



Trend-Following: What's Not to Like?

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Trend-following strategies have historically performed as well as equities over the long term, yet got there with lower risk, smaller drawdowns, and tended to do best when equities were at their worst. What's not to like about that?

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Introduction

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What's not to like about that?

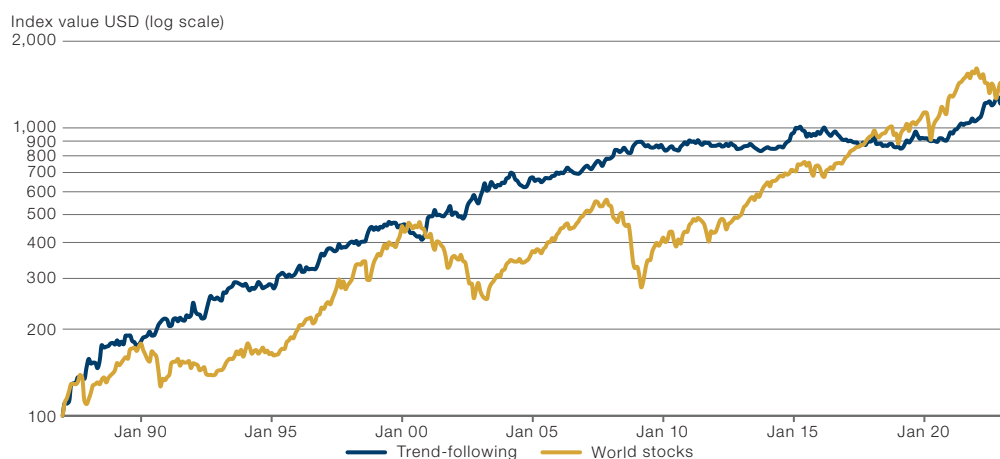
Trend-following should be at least as popular as equity investing, right? Well, given equity markets are nearly 300 times the size of trend-following's assets under management¹, either these facts are not well known, or there is some other issue.

In this short article, we touch on both possibilities.

Trend-Following Performs as Well as Equities in the Long Term. Really?

Since inception in 1986, the Barclay BTOP50 Index (which comprises of mostly trend-following strategies) has returned 7.0% annualised, only 0.7% shy of world stocks (Figure 1). Trend-following's risk is significantly lower, however, whether risk is measured in terms of volatility (9.6% versus 14.4%) or maximum drawdown (-16% versus -50%).

Figure 1. Trend-Following Performance Versus World Stocks Since inception of BTOP50 Index



	Trend-following	World stocks
Annualised return	7.0%	7.7%
Volatility	9.6%	14.4%
Sharpe ratio	0.37	0.29
Max drawdown	-16.1%	-50.4%

Past performance is not indicative of future results. Source: Man Group, BarclayHedge, Bloomberg; between 1 January 1987 to 31 March 2023. Trend-following represented by Barclay BTOP50 Index; world stocks represented by MSCI World Net Total Return Index hedged to USD.



At face value, trend-following is a remarkably simple strategy. Buy something that is going up, and sell something that is going down.”

At face value, trend-following is a remarkably simple strategy. Buy something that is going up, and sell something that is going down. Finance 101 says that trends should not exist; markets are efficient, and information is instantaneously reflected in prices. Of course, this ignores the fact that decisions lag news flow, that economic cycles play out over years, and that humans get emotional; we hate losses more than we love gains, and in doing so we make irrational choices (see, for example, Kahneman & Tversky (1979)).

Try and earn a crust off trend-following in one market, however, and you might end up hungry. There's only a slight edge, which is why managers run the strategy over tens, if not hundreds, of liquid markets to eke out consistent returns. They use computers for repeatability and because computers don't get emotional.

1. CTA assets under management: www.barclayhedge.com/solutions/assets-under-management/cta-assets-under-management/cta-industry/. Bloomberg: World Exchange Market Capitalisation.

Genuinely Diversifying

Since its inception, the correlation of the BTOP50 to world stocks and other traditional markets is effectively zero (Figure 2). Intuitively, this is because trend-followers seek to capture trends in all these markets simultaneously, either up or down. Our correlations also show just how little diversification is obtainable within asset classes. World stocks correlate to US stocks at 0.97, world bonds to US bonds at 0.86. The real surprise is that world stocks correlate to a diversified '60/40' portfolio at 0.99.

Figure 2. Trend-Following Strategies Are Highly Diversifying

		US stocks: Highly correlated to world stocks		US bonds: Highly correlated to world bonds		60/40: An equity proxy!		
	Trend following	World stocks	US stocks	World bonds	US bonds	60/40	Commodities	Dollar index
Trend following	1.00	-0.08	-0.08	0.16	0.18	-0.06	0.15	-0.05
World stocks	-0.08	1.00	0.97	0.07	-0.20	0.99	0.36	-0.21
US stocks	-0.08	0.97	1.00	0.12	-0.13	0.96	0.36	-0.27
World bonds	0.16	0.07	0.12	1.00	0.86	0.21	-0.02	-0.17
US bonds	0.18	-0.20	-0.13	0.86	1.00	-0.07	-0.10	-0.19
60/40	-0.06	0.99	0.96	0.21	-0.07	1.00	0.35	-0.23
Commodities	0.15	0.36	0.36	-0.02	-0.10	0.35	1.00	-0.44
Dollar index	-0.05	-0.21	-0.27	-0.17	-0.19	-0.23	-0.44	1.00

↑
Trend-following: Low correlation to other asset classes

Diversification does not assure profits nor protect against losses. Past performance is not indicative of future results.

Source: Man Group, BarclayHedge, Bloomberg; From 1 January 1987 where available, otherwise from 31 January 1995 until 31 March 2023.

Trend-following represented by Barclay BTOP50 (from Jan. 1987), World stocks represented by MSCI World Net Total Return Index (from Jan. 1987), US stocks represented by S&P 500 Index (Local Currency Gross Dividend Total Return) (from Jan. 1987), World bonds represented by Bloomberg Global Aggregate Bond Index Hedged USD (from Jan. 1995), US bonds represented by Bloomberg/EFFAS Bond Indices US Govt 5-10 Yr TR monthly return (from Jan. 1995), 60/40 represented by 60% World stocks + 40% World bonds (from Jan. 1995), Commodities represented by Dow Jones-UBS Commodity Total Return Index (from Jan. 1995), Dollar index represented by US Dollar Index Spot (from Jan. 1995).

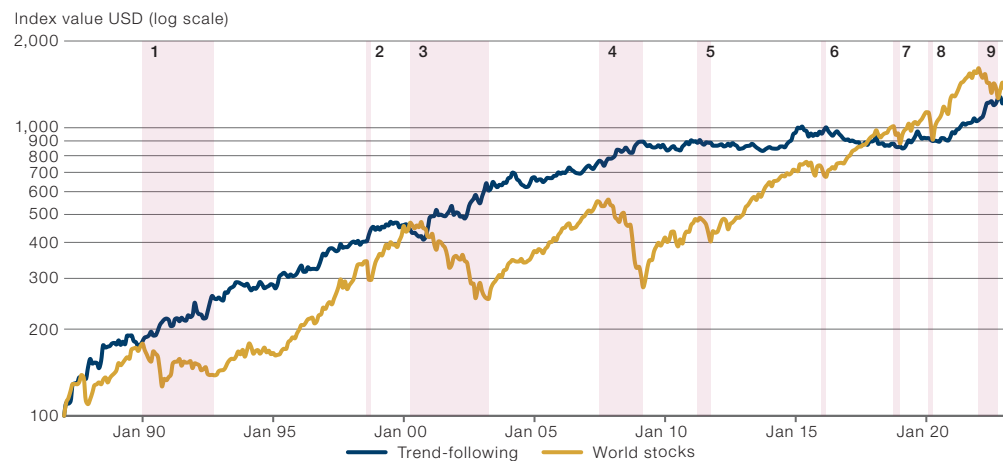


Trend-following strategies have another trick up their sleeve: negative correlation to risk assets in times of crisis.”

Performs Best When Equities Are at Their Worst?

Long-term low correlation is one thing, but trend-following strategies have another trick up their sleeve: negative correlation to risk assets in times of crisis. Coined 'Crisis Alpha' (see, for example, Greyserman & Kaminski (2014)), it relates to trend-following's historic positive performance during sustained equity market weakness. As Figure 3 illustrates, the BTOP50 returned 37% when the tech bubble bust and 17% during the Global Financial Crisis. Both of these episodes lasted years. During shorter periods such as the Covid-19 episode, however, performance is more mixed. This is because trend-following strategies take time – typically 3-6 months – to discover, and trade into, a new trend.

Figure 3. Trend-Following's 'Crisis Alpha' Credentials



	Total return over the period	Trend-following	World stocks	Crisis length (months)
①	1990 recession 1 Jan 1990 to 30 Sep 1992	41%	-22%	33
②	Russian crisis and LTCM 1 Aug 1998 to 30 Sep 1998	10%	-14%	2
③	Tech bubble burst 1 Apr 2000 to 31 Mar 2003	37%	-46%	36
④	Credit crisis 1 Jul 2007 to 28 Feb 2009	17%	-49%	20
⑤	European sov. debt crisis 1 Apr 2011 to 30 Sep 2011	0%	-15%	6
⑥	China crisis 1 Jan 2016 to 29 Feb 2016	5%	-7%	2
⑦	Q4 2018 Sell-off 1 Oct 2018 to 31 Dec 2018	-2%	-13%	3
⑧	COVID-19 Pandemic 1 Feb 2020 to 31 Mar 2020	-2%	-20%	2
⑨	Inflation / Rate rise 1 Jan 2022 to 30 Sep 2022	19%	-21%	9

Source: Man Group, BarclayHedge, Bloomberg; Between 1 January 1987 and 31 March 2023. Trend-following represented by Barclay BTOP50 Index; world stocks represented by MSCI World Net Total Return Index hedged to USD. Past performance is not indicative of future results. The periods selected are exceptional and the results do not reflect typical performance. The start and end dates of such events are subjective and different sources may suggest different date ranges, leading to different performance figures.

So Why Aren't Trend-Following Strategies More Popular?

The performance of a traditional equity portfolio is fairly simple to understand, particularly if it is well-diversified. It hopefully goes up in the long term, but if there is a negative headline, a global pandemic for example, you might anticipate some losses. As we show in Figure 2, diversification across regions, or even a 40% allocation to bonds doesn't help too much here.

Performance of a trend-following strategy is far less intuitive. Trend-following strategies trade many markets across multiple asset classes, not just equities. Indeed, a positive beta to equities, or risk assets in general, could originate from places other than equities: long foreign currency in emerging markets or short gold. Complicating things further, this positioning can change as trends in different places emerge or dissipate. A trend-follower's beta to any asset is dynamic.

So how can an investor get comfortable with the performance of a trend-following strategy? The key lies in knowledge of positioning. That this is published in fact sheets is a given, but potential investors should understand what trend sensitivity is in their investment. 'Medium-term' trend-following space spans managers with trend sensitivity between two and six months, in our view. At the shorter end of that spectrum, a manager may be able to shift position quickly, being more responsive in a crisis.



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At six months trend sensitivity, on the other hand, the manager may respond slower to a change in market direction, but should have improved longer-term performance. Market choice can also be a factor in understanding performance.

Trend-following strategies are often portrayed as 'black box', inferring opaqueness or mystery, which could originate in lack of knowledge of positioning, or because of the use of computers. But trend-following strategies use rules which can be written down, are based on understandable inefficiencies in markets, and computers are utilised for scalability and to remove human emotion. Surely this is a 'transparent' box?

A reason we frequently hear for not liking trend-following is that performance was flat for an extended period post 2008. Indeed, as Figure 1 illustrates, the BTOP50 index returned zero between 2009 and 2019 when equities returned around 200%.² Here is that direct comparison with equities again. This may be true, but how bad is 'flat' in comparison to the 50% or so lost by equities twice since 2000?



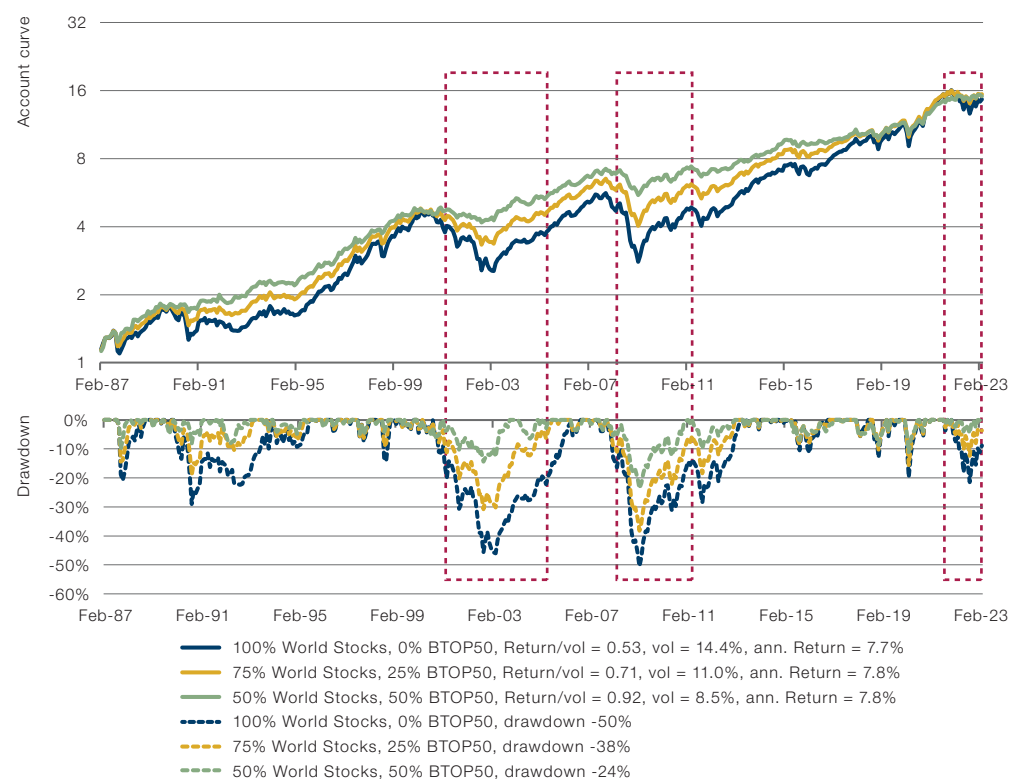
Over the last four decades or so, substituting up to 50% trend-following to a traditional portfolio helped preserve return, but substantially reduced volatility and drawdowns.

Some Parting Comments

We are sympathetic to the argument that it is hard to hold an investment that doesn't make any money for 10 years. Every strategy has its day in the sun.

But think about the portfolio. If you hold a trend-following strategy alongside your traditional equity portfolio, in the long term, history suggests that both should be profitable. Further, during crises, trend-following can potentially help cushion losses. Holding the two together potentially gives higher risk-adjusted returns and lower drawdowns than traditional assets alone. As we highlight in Figure 4, over the last four decades or so, substituting up to 50% trend-following to a traditional portfolio helped preserve return, but substantially reduced volatility and drawdowns. While it is fresh in our memories, notice how a 50/50 blend substantially mitigated 2022's drawdown.

Figure 4. Allocation to Trend-Following Can Enhance Risk-Adjusted Returns (Upper Panel) and Drawdowns (Lower Panel) of Traditional Equity Portfolios



Past performance is not indicative of future results. Source: Man Group, BarclayHedge, Bloomberg; Between 1 January 1987 and 31 March 2023. Trend-following represented by Barclay BTOP50 Index; world stocks represented by MSCI World Net Total Return Index.

2. From 31 January 2009 to 31 May 2019, MSCI World Net Total Return Index, Hedged USD.

Conclusion

If you want to buy a house, you might listen to your estate agent / realtor with some degree of skepticism. They are interested parties, after all. Man AHL has been running trend-following strategies for over three decades, so we are interested parties in this discussion too. But we have tried to be objective in writing this article; all performance numbers are at the index level.

It remains a surprise to us that trend-following strategies are not more popular than they are. To finish where we started, trend-following has historically performed as well as equities over the long term, been lowly correlated, had better risk-management properties, and generally worked well when equities didn't. Trend-following has historically performed particularly well in conjunction with equity portfolios. What's not to like about that?

Bibliography

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Kahneman, D., & Tversky, A. (1979). "Prospect theory: An analysis of decision under risk". *Econometrica*, 47, 263-291.

DISCLOSURES

One should carefully consider the risks associated with investing, whether the strategy suits your investment requirements and whether you have sufficient resources to bear any losses that may result from an investment:

Market Risk: Trend-following strategies are subject to normal market fluctuations and the risks associated with investing in international securities markets; therefore, the value of your investment and the income from it may rise as well as fall and you may not get back the amount originally invested.

Counterparty Risk: Trend-following strategies are exposed to credit risk on counterparties to trades for on-exchange traded instruments such as futures and options and where applicable, over-the-counter (OTC, or 'non-exchange') transactions. OTC instruments may also be less liquid and are not afforded the same protections that may apply to trading instruments on an organized exchange.

Currency Risk: The value of investments designated in another currency may rise and fall due to exchange rate fluctuations. Adverse movements in currency exchange rates may result in a decrease in return and a loss of capital. It may not be possible or practicable to successfully hedge against the currency risk exposure in all circumstances.

Liquidity Risk: Trend-following strategies may make investments or hold trading positions in markets that are volatile and which may become illiquid. Timely and cost-efficient sale of trading positions can be impaired by decreased trading volume and/or increased price volatility.

Financial Derivatives: Trend-following strategies invest in financial derivative instruments (FDI) (instruments whose prices are dependent on one or more underlying asset). The use of FDI involves additional risks such as high sensitivity to price movements of the asset on which it is based. The extensive use of FDI may significantly multiply the gains or losses.

Leverage: The use of FDI may result in increased leverage which may lead to significant losses.

Model and Data Risk: Investment managers to trend-following strategies rely on quantitative trading models and data supplied by third parties. If models or data prove to be incorrect or incomplete, the strategy may be exposed to potential losses. Models can be affected by unforeseen market disruptions and/or government or regulatory intervention, leading to potential losses.

Commodity Risk: Trend-following strategies may have exposure to commodities, the value of which can be volatile and may carry additional risk. Commodity prices can also be influenced by the prevailing political climate and government stability in commodity producing nations.

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Graham Robertson is a partner and Head of Client Portfolio Management at Man AHL and is a member of the investment and management committees. He has overall responsibility for client communication across Man AHL's range of quantitative strategies. Prior to joining Man AHL in 2011, Graham developed capital structure arbitrage strategies at KBC Alternative Investment Management and equity derivative relative value models for Vicis Capital. He started his career at Credit Suisse in fixed income before moving to Commerzbank, where he established the relative value team and subsequently became Head of Credit Strategy. Graham holds a DPhil from the University of Oxford in Seismology and a BSc in Geophysics from the University of Edinburgh.

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Beta: A measure of volatility versus a benchmark. A beta higher than 1.0 indicates the investment has been more volatile than the benchmark and a beta of less than 1.0 indicates that the investment has been less volatile than the benchmark.

Correlation: Correlation is a measure of how two assets perform in relation to each other. Assets that are strongly correlated (with a measure near 1) tend to move together, while uncorrelated assets (with a measure near -1) tend to move in opposite directions.

Drawdown: The peak-to-trough decline for an investment. Maximum/worst drawdown means the largest decline in a specific period.

Sharpe ratio: A measure of return per unit of risk. The higher the Sharpe ratio, the better the risk-adjusted performance was for the period.

Trend-following strategy: A systematic, rules-based investment strategy that can generally go long or short futures contracts across equities, fixed income, commodities, and foreign-exchange markets. The value of a long position in an asset moves in the same direction as its market price. The value of a short position in an asset moves in the opposite direction as its market price.

Volatility: A statistical measure of risk. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index. Commonly, the higher the volatility, the riskier the security.

Indexes are unmanaged and one cannot invest directly in an index. The **Barclay BTOP50 Index** seeks to replicate the overall composition of the managed futures industry with regard to trading style and overall market exposure. The BTOP50 employs a top-down approach in selecting its constituents from among the largest investable trading advisor programs, as measured by assets under management, representing no less than 50% of the investable assets of the Barclay CTA Index universe in aggregate. The **MSCI World Index** captures large and mid-cap representation across 23 Developed Markets (DM) countries, with 1,512 total constituents. The index covers approximately 85% of the free float-adjusted market capitalization in each country. The index is hedged to USD through a combination of standard FX forward contracts which are overlaid on the index to mitigate the effect of foreign exchange rates impacting returns. The **S&P 500 Index** is an unmanaged, market-capitalisation weighted index comprising of 500 of the largest common stocks publicly traded in the United States. The **Bloomberg Global Aggregate Index** is a flagship measure of global investment grade debt from 28 local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. The index is hedged to USD through a combination of standard FX forward contracts which are overlaid on the index to mitigate the effect of foreign exchange rates impacting returns. The **Bloomberg/EFFAS Bond Indices US Govt 5-10Yr TR Monthly Index** is designed to measure the total return of U.S. Treasury bonds maturing in 5 to 10 years, including both changes in price levels and coupon payments. The **Dow Jones Commodity Index** is a broad-market commodity index comprised of 28 liquid commodities futures contracts from three major sectors: Energy, Agriculture and Livestock, and Metals. The sectors are equally weighted within the index and rebalance monthly. Individual commodities are weighted by relative liquidity based on the five-year average total dollar value traded (TDVT) annually. Spot returns reflect only price levels of futures contracts included in the index, and are used as a calculation component of total return, which also includes collateral yield. The **U.S. Dollar Index** is a geometrically-averaged calculation of six currencies weighted against the U.S. dollar, including the euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc.

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