Brexit & CTA’s: Machines – or Back to Humans?

Stockholm (HedgeNordic) – As HedgeNordic has reported, CTAs have emerged as the best-performing hedge fund strategy following the Brexit vote, while others, such as equity hedge funds, have suffered. Now, the Wall Street Journal is reporting the emergence of an increasingly clear demarcation between “human” and “machine” analysis in light of the results and the market fluctuations and hedges made leading up to the vote. These developments come on the heels of a steadily increasing interest in CTAs over the past few years.

In essence, many investors wound up betting on the result they wanted politically, not necessarily the one they expected, and not the one “cold-hearted” machine analysis, such as that employed by CTAs, apparently would have yielded. What this will this mean considering that the market tumult is likely to continue is as yet unclear, though the popularity of CTAs is likely to continue increasing. Brexit-related events will continue unfolding for the next several years, perpetuating uncertainty over a possible Scotland referendum and concerning the terms of Brexit and the types of trade arrangements negotiated between the U.K. and EU. There are also several major macro events in the near future, such as the U.S. elections. Brexit has shown that what seemed rationally impossible may no longer be so under the circumstances many voters perceive themselves to be in.

Brexit was, to put it mildly, a surprise. Public polling until early June and the week immediately prior to the vote June 23rd had led the majority of politicians and storied investors like George Soros to prognosticate a vote for Remain. Financial leaders and banking elites had remained more muted on the issue for fear of populist backlash, but were equally understood to have expected that outcome, with the British pound rallying accordingly. The underlying rationale had been that the potential economic devastation Brexit was likely to wreak both globally and on the U.K. would suffice to throw a cold shower on nationalist and other political imperatives subtending the Brexiteers’ drive to leave the European Union.

Rational they may have been, but establishmentarians and seasoned investors alike underestimated the sentiments of the (bare; subjected to conflicting pressures) majority. Personal sentiments on either side of the debate were not considered by hedge fund CTAs, however, which use customized trading algorithms that spot market trends and place bets on futures and other derivatives. Many of these models did not compute election polls, bookie odds or political prognostication that may have convinced investors intellectually that a vote to Remain was the greater likelihood. It follows that CTA models can tune out noise like election or crucial economic data around market moving events that are important to investors, but which can be next-to-impossible to forecast accurately. “”Our models aren’t going to be affected by the same sentiments a human would be,” according to Ms Lara Magnusen, portfolio strategist for Altegris, whose fund was among the Brexit winners.

As HedgeNordic reports, the BarclayHedge CTA Index, an industry benchmark aggregating returns for the largest CTAs in the world, gained an estimated 1.6% on June 24th and added another 0.69% on June 27th, bringing month-to-date numbers to +0.99%. In the weeks leading up to the Brexit vote, says the WSJ, trading models at hedge funds with CTA strategies, which constitute around 15% of all hedge funds, according to Agecroft Partners, “adopted a defensive pose… favouring high-quality government bonds, gold and safer currencies like the yen, while mostly avoiding risker bets like oil and emerging markets.”

This proved fruitful after Brexit caused the pound to crash and more volatile assets such as equities to plunge as the results became apparent. The Société Générale CTA index gained 1.5% the following day. CTAs like Capital Management LLC, Fort and Welton Investment Partners LLC were among big the gainers, the WSJ reported, even as the HFRX Global Hedge Fund Index was down 1.1% on June 24th. HedgeNordic reported that among Nordic managers, Lynx was up 5.1%, SEB Asset Selection was up 1.3%, while RPM Evolving CTA Fund was up 5.9% and RPM Galaxy C was up 6.4%, with each making further gains early the following week.

As also recently reported by HedgeNordic, a recent survey from Preqin suggests CTAs have been experiencing notable increases in their active investors and inflows numbers in the first part of 2016. The boom is ascribed to CTAs meeting expectations for the first two quarters of 2016, and a steady increase of active investors from 2014 onwards and inflows over four quarters since the beginning of 2015, with net asset flows of USD38b in new investor capital. Total AUM for CTAs stood at USD241b at the end of Q1 2016, putting combined CTA assets above those held by credit strategies funds. CTAs had therefore seen the highest level of inflows across all leading hedge strategies in 2016 even before the Brexit vote.

It may be tempting to correlate this investor increase in CTA popularity with a corresponding increase in market uncertainty regarding macro events more broadly. As Brexit has demonstrated, voter anger with national institutions in the face of a globalization and market forces increasingly perceived to work against the broader middle classes can lead to events previously considered by the broad political and financial establishments to be taboo. As Anne Applebaum, a political columnist has suggested, Brexit itself may be the first pillar of the entire edifice of the Western liberal-industrial-military complex to fall, were it to be followed by a Trump election this year and a "Frexit" led by Marine Le Pen the next. Such apocalyptic visions have, regrettably, taken one step closer to reality.

As for Brexit itself, speculation is rife, with the Leave side in apparent disarray as to how it will implement its policies, a number of Brexit supporters regretting their vote on behalf of future generations, and suggestions there may be a way around even implementing it. It seems almost as certain that CTAs, with their models unaffected by human temperament, will continue to improve on their performance under such conditions in the near future given their recent track record, as it is certain that human judgment will always remain fallible.