FT BIG READ. INVESTMENT

AHL was one of the pioneers of the $300bn industry in hedge funds that uses computers to search for market trends. More than 30 years later, its three founders disagree if the strategy still makes sense.
By Laurence Fletcher and Robin Wigglesworth

Finding value in following trends

In 1982, Mike Adam, a scholarship student who had dropped out of Magdalen College, Oxford, took a backroom job in his father's sugar broking firm in London.

The new job entailed drawing commodity price charts by hand and tracking the brokerage's trades. To save time, Mr Adam programmed the first computer to arrive in the firm's offices to do the job for him. Soon, overcome by curiosity, he began to test whether the computer could be coded in such a way that he could make money from trading patterns.

Together with his close friend from university, Marty Lueck, who was a programmer, and David Harding, a Cambridge-educated scientist fascinated with finance, he designed a trading system. At its heart was a simple concept — financial markets exhibit trends, and computers can be programmed to spot those trends and profit from them.

Amid much scepticism from a finance industry that largely believed using computers to predict market moves was little more than hocus-pocus, the trio in 1987 launched AHL — a name based on the first letters of their surnames. The firm, which now runs $30bn in assets, went on to help spawn a $300bn-dollar industry of similar hedge funds that follow market trends and which have minted vast fortunes.

But a long period of prolific performance has been replaced by lean, often lossmaking, years for much of the decade since the financial crisis.

That has created a major faultline: on one side are managers who think trend-following no longer works as well as it once did.

On the other are those who say the flat returns of recent years are merely a historical blip. They are urging investors to stick with trend-following to avoid missing out when the good times return.

'The genius of trend-following is its incredible mediocrity, which is far harder to engineer than people think'

AHL's original team, from left: Mike Adam, David Harding and Marty Lueck. Mr Adam and Mr Lueck co-founded Aspect Capital, while Mr Harding established Winton — FT montage

The three co-founders of AHL, who all left the firm many years ago following a 1989 takeover by investment firm Man Group, embody the differing views of what has happened to trend-followers and why.

Trend-following is now delivering "a pretty uneconomic level of return", says Mr Harding, who is now chief executive of hedge fund Winton Group. "Certainly not enough to justify being a big swinging dick hedge fund."

Mr Lueck disagrees with the idea that the strategy has become overcrowded and has run its course. "As a species, we have not evolved very much" in terms of the crowd behaviour that drives trends, he says.

Behind it lies a more fundamental question about financial markets: do they essentially work the same way through the centuries, because humans tend to behave the same way? Or does the way they function change subtly over time, for instance because of technological or societal developments, or even because of the way investors trade, eventually rendering some trading strategies obsolete or less effective?

Performing amid crisis

Trend-following is as old as financial markets. David Ricardo, the early 19th-century economist, first formulated the basic rules as "cut short your losses" and "let your profits run on". But AHL showed that computers could do it far better than any human.

In its early days it could charge clients an annual fee of 6 per cent — a rate most hedge funds today can only dream of — plus a performance fee of 15 per cent, plus trading commissions. Mr Harding estimates that in 1990 about $1bn of fees or more were earned by an industry containing a relatively small number of these so-called managed futures funds.

Frequent double-digit annual returns during the 1990s and 2000s helped pull in investors. But the sector really burnished its reputation during the credit crisis, with an 18 per cent average gain in 2008, according to data group HFR, helped by bets on falling stocks and the sharp fall in oil prices. That helped persuade many large, institutional investors that these funds could help protect their portfolios.

The concept of trend-following is simple. A basic approach would be to monitor when an index's shorter-term moving average, for instance 30 days, crosses its longer-term moving average, for example 100 days. When the 30-day average moves above the 100-day, it suggests an uptrend has emerged and that it is time to buy. When it moves below, it is time to sell.

Man Group CIO Sandy Rattray, below, says the 'idea we have changed the behaviour of the S&P 500 is garbage'

Such models tend to make lots of money when prices move in one direction — either up or down — for long periods. When markets are rangebound and have few clear trends, these funds may start to buy, thinking the market is trending up, only to find the market quickly moves against it. Huge market moves, such as Monday's oil price rise, can badly hurt them if they had believed the market was trending the other way.

A shortage of clear trends appears to be at least partly to blame for mediocre returns in recent years. An investor who put $1,000 into such funds at the start of 2011 would have made a profit of just $72 by the end of August this year, according to FT calculations based on HFR data — though performance in recent months has been much stronger. Remarkably, before June this year such a position would have been lossmaking. In contrast, from the start of 2011 until the end of last month, a $1,000 investment into the S&P 500 would have turned a $1,327 profit.

Much is at stake. In addition to the $300bn of funds which directly use trend-following, the strategy's success has spawned an unquantified amount — which some industry insiders estimate at hundreds of billions of dollars — of cheap, replica products that also follow market trends.

Decline in 'sexy returns'

When Mr Harding left AHL, he went on in 1997 to found Winton, another computer-driven hedge fund firm which manages about $20bn of assets. His success at trend-following has made him one of the UK's wealthiest people — in 2011, for instance, he was estimated to be the UK's highest earner. He now has a £1.02bn fortune, according to the Sunday Times Rich List.

But he has disrupted the industry by cutting the trend-following component of Winton's flagship fund from between one-half and two-thirds in 2016-17 to one-quarter currently.

"In the past it [trend-following] has returned quite sexy returns," says Mr Harding, whose "strong view" is that financial markets change over time. But now, "on its own, long-term trend-following is scarcely good enough to run a hedge fund on".

One of the main reasons, he believes, is overcrowding — there are too many investors trying to do the same thing.

"If there are trends there, someone finds a way of exploiting them [and] a big industry evolves — that's going to affect the nature of the trends," he says. "It happens in every other industry."

He is not alone. Jim Simons' Renaissance Technologies, one of the world's most influential and secretive hedge funds, has sharply cut back its use of the strategy in one of its funds due to its lacklustre performance.

Mark Carhart, who wrote an influential paper on market momentum in 1997 and manages Kepos Capital, a $2bn hedge fund, has also become gloomy.

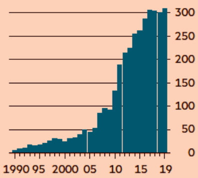
"I'm in Harding's camp," he says. "It's become so well-known and the barriers to entry are low . . . I don't think it's dead, but it definitely has lower expected returns, with more pronounced shocks."

After leaving AHL, Mr Lueck also set up a new business. Together with Mr Adam and former AHL staffer Anthony Todd, he co-founded London-based trend-follower Aspect Capital in 1997, which now manages $8bn. He and Mr Todd, whose fund remains predominantly a trend-follower, strongly believe the strategy still works.

"The four most famous words in finance are, 'This time it's different'," says Mr Lueck. He disagrees that the sector is overcrowded, arguing that some funds in the HFR sector are not trend-followers.

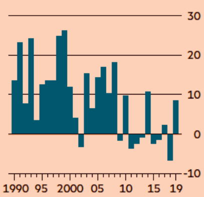
Investors have piled into trend-following hedge funds ...

HFRI Macro: Systematic Diversified funds, assets under management ($bn)



... but returns have evaporated in the sector

Performance of the HFRI Macro: Systematic Diversified index (%)



Source: HFR

Co-founder Mr Todd believes trend-following "unequivocally does work". He says: "It's inescapable that the last few years have provided challenging conditions for trend-followers," but adds "the market can go through some quiet, rangebound periods."

US asset management giant AQR, which runs $194bn in assets, says trend-following has been through "a very challenging period" but agrees that it will come good again.

"We believe that the reason why trend-following exists is tied to human biases and how we react to news," says AQR principal Yao Hua Ooi. "We don't think human biases have gone away."

AHL itself has expanded into other strategies, trading the market's volatility or its seasonal patterns, but remains largely a trend-follower. Sandy Rattray, chief investment officer of AHL parent Man Group, says: "Giving up on core features of markets, features that have been observable for very long periods of time, doesn't feel like a smart thing."

He also rejects the idea of an overcrowded market and says managed futures funds are tiny compared with the size of global futures markets. Daily average turnover of global, exchange-traded futures was just over $8tn in March, according to the Bank for International Settlements.

"When you really take that assertion down to its core, it's saying that people like us and our peers have changed the behaviour of the S&P 500 and other key markets," says Mr Rattray. "And I think that's garbage."

HFT gains from the trends

Mr Adam left the industry a decade ago to work as a musician. Appearing under the stage name Mike Marlin and in a band called The Melomaniacs, he has supported big names in music such as The Stranglers and Big Country. He now spends his time as a technology entrepreneur and writing and producing for another artist.

Mr Adam, who admits he had believed it would be "game over" for trend-following by 1995, says the strategy has proved more resilient than many other hedge fund strategies.

That is because, like the house's advantage in a casino, the odds of any one of a trend-follower's thousands of trades making money is only a fraction over 50 per cent. While many of its trades will not work, a fund can profit if on average a slightly greater number do work.

"The genius of trend-following is not how awesome it is, but its incredible mediocrity, which is far harder to engineer than people think," he told the FT. "It's like trying to cheat at the casino, if you're too good then the casino throws you out. Trend following works right at the edge of randomness."

Unlike his former colleagues, he thinks that returns from trend-following are still present but they may now be going to so-called high-frequency traders — algorithms that trade in milli or microseconds. They may be "getting to markets before trend-followers even see the price", he says.

So far, most investors remain on the fence over the merits of trend-following. Money has dribbled out this year, but the outflows have been modest.

Many retain a long-term faith in the strategy. New York-based SkyBridge Capital, which invests in hedge funds, has had no exposure to managed futures funds for several years because it believed their bets on rising stocks added risk to its portfolios.

But it thinks they will come good again. Managed futures "are cyclical like almost every other hedge fund strategy", says Robert Duggan, a partner at SkyBridge. "We don't think trend-following is dead or dying."

In an industry where analysts look back at market data over decades or even centuries, neither side of the debate is yet ready to admit they are wrong about what has happened to trend-following.

However, an unexpected uptick in performance this year — funds are on average up 13.1 per cent this year thanks to steadily falling bond yields and rising stocks — is helping the case of those who have stuck to their guns.

"I'm holding my breath this year as trend-following is doing pretty well," says Mr Harding, who says his decision will not be proved right or wrong until 2030. "It's a big decision, it will affect my life, it will turn out to be right or wrong."

Speed read

Trend setter AHL and its three founders went on to spawn a $300bn-dollar industry of similar hedge funds

Rebound course Managed futures funds, including trend-following funds, are on average up 13.1% this year

Lean times David Harding argues that 'on its own, long-term trend-following is scarcely good enough to run a fund on'