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David Harding – Update on Research and Investment

The whole focus of our research and investment management group is on developing confidential strategies proprietary to Winton.

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10 MINUTE READ

David Harding, Winton's Founder, CEO and Co-CIO, shares his thoughts on the evolution of Winton's investment strategy, the direction of the firm's research and investor transparency.

2019 in Review

The last 12 months have amounted to a rather unremarkable (and somewhat wearing) year for Winton investors, with a lot of heat and noise but little forward progress. By contrast, and rather surprisingly, it has been a banner year for stocks, with most markets making further substantial gains on top of the 10-year bull market already recorded. Commentators may say that we “underperformed” the market, but that is a misunderstanding, as there should be no expectation of our strategy correlating with it. That doesn’t mean we expect to go down when the market is up; that would be anti-correlation, and we expect that no more than we expect automatically to perform well in a bear market for equities.

Indeed, it was partly our unwillingness to take on the burden of being “portfolio insurance” that led us in February 2018 to dramatise our departure from being characterised as either a CTA or a trend follower. Both terms have become synonymous with portfolio insurance, crisis risk offset or tail-risk hedging, and involve a whole industry following a pre-programmed selling strategy in a bear market, irrespective of the speed of the decline. This would be no problem in a long, slow bear market, but in the event of a sudden drop it could easily exacerbate short-term dislocations with destabilising consequences such as those that occurred in 1987. We do not wish to take the risk of playing a leading role in such events, and for this reason, as well as the evidence we have found for crowding in the strategy, we accelerated our long-standing movement away from too heavy a reliance on trend following.

other hand, we continue to offer pure trend following funds to those who are quite explicit about what they want.

Slightly ironically, in addition to it having been a great year for stocks, it has been a pretty good one for trend following and the strategy has contributed positively to our performance. However, one year of data is insufficient to change our long-run expectation of trend following performance. Over the last 10 years, the Sharpe ratio of trend following on futures has been around 0.5, and much of this return has come from quantitative easing driving bond and equity prices even higher. Our expectations for trend following returns are derived from the last 50 years of economic history; they were not etched in stone on a tablet brought down from a mountain by Moses! The future of the strategy is very unpredictable, but there is no law or imperative that says its Sharpe ratio should revert to its 1980-2010 level.

Research Agenda in Focus

Winton, like AHL, was founded on the belief that research into financial time series could give rise to investment strategies with better than even statistical chances of success. This belief was directly contrary to the prevailing wisdom of the time, which held that securities markets already took account of all the information relevant to their prices, and that statistical research approaches into the history of those prices could not thus provide a meaningful investment advantage.

To some, among whom I would include myself, the prevailing wisdom always appeared faulty for its failure to recognise that market prices cannot take account of information that research is yet to uncover. Ruling out certain research avenues on *a priori* grounds does not seem compatible with a scientific and reason-based frame of mind. Indeed, the proliferation of computing power in the last 50 years has made it possible to research many traditional ideas about investment through modelling, backtesting and simulation.

Backing strategies such as trend following for which there was strong, if not conclusive, statistical evidence, proved to be a good business idea. The success of trend following led both AHL and subsequently Winton to thrive. This gave us the resources to grow our research and technology teams and embark upon a wide variety of further research projects. Over the years, we expanded our efforts to study a range of time series data with potential forecasting power, of both a fundamental and technical nature.

Although never simple, we and others were in time able to develop a multitude of other quantitative, systematic trading strategies. In more recent times, some of these became well known and were lumped together in newly invented investment categories like “smart beta”, or “alternative risk premia” – terms intended to suggest risk exposures to factors other than the market’s returns.

Less well-known trading strategies do not qualify as smart beta but as alpha. Many of the most successful hedge funds in the world are quantitative, systematic funds, employing a multitude of alpha-type systematic strategies. The difference with Winton is that those with the highest Sharpe ratios all without being likely to attain extremely high Sharpe ratios.

The consistent mantra behind Winton's investment approach has been one emphasising the combination of many strategies, none very good in itself, but in aggregate producing a superior track record. The inspiration behind this has been the success of a portfolio of modest Sharpe ratio slow trend following systems, the collective performance of which was sufficiently impressive for it to have become by now an established part of investment wisdom.

We know that some of our strategies are not unique or necessarily uncrowded. Some that we have developed over the years have already been copied from us by competitors; the research behind others has been inspired by strategies in turn run by our competitors. Yet there are still others we believe to be proprietary to Winton, having been derived from our own research and kept confidential. Our whole research focus is on developing more such strategies.

To produce really superior results, you need to be at the front of this secretive field. With shorter term strategies it is easier to adduce whether one is being successful, while with longer term ones it is harder to tell. A lower Sharpe ratio means that the return in any time window is inherently more uncertain, and that makes it, in a sense, harder to know what the true Sharpe ratio is. Nevertheless, there are stepping-stones along the way, other than measured Sharpe ratio, that can give one more or less confidence that one is making progress. A new computational method, cleaner data, new data, discovery of past errors, a new mathematical result – all these things point to progress without resulting in an immediate improvement in realised returns. By the same token, a more responsive research organisation, better teamwork, and more constructive intellectual engagement are also factors that you would expect to associate with progress.

By these standards, Winton's condition today is a healthy one. Our research and investment management group, which I lead with Jonathan Duke, my co-Chief Investment Officer, is tighter and better coordinated following the centralisation of researchers at our London headquarters over the last 18 months. Our research agenda is narrower but more focused, as senior researchers have gradually been aligned more directly with specific strategies. (This alignment has made these individuals more accountable for each strategy's relevant research, that strategy's integration into the investment system and its ongoing management.) And we are continuing to hire this year after 2019 saw the recruitment of several senior researchers.

To expand the range of our strategies yet further, we have created a new unit called the Portfolio Manager Platform to broaden the scope of our recruitment. The Portfolio Manager Platform offers individuals with their own trading strategies – complementary to Winton's and still systematic in nature – a share of the performance fees they generate, in a structure similar to those some other firms employ.

Oversight for the platform initiative rests with Carsten Schmitz, a longstanding member of our senior research and investment team. Carsten will make recommendations on strategy allocations to the Investment Board, and we intend to begin making allocations by the end of March. The first to gain exposure to the portfolio managers' strategies will be clients of the multi-strategy funds, with access provided via a new trading vehicle.

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aggregating up many lower Sharpe ratio investment strategies into one aggregate higher Sharpe ratio investment strategy.

It will, however, be Winton's core research division that will remain for the foreseeable future by far the most important determinant of our strategies' performance. This is a substantial group consisting of around 80 people, supported by a 50-strong technology division. Its culture, characterised by statistical and methodological excellence and intellectual integrity, has been developed over two decades. Our recent effort to centralise this group in London has given me a closer handle on our research projects and greater confidence that the resources they receive are being well spent.

Winton's Intellectual Capital

Over time, Winton has sought to meet increasing investor demands for transparency, consistent with our responsibility to you as investors. The modest Sharpe ratio nature of the individual components that make up our overall investment strategy has previously made it possible to strike this balance fairly successfully, since they are more difficult than many others to copy or front run. Nevertheless, some of our intellectual property has undoubtedly leaked out.

We therefore think that this is a good time to remind investors of the level of disclosure to be expected from Winton, particularly where it concerns the detailed operation of our strategies and the explanatory variables they employ.

We do of course recognise that investors want to probe all aspects of our strategy as much as possible as part of their due diligence. We also recognise our obligation to make available all the risk statistics and information necessary for investors to gain an understanding of their market exposures through Winton to multiple risk factors.

After considered reflection, however, we feel that it is in our investors' long-term interest for us to resist engagement in detailed discussion of the nature and behaviour of our explanatory variables and trading systems. This applies equally to questions about our trading systems' response to evolving or potential developments in the markets. This will be something of a challenge: investors and their agents often feel an understandable obligation to try to interrogate how our system will behave in various hypothetical scenarios, in order to understand how to incorporate our products into their overall portfolios. But since our investment strategy is based on probability and statistics, we have always been uncomfortable with trying to relate its performance to potential future scenarios (hence our resistance to the crisis risk characterisation).

Indeed, we do not design our strategy to profit only in specific circumstances such as a broader market decline. Instead, our overall aim is to produce a positive return over time at an acceptable level of risk. To do this, we build large and diverse portfolios of assets, which gradually and continuously adjust their exposures in response to macro- and micro-economic input data. We aim to base the adjustment process as much as possible on statistical evidence of repeatable phenomena and do not take into account narratives embodying social and economic theory or current events.

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themselves to being purchased with a particular world view in prospect. We believe the main consideration that should be relevant to investors is the intellectual capital of Winton in this specialist discipline: mathematical and statistical modelling and forecasting of investment strategies and portfolios.

Wishing you a prosperous 2020,

David W. Harding

Winton Group Founder, CEO and Co-CIO