Issue 19 October 2014


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PUBLISHED BY HFMWEEK


# 12 for 2015

*Rounding up the hottest new prospects in managed futures*

# An honest update on the trend-following landscape

Thomas Rollinger, managing partner, and Scott Hoffman, partner, of Red Rock Capital compare the performance of trend-following CTAs

Trend-following is the most prevalent strategy utilised throughout the managed futures industry. What is the best way to objectively analyse, measure, and compare the performance of a particular group of trend-following CTAs?

Last autumn, we attempted to answer this question by publishing a research paper that introduced our own metric that measures and compares the 'goodness' of similar managers' returns. This article updates that original piece, and the measurements and ranking methodology that we initially introduced remains the same.

Due to the inherent (i.e. free) leverage found in the futures markets, risk-adjusted returns (not absolute returns) are the only proper way to compare similar managers' returns.

A CTA investor subjectively chooses at what margin-to-equity level to operate a program. But the level chosen is not, in and of itself, a source of 'goodness'.

This point is repeatedly misunderstood by many in the managed futures industry. A program run with a higher margin-to-equity ratio will produce a higher compound rate of growth at the price of higher drawdowns (periods of loss). For example, assume one manager produces a 20% net return over 12 months and another manager only produces a 10% net return. If the second manager used only half as much margin-to-equity, and produced only half as much volatility in their returns, then the two managers' performance were essentially equal on a risk-adjusted basis. Yet the first manager will often win awards and acclaim for having 'better' performance – which demonstrates a lack of understanding of, or at least a lack of concern for, a crucial aspect of managed futures and how to correctly measure performance.

**Due to the inherent leverage in futures markets, risk-adjusted returns are the only proper way to compare similar managers**

Our proprietary metric aims to step into the shoes of a loyal, long-term investor with any of the managers analysed, and ask: "What aspects of my CTA manager's performance are most important to me?". The Ranking Metrics table conveys the most important aspects, the proxies we use to measure them, and the weight we give to each measurement in our weighted final ranking.

For the period since the inception of our flagship Systematic Global Macro (trend-following) program, September 2003 to August 2014, we measure each aspect of the managers' returns with our proxies and then assign them a weight similar to how one calculates a grade point average.

## RANKING METRICS

| Important aspect of manager's returns | Proxy for measurement | Weighting |
|---|---|---|
| When was the last net new equity high made? | Months in Current Drawdown | 25% |
| What is the current drawdown from that last high-water mark? | Depth of Current Drawdown | 25% |
| How good have the manager's risk-adjusted returns been over the long-run? | Sortino Ratio | 50% |
| | | 100% |

Once we have the rankings for each of the managers on the individual aspects, we can combine the rankings (at their respective weights) to arrive at a final rank. This is a simple, quick method to rank similar managers against one another.

To simplify the process, by design the rankings do not have proportional information embedded in them, ie how much better is manager A than manager B, etc. In considering the results of our ranking, the following should be noted:

- A CTA's returns, volatility, and drawdowns are functions of a subjective decision that has been made by the manager – ie at what volatility will they run their program. Or to put it another way: at what margin-to-equity ratio will they run their program. For this reason, only analysing the managers' months in current drawdown and the depth of that current drawdown is not sufficient. A risk-adjusted metric (Reward to Risk Ratio in the table) must be applied that normalises managers' returns against one another.

- As we convey in our white paper, *Sortino: A 'Sharper' Ratio*, the Sortino ratio is a more appropriate measure to use for this purpose than the Sharpe ratio. The Sharpe ratio assumes that the returns it is measuring are normally distributed, and therefore, unfairly and incorrectly penalises managers whose returns exhibit positive asymmetry (skewness). In reality, investors typically welcome upside volatility and perceive only downside volatility as actual risk.
- In addition to the 22 managers we analysed, this year we added two well-known and respected industry benchmarks: The Newedge CTA Index and the Newedge Trend Index. The former represents the equal-weighted performance of the top 20 largest diversified CTAs open for investment. The latter represents the equal-weighted performance of the top 10 largest trend-following CTAs open for investment.

## RANKINGS: SEP 2003 - AUG 2014

| | | | | Ranking on each individual measure | | | |
|---|---|---|---|---|---|---|---|
| | Months in current drawdown | Depth of current drawdown | Reward to risk ratio | Months in current drawdown | Depth of current drawdown | Reward to risk ratio | Weighted overall ranking |
| Winton | 0 | 0.00% | 1.80 | 1 | 1 | 2 | 1 |
| Red Rock | 0 | 0.00% | 1.57 | 1 | 1 | 3 | 2 |
| Lynx | 0 | 0.00% | 1.35 | 1 | 1 | 5 | 3 |
| Covenant | 15 | -9.28% | 1.84 | 5 | 10 | 1 | 4 |
| Transtrend | 40 | -1.08% | 1.24 | 7 | 6 | 6 | 5 |
| BlueTrend | 40 | -10.86% | 1.40 | 7 | 12 | 4 | 6 |
| Abraham | 42 | -4.54% | 1.06 | 15 | 8 | 8 | 7 |
| Dunn | 0 | 0.00% | 0.46 | 1 | 1 | 20 | 8 |
| Newedge CTA Index | 40 | -6.03% | 0.78 | 7 | 9 | 13 | 8 |
| Eckhardt | 40 | -14.88% | 0.87 | 7 | 14 | 12 | 10 |
| Man AHL | 68 | -0.19% | 1.02 | 23 | 5 | 9 | 11 |
| ISAM | 42 | -17.49% | 1.16 | 15 | 18 | 7 | 12 |
| Welton | 42 | -15.73% | 0.96 | 15 | 15 | 10 | 13 |
| Estlander | 40 | -21.99% | 0.92 | 7 | 22 | 11 | 14 |
| Newedge Trend Index | 42 | -4.53% | 0.64 | 15 | 7 | 15 | 15 |
| Aspect | 30 | -13.37% | 0.58 | 6 | 13 | 17 | 16 |
| Millburn | 40 | -9.91% | 0.53 | 7 | 11 | 19 | 17 |
| Chesapeake | 40 | -18.28% | 0.55 | 7 | 19 | 18 | 18 |
| Graham | 40 | -16.72% | 0.45 | 7 | 17 | 21 | 19 |
| Drury | 42 | -20.48% | 0.64 | 15 | 21 | 15 | 19 |
| Altis | 44 | -42.06% | 0.76 | 21 | 24 | 14 | 21 |
| Hyman Beck | 42 | -29.95% | 0.36 | 15 | 23 | 23 | 22 |
| Sunrise | 57 | -19.83% | 0.44 | 22 | 20 | 22 | 23 |
| Campbell | 86 | -16.04% | 0.35 | 24 | 16 | 24 | 24 |

Sources: BarclayHedge, Allegro, IASG, Bloomberg. Reward to Risk Ratio is Sortino Ratio (Target = 0) for period September 2003 to August 2014 except: BlueTrend is from April '04, Welton is from June '04. Past performance not necessarily indicative of future performance.

### Observations and comments on the results

- Winton Capital continues to lead the pack and deserves the kudos that it receives.
- Four CTAs on the list just made net new equity highs and, therefore, are not in a drawdown. This gives them a #1 rank in both categories which has boosted their overall rank – as it should.
- While Winton has approximately $25bn in AuM, and the combined AuM of the rest of managers is around $20bn, a significant portion of assets do not appear to be invested with managers ranked highest on the list. The results of this paper suggest investors may have been better served by concentrating on some of the more 'boutique' managers on the list, such as Covenant or Abraham.

**Only four trend-following CTAs we studied are making new equity highs**

- An interesting related exercise to our objective ranking methodology is to subjectively study and rank the attractiveness of each of the managers' VAMIs/growth curves over our study period. We found that Winton and Lynx win out in this category. Interestingly, the 'just eye-balling it' approach favours two of the quantitatively chosen top three overall ranked managers. The exception is Red Rock Capital, which ends up with a higher overall rank than Lynx. This is because Red Rock has a higher Sortino ratio (though Lynx has a slightly higher Sharpe ratio).
- Good 'recent performance', as so many like to focus on and reward with praise, needs to be kept in the correct perspective. For instance, a manager could be up 10% one year and then up another 5% the following year (and win awards) then be down -11%, and back up 8%,yet the entire time still be under their high water mark. Does a savvy, loyal investor who has not seen a net new equity peak in more than 55 months really care if a manager is "up" this year-to-date? We argue that they should not.
- Considering the length of some of the managers' drawdowns, we believe concern is warranted, from a current or prospective investor standpoint, as to whether or not such managers will ever make another new equity high again. Unfortunately, as we've seen many times before in our industry, managers who share the same concern conveniently close down that particular program – only to launch another. Prospective investors would do themselves a favour by being skeptical of firms launching new programs in the wake of ailing flagship programs.

In this article we present an efficient and objective way to measure the performance of similar trend-following CTAs. Since late 2013, several of the managers in our analysis, as well as with the trend-based CTA indices have picked up some steam, and with the recent directional volatility seen in the global currency and commodity markets there is a possibility that the environment will continue to shift to a good one for trend-followers. CTA