

# Theme: Trend Following

DECEMBER 2024

## Overview

"The Trend is your friend", Martin Zweig

Trend Following is a systematic investment strategy designed to profit from price trends, both up and down, across equities, fixed income, currencies and commodities. All markets exhibit exploitable trends, which Trend managers take advantage of through long or short positions.

Trend Followers have a history of generating uncorrelated returns for investors, often during difficult environments for equities and bonds. This was evident during the inflationary 1970s, the recessionary bear markets in the 2000s and most recently in 2022, when equities and bonds fell in tandem amidst a spike in inflation.

The popularity of Trend Following waxes and wanes, and can often be overlooked by investors after periods of strong relative performance for equities and bonds (and vice versa). In the decade after the great financial crisis of 2008/09, equities and bonds, and '60/40' portfolios combining both, performed very strongly, propelled by low interest rates and inflation. The perceived need for diversifying strategies, such as Trend Following, has declined.

However, the uncorrelated relationship equities and bonds exhibited over the past few decades broke down dramatically in 2022, when rising inflation and tight monetary policy led both asset classes to decline in tandem. In 2022, 60/40 portfolios delivered their fifth worst calendar year return since 1871 (source: AQR). Trend Followers, shorting both asset classes, delivered one of their best annual returns in over 50 years. It was a stark reminder for investors of the importance of truly uncorrelated alternative strategies.

As investors rushed back into Trend Following strategies in late 2022 (attracted by recent, record outperformance) we remained un-invested observers. Just as history suggests that selling Trend Followers after a prolonged period of subdued performance is an ill-advised strategy, so too is chasing positive records.

The reversal of fortunes for equities through 2023, and a tentative recovery for bonds, left Trend Followers looking relatively pedestrian, with many posting absolute losses for their investors. Inflections in major price trends are not ideal for strategies that seek to benefit from trending markets.

Enthusiasm for Trend Followers waned just as the merits of their uncorrelated return streams appeared to us to rise appreciably. This elicited our first investment in Trend Following in December 2023. Since March 2024 we have maintained a 5% core exposure to two specialist Trend Following managers in our Balanced portfolios.

The theme can be summarised as follows:

- **What?**  
Systematic, multi-asset Trend Following strategies
- **Why?**  
Trend following has consistently proven itself to be a low-cost, liquid, uncorrelated diversifier in 60/40 portfolios. This is particularly the case in challenging macroeconomic cycles
- **How?**  
Specialist Trend Following managers
- **Holding Period?**  
3yrs+

A more detailed explanation of why Trend Following strategies (which we refer to simply as 'Trend' below) are compelling portfolio diversification investments is as follows:

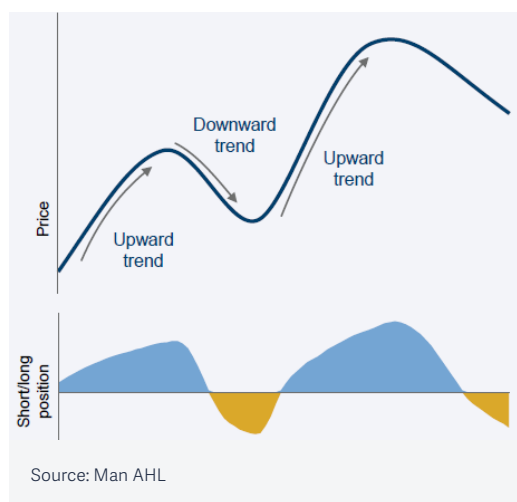
### What is Trend Following?

“Trend is not a hedge. It is a diversifying, uncorrelated strategy”, Niels Kaastrup-Larsen

Trend is:

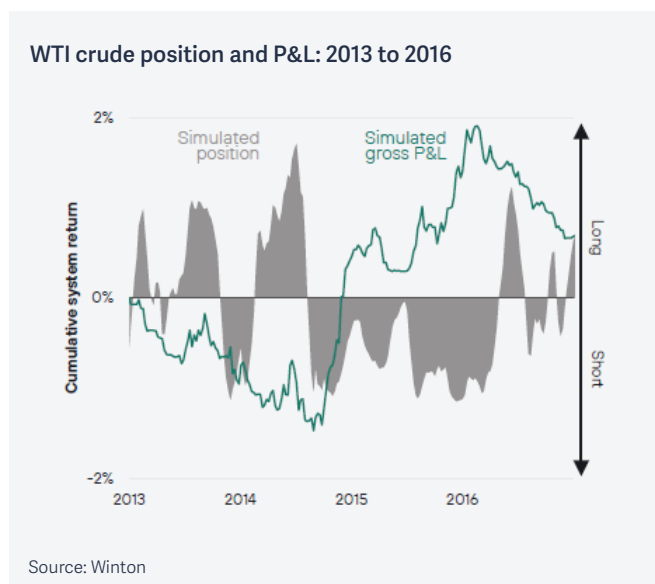
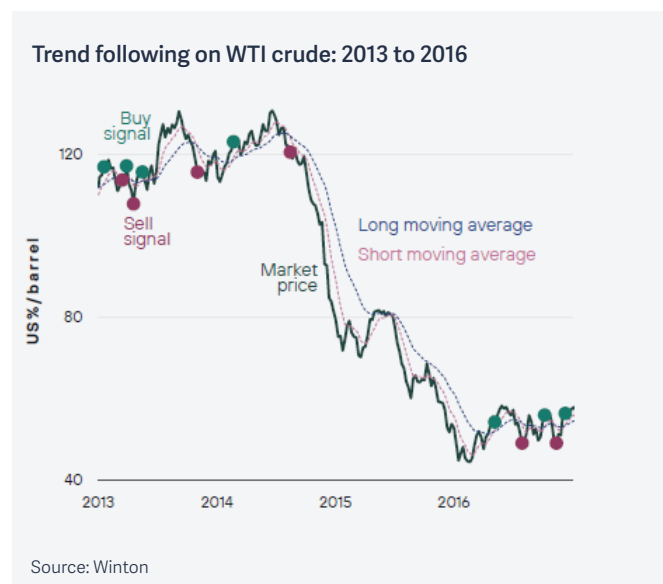
- **adaptive** (it can handle a wide range of economic scenarios)
- **dynamic** (as markets change, its positions change)
- **robust** (it will not double-down on losing positions)

Trend is a systematic investment strategy designed to profit from price trends, both up and down, across equities, fixed income, currencies and commodities. All markets exhibit exploitable trends, which Trend managers take advantage of via long or short positions:

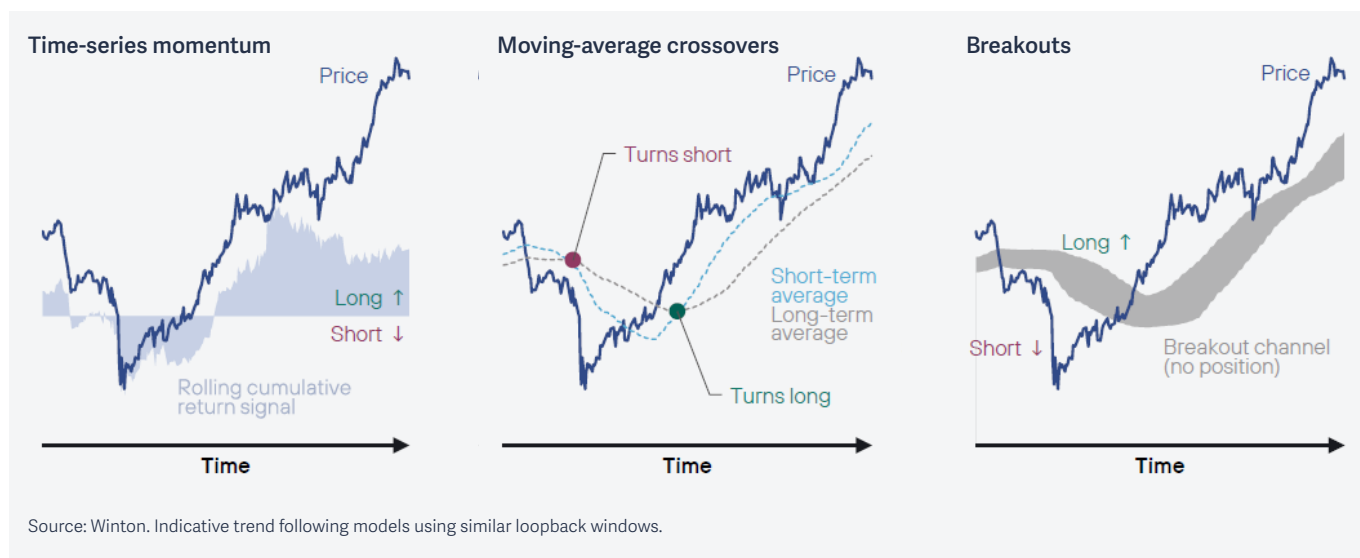


Trend strategies gain exposure to markets using futures contracts. This makes Trend highly liquid and cash efficient, as only a minority of the notional value of futures positions needs to be posted as margin (typically 15% of a fund's assets). The majority of fund assets (~85%) are free to earn interest, typically by investing in US Treasury bills. Trend therefore offers investors a cash return in addition to the profit and loss from the strategy itself.

The direction and strength of trends is identified systematically by the crossing of long and short moving price averages. A strategy tends to profit during trending markets but does less well in sharp reversals and range-bound trading. An example of Trend trading in Oil is shown below:

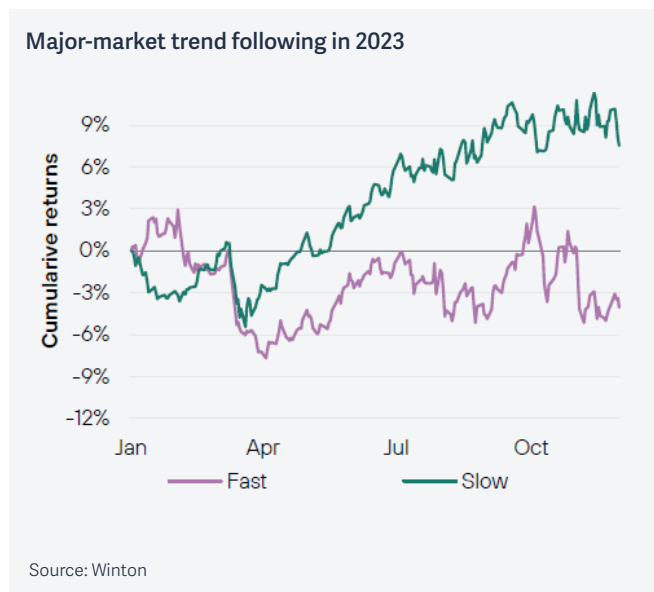


Examples of various common indicators used by Trend strategies are also shown below:



These indicators are designed to capture the same effect: the price trend. All indicators have a parameter that controls how fast the signal changes and how quickly it absorbs new information about direction changes. This is known as the “speed” of the signal. As we do not know in advance which markets will trend, Trend works best when applied to multiple markets and multiple asset classes.

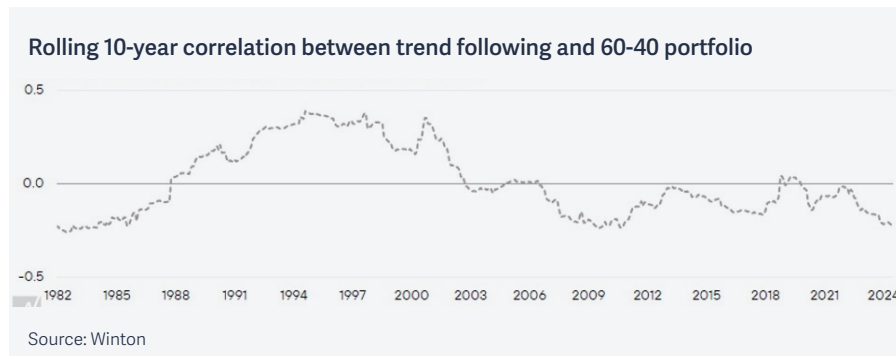
A common misconception is that faster strategies are superior. Slower models perform well in long, steady trends, but can underperform at turning points. So specific environments can lead to vastly differing results for faster and slower models.



**Diversification**

“When inflation comes back, bonds don’t help you...Trend might”, David Harding

Trend has an environment-agnostic approach that has had low long-run correlation with other asset classes and particularly, from our perspective, the 60/40 portfolios we manage.



The directional agnosticism of Trend has led to positive performance in periods of tightening monetary policy, with profits coming from trends across multiple sectors (often shorts in equities or bonds). Historically commodities, which form a core of Trend’s investable universe, have fared well during periods of rising inflation (such as in 2022).

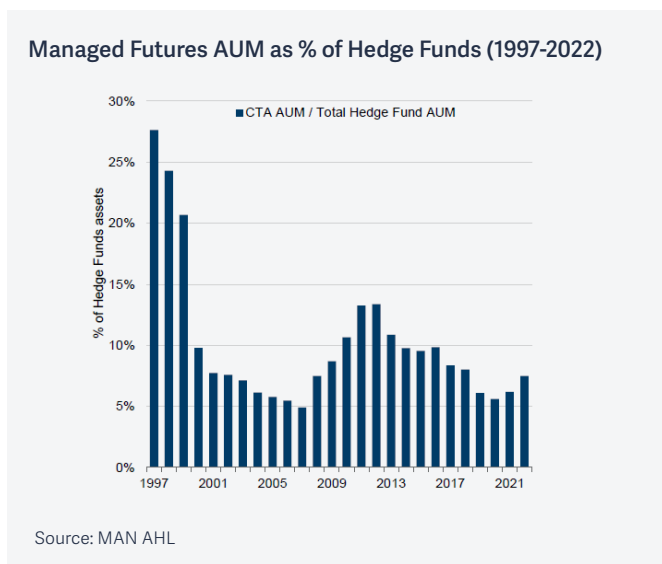
In contrast to Trend, many popular ‘alternative’ strategies are positively correlated to equities and bonds, particularly during crisis periods. Of the 53 distinct strategy hedge fund categories tracked by Hedge Fund Research with returns back to 2009, only four (including Trend) have a correlation to a 60-40 portfolio of 0.1 or less and 36 have a correlation of 0.5 or more (in the period end Q4-08 to Q3-23, source: AQR). The lower the correlation, the better.

The popularity (and good performance outside of crisis periods) has led many Trend managers to diversify their own products in recent years in an effort to improve their commercial success. Trend has been down-weighted even by Trend managers themselves!

**When to Buy?**

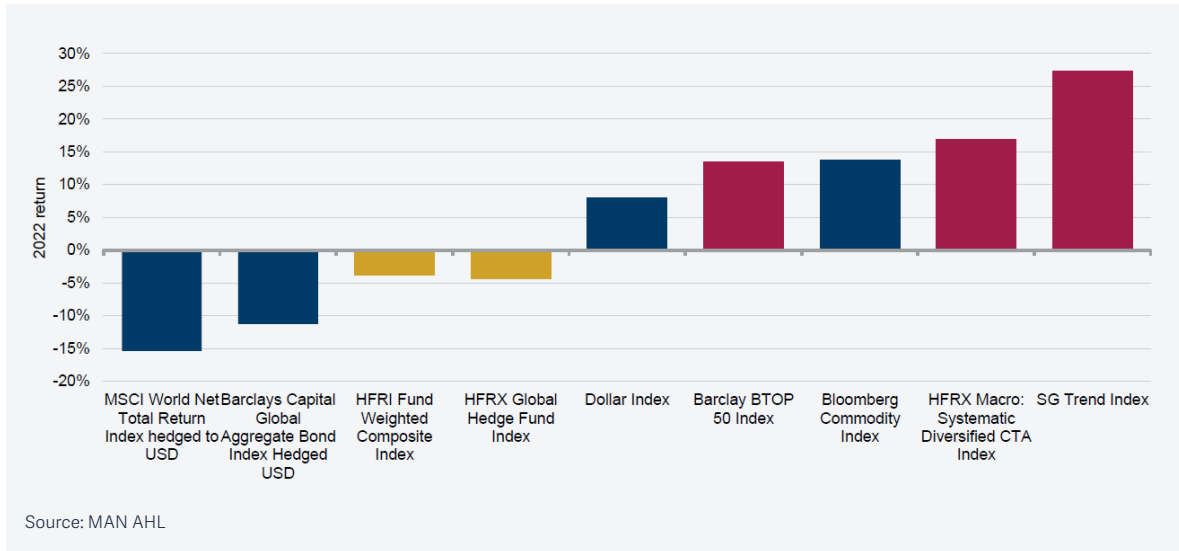
Periods where the 60/40 portfolio performs poorly, such as the 1970s and the 2000s, lead portfolio optimisation analysis to suggest high allocations to Trend. At the other end of the spectrum, there are times when Trend results in an opportunity cost by underperforming equities and bonds.

Cyclical peaks in Trend Following (‘Managed Futures’) assets under management (AUM), as a share of total hedge funds’ AUM, occur in the years shortly after strong periods of Trend outperformance (such as in 2011/12, which followed Trend’s strong return in 2008). Cyclical troughs in Trend AUM follow multi-year periods of subdued performance (such as in 2020/21).

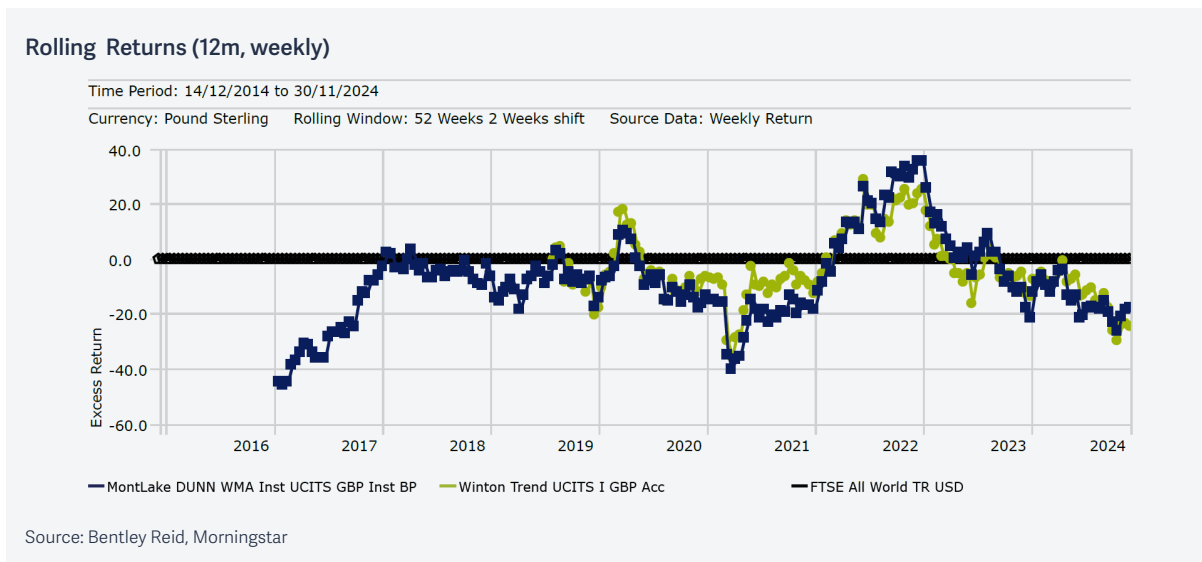


A contrarian strategy (buying into trailing relative and absolute price weakness in Trend, and vice versa) is one we find most desirable. After extended periods of underperformance, investors should consider adding or increasing exposure to Trend. Investor disinterest, as measured in this way, tends to cyclically trough near attractive entry points.

We first invested in Trend in December 2023, motivated by the marked underperformance of Trend versus equities (in particular), cash and bonds over the preceding 12 months. This underperformance prompted many investors to sell or reduce Trend allocations. This followed very strong inflows to Trend strategies in late 2022, after Trend had outperformed the All World equity index by over 35% in the preceding 12 months. The SG Trend index was amongst the best performing strategies in 2022:

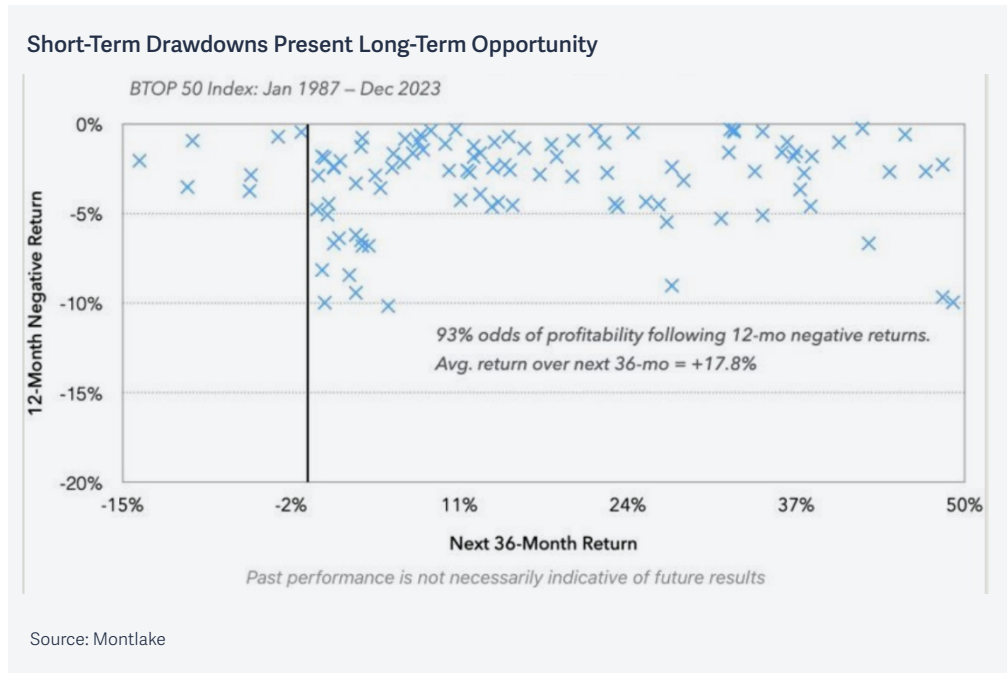


We measure the relative attraction (or lack thereof) of Trend through ‘rolling alpha’ analysis of its performance relative to equities, bonds and cash. The chart below illustrates the rolling 12-month performance of our two favoured Trend managers, DUNN and Winton, versus the All World equity index:



The attraction of Trend at the time of our investment was and remains above average, hence our core allocation for Balanced portfolios.

Investing into Trend during drawdowns, such as in December 2023, has been a rewarding strategy. Since its inception in 1987, the BTOP 50 (an index comprised of Trend Followers) has seen 106 instances where its 12-month return was negative. The average return over the subsequent 36-months was +17.8, with profitable returns ~93% of the time (99/106 instances).



### What does Historic Performance Look Like?

“We tend to make money out of surprises... Most surprises unfold gradually”, David Harding

Trend is an attractive portfolio construction tool because it offers low long-term correlation to equities and bonds and has a history of performing strongly during difficult periods for traditional investments.

As the table below shows, most of the returns for Trend, at least at the start of an equity drawdown, come from accelerating trends in markets negatively correlated with equities. Examples include oil as the global financial crisis began in 2007 and agricultural commodities in the early 1970s:

Crisis	Peak	Trough	Length (days)	S&P 500 return	Fast trend hypothetical net return	Slow trend hypothetical net return
Global Financial Crisis	9 Oct 2007	9 Mar 2009	370	-55.7%	25.8%	20.7%
Dotcom Bubble Burst	24 Mar 2000	9 Oct 2002	664	-47.9%	37.0%	47.9%
Nixon Shock/Oil Crisis	11 Jan 1973	3 Oct 1974	451	-44.4%	63.0%	49.1%
Covid-19 Pandemic	19 Feb 2020	23 Mar 2020	24	-33.8%	13.4%	-2.7%
Black Monday	25 Aug 1987	4 Dec 1987	74	-33.1%	0.4%	-5.5%
Return of Inflation	3 Jan 2022	12 Oct 2022	203	-24.8%	15.1%	20.8%
Volcker Rate Hikes	28 Nov 1980	12 Aug 1982	445	-21.9%	46.8%	50.2%
Growth Worries	20 Sep 2018	24 Dec 2018	68	-19.5%	2.8%	-8.2%
First Gulf War	16 Jul 1990	11 Oct 1990	64	-19.4%	17.6%	14.4%
Russian Debt Crisis	17 Jul 1998	31 Aug 1998	32	-19.0%	9.3%	6.4%

Source: Winton

The strong historic returns from Trend during crises are rarely driven by short positions in equities, at least in the early stages. Trend Followers are typically long equities when the market is at all-time highs, since equities will have trended upwards for some time. The chart below disaggregates the hypothetical return from Trend strategies during prior crisis periods to highlight the components of overall Trend returns:

Crisis	Peak	Trough	Length (days)	Equity Indices	Fixed Income	Currencies	Commodities
Global Financial Crisis	9 Oct 2007	9 Mar 2009	370	7.6%	5.3%	2.1%	8.9%
Dotcom Bubble Burst	24 Mar 2000	9 Oct 2002	664	15.1%	17.3%	4.6%	13.5%
Nixon Shock/Oil Crisis	11 Jan 1973	3 Oct 1974	451	12.2%	14.2%	0.0%	23.7%
Covid-19 Pandemic	19 Feb 2020	23 Mar 2020	24	-7.1%	2.9%	-1.1%	2.7%
Black Monday	25 Aug 1987	4 Dec 1987	74	-9.5%	1.2%	1.6%	0.6%
Return of Inflation	3 Jan 2022	12 Oct 2022	203	-1.6%	13.2%	7.7%	5.1%
Volcker Rate Hikes	28 Nov 1980	12 Aug 1982	445	5.6%	0.0%	12.3%	18.7%
Growth Worries	20 Sep 2018	24 Dec 2018	68	-1.4%	-2.5%	-1.4%	-3.2%
First Gulf War	16 Jul 1990	11 Oct 1990	64	3.4%	2.9%	4.3%	4.5%
Russian Debt Crisis	17 Jul 1998	31 Aug 1998	32	-3.5%	3.5%	2.8%	4.5%

Source: Winton

It can take weeks or months for slower Trend strategies to reduce equity positions when inflections occur. This highlights market conditions in which Trend strategies are most vulnerable (and unprofitable): trendless markets or when fast, idiosyncratic events impact the market, such as the US regional bank crisis in March 2023:

## Trend-following hedge funds suffer sharp downturn in bank chaos

Bond market reversal following collapse of Silicon Valley Bank stings so-called CTAs

Faster strategies can adapt more quickly, and tend to outperform slower peers in choppy markets, or the early stages of a crisis. Trend Followers choose between the two speeds when designing their strategies. We opt to invest in one slow moving strategy (DUNN) and a medium-term strategy (Winton) to diversify our overall Trend allocation.

### Are Trend Followers an Opaque Black Box?

A common refrain cited by many investors who choose not to invest in Trend strategies (also known as Commodity Trading Advisers, 'CTAs') is that they're an opaque, 'black box'. Many of the proprietary trading signals, and non-Trend strategies, employed by CTAs are protected zealously by managers and their teams of experienced, PhD-wielding analysts they employ.

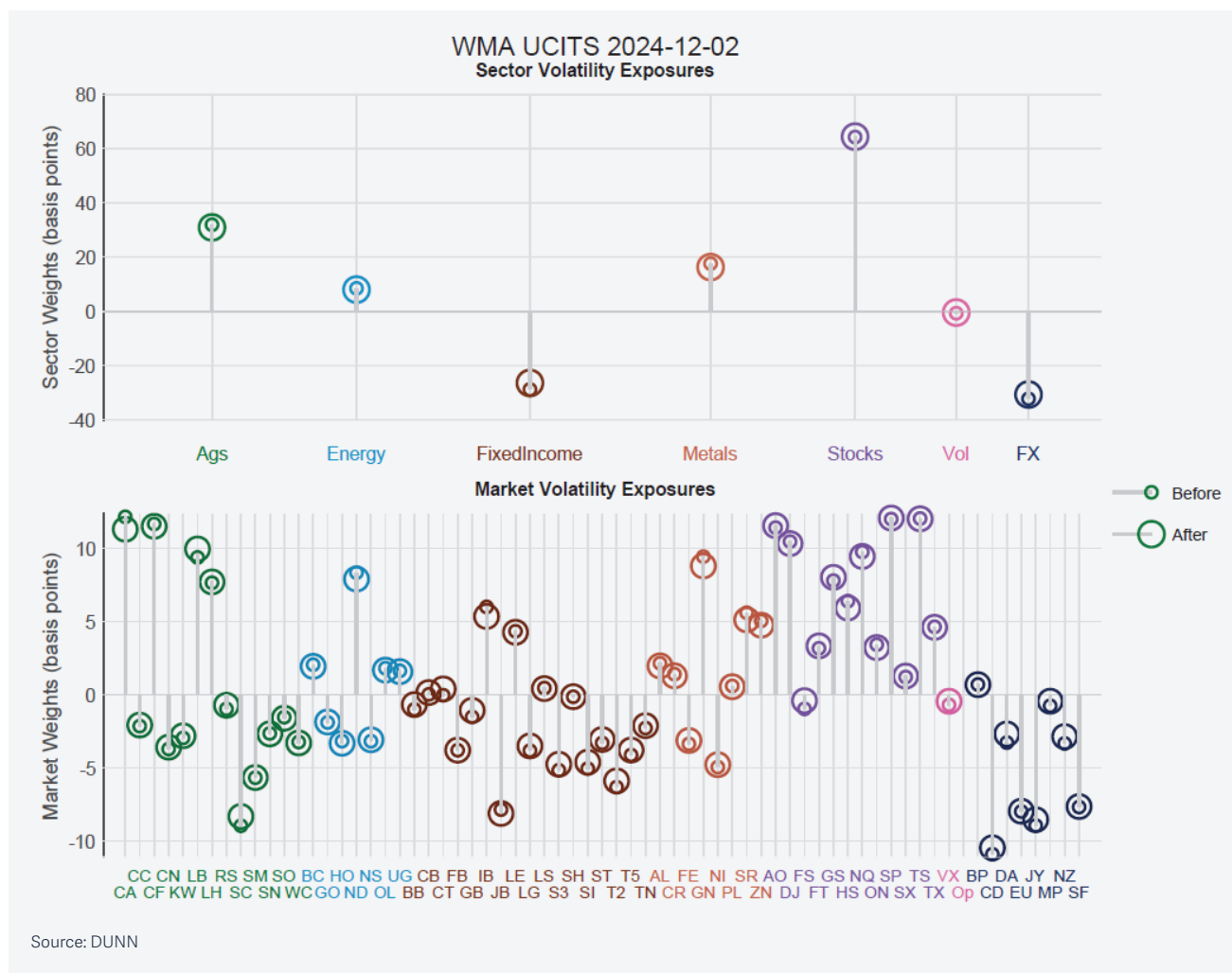
However, in favouring pure Trend strategies, we have a material transparency advantage over more complex non-Trend hedge fund strategies offered by CTAs. Trend is a simple proposition: a manager invests long or short of a predefined set of markets, via futures, using signals of varying speeds.

The two managers we invest with trade 66 & 150 individual markets, respectively. The 66 markets DUNN can be long or short of are shown in the table below:

Commodities		Currencies	Interest Rates	Equities	Volatility
Aluminum	Nickel	Aussie Dollar	Aussie 3 Year	ASX SPI 200	VIX
Brent Crude	Platinum	British Pound	Aussie 10 Year	CAC 40	S&P 500 (Hedge)
Canola	Silver	Canadian Dollar	Bobl	Dow Jones	S&P 500 Options
Cocoa	Soybean Meal	Euro	SOFR	Euro Stoxx	
Coffee	Soybean Oil	Japanese Yen	Canadian Bond	FT-SE 100	
Copper	Soybeans	Mexican Peso	French Bond	German Dax	
Corn	Sugar	Swiss Franc	German Bund	Hang Seng	
Cotton	Unleaded Gas	New Zealand Dollar	Italian Bond	NASDAQ	
Crude Oil	Wheat (CBOT)		Euribor	Osaka Nikkei	
Diesel	Wheat (KC)		Long Gilt	S&P 500	
Dutch Natural Gas	Zinc		Schatz	Topix	
Gold			Short Sonia		
Heating Oil			TSE JGB		
Iron Ore			U.S. 2 Year		
Lean Hogs			U.S. 5 Year		
Live Cattle			U.S. 10 Year		
Natural Gas			U.S. Bonds		

Source: DUNN

Current positioning and the portfolio’s sensitivities to various asset classes and markets is made available to us in real time via the managers we are invested with (DUNN and Winton). At the time of writing (Dec-2024), DUNN’s portfolio positioning is per the chart below - long Agriculturals (e.g. Cocoa ‘CA’ & Coffee ‘CF’), short Bonds (e.g. Japan ‘JG’):



Source: DUNN

Timely, detailed transparency from Trend managers helps us understand their current risk and positioning, which we can analyse relative to other holdings in our portfolios.

### Why Invest via Specialist Trend Managers?

Our two favoured Trend managers, DUNN and Winton, are attractive in three important ways.

- **Expertise in Trend:** DUNN, founded in 1974, is the world's oldest pure Trend Follower. The \$1.5bn AUM firm invests in a relatively concentrated universe of 66 markets, across equities, bonds, FX and commodities. Its strategy is a slow timeframe programme (their signals are focused on a 100-250 day timeframe; "the trend sweet spot").

Winton was founded by Trend pioneer, David Harding, in 1997. The London based manager oversees \$12bn AUM and retains a strong focus on Trend, where it opts for a medium timeframe, partly to differentiate itself from the Trend peer group. Winton sizes positions inversely to volatility; taking profits, and reducing risk, systematically when large price moves lead to an increase in the underlying market's volatility. Winton trades 150 markets across equities, bonds, FX and commodities.

- **Diversification:** Winton's medium term signal, 150 markets and counter-cyclical approach to portfolio risk is a useful differentiator to DUNN's slower signal and more concentrated portfolio (66 markets). The correlation between both funds tends to be lower than between the average of the Trend sector.
- **Cost:** DUNN and Winton's strategies are available at far superior fee terms than the average of the Trend universe.

DUNN charges no management fee and a 20% performance fee that accrues only above a single high water mark (~13% above the price of our initial investment in December 2023). Winton's 0.8% annual management charge plus zero performance fee stands in stark contrast to the mean average management fee for the SG Trend Index of Trend peers of 1.2%. Additionally, for the 60% of Trend index constituents that charge a performance fee, the average is 16%.

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