22 MARCH, 2024

Know the essentials of trend following

How can we define trend following?

Trends are everywhere, in fashion, food, travel etc, and people often follow them. They stem from our propensity as human beings to follow "the herd".

In the world of finance, this "herd mentality" translates into the fact that when the price of a security has been rising, more people will want to buy it, and it has more chance than not to continue to rise, and vice versa when the price has been falling. There is indeed evidence to show that there is money to be made from buying when prices go up, and selling when prices go down. For instance, in 2023, many people followed the AI trend, which led semiconductor stocks to outperform.

Isn't it a tricky business trying to follow several markets up and down?

Indeed, when a rising trend finishes and eventually reverses down, often faster than on the way up, investors risk losing their gains before they have a chance to bank their profits and "go to cash".

This is where CTAs or systematic trend followers come into the picture! Originally, Commodity Trading Advisors (CTAs) were acting as intermediaries to allow both farmers and grain wholesalers to reduce their risks by enabling them to agree to buy or sell their merchandise at a set price at a future date. Although the name has remained, CTAs are now synonymous with buying or selling futures in all asset classes available (equities, bonds, currencies, commodities), which enables them to buy futures in upward trends, and sell futures in downward trends.

How exactly do CTAs make money, and what happens when a trend reverses?

As it is very difficult to pinpoint when a specific trend really starts or ends, trend following requires diversification and good risk management.

CTA strategies will gradually build up positions once a trend is identified through technical signals, traditionally moving averages. The strength of the signals will also determine the maximum size of that position. Likewise, as the signals begin to weaken, positions will be gradually reduced, so when the trend eventually ends or even abruptly reverses, some profits have already been taken, and the negative impact is reduced. Indeed, the enemy of trend following is trend reversal. Therefore, investors need to ensure that when the trend reverses (and it always does at some point), they can get out quickly and cheaply and not wipe out all their gains. This is why liquidity is key, and CTAs only operate in liquid and mostly listed futures. As a consequence, CTAs offer daily or weekly liquidity in the UCITS form, monthly liquidity in the non-UCITS form. Finally, in order to limit the impact of trend reversal, you also need to diversify into as many different trends as liquidity allows, which will rise, fall, or reverse at different points in time.

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How have CTAs performed historically?

That is an interesting question. Since inception in 1986, the Barclay BTOP50 Index, comprised mostly of trend-following strategies, has averaged an annualised returned (as at the end of 2023) of 8.9% per year, whilst global stock markets have averaged 8.3% over the same period. At the index level, the risk of trend following has been significantly lower over the same period, whether risk is measured in terms of volatility (9.4% versus about 15%) or maximum drawdown (-16% versus -50%). By definition, CTAs should do better when there are many clear trends, and less well when markets are choppy or trading in a tight range. But in those situations of weak trend signals, the models will reduce positions.

How do CTA strategies improve diversification ?

Well, in the last 15 years until 2022, diversification has been achieved by spreading your risk across asset classes moving in different directions (traditionally equities and bonds) – for example via a 60% equity / 40% bond portfolio. But when these two asset classes fall simultaneously in a trend, as observed in 2022, your diversification is essentially meaningless. In such bearish markets, CTAs will naturally become sellers of bonds or equities, and therefore protect your portfolio.

Furthermore, as CTAs are systematic, i.e. computer programs without human interventions or sentiments, they will keep their selling positions for as long as the down trend continues, thus continuing to provide portfolio protection for as long as the down market lasts.

As an example, in 2022-2023, many CTAs have benefited from higher interest rates by betting against bonds. Clearly, this unique capability of making money as markets fall adds a nice form of protection to your portfolio.

In practical terms, how can individual investors use CTA strategies in their portfolio?

As we have just seen, CTAs are good diversifiers: they can generate returns that are uncorrelated to both equity and bond markets. It is very difficult to time an investment in a CTA as it is difficult to anticipate trends, so we see them as a permanent fixture in an investment portfolio, especially within a broader allocation to alternative investments. In a nutshell, they can be a good source of uncorrelated returns versus traditional markets and tend to really prove their worth in bear markets.

A powerful addition to a strategic asset allocation. I would like to remind would-be investors that "Past performance is not a reliable indicator of future performance".

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