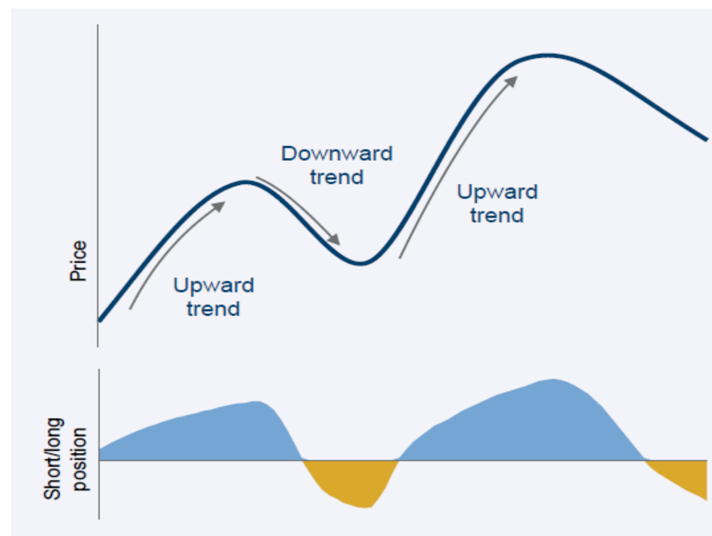
Introduction to Trend-following

What is Trend-following?

As the name implies this is a strategy that seeks to profit from trending behaviour in markets. Trend-following funds, often also referred to as momentum funds, are a sub-set of managed futures and are sometimes also referred to as CTAs (commodity trading advisors), although that term also includes other non-trend strategies.

Trends are a widely recognised feature of markets even if the reasons for their existence are often debated. Essentially trends are caused by the adjustment of prices over time to changing fundamentals, often exacerbated by the 'herding' nature of investor behaviour. The strategy seeks to capture those trends, whether they are to the upside or the downside; the strategy can harvest both equally effectively.

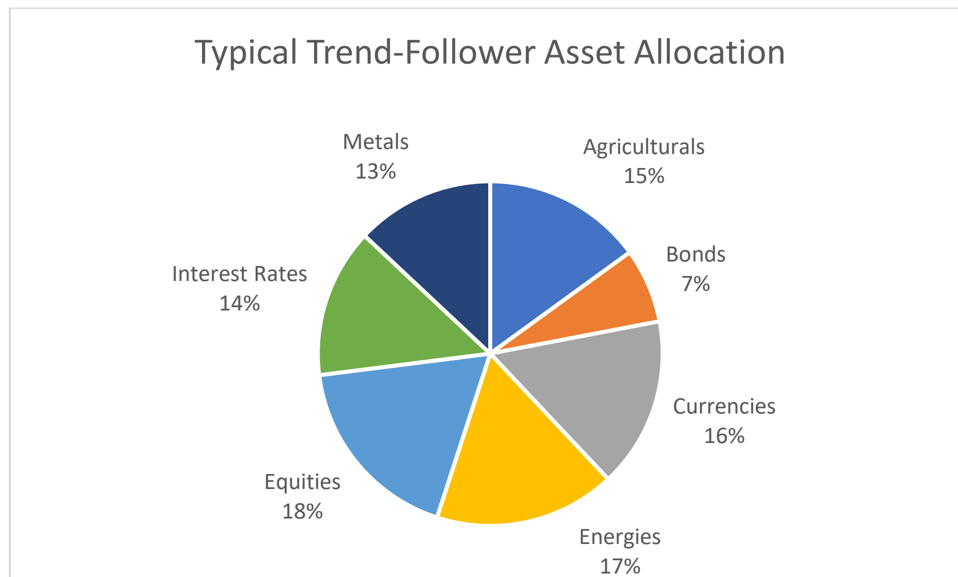


In any single market this strategy works, but not consistently. Developing trends frequently come to nothing, and the strategy is liable to 'buy high' and 'sell low' in these periods while losses and higher trading costs are incurred. However, this seemingly very simple and moderately effective strategy becomes a powerful one through a combination of diversification and operational efficiency.

By trading multiple markets, the odds of mining a profitable trend at any given point in time are increased[1], and the overall return stream is much less lumpy. Adding more markets, especially ones that are truly independent of each other, for example coffee and, say, the Japanese yen, improves the risk adjusted returns. Many trend-followers now trade several hundred different markets, and those that have unique drivers (such as coffee) are more

[1] Trend-following is by definition a "cut your losses and let your profits run" strategy – the average gain is larger than the average loss. This means a decent trend in one market can offset smaller losses in several others.

attractive than those likely to be highly correlated to other markets (such as, yet another sovereign bond market). Note in the chart below that smaller but more idiosyncratic markets like those in the agricultural complex have a greater allocation than larger, but more highly correlated sectors, such as bonds.



The other way to add diversification is to add different time horizons into each market. A market may be trending strongly over a multi-hour timeframe but be directionless or perhaps even trending in the opposite direction over a multi-week timeframe. The short-term models in this market can hold positions contrary to the longer-term models, resulting in a small or even zero net position. Most sophisticated trend-followers trade 6-8 different time horizons for each market. If there are 300 markets, and 7 timeframes for each, that represents 2,100 different 'markets' running at any given time. This becomes complex to manage and highlights the importance of operational efficiency.

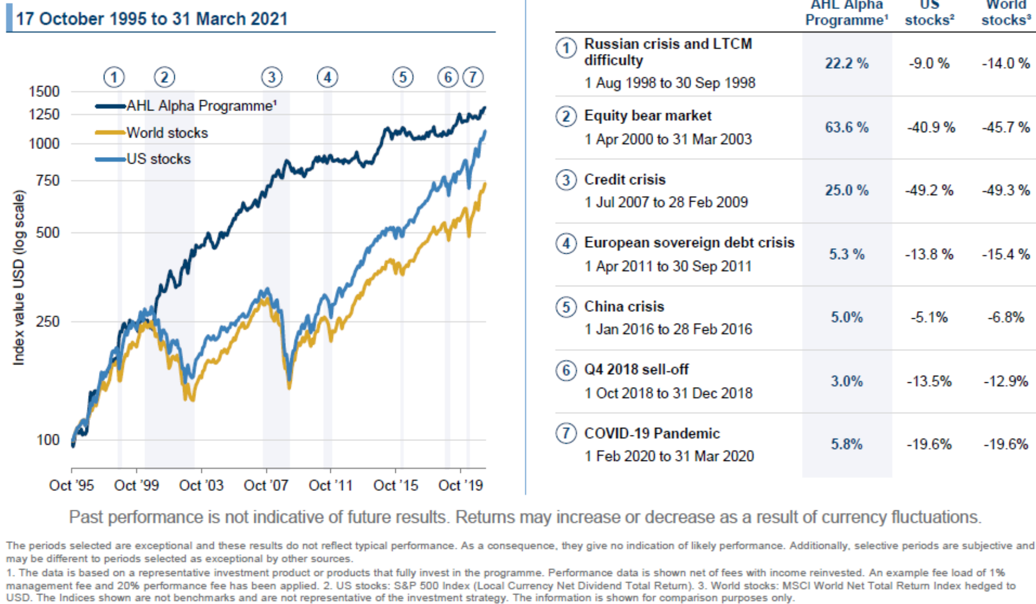
Clearly computerised systems are far more capable of efficiently monitoring 2,100 different markets than are people. They are also much more capable of applying rules to allocate risk between those markets, to ensure overall portfolio risk is within bounds, to calculate which trades need to be implemented and sending orders to the market in such a way as to minimise trade costs. The systems are designed by people but implemented by computers with human oversight.

What does Trend-following offer portfolios?

Trend-following is obviously not a form of fixed income, but it does have attributes that mean it can perform part of the role that fixed income has traditionally performed in portfolios – particularly risk mitigation. Unlike most dedicated risk mitigators though it also has a positive expected return.

The best environment for trend-following is one in which there are large, sustained moves across multiple markets at the same time, and this happens most dramatically during equity bear markets. This translates into very welcome gains when portfolios most require them.

The following chart from one of our favoured trend-following managers, AHL, shows the performance of their Alpha program since inception in 1990.



	AHL Alpha Programme[1]	US stocks[2]	World stocks[3]
(1) **Russian crisis and LTCM difficulty** 1 Aug 1998 to 30 Sep 1998	22.2 %	-9.0 %	-14.0 %
(2) **Equity bear market** 1 Apr 2000 to 31 Mar 2003	63.6 %	-40.9 %	-45.7 %
(3) **Credit crisis** 1 Jul 2007 to 28 Feb 2009	25.0 %	-49.2 %	-49.3 %
(4) **European sovereign debt crisis** 1 Apr 2011 to 30 Sep 2011	5.3 %	-13.8 %	-15.4 %
(5) **China crisis** 1 Jan 2016 to 28 Feb 2016	5.0%	-5.1%	-6.8%
(6) **Q4 2018 sell-off** 1 Oct 2018 to 31 Dec 2018	3.0%	-13.5%	-12.9%
(7) **COVID-19 Pandemic** 1 Feb 2020 to 31 Mar 2020	5.8%	-19.6%	-19.6%

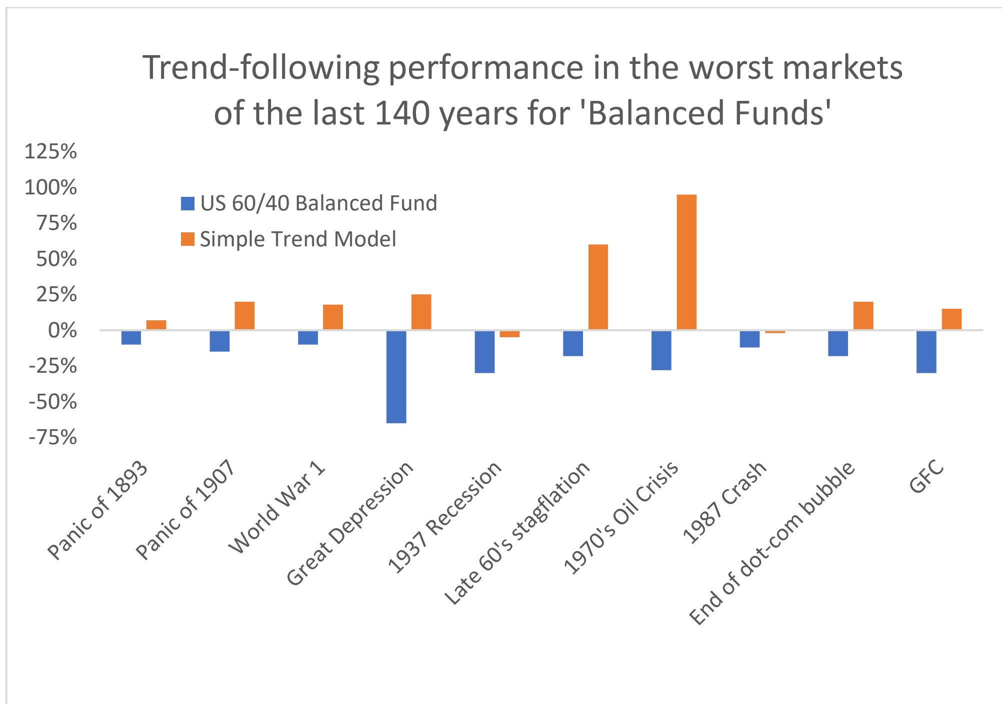
Past performance is not indicative of future results. Returns may increase or decrease as a result of currency fluctuations.

The periods selected are exceptional and these results do not reflect typical performance. As a consequence, they give no indication of likely performance. Additionally, selective periods are subjective and may be different to periods selected as exceptional by other sources.
1. The data is based on a representative investment product or products that fully invest in the programme. Performance data is shown net of fees with income reinvested. An example fee load of 1% management fee and 20% performance fee has been applied. 2. US stocks: S&P 500 Index (Local Currency Net Dividend Total Return). 3. World stocks: MSCI World Net Total Return Index hedged to USD. The Indices shown are not benchmarks and are not representative of the investment strategy. The information is shown for comparison purposes only.

The excellent long-term performance, even exceeding that of equities over the last 30 years, is even more pronounced in periods of equity market weakness (shown in grey above).

One of the primary risks facing traditional balanced portfolios is a rise in inflation with rising interest rates and bond yields, probably lower equity indices, and very likely large moves in currencies, metals and energies. Although we cannot be certain, trend-following is likely to capture and profit from all of these moves, whether they are to the upside or the downside.

There have been several long-term studies of the performance of the strategy. It is entirely rules-based and so performance can be reasonably accurately calculated for periods before it was first implemented. The chart below shows that trend-following has delivered exceptionally strong returns in the worst periods for balanced funds, with the inflationary episodes of the late 1960s and 1970s being the best examples.



Trend-Following’s weaknesses.

Despite these positive attributes, there are downsides to trend-following. It does not provide the elusive ‘free-lunch’.

Although it can provide some of the risk mitigation characteristics that have become expected from fixed income, it certainly does not deliver returns that resemble fixed income. It can be ‘streaky’ and quite volatile, delivering returns intermittently, with periods where it seems to be consistently wrong-footed. This can make it difficult to own for those without conviction and its presence will result in portfolios performing differently, both for the better and the worse, to those with more traditional assets.

It is also expensive to implement. There is typically both a high management fee and a performance fee. Trend-following managers employ extensive research teams and have state of the art systems and thus it is an expensive strategy to implement. We have evaluated cheaper options, but this is one strategy where there is strong empirical evidence that paying more, results in better outcomes, net of fees.

Trend-following can be wrong-footed in the early stages of a crisis. This is particularly the case if the catalyst is something that arrives suddenly from beyond the financial world, such as a pandemic or large terror attack. In these cases, it is essentially chance as to whether the trend-follower was positioned correctly or not in each market when the shock occurs. In time positions will adjust to be aligned with the new trend, but there can be losses initially.

Conclusion

Trend-following is a powerful risk mitigator with a high probability of profiting from large, sustained bear markets. It is also likely, based on historical evidence, to generate better performance than investment grade fixed income, with low correlations to other assets, over the next few years, with or without the presence of a market crisis. The combination of a positive expected return and downside protection is rare. As such it is a powerful tool in portfolios.

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MyFiduciary recommends seeking assistance from a properly qualified financial adviser when considering the application of the investment views expressed to any particular situation.