MASECO
PRIVATE WEALTH

the tortoise & the hare

Trend Followers - An ingredient to portfolio diversification

Currently significant diversification is hard to achieve. The performance of equities across different countries or global sectors often shows the same directional sign (though of different magnitudes). This direction is largely positive in most calculable periods since the global financial crisis. Perhaps this is not surprising given how strong economies are increasingly linked and the operating style of global firms. Whilst this is not of great concern in bull markets, it could cause great pain when the tide turns. Will bond markets jump to the rescue as they have done in the past? Given how low (or even negative) bond yields and interest rates are in much of the developed market world, it is justified to have doubts and it may be that now is the time to identify additional diversifiers and adjust the portfolios. It would be great if those new portfolio diversifiers can also contribute positive performance in rising markets, otherwise they might turn out to be nothing more than an expensive insurance for a portfolio. These reasons were our main motivation to investigate the space of so-called "Trend Followers".

What are Trend Followers?

Trend Followers are investment strategies which select and invest in markets, rather than individual securities. They do so by trading financial derivatives like future contracts, which is why they are often categorized as "managed futures". Trading derivatives allows them to position the portfolio to benefit not only from positive market performance but also by taking what is called a "short" position from negative market performance. The respective derivatives are very liquid and exist in various asset classes - equity, fixed income, currencies and commodities, allowing the strategies to spread their investments across many different ideas. Trend followers analyse historic prices of the markets over various time periods, aiming to profit from a continuing positive or negative price trend, a phenomenon also called "momentum" in academic literature.

Why does momentum occur?

Momentum is the tendency of market prices to show an upward or downward consistency over time. Research has linked this anomaly with the actions of a few, significant market participants, such as central banks, which may cause price trends in the currency and fixed income markets. Another possible cause is certain behavioural biases displayed by many investors. Behavioural finance literature suggests the following:

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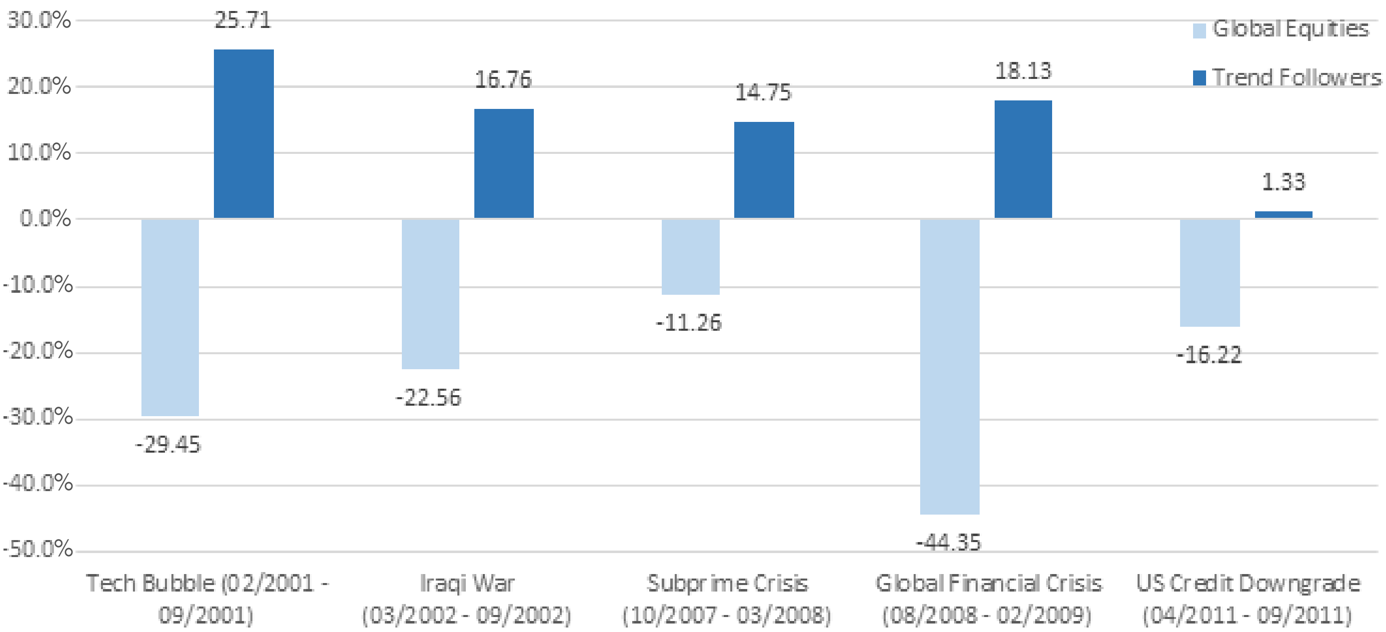
- Herding behaviour – the tendency for investors to replicate the rationale of other investors and consequently mimic their trading actions
- Confirmation bias – investors only buying investments that have positively performed in the recent past and selling those with poor performance
- Disposition effect – investors tend to hold onto losers for too long, and sell winners too quickly

Now we know why momentum occurs, how do you go about detecting it?
Strategies identify trends by using various techniques of differing levels of complexity. For example, moving average crossovers, a basic technique, compares the relationship of movements in a market's shorter term price average vs. its longer term price average. The goal is to generate a signal to either buy or sell the asset.

For example, by comparing the 3-month price average vs. the 12-month price average, if the latest 3-month average is becoming higher than the 12-month price average, this signals a positive trend, instructing a buy, whereas if the 3-month average falls below the 12-month price average, this signals a negative trend instructing to short/sell the asset. Many funds focus on analysing 3-month to 18-month price histories. Every market is usually analysed in isolation, though risk is controlled both on a position as well as at a portfolio level.

What does history suggest?

Performance of Trend Followers and Global Equities during Crisis period (monthly data)



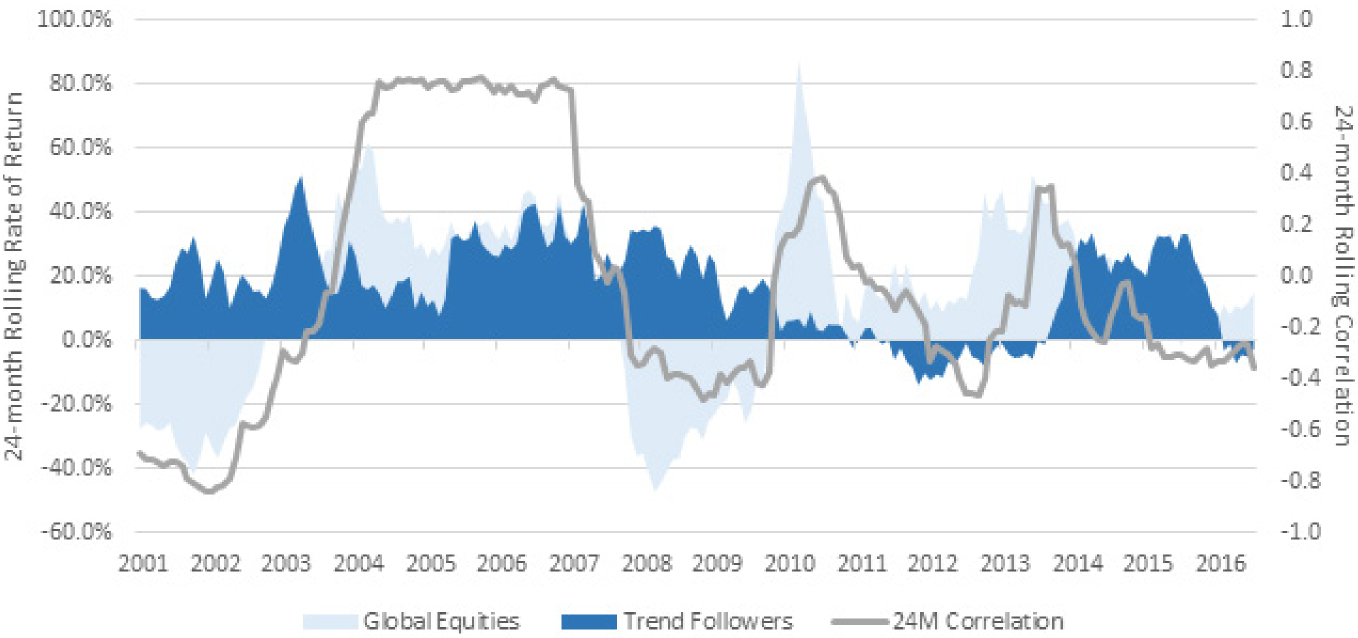
Source : Morningstar; Global equities are represented by the MSCI World index, Trend Followers are represented by the Credit Suisse Managed Futures Liquid index. Observation Period: Feb 2001 to Sep 2011.

During periods of market turbulence, trend followers have tended to deliver positive returns and offer attractive returns when the equity markets have had prolonged downward movements. This can be seen during severe equity declines such as the global financial crisis when the MSCI world index (light blue) declined by 44.3%, whereas during the same period the Credit Suisse Managed Futures index (dark blue) rose by 18.1%, resulting in a difference of 62.4% in return!

But why do they do well during bear markets? During these periods, bear markets take months to develop rather than days, which allows trend followers to position themselves short after the initial market decline and therefore profit from a continued decline.

Trend Followers - An ingredient to portfolio diversification

Rolling 24-Month correlation of Trend Followers and Global Equities



Source : Morningstar; Global equities are represented by the MSCI World index, Trend Followers are represented by the Credit Suisse Managed Futures Liquid index. Observation Period Jan 2000 to June 2017.

There are clear diversification benefits to trend following investments. During times of negative equity returns (light blue), trend followers (dark blue) tended to result in positive returns. Importantly, even when equity markets produced positive returns, trend followers still tended to give positive returns. In other words, during times of market decline, trend followers were negatively correlated to the market, yet were positively correlated during rising markets. This is key as the strategy has offered both positive risk-adjusted returns and delivers diversification benefits.

What does the future look like?

Over recent history, market price trends have reversed very quickly, resulting in lower but still positive returns for trend followers. This has happened before and will happen again, as will periods of longer lasting price trends. More importantly, the reasons behind momentum are unlikely to go away. Additionally, there are more markets to invest in than ever before, resulting in further opportunities to seek trends.

Further to this, in a period of rising interest rates, such as those we have started to observe in the US over the past year, fixed income securities and markets fall in price. Some equity markets like the US are trading at historical valuation highs, potentially creating negative future returns as valuations are expected to normalize and the respective markets fall. Should both of these scenarios play out, which is entirely plausible, trend followers may still be able to identify profitable opportunities, providing a boost to overall portfolio return and highly valuable diversification.

In summary, we believe a conservative allocation to trend following strategies is a useful ingredient for most portfolios, increasing expected risk-adjusted returns on an overall portfolio level.

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Finally, bonds can be subject to prepayment risk. When interest rates fall, an issuer may choose to borrow money at a lower interest rate, while paying off its previously issued bonds. As a consequence, underlying bonds will lose the interest payments from the investment and will be forced to reinvest in a market where prevailing interest rates are lower than when the initial investment was made.

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