

# The Path Out of Drawdowns

*By Michael Melissinos*

Drawdowns are natural to investing, especially in trend-following. Similar to a planting cycle, drawdowns represent the breakdown and re-nourishment of the soil that sets the stage for new trends (life) to emerge. Many people cannot accept this natural order, however, and instead believe that drawdowns represent a flaw in the overall approach.

Responding to drawdowns with unproductive tinkering and outright abandonment is all too common. Today, we're once again seeing negative articles on trend-following and assets withdrawing from funds following poor performance over the past few years. This is not new.

In this paper, I present the daily path out of major drawdowns for a managed futures trend-following system. This, I hope, can help provide some perspective that drawdowns are natural to trend-following and that the path to new highs isn't always a smooth ride.

Committing to the process is vital for successfully navigating drawdowns.

## Well, Here We Are...Again

Welp, trend-following is in another drawdown. Many equity curves peak at some point in 2022, stagnate through 2024 and then experience a steep leg down in early 2025 on Trump's back and forth tariff rhetoric. Whipsaws galore across all markets. The WSJ came out with a negative [article](#) recently.

The good news is that drawdowns are nothing new to trend-following. We've been here many times before and the current one won't be the last. Regardless of the reason(s) for any losing period, it never feels nice when you're going through it and can sometimes make you question the philosophy altogether. This paper is to help combat against losing that confidence.

Drawdowns are typically a period when investors (and managers for that matter) quit and rush in to a recent hot trend. This is a all too common mistake — jumping from one instrument the next to avoid feelings of impatience, pain, etc that so many often feel when their account values decline.

I'm writing this paper to offer some perspective on drawdowns; specifically, what the path out can look like, so you might not be as quick to bail out on an otherwise solid investment that's simply experiencing a statistically normal poor period.

## A Confidence Builder

When drawdowns occur, especially large ones, people tend to think there's something wrong with the investment approach. For managed futures trend-following, this feeling intensifies when drawdowns occur during stock market rallies.

*"How can your system be in a drawdown with so many stock markets at all-time highs?"*

The reasons aren't my focus here, but trend-following managers have to wrangle with this pressure from their investors if they don't understand how the system works and behaves.

In the next section, I review the behavior of the largest drawdowns a sample trend-following system experiences over the past 40+ years. My hope is that this simple exercise can help you become more accepting of drawdowns and offer you some peace of mind if/when you find yourself in one.

## The Drawdowns

As a proxy for this exercise, I use a simple and aggressive trend-following system. It has a correlation of 0.62 to the [BTOP 50 Index](#) (a popular index comprised of many large trend-following funds). It trades a diverse portfolio of markets that span commodities, equities, currencies and fixed income. It takes long, short and flat positions.

In this section, I review **five** of the largest drawdowns this system experiences over the past 40+ years in time order.

**Drawdown #1 [-56.8%, Mar 1980 – Aug 1981]**

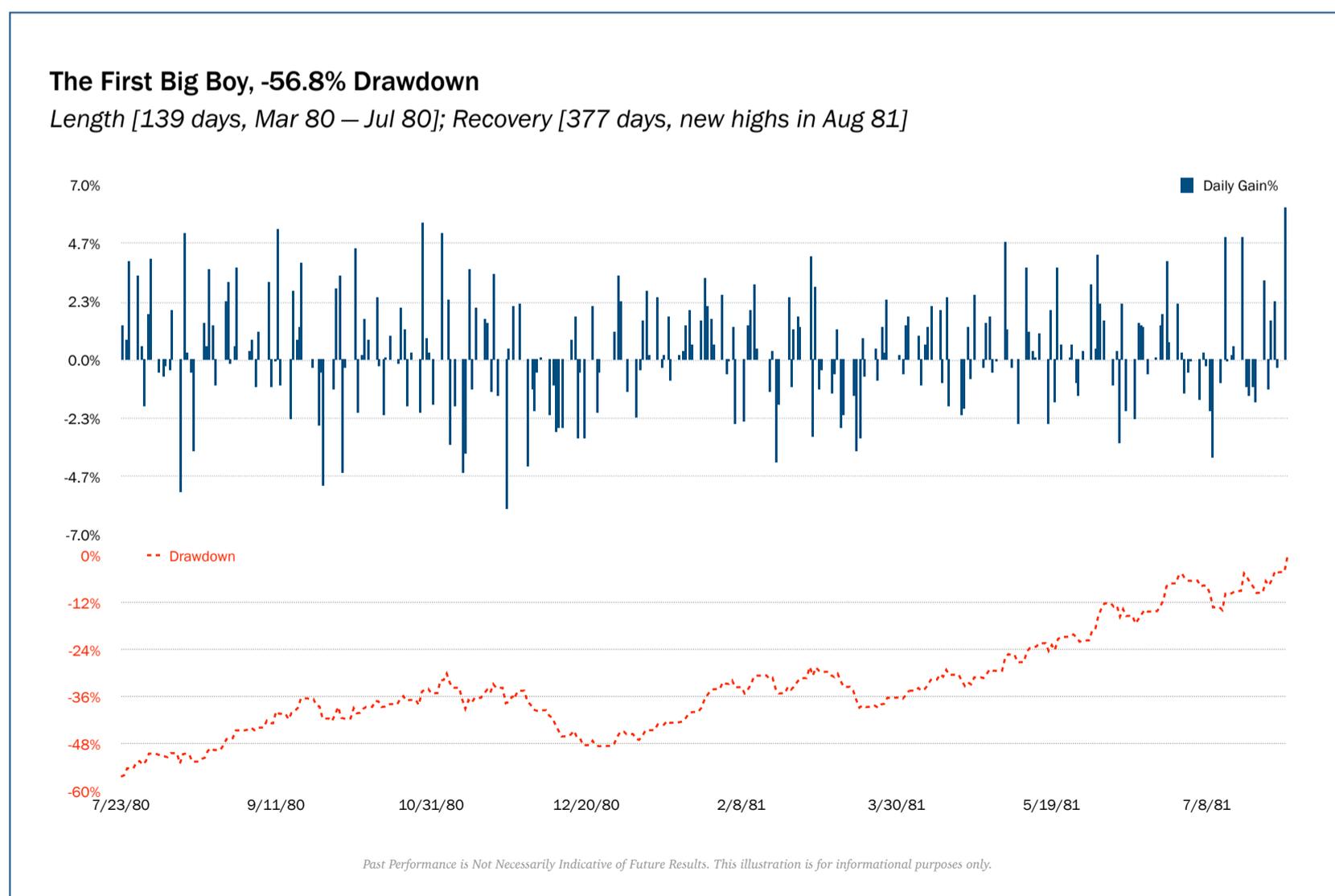
Imagine losing over half your money in less than three months then seeing your manager say in the monthly reports that, “the markets have been tough recently, but hey this is normal and not to worry.” Tough recently!? This is...normal? You might think that this guy is delusional and that if he had a system worth its salt, there’s no way a drawdown like this could happen.

This drawdown took only 140 days to lose -60%. Then it took nearly 400 days to recoup. Over a year and half. Rough. Even eight months after bottoming, the system was still in a -35% drawdown. That’s a lot time deep underwater. Recouping this drawdown came with a hefty amount of negative days too. Out of the ~400 days it took to achieve new highs, nearly 40% of them were **negative!**

Even the most ardent trend-followers could lose faith in a stretch like that.

The markets don’t ring a bell, so you never know when the bottom of the drawdown is in. But a lot of time can pass until you hit new highs as we’ll see in the coming, but not all, examples. A lengthy drawdown can get those unhealthy juices flowing where you think how much money you’ve lost, about how much better off you’d be if you had invested in something else, etc.

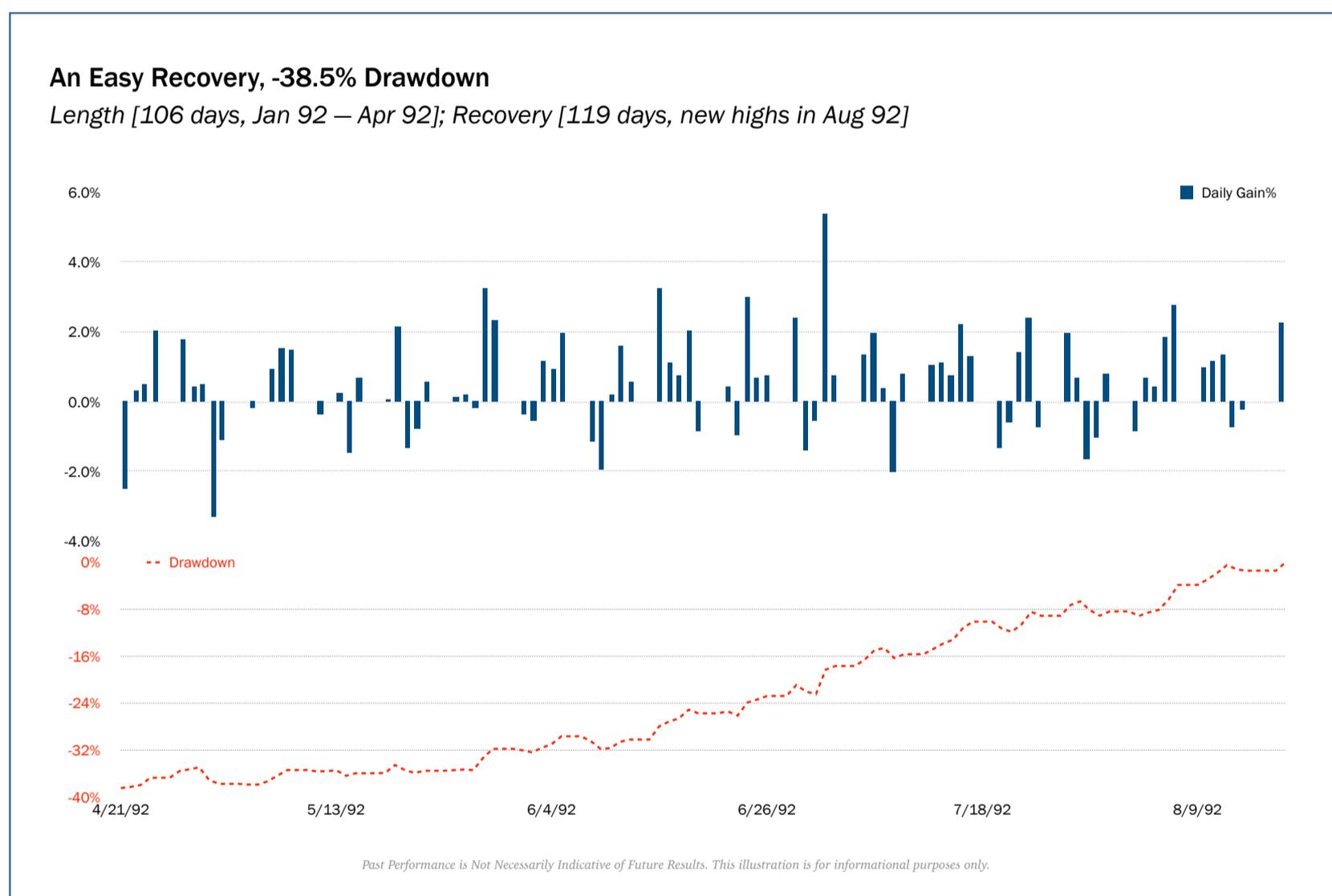
This kind of emotional roller coaster is generally enough for managers to abandon their system and for investors to abandon their manager.



## Drawdown #2 [-38.5%, Jan 1992 – Aug 1992]

Not as intense at the first drawdown, but losing nearly 40% of your money doesn't feel particularly nice. Thankfully, the market gods weren't as cruel on this one. The total journey only took about 40% of the time as #1.

Out of the 119 recovery days, 92 of them were positive. And the worst single day was -3.3%, which isn't too bad considering the previous drawdown had multiple -5% days. It took a couple of months before the system started significantly recouping the drawdown, but once it got going it was smooth sailing to the high-water mark.



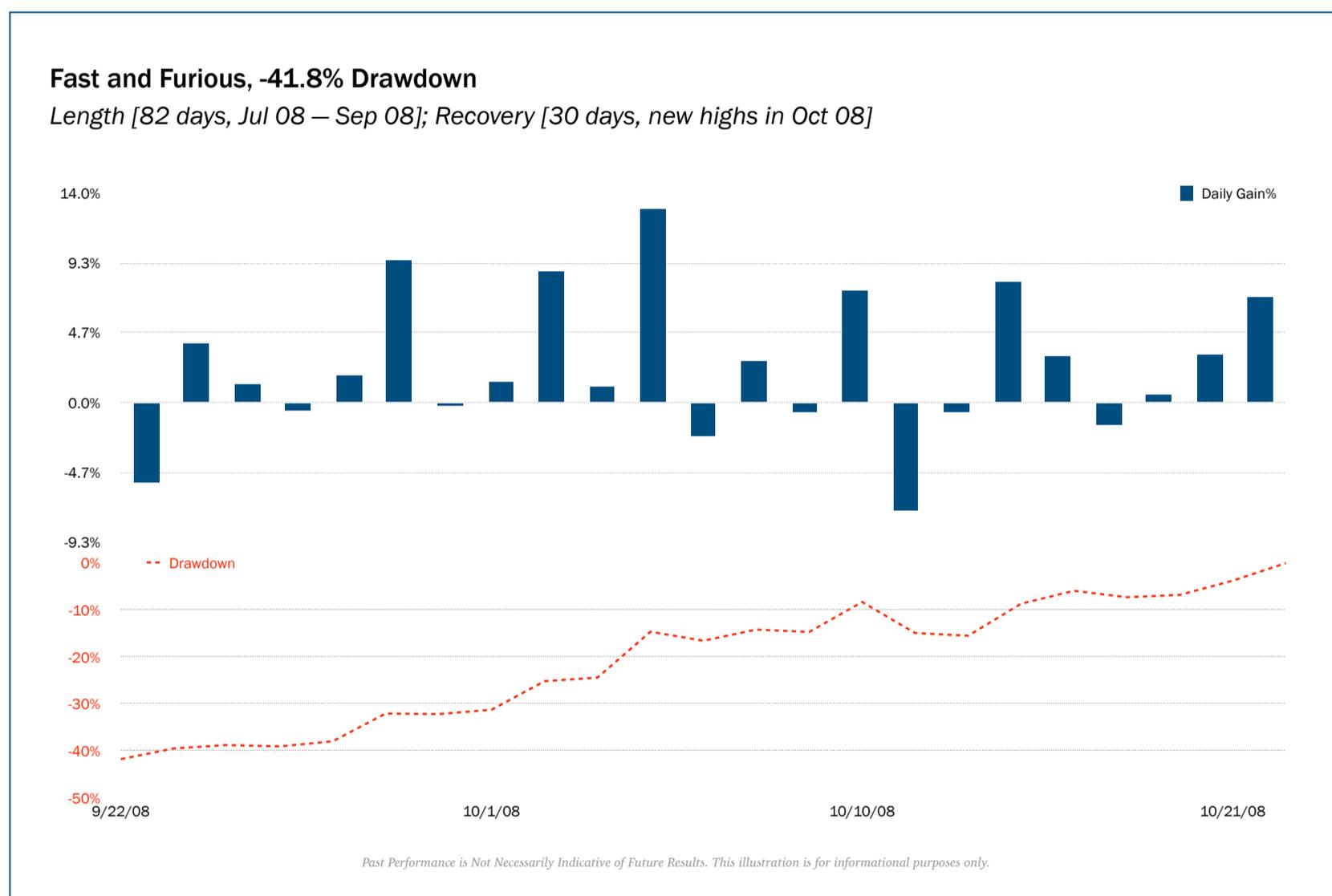
## Drawdown #3 [-41.8%, Jul 2008 – Oct 2008]

This one was fast and fierce. 80 days in, 30 days out. Most people remember 2008 as a strong year for trend-following, which it was, but it did come with a significant gut-punch in the summer — a two-month -42% decline. YTD performance peaked at +70% in early July before turning **negative** 40 days later.

A few months ago, I wrote an essay specifically on this particular drawdown ([Trend-Following in 2008: From +70% to Negative 1% to +92%](#)) to provide investors with perspective as early 2025 performance declined significantly. This essay then motivated me to expand on it and write the paper you're reading right now.

After performance peaked in early July, many markets, especially energies, reversed sharply. Naturally, this particular long-term system took some pain before hitting the exits. Then as the Financial Crisis unfolded in the fall months, trends revved back up and provided enough profit for the system to achieve new highs.

I'd say the most painful part of this drawdown was the speed at which it occurred since the path out was fairly painless. Going from +70% to -1% is indeed jarring. This was also a very news-heavy time period, so it's possible that traders and investors could have decided to cut back exposure because of a general fear of the markets.



#### Drawdown #4 [-45.1%, May 2011 – Dec 2014]

This was the first major drawdown that I experienced in actual trading. When I started my fund in January 2011, we had some good trends right out of the gate but little did I know that it was a send-off before entering one of the worst drawdowns for trend-following in years.

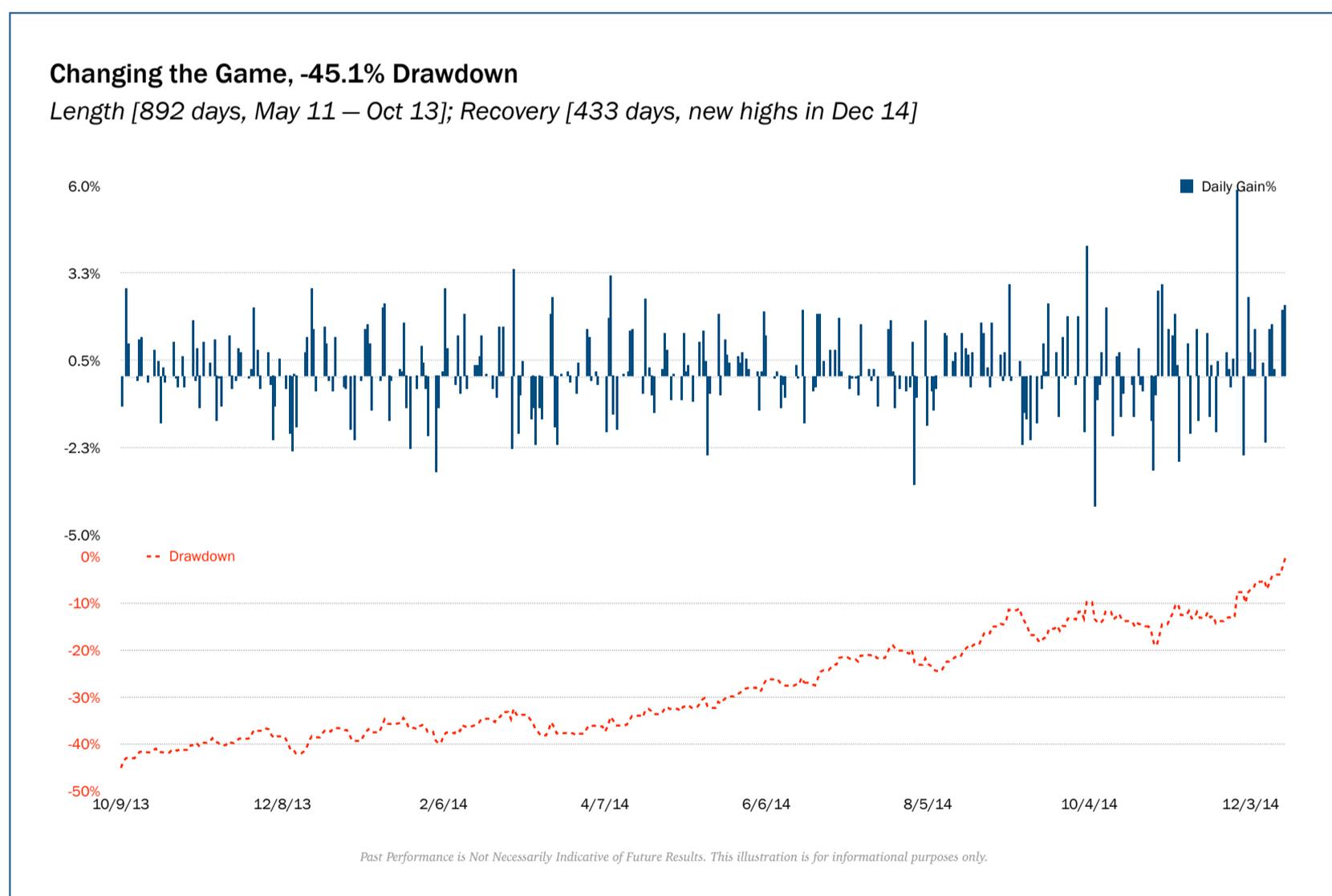
For the majority of mid-2011 thru mid-2014, this trend-following system gets chopped up from what seems like endless whipsaws. I recall several veteran trend-traders calling it quits during this period while others went back to the drawing board to “improve” their systems so to avoid drawdowns like this in the future.

When you make changes to any strategy, especially in response to the current drawdown, you often inhibit the ability to come out of it. I recall buy-and-holders questioning their approach near the bottom in 2008-09. If you operate under the belief that drawdowns can be avoided or fixed, you set a precedent that it's OK, even encouraged, to not follow your system. "Hey if you're trying to improve it, make those changes man!" Careful.

This is the culture we have. Investors demand consistent outperformance, while managers out of fear their investors will leave them, tinker to improve their system. Worse results is typically the result though.

As we've seen with this particular system, it keeps making new highs **despite the drawdowns**. Drawdowns are only a problem if they force you to abandon or change the system (at least in a significant way).

This drawdown, at the time, was one of the longest on record. Unlike some of the others that only last several months, this lengthy one weighed on the psyche of many in the trend-following community. I'd even go as far as saying that it changed beliefs, even for the old-timers, about trend-following (the philosophy) and trend-following (the business).



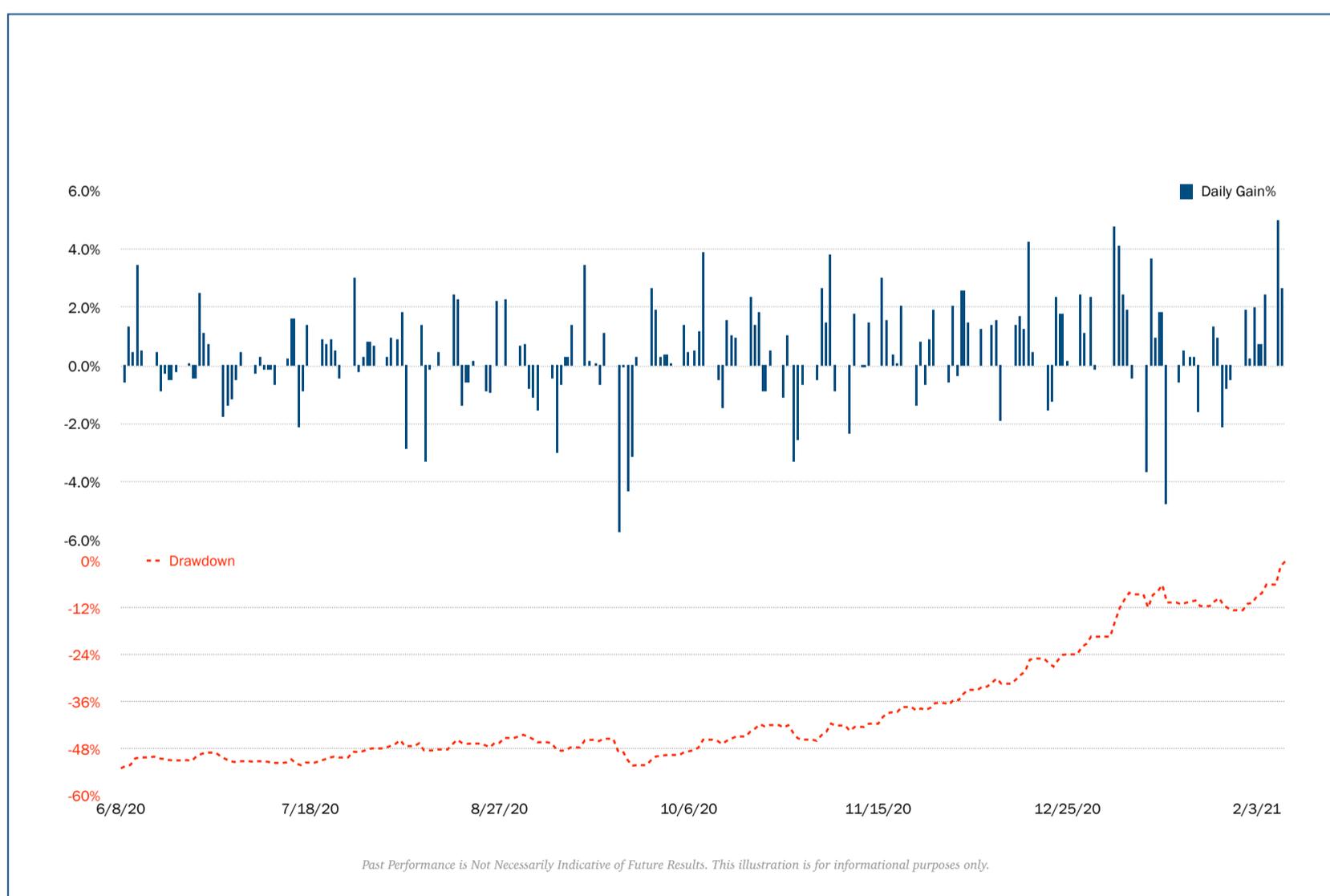
**Drawdown #5** [-52.9%, Jan 2016 – Feb 2021]

As if the previous drawdown wasn't tough enough, a bigger one comes right behind it. Sixteen hundred days of a slow drip lower. A water torture of whipsaws. I smashed an iPhone to pieces during this one.

The path in was tough because it never seemed to end. If the previous drawdown started changing people's minds about trend-following, this one reinforced their beliefs. Tinkering was now fully embraced. But if you look at the numbers and only the numbers, sure this one looks gnarly but it's not out of the statistical norm – especially for the aggressive system we're using in this exercise.

Having recently experienced this one, I remember feeling dejected during the summer months of 2020. Here was another round of very intense whipsaws making it so hard to find the confidence to market my trend-following fund. Had the markets changed? Would we ever see good markets again? Do I need to change some things?

Well, what happened next was nothing short of eye-popping. This system gained +150% and +440% over the following 12 and 24 months. No tinkering needed. Just relaxing and sticking with it. Markets, man.



### The Current Drawdown

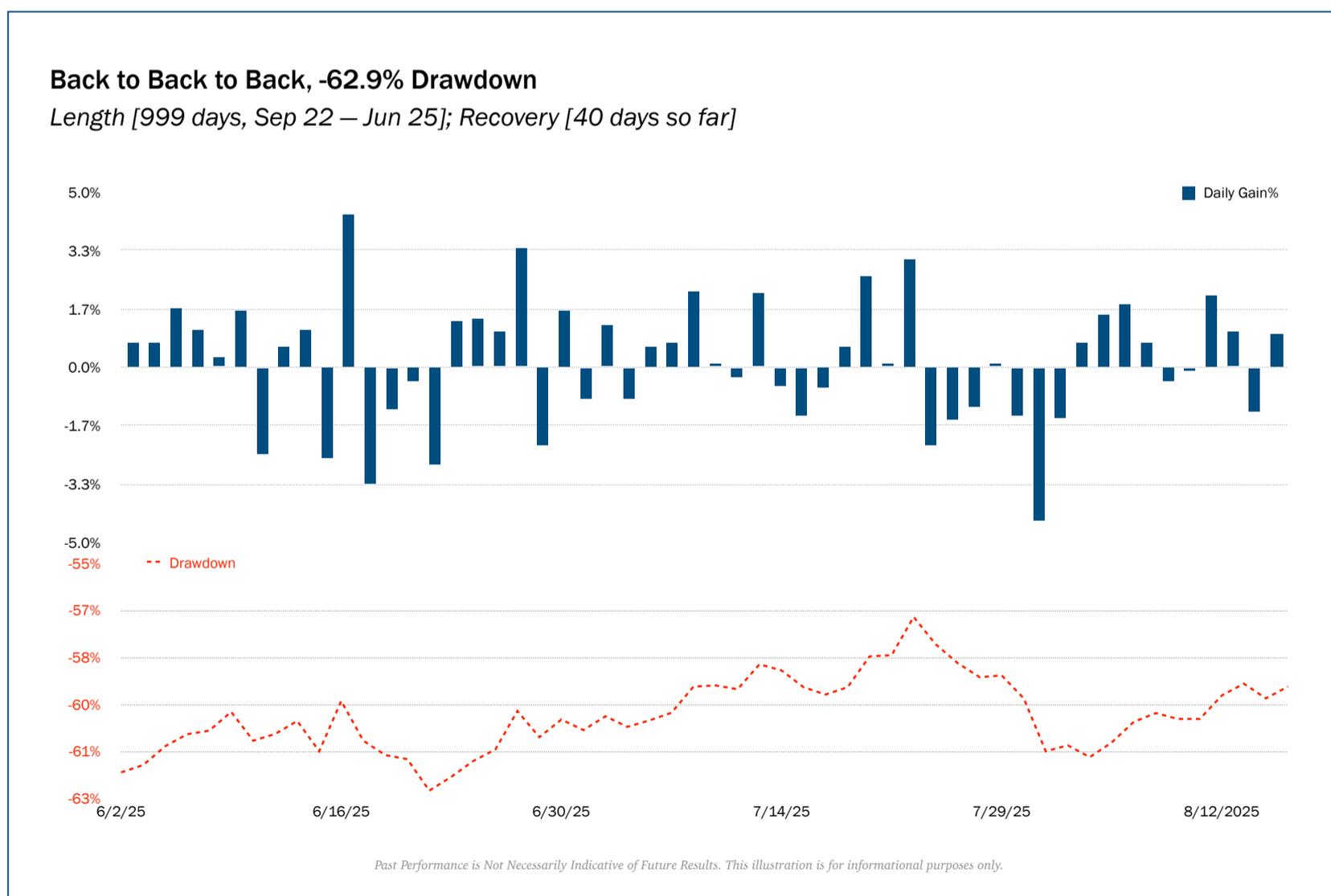
And this brings us to the drawdown we're presently dealing with. The lows may not be in yet, but for sake of monitoring the current path let's assume it is.

This is the third big-boy drawdown I've experienced in my ~15 years of trading. One might conclude that this one is indeed different because of Trump, because of Biden, because of the elites, because because because. Markets are ever-changing.

This exercise doesn't cover all of the drawdowns this system experienced over the 40+ year simulation, but only the five most significant in terms of magnitude. In fact, this system experienced an additional 27 drawdowns of at least -20%. Twenty-seven. Drawdowns are the norm. Some are bigger than others. That's life in the markets.

I understand I may sound like a broken record at this point, but the rules are black and white. The complexity resides not in the math, but in our ability to obey the math. When considering only the data, this drawdown is a large one but a system that carries a ~30% annualized volatility like this one does, a -60% drawdown is to be expected at some point. Just because it hadn't happened in the backtest doesn't mean it won't happen in real life as we march forward.

In the 40 days since the most recent low, 17 days have already been negative (43%). Sounds about right to me.



## Summing Up

No two drawdowns are the same. Each has their own story. There's no way to utilize the pattern of a past drawdown as a predictor for the current one. Maybe the only sensible prediction we can make about trend-following is that drawdowns will continue to occur over time.

Commonalities between drawdowns:

- The path in and out of a drawdown is unpredictable
- The path out of a drawdown typically includes an abundance of losing days, weeks and months
- Drawdowns generally ignite a loss of confidence amongst traders and investors
- Tinkering, system-hopping, negative press and other unproductive behavior typically occur during drawdowns

Drawdowns must be accepted and embraced. Trend-following is about continuously culling out losing positions, surviving through periods of whipsaws and having the toughness to execute flawlessly when those opportunities eventually come around.

The path out is through.

### The path out of drawdowns is often bumpy, but only the committed get to reap the rewards

Sample Managed Futures Trend-Following System [1978 – 2025]

	Size	Days to Highs	Number of Negative Days					3-Year Return from Low
			0 to -2%	-2 to -4%	-4 to -6%	-6 to -8%	> -8%	
Mar 80 – Aug 81	-56.8%	377	74	32	7	0	0	479%
Jan 92 – Aug 92	-38.5%	120	25	3	0	0	0	349%
Jul 08 – Oct 08	-41.8%	31	5	1	1	1	0	273%
May 11 – Dec 14	-45.1%	433	244	14	1	0	0	117%
Jan 16 – Feb 21	-52.9%	246	122	10	3	0	0	412%
<b>Sep 22 – Jul 25</b>	<b>-62.9%</b>	<b>? (40 so far)</b>	<b>21</b>	<b>2</b>	<b>1</b>	<b>0</b>	<b>0</b>	<b>?</b>

*Past Performance is Not Necessarily Indicative of Future Results. This illustration is for informational purposes only.*

## Disclosures

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