



TREND FOLLOWING

THE OUTLOOK FOR CTA AND SYSTEMATIC INVESTING

EXECUTIVE SUMMARY

Managed futures and systematic strategies were among the big winners in the equity and bond sell-offs last year. In 2023, performance been more mixed, with trend-followers posting losses following the Q1 banking crisis but staging a comeback in Q3 as markets adjusted to a 'higher-for-longer' rates environment, boosting short bond positions.

In October, Hedgeweek spoke to industry leaders from some of the key firms in the sector to unpick the key recent performance drivers and reveal how funds are positioned heading into 2024. The performance and market outlook facing systematic is the focus of this report's first part.

Part two will focus on innovation in the ever-evolving space, focusing in particular on how emerging AI technologies can be used to drive performance gains and enhance efficiencies in the future. There will also be a focus on launch plans in the space, and a comparison of regulatory priorities.

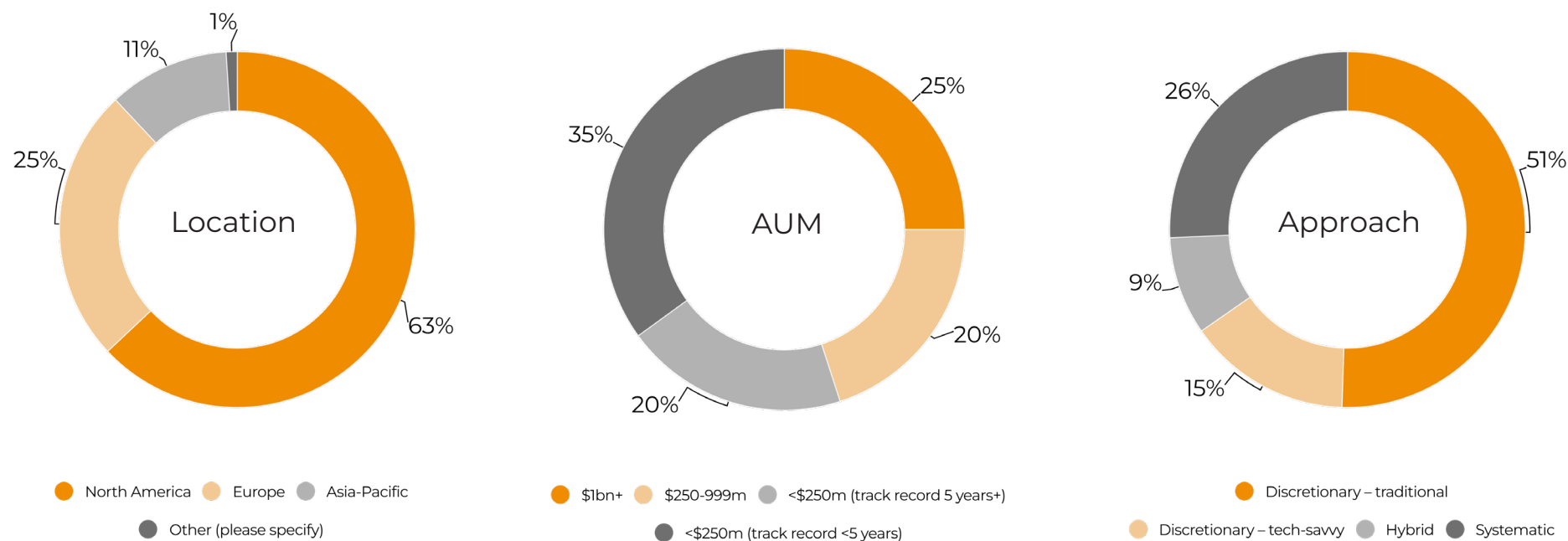
This data-driven report is underpinned by proprietary findings from Hedgeweek's Q3 manager survey, arming professionals in the space – whether GP, LP, or service provider – with useful intelligence to help them better navigate the CTA and systematic sector. There is also data from trusted partners of Hedgeweek providing colour on performance and flows.

WILL WAINSWRIGHT
HEAD OF HEDGE FUND RESEARCH

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Breakdown of respondents to Hedgeweek's Q3 Hedge Fund Manager Survey by firm location, size, and approach:



METHODOLOGY

A key source of data in this report is the results of Hedgeweek's Q3 Hedge Fund Manager Survey conducted in August 2023. Of the 89 hedge fund firms that participated in the survey, just over one quarter labelled their hedge fund business as 'systematic' in trading style. Where survey data refers to systematic funds or firms, it refers to this group. Further insights in this report were gathered during interviews in October with named and unnamed hedge fund sources, and additional third-party research and intel.

KEY FINDINGS

1

After a tough H1, CTA performance improved in Q3

After a strong 2022, trend reversals in H1 2023 hit CTAs hard as the short-duration trade, built around expectations that central bankers would have to tighten more than expected, was undone during the US regional banking crisis. But H2 has proved better, driven by the market's adjustment to the higher-for-longer rates setting. What are the key positioning headlines? The report calls on expert testimony to reveal performance drivers and the outlook heading into 2024.

2

Quants lead AI adoption – but 20% still uninvolved

Unsurprisingly given their tech skillsets, systematic firms have been at the vanguard of artificial intelligence. AI use or exploration is over 80% among quants, compared to 65% in the industry as a whole. Part two reveals that alpha generation is the key use case, whether driving trading strategies or helping with research. But discretionary firms remain in the arms race, with many using AI tech – the natural next phase of their recent move to build more quant processes into discretionary approaches.

3

Nearly half of quants looking at autonomous trading

The quant/discretionary divide over AI uptake is most stark in terms of autonomous trading. Almost half (44%) of systematic firms are exploring the use of AI for this purpose, compared to just 15% of the industry as a whole. And 39% of systematic firms are exploring the use of AI to assist the research process, compared to just 27% of the industry overall. If AI yields serious performance differentials, a quant/discretionary performance gap could emerge.

4

Product improvements the priority, not new launches

Honing existing products appears a higher priority for many systematic firms – ensuring their approach does not become outdated as technology quickly moves on – than starting new funds. That is indicated by the fact that slightly fewer systematic funds are planning to start a new product (56%) compared to the industry average of 63%. The launch market is in recovery after hitting a post-2008 low of just 71 in Q3 2022.

BOUNCING BACK

If 2022 was a ‘banner year’ for CTAs, 2023 started out differently. But after a strong Q3, managed futures specialists – and quants in general – have reasons to be optimistic heading into 2024.

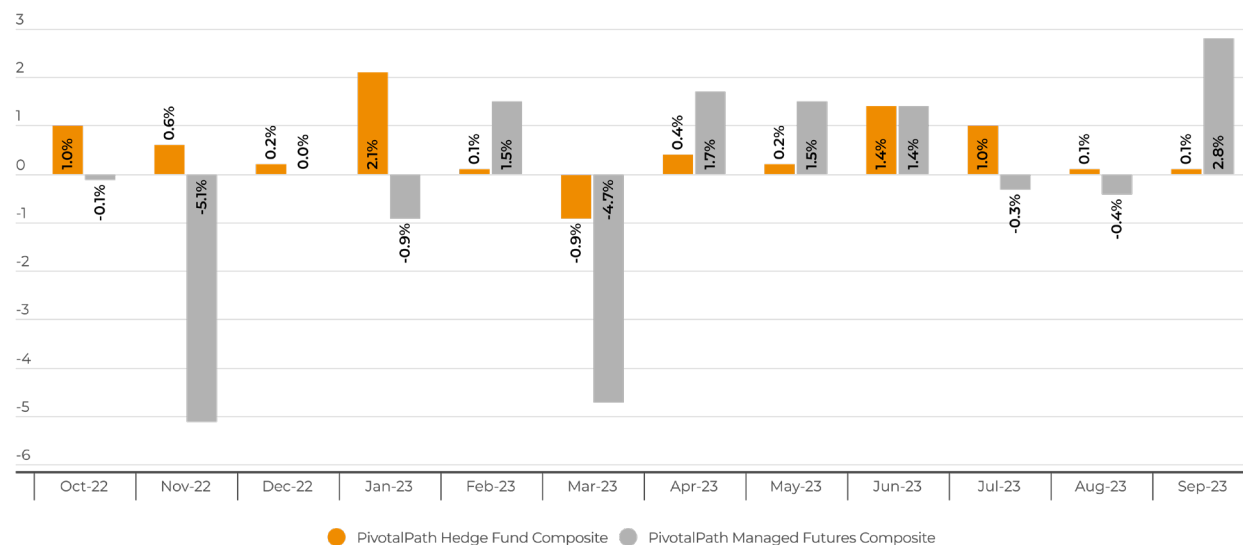
Last year was historic for CTAs. Societe Generale’s index of ten large trend-followers made 27.3%, beating the return achieved in the strategy’s defining breakthrough year of 2008, and the SG CTA index made 20%. Over the past 12 months, performance has been more mixed, according to PivotalPath data (see Figure 1.1).

“Last year shorting fixed income was the biggest and most successful trend for the space in years,” says Kathryn Kaminski, chief

research strategist and portfolio manager at AlphaSimplex.

CTA performance came back to earth in 2023 as turbulent events and market doubts over the pace of rate hikes and course of inflation caught out trend-followers.

“The biggest market theme since 2022 has been the change in interest rate regimes,” adds Kaminski, with trends markedly weaker this

Fig. 1.1 Managed futures monthly returns versus hedge fund monthly returns, past 12 months

Source: PivotalPath

year. “The shock and reversal in yields during the US regional banking crisis caused losses for most CTAs.”

The demise of Silicon Valley Bank in March fed an increase in bond prices after a slower pace of rate rises was anticipated. The short-duration trade, built around expectations that that central bankers would have to tighten more than expected, was undone as the two-year US Treasury yield’s rapid decline caught out CTAs,

says Philip Seager, head of absolute return at French quant firm CFM.

“The speed of the reversal was too fast for trend-followers to adapt to after having built up a sizeable short position over the period of Fed tightening started in 2022.” Managed futures funds lost 4.7% in March, according to PivotalPath.

“CTA performance depends on market

‘trendiness,’” says Nicolas Gaussel, founder of \$800m Paris-based managed futures specialist Metori Capital Management. “Our trend indicator which was high in 2022 turned to low levels throughout 2023. It bottomed in April in the wake of the banking crisis which hit trend-following strategies.”

This year’s established narrative around managed futures/systematic performance was summed up by the FT headline ‘Hedge fund

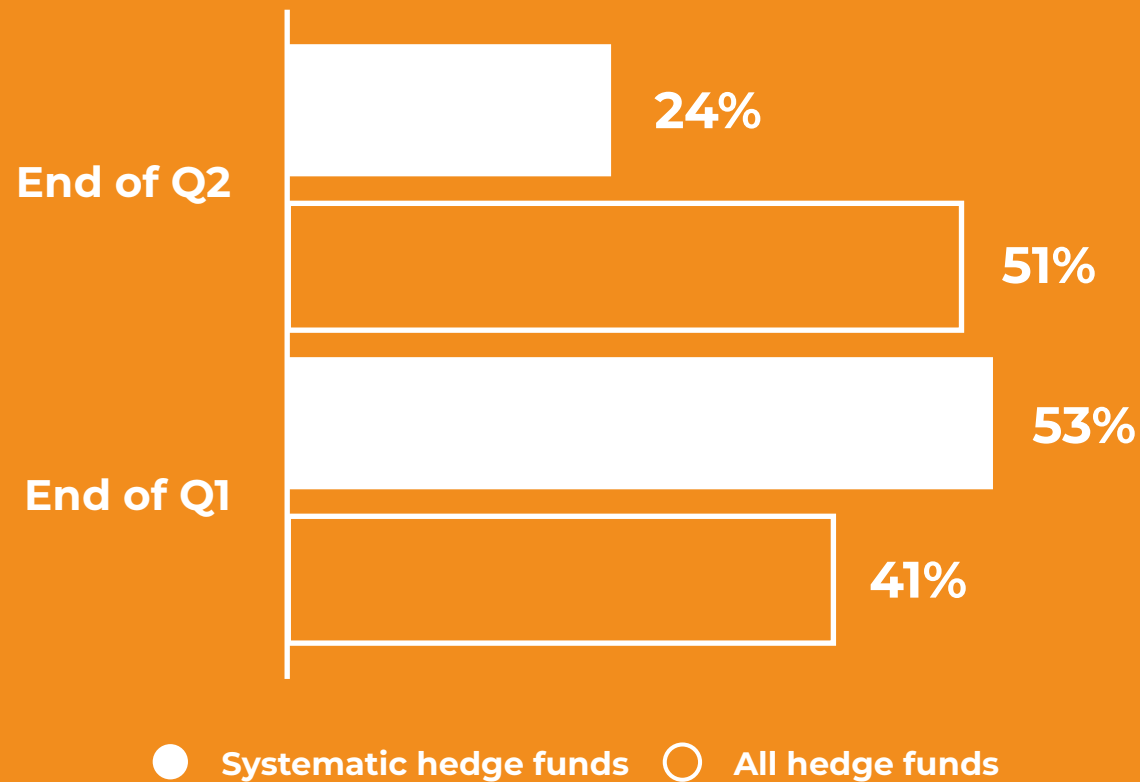
trend followers endure tough year after banner 2022’ in late August. Though Seager points out that the strategy’s low Sharpe ratio means “flat years are probable... the flat performance of the SG CTA index this year is consistent with statistics and as such is a non-event.”

Then came September. Short bond and long oil positions were key drivers as the market adjusted to higher-for-longer interest rates and the oil price surged amid new volatility. It was a

KEY FINDING

After a strong 2022 then tough start to 2023, few quants ended H1 at their highwater mark

Proportion of systematic hedge funds surveyed by Hedgeweek – including CTAs and other quantitative strategies – at their high-water mark at the end of Q2 2023 and Q1 2023:



turnaround month and funds averaged a 2.8% gain, according to PivotalPath.

DRIVING RETURNS

"Trend following provided valuable diversification for equities and bonds in September, as investors braced themselves for higher interest rates for longer," reported London-based Winton Capital in a note.

Short bets on fixed-income, Japanese yen and US natural gas positions were responsible for much of last month's gain. "Most strategies are now either up or broadly flat year-to-date, having recovered losses from March's fixed income reversal."

AQR Capital Management posted gains across its range in September, capitalising on the market's shift in outlook. AQR Alternative Trends Strategy made 2% and is now up 13.1% for the first nine months.

Quest Partners in New York made 7.5% in its AQO flagship but remains down 9.3% for the year so far. "The return of trends and volatility are warmly welcomed in a year that has been challenging for short-term strategies, especially those like AQO that seek to provide robust positive skew," the firm told investors.

ALLOCATOR VIEW

UBP said shorter-term strategies tended to perform best. "These had switched short on a number of losing assets in September including equities, and GBP and CHF whilst

Fig. 1.2 Hedge fund flows 2023 YTD versus 2022 and 2021, by primary strategy (\$bn)

	YTD 2023	2022	2021
Managed futures	2.43	6.12	12.98
RV Credit	1.95	-5.52	0.84
Equity MN	-0.18	0.02	2.78
Convertible arb.	-0.66	-0.26	2.53
Directional credit	-2.61	-26.57	-11.97
Multi-strategy	-2.72	6.21	23.17
Distressed	-4.62	-4.71	-2.24
Macro	-6.73	-31.40	-5.07
Equity L/S	-22.73	-38.02	-16.48
Event driven	-23.12	-7.55	3.73
All hedge funds	-68.19	-112.19	13.92

Analyst note: Table covers primary strategies and is not exhaustive.

Source: eVestment

How are CTAs positioned going into 2024?

“Trend followers head into the final quarter of 2023 with short positions in fixed income and metals; net long exposure to energies, the US dollar and agricultural commodities; and short or rapidly reducing long positions in stock indices,” according to Winton Capital.

As of end-September, Metori is long GBP (versus USD and EUR), European and US equities, Latam currencies and some agricultures contracts; and short fixed-income, Japanese Yen (versus USD and EUR), palladium and natural gas.

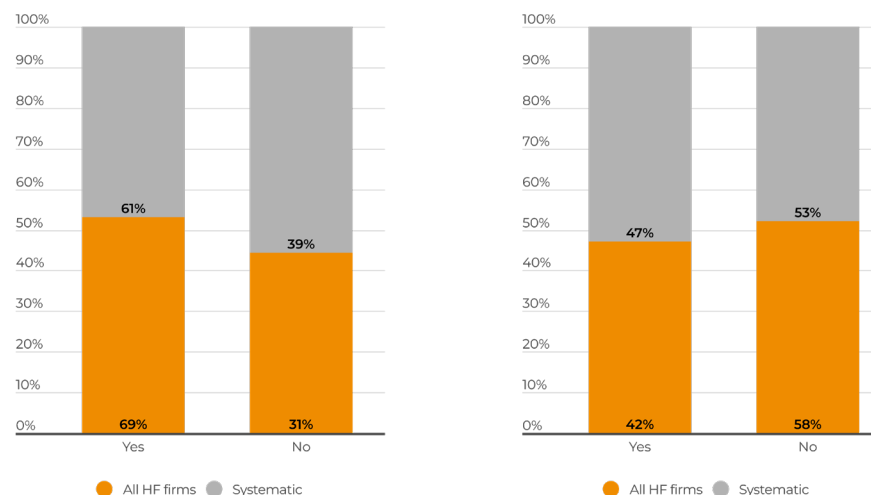
Moving into the end of 2023, fixed income signals remain short with bonds still under pressure despite the dis-inversion of the US yield curve, according to Kaminski. “The US dollar has come out the winner with equities under pressure, higher yields and moderate growth expectations for the US,” she adds.

“Divergence across equities remains something to watch as large mega cap stocks and indices remain strongly better positioned than small caps in a higher for longer regime.”

“

Moving into the end of 2023, fixed income signals remain short with bonds still under pressure despite the dis-inversion of the US yield curve.

Fig. 1.3 Systematic hedge funds that received allocations and redemption requests in Q2 2023



Analyst note: Survey respondents were asked during Q3 2023, did you receive in the previous quarter: a) an allocation from a hedge fund investor? and b) a redemption request from a hedge fund investor?

Source: HedgeWeek Q3 Hedge Fund Manager Survey

longer-term models and more diversified strategies with more carry-related components underperformed.”

The Swiss allocator said statistical arbitrage also benefited from the increased macro and earnings related volatility in the period.

According to eVestment’s tracking of almost \$200bn in managed futures strategies, investors allocated a net \$2.4bn in the first nine months, more than any other strategy. That follows net

inflows of \$13bn in 2021 and \$6.1bn in 2022. (see Figure 1.2).

The popularity tallies with evidence gathered by prime brokers that CTA strategies are seeing increased interest in the new macroeconomic environment. A survey this summer by BNP Paribas’s cap intro team found nearly half of investor respondents were making strategy allocation changes because of the change in rates, with credit, CTA and discretionary macro being the largest beneficiaries.

Not all the data points that way. HedgeWeek’s Q3 manager survey has 57% of systematic funds receiving an allocation in the prior quarter, below the 63% rate across all hedge funds. Among the latter, 40% had at least one redemption request, in line with the 42% rate among systematic funds (see Figure 1.3).

That said, with inflation still high in many western economies and interest rates elevated, the increased return and diversifying benefits of CTAs are clearly in demand. “Systematic

strategies have demonstrated the diversification benefits they can offer in periods of macro uncertainty,” observed UBP. “Price based strategies have reacted strongly to the reflation dynamics in the market.

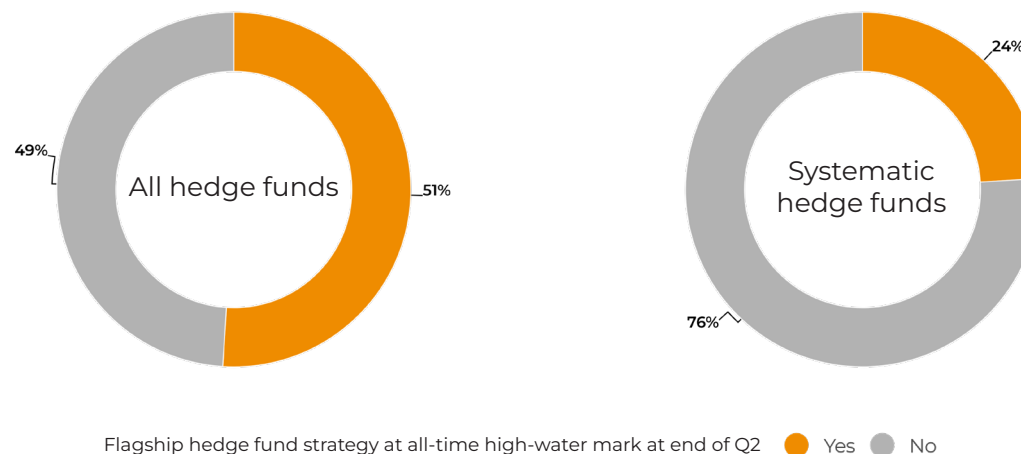
“Trend and momentum are the most important strategy components and will dominate performance and these strategies have seen performance recovering well in Q3 after some gave back in the strategy performance in H1 2023.”

“

The positioning of [trend followers] in treasuries is likely back to where it was ahead of the SVB period. The risk going forward is one of another such reversal in these markets.

Philip Seager
Head of Absolute Return, CFM

Fig. 1.4 Systematic hedge funds at high watermark



Analyst note: Survey respondents were asked during Q3 2023, at the end of the previous calendar quarter, was your firm's flagship hedge fund strategy at its all-time high-water mark?

Source: Hedgeweek Q3 Hedge Fund Manager Survey

They have some catching up to do, with fewer systematic hedge funds at their high watermark compared to the wider industry (see Figure 1.4).

RISK FACTORS

What possible risks are there on the performance front? Research from PivotalPath found that managed futures managers are even more negatively exposed to a rally in Treasuries today than they were in March.

"That exposure worked out well last month as rates continued their path higher," said the industry data provider in its latest monthly update. "However, investors remain negatively exposed to a sudden rally in Treasuries or a flight to quality to event, like we saw in March of this year around the regional banking turmoil."

"The risk going forward is one of another such reversal in these markets," adds Seager of CFM.

Man FRM continues to "see interesting opportunities for more niche exposures in the macro quant space, with a positive outlook for alternative trend strategies that focus on less liquid markets, particularly those with exposure towards commodities, where we expect to see continued high levels of volatility and opportunity over the next few years.

However, discretionary be better placed to navigate the environment if there is another shift. "We feel there is a risk that we are

approaching an inflection point in the post-inflation scare environment, and as such discretionary macro managers may be able to navigate the market uncertainty better than trend-following machines."

UBP noted the same. "If we continue to see sudden shocks such as March 2023 that cause a reversal of the medium terms themes or markets revert into a range bound environment, then returns will be at lower end." ■

AUGMENTING ALPHA

In an ever-evolving sector, AI and other advancements have increased both the opportunity and pressure to innovate. Here, practitioners discuss their priorities, focusing on alpha generation.

Innovation is the perennial watchword in systematic investing, and the pace of change will only accelerate in months and years ahead following recent advances in artificial intelligence (AI).

Systematic hedge fund firms interviewed by HedgeWeek, from sub-billion-dollar start-ups to \$10bn-plus established firms, agreed on the importance of R&D with one overriding end-goal: boosting alpha.

Nicolas Gaussel, founder at Metori in Paris, outlined how his firm is innovating to meet

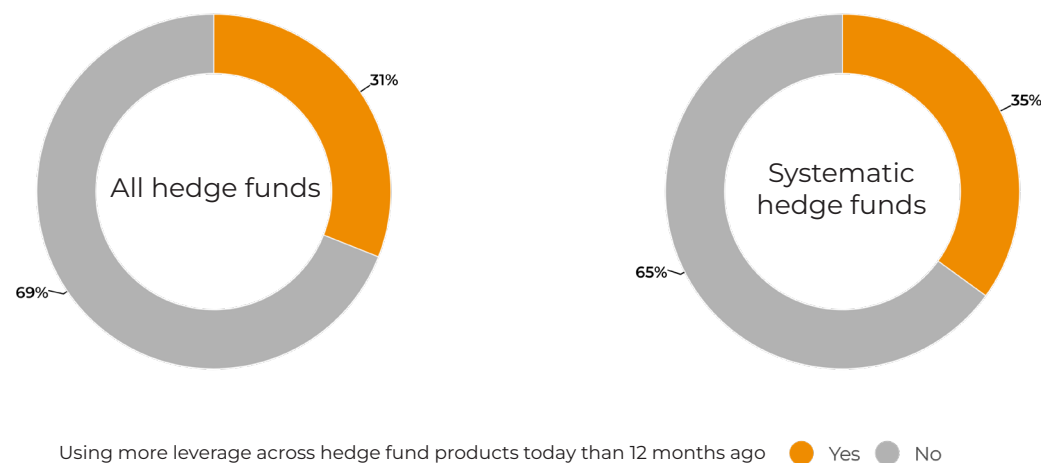
technological challenges ahead. “Metori is continuously investing in R&D, a large part of which is dedicated to maximising our alpha potential,” he says. “Ongoing improvements of our model come first and include research areas such as in-depth studies of market dynamics.”

Middle and back-office efficiencies can also be leveraged to boost returns. “We also invest a lot in our IT infrastructure which is how innovative ideas can be turned into practical improvements,” adds Gaussel.

Philip Seager, head of absolute return at CFM,



Fig. 2.1 Systematic hedge funds' use of leverage



Analyst note: Survey respondents were asked, *is your firm using more leverage across its hedge fund products today than it was 12 months ago?*

Source: Hedgeweek Q3 Hedge Fund Manager Survey

says their priority moving forward in terms of strategy evolution and technology centres on data.

“Our strategy for our flagship funds is to be as informed as we can through the use of the ever growing, abundant amounts of alternative and traditional data available. Our investment in technology predominantly revolves around facilitating our ability to do this.”

The \$10bn Paris firm treats its trend-following funds separately. “We prefer to keep our trend-following funds, as distinct from our flagship alpha funds, free of style drift applying a dedicated trend following approach for signal generation,” he says.

He echoes Gaussel in pointing to the importance of R&D across all parts of the firm. “The R&D priorities of our trend following

programs are to benefit from advances made in portfolio construction, execution and risk control.”

LAUNCH PLANS

The significance placed on innovation suggests that honing existing products is perhaps a higher priority for many systematic firms – ensuring their approach does not become outdated as

technology quickly moves on – than starting new funds.

That is indicated by the fact that slightly fewer systematic funds are planning to start a new product (56%) compared to the industry average of 63% (see Figure 2.2).

Respondents were asked in Q3 against the backdrop of a hedge fund launch market

KEY FINDING

Over 60% of quants are using AI to generate returns – nearly half for autonomous trading

Proportion of systematic hedge funds surveyed by Hedgeweek – including CTAs and other quantitative strategies – using AI to generate returns, compared to all hedge funds:

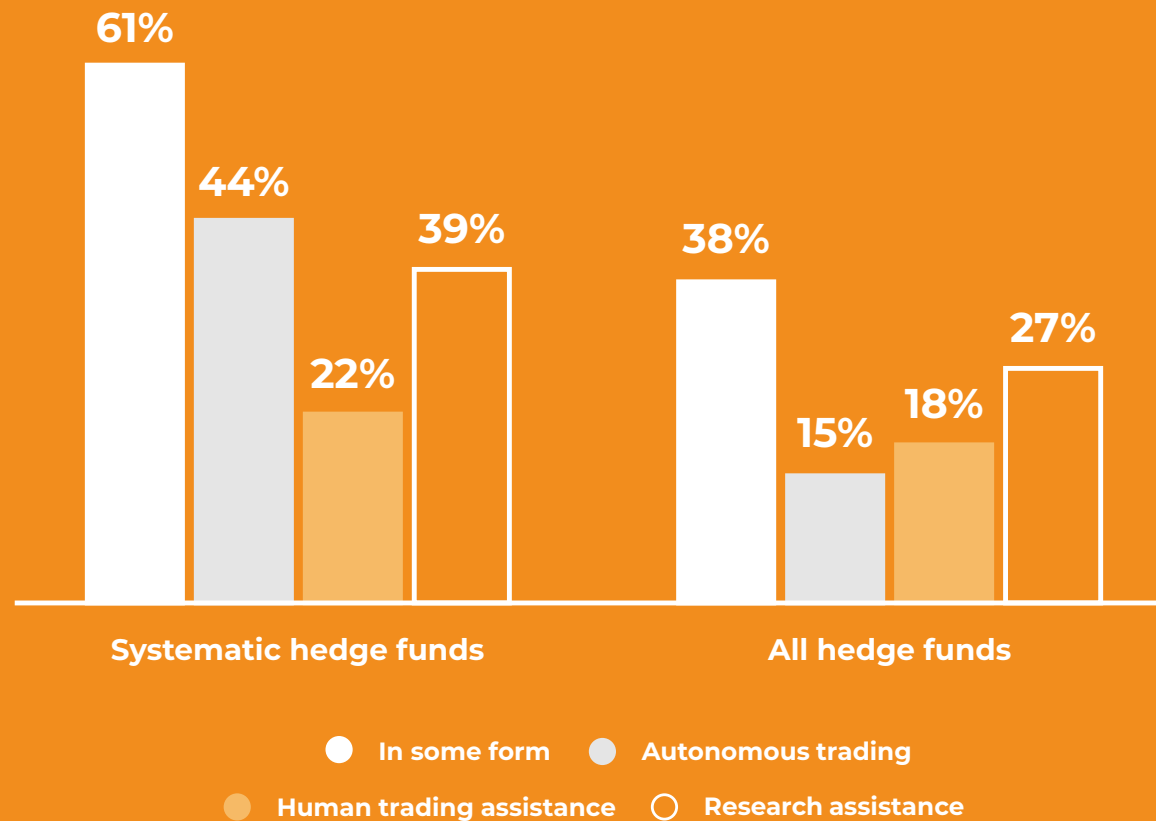
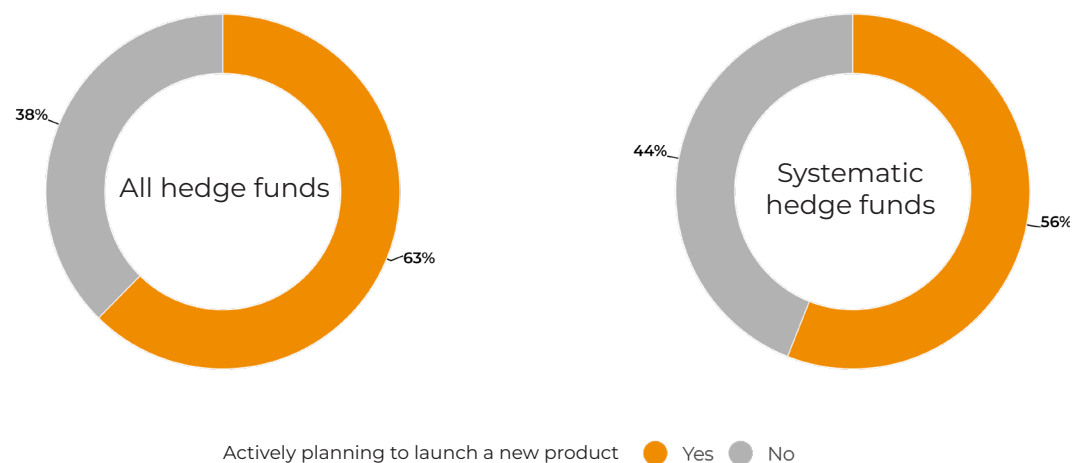


Fig. 2.2 Systematic hedge funds planning to launch a new product



Analyst note: Survey respondents were asked, *Is your firm actively planning to launch a new product?*

Source: HedgeWeek Q3 Hedge Fund Manager Survey

in recovery after hitting a post-2008 record quarterly low of just 71 in Q3 2022, according to HFR.

This year has been more positive as hedge fund launches outpaced closures in Q2 for the first time in more than a year, as start-ups with a multi-strat heritage helped drive a recovery in numbers.

The difference between human and quant approaches should not be over-stressed, according to Anu Pohani, co-founder and COO at London-based Allermuir Capital, which uses a proprietary artificial intelligence system to drive its investments.

“The human touch is incredibly important. The humans behind the models, their experience, knowledge, drive model performance,” she says.

“Ultimately markets are made up of millions of human decisions, models help us to synthesise and understand the overall behaviour and trend (if any).”

FOCUS ON: AI

No report on innovation in systematic investing would be complete without a strong focus on AI. Quant firms are leading the adoption of

AI approaches in multiple ways, according to HedgeWeek’s quarterly survey (see Figure 2.3).

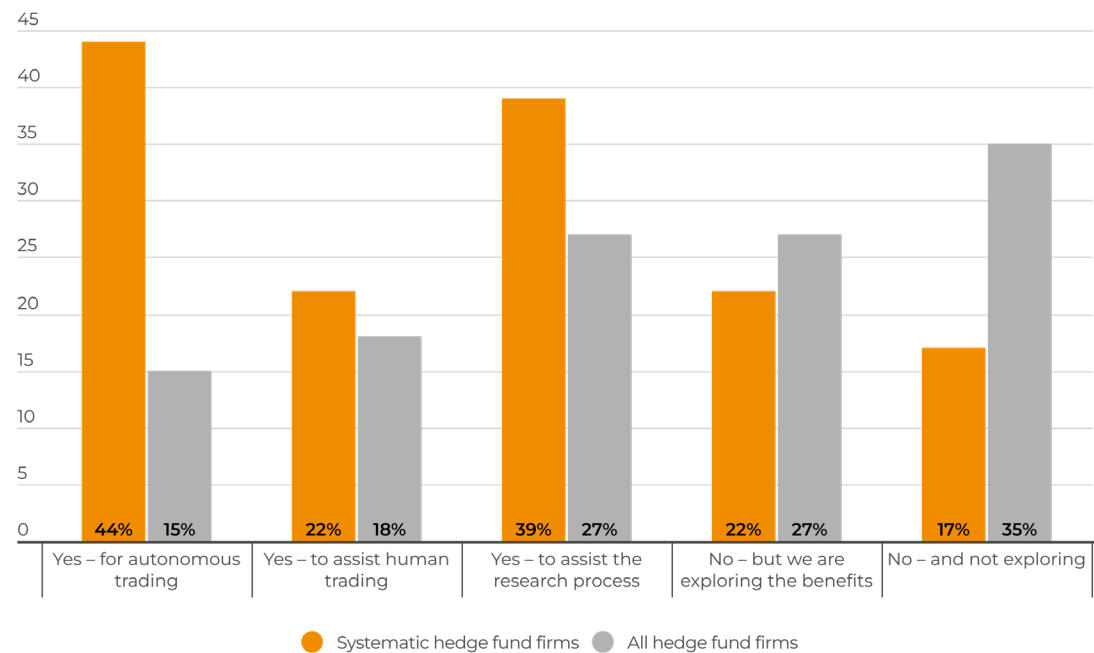
Almost half (44%) of systematic firms are exploring the use of AI for autonomous trading, compared to just 15% of the industry as a whole. And 39% of systematic firms are exploring the use of AI to assist the research process, compared to just 27% of the industry overall.

“

As inflation, higher interest rates, geopolitical risks, and the de-globalization of supply chains continues, commodities should continue to be a key factor for global trends.

Kathryn Kaminski
Chief Research Strategist and Portfolio Manager, AlphaSimplex

Fig. 2.3 Systematic hedge funds using AI to generate returns



Analyst note: Survey respondents were asked, Does your firm use AI/machine learning to generate returns? Please select all that apply

Source: Hedgeweek Q3 Hedge Fund Manager Survey

More than a fifth (22%) are doing so to assist human trading, though this figure is roughly in line with the 18% rate across the wider industry. Use of AI is the natural next step for discretionary firms which have used quant techniques far more in recent years.

“Quantitative techniques are being used to enhance discretionary portfolios in a range of areas,” noted Man Group, the world’s largest listed hedge fund manager, earlier this year.

“From alpha generation, including the use of alternative data, to risk management, portfolio construction and performance analysis, the marriage of quant and discretionary management is underway – and reaping the rewards of both disciplines.”

Only 17% of systematic hedge firms were not using or exploring the use of AI in any way, highlighting the widespread adoption and intended adoption. This contrasts with 35% of the industry as a whole not using or exploring the use of AI.

Anu Pohani of Allermuir describes AI as “the foundation of our portfolio construction and management. Our proprietary technology, Hebrides, performs the quantitative work to standardise, project and rank corporate earnings. These are the building blocks for our long/short strategy.”

She says the new different market paradigm “to one which had prevailed over say 2000-2020” will have a big impact on innovation priorities going forward.



Currently, interpretation and understanding of complex regulatory requirements and managing compliance with multiple jurisdictions, both selected by 28% of systematic respondents, are the top regulatory challenges.

Focus on: Regulation

The last word, even in a report focused on innovation, goes to regulation, which cannot be ignored against the backdrop of greater scrutiny of alternative investments led by the US.

Regulation in the arena of AI is a nascent but quickly developing area, with the UK hosting an AI Summit in London this quarter focused on safe uses and possible regulatory approaches. How much a more concerted regulatory effort could affect hedge fund use is unknown at this stage.

Currently, interpretation and understanding of complex regulatory requirements and managing compliance with multiple jurisdictions, both selected by 28% of systematic respondents in Hedgeweek's quarterly manager survey, are the top regulatory challenges (see Figure 2.4).

It is interesting that 34% of the wider industry selected the complex regulatory requirements point, suggesting that discretionary firms face as great, if not a greater, challenge on that front.

Allocating resources for compliance purposes (22%) and integrating technological solutions for compliance (19%) were the next biggest challenges for quant firms.

Ensuring accurate and timely regulatory reporting was selected by 6% of quant firms and 14% of the wider industry, suggesting that automation by systematic firms made this easier to handle while discretionary firms struggle with new processes in an era of increased reporting.

"It will be interesting to see how investment selection evolves and incorporates this new paradigm. Also, developments in AI bring systematic techniques to traditional human-led areas which is a process that will continue to evolve and impact how markets operate."

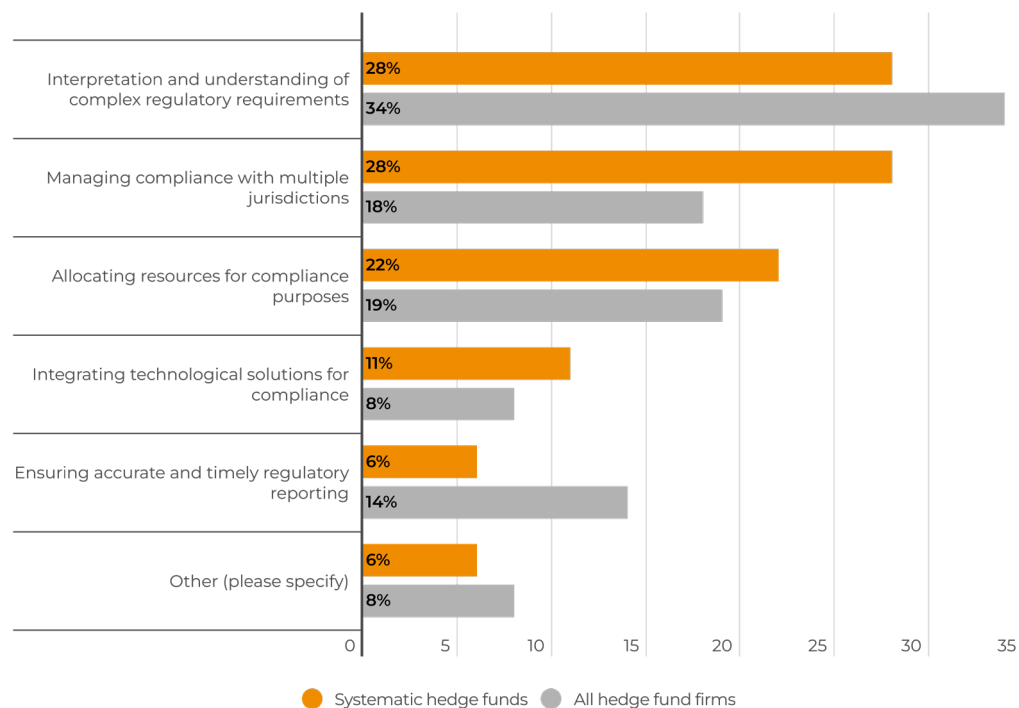
COMMODIFICATION

Preparing for the new market paradigm dominated – in particular – by commodities will be imperative for all systematic firms, according to Kathryn Kaminski, chief research strategist and portfolio manager at AlphaSimplex.

"Commodities tended to be range bound during a period of globalization, low interest rates, and low inflation. We are no longer in that environment," she says. Innovation in this area – central to a large part of systematic investing for decades since the start of CTAs – will be crucial.

"As inflation, higher interest rates, geopolitical risks, and the de-globalization of supply chains continues, commodities should continue to be a key factor for global trends." ■

Fig. 2.4 Top regulatory challenges for systematic hedge fund firms



Analyst note: Survey respondents were asked, What is the most significant regulatory challenge you face as a hedge fund manager when it comes to reporting and compliance?

Source: Hedgeweek Q3 Hedge Fund Manager Survey

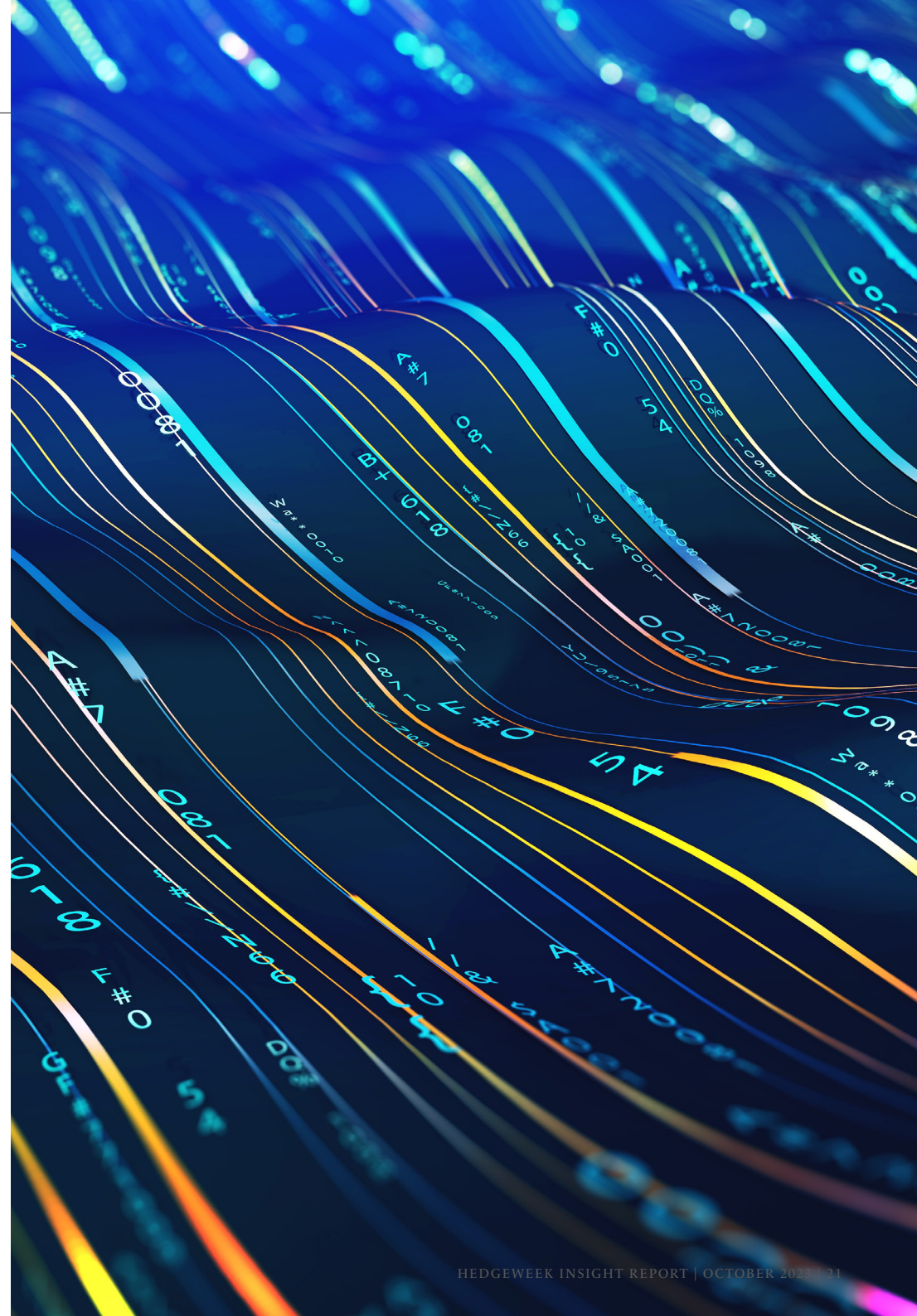
CONCLUSION

A huge performance advance meant 2022 was a transformative year for CTAs, with trend-followers boosted by short fixed-income positions. It was, in the words of Kathryn Kaminski, chief research strategist and portfolio manager at AlphaSimplex, “the most successful trend for the space in years.”

Replicating such an outsized gain will be difficult, but systematic strategies are well placed to deliver in the new higher-for-longer rates environment. That was demonstrated by the performance turnaround in September – and GPs and LPs expect it to continue into 2024, as the findings in part one of this report show. And, all-importantly, allocations into the space lead the rest of the hedge fund industry.

But it is not time to stand still. Innovation remains the sector’s watchword and AI will be top of mind in the months and years ahead as systematic managers look to build on the momentum. Honing existing products could take priority over new launch plans. Regulatory pressures could pose a risk, with the AI agenda yet to be decided.

Still, the direction of travel is clear as quant firms lead the sector in AI adoption. It could be the key to unlocking the sector’s next phase of growth, delivering the risk-adjusted returns LPs crave in a turbulent market environment.



HEDGEWEEK

CONTRIBUTORS:

Will Wainwright

Head of Hedge Fund Research
will.wainwright@globalfundmedia.com

Tony Griffiths

Head of Content
tony.griffiths@globalfundmedia.com

Johnathan Glenn

Head of Design
johnathan.glenn@globalfundmedia.com

FOR SPONSORSHIP & COMMERCIAL ENQUIRIES:

Ince Saleem

Chief Revenue Officer
ince.saleem@globalfundmedia.com

Published by: Global Fund Media, Lion Court, 25 Procter St, London WC1V 6NY

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