MONOGRAM™

NEWSLETTER

Trend following strategies, lessons to be learnt…

March 2018

After a strong 2017 performance of +10.8% and a strong January of +2.5%, the MONOGRAM fund returned -2.3% in February, bringing the 2018 year-to-date return to +0.2%.

For equities, February was the worst month since 2009 – Global Developed Equities (MSCI World Index) were down -3.4%, Non-US Developed Equities (MSCI EAFE Index) down -3.7% and Emerging Market Equities down -5.2% (after a 7% gain the previous month). US Investment Grade Bonds were also down -1.0% and Gold lost -1.2%.

Turbulent February

As we have just seen, the ups and downs of investment returns can at times capture the headlines and penetrate the imagination of everyday folk, spreading excitement and fear in equal measure. The long-running equity bull market looked set fair through January only to be tripped up in dramatic fashion in the first few days of February. In particular, Monday 5th of February saw the Dow Jones Index slip a whopping -4.6% and the S&P 500 Index -4.1%.

Most investors pointed to the rising threat of inflation in the US that came following consumer price inflation (CPI) statistics released earlier in the month. A healthy jobs report didn't help either – this was a month in which investors reacted negatively to good economic news. Investors became concerned that a strong economy thriving on the tailwinds of tax reform could overheat, necessitating Federal Reserve intervention. Wall Street was also faced with a new Fed Chief in Jerome Powell, who brought with him uncertainty regarding the pace of interest rate hikes culminating in the worst February for stocks since 2009.

Trend Following Tantrum

What should investors have done in such market environment? And what does that mean for investors in the MONOGRAM strategy?

The philosophy underlying the MONOGRAM strategy has two key features: firstly, diversification across asset classes (the so called *only free lunch in finance)*, and secondly a willingness to 'diversify' in a time-related way by switching into cash when momentum in an asset classes turns negative. This ability to switch into cash allows us to reduce drawdown in the fund and protect investors in falling markets.

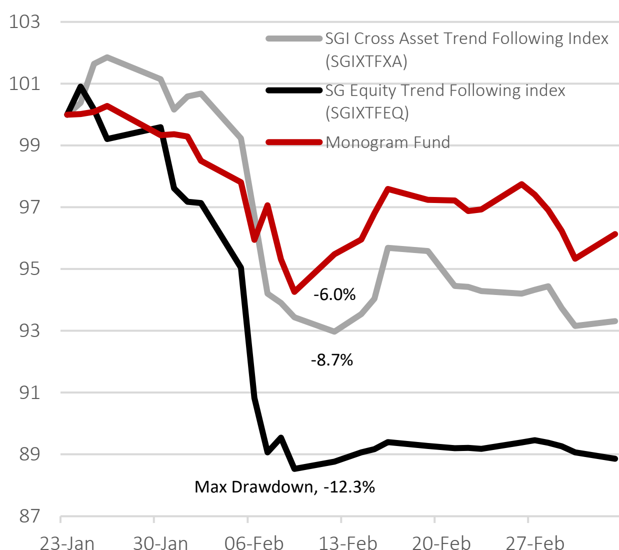
With regards to the diversification, the MONOGRAM fund was well diversified across asset classes in February – it held (and still holds) US Equities, Japan Equities, Emerging Market Equities, Investment Grade Bonds, Short Duration High Yield Bonds and Gold. However, even the best diversified of strategies can come a cropper: witness the legendary diversification of the Yale and Harvard endowment funds suffering c. -30% falls in 2008-9, leading to hundreds of layoffs and the cancellation of capital projects running to the billions of dollars.

The MONOGRAM loss of -2.3% in February is fairly modest compared to other well-known managers, market indices as well as trend following indices. The turbulence led to a fall of approximately -5.7% in the SocGen Cross Asset Trend Following Index (SGIXTFXA), while, the SocGen Equity index (SGIXTFEQ) suffered a loss of -8.4% making it,

according to the Financial Times, the worst period for systematic hedge funds since 2001[1].

The danger for such funds which trade trends and momentum in asset classes is that they get whipsawed moving in and out of markets under such volatile conditions; essentially they 'over-trade', incurring expensive transactions' costs in a vain attempt to time the market.

Extract 1: Drawdown as of peak (23rd January to 28th February).



Source: Bloomberg, MONOGRAM Capital Management.

We at MONOGRAM follow a rather different approach of only trading once a month in a rigorous, systematic way, and avoiding intra-month market timing. This is based on sound, publicly available research, which shows that many of the more popular practices of the investing industry do not serve clients well.

> *In a vain attempt to 'do something' transactions costs are the only winner!*

Using a long run of daily returns on the S&P500 index we have shown (along with co-researchers) that simple rule-driven investing aimed at capturing trends works far better when one looks at signals and trades only once a month! Trading everyday increases trading costs 5 times with no extra return when using simple trend following models.[2]

Why is this and what is the lesson for the MONOGRAM strategy?

We believe that returns often move in exaggerated fashion over short periods, overreacting and mean-reverting on a regular basis, as indeed we saw in the month of February, where in the first few days of the month the S&P fell up to -8.6% (as of 8th Feb.) but then recovered to -3.9% by month end. To try and anticipate such movements on a minute-by-minute, day-by-day basis leads to overtrading and no benefit to investors. This helps explain the poor performance of other trend following strategies as highlighted above.

Investors quite naturally sense that managers should 'be doing something' when markets are volatile, but the research mentioned above also shows that setting fixed maximum stop losses is also a vainglorious activity: quite simply, once again, transaction costs are the only winner!

Hence the MONOGRAM strategy of monthly decision-making and trading underpinned by the natural mean-reversion and serial correlation of asset returns is backed by both solid research and an understanding of the behavioural biases of investors: the month of February 2018, was a shining example of this in practice.

Portfolio Positioning

For the month of March our indicators continue to favour US, Japanese and Emerging Asia Equities, as well as US Investment Grade Bonds, US High Yield and Gold.

[1] Financial Times, 26th February 2018: Volatile month sees S&P 500 fall nearly 4% in February.

[2] Journal of Asset Management, 2012, Breaking into The Black box: Trend Following, Stop Losses, and the Frequency of Trading: the case of the S&P500, Clare, Seaton, Smith, Thomas.

About MONOGRAM

MONOGRAM Capital Management is an investment boutique founded in 2014 and headquartered in London. We take an innovative empirical, evidence-based approach to investing and believe there are fundamental, identifiable, persistent, and exploitable sources of return; risk is the permanent impairment of capital (peak-to-trough drawdown) and not volatility in its various forms.

There are two options for investors to access MONOGRAM's investment strategy. Investors can invest in the Luxembourg Domiciled MONOGRAM Fund or in MONOGRAM's bespoke segregated managed account, provided the investors meet the minimum subscription requirements. Further details are available on request.

For further information on MONOGRAM or to invest, please contact Milena Ivanova on **milena.ivanova@monograminvest.com** or **+44 (0)7931 776206**.

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