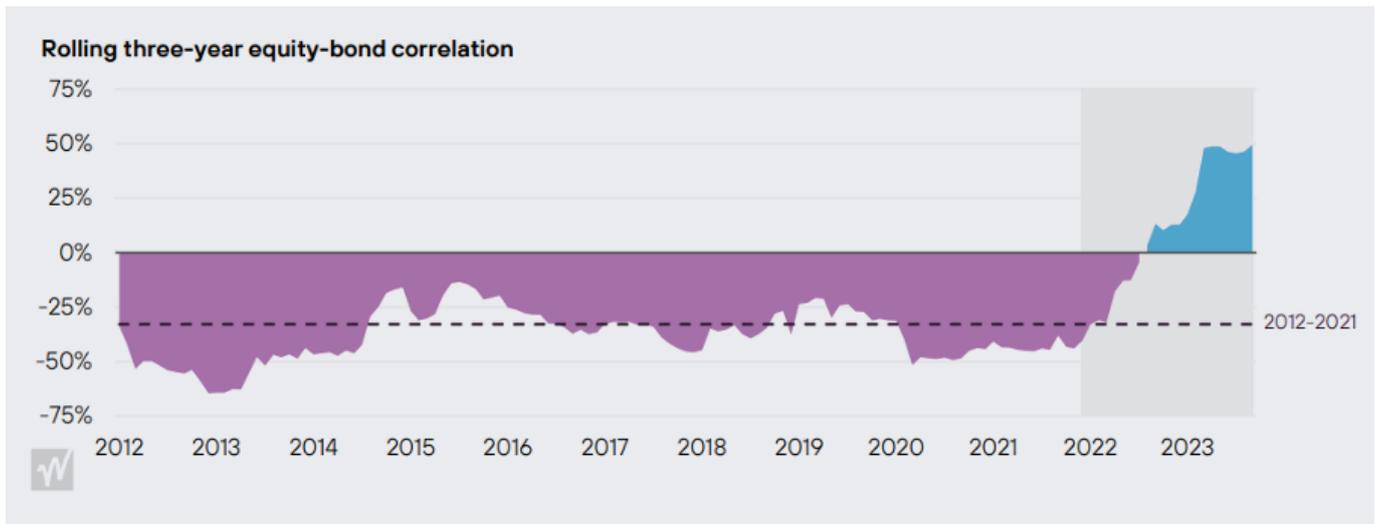


# Investment Views

MAY 2024

## Trend-following as a compelling portfolio allocation

The macroeconomic environment has shifted considerably since 2021, with inflation and interest rates remaining stubbornly high and bond and equity markets exhibiting positive three-year rolling correlations for the first time since the 1990's (see chart below).



Source: Winton, Bloomberg

During market downturns this significantly impacts portfolios, as diversification benefits disappear and bond holdings decline at the same time as equities. One option for countering this is an allocation to alternative investments, provided the strategy is a genuine diversifier as opposed to a pseudo equity or bond allocation. Trend-following, also called Commodity Trading Advisor or CTA, is such an investment.

Trend-following strategies use quantitative analysis and models to identify and profit from market trends regardless of their direction. This means they can theoretically produce positive returns in bull or bear markets during periods when "the trend is your friend". We believe we are currently in such a period, with price momentum re-establishing itself in numerous markets over the last six to twelve months. This is especially evident in parts of the equity market with the large US tech stocks trending strongly (higher), but similar patterns are emerging in other assets, including commodities and currencies.

For instance, cocoa prices have soared due to unusually bad weather in West Africa as high temperatures have negatively impacted production levels. In currency markets, the value of the Japanese yen has declined steadily against the dollar, down 9% since the start of the year. All of which provides opportunities for trend-following strategies to make money in a manner that is diversified from and lowly correlated to the broader asset classes that typically make up the bulk of portfolio allocations.

What does trend-following actually mean? The strategy is grounded in the belief that market prices in various asset classes exhibit persistent trends over time. Unlike traditional investment strategies that rely on fundamental analysis or economic indicators, trend-following is purely technical in nature, almost ignoring the reasons why the trend works. It simply focuses on analysing price movements and identifying patterns that signify the emergence of a trend.

Funds then employ sophisticated algorithms and trading techniques to navigate these trends, aiming to generate consistent returns over time. Once a trend is in place, the fund may enter into long or short positions, depending on whether the trend is bullish or bearish. The goal is to ride the trend until it shows signs of reversal, at which point the fund will exit the position.

Although the specifics of a CTA fund will vary from one to the next, they tend to share several important characteristics that can improve the risk and return profile of an investor's portfolio:

1. **Diversification:** they maintain diversified portfolios across multiple asset classes and markets, helping to spread risk and reduce the impact of adverse market movements on overall performance. When a number of unrelated markets start to trend, many funds seek to improve returns by increasing leverage (the use of debt to fund positions), since their portfolios are better protected against sudden reversals in any one or two markets.
2. **Systematic Trading:** they rely on rules-based trading strategies rather than discretionary decision-making. This aims to remove emotional bias from trading decisions, in turn seeking to ensure consistency in approach and execution.
3. **Risk Management:** risk management is paramount in trend following strategies. Funds typically incorporate tight risk controls and stop-loss mechanisms to limit downside exposure and preserve capital during periods of market turbulence.
4. **Adaptive Strategies:** Successful trend following funds exhibit adaptability, adjusting their strategies in response to changing market conditions. This flexibility allows them to capture trends across different periods and adapt to evolving market dynamics.

The performance of trend following funds can vary significantly depending on market conditions. In recent years, they have faced both challenges and opportunities amid unprecedented market volatility and shifting macroeconomic trends.

The COVID-19 pandemic, for instance, presented a unique test for trend following strategies. The rapid onset of the crisis led to extreme market volatility and sharp fluctuations in asset prices. While traditional investment approaches struggled to navigate the uncertainty, some trend-following funds capitalized on the volatility by identifying and exploiting short-term trends across various asset classes.

However, the post-pandemic recovery brought its own set of challenges for trend-followers. As central banks unleashed unprecedented monetary stimulus and fiscal support measures, markets experienced periods of compressed volatility and erratic price movements. In such environments, trend-following strategies may encounter "whipsaw" effects, whereby rapid changes in market direction lead to false signals and losses.

Despite these challenges, trend following funds have demonstrated resilience over the long term. Historically, they have proven adept at navigating diverse market conditions including periods of heightened uncertainty. While short-term performance may exhibit variability, CTA funds can deliver consistent returns over the medium to long term by capturing trends and managing risk effectively.

Since late 2023, we have added two trend-following funds to the Alternatives section of Balanced mandates, seeking to take advantage of the price momentum now emerging across multiple different asset classes.

Montlake DUNN is the oldest pure trend-follower, founded in 1974 and based in Florida. It was a pioneer in applying quantifiable techniques to financial markets and developing rules-based portfolio management. It offers a best-in-class, long-term systematic program that has performed well across a wide range of market conditions. It trades around 65 markets within foreign exchange, bonds, equities and commodities and typically seeks to build a diversified balance across all asset classes. It is also very liquid and cash efficient. Its investment objective is to extract profits from up and down-trends, resulting in a return stream that exhibits very low correlation with traditional asset classes such as equities, bonds and real estate.

Winton is also a pioneer in this space with more than 25 years' experience of trend-following, led by Sir David Harding. Its Winton Trend UCITS fund has no directional bias in equities or bonds and aims to generate capital appreciation over the long term, regardless of whether markets are rising or falling. It provides us with a second liquid, low cost, diversifying allocation for portfolios that will perform with little to no correlation to the broader asset classes over the medium term.

Whilst both holdings are CTAs, we believe they complement each other due to important differences in their approaches:

- Winton trades around 400 markets compared to only 65 for DUNN
- Winton takes a more countercyclical approach to volatility and leverage than DUNN
- Winton is a medium speed trend-follower whereas DUNN is a little slower, focusing on medium to long-term opportunities. Both of these approaches have their advantages and disadvantages in varying market environments

For long-biased portfolios, we believe alternative strategies that provide diversification to traditional bond and equity holdings will play an increasingly important role going forward. And with many asset classes witnessing the emergence of medium to long-term price trends, the holdings in Winton and Montlake DUNN should prove to be valuable tools in reducing portfolio volatility, whilst adding to long-term returns. Simply put, trend-following is not just a hedging tool. It is a diversifying, uncorrelated strategy that also offers attractive return potential.

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