# Gaining Momentum: Where Next for Trend-Following?

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We investigate trend-following's strong performance in the first five months of 2022 and, more importantly, what we might expect going forward given current macro-economic themes.



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> But is trend-following's recent positive performance just predicated on continued worries around inflation?

## 1. Introduction

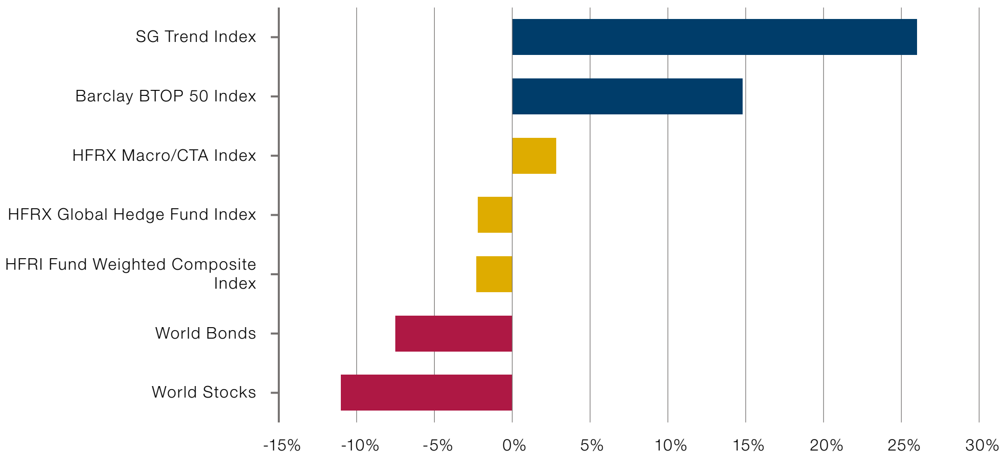
Trend-following indices, such as the SG Trend and Barclay BTOP50, have posted their best year-to-end-May returns since 2000[1], against a backdrop of poor performance from traditional asset classes such as equities and bonds. This should not come as a surprise: after all, we are seeing the presence of strong trends in futures markets which are sensitive to macro-economic themes such as inflation. We also note that, in contrast to recent history, this performance alongside weak equity markets has occurred, and even been supported by, simultaneous weakness in fixed income markets.

But is trend-following's recent positive performance just predicated on continued worries around inflation? Or are there further prospects that could act as additional opportunities for the strategy this year?

## 2. Trend-Following: The Alternatives Strategy du Jour

Trend-following strategies have had an outstanding 2022 so far, outperforming not only traditional asset classes like stocks and bonds, but also hedge funds in general (Figure 1). In fact, both the SG Trend and Barclay BTOP50 indices, which include trend-following managers, have posted their best year-to-end-May returns since 2000.

**Figure 1. 2022 Returns of Various Traditional and Alternative Investments**




Source: Man Group, Bloomberg, MSCI, BarclayHedge; as of 31 May 2022. HFRI data to 30 April 2022.
Note: World bonds represented by Barclays Capital Global Aggregate Bond Index Hedged USD. World stocks represented by MSCI World Net Total Return Index Hedged USD.

We have written extensively about trend-following's persuasive credentials during **inflationary periods** and **equity crises**. As such, with inflation's return and weak equity markets this year, it is perhaps not too big a surprise that trends are back in vogue.

## 3. Features of Trend-Following's Performance This Year

As Figure 1 shows, the SG Trend and Barclay BTOP50 indices returned 26% and 16%, respectively, as of the end of May. Both of these indices contain trend-following managers, and have outperformed not only traditional asset classes like stocks and bonds, but also hedge funds in general.

The outperformance of trend-followers over traditional assets and hedge funds can possibly be explained by the number of constituents in the indices. The BTOP50 and SG Trend indices have 20 and 10 constituents, respectively, which suggests there is considerable dispersion between trend-following managers in 2022. This could be down to various factors – risk targets, market allocations, models and trading speed, etc. – which are hard to quantify without detailed knowledge of how managers trade. At Man AHL, however, we are fortunate to be running multiple trend-following programmes, spanning the full spectrum of markets, models and risk budgets, so we

**1.** Source: Société Générale and BarclayHedge are potentially in a good position to isolate the real drivers of performance. We discuss some of these, using our own experience, in more detail below.

> What we have found in 2022 is that for the first five months at least, simple is best: pure trend strategies trading the largest futures markets have been the star performers.

### 3.1. Traditional Trumps Non-Traditional in 2022

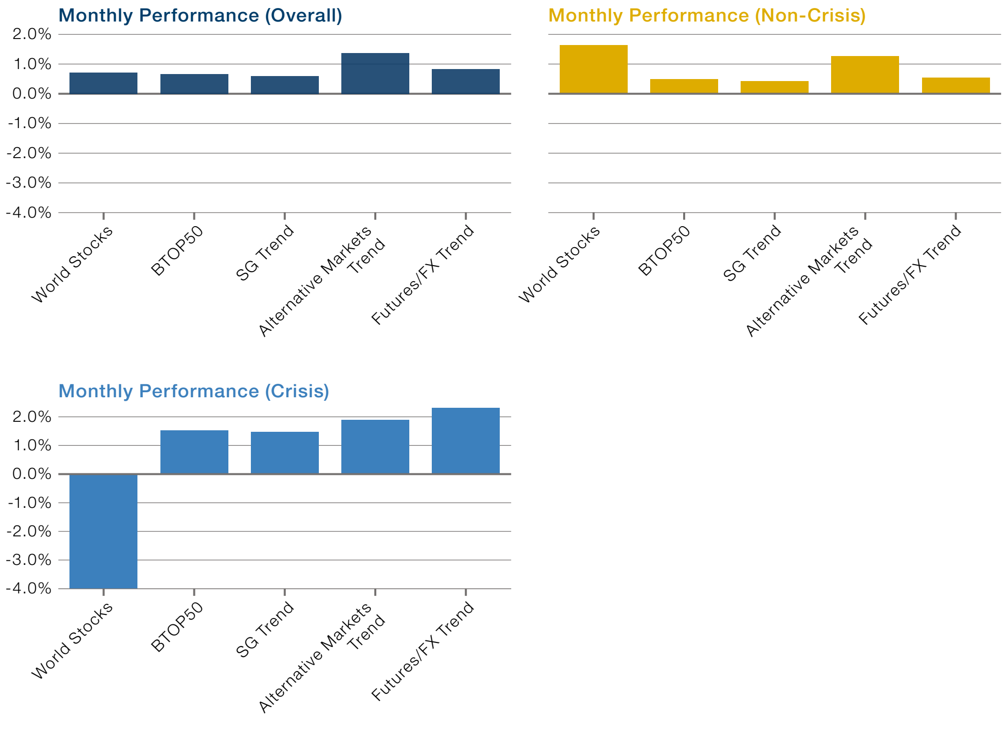
What we have found in 2022 is that for the first five months at least, simple is best: pure trend strategies trading the largest futures markets have been the star performers. In a sense, this is intuitive. Macro-economic themes are driving markets, in our view; inflation, central bank activity, war, supply chain disruption, de-globalisation and post-pandemic recovery, to name but a few. They are all interlinked, of course, but these are macro trends which are best observed in macro-sensitive instruments such as futures on global markets, be they country-level equity indices, government bonds or the largest of the world's commodities. These are the traditional fayre of CTA trend-followers. What are now called 'non-traditional' or 'alternative market' trend-followers generally boast a wider range of price drivers and better diversification through trading a broad range of typically over-the-counter ('OTC') markets such as emerging market interest-rate swaps or European hydro-electric power markets.

When trends are concentrated in certain markets at a given point in time, it stands to reason that the more concentrated the trend-follower is in these markets, the better performance is likely to be at that time. And this is the case at the moment; traditional trend-following (futures markets) has broadly outperformed non-traditional trend-following (mostly OTC markets).

### 3.2. Traditional Trend Works Better in Crisis Periods

In the long term, we believe diversification is the key feature in designing robust trend-following strategies. Figure 2 shows how an alternative markets trend-following strategy – with its greater diversification – outperforms a simulated futures/FX trend one. This is particularly true in the non-crisis periods. However, it is not the case for crisis periods such as the Global Financial Crisis of 2008 and the coronacrisis of 2020.

**Figure 2. Alternative Market Versus Traditional Trend-Following: Performance in Crisis and Non-Crisis Periods**




Source: Man Group, Bloomberg, Société Générale, BarclayHedge; between 1 September 2005 and 31 May 2022.
Simulated past performance is not indicative of future results. Returns may increase or decrease as a result of currency fluctuations.Please see the important information linked at the end of this document for additional information on hypothetical results.
Note: Data normalised to same volatility as world stocks (14%). World stocks represented by MSCI World Net Total Return Index Hedged USD. Alternative trend results are from a strategy which trades predominantly OTC markets. Futures/FX trend results are based on strategies trading predominantly futures/FX markets.

> Can it be true that diversification is less effective in a crisis?

Can it be true that diversification is less effective in a crisis? Again, we would fall back on intuition to explain this. 'Crisis' typically relates to developed markets, most often equities. News of a crisis in European hydro-electricity rarely makes the headlines or ripples through financial markets. In this case, we believe it stands to reason that global futures markets should be the instruments of choice for a trend-follower if an investor seeks a crisis hedge.

### 3.3. Trend-Followers Make Money… in Down Markets… From Short Bonds?

It has long been alleged that trend-following's 'crisis alpha' credentials stem from long bond positions. This is understandable:

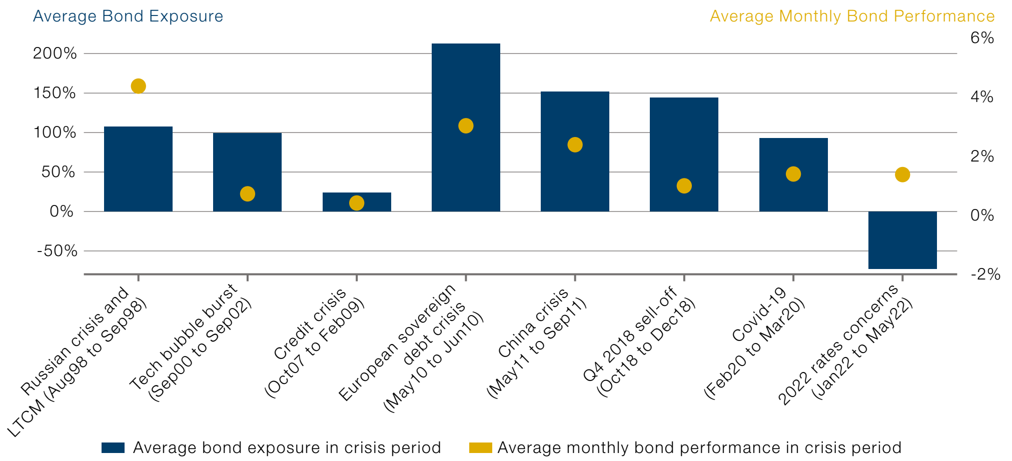
1. The longest-lived trend-following managers have been around for four decades, during which time yields have been in secular decline, so trend-followers should have been mostly long bonds;
2. In a crisis, for which we infer a crisis in risk assets, there is often a flight-to-quality of bonds – particularly high quality government bonds.

Using simulations with data back to 1970s – the last time we saw sustained inflation and rising rates – we **showed** that 'crisis alpha' applied to bonds as well as equities.

The Barclays Capital Global-Aggregate Bond index (USD hedged) has lost 7.7% in the first five months of the year, and is in a drawdown of around 9%. This sounds bad, but in the context of history – looking back three decades – this is almost twice as bad as the 1995 drawdown, and around three times historic volatility. In fact, 2022 represents a bond rout and gives us the first 'real world' opportunity to see whether our 'crisis alpha' **research** holds in reality.

The results for a trend-following portfolio consisting of both futures/FX and alternative markets are shown in Figure 3. What we find is that bond attributions are positive in crisis periods, and result from long bond exposure. The notable exception is 2022, where a positive bond attribution has resulted from short bond exposure in aggregate.

**Figure 3. Gross Bond Attribution and Net Bond Exposure During Crises**




Source: Man Group database.
Simulated past performance is not indicative of future results. Returns may increase or decrease as a result of currency fluctuations. Please see the important information linked at the end of this document for additional information on hypothetical results.

"We make two points: (1) trend-following is an all-weather inflation performer; and (2) it is a strategy for volatile environments."

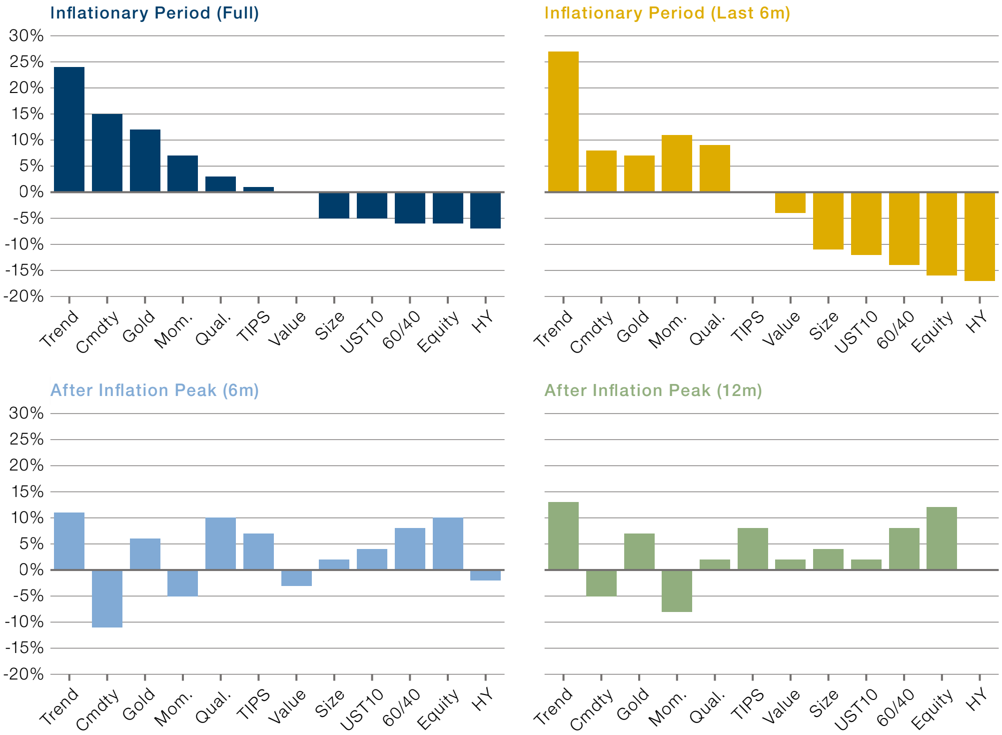
## 4. The Outlook for Trend

History is one thing, but to quote the first rule of Italian driving: "What's-a behind me is not important."[2] What is ahead is what matters, and for this we lean on an article written by our colleagues at Man Group: '**Inflation Can Go Down as Well as Up**'. We make two points: (1) trend-following is an all-weather inflation performer; and (2) it is a strategy for volatile environments.

### 4.1. Trend-Following: An All-Weather Inflation Performer

Figure 4 reproduces a chart from **Inflation Can Go Down as Well as Up**, showing that trend-following is not only a robust performer in inflationary periods in general, but also in the last six months of the episode, as well as in the 6- and 12-month timeframes following inflation's peak.

**Figure 4. Annualised Real Returns for Inflation Regimes (1926 to Present)**




| From Good to Good | From Good to Bad | From Bad to Good | From Bad to Bad |
|---|---|---|---|
| Trend, Gold, TIPS and Quality | Commods, Eq. Mom. | US Equity, UST10, 60/40 | HY |

Source: Equities are the S&P 500 using Professor Shiller's data. UST10 is from GFD. 60/40 is the monthly rebalanced 60% equity, 40% bonds portfolio. Commodities are proxied by an equal weight portfolio of all futures contracts as they appear through history. From 1926 to 1946 this is based off work done by AQR. From 1946 we use returns from the Man AHL database. Styles are the Fama-French portfolios (Mom., Value (HML) and Size (SMB)), and AQR (QMJ) for Quality. TIPS prior to 1997 based off a backcast by William Marshall at Goldman Sachs, otherwise Bloomberg. HY portfolio constructed by the Man DNA team, using data provided by Morgan Stanley; as of 28 April 2022.

Figure 4 also tells us that by using a trend-following strategy, we don't need to be able to predict when an inflationary period may peak or end. Intuitively, this is because given sufficient time, trend-following strategies are likely to adopt the market direction, whether it be long commodities, short bonds and equities in inflationary periods or the other way around after inflationary peaks.

**2.** Raul Julia as 'Franco' in The Gumball Rally (1976) **www.youtube.com/watch?v=hVp7FbLpVSU**

### 4.2. Trend-Following: A Strategy for Volatile Environments

In **Inflation Can Go Down as Well as Up**, the authors conclude their note with "Higher inflation = more volatility. We should all get used to it." Whether this is a recommendation or a threat is in the eye of the reader.

Trend-following's 'long volatility' characteristics have been noted for several decades (see for example Fung and Hsieh, 1997), and will be the subject of a future note, so we will not dwell on this here. From a trend-follower's point of view, however, it translates the conclusion from the above article as an opportunity.

## 5. Conclusion

"At its heart, trend-following is an intuitive strategy; it should do well when markets move a lot, as they often do in inflationary environments."

We have used the words 'intuitive' or derivative thereof three times – hopefully a surprise to our reader who has persevered to get here since we don't want to labour the point. But it is important.

At its heart, trend-following is an intuitive strategy; it should do well when markets move a lot, as they often do in inflationary environments. History shows that trend-following can potentially do well after a period of inflation too.

Further, if an investor wants to tune a trend-following strategy to a crisis, and that crisis is in macro-economies, we believe instruments that are sensitive to the macro-economy should be used. If the aim is to upset a systematic trader, describe their strategies as 'black box'. The term suggests mystery, or some kind of magic. In our view, the robust and intuitive performance of trend-following so far in 2022 has been anything but.

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