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NY Quant Firm Finds Some Trend Strategies Are Losing Positive Convexity

Some of the largest trend-following strategies appear to be losing their high average returns as well as their positive convexity, according to recent research by New York-based Versor Investments. Versor founding partner Ludger Hentschel, a co-author of the report, said he and his colleagues found that, over time, the long-term trend signals favored by the largest commodity trading advisor funds have lost more convexity than short-term trend signals that require faster trading.

Trend-following strategies have become popular as part of risk-mitigating sleeves in institutional investors' portfolios, because historically they have combined high average returns and positive return convexity and they have capacity for large investors. Investors are also newly reconsidering the strategies, often employed by CTAs, as the market environment has changed after a difficult decade for trend between 2010-2020. Versor's paper, however, found that not all trend strategies are equal when it comes to performance and positive convexity in particular. "Although trend has had a good run since the start of the decade, we do have [to keep] in mind that not all trend following is the same when it comes to positive return convexity, which arguably is the most attractive characteristic of trend following," Hentschel said.

"Our concern, based on the analysis in the paper, is that many of the very largest and best-known trend-following managers, probably because of their size, have shifted toward long-term trend following signals, and those signals have never provided positive return convexity," Hentschel said. Versor studied the managers in the SG Trend index, which is an average of the returns for the 10 largest CTA hedge funds, and Hentschel and colleagues found that the make up of these funds has changed over time. "Among the trend-following styles, long-term trend-following now contributes the largest amount of risk," the paper's authors wrote. "This contrasts with the large risk share of short-term trend-following styles in the early 2000s, when many of the included CTA funds were much smaller. We attribute this preference for long-term trends among the largest CTA funds to the potentially large market impact associated with the faster trading required for short-term trend signals. Very large CTA funds likely find it prohibitively expensive to implement these short-term trends."

Hentschel said Versor believes that its shorter-dated strategy has capacity in the billions of dollars, given the depth of the futures market. "A positive return, positive convexity trend-following strategy is not a niche thing for which there isn't capacity for institutional investors," he said. "It can be done, but maybe not in a few gigantic portfolios." The key is risk management and, in particular, managing the higher turnover that comes with shorter-dated strategies. "Risk management in order to ensure broad-based diversification is absolutely crucial in these strategies," he said. "We spend a great deal of time customizing our execution by instrument and exchange." Versor also differentiates its strategy by looking at non-trend signals that can help increase positive convexity, he said. "If investors agree that what they find most interesting about trend following is this positive return convexity that historically trend following as delivered to them, then there's no reason to restrict the strategy to trend following."

Versor is a USD3 billion alternative investments boutique that runs hedge funds as well as risk premia strategies.