

Trading Strategies

“The big money [is] not in the individual fluctuations but in the main movements – that is, not in reading the tape but in sizing up the entire market and its trend.” Jesse Livermoreⁱ

For this issue of the Tapestry **SPOTLIGHT** we focus on CTAs, consider why it is important to incorporate more than one type of CTA strategy within a broader portfolio, and review the evolution this group has undergone during the last decade.

Technical and Fundamental analysis represent two cornerstone concepts to investing in the financial markets. Simply put, Technical analysis uses historical price and price related characteristics to provide insight into current market trends and patterns. Fundamental analysis on the other hand attempts to explain why markets are moving through the review of a myriad of factors including supply and demand characteristics, economic indicators and geopolitical factors. CTAs can utilize one or both of these concepts in their trading approach depending on their overriding investment philosophy.

Systematic and Discretionary define the two broad investment styles within the CTA strategy classification. The distinction between these two can be confusing in that both can rely on Technical and Fundamental analysis. At the most basic level, Discretionary CTAs incorporate personal biases into how, what and when they trade whereas Systematic CTAs remove these biases from their trading. Make no mistake, there is a discretionary element to Systematic CTAs, but it renders itself primarily in the conceptualization and planning phase of a strategy’s development. Conversely, Discretionary CTAs can use Systematic tools to execute trades and manage risk.

Systematic Managed Futures defines the categorization of money managers that are registered with the CFTC as CTAs. Systematic CTAs primarily invest through futures and more recently have added cash equities to their trading universe. Trend Following is the Systematic approach that serves as the core building block to other Systematic trading approaches including break-out, reversal, counter-trend, and spread trading. CTAs that employ Trend Following techniques seek to capture the majority of a trend (up or down) to generate a profit and can generate this profit across stocks, bonds, currencies, and commodities. The exact origin of this approach is difficult to pinpoint but it is arguable that investing on the basis of an identified trend was used soon after the market exchanges opened for business. As an example, consider the economist and trader David Ricardo, who flourished in the London markets from the 1790s until about 1818. He was a very predominant and successful trader in bonds and stocks and coined the phrase, “Cut short your losses; let your profits run on.”ⁱⁱⁱ Perhaps more notable personalities of this early period are the market manipulators, pools, rings and corners which made Trend Following a necessity on behalf of smaller investors.ⁱⁱⁱ

A more Systematic approach to technical trading cemented itself in the late 19th and early 20th century with published articles (1899 to 1902) in the Wall Street Journal by Charles H. Dow on the Dow Theory which defined what constituted a meaningful high or low. This was followed by the seminal work of William Dunnigan on market forecasting, and later work by Richard Donchian on moving averages and the introduction of the concept of trading many markets at the same time. Donchian was followed in the late 1970s and early 1980s by Millburn, Campbell and AO Management who were the first managers to be used in public commodity funds. This group of Systematic traders were followed by the likes of Bill Dunn, JW Henry and Richard Dennis who came to be commonly known as the ‘father of the turtles.’ Today, firms like Winton, Bridgewater, Bluecrest and Transtrend have built institutional shops with each firm managing in excess of \$10B.

Pattern recognition is another technically oriented approach related to Trend Following that in its purest form is used to set up entry and possibly exit of trades through recognizing a pattern or “set up” across multiple indicators. Pattern recognition is something of a “catch-all” phrase and can define the use of chart patterns or formations, but can also reference the incorporation of complicated algorithms and machine learning. In the early 20th century, Richard Schabacker published work on continuation, trend change, and consolidation patterns. Soon after, Robert Edwards (Schabacker’s nephew) and John Magee published, *Technical Analysis of Stock Trends* which today is still viewed as required reading for any technical trader.

Trend Followers tend to rely on price data as the main input to their back testing/simulations, but may also incorporate fundamentals into their models such as historical supply and demand characteristics of a given market. Approaches tend to vary in how this group initiate and exit positions, the time period of the trend they seek to profit, and the risk management approach that guides sizing and acceptance of volatility. This group does not seek to predict where the market is headed (a common misconception); rather they seek to follow a trend and get out before it breaks or reverses.

Trend Following receives some criticism from followers of Eugene Fama’s Efficient Market Hypothesis, which findings support that past prices cannot be used to profitably predict future prices. Trend Followers (and the larger group of market technicians) believe that because future stock prices can be strongly influenced by investor expectations, that past prices influence future prices. Peter Matthews, co-founder of Mint Trading and now running PJM, conducted research to better understand more specifically why Trend Following works. He found that this approach possesses the elements of a Complex Adaptive System (CAS) which supports that (1) markets are made up of heterogeneous agents (different traders with different models), (2) they use a feedback process (each new price can alter what next is done), (3) are based on limited resources, and (4) are self organized. Broadly speaking, he believes that anything can happen (fat tails, big standard deviation moves) and that you need to be on the right side of the trend to capture excess returns as well as employ stringent risk management tools to mitigate losses.^{iv}

Systematic CTAs for the most part adhere to a strict rule based trading approach without exceptions. This more defined approach imbues them with a bit more predictability (hopefully) than their Discretionary counterparts. Trades can be sized based on liquidity, correlation, and contribution to risk. Exiting trades can be based on stop loss, profit targets and/or counter-signals (to name a few). One result of the principle of adding to winning trades is that they tend to have give backs after big profitable runs. The most difficult period is when markets are not trending and trading sideways causing managers to get whipsawed. Advancements in the utilization of entry and exit filters and diversification across time periods and types of models have reduced some of these headaches. Pattern recognition models have also been added to systems in an effort to further confirm price movements through the analysis of current price patterns in the context of history.

The industry tends to split the universe of Systematic CTAs into short, medium and long-term Trend Following, defining just the timing aspect of their trading style (this is true of any industry classification which provides a first cut of a larger universe). Short-term CTAs tend to provide a good balance against longer-term CTAs given they are looking to profit from market inefficiencies that occur over the course of a few minutes (in the case of high frequency models) to a few weeks.

The return profile of shorter-term Trend Followers tend to offer attractive risk adjusted return in comparison to longer term traders (not to mention the correlation benefit between the two). These traders also tend to have a lower correlation to broader hedge, equity and fixed income strategies. The latter group of medium to longer-term Trend Followers utilize many of the same tools, but seek to profit from trends that persist for a longer period of time. This extension of time results in a more volatile profile with potentially more upside

return. Including both styles of trading provides for a more balanced Systematic component of a broader portfolio as well as ultimately a more robust return.

Discretionary can be further broken down into Global Macro, Discretionary/Systematic, and what is termed GTAA (Global Tactical Asset Allocation). Global Macro defies categorization in that it can be employed by a hedge fund or CTA, with the distinguishing feature between these two is somewhat contingent on the percentage of Futures traded in the portfolio versus cash instruments. They can be oriented to one or many assets classes, can be aggressive or conservative in nature, can employ technical and/or fundamental tools for trading and risk management, and can be managed by one or many portfolio or sub-portfolio management teams. The one characteristic consistent across most Global Macro strategies is that there is a theme or multiple themes involved. It is not uncommon for Equity L/S and Arbitrage managers to evolve into Global Macro as they get more seasoned and there is an increase in their total assets under management.

Risk management by Discretionary managers can differ dramatically across funds and these managers as a group have had to employ many of the volatility mitigating filters as their Systematic counterparts to garner institutional asset growth. GTAA approaches generally use Systematic inputs, but will employ discretion in how they use the information and trade across asset classes. The history books are filled with stories of famous Global Macro and Discretionary CTAs, including the likes of Soros, Tiger, Moore, Caxton, and Tudor.

During the last decade, CTAs have become more widely accepted by institutional investors as a separate and distinct asset class and as a result total fund assets have grown from \$38B in 2000 to \$268B in 2010.^v Growth in the industry has been positive but has also required some of the larger Systematic funds to evolve their approach from “simple” Trend Following to a more diversified and risk managed approach. Diversification has been achieved by adding timeframes, markets, strategies, and trade types (adding relative value or spread trades). These tools have for the most part been additive to the risk management framework of many funds, but arguably have capped some of the upside potential generated by more aggressive and concentrated approaches. The growth and potential for growth in assets has also led managers to look beyond investing in the futures market and seek out opportunities in alternative instruments including OTC derivatives and cash equities.

Given the varied trading approaches and tools noted above, it is our contention that investors should gain exposure to CTAs using a well thought out and diversified approach. While we are not large supporters of the popular myth that CTAs are negatively correlated to other strategies (correlations move around too much over longer periods and ranges can be quite extreme), we like the longer term independent return stream and diversification across asset classes like commodities and FX not utilized by other alternative managers. For these reasons it is our belief that adding CTAs to a diversified portfolio provides for a compelling and ultimately more profitable return.

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MR: 11-222

ⁱ Edwin Lefèvre, *Reminiscences of a Stock Operator* (Garden City, New York, 1923), p.54.

ⁱⁱ James Grant, *The Great Metropolis: second series volume II* (London, 1837), p.81.

ⁱⁱⁱ On the Nature and Origins of Trend Following, by Stig Ostgaard

^{iv} Matthews' New Program Minty Fresh, *FuturesMag.com*, 10/1/2009

^v Barclay Hedge, CTA Industry – Assets Under Management
Hedge Fund Review, Issue III, Jan 2010, Systematic Trading