

ABR Dynamic Funds – 3Q 2023 Newsletter

What's the difference between trend following and performance chasing?

Introduction

Trend following has worked to the benefit of many investors. Performance chasing has worked to the detriment of many investors. On the surface, both involve buying recent winners and selling recent losers. What has caused the generally differing outcomes?

Trend Following

Trend following is backed by what may reasonably be characterized as a mountain of historical evidence supporting its efficacy. There is in-sample evidence (backtests) and out-sample evidence (performance) across geographies, asset classes, time periods, and market environments in support of a trend-following approach.

At ABR, we adapted trend following to volatility trends and instruments. The ABR 75/25 Volatility Strategy is a systematic volatility trend-following strategy. With its potential to quickly follow trends in volatility, the Strategy has been able to turn large losses into large gains during high volatility crises (e.g., Covid-19 in live data and the GFC in pre-inception hypothetical data) without generally causing a significant drag at most other times.

Rolling 6-Month Returns and Correlations 2006-3Q23 (based on equity and volatility market conditions)

S&P 500 6-Month Performance	Average Correlation	Average 6-Month Return		Observations	
		S&P 500	ABR 75/25	Count	%
Market Up	0.89	9.9%	8.8%	159	76%
Market Down & VIX High < 40	0.96	-6.6%	-7.4%	25	12%
Market Down & VIX High > 40	0.26	-12.8%	10.7%	24	12%

As a result of this behavior, the ABR 75/25 Volatility Strategy has improved diversification and returns over time as a partial replacement of a model core portfolio:

	YTD	1-Year	3-Year	5-Year	10-Year	Since 2006
60/40	7.2%	13.0%	4.0%	6.3%	7.7%	7.0%
ABR 75/25	12.5%	20.4%	1.8%	7.2%	7.7%	13.1%

Performance: 2006 - Sep 2023



	Return	St Dev	Sharpe	Down Dev	Beta	Alpha	Treynor	Sortino	MAR	Max DD
100% 60/40	7.0%	9.7%	0.57	7.5%	1.00	0.000	0.06	0.74	0.21	33%
90% 60/40 + 10% ABR 75/25	7.7%	9.6%	0.64	6.8%	0.99	0.008	0.06	0.91	0.27	29%
80% 60/40 + 20% ABR 75/25	8.3%	9.7%	0.71	6.6%	0.97	0.015	0.07	1.05	0.33	25%

All of the above charts and graphs include pre-inception hypothetical performance before February 2017. See the disclosures for important information.

Performance Chasing

Performance chasing is also backed by evidence, but the evidence suggests a very different conclusion. We've all heard the anecdotes of high performing funds producing negative returns for their average investors over time, due in part to the unfortunate timing decisions of those investors. We've also probably all heard the catchy one-liners about how often performance chasers would have fired even the best performing managers over the years.

Although particular instances of performance chasing are not systematic, there is academic evidence to support the anecdotes and catchy one-liners. The evidence suggests that, in the aggregate, performance chasers hurt their long-term results. For example, in "Behavioral Biases of Mutual Fund Investors,"¹ the authors conclude in part that "investors with strong behavioral biases...time their buys and sells poorly, thereby damaging their portfolio's performance. They also exhibit stronger trend-chasing behavior, suggesting that trend-chasing...is not the result of rationally inferring managerial skill from past performance."

¹ Bailey, Kumar, Ng, (2010), Behavioral Biases of Mutual Fund Investors: Journal of Financial Economics

What Sets Trend-Following Apart from Performance Chasing?

We think there are a number of key characteristics that contribute to the differing outcomes. Of course, this discussion is necessarily general, and not all forms of performance chasing and trend following will exhibit all of these characteristics to the same degree. With that caveat, here are three differences we think are important:

1. Trend following is generally systematic, free of emotion, and based on research.
2. Trend following generally contributes to, instead of detracts from, diversification.
3. Trend following is generally based on shorter measures of trend than performance chasing.

A Closer Look at the Key Differences Between Trend Following and Performance Chasing

1. Systematic Nature of Trend Following

Performance chasing, as a manual human decision, may be susceptible to human emotions and biases – panic in a crash and greed in a bubble, for example. In “Crash Narratives,”² the authors note essentially that volatility in a crash is explained in part by pervasive media narratives. In “Bubbles and Anti-Bubbles,”³ the authors find an extent to which investors no longer behave as though stock valuations are mean reverting in some situations. In “Volatility Clustering in Financial Markets: Empirical Facts and Agent-Based Models,”⁴ the author finds that some of volatility clustering may be explained by investors being shocked out of inertia and into a higher-activity manner of trading.

Simply put, these papers partially point to the idea that changes in investor behavior – especially in more extreme circumstances – may drive some of the irrational buying at the late stages of bull markets and some of the irrational selling in crashes. Conventional trend following, on the other hand, follows the same rules throughout market conditions.

2. Potential Diversification of Trend Following

Performance chasing may reduce diversification. As an example of how it may happen, consider a performance chaser who is evaluating bond exposures in a portfolio during a strong equity bull market. It is not unreasonable to think that a period of strong returns for companies’ equities is also a period of strong returns for companies’ credit risks. In this theoretical scenario, acting on the better recent returns of the higher yield bonds – the bonds with more credit risk – may cause the performance chaser to add additional credit risk to the bond exposures in the portfolio. This activity may make the bond exposures subsequently behave more like the equity exposures and reduce the diversification of the portfolio.

More generally, different types of risk perform better in different market conditions. Therefore, selecting primarily from investments that have exceptional recent performance may mean selecting investments that have more similar risks. In other words, it may mean reducing diversification.

² Goetzmann, Kim, Shiller, Crash Narratives (July 2022). NBER Working Paper No. w30195

³ Tarlie, Sakoulis, Henriksson, (2018) Stock Market Bubbles and Anti-Bubbles

⁴ Cont, (2005). Volatility Clustering in Financial Markets: Empirical Facts and Agent-Based Models. A. Kirman & G. Teyssiere (Eds.), Long Memory in Economics. Springer (2005).

Conventional trend following, on the other hand, generally utilizes risk or exposure limits on both individual positions and types of positions. It also utilizes long and short positions and has had a generally low correlation to typical core portfolios over time.

3. Shorter Measures of Trend in Trend Following

Performance chasing often occurs in response to 6-month to 5-year time periods. The link between fund flows and lagged performance is strong in those time frames. For example, a study using data from Hedge Fund Research found a negative link between flows and performance on a quarterly basis but strong positive links between flows and performance on one- and three-year bases. The mountain of evidence on trend-following (and mean reversion) suggests that these performance-chasing time frames are not at all ideal. In fact, the longer half of that range has generally been better treated as a mean-reversion time frame, with trend-following time frames occurring on a shorter-term basis.

Conventional trend following, again in contrast to performance chasing, typically measures trends in 2- to 9-month periods, often at the shorter end of that range. At ABR, we think trend following in volatility instruments should be even faster. Volatility trends can develop in weeks (e.g., Covid-19, when the VIX Index went from below 20 to above 80 in 3-4 weeks). Although there is no guarantee of profit, the ABR 75/25 Volatility Strategy's model is geared toward these faster trends.

In large part based on these important functional differences and, of course, based on the resultant differences in investor outcomes, we think systematic trend-following strategies have a place in investor portfolios.

To learn more about the ABR 75/25 Volatility Strategy, please reach out to us at info@abrfunds.com.

Disclosures:

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The "ABR 75/25" Volatility Strategy is represented by a blend of 75% of the returns of the ABR Dynamic Blend Equity and Volatility Index Powered by Wilshire (ABRVXX) and 25% of the returns of the ABR Enhanced Short Volatility Index Powered by Wilshire (ABRXIV) respectively (collectively, the "ABR Indexes"). Wilshire® is a service mark of Wilshire Associates Incorporated (Wilshire) and has been licensed for use by ABR Dynamic Funds, LLC. The ABR Indexes are not sponsored, endorsed, sold or promoted by Wilshire, and Wilshire makes no representations or warranties with respect to the ABR Indexes. ABR Dynamic Funds, LLC may receive compensation in connection with licensing the ABR Indexes to third parties. The strategy's calculations and performance utilized month-end rebalances back to the stated blend.

The ABR 75/25 Volatility Strategy includes pre-inception performance and is shown net of hypothetical expenses of 2.00% fixed and 20.00% incentive per year. Actual expenses may vary. ABRVXX was launched 30 Apr 2015, and ABRXIV was launched 31 Jan 2017, such that performance information before those dates constitutes pre-inception (hypothetical) index performance. The performance history of each Index, both pre-inception (or hypothetical) and post-inception, was derived by application of ABR's algorithmic trading models to market data going back to 2006. Hypothetical performance results have certain inherent limitations. Hypothetical trading programs in general are designed with the benefit of hindsight. Investors cannot invest directly in an index.

Hypothetical performance results have certain inherent limitations. Hypothetical trading programs in general are designed with the benefit of hindsight. HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM. ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR TO ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES ARE MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS.

The inception date of the non-U.S. pooled vehicles that utilizes the ABR 75/25 Volatility Strategy was 21 Oct 2021. There also exists a U.S. pooled vehicle which utilizes the Strategy and for which various terms, including expenses, vary. For more information on the live-trading performance of various ABR-advised funds and strategies, or the hypothetical performance presented, please contact us. Past performance does not guarantee future results.

"60/40" is 60% equities plus 40% bonds and functions as the benchmark for calculations. Equities are represented in the above material by the S&P 500 Total Return Index. Bonds are represented by the Bloomberg Barclays US Aggregate Bond Index. 60/40 was reduced pro rata to accommodate the addition of 10% and 20% exposure to the ABR 75/25 Volatility Strategy.

The Strategy may acquire or enter into derivatives instruments and transactions. Derivatives are financial instruments that have a value which depends upon, or is derived from, a reference asset, such as one or more underlying securities, pools of securities, options, futures, indexes, or currencies.

Derivatives may result in investment exposures that are greater than their cost would suggest; in other words, a small investment in a derivative may have a large impact on the Strategies' performance. The successful use of derivatives generally depends on the ability to predict market movements. There may be an imperfect correlation between a derivative and its reference asset. Certain transactions, such as those involving investing in certain derivatives, may give rise to leverage, causing the Strategy to be more volatile than if it had not been leveraged.

Incorporating a dynamic volatility strategy into a portfolio is designed to help an investor potentially mitigate, and potentially benefit from, volatility in the U.S. stock market. However, all investing involves

risk including the possible loss of principal. There can be no assurance such a strategy will achieve a gain or prevent a loss. Volatility assets and strategies may not be suitable for some investors due to their financial circumstances and risk tolerance. A volatility strategy should not be viewed as a complete investment program.

Volatility assets entail their own unique risks that investors should consider when evaluating a volatility strategy. Volatility-based futures can become volatile and difficult to value and can be imperfectly correlated to the underlying asset or index. Due to leverage, the loss on a long futures contract could greatly exceed the initial investment. The loss on a short contract theoretically is unlimited since the appreciation of the shorted asset also theoretically is unlimited. Thus, a small investment in derivatives could have a large potential impact on the performance of a portfolio. Further, a volatility strategy may at times call for high portfolio turnover rates, which increases brokerage costs. High turnover also may generate net short-term capital gains.

Dynamic Funds for a Dynamic Future



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