The Quiet Outperformers: A New Trend for Trend Followers

Finding Resilience in Alternative Markets

November 2024

2022 was a horrible year! Except for Trend Followers (CTAs), who made a strong comeback by delivering almost 30% returns according to the SG Trend Index. Whilst everyone took notice, it didn't come as a particular surprise since these managers are often labeled as "Crisis Alpha". However, what may have been unnoticed is the quiet revolution that started with a few managers going after "Alternative Markets", and has enabled them to significantly outperform classical trend followers and produce attractive returns without any crisis.

Polyvinyl Chloride (PVC), one of the new underlyings traded by Alternative Markets Managers.

Hedge Funds became popular for their ability to innovate. Alternative Markets Managers are doing just that.

My issues with Trend Followers

Trend Followers arguably go back to David Ricardo in the 1800's who was (probably) the source of one of the first rules applied to markets: "cut short your losses, [and] let your profits run on". In my opinion, Trend Followers are well known today for three main reasons:

1. they shield investors from emotions;
2. they provide protection during market corrections; and
3. they are liquid.

The strategy now encompasses well-known managers worldwide with many different sub-strategies across markets and time horizons. I recommend [RCM's infographics]() for a good overview.

2022 put these strategies back on the scene given their strong performance and their ability to diversify global portfolios. The SG Trend Index finished 2022 up 27.1% – its best annual gain since Société Générale began calculating the index in 2000[1].

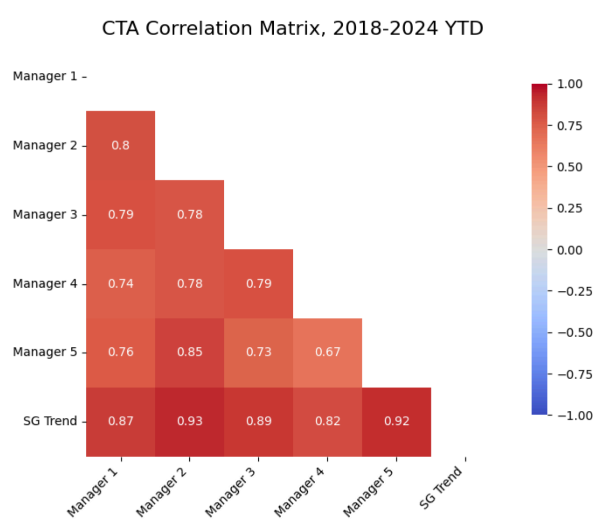
But two things always bothered me when selecting CTAs:

1. they will typically give back performance after a good year, for example the SG Trend index was down -4.2% in 2023; and

2. they all seem to be doing the same thing, i.e. they are highly correlated with one another.

The chart on the right provides the correlation from 2018 up to September 2024 of five of the most well known Trend Followers. One could argue that to completely prove my point I should have looked at the twenty constituents of the index. However, it is also true that there was no selection bias in selecting these specific five and it thus provides a good starting point.

The average correlation between the five managers is 0.8, and it is 0.9 with the SG Trend index, which is not surprising since they are major components of that index.



These correlations do not change significantly using different time windows.

[1] The SG Trend index tracks the 10 largest trend-following CTAs by assets under management that are open to new investment.

Something new?

Post 2022, I wondered if it was possible to find Trend Followers who have overcome the two challenges mentioned above. I quickly discovered that a few managers had started going after “Alternatives Markets” and seemed to be solving my problems.

What these managers label as “Alternative Markets” are harder to access markets and assets due to some barriers to entry . Not only would these “new” underlyings provide them with more breadth but it would also potentially provide them with new sources of Alpha and uncorrelated returns. In fact, one of these managers has been able to go from 300 underlyings to more than 750 in just a few years. Richard Grinold and Ronald Kahn, fathers of the Fundamental Law of Active Management[2], would marvel at this breadth increase!

These markets are harder to access in two ways. Firstly, they are simply harder to access: local exchanges with voice orders, small exchanges in a foreign country where you need physical presence to trade. Secondly, they are simply harder to implement, for example yield curve steepeners or flatteners, or properly constructed Equity Factors. In other words, these managers are creating new underlyings by detecting trends on yield curves (2s vs. 10s for example) or by getting access to commodities like Jujube or Ethenylbenzene (yes I checked, there is no typo) or even Crypto assets.

There are several key benefits to this approach. With harder to access markets, this potentially means Alpha with less decay. In addition, many of these markets are less crowded than the typical futures markets used by classical trend followers. Indeed, many of these commodities markets are used by physical hedgers and in some countries like China there is a large proportion of retail investors. As a result, trends for these markets seem to be more persistent. Concentration in this case, and for once in Finance, is good!

While in theory that made sense and spiked my interest (I had never heard of Ethenylbenzene, let alone that you could trade it), I was initially skeptical about this new category, wondering if it was just marketing and if it made a difference at the end of the day.

But I also remembered a key statement from one of these managers that after all, good signals should work across underlying universes and market environments and be selected based on their economic intuition, historical efficacy in forecasting returns, statistical and economic significance and effectiveness.

Does it work?

More specifically, do these managers avoid giving back performance after a strong year and are their returns streams different from the other CTA managers?

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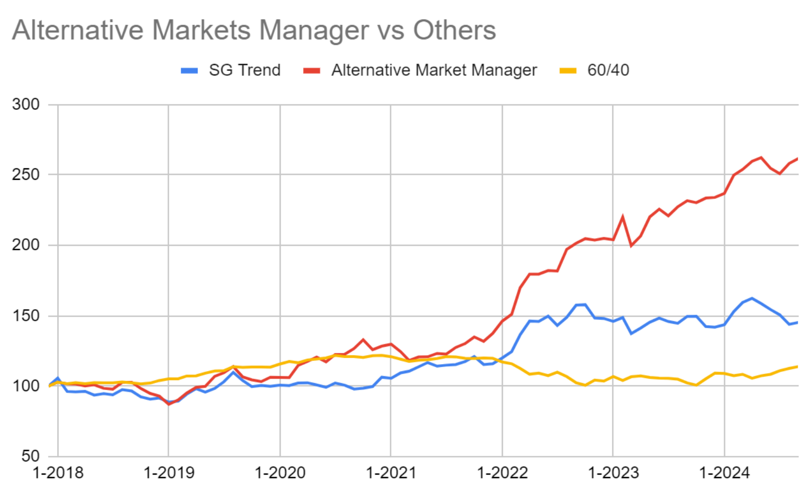
[2] Developed by Richard Grinold and Ronald Kahn, the Fundamental Law of Active Management states that an active manager's added-value depends on the quality of his/her skills (information coefficient) and the frequency in which the skills are applied at work (breadth). The higher the breadth, the higher the added-value (information ratio) per unit of information coefficient.

As with other Hedge Funds strategies, there is a high degree of dispersion amongst these alternative markets managers. Said differently, even if they are in the same sub-strategy, the results can vary significantly between the best and the worst. Yet I have found a few managers that seem to solve my concerns. Let me illustrate with one of them.

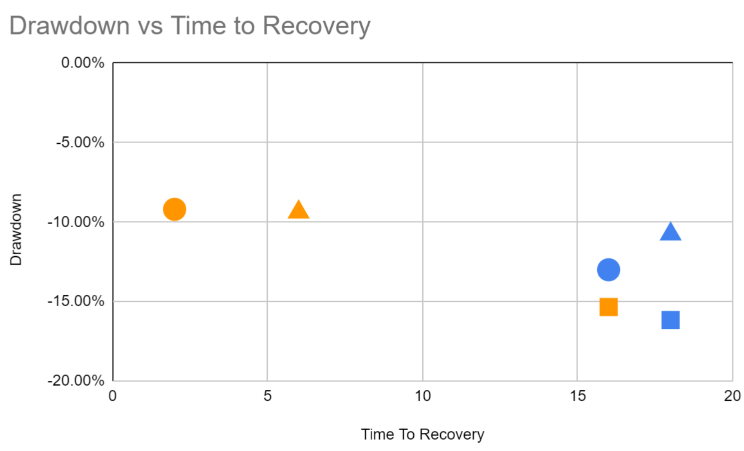
The chart below displays this manager's net dollar return since 2018 (fund inception) vs. the SG Trend index as well as vs. a balanced 60/40 portfolio.



The overall performance is better than the index or the balanced portfolio, especially during bad times like 2022. In fact, the annualized return for the Alternative Markets Manager is +15% vs +7% for the index, while their Sharpe ratios are 1.05 and 0.58 respectively. And both have a similar volatility of 12%, so the difference is not coming from risk.

In addition, the manager does not seem to give up performance after strong years. Indeed while 2022 was a very good year for Index (+27.1%) it was down -4.2% in 2023: meanwhile the Alternative Market Manager was up +14.0% in that year after a +49.1% in 2022.

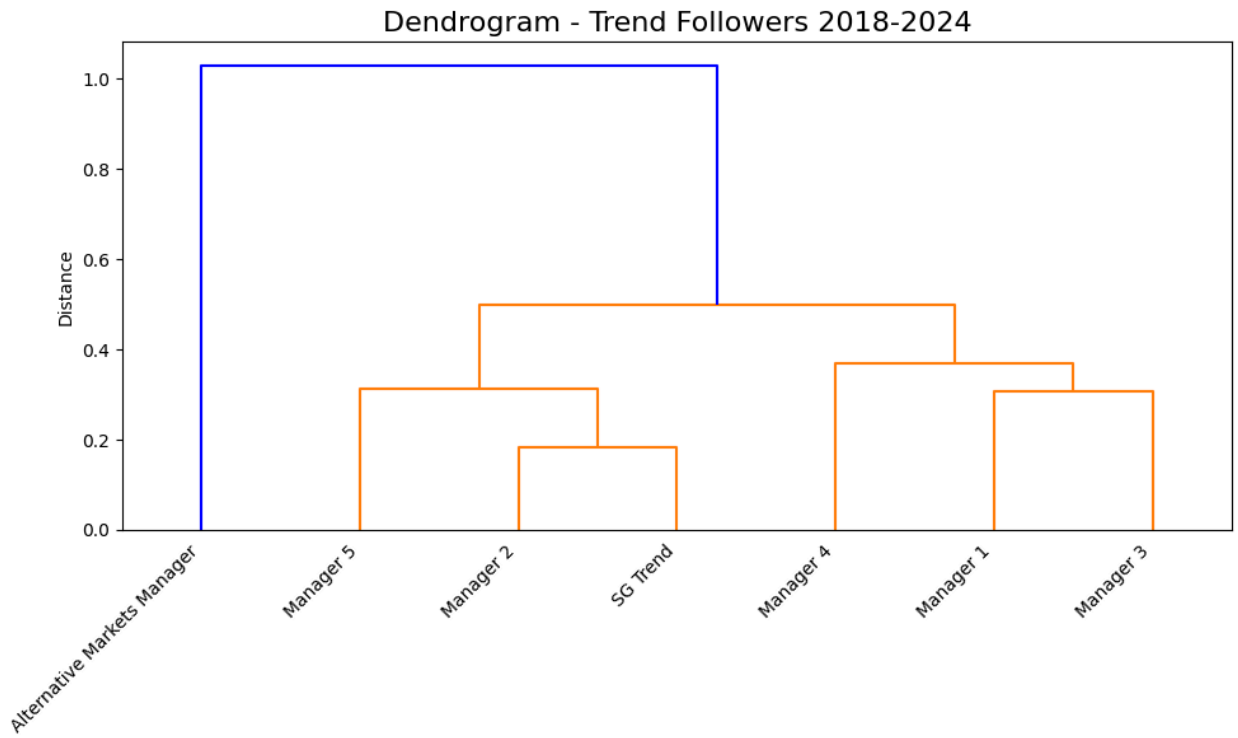
Upon closer inspection with the chart on the right, it is clear that the manager recovers faster from drawdowns than other CTAs. Looking at the SG Trend Index's (blue) three largest drawdowns since 2018, the manager's drawdowns and time to recovery (orange) are significantly better. For example, during the worst index drawdown (March 2018 - August 2019, squares on the chart), the manager's drawdown was 16% vs. 18% for the index and it recovered in 16 months vs. 18 months for the index. In fact, the average time to recovery since 2018 for the manager is 3.7 months while it is 8.1 months for the index.



As another example, take this summer, when CTA's generally started to have a difficult time. While the index was down about -5% over June and July, the fund was down -3% over the same period. However, and this is the interesting part, the fund was up more than +2% in August while the index was down another -4.5%. This is again mainly driven by the manager's breadth and the idiosyncrasies of these alternative markets quickly taking over again.

The correlation of that manager since 2018 is 0.5 with the other five classical Trend Followers and 0.6 with the index.

The dendrogram below is a great way to visualize how different this manager is from classical Trend Followers (other than performance of course). Using the correlation since 2018[3], the Alternative Markets Manager is clearly a distance apart from the others.



Operational Alpha

Simply put, Alternative Markets managers are able to create Alpha from their operations in addition to their research.

Accessing these markets and implementing potentially daily rebalancing requires state of the art operational resources. This is not something that every CTA manager can implement. Their ability to execute on these markets is giving them, at least for now, an edge. Again, this has

[3] More specifically using Distance = 1 - Correlation

enabled them to double the number of underlyings, going from 300 before 2020 to more than 700, thus doubling their market breadth.

Implementing trades on alternative investments such as Equity Factors or Yield Curve positioning also requires risk management acumen. Expressing a pure view on Equity Factors means stripping away any market beta, sector or country risk on a daily basis while a steepening trade on a yield curve requires eliminating any duration risk.

The managers with the best research and execution capabilities have been able to overcome these barriers to entry to harvest Alpha, resulting in a significant outperformance versus classical trend followers.

Now this edge might disappear in a few years as more players are able to access these markets and current managers active in “Alternative Markets” might become too big to scale in these markets given the liquidity constraints. But for now, these funds are not big enough to be constrained and are able to deliver resilient and attractive returns to investors.

Should you want to talk about these managers, feel free to reach out.

Cédric

Seneko founder

About Seneko

Seneko specializes in scouting outstanding alternative asset managers for its investor network spanning Family Offices, Banks, Asset Managers, Pension Funds and Wealth Managers, primarily in Europe and the Middle East.

Our selection process focuses on identifying and selecting smart and resilient managers with proven track records, a repeatable investment process, a real and active risk management process and utilizing cutting edge technology within their organization.

With direct access to decision-makers and extensive relationships built over decades, Seneko ensures its investors have unparalleled access to managers for analysis and for any ongoing communication.

We handpick a select few alternative managers, all of whom have demonstrated outstanding performance.