RPM EDUCATIONAL

1.

Should I stay or should I go?

Invest, divest, or keep your allocation when CTAs are in drawdown?

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SHOULD I STAY OR SHOULD I GO?

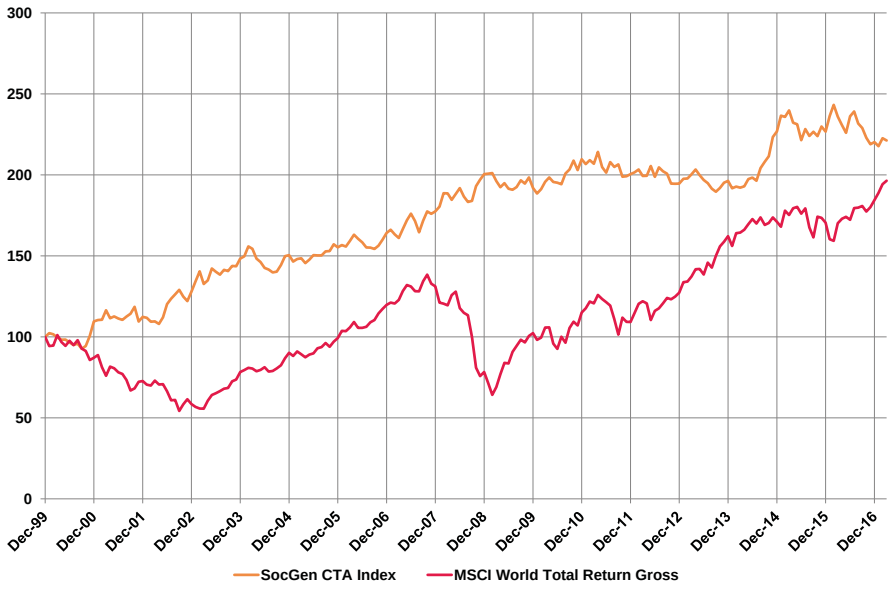
Key point: Returns looking back 3, 6, and 12 months after a major drawdown in the CTA industry are significantly stronger than average returns over the same periods. Major drawdowns have been good times for investment with CTAs – and less good for divestments.

INTRODUCTION

Most CTAs and CTA funds are now in a drawdown. A drawdown is the depreciation in value of an investment from a previous all-time-high (ATH). It is usually expressed as a percentage. At the time of writing (early April 2017), the Société Générale CTA Index – a widely used benchmark for CTA performance – is in a drawdown of around 11% from the previous ATH (daily data). A drawdown has nothing to do with calendar time or year-to-date performance – only depreciation in value from ATH. Drawdowns are unpleasant. They create uncertainty. Will it get worse? Should I divest? We cannot predict the future. But an analysis of past performance and drawdown patterns may give us some guidance when uncertainty sets in. So here is a straightforward look at what followed after past drawdowns. For those not familiar with CTAs, figure 1 shows the performance of the SocGen CTA Index since its inception in 2000. Equities, represented by the MSCI World Total Return Gross Index, is also in the chart for reference.

FIGURE 1

Performance Indices for CTAs and MSCI World. January 2000 - March 2017, Monthly Data. Source: BarclayHedge



CTA INDEX

We have used the SocGen CTA Index as a proxy for CTA performance since 2000. We have reduced the performance with the US 3 month T-bill rate and only look at what is called the excess return – the return above the risk-free rate. For simplicity, we call this index "CTAs" below. The analysis covers the period from Jan. 3, 2000 until March 31, 2017 – a total of 4,495 trading days. We are most interested in what happened after major drawdowns – defined as the worst 25% of all drawdowns on a daily basis – ATH-days with a drawdown of 0% included. These drawdowns range from -7.0% to -12.7%[1]. CTAs were in a drawdown of that magnitude 25% of the time. What investors and other industry participants are experiencing right now is obviously not that unusual.

WHAT HAPPENED AFTER THE DRAWDOWNS?

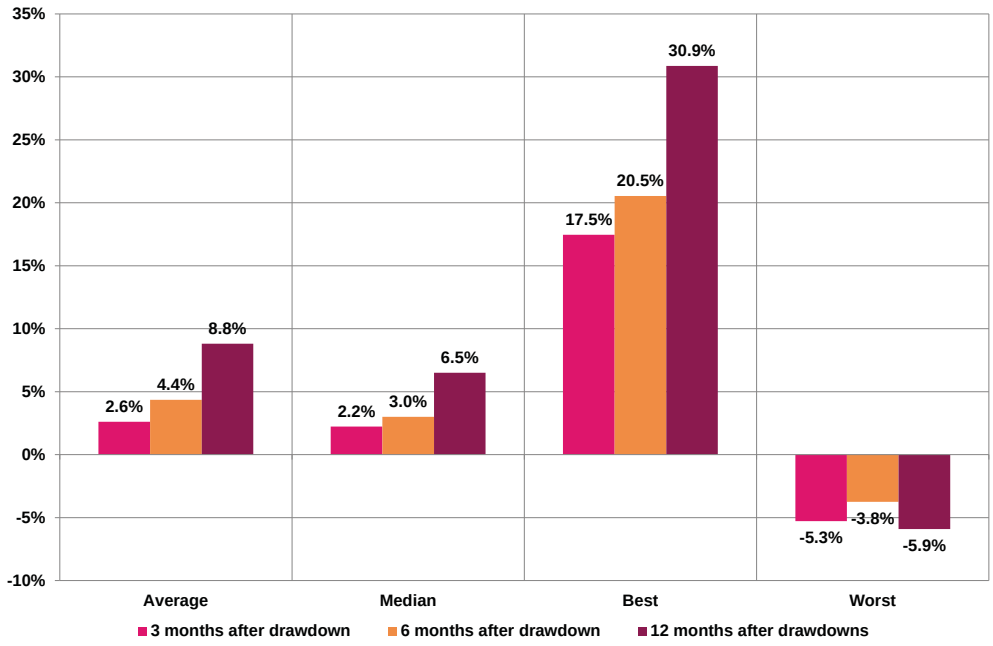
Looking back one year (260 trading days) after each of the 25% worst drawdown days, the average return was 8.8% plus the risk-free interest rate. This is significantly higher than the average of all 260-day periods (4.0% plus interest). The average return following a drawdown, was also higher for deeper drawdowns.

1. Those interested in more detail on how the calculations is done, please send an e-mail to info@rpm.se

Figure 2 illustrates the performance after drawdowns for three timeframes:

FIGURE 2

Performance following the 25% largest drawdowns from previous ATH, January 2001 - March 2017. Source: BarclayHedge



Example: 6 months after a drawdown in the first (worst) quartile, the returns from CTAs ranged from -3.8% to 20.5% plus risk-free interest. The average and median returns were 4.4% and 3.0% plus interest.

In the table below, these returns are compared with the average returns for all corresponding time periods. The differences are significant.

	12-month performance		6-month performance		3-month performance	
	After drawdown	All periods	After drawdown	All periods	After drawdown	All periods
Average	8.8%	4.3%	4.4%	2.3%	2.6%	1.2%
Median	6.5%	3.1%	3.0%	1.3%	2.2%	0.6%
Best	30.9%	30.9%	20.5%	22.2%	17.5%	20.4%
Worst	-5.9%	-9.9%	-3.8%	-12.0%	-5.3%	-8.7%

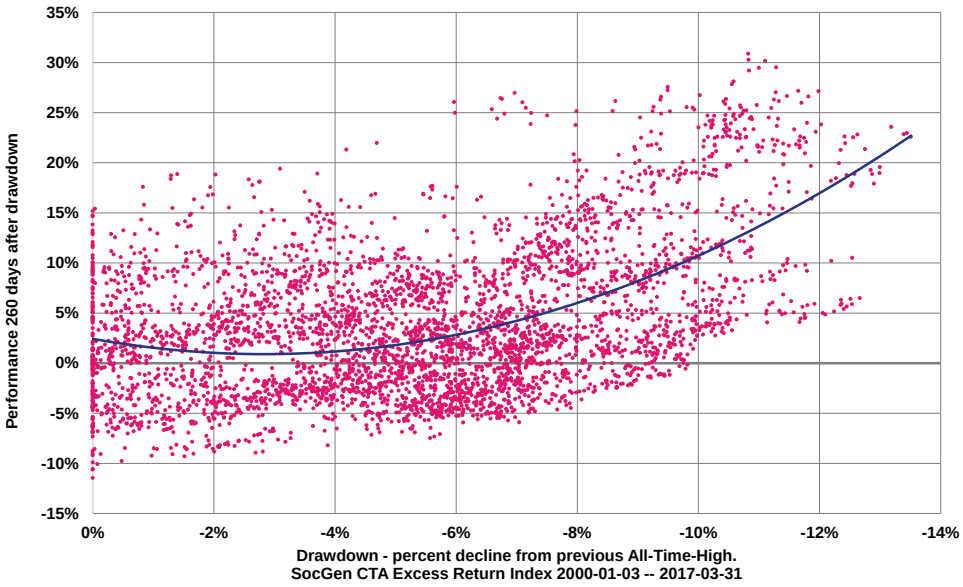
A word of caution: This analysis is performed on a CTA Index calculated from the performance of 20 CTAs. These CTAs are not the same and each CTA has its own idiosyncratic risk profile. Investing in one CTA carries a significantly higher risk than investing in a diversified portfolio of several CTAs. As with stocks, it makes sense to distinguish between market risk and idiosyncratic risk when it comes to CTAs. Investing in a well-diversified portfolio of CTAs would increase the probability that the return patterns presented in this analysis are repeated.

WHAT DID THE DISPERSION OF RETURNS LOOK LIKE?

Figure 3 show the relationship between drawdowns and subsequent 260-day return for all days – the ATH-days included. The size of the drawdown is read off the X-axis and the subsequent 260-day return off the Y-axis. A dot in the chart thus shows the combination of drawdown and 260-day return for one of the 4495 trading days.

FIGURE 3

Performance following the 25% largest drawdowns from previous ATH, January 2001 - March 2017. Source: BarclayHedge



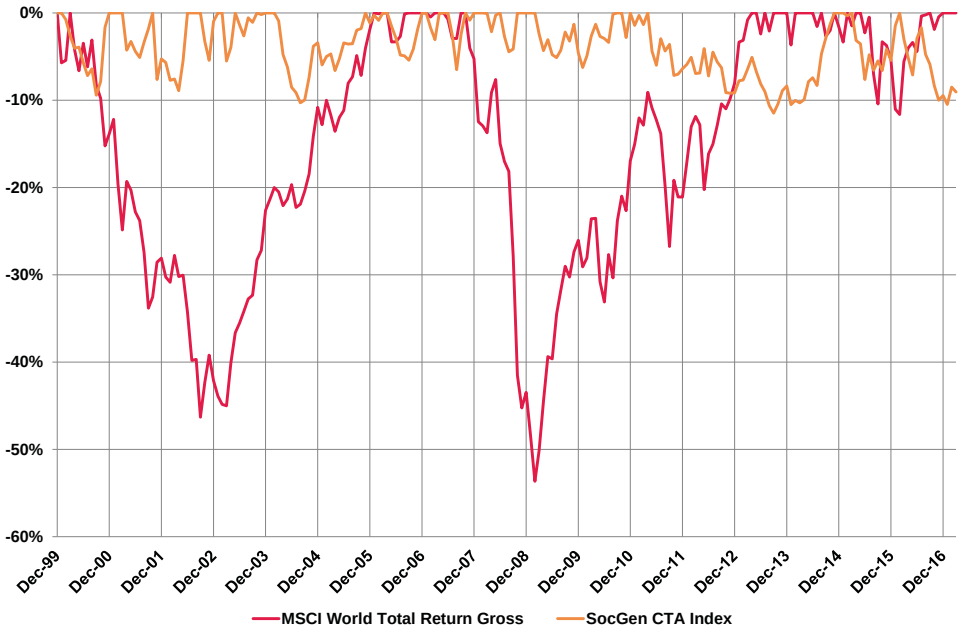
It is interesting to note that there were no negative 260-day returns after drawdowns of around 10% and beyond. Admittedly, there were not that many days with drawdowns of such a magnitude so the result should be viewed with caution.

WHY IS IT LIKE THIS?

The fact that CTAs had a stronger return than on average after drawdowns, is not surprising. It is mainly a result of the fact that CTAs have had a positive mean return over time with some volatility. Investing in drawdowns has thus been the equivalent of buying low or "buying on the dip". In this respect, CTA return patterns are not in principle different from i.e. the stock market. But compared to the stock market, periods of positive performance leading to new ATH are typically more concentrated in time. CTA drawdowns have also, on average, been significantly smaller and shorter in time than what has been the case with stocks. This is also true if CTA returns are levered to the same volatility as i.e. MSCI World. And this is most likely due to the fact that CTAs practice active risk management that result in a gradually decreased risk-taking in difficult times. When in a drawdown of some significance, most CTAs can be said to enter a kind of waiting mode - positions are reduced, VAR and stress risk measures come down to low levels – until the next period of price trends in financial and commodity markets appear.

FIGURE 4

Drawdown - Percent Decline from All-Time-High for Equities (MSCI World Total Return) & CTAs (Soc Gen CTA Index), January 2000 - March2017. Source: BarclayHedge



In Figure 4, the full SocGen CTA Index including interest rate income is used for comparability. In light of the fact that CTAs have delivered a stronger return than the MSCI since 2000 (121% vs. 96%), the difference in drawdown risk is remarkable.

CTA DRAWDOWNS AND PRICE TRENDS

CTA drawdowns are closely related to the reversal of and/or lack of price trends in the up to 200 futures markets a CTA may be active in. The level of price trends can be measured and monitored over time. One such measure, RPMs Market Divergence Indicator (MDI™), display strong mean reversion properties – meaning that if the reading is low, the next move of any significance will be up and vice versa. Periods with strong price trends are replaced with weaker periods and weaker periods are replaced by strong periods, etc.

Why price trends come and go in an almost cyclical fashion is another story (which we will deal with in the future). But the answers are all related to change: macroeconomic, political, climatic, central bank policy etc.

CONCLUSION

To start with – all of the above is based on historical data with all the limitations this implies. But if one holds the view that historical analysis may be of value in assessing the current and possible future state of things, it may be worth to note the following:

- Periods of larger drawdowns have been replaced by periods of strong performance.
- The size of the drawdown and the size of the future return have been positively correlated.
- Large drawdowns have been good times to invest in CTAs and less good times for divesting from CTAs.

This is the first "RPM Educational" and we are more than happy to receive feedback, questions, comments and to engage in further discussions regarding CTAs in general. Please reach out to us on:

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