RED ROCK

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AN HONEST UPDATE ON THE TREND FOLLOWING LANDSCAPE

Background

Trend following is the most prevalent strategy utilized throughout the managed futures industry. Over 20 months ago, during the toughest recession our industry has ever experienced, we published the original version of this paper to offer a transparent and intellectually honest update on the track records of many of the most well-known trend followers. At that time, all twenty managers included in our analysis, including our Systematic Global Macro (systematic trend following) program and all of the major CTA indexes, were in a drawdown off their all-time high water marks.

As many expected, as the Central Banks' previously concerted policies began to diverge, beneficial *(directional)* volatility began to manifest in many of the futures markets that make up the core of most trend following CTAs' portfolios. Most trend followers were able to capitalize on these favorable market conditions, with the best-performing managers producing all-time net-new equity highs, and in many cases, and then some.

With all of the recent impressive performance from these managers, the question remains the same as we posed in the original version of our paper: what is the best way to objectively analyze, measure, and compare the performance of a group of trend following CTAs?

To help answer this question we developed our own metric that measures and compares the "goodness" of similar managers' returns. This paper updates our original work (and a subsequent version that was published in September 2014) and the measurements and ranking methodology that we initially introduced remain the same.

Who was analyzed?

This updated version of our paper includes analysis on 19 of the 20 trend following managers that we initially studied (one closed down), plus we include the Newedge CTA Index, the Newedge Trend CTA Index, the Newedge Trend Indicator, and an additional 4 managers. It is important to note that the Newedge CTA Index represents the equal-weighted performance of the top 20 largest diversified CTAs open for investment, the Newedge Trend CTA Index represents the equal-weighted performance of the top 10 largest trend following CTA open for investment, and the Newedge Trend Indicator is a fully-disclosed, rule-based trend following strategy that offers an interesting and transparent look into the daily performance and positions of a professionally developed, albeit basic, trend model.

Misunderstandings

Two of the managers we include in our analysis, one that we specifically added this time to help make an important point, received accolades for their impressive, outsized performance during 2014: Mulvaney Capital Management made +67.38% and ISAM produced +61.95%. However, the problem is (and this is a fact, not just our opinion), reporting only these types of "return" numbers tells only half of the story. When you hear a manager's performance being quoted, the first question someone should ask is, "At what level of risk / margin-to-equity / volatility?" A Commodity Trading Advisor makes a <u>*subjective*</u> <u>*choice*</u> as to what level margin-to-equity to operate his or her program – but the level chosen is <u>*not*</u>, in and of itself, a source of "goodness." Furthermore, an investor who opens a managed account with a CTA, through the use of notional funding, can modify the manager's regular program volatility to suit their own appetite for risk. Therefore, due to the inherent (i.e. free; no cost to lever up, as there is with stocks) leverage found in the futures markets, <u>*risk-adjusted*</u> returns (not absolute returns) are the only accurate and proper way to compare similar manager returns.

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This point is repeatedly misunderstood by many in the managed futures industry. A program run with a higher margin to-equity ratio will produce a higher compound rate of growth at the price of higher drawdowns (periods of loss). For example, assume one manager produces a +60% net return over 12 months and another manager only produces a +20% net return. If the second manager used only 1/3 as much margin-to-equity, and produced only 1/3 as much volatility in his returns, then the two managers' performance were essentially equal on a risk-adjusted basis. However, the first manager will often win awards and be touted for having "better" performance – which demonstrates a lack of understanding of, or at least a lack of concern for, a crucial aspect about managed futures and how to correctly measure performance.

To bring this point full-circle, while Mulvaney's +67.38% and ISAM's +61.95% performance in 2014 indeed sound impressive on the surface, a study of their track records shows that the former lost over 35% in one recent calendar year (and lists a 45.04% maximum historical drawdown) and the latter lost money in three consecutive recent calendar years and lists a 34.79% maximum drawdown. Both managers recently made all-time net-new equity highs, for which they should be commended, however, in order to get an intellectually honest and accurate reading of their true performance, one must include data on both returns and risk in one's analysis.

Ranking Methodology

Our proprietary metric aims to step into the shoes of a loyal, long-term investor with any of the managers that we analyze, and asks, "What aspects of my CTA manager's performance are most important to me?" The following table conveys the most important aspects, the proxies we use to measure them, and the weight we give to each measurement in our weighted final ranking:

Important Aspect of Manager's Returns	Proxy for Measurement	Weighting
When was the last net new equity high made?	Months in Current Drawdown	25%
What is the current drawdown from the last high-water mark?	Depth of Current Drawdown	25%
How good have the manager's risk-adjusted returns been over the long run?	Sortino Ratio	50%
		100%

For the period since the inception of our Systematic Global Macro program in September 2003, through March 2015, we measure each aspect of the managers' returns via our proxies and then assign them a weight similar to how one calculates a grade point average.

Once we have the rankings for each of the managers on the individual aspects, we then combine the rankings (at their respective weights) to arrive at a final rank. This is a straightforward, quick method to compare similar futures managers to one another. By design, and to reduce the complexity of the process, the rankings do not have proportional information embedded in them, i.e. *how much better* is Manager A than Manager B, etc. In considering the results of our ranking, the following should be noted:

- Since a CTA's returns, volatility, and drawdowns are functions of a subjective decision that has been made by the manager, only analyzing the managers' length and depth of their current (if applicable) drawdown is not sufficient. A risk-adjusted metric (referred to as "Reward to Risk Ratio" in the forthcoming table) must be applied that normalizes managers' returns against one another.

- As we convey in our white paper, *Sortino: A 'Sharper' Ratio*, the Sortino ratio is a more appropriate measure to use for this purpose than the more popular Sharpe ratio. This is because the Sharpe ratio, by assuming that the returns it is measuring are normally distributed, unfairly and incorrectly penalizes managers whose returns exhibit positive asymmetry (skewness). In reality, investors typically welcome upside volatility and perceive only downside volatility as actual risk.

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Results of Ranking

Sept 2003 - Mar 2015	Months in Current Drawdown	Current Drawdown	Reward to Risk Ratio	Ranking by Individual Sector: Months in Current Drawdown	Ranking by Individual Sector: Current Drawdown	Ranking by Individual Sector: Reward to Risk Ratio	FINAL RANK
WINTON	0	0.00%	1.95	1	1	2	**1**
RED ROCK	0	0.00%	1.78	1	1	3	**2**
LYNX	0	0.00%	1.59	1	1	4	**3**
BLUETREND	0	0.00%	1.56	1	1	5	**4**
ISAM	0	0.00%	1.55	1	1	6	**5**
TRANSTREND	0	0.00%	1.42	1	1	7	**6**
MULVANEY	0	0.00%	1.24	1	1	8	**7**
MAN AHL	0	0.00%	1.22	1	1	9	**8**
WELTON	0	0.00%	1.19	1	1	10	**9**
ABRAHAM	0	0.00%	1.16	1	1	11	**10**
NEWEDGE CTA INDEX	0	0.00%	1.11	1	1	12	**11**
NEWEDGE TREND CTA INDEX	0	0.00%	0.88	1	1	16	**12**
ASPECT	0	0.00%	0.87	1	1	17	**13**
COVENANT	2	-3.24%	2.07	17	22	1	**14**
GRAHAM	0	0.00%	0.74	1	1	20	**15**
DUNN	0	0.00%	0.65	1	1	21	**16**
CHESAPEAKE	0	0.00%	0.64	1	1	22	**17**
ECKHARDT	47	-1.09%	1.02	20	19	14	**18**
ESTLANDER	47	-9.60%	1.06	20	25	13	**19**
NEWEDGE TREND INDICATOR	42	-1.56%	0.84	19	20	18	**20**
ALTIS	51	-22.56%	0.97	25	26	15	**21**
DRURY	49	-3.45%	0.78	23	23	19	**22**
CAMPBELL	2	-0.91%	0.58	17	18	25	**23**
MILLBURN	47	-0.63%	0.62	20	17	24	**23**
HYMAN BECK	49	-1.56%	0.64	23	20	22	**25**
SUNRISE	64	-8.92%	0.55	26	24	26	**26**

Sources: BarclayHedge, Altegris, IASG, Bloomberg. Reward to Risk Ratio is Sortino Ratio (Target = 0) for period September 2003 – March 2015 except: BlueTrend is from April '04; Welton is from June '04. Past performance not necessarily indicative of future performance. For informational purposes only. Red Rock Capital, LLC not responsible for modifications to or accuracy of performance data.

Observations & comments about the results:

- Winton continues to lead the pack and deserves the kudos that it receives.
- 69% of the CTAs and indexes analyzed, through March 31st, are or were at their all-time net new equity high within the past two months. Managers making all-time net new equity highs are, by definition, not in any drawdown, and this gives them a high ranking in both of the first two categories – as it should.
- With so many managers making all-time net new highs, the competition is tight and even a small drawdown after a recent net new equity high will drop a manager in the overall rankings.

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- While Winton has approximately $30 billion firm-wide assets under management, managers with final rankings of #2 – 26 have a combined approximately $20 billion of assets under management, however, about half of those funds are not invested with managers ranked highly on the list.

- An interesting related exercise to our objective ranking methodology is to subjectively study and rank the attractiveness of each of the managers' VAMIs / growth curves throughout our study period. We found that Winton wins in this category as well, with Lynx a close second place. Interestingly, the "just eye balling it" approach chooses 2 of the quantitatively chosen top 3 finally ranked managers. The exception is Red Rock Capital who ends up with a higher overall rank than the impressive $5.4+ billion CTA Lynx. This is because Red Rock has a higher Sortino Ratio (though Lynx has a slightly higher Sharpe Ratio).

- The Newedge Trend Indicator, a fully disclosed and freely-available-to-the-public strategy, has outperformed several of the historically best-known CTA trend following managers. As a caveat, though, the Trend Indicator was launched in August 2010 so only its performance since, and not before that time, can be considered out of sample.

- Good "recent performance", as so many like to focus on and reward with praise, needs to be kept in the correct perspective. For instance a manager could be up 10% one year and then up another 5% the following year (and win awards, etc.) then down -11%, and back up 8%... yet the entire time still be under their high water mark. Should a savvy, loyal investor, who has not seen a net new equity high in 64+ months, really care if a manager is "up" this year to date? We argue that they should not.

Considering the length of some of the managers' drawdowns, especially factoring in the fruitful trend following environment that has been in place since late 2013, we believe concern is warranted, from a current or prospective investor standpoint, as to whether or not such managers will *ever* make another new equity high again. Unfortunately, as we've seen too many times before in our industry, those managers often share the same concern – and conveniently try to shift focus away from that particular program – only to launch another "new and improved" variant. Prospective investors would do themselves a favor by being skeptical of firms launching new programs, Mutual Funds, and ETFs in the wake of ailing flagship CTA programs.

In this article we present an efficient and straightforward method to objectively measure and compare the performance of similar trend following CTA managers. Since late 2013, many of the managers in our analysis, along with the major CTA indexes, have produced very respectable risk-adjusted returns. With all that is happening globally (e.g. FED Q.E. program ceased, possible Greek exit from Euro, negative interest rates, equities and bonds near all-time highs) it will be interesting to see what kind of market environment trend followers will have to work with in the coming months and years.

– Thomas N. Rollinger, Managing Partner
– Scott T. Hoffman, Partner

Important Disclosures

About Red Rock Capital

Red Rock Capital is an award-winning commodity investment management firm located in Chicago. During the summer of 2015 Red Rock will proudly celebrate its 12th anniversary. The firm is led by Thomas Rollinger, who is most notably a devoted pupil and former protégé of quantitative hedge fund legend, Edward O. Thorp. Given recent developments with the firm, plus increasingly favorable market conditions, Red Rock is especially well-positioned to continue to grow and thrive in the managed futures industry.