Is Trend Following Dead?

Inside of poor managed futures performance in 3 of the past 4 years has been even poorer performance for the **trend following commodity trading advisors** which make up the bulk of the industry. Many of the trend followers we follow are in drawdowns of 15 to 20 months or more, and a select few have failed to make new equity highs following the boom times of 2008.

Further struggles are evident when we look at the Newedge Trend Following Sub-Index, which is down -4.73% year-to-date, down -5.89% since the bottom of the financial crisis in March 2009, and down -9.77% since July 20th of this year. We wish we could say it was just the Newedge Index, but it's not. The BarclayHedge Systematic Traders Sub-Index is down -2.23% year to date, as well.

It's all lead to more than a couple people we've talked to recently uttering those words we actually love to hear: *"is trend following dead"?*

These are fighting words in most managed futures circles, but every now and then, this bandwagon starts up. Everyone has a different reason for the proclamation. The space has gotten too crowded, they'll argue, or the biggest players have become too dominant. Others will say that high-frequency trading has killed traditional market dynamics, while others point to government intervention and the always-on monetary printing press as culprits in underperformance.

Doubting Trend Following = Opportunity

But what we see more than anything else when this sort of talk starts up is opportunity. We can quote clichés like "one man's trash is another's treasure" and "buy the dips," but our view of trend following drawdowns is actually steeped in some slightly more sophisticated logic.

You see, trend following is at its core a long volatility strategy which suffers frequent but small losses in exchange for infrequent but large gains. The strategy attempts to keep its head above water until some market movement provides a large outlier move in which the strategy can profit. To say the periods between these large outlier moves equates to the strategy not working is akin to saying your car isn't working when going slow in traffic.

And to follow along with that point, to say that you will forever be stuck in traffic – that the road will never clear up, is to say there will never be another volatility spike in the markets or event such as this summer's drought, stock market sell-off, or rising interest rate environment with which to create market trends… it sure seems hard to us to think there will be no more volatility or market trends.

What others are saying:

We obviously have our own opinion on the subject, but we wanted to reach out and get some outside opinions others in the managed futures world. We spoke with a variety of folks from across the industry (both trend followers and otherwise), and here's some of what we heard:

> "Trend following is no more dead than the sport of sailing or the act of kite flying would be considered dead if for a period of time the wind didn't blow. Like a sailboat or a kite, a trend following trading model is designed to capture the power of environmental forces. When the requisite environmental forces don't occur for stretches of time, activities that depend on those environmental forces are not going to be successful. But if the wind stopped blowing for a month, would that mean that that the concept of sailing or kite flying no longer makes sense? Of course not. The physics of both activities would still make perfect sense and once the wind starts blowing once again, sailboats will again sail and kites will again fly. The same holds true for trend following. Just as the wind will always return to blow in the future, the forces that drive price trends—greed, fear, euphoria, panic—will return at some point and when they do, trend following trading models will make a great deal of money."

> "Having been in the business for nearly 30 years, all I can say is if I had a nickel for every time I've heard trend following pronounced dead… Assets will always be subject to revaluation. It's inevitable. The performance profile of trend following is fairly persistent. Periods of below average performance are followed by periods of above average performance. It's a vicious cycle. Just remember to buy the dips. Trend following will remain a viable performance strategy during periods of crisis. It doesn't matter if markets are moving lower or higher, a crisis period will bring about volatility expansion and trends following strategies will perform well during these periods."

> "What exactly is the evidence that trend following is dead? There are decades upon decades of trend following performance evidence. Doesn't the person who makes the "dead" claim have to have more to their critique than an emotional opinion/plea alone?"

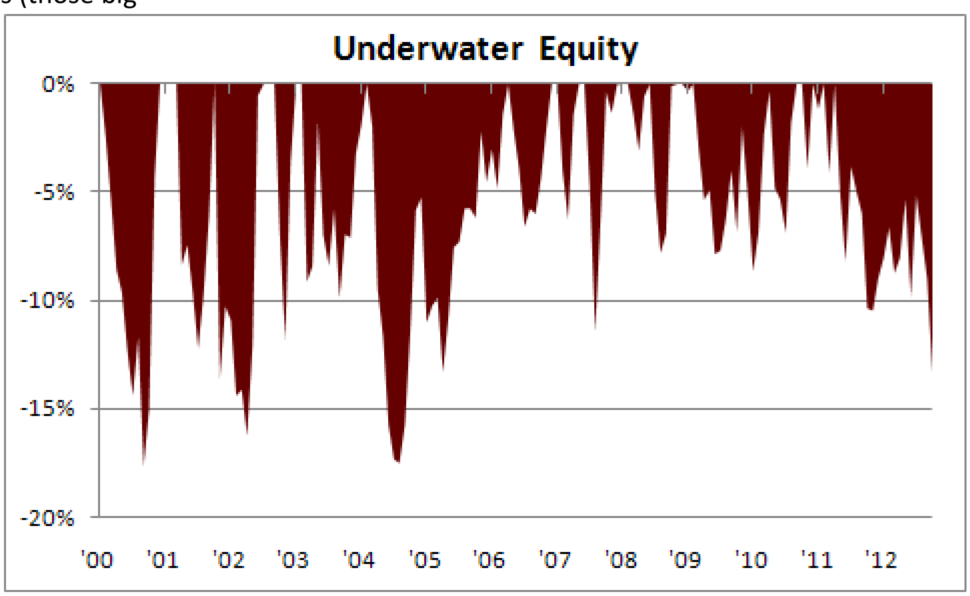
> "The obituary for trend following has been written many times before. It usually happens twice a decade. Yet, no other style of investment has done as well over the last 4 decades. The fact is that most of the people saying trend-following is dead are the same old poor industry hacks that don't like it during its good periods either. They don't understand it, they don't like it, and they will be going back underground sooner or later.

Trend Following Drawdown Periods = Opportunity

One of the things about trend followers is that their performance can be quite cyclical; as the markets they follow cycle into and out of trending periods. Just like we know Apple's stock price can't keep going up forever, likewise Corn or Crude Oil or the Australian Dollar can't trend indefinitely in one direction. Eventually, the trend will end, the market will go up and down, sideways, and everywhere in between – before a new trend emerges.

You can see this in trend follower's track records. While past performance is not necessarily indicative of future results, many of the stalwarts of the trend following space boast track records that include many ups AND downs; no one has a skyward-bound straight line for their performance.

Just look at the so called "underwater equity graph" of the Newedge Trend Sub Index, and you can see how the past 12 years have had many drawdowns (those big iceberg looking things – now you see why it's called an underwater equity graph), and many recovery periods.



Each bit of white space above between the drawdown "icebergs" are the points at which the trend following index returned to new equity highs, leading to a few questions:

1. Is this time different? Will trend follower fail to recover as they have in the past?

2. If it isn't different, and trend following recovers - what does the performance look like when you invest at those low points?

To answer the first question: how many times has the "this time is different" crowd been right? We can't think of many (internet bubble, housing bubble, etc) times this time has really been different. But perhaps this time is different and government intervention, high frequency trading, and the billion-dollar CTAs are hurting trend following. Perhaps. But that would also mean there will be no more volatility spikes, market sell-offs, and trending markets, and that is simply hard to believe.

For the second question – what happens when investing during a drawdown phase - we'll dive into the stats.

Time to Double Down?

In a 2010 newsletter, we looked at how drawdown periods are often more of an opportunity to put more capital towards a managed futures investment than a time to shut the investment down. Armed with the Newedge Trend Following Sub-Index, we went to test that theory again as it pertains to solely trend followers. Now, to be fair, the Newedge Index isn't perfect as it includes a bias towards some of the largest programs in the industry, but it is intended to function as a snapshot of the strategy, giving you a glimpse of its overall performance.

To replicate investing in a drawdown, we identified those periods when the index suffered a drawdown greater than 50% of its max drawdown over the past 36 months. So, if the index had a max DD of -15% over the past 36 months and went into a drawdown of -8%, we would look to "invest" at that point, treating a current drawdown at least half as large as the previous 36 month drawdown as our trigger. We then kept the "extra" allocation active until the index hit a new equity high, at which point the "extra" allocation was removed.

Here's where things get tricky, though, as there are a few ways you can do that extra allocation after the drawdown trigger:

1. Do an extra allocation without putting any more cash towards the investment (Notionally Funded drawdown add)

2. Do an extra allocation, but actually put the minimum investment amount in the account (Fully Funded drawdown add)

3. Only do the extra allocation, and don't invest in the program during normal times at all, using a fully funded account. (Only drawdown add)

Turns out, no matter how you do the extra allocation, it paid to do so, with all three cases outperforming the index itself since 2000. Past performance is not necessarily indicative of future results, but there is quite a bit of difference between the fully funded and only drawdown cases (2 & 3 above) and the notionally funded case, where you are not only gaining the benefit of getting involved during a drawdown phase, but compounding the effect, in effect, by not putting up any additional capital. This of course would double your risk (and reward) on a percentage basis, as you can see with the stats below and the higher drawdown. But you would be making (or losing) the same amount of dollars as the fully funded drawdown investor, just doing so on half as much money.

		Add extra allocation after DD		
	Normal	Only DD	Notionally Funded	Fully Funded
Comp. ROR	6.23%	8.09%	**13.67%**	7.33%
Max DD	-17.66%	**-10.00%**	-25.11%	-13.24%
Sharpe	0.41	0.61	0.58	**0.62**
MAR	0.35	**0.81**	0.54	0.55

Disclaimer: past performance is not necessarily indicative of future results.

But the real item of note here is not how investing in drawdowns increases returns (it does in all three cases), but how it reduces drawdown. Investing only after the drawdown trigger results in the max drawdown being cut by nearly half (43% lower), while the fully funded methods cuts it by a quarter (25% lower).

That adding to a program in drawdown reduces the overall investment's drawdown is the epitome of counter-intuitive thinking, and likely why so many investors are hesitant to do so. Most investors see a program in drawdown and think of the risk that represents, while in many ways they should be looking at how much of the risk they avoided (any drawdown avoided is money saved). To drive that point home, look at the results of this test reversed (investing an extra allocation at equity highs, and removing it when the current drawdown is 50% or more of the past 36 months' drawdown).

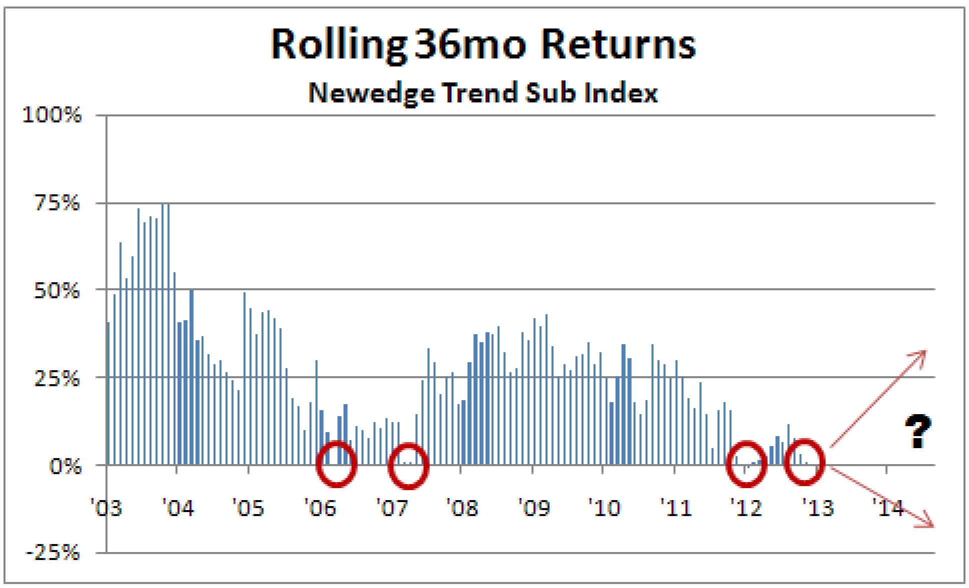
	Add an Allocation at Equity Highs
Comp. ROR	2.53%
Max DD	-36.35%
Sharpe	0.11
MAR	0.07

You'll see returns only 1/3 of what they were, and a max drawdown double the "normal" amount (and about 45% higher than the notionally funded, add during drawdown test).

For all those who like to go with the best performing program, pay heed to the table above and what happens when getting in at new equity highs.

Trend Following is NOT Dead... It is Poised for a Breakout

So is trend following dead, or is this just like some of the previous periods where the reports of its death were, as Mark Twain put it, greatly exaggerated?



Cue 2008.

As some of our outside voices above alluded to, we've heard this talk of trend following being dead before. In 2006 and 2007, option sellers were seen as the new hot ticket investment in managed futures, while trend followers, flummoxed by the contracting volatility of the time, were pronounced dead and no longer working. The general idea was that we had reached a new normal, and in that new normal, trend followers would never be able to perform.

Surely this time won't look exactly like the last, and technical analysis may not apply to an index such as this; but that sure looks like a double bottom separated by about a year in 06/07, and the same double bottom look now in 11/12. As for that last double bottom, the rolling 36 month return for the Newedge Trend Sub Index was just above 0 in March of 2007 (0.52%), and above 35% just 12months later, showing just how quickly things can change in this area.

The point is, now is not the time to run away from managed futures. Quite to the contrary, the stats and history point to now being the time to be running towards managed futures. Now is the time to take a step back, look at how and why trend followers do what they do, and build a portfolio that makes sense for you and your investment goals (perhaps doubling down on a manager in drawdown, or perhaps finally getting into managed futures for the first time at these opportunistic levels).

Break the cycle of getting in at the highs and out at the lows today, and thank yourself tomorrow.

Jeff Malec, CAIA
CEO & Founding Partner
Attain Capital Management

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