Sic Transit Gloria Mundi

February 25, 2020

Almost exactly four years ago, there was a cover story about how our liquid alternative funds were outperforming competitors with a simply gorgeous picture (though it had some weird photographic trick in it that seems to show David Kabiller as taller than me).

Today the story is about how managed futures funds are not even beating T-Bills, and AQR's fund is particularly lackluster.[1]

Well, if you don't like my Latin title, you can also read Kipling's advice:

"If you can meet with Triumph and Disaster

And treat those two impostors just the same"

We try to do this. Though it's hard. Really hard. We preach, in good times and bad, about acting as a mild contrarian at longer than, say, a 12-month time horizon (#3 in the link above). We evangelize in good times and bad about how individual investment factors like trend following or value-based stock selection have tremendous (to us overwhelming) evidence and economic reasonableness on their side. But done at a scale big enough to matter, they yield only modest Sharpe ratios.[2] This means an investor will occasionally have to weather long periods of pain to get the even longer-term benefits.[3] Further, we sermonize in good times and bad that even things you're quite convinced are long-term edges (such as better implementation of such factors) are themselves low Sharpe processes, and should be judged on their economic reasonableness and as much evidence (time, asset classes, geographies, backtests and live results, etc.) as possible, as real life results are sadly almost always too short for the task.[4]

But, this is the business we have chosen. We know that assets follow performance, and while advocating for (mildly) the opposite,[5] we have net benefitted from this over the long term. We have been over-lauded by the financial media in the far more prevalent good times and over-dissed in the rarer, but still, annoyingly, excruciatingly inevitable (if unpredictable) bad times. We are not indifferent between the two! Computer monitors and office supplies of all kinds within my reach would testify to this if they could talk[6] (though truth be told, the computer monitor stories are true but certainly exaggerated as all stories seem to become over time). But caring desperately should not lead to acting foolishly. We think much of long-term investment success is still about sticking with real but modest edges for the long term.[7,8]

OK, I think you get the point, and I'm almost done. Though I must take a moment to pause and discuss the last paragraph in the recent (much less fun for us) *Barron's* piece.[9]

> "When markets get rockier, investors might want to check these funds out. But with high fees and generally weak returns, managed-futures funds look like a diversifier that investors can do without as the bull keeps galloping."

Do you know what Andrew just described as to how he'd decide when to return to managed futures and presumably lighten up on the stock market? It's called TREND FOLLOWING!!![10] That is, he'd wait to see the rotation start. Now, I have to ask – is it really as easy as the above paragraph seems to imply? What if the stock market starts to dip and trend following starts to gain traction, and then it all reverses and you get whipsawed?[11] Do you keep following Andrew's advice again and again? What if the stock market hits a plateau for a while, then crashes with trend following doing ok? Did you get some money out and into trend following, or was plateauing not enough to make your move? You see, the game is much harder to play real time! But I will take Andrew's implicit endorsement of trend following as a wonderful conclusion to his article .[12]

So find an edge, hopefully many (small ones usually). Use good risk-control[13] and discipline.[14] Keep an open mind that things may have changed but not so open that your brains (and the money in your wallet) fall out.[15] And definitely don't believe your own press, be it fawning or damning. Treat those two imposters the same.

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[1] And, as you can find throughout these blogs and in many other AQR publications and presentations, it's far from just managed futures that's been a problem these last few years. But it's not all a tale of woe. My colleagues have just written a great (IMHO) paper on low-risk investing, something we helped pioneer (or resuscitate as Fischer Black was ahead of all of us) and that has been the clear winning factor for a long time. I hope to blog about their paper soon.

[2] Everyone wants to invest in the Medallion Fund, but nobody wants to be kicked out of it forever! Giant Sharpe ratios are an amazing achievement. But if not doable at large scale and open to clients at a reasonable fee, they are also irrelevant.

[3] Yeah, like you, if I hear myself say "long-term" one more time I'm going to scream. But, of course, that's why it's so hard to be long-term. ARGHH!!!!

[4] For example, things in market-neutral equity, such as keeping a relatively constant volatility, targeting a zero conditional beta, adjusting valuation measures for industry differences and diversifying away from book-to-market as the sole value measure, are all improvements we believe in for the long term, but they are all things that have hurt recently. While painful, this changes our belief nary an iota. Similarly, in managed futures, focusing only on fixed income, where the trend has been mostly one-way for a long time, would've been a far better strategy in the last few years than diversifying across asset classes. However, we believe such a concentrated strategy is clearly not the better long-term alternative. Related but distinct, risk-control where you will only allow so much exposure to any one asset class is, in our view, the right long-term decision (especially in equities, as investors are already overexposed to long equity exposure) but has hurt over the last few years. Again, we feel the pain (boy do we), but it changes our view the same nary amount.

[5] That is, more contrarian and less trend following at medium- to long-horizons. In fact, we've coined (or tried to coin) a term for the opposite. We call it "trend following at a value time horizon." Both trend following and contrarian/value strategies can (and we believe do) work long term. But they operate at very different time scales. Sadly, much of the investment universe, including managers, investors, and the media, often push the worst combination (trend following at a value time horizon!).

[6] I hereby release all broken computer monitors from their previously signed non-disclosure agreements.

[7] While, of course, still always being open minded about and putting energy into the idea that things might have changed or can simply be improved. See about 1000 recent AQR publications and presentations for more about this lately.

[8] As my colleagues pointed out, again written in very good times for us, much of Warren Buffett's edge has not been about never losing or about possessing a 2+ Sharpe ratio (he doesn't), but rather sticking with something good, in his case aggressively, for his preferred time horizon of forever.

[9] Andrew Bary, the article's author, is an excellent financial journalist, but I can't let a paragraph like this go without comment! Please note, he also wrote the very nice (too nice? – remember your Kipling!) article on us four years ago. Just like a lot of musicians, I have to say that I prefer his earlier work!

[10] By the way, much of the innovation in these funds' origination was not competing with index fund pricing but still charging far, far lower fees than the managed futures industry did generally.

[11] My colleagues have written a great paper (with a title I wish I came up with) on how, while there is tremendous evidence that trend following works over time (and asset classes, and geographies, you know the list by now!), it is not a simple thing to say whether or why it works over any specific time period. Importantly, they find that the difficulties of trend of late have not come about as trends have been somehow harder to capture in recent times. But, rather, when examined in a disciplined way, because across many many securities there have simply been fewer large trends than usual. That's less obvious than you might think. If trends were actually strong in recent years but somehow oddly uncapturable now versus in the past, it would indeed be a candidate for that rare distinction "the world has changed and perhaps this no longer works." Once more, real life is more complicated than the simplistic "sure, I would not recommend it now, but once it's clear that trend following is working again, and long-only markets aren't, I'd pounce."

[12] And he seems to agree with our belief that managed futures has tended to do quite well in equity drawdowns (see here). He just thinks they're far easier to time than we do.

[13] While Kipling's poem is excellent advice about how you should treat medium-term results, it's considerably worse on risk-control. We do not recommend this part: "If you can make one heap of all your winnings / And risk it on one turn of pitch-and-toss, / And lose, and start again at your beginnings / And never breathe a word about your loss…." In fact, I'd be particularly bad at "never breathing a word" about losses!

[14] Again, we think good risk-control has hurt our managed futures in recent years, in absolute and relative terms, as we'll only take so much one-way equity risk or bond risk, and those have been the risks to take. That doesn't make us lighten up on our risk-control going forward!

[15] This is the tendency we all must fight as "the world has changed" type explanations for tough performance are especially seductive in bad times. In these times, the "explanations" we come up with are often the ones we make fun of in future years (a favorite from the tech bubble was to replace book-value with hits-to-your-website in measuring valuation).