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A Game of Two Halves

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Trend following strategies (sometimes known as CTAs) have been embraced by many investors as a 'one stop' solution to their alternatives allocation. In this Insight, Ibbotson Associates' Head of Alternative Investments, Craig Stanford, discusses some of the issues posed by gaining all of your alternatives exposure through a concentrated exposure to trend followers instead of a more diversified portfolio including hedged equity, credit, event driven, macro and other alternative strategies.

Prior to the GFC, trend following strategies were popular with investors and it is not hard to see why. They had a solid standalone track record, invested in liquid instruments and had valuable portfolio construction benefits due to their low correlation and low beta to both equities and bonds. Their performance during the GFC cemented this view, as they were one of the few strategies that investors viewed as having delivered on their return promises.

This led many investors to rely solely on trend following funds, and in more extreme cases a single trend following fund as their only alternative investment.

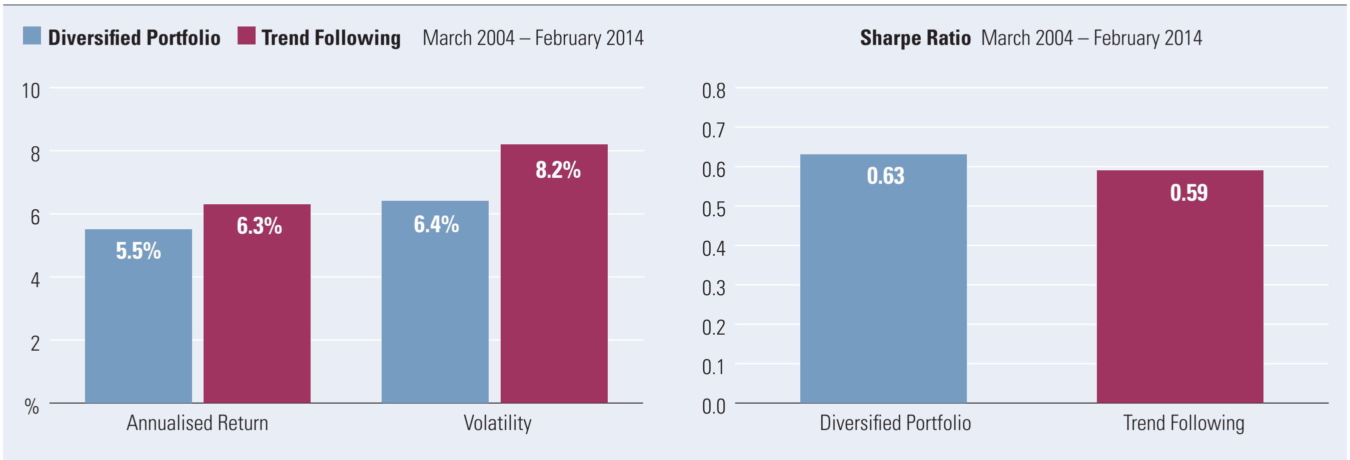
In this paper we compare the performance of a concentrated allocation to trend following strategies (represented by the HFRI Macro: Systematic Diversified Index) to the performance of a diversified hedge fund portfolio including trend following (represented by the HFRI Fund Weighted Composite Index). With the five year anniversary of the equity market bottom (March 2009) now behind us, it is a good opportunity to compare the performance of trend followers to a diversified hedge fund portfolio over two separate periods – for the five years prior to the market bottom during the GFC, with the five years since then.

Comparing performance across the ten year period from March 2004 to Feb 2014 (Figure 1), trend followers have outperformed a diversified hedge fund portfolio by a small margin, albeit with a higher level of volatility. If you look at a risk adjusted return measure like the Sharpe ratio then the performance of both portfolios is very close.

However, when you break the ten-year period into two five-year periods either side of March 2009 (Figure 2), you can see that the overall return statistics mask two very different periods.

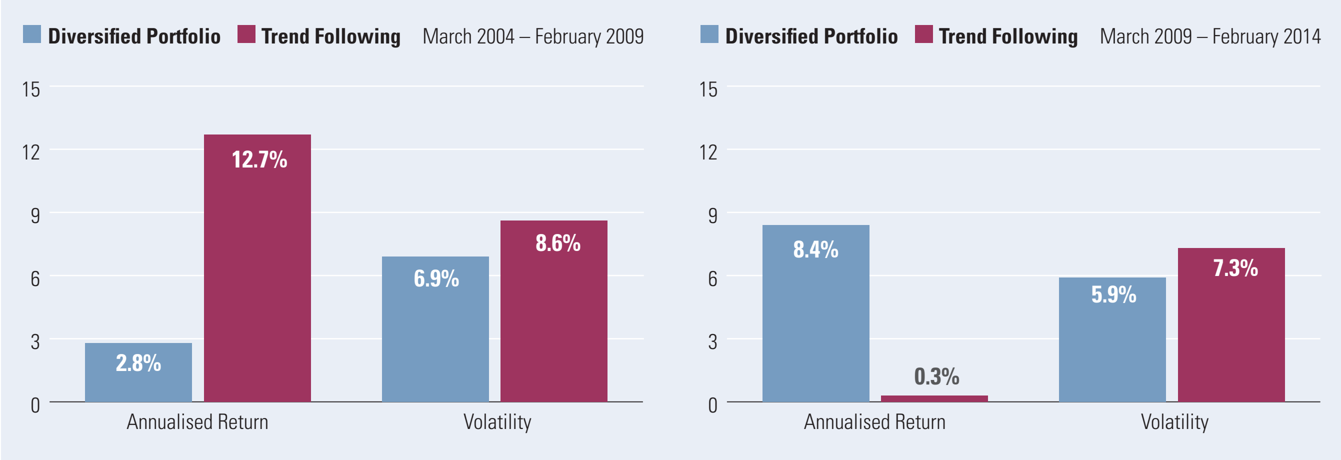
In the first period, the trend following portfolio outperforms the diversified hedge fund portfolio by just short of 10% p.a. but in the second period the roles are reversed and the diversified hedge fund portfolio outperforms by over 8% p.a. The unfortunate thing for many investors is that a significant amount of capital flowed into trend following strategies as a result of their performance up until February 2009 and it is almost certainly the case that performance since then has lagged expectations.

Figure 1: Risk and Return Outcomes – 10 Years Ending 28 February 2014.



Source: Ibbotson Associates

Figure 2: Risk and Return Outcomes – Five Years Ending 28 February 2009 Versus Five Years Ending 28 February 2014.



Source: Ibbotson Associates

Figure 3: Performance During Negative Equity Months.

Source: Ibbotson Associates

What conclusions can be drawn from this? The first is in the standard performance disclaimer – past returns are no guide to future returns. The second is that trend following performs better in some environments than it does in others.

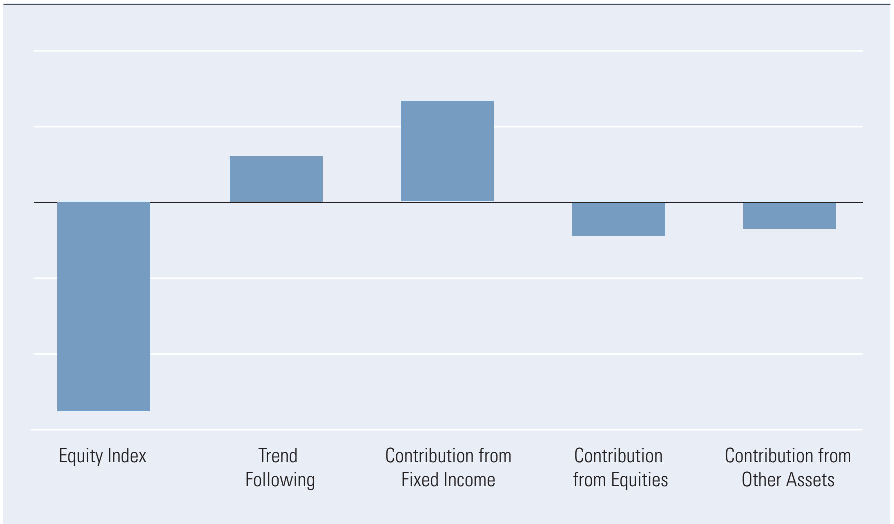
Building on the point above, another interesting comparison would be to look at the performance of trend following during months when the stock indices do poorly since this is a key selling point for the strategy. For this comparison we have once again broken the ten year period into two five year periods and taken the ten worst months for the ASX 200 Accumulation index in each five year period.

Once again the contrast is quite stark. In the five-year period prior to February 2009 the trend followers outperformed the diversified hedge fund portfolio during difficult months by a median amount of 2% (median positive performance for trend following of 0.1% versus a median loss of 1.9% for the diversified hedge fund in an environment in which the overall market lost 5.5%). However, looking at the more recent five-year period, the median returns during those difficult months are much more closely matched with only 0.1% difference in favour of the trend followers vs. the 2% difference in the prior period.

The conclusion to be drawn from this is that during those difficult months for equity markets, trend followers have not been that much more helpful than a diversified hedge fund portfolio over the last five years. It also almost certainly confirms that the environment for trend followers has changed between the two periods and if you combine this with the outright performance numbers quoted earlier, it is fairly clear that the diversified hedge fund portfolio has been a much better investment since the GFC. Whether or not this will remain the case going forward remains to be seen but any investor counting on trend following alone is making a bet that conditions will return to those that prevailed pre-GFC.

Anecdotally, some market participants attribute trend follower's ability to make money during difficult months for equity markets due to the strategy being 'long volatility' whilst others think that short equity or commodity positions are the key. Unfortunately, neither is generally correct. The strategy doesn't buy options or other volatility based instruments so it is not really 'long volatility' – it may sometimes behave as if it is 'long volatility' but correlation doesn't imply causality. The strategy may or may not be short equities and commodities at times but this depends on how trends have developed prior to that point in time. If markets have been consistently trending upwards for some time (and remember the very long term trend in most assets has been up, so the natural bias is to be long most assets) then it is highly likely that a trend follower is long those markets and is unlikely to switch from being long to being short very quickly.

Figure 4. Stylised Contribution to the Returns of Trend Followers During Poor Markets.



Source: Ibbotson Associates

The key and most consistent profit generators for most trend followers during difficult months for equities are long positions in fixed income (typically at both the front and back end of the curve). Intuitively the reason for the positive contribution makes sense because fixed income typically rallies during equity market sell-offs. It also explains why trend followers performed poorly in May and June 2013 when equities performed poorly – in a departure from their historical behavior, bonds and equities both sold off at the same time and their long positions in fixed income produced losses.

In fact, if you were to look at all the months when equities fall, and then look at the combined contribution to trend follower's returns during those months from fixed income, equities, commodities etc. you would likely find that fixed income was a significant and positive return generator whilst the other asset classes had negative contributions. This is represented graphically in Figure 4.

Given that long positions in fixed income have been so important, it is also worth thinking about what would happen during a bear market for bonds – could trend followers still make money but perhaps more importantly, how would this impact the benefits they bring in a portfolio construction sense?

The first thing to consider is can trend followers make money by being short fixed income? The good news is yes, they can – but the reality is that it is not quite a simple reversal of being long. Being short fixed income means that you are paying away the bond coupon instead of receiving it so there is a consistent drag instead of a consistent boost to returns, although this may be somewhat offset by earning more interest on the fund's cash balances.

The other and probably more important factor though, is that being short fixed income is the reverse of the position that has generated the bulk of the profits during difficult months so the implication is that this position will probably start to generate losses during difficult months and compound your negative performance instead of offsetting it.

Conclusion

The purpose of this Insight is not to discredit trend following as a viable strategy or suitable investment since we invest in the strategy as a component of our diversified alternatives portfolios, even though the benefits of doing so have been less clear since the GFC.

In trying to explain the last five years of subdued performance by trend followers, some managers have blamed central bank intervention but this is really guesswork because we have no ability to know what would have happened in the absence of intervention. It is entirely possible that intervention has caused movements in the currency, fixed income and equity markets that have been a net benefit to the strategy.

What we have shown in this paper is that using trend following strategies alone, as a substitute for a diversified alternatives exposure, can be a risky strategy because trend following does not work well under all market conditions – this was evidenced by comparing the performance characteristics of the trend following indices between two distinct five-year periods across a number of metrics.

We also analysed how trend followers tend to generate positive returns during difficult months for equity markets and concluded that most often it was long positions in fixed income that were the key profit generators as against short positions in equities or other assets.

We then offered some thoughts on how trend followers might perform during a bear market for fixed income, when they are short the asset class, and concluded that many of their desired performance characteristics will in fact reverse with the impact on a portfolio being larger instead of smaller losses.

To conclude, we believe that a balanced approach is best and that a diversified portfolio is better suited to most investor's needs. i

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