Insight Paper

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Trend: Adaptive, Agile and Resilient

March 2023

It feels like everyone is talking about trend following – and so they should. Against one of the most challenging economic backdrops in several decades, trend following managers largely managed to deliver substantial profits to their investors in 2022. Unsurprisingly, this has generated a rising tide of interest in the strategy from a new cohort of investors – many of whom will have started their careers since the Great Financial Crisis nearly 15 years ago.

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The Science of Investment

It feels like everyone is talking about trend following – and so they should. Against one of the most challenging economic backdrops in several decades, trend following managers largely managed to deliver substantial profits to their investors in 2022. Unsurprisingly, this has generated a rising tide of interest in the strategy from a new cohort of investors – many of whom will have started their careers since the Great Financial Crisis nearly 15 years ago. There are plenty of good articles describing the utility and contextual application of trend following strategies, including some of our own, but the general discourse on trend benefits from a few additional observations:

- Trend has ably navigated a multitude of economic environments over the last five decades. It appears the post-GFC, pre-pandemic, QE-dominated 2010-2018 period has been the abnormal one in offering fewer opportunities.

- Trend is a trading strategy. Hence recent past performance is a poor indicator of subsequent future performance. Just because the strategy has had a strong/poor run of performance there is no rhyme or reason why that run of performance should either continue or revert.

- Regardless of performance some properties endure. Trend is:
  - adaptive (can handle a wide range of economic scenarios)
  - agile (as markets change, its positions change)
  - resilient (won't double-down on losing positions – self-healing profile)

1. Chilling Effect of Quantitative Easing

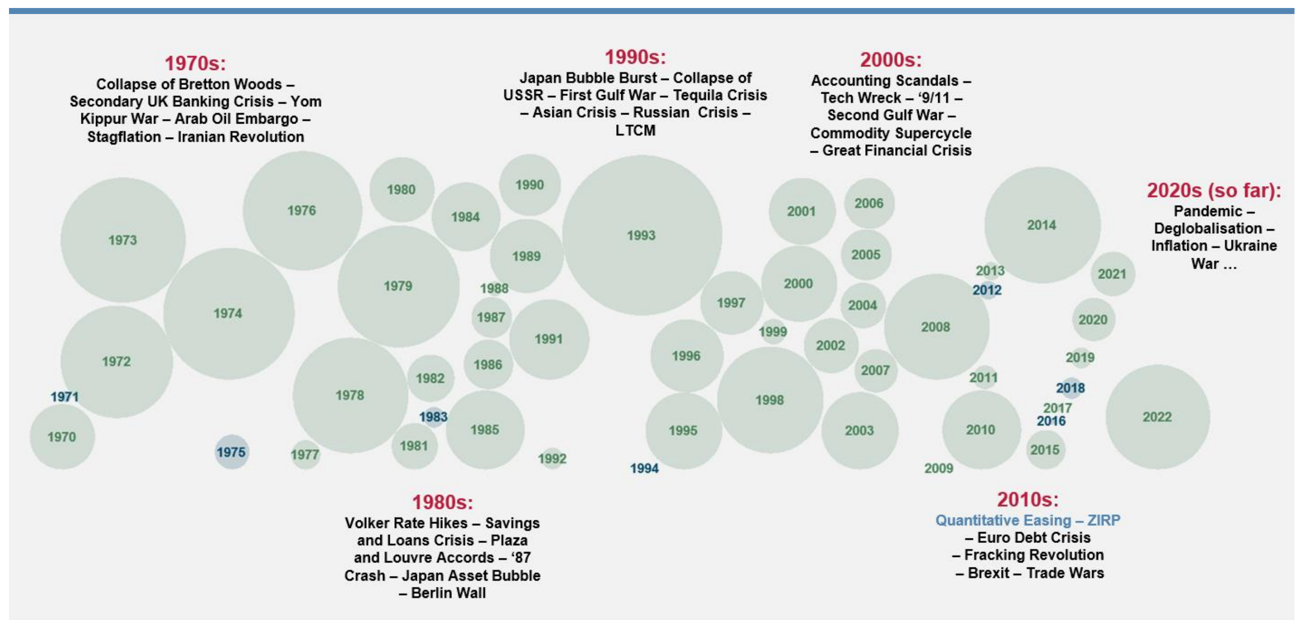


Figure 1: Fifty Years of Trend: Navigating a Multitude of Challenging Macro Events, 1970 – 2022

Note: Stylised representation of trend following strategy profile. Radius of bubble is proportional to absolute return. Green denotes a positive number and navy blue a negative number. **THESE RESULTS ARE BASED ON SIMULATED OR HYPOTHETICAL PERFORMANCE RESULTS THAT HAVE CERTAIN LIMITATIONS. UNLIKE THE RESULTS SHOWN IN ACTUAL PERFORMANCE RECORD, THESE RESULTS DO NOT REPRESENT ACTUAL TRADING. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. Please see important risk disclaimer at the end of this document.**

The application of trend following as a strategy has a very long history, stretching back to the late 1940s when Richard Donchian established Futures, Inc., which employed a trend following strategy based on channel breakouts. To this day, several trend managers that started their track records back in the 1970s still remain, highlighting the longevity of the CTA industry.

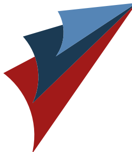
To create the information used in Figure 1, we simulated a trend strategy back all the way to 1970, synthetically extending the market universe such that we have sufficient coverage of markets before they were available as futures. In the stylised representation of trend following through the years, the radius is proportional to the absolute return and green and navy blue represent up and down years, respectively.

We also highlight a selection of major macro-economic or geopolitical events that defined the various decades. From the oil crises and stagflation of the 1970s, to the savings and loans crisis of the 1980s, the collapse of the USSR, the bursting of the Japanese bubble, the Asian and the Russian crises of the 1990s, to the accounting scandals, the Tech Wreck and the Global Financial Crisis of the 2000s –in this simulation trend has demonstrated its adaptability and suitability to navigate a myriad of challenging economic environments.

Again, looking at the pandemic and post-pandemic, inflationary, deglobalising, geopolitically charged era so far in the 2020s, trend has also ably managed to navigate this environment.

This leaves the 2010s as an anomalous period in global markets where the most significant and enduring economic theme was that of large scale and globally coordinated quantitative easing (QE) programmes and extremely low to negative interest rates in major economies referred to as ZIRP (zero interest rate policy) in the financial lexicon. The chilling effect of the artificial suppression of risk during the QE/ZIRP period resulted in rather muted performance from divergent macro strategies, dubbed retrospectively as the 'CTA Winter'. Looking back at Figure 1, during the QE/ZIRP dominated era, the size of the bubbles is generally quite small and there is almost an even split between navy blue and green ones (uncharacteristic of any other period). The outlier event during that decade which happened outside the tightly controlled financial markets was the 'Fracking Revolution' resulting in a significant oil market collapse in 2014-5 which provided a fertile ground for trend following strategies.

Without needing to make any specific forecast for the next decade (other than assuming that we will not go back to widespread QE and ZIRP anytime soon), the message from history feels clear. The general adaptability of trend following across numerous different environments through the decades means, the outlook for trend could be favourable.



2. Down the Escalator – Up the Elevator

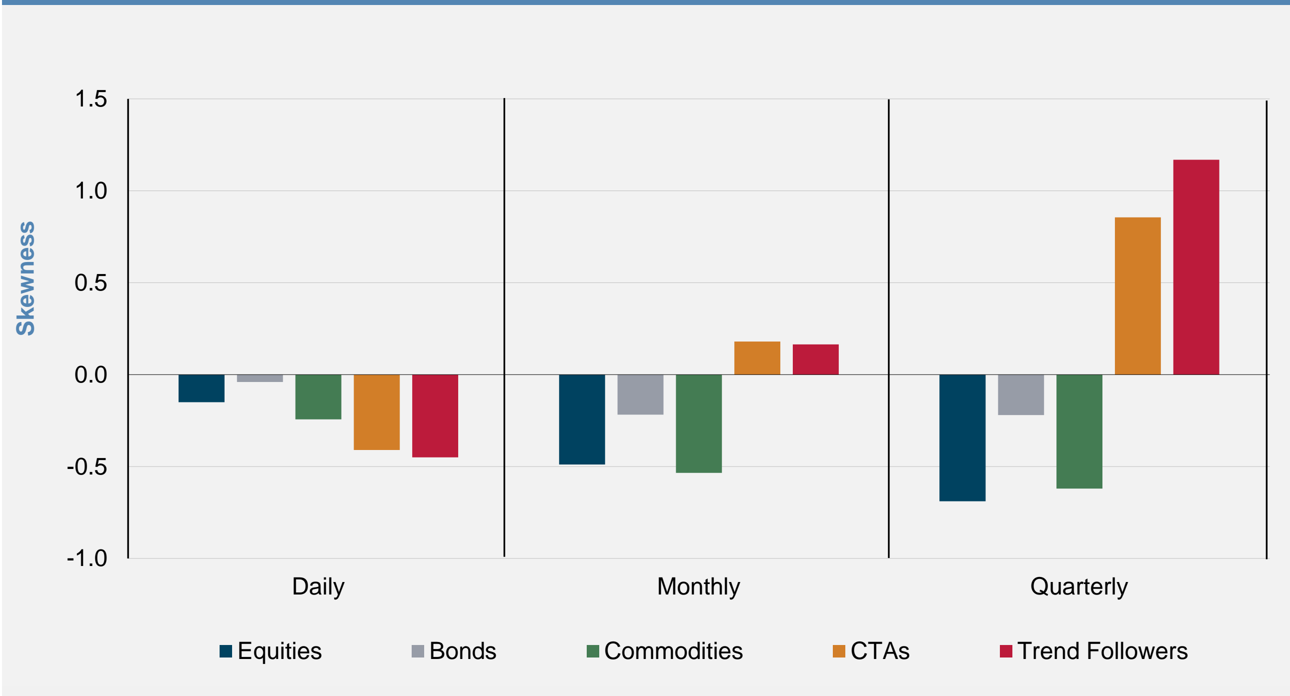


Figure 2: Skewness Measured over Different Observation Periods: 2000 to 2022

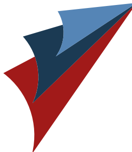
Note: Bloomberg. Indices used: Equities: MSCI World, Commodities: Bloomberg Commodities, Bonds: Barclays Global Aggregate, Managed Futures: SG CTA Index, Trend Followers: SG Trend Index. The data above with respect to various indices is shown for illustrative purposes only. Detailed descriptions of the indices used are available from Aspect upon request.

An underappreciated property of trend strategies is that of potentially transforming negatively skewed return distributions of traditional assets into positively skewed ones. In Figure 2 we measure the skewness of the three main traditional asset classes, equities, bonds and commodities as well as the skewness of two managed futures manager indices, CTAs and Trend Followers. Skewness here refers to how lop-sided the return distribution looks.

For example, negative skewness implies that the majority of the returns are a bit above average but that the outsized returns tend to be significantly below average. A good visual analogy that helps here is to imagine being able to 'walk the return path' – negative skewness implies travelling steadily up the escalator and then going quickly down the elevator whereas positive skewness is akin to travelling down the escalator but up the elevator.

The analogy may be a stretch but effectively what we observe when we look at return data is that traditional asset class returns are negatively skewed over all time periods, whether we measure things on a daily, monthly or quarterly basis. In other words, despite the most common return being a positive return, the larger returns tend to be surprises or shocks to the downside. When it comes to trend following strategies, the investment process is such that over the longer time horizons it transforms negatively skewed distributions into positive ones through adaptive and dynamic positioning.

At this stage it may well be worth emphasising why positive skewness is such a desirable property in a strategy. Provided the strategy has a positive expected return then having positive skewness implies that the maximum expected upside is larger than the maximum



expected downside. Conceptually this conforms to the old adage: 'Run your winners and cut your losers'. From a risk management point of view this type of strategy profile is also desirable as the likelihood of outsized returns will tend to be on the upside rather than the downside. However, from a behavioural aspect, living with a positively skewed return profile presents a challenge. Having a higher proportion of returns below average means that at some point doubt may creep in to an investor's mind – 'What if those infrequent large returns don't materialise?' The need for patience and a long-term holding horizon is paramount to be able to extract, in practice, the benefits of positively skewed strategies.

Let's illustrate the concept with a generic stylised example to tease out these inherent properties and build intuition.

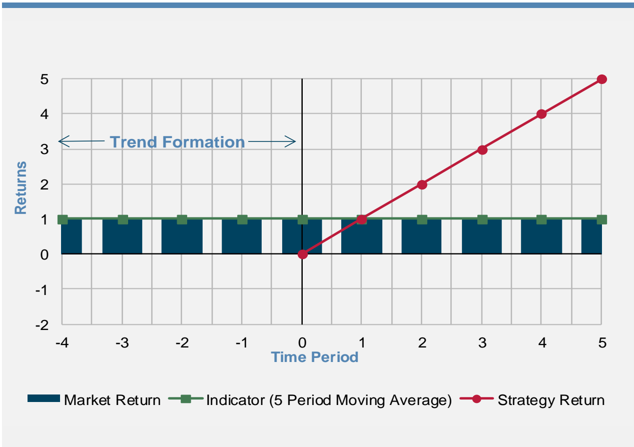


Figure 3: Generic Example: Trend Continuation

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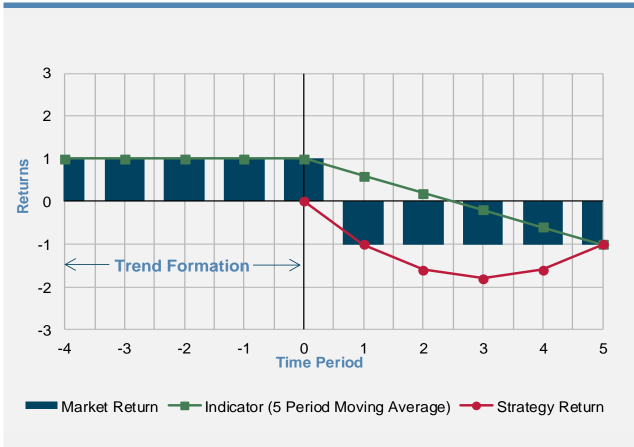

Figure 4: Generic Example: Trend Reversal

We use a very simplistic generic trend following model to highlight some of the inherent properties of trend strategies such as adaptiveness and agility which in turn gives rise to the positively skewed return profile and therefore, by extension, generates resiliency. The example shown in Figures 3 to 5 span 10 periods. We use the first five periods, labelled Trend Formation, to construct our Trend Indicator. The market return is uniform and binarised, in other words, the market can go up by one unit or fall by one unit over any period. Our trend indicator is simply the moving average of the previous five period market returns. At time 0, we use our indicator to tell us how many units of the market we wish to buy or sell for the next period. The strategy return is then a product of our position and the next period of market return.

Figure 3 shows the ideal trend continuation example. After five up periods, at time 0, our indicator is maximally long and the best result for our strategy would be for the market to continue to go up. Indeed it does – the next five periods are all +1 and as a consequence the strategy return is +5 units at the end of the example.

Figure 4 shows a reversal. The set up is identical at time 0, we start with a fully committed long position but the market is not kind to us and as soon as we put on a long position, it falls and continues falling for the rest of the example. Despite the trade going against us initially, the trend indicator is adaptive and responds to new information, reducing its conviction. By period 3 it has already switched to a short, thus beginning to recover some of the early losses and demonstrating self-healing behaviour.

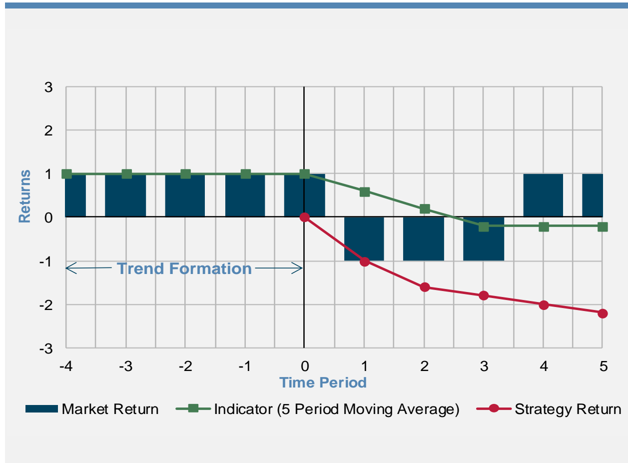

Figure 5: Generic Example: Range-bound Conditions

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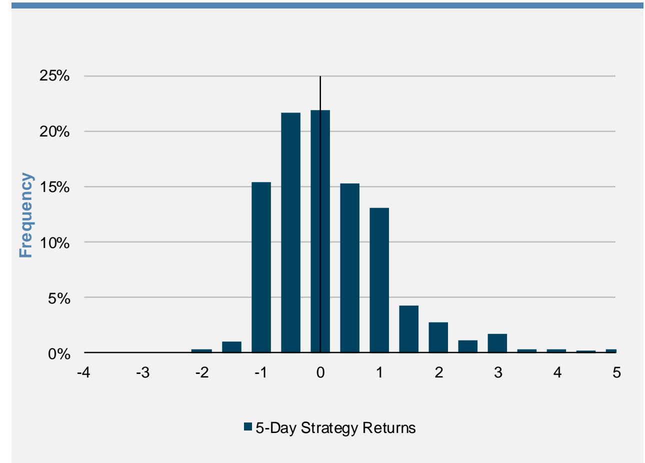

Figure 6: Distribution of All Possible Outcomes Exhibits Positive Skew

Figure 5 shows the effect of range-bound conditions. Again, the trend formation set up is identical at time 0. We put on a fully committed long position, the market goes against us, the strategy incurrs losses but the indicator adapts and just as we flip our position from long to short at the end of period 3, the market bounces back and we are once again the wrong side of the price move - but the indicator does not have much conviction here as the market returns are scrambled or range-bound. The position remains small until the end of the example, thus the strategy return continues to decline but at a much shallower rate than initially.

Finally, in Figure 6, we conduct this experiment over all possible combinations, 2^{10} possible paths with no average bias or trend, and we plot the distribution of strategy returns, showing clearly positive skewness. The lesson here is profound: despite a highly simplistic model construction and input prices with no average trends in them, the inherent properties of a trend following strategy allow it to adapt to new information, respond to changes in market direction, and remain resilient during reversals and range-bound conditions. Losing positions get reduced while winning positions are retained, meaning the biggest losses are smaller than the biggest profits and the return distribution takes on a positive skew. These features are also evident in trend following strategies when they are applied to real market conditions and we will demonstrate this with a rather more realistic experiment in the final section of this paper.

3. Trend Scenarios – A Monte Carlo Approach

Storytelling is a fundamental part of being human and unsurprisingly we find that the investment industry too is awash with storytelling of some sort or another. More generally, the concept of an overall outlook is central to many investors' approaches to adjusting their portfolios. What is the outlook for this economy, this market, this factor, this strategy? Answers to these questions can significantly influence the composition of many an investment portfolio. Yet, when it comes to trend following strategies, the concept of outlook is somewhat foreign. As we have seen through empirical examples, trend does not require a narrative to construct its portfolio nor does trend anticipate particular scenarios – instead trend adapts and follows whatever market environment ensues. Regardless, the most commonly asked question we face when interacting with our clients and prospects is: What is the outlook for trend?

One significant advantage that systematically implemented trend strategies have over other discretionary strategies is that they can be simulated over a wide range of scenarios to demonstrate their attributes. We will use this framework to generate a way to visualise what an outlook for trend might look like.

Figure 7: Example 10 Year Note Price Propagation 1 Year Forward

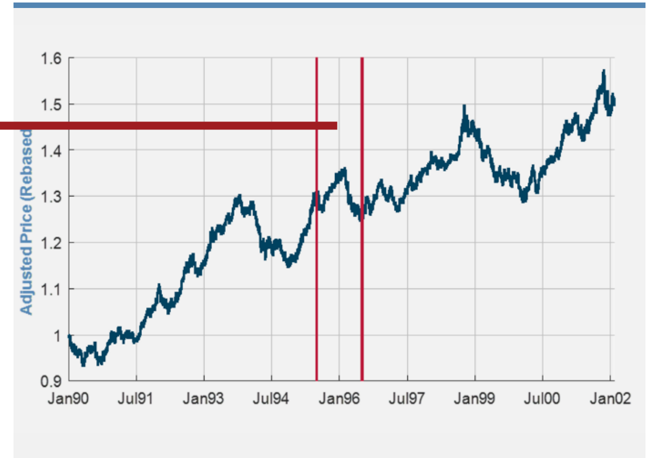

Figure 8: Sample 10 Year Note Historical Price Dynamics

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Given that trend following is effectively a deterministic strategy – a set of rules applied consistently to possibly random inputs (price action) – that makes the output probabilistic but measurable. Monte Carlo simulation is a mathematical technique that is useful in this environment. To set up our experiment we begin with a typical trend following strategy and we start with the positioning it had at the end of January 2023. We then generate future potential price paths for every tradeable market by randomly sampling slices of one-year returns from that market's historical return data going all the way back to 1985.

In Figure 7 we show how we propagate forward the price action for the 10 Year Treasury Bond future by randomly choosing the historical returns observed during mid-1995 to mid-1996 and stitching them onto the price action ending January 2023. There are approximately ten thousand such historical time slices we could use. Stitching the same randomly selected one-year period of history to every market in the portfolio, thereby preserving correlation structures, generates one possible forward looking portfolio scenario. Repeated 10,000 times, we generate the distribution of returns shown in Figure 9.

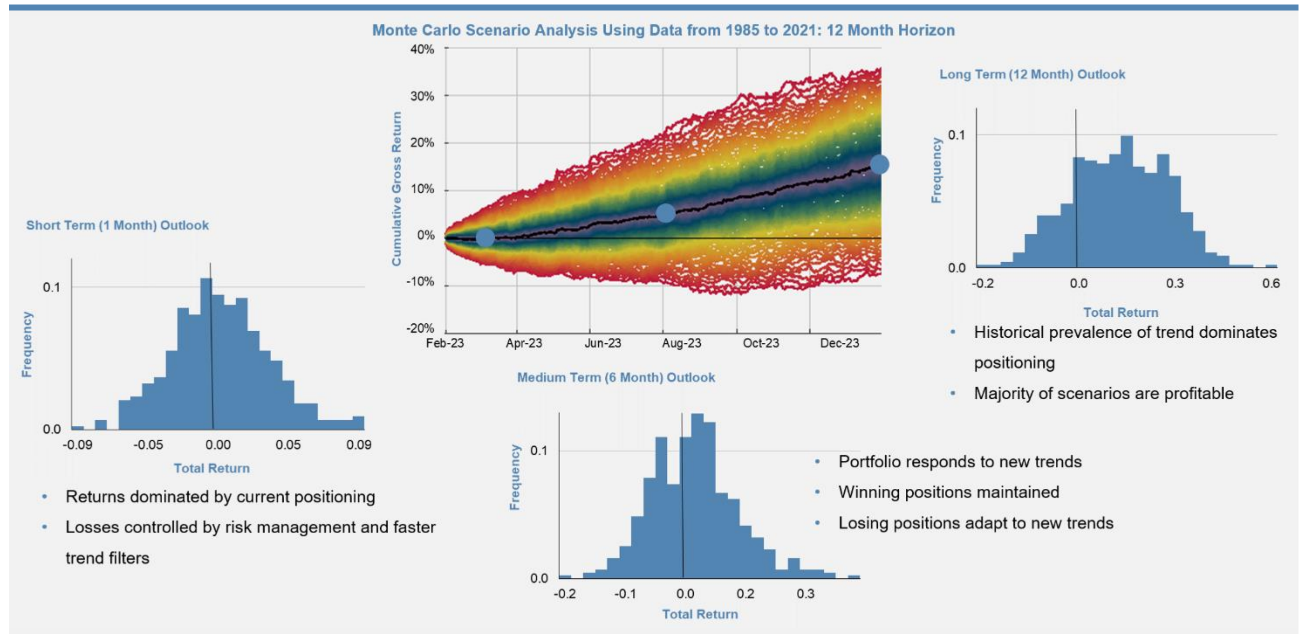

Figure 9: Monte Carlo Scenario Analysis Using Data from 1985 to 2021: 12 Month Horizon

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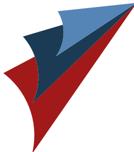
The results, reassuringly, display all the properties of trend we have discussed thus far. Let's step through the scenario and interpret the results. The top chart in Figure 9 shows the 5th-95th range of possible returns up to one year out. The black central line is the 50th percentile return. We additionally show in the three subplots below, the full distribution of returns after one month, six months and one year. The general shape of the distribution starts out fairly normal with expected returns being centred around zero in the first month. Starting portfolio positioning and risk management are the main protagonists here. As time progresses, emergent trends are increasingly captured and by the time we reach a full year out, approximately 85% of scenarios are positive.

This result is achieved despite the fact that the starting portfolio is positioned significantly short in fixed income at the end of January 2023 and fixed income has been in a bull market for the last 40 years or so. The adaptability of the trend portfolio is plain to see. Given a couple of months to adapt, trend exhibits positive skew and is resilient across a multitude of economic scenarios, regardless of the way it is positioned coming into the scenario.



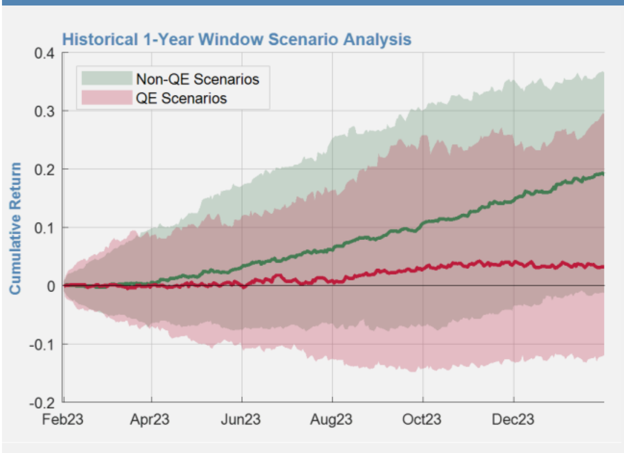


Figure 10: Monte Carlo Scenario Analysis Using Data from 1985 to 2021 - Conditional on QE Periods: 12 Month Horizon

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We complete the Monte Carlo scenario analysis by seeking to identify the 'CTA Winter' by partitioning our data between QE/ZIRP and non-QE scenarios. Figure 10 provides us the visual evidence.

The mean expected returns are very similar under both scenarios for the first 1-2 months but then the general lack of trends that was symptomatic of the QE era persists for six months before some positive drift appears. By contrast the non-QE era scenarios show strong positive skewness and a steady trend capture as evidenced by the steadily increasing median expected returns plotted by the green line.

4. What is the Outlook for Trend?

Trend following is an adaptive, agile and resilient strategy with an inherently positively skewed return profile. The outlook is favourable and robust across a multitude of economic scenarios. Additionally, trend has tended to generate more muted but still diversifying returns during the years dominated by quantitative easing and (near) zero interest rate policies when risk-reward was heavily distorted by central banks. However, the likelihood of the next decade being a return to the QE/ZIRP era seems remote as inflation, deglobalisation, decarbonisation, energy scarcity and significant geopolitical stress all tend to point towards a more dynamic market environment – one that potentially favours both the adaptability and the resiliency of trend.

Chart Disclaimer

All figures are for illustrative purposes only.

Figures 3, 4, 5 and 6: Generic example of trend following behaviour using a simple model of a market moving by +1 or -1 each period, and a trend following indicator defined as the average of the market moves over the 5 previous periods.

Figures 1, 7, 8, 9 and 10: The analysis shown is based on a carve out of the trend following component of the current implementation of the Aspect Diversified Programme (futures markets only). Portfolio positions as at 31 January 2023 are used to apply historical 12 month periods of markets return and simulate forward looking scenario analysis. Each 12 month period starts from each month-end date from Jan 1985 to Jan 2021. Where historical market prices are not available back to Jan 1985, a proxy for that market is used, this is based on the market with the highest correlation within the same sector. This analysis is for illustrative purposes only and is not indicative of future performance. The performance data shown above is gross. As such, it does not reflect the deduction of fees and expenses which would have lowered performance. The returns shown include the reinvestment of all sources of earnings. THESE RESULTS ARE BASED ON SIMULATED OR HYPOTHETICAL PERFORMANCE RESULTS THAT HAVE CERTAIN LIMITATIONS. UNLIKE THE RESULTS SHOWN IN ACTUAL PERFORMANCE RECORD, THESE RESULTS DO NOT REPRESENT ACTUAL TRADING. Past performance is not indicative of future results.

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