Pictet Alternative Advisors SA

Hedge funds: the case for 'trading strategies'

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A successful 'trading strategy' is able to adjust a portfolio's risk profile rapidly to short term market conditions, regardless of long term convictions.

The use of trading strategies, especially Global Macro and Commodity Trading Advisors (CTAs) funds, has been effective in achieving resilience during periods of market stress.

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'... the unquenchable capability of human beings when confronted with long periods of prosperity is to presume that it will continue'
Alan Greenspan

While no-one doubts that future financial crises, by their very nature, remain unpredictable, one thing is certain: there will be crises in the future. Investors must therefore find ways of minimising the impact of unexpected financial shocks to their portfolios.

There are important benefits to be gained from exposure to a dynamic hedge fund strategy that has little correlation to markets during periods of stress. The best approach for investors would be to maintain an allocation to a diversity of trading strategies at all times.

A successful trading strategy is able to adjust a portfolio's risk profile rapidly to short term market conditions, regardless of long term convictions. Historically, the use of such trading strategies has been an effective means of achieving this aim.

Carefully selected hedge funds within these strategies, mainly Global Macro and Commodity Trading Advisors (CTAs) funds, can provide resilience to market shocks in the context of a traditional portfolio.

Pictet has more than 20 years of experience investing in hedge funds for clients and for its funds of hedge funds (FoHFs). Among these FOHFS, Mosaic Trading specialises in hedge funds employing trading strategies.

Trading strategies

AHL: a quantitative investment manager established in 1987, acquired by MAN and now their largest and most successful fund.

Turtle Traders: an early 1980s experiment led by commodities trader Richard Dennis and business partner William Eckhardt. See Way of the Turtle – How Ordinary People Became Millionaire Traders, M. Hendrix

What does a 'trading strategy' mean?

A successful *trading strategy* is characterised by the ability of a hedge fund manager to adjust rapidly the risk profile of a portfolio to short term market conditions, regardless of long term convictions. Such tactical moves can be made either judgementally or with a systematic approach, and may be based on a wide range of data, from economic fundamentals to pure technical indicators.

Which hedge fund strategies qualify?

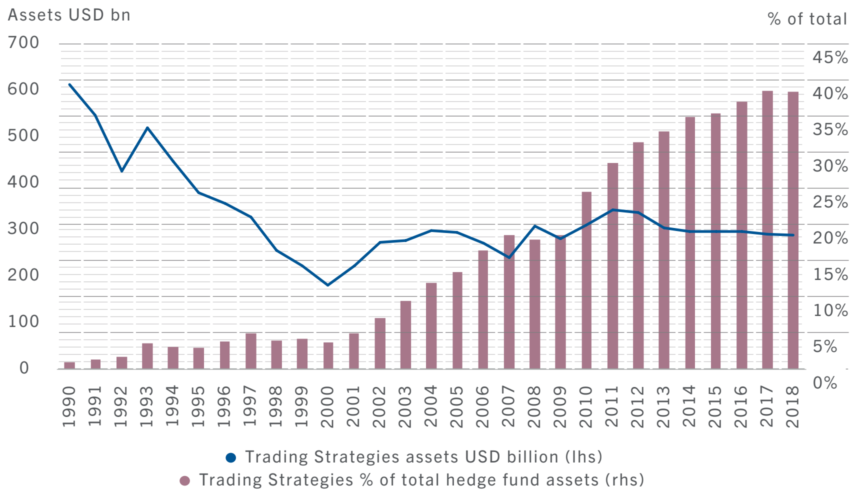
The two main trading strategies in use are **Global Macro and Commodity Trading Advisors** (CTAs), also known as 'managed futures'. Opportunistically, trading managers are also found in almost all other strategies, such as in Long/Short, Emerging Markets and Fixed Income. In general, managers whose strategy can be characterised as buy-and-hold, or who invest in less liquid instruments, such as Event Driven or Distressed, generally do not qualify.

The original trading strategies: Global Macro and CTAs

Global Macro and CTA managers were pioneers in the hedge fund industry with some track records dating back to the 1980's. The Global Macro world was populated by legendary figures such as George Soros and Paul Tudor Jones, while CTAs achieved prominence through the success of groups such as AHL or the Turtle Traders.

Initially, Global Macro and CTA strategies represented the bulk of hedge fund assets under management. Today, although assets in trading strategies continue to grow significantly, their share of the hedge fund industry has diminished due to the growth of other hedge fund styles and the popularity of equity related strategies.

TRADING STRATEGIES – ESTIMATED GROWTH OF ASSETS VS % TOTAL HF ASSETS



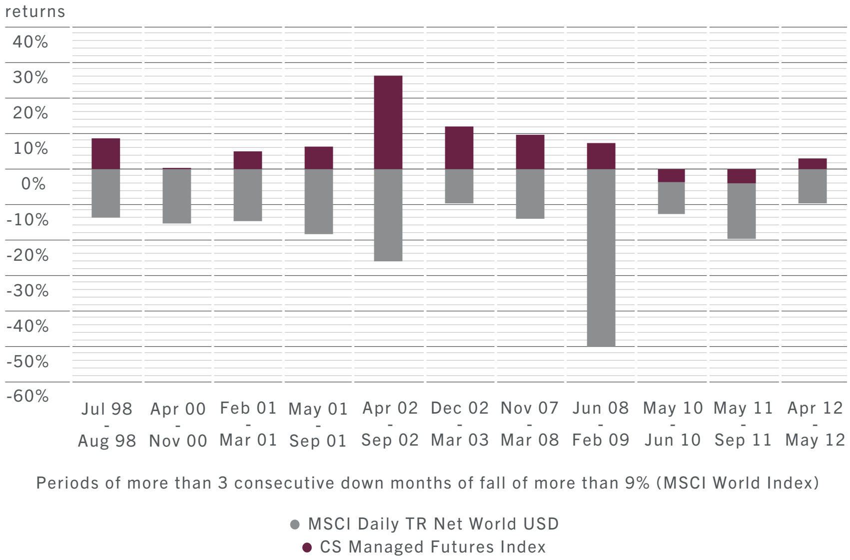
Source: Global Hedge Fund Industry Report - First Quarter 2018

Trend followers take advantage of long term moves across various markets. They do not predict or forecast specific price levels, rather they identify a trend and ride it.

What is Global Macro?

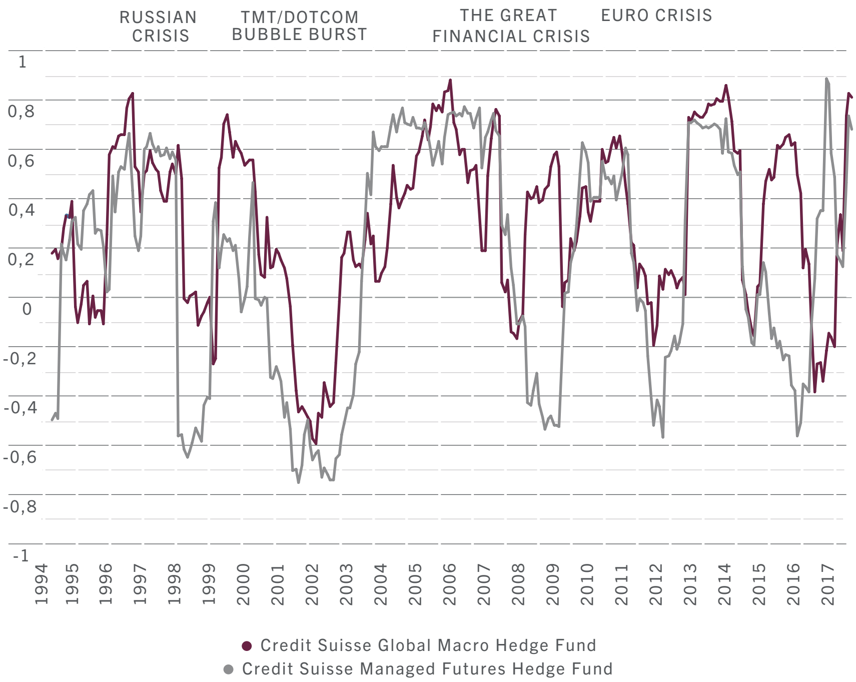
A Global Macro approach typically involves the analysis of large quantities of macroeconomic data across markets and regions. Managers try to identify potential trends or imbalances in the risk premium relating to the main asset classes, such as equities or currencies. This top-down process helps them narrow down opportunities in the asset class and to find ways to extract the most value from the identified themes. Great focus is attached to expressing the trade in the most profitable way – in other words, to uncovering the financial instruments that offer the best risk/reward profile. In this case, the most liquid opportunities take priority.

CTAS SHOW PERSISTENT OUTPERFORMANCE DURING MARKET STRESS 1994-2018



Source: Bloomberg, data as at 30.06.2018

12-MONTH ROLLING CORRELATIONS OF CTAS AND GLOBAL MACRO DURING BEAR MARKETS



Source: Bloomberg, data as at 30.06.2018

What are Commodity Trading Advisors (CTAs)?

CTAs have two main characteristics. First, they only trade on the futures markets. Second, they take positions by following systematic buy and sell signals based on sophisticated computer models. Generally speaking, most of the inputs are priced-based indicators, while most models are derived
from trend-following algorithms.

Nevertheless, over the past decade, CTAs have invested considerably in research in order to diversify away from classic trend-following systems. Today, managers employ a wide range of time-frames and models. For instance, the average holding period can range from hours to months, while pattern-recognition or counter-trend models are also becoming popular.

CTAs have often proved resilient during periods of market stress. In the following chart, in each period of more than three consecutive down months or a fall of more than 9 per cent in global equity markets, CTAs have generally shown a positive return.

This remarkable resilience can be expressed in a different way, by looking at the 12-month rolling correlations of CTAs and Global Macro during bear markets. In the following chart, correlations turn sharply negative during such periods.

Opportunity cost:
the cost of not being invested in other hedge fund strategies

THE BENEFITS AND RISKS OF TRADING STRATEGY HEDGE FUNDS

Benefits	Risks
'Trading' hedge funds tend to be managed by the most seasoned managers with long track records across all market cycles.	Some 'trading' hedge funds are still concentrated and highly leveraged with large directional bets.
Trading managers employ financial products and strategies outside the classic stock-and-bond allocations.	A correct macroeconomic view can be expressed in an ineffective way, by choosing the wrong financial instrument.
Operational risk is lower because they mostly use financial instruments that are liquid and exchange-traded.	CTA trend-following systems may be upset by certain volatility conditions that trigger false signals.
Risk management is generally rule-based and strictly enforced, preventing irrational attachment to a position or theme.	Because CTA returns are highly cyclical, too high an exposure involves an opportunity cost.

Source: Pictet Alternative Advisors SA

A Goldilocks economy is 'neither too hot, nor too cold, but just right' *Multiple references mid 1900s onwards*

'Once you recognise that market moves are random you simply need to put yourself in a position where you can capitalise on a move when it happens' *Michael Covel, Turtle*

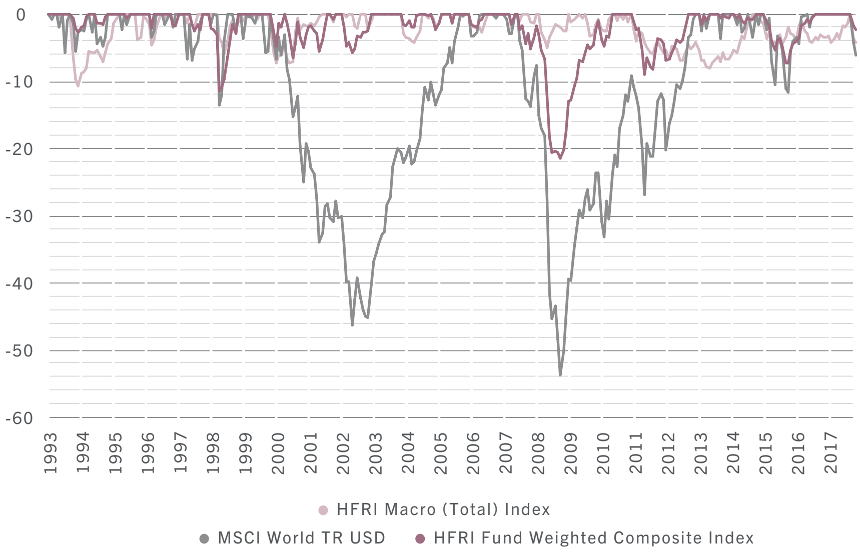
When do Global Macro and CTAs go wrong?

There are two specific market conditions during which both Global Macro or CTAs may underperform. The first is during an extremely low volatility environment. The best historic example is during the so-called 'Goldilocks' economy. With low uncertainty, predictable central bank policies and synchronized growth worldwide, there were few opportunities to benefit from mispricing. The second circumstance is during repeated volatility spikes, which are difficult to manage and can hurt performance. While trading managers can and do actively trade, they are not day traders and can therefore be 'whiplashed' if a spike in volatility triggers – through automatic risk management rules – a sudden deleveraging, only for the initial trend to resume. A typical example of what triggers a volatility spike would be surprise government intervention.

When do they perform best?

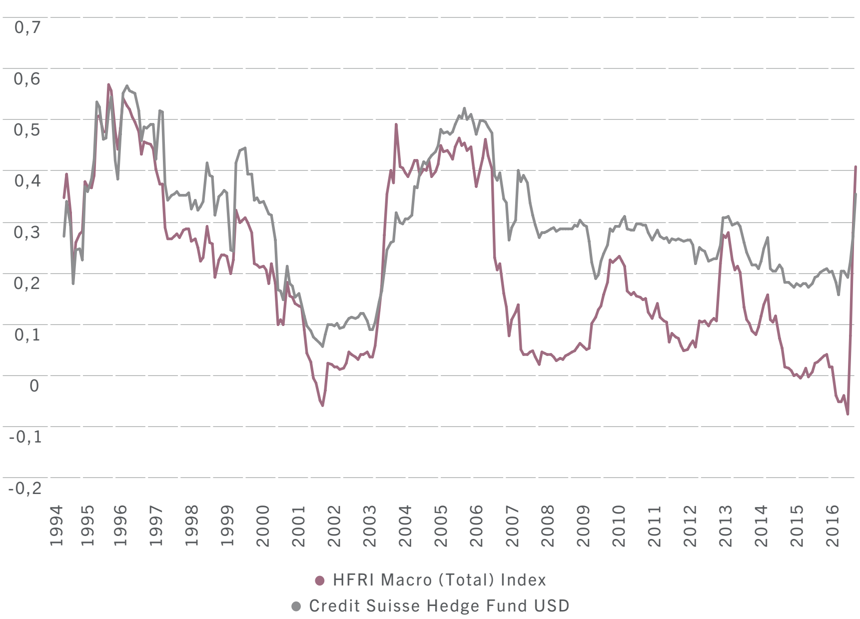
There are two specific market conditions during which both Global Macro or CTAs may outperform. First, a high and lasting volatility regime in key markets is positive for trading strategies, especially relative to other strategies and asset classes. In such circumstances, Global Macro should outperform CTAs. Indeed, their short-term tactical bias would dominate long term views, while trend-following models with a longer time frame would struggle. Second, clear trends in key markets, and not necessarily in equity or credit indices only, are particularly favourable. In this environment, CTAs would be likely to outperform Global Macro managers, because of their use of trend-following models.

DOWNSIDE RISK CONTROL IN STRESS MARKET CONDITIONS



Source: Lipper, Hedge Fund Indices, data as 29.03.2018

TRADING STRATEGIES & GLOBAL MACRO - BETA AGAINST GLOBAL EQUITIES



Source: Lipper, Hedge Fund Indices data as 29.03.2018

Why include these strategies in a portfolio of traditional asset classes?

Based on track records back to the 1990s, it is clear that in times when equities fall, trading strategies have tended to outperform both traditional funds and other hedge funds strategies. They even delivered positive returns in many instances. Trading strategies would therefore have tempered the worst effects of past market crises. Furthermore, there have been many academic studies showing that an allocation to CTAs improved the overall Sharpe ratio of a portfolio composed of equities and bonds.

How do these strategies differ from a classic multi-strategy fund of hedge funds?

Multi-strategy funds of hedge funds can invest in all the hedge fund strategies available, and they can make tactical adjustments depending on the economic cycle. For example, after a credit crisis, investments in distressed managers may be increased significantly, while long/short managers may be favoured during an economic recovery. Overall, multi-strategy FoHF returns should be less cyclical than a thematic product, but they are likely to underperform a pure trading strategy product in a period of market stress, particularly during an equity bear market. Compared with a pure trading product, the correlation of multi-strategy FoHFs to equity indices is higher and their beta against those indices less variable, as the chart below demonstrates.

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