrest sees your trend following success in simple terms: You can buy rules from someone, make them up yourself, or buy some and make changes so they become your own. But most people aren’t willing to put the time in. You should be smiling at that. That’s motivating. If most people won’t put in the time, or can’t do it, or just have some excuse—that opens the door wide for you.

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Trend trading is a rollercoaster. Having the wherewithal to stay with it when the rollercoaster is roaring downhill is essential.

It’s too easy to find other ways that seem to work at the moment of chaos, but if you’re changing your rules around all of the time, you have no chance. Take that to the bank.

Knowing What You Don’t Know

Gary Davis never felt like he knew anything in the beginning. He was an intelligent doctor and worked hard, but approaching trading like a research scientist may have been his real

genius. The one thing he firmly understood after trend trading research was that if he didn't follow his plan, he had nothing. It was pretty clear that if he just did it, he'd make money.

One of the nice things about being a *mechanical trader* is that mechanical trading is not time intensive. The research can be time intensive, but the actual trading isn't. You just have rules, you follow them, and you don't deviate.

Almost anybody that follows markets knows that they react in certain ways once momentum starts, and especially as it builds. Moves eventually get excessive, stop, and go the other way. To not understand that about markets is to not understand anything about human nature. Davis saw this early.

White Noise

Watching the news, reading financial magazines, and listening to the President, is not how you make money in the markets. Davis is clear on this: "You don't make money by explaining how things happen and you don't make money by guessing what's going to happen in the future. You don't know what's going to happen in the future. The things that occur in the future that make you money are all things you couldn't figure out were going to happen."

It always makes for an interesting story to say, "Well, this is going to happen because this or that." That is

information everybody already knows. It's already baked into the market price.

Most traders, and most people, think a good result or big profit happens only because they are smart. That is pure fundamental reasoning. Playing your results is a dangerous game. By playing your results, you play into believing your own hype: "If I made money on it, it was a good idea. If I didn't make money on it, it was a bad idea!"

This is not necessarily true. A lot of great trades that should have won don't end up winning, but just because it was a losing trade doesn't make it a bad idea, or make it a wrong trade.

Davis painted the lesson with sports, "You are a football coach. It's fourth and inches and you've got an 85 percent chance of making a first down to end the game, or you can punt, give it to the other team, and you've got a 70 percent chance of winning the game. People will evaluate you on whether you made the first down, not whether you assessed the odds correctly. And if you don't make the first down, many will say it was an awful decision. If you make it, they'll say, 'You had guts.'"

That's the wrong way to think. You want to try and make assessments of the odds. "If I do it this way, what are the odds?" Are the odds with me or are the odds against me? That's something that you can't do very well with fundamental trading.

The Big Money

I know that you want to get rich in a nice straight line that only goes up. No can do. It doesn't work that way. You can't imagine your account having some volatility? Don't trade! If you're going to trade for yourself and you want the chance to make the big money, you will face periods where your account value can drop significantly. Meaning, if you want the chance for your account to go from 100 to 200, it might go to 60 before it goes to 200. That's life. Does it have to be that volatile? No. In fact, when Sunrise trades for their clients they aim for less return and less *drawdown*. Drawdown is the measurement in both time and money of an account's losing period. These are choices.

The experts who write books on fundamental analysis, appear on financial TV with daily predictions, or worse the ones who write articles saying that you can't be the next Gary Davis, Jack Forrest, or Rick Slaughter—while ignoring 30 years of positive performance—are just wrong. I would argue that critics in the face of performance proof are delusional. Their fears and concerns are a broken record, while at the same time the trend men keep producing.

However, some academics are concluding that taking a systematic approach to the markets is viable. They are learning, as trend traders already know, these strategies can

make you money and reduce your overall portfolio risk. You really can take any reasonable systematic approach, track multiple markets, and have the chance to make serious money in the long run.

But don't be fooled—it takes hard work.

People always want the big moneymaking strategies, and they exist, but it takes practice to win—just like learning to play the piano. Most people are not willing to sit down, get a good teacher, and practice. Trend trading success is very analogous to learning an instrument. There's no difference. People would like to make the big money, but no one is going to give it to you. You have to work and do something for it.

That something, in the case of Sunrise Capital, is sticking to an ideology. This is how Sunrise has been able to stay strong as a systematic trend following company. Their success is an inspiration for everyone.

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