

Covenant promises efficiency

Nashville-based Covenant Capital Management is unique among long-term trend following managers in that they only take long positions. It is not a directional bias *per se* but the result of research into all of their trade signals going back over a decade.

Covenant uses a somewhat simple moving average algorithm to determine trends. They risk a certain amount per trade selecting entries with stops based on the algorithm.

Three years ago Covenant instituted a change in its program based on research aimed at pinpointing their most profitable trades. They separated their signals into long and short and low and high volatility. (See Hot new CTAs, October 2003.) They discovered that more than 70% of profits — despite only a quarter of the signals — came from low volatility long trades. In early 2002 they executed only low volatility long positions and have had a compounded annual return of 41.25% since.

Principals Scot Billington and Brince Wilford say the adjustment allowed Covenant to produce better risk-adjusted returns and matched their philosophy of keeping things simple and keeping costs low. Fewer trades mean lower fees and less slippage. With no management fees, Billington claims their low-cost approach gives investors a 5% to 6% a year edge over typical trend followers.

Covenant's performance in 2004, 28.11%, was more remarkable considering most long-term trend followers had a bad year and that Covenant's unique system kept it out of many of

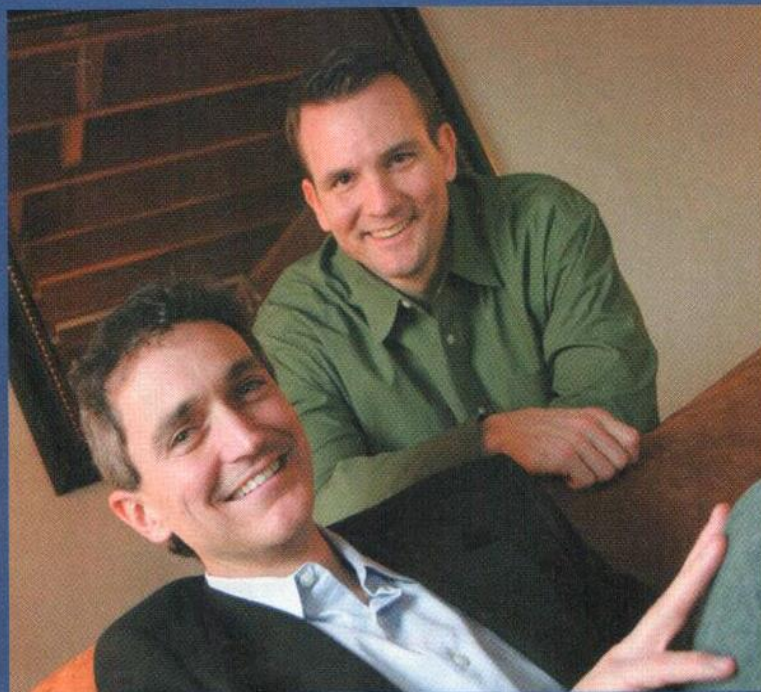


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SCOT BILLINGTON

low-risk trades. "By not taking that high-volatility crude oil trend, we were able to double the risk we took in a low-volatility coffee trade. We made just as much money on a smaller move," Wilford says. "High volatility is an under-appreciated risk by most trend followers. One of the advantages we have is we take recent high volatility as a warning [sign] and our model keeps us out of those [churning] trades."

Covenant enters about 25 positions per year. Billington says diversification can be deceiving. "A lot of these trends, even if the markets are not correlated, get correlated when you least want them to be. If I am long gold and short the dollar, that is

really not a lot of diversification," he says, adding, the program currently is quite diversified being long the Nikkei, sugar, Mexican peso, coffee, S&P, Euro FX and the bund.

Billington says Covenant won't always perform at the same clip it has the last three years, but he expects to beat the competition by keeping costs low.

