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Global Macro Managers

Why aren't they making any money?

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Trend Following: CTA Funds Assessed

In the first of a series of articles, Karim Taleb, Principal at New York-based global investment management firm Robust Methods, asks: Why aren't CTA and Global Macro Managers making any money?

Holding one of the longest verifiable track records, trend-following strategies have developed a respectable performance reputation over time. Their tendency to provide uncorrelated returns and a positive performance in times of market distress – a period during which most other hedge fund strategies typically break down – made their proposition truly unique and differentiated, and a must- have in every portfolio.

At a recent Commodity Trading Advisors (CTA) & Hedge Fund Managers Summit which took place in New York, the mood was not particularly cheerful nonetheless, and with the CTA's and their nearest relatives in the Global Macro space traversing one of their longest and most challenging periods; they are living the ironic adage of "you're as good as your last trade" – at least in the eyes of their clients.

At the investors roundtables, institutions who had come in droves to allocate to CTA managers back in 2009, and after noticing their robust gains in the crashing markets of 2008, find themselves today sitting in the house of pain pondering some double digits portfolio losses.

So what happened to these global managers, who only very recently were held in high esteem?

One of the well-documented characteristics of the financial markets is their endogenous propensity to develop big and small price trends, and as part of a free interaction between buyers and sellers. These trends that arise here and there, and now and then, are at the core of price volatility.

This observation does not come as a surprise, and nor is it limited to markets; it is found in most natural phenomena and provided they're characterised by a minimum degree of mobility or dimensional freedom.

The success of the CTA managers had stemmed from their intimate market experience navigating the ups and downs of volatility, and graduated from the proverbial school of hard knocks. From a philosophical viewpoint, they wore a humble demeanour, and impressed investors in being quick to adapt to market conditions, and by not holding obstinate opinions related to their positions. They kept their focus on a disciplined execution and a seasoned respect for risk.

The low correlation to both equity and bond indexes made their returns profile an ideal component to include in any portfolio, and a perfect complement to a traditional one comprised of stocks and bonds.

Compared to their closest peers in the Global Macro strategy, they scored quite favourably; while both strategies delivered comparable returns over time, the CTA's performance, as a group, tended to be more consistent and predictable versus the one of the global macro managers, and whose performance exhibited a much wider degree of dispersion.

Against most other hedge funds strategies, and especially the credit and fixed-income short-volatility type, notorious for rewarding investors in an apparently consistent manner just to experience a swift and severe loss, the CTA proposition also stood in positively stark contrast.

For the cash-watchful investors wanting to buy optionality on markets but without committing the entire amount otherwise required in the physical market, the CTA proposition also proved very convenient; CTAs provided a mimicking portfolio by using forward contracts and spared investors the full funding.

The increased mystique and desire to know how CTA's operated prompted some Fund of Funds to make appointments and show up at CTA shops with a long list of prepared questions – and a notepad. Some, underestimating the value of research or knowing too well what it means, would even take the risk of transgressing on professional ethics by asking detailed questions related to the intricacies of the proprietary nature of the various strategies.

Given such a growing demand for the strategy, the advent of algorithmic market modelling and trading tools opened the door to a further refinement of the original proposition of the "turtles" (the long-term trend followers): A new breed of a short-term and quantitatively oriented managers started to emerge and which aimed at capturing the short and mid-term trends instead, and some started trading ETFs and equities to expand the opportunity set.

With the original turtles being notorious for deep and long drawdowns that few investors had the stomach or patience to sustain, the short-term CTAs promised to fill that gap by attenuating drawdowns while delivering better risk-adjusted returns. The approach remained conceptually close, and inclusive of the benefit of using an objective and historically validated trading model.

Both the Global Macro and CTA strategies worked within their expected range for some time, but then a noticeable change started to occur in the past few years when some programs started exhibiting signs of fatigue. Other programs experienced deep drawdowns that raised doubts about their ability to recover.

Those that made money over the past few years did so mainly being long the global bonds and equity markets and going short the Japanese yen after the shocking announcement of plans to double the money supply. All these trades were clearly driven by unprecedented and insane monetary policies which skewed the markets to create extreme and unusual trends. Buying into such artificial trends also embedded a serious dose of systemic risk.

Other CTA programs that made money were some niche strategies such as "contrarians",

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"spread traders" or "volatility trading", but these fall outside the generally accepted profile of a CTA.

The representative indexes are in negative territory over the past five years, and despite their significant survivorship bias, their initial self-selection construction bias, or the regular reshuffling and re-weighting with the benefit of hindsight.

The main point of this general assessment described above is that it reveals something unusual, if not contradictory; how come these proven and well versed managers have not made any money in five years? Did the CTA and Global Macro managers lose their skills rather abruptly, or has the fabric of the markets been seriously compromised?

About the author...

Karim Taleb, PhD is the Principal of Robust Methods LLC, a global investment management firm specialising in absolute returns strategies for private and institutional investors.

Possessing state of the art quantitative expertise, Robust Methods draws from deep market insight and theoretical and computational methods to design and produce superior trading strategies for the financial & commodities markets.