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A Summit PUBLICATION

Trader Profile

BY DANIEL P. COLLINS

Covenant: Keeping promises

Sometimes the simplest of ideas last the longest. Covenant Capital Management has now traded their simple diversified long-term trend following program based on weekly closing prices for more than a decade, producing a compound annual return of 14.51% since 1999.

Despite a year that was not conducive to long-term trend followers, Covenant produced a 15.48% return in its original program, 28.18% in its aggressive and 65.19% in its optimal.

But Covenant isn't your conventional trend follower. They filter out a majority of signals, only taking those with the best chance of being profitable. And they are much longer-term than most, with average holding periods of 230 days on winners and 40 days on losers.

When we first spoke with Covenant's principals Scot Billington and Brince Wilford, they were one of our selections for Hot New CTAs in 2003. They explained how they altered their approach to eliminate short positions and high volatility trades. A year and half later, they were featured as one of the Top CTAs of 2004. "We do things very different from other trend followers," Billington says. "We are trend following in its purest sense. We only take the trades [when] there is strong evidence to suggest they have the biggest profit potentials."

BRINCE WILFORD SCOT BILLINGTON

Covenant has tweaked its system since we spoke with them last, taking some short positions, but their philosophy has not changed. "We might take a quarter of the shorts [of other programs but] we only take those with half of the risk of a long trade," Billington says.

He estimates that they filter out 62% of the trades other trend followers take. "Obviously if those trades go gangbusters they are going to do better than us. If those trades don't go very well, we are going to do better than them."

Every year their filtering causes them to miss out on some nice moves, but also to avoid a lot of chop. They average 20-25 trades a year. In 2009, they missed out on moves in currencies and stock indexes but avoided the chop and reversals in grains and energy. Sugar and copper produced their best profits. They manage $181 million in all programs.

Billington, a former Chicago Board Options trader, estimates that their selectivity puts them at a 6 to 8% advantage over most other traders. Covenant traded approximately 190 roundturns per million under management in 2009.

"The biggest [drawback] to the limited amount of trades [we take] is we have fewer times to use our edge. The trade off of that is cost," Billington says. He estimates that at 190 roundturns per million, Covenant is 9% ahead of a manager with 2,000 roundturns per million. And that is not theoretical, that is real cost that must be overcome by performance.

"I would argue that people spend way too much time on their abilities to forecast and not enough time reducing the amount that they are forced to forecast, and the easiest way to do that is to trade long-term," Billington says. "We are talking about a world where a 15-18% return puts you in the best of the best category; saving 6 to 8%, that is half way there."

If it wasn't for adding some limited short positions, Covenant would have been out of the market completely from August 2008 until January 2009. "There were a lot of big short trends at the end of the year and we only participated in a limited amount, however, when those short trends ended we didn't take the losses others did," Billington says.

He adds that even the big short trends don't make nearly as much money as the long trends. "That is because when you get long, the volatility is usually less than when you get short. I get in during a period of low volatility and I ride it into a period of high volatility."

A good example of this was crude oil in 2008. "I guarantee you that as a group [CTAs] made more money on the move up from $70 to $140 than they did on the move down from $140 to $32."

Billington says adding short trades has improved overall returns. "Sometimes the expectancy of short trades increases enough that they are worth taking combined with the fact that those trades tend to make money when the long trades aren't. The timing when it makes money makes it worthwhile," he says. Covenant, which is based in Nashville though Billington lives in the Chicago area, is not a household name, but its simple approach has proven itself.

"I don't take long trades in periods of high volatility; I don't take the gross majority of short trades; I have a much longer time frame. Guys may be getting out and getting short when we are still in. Now if that takes us out, they are going to do better. If it turns back around and keeps going, we are going to do better. Both those things are going to happen, but since 2002, we have made more money in our proprietary account that has been open since the beginning than Winton, Aspect, Campbell and Transtrend combined," Billington says.

He realizes that those are pretty lofty programs — "They are good traders and in many ways I strive to look exactly like them," he says — but if Covenant's next decade is anything like the last, it could be listed in that company.

PHOTO BY KELLY BILLINGTON /ELA BABY PHOTOGRAPHY

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