Insight Paper

Capturing Unpredictability

Trend Following Alpha

February 2024

In this paper we explore whether it is time to move on from the "Crisis Alpha" label for trend-following strategies, and instead think of them in terms of "Unpredictability Alpha".

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Trend Following Alpha

Trend following CTAs have been able to capitalise on bull and bear markets across asset classes in recent years, encouraging investors to view them once again as an all-weather allocation in a climate where considerable uncertainties can upend forecasting-based approaches. In this paper we explore whether it is time to evolve the "Crisis Alpha" label for trend following strategies, and instead think of them in terms of "Unpredictability Alpha".

Beyond Crisis Alpha

The "Crisis Alpha" description of trend following CTA return profiles has become limiting in the post-Covid and post-QE/ZIRP environment of heightened economic, policy, political and geopolitical uncertainty.

Granted, crisis alpha remains a core utility of trend following, but this perception can pigeonhole the strategy too narrowly into being seen as a form of "portfolio insurance", which implies at least some opportunity cost - even if it does not suffer from the negative carry drag of a tail risk hedging strategy that pays away option premiums.

In the decade after the Great Financial Crisis (GFC), an era dominated by Quantitative Easing (QE) and Zero Interest Rate Policies (ZIRP), some might argue that there was indeed some degree of opportunity cost to holding CTAs, which delivered risk-adjusted returns of around 0.2 to 0.3 (information ratio) – a period that some now refer to as the "CTA Winter". This was a respectable return for a highly diversifying allocation, but it was disappointing on a relative basis when the classic equity and bond portfolio had its best decade in 50 years. However, looking over much longer time scales, it is this post-GFC decade which appears abnormal for both CTAs and traditional assets.

However, looking over much longer time scales, this post-GFC decade appears abnormal for both CTAs and traditional assets alike.

Yet even in the ZIRP period, periods of strong returns for CTAs were seen even in the absence of equity market crises, as strong diversifying trends emerged in other asset classes, such as commodities. The best year for CTAs during the CTA Winter was 2014, when a key driver was the collapse in oil prices as the US shale oil revolution came to fruition: an excellent example of "Unpredictability Alpha".

Post QE/ZIRP Risk Normalisation

The era of globally coordinated quantitative easing and low or negative interest rates massively compressed all sorts of risk premia, from liquidity to credit, to term structure and duration, as well as keeping inflation under control. This distorted the pricing and perception of these risks as everything was anchored to predictably low rates. This, in turn, suppressed dispersion across many macro variables and contributed to reducing the opportunity set for CTAs. Now, the return of inflation coupled with the unwind of QE, the advent of QT and a re-normalisation of interest rates has resulted in a state of flux across many asset classes and geographies, emanating in fixed income but propagating outwards across currencies, commodities and equity markets.

Since 2020, the information ratio of a typical trend follower has returned towards its historical average approaching 0.8.

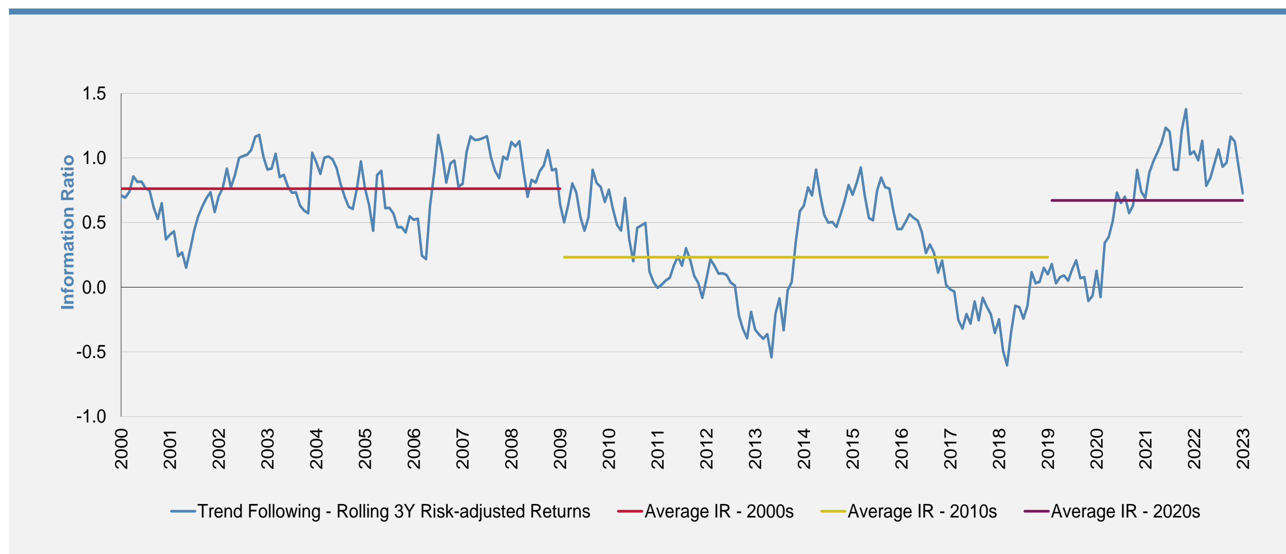

Figure 1: Risk-adjusted Returns for CTAs by Decade: 2000 to 2023

Source: SG CTA Index. Note: The data above with respect to various indices is shown for illustrative purposes only. Detailed descriptions of the indices used above are available from Aspect upon request. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. Please see relevant risk disclaimers at the end of this document.**

Yet the CTA strategy itself is not predicated on mean reversion in markets. Some strategies, including value, relative value, and market neutral approaches, are often plays on convergence, reconvergence or mean reversion. CTAs and global macro strategies are examples of divergent approaches that can profit from the change arising from surprising disequilibria, new regimes and new paradigms. Equity bear markets are only one, relatively infrequent, subset of disequilibria, which can be manifested across any asset class, or sometimes limited to individual markets within broader asset groups.

Macroeconomic divergence and dispersion are back

The re-normalisation of interest rates has percolated into economies and asset classes, contributing to substantial dispersion and divergence in current and forecast levels of inflation, interest rates and GDP growth between the major and minor economies. This in turn translates into more divergent prices in equity, bond, currency and commodity markets.

Dispersion has returned as economies, and rate cycles, are no longer moving in sync. Growth, inflation and interest rate cycles that were closely clustered during the ZIRP period have now diverged: for instance, in 2023 the US continued to outperform on GDP growth, China surprisingly slowed down and cut rates while the US and most European countries were raising rates, and Japan held rates relatively steady. In absolute terms, there has been a near double-digit spread between the highest and lowest G10 inflation in 2023, which fuelled dispersion.

Relative to consensus forecasts, some countries are overshooting, and others are undershooting on inflation. This makes it harder for central banks to provide forward guidance. Against that backdrop, the concept of “Unpredictability Alpha” may be more useful than “Crisis Alpha” when thinking about the role of a CTA allocation.

IN OUR RECENT PAPER, ‘THE CURRENCY PHOENIX HAS RISEN FROM THE ASHES’, WE DEMONSTRATED EXAMPLES OF THE MACRO-ECONOMIC INDICATORS ESSENTIAL TO PRICING CURRENCIES DIVERGING AND THE IMPACT ON THE OPPORTUNITY SET FOR TREND STRATEGIES AS A RESULT.

Politics and geopolitical forces

In addition to the end of QE, the pandemic released and accelerated disruptive structural changes that were already underway. These include peak globalisation giving way to deglobalisation, trade wars, onshoring and supply chain disruption.

Political polarisation has also been seen in extreme right-wing and left-wing political parties maintaining or winning power, or significant influence, in countries such as Hungary, Slovakia and the Netherlands. In many emerging markets, "democracies" have moved along the spectrum towards authoritarian dictatorships.

Other disruptive and destabilising forces include climate change and the decarbonisation agenda, which could add dynamism to markets such as fossil-fuel based and alternative energy linked commodities, metals, and agricultural commodities.

Geopolitics is another dimension that shows no signs of stabilising. The "hot war" in Europe and an increasingly escalating conflict in the Middle East, at a minimum, can be catalysts for instability.

All these enduring sources of instability have the potential to drive up trend formation in ways that need not be anticipated, because trend following strategies by their nature are reactive and adaptive.

Multiple Regimes over Five Decades

Trend following can harness a variety of both benign and malign economic regimes. These new regimes nearly always surprise investors, and give trend followers a chance to demonstrate "unpredictability alpha". Looking back over 50 years as we do in figure 2, major macro regimes included intense inflation in the 1970s associated with wars, revolutions and embargoes in the Middle East. Inflation peaked in the early 1980s, which brought its own surprises from a US banking crisis, an agreement on the US dollar, the 1987 stock market crash and the ensuing Japanese bubble, which then started to burst in the 1990s as the USSR imploded. That decade ended with Asian and Russian crises, and a tech stock bubble that burst in the 2000s, when commodities came back into fashion. The noughties finished with the deepest recession in generations, dubbed the Great Financial Crisis, which paved the way for the QE and ZIRP era including the European debt crisis, the Shale Revolution and Brexit. The 2020s have also been eventful with Covid, deglobalization and the biggest "hot war" in Europe since the Second World War. Trend following CTAs garnered positive returns in all of these decades, from a variety of long and short positions across and within asset classes, demonstrating adaptability, agility and resilience in response to unpredictable markets.

Chilling Effect of Quantitative Easing

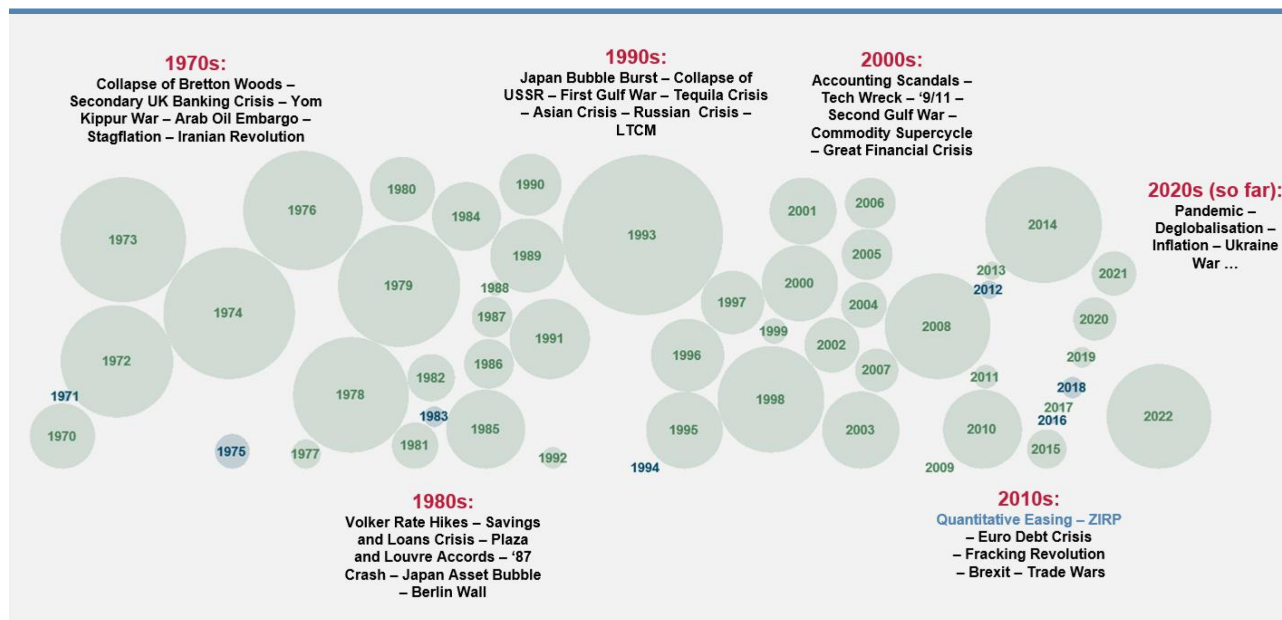

Figure 2: Fifty Years of Trends: Navigating a Multitude of Challenging Macro Events, 1970 to 2022

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.**

Unpredictability in the New Market Regime

Discretionary managers often aim to accurately anticipate trends and turning points, whereas systematic trend followers are more reactive. Paradoxically, an unpredictable environment can engender stronger trends. The QE period was dull for many divergent strategies, in no small part due to forward guidance on monetary policy and interest rates working so predictably well. Now it is becoming harder to navigate, as Fed Chairman Powell said in August 2023: "we are navigating by the stars under cloudy skies".

With the benefit of hindsight, policymakers massively under-forecasted inflation and interest rates, and should have raised interest rates earlier. This led to one of the most intense rate hike cycles in 2022 and part of 2023. The pattern of rate hikes was ideal for trend followers because it took time for the forward expectations to adjust and be priced into fixed income markets, meaning that there was plenty of time to latch onto the trade and catch the trend. Some discretionary traders might have missed out on part of these moves if they were "in denial" about the new regime. Since 2022, rates volatility has shot up, returning towards levels seen between 1990 and 2010. Though, at the time of writing, interest rate cuts are now expected in 2024, nobody is forecasting a return to zero rates everywhere any time soon. A cost of borrowing should remain, which should help to maintain more normal financial markets.

Central bank forward guidance is only one example of an area where more economic policy surprises are happening. Broader indices of economic surprises, such as the Citi Economic Surprise index, have also picked up.

Inflation and interest rates have shown more dispersion between apparently similar economies. In Europe, the UK and the Netherlands have seen much higher inflation than some neighbouring countries. The range of short-term interest rates in major economies is now twice as high as during the ZIRP era, but equally it is really just normalising back to the prior period between 1990 and 2008.

In equity markets, the enthusiasm for AI has created outperformance for US equities in general and US tech stocks in particular. Meanwhile, Hong Kong's Hang Seng index has been touching multi-year lows.

Interestingly, trend following managers have managed to generate strong diversifying returns over the last two years (2022 to 23) with many traditional markets barely recouping the losses seen in 2022. The chart below shows total nominal returns in USD across a wide range of traditional assets as well as CTAs represented by the SG Trend and CTA indices.

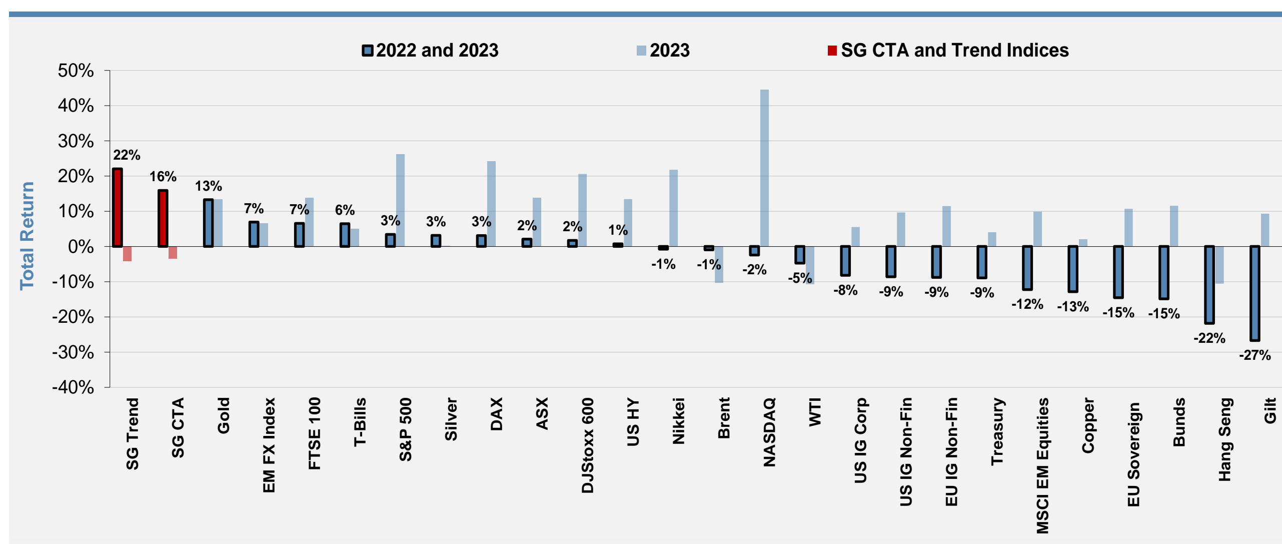

Figure 3: Trend Following Well Placed to Navigate Macro Divergence

Source: SG CTA Index, Bloomberg. Note: Equities, credit, bonds and FX indices are shown on total return basis. Commodities shown on front month future return. All indices are converted to USD where relevant. The data above with respect to various indices is shown for illustrative purposes only. Detailed descriptions of the indices used above are available from Aspect upon request. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. Please see relevant risk disclaimers at the end of this document.**

Why Trend?

Trend following strategies have ideal characteristics for trading in an unpredictable and divergent macro environment.

Over sufficiently long periods of time, we believe trend followers should capture long-term positive performance from all the asset classes and sub-asset classes they trade, whenever and wherever trending behaviour manifests, thus navigating a variety of different cycles and regimes. Over the last 25 years, we have seen bonds and interest rates dominate performance for long periods of time. However, at other times during that period, agriculturals, energies, currencies and metals have all had phases of strong trending behaviour. This in our view highlights the adaptive and opportunistic return profile of trend strategies which can provide useful diversification. Therefore, investors in trend do not need to formulate a preconceived narrative or outlook. The strategies are designed to adapt by aiming to find and capture the prevailing trends.

The strategy is by its nature directionally agnostic, and is agile enough to adapt to changing regimes with models trading over varying timeframes.

Trend following can be seen as a solution for tactical asset allocation, which maintains high liquidity and asset class diversification: flagship trend programmes have a relatively high allocation to currencies and commodities, which can be useful diversifiers for the equities and bonds that often dominate portfolios.

Statistically, trend following return profiles also add a different pattern to portfolios. They show a positive skew, over time frames longer than a month or so with bigger upside than downside moves, whereas many other asset classes and strategies are negatively skewed.

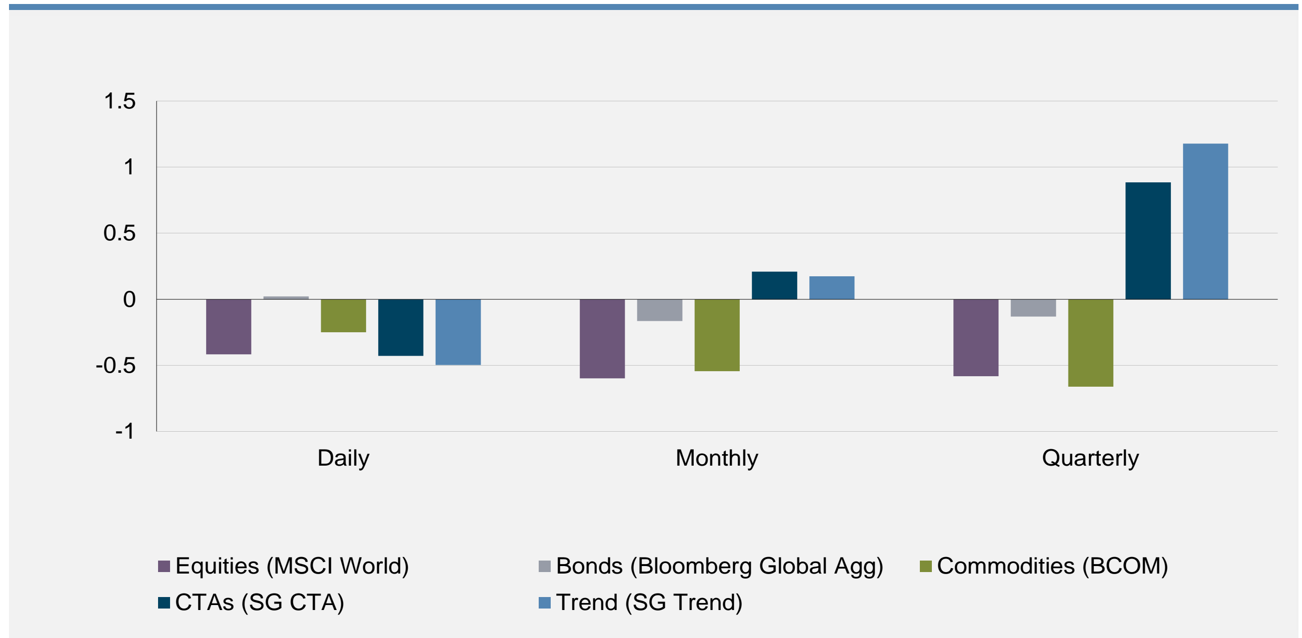

Figure 4: Skewness Profile of CTAs vs Traditional Asset Classes: 2000 to 2023

Source: SG CTA Index, Bloomberg. The data above with respect to various indices is shown for illustrative purposes only. Detailed descriptions of the indices used above are available from Aspect upon request. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. Please see relevant risk disclaimers at the end of this document.**

Bonds in contrast have not been a good diversifier for equities in 2022 or 2023, as the two asset classes have returned to the positive correlation pattern they demonstrated for most of the period between 1975 and 2000. Trend following does not assume or predict particular asset class correlation patterns. The unbiased and unfitted approach could be well placed to profit from a breakdown of such relationships.

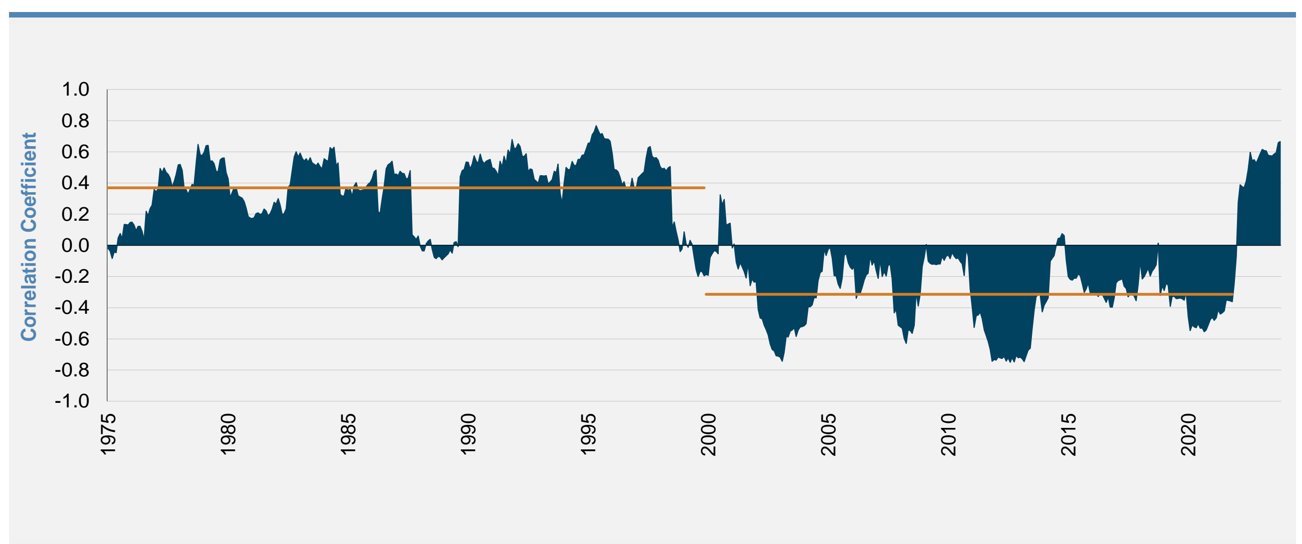

Figure 5: Stocks and Bonds Rolling 24 Month Correlation: 1975 to 2023

Source: Bloomberg. The data above with respect to various indices is shown for illustrative purposes only. Detailed descriptions of the indices used above are available from Aspect upon request. **Please see relevant risk disclaimers at the end of this document.**

In the final two charts below we show, using proxies, that although stocks and bonds have tended to be good diversifiers for one another, the unpredictability of 2022 saw both major asset classes declining at the same time. Trend following, on the other hand, has demonstrated its “unpredictability alpha” credentials by reliably mitigating drawdowns in multi-asset portfolios, regardless of whether it was equities, bonds or both asset classes that generated those losses.

Conclusion

As we enter 2024, uncertainty remains at the forefront of investors’ minds. Trend following does not try to predict the future. Instead, it uses its main attributes – adaptability, agility and resilience – to navigate the macro landscape and provide investors with valuable “unpredictability alpha” at a time when it might be most needed.

Unpredictability Alpha

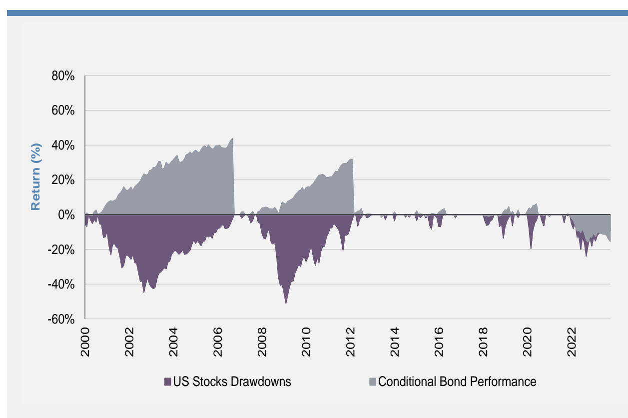

Figure 6: Conditional Bond Performance During Extended Equity Drawdowns: 2000 to 2023

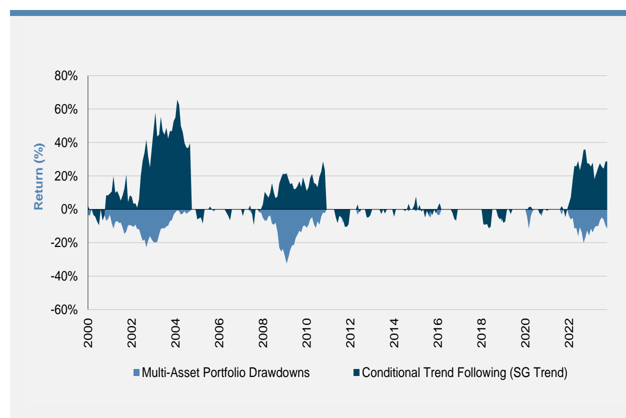

Figure 7: Trend Following Index During Extended Multi-Asset Drawdowns: 2000 to 2023

Source: Aspect Capital Limited, Bloomberg, Macrobond. THE MULTI-ASSET RESULTS IN FIGURE 7 ARE BASED ON HYPOTHETICAL PERFORMANCE THAT HAVE CERTAIN LIMITATIONS AND DO NOT REPRESENT ACTUAL TRADING. The indices shown are for informational purposes only and are not reflective of any investment. As it is not possible to invest in the indices, the data shown does not reflect or compare features of an actual investment, such as its objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, or tax features. **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.** Please see relevant risk disclaimers at the end of this document.

US Equities	S&P 500 Total Return Index
US Bonds	Bloomberg US Aggregate Total Return Index
Trend Following	SG Trend Index
Multi-Asset Portfolio	60% US Equities and 40% US Bonds

Chart Disclaimer

All figures are for illustrative purposes only. Detailed descriptions of the indices shown above are available from Aspect.

Figure 2: 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. 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). Where historical market prices are not available back to Jan 1970, 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**. Please see the relevant risk disclaimers at the end of this document .

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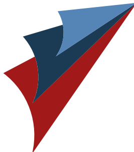

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