

Multi-Asset Insights

Q2 2024

For professional investors only

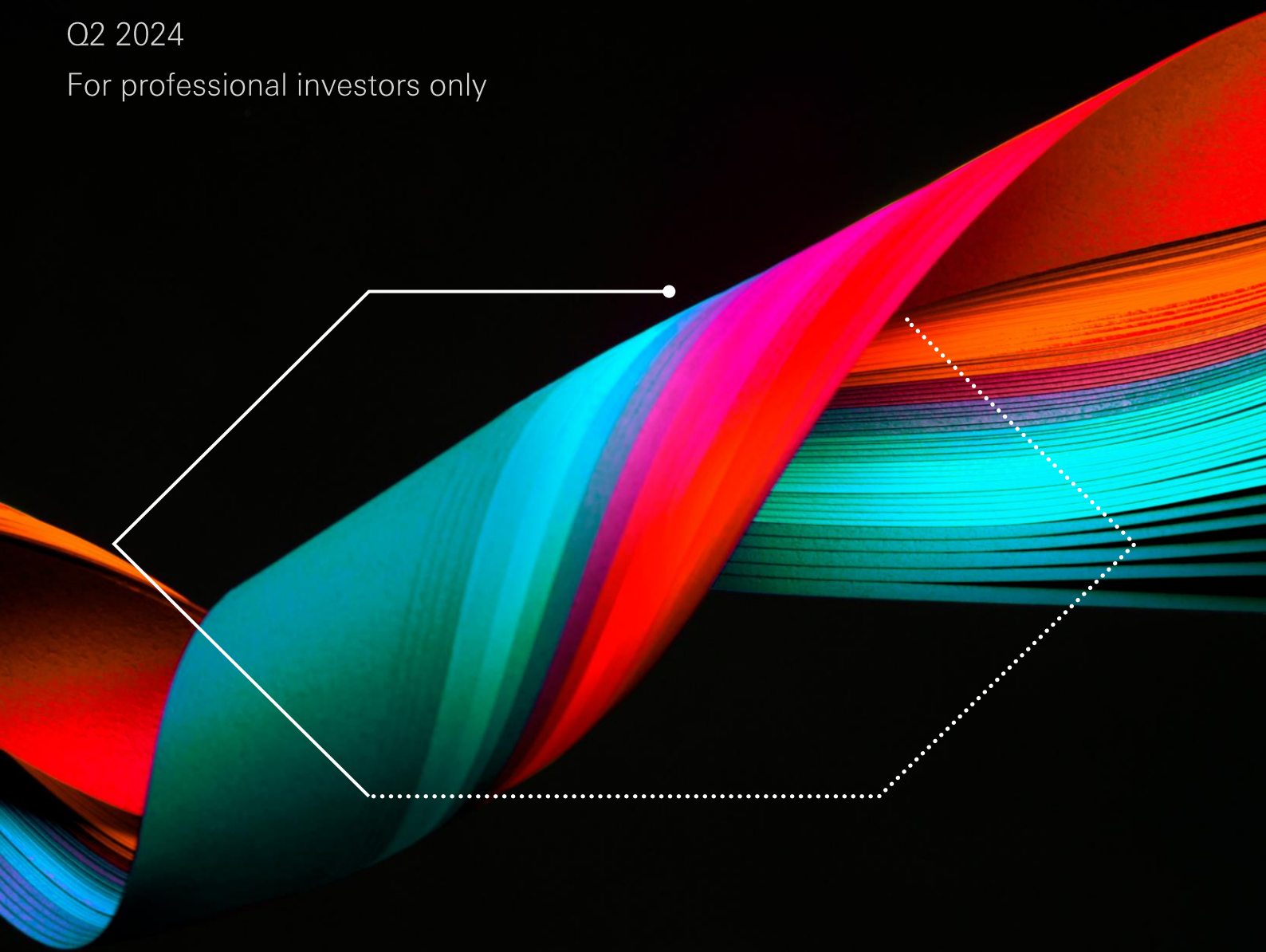


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Foreword



Investors have been able to breathe a sigh of relief at positive macro trends overshadowing risks that remain. We think addressing idiosyncratic risks in portfolios will be particularly important to protect and deliver returns ahead.

Welcome to the latest edition of our Multi-Asset Insights series, where we present the findings of our quarterly Strategic Forum.

We publish this edition following a period of relatively strong performance in markets. However, much uncertainty remains in the outlook for major economies. While progress on inflation has continued, the lagged effect of restrictive monetary policy remains a concern to growth levels to be achieved ahead. The soft landing being priced by markets is certainly not guaranteed. Accordingly, any bad economic news presents outsized risks to current asset pricing. This is why we think that protecting against risks should move up the priority ladder, but in a manner that does not preclude growth opportunities.

In this vein, we take a look at the role of trend following strategies in portfolios. Under a new regime where reliance on negative stock/bond correlations cannot be given the same confidence it was in the 2010s, supplemental means of diversification such as trend following strategies present interesting characteristics. Most recently, they have proven their usefulness in times of crisis, while also delivering solid returns in strong markets. However, the appropriate design and application of signals to effectively capture trends is paramount to achieving the desired objectives.

Separately, we analyse concentration in US stock markets. Following the strong run by US megacaps, market cap-weighted indices increasingly lack the diversification asset allocators desire. We explore the risks to portfolios, such as potential for larger drawdowns, and evaluate whether alternative approaches to US equity exposure can be beneficial, either now or in the periods ahead.

I trust you will find our analysis and takeaways interesting and a useful resource.



Jean Charles Bertrand
Global CIO, Multi-Asset
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In a nutshell

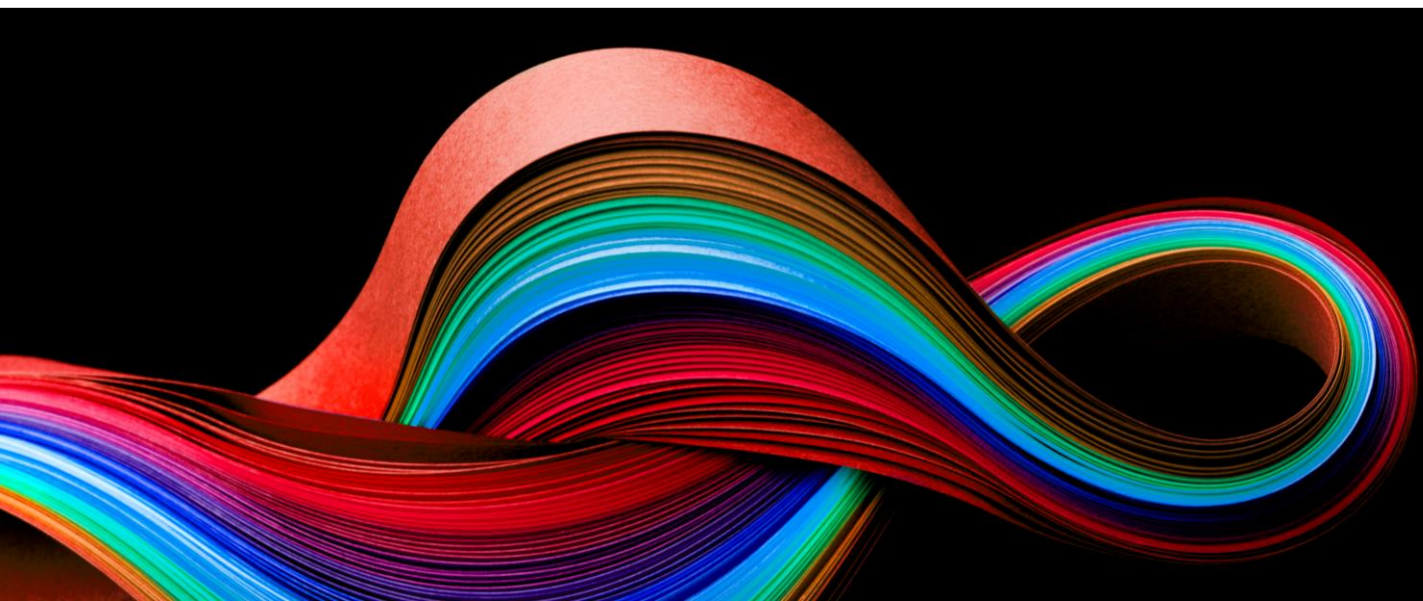
Should US equity market concentration be a concern?

- ◆ As measured by the Herfindahl-Hirschmann Index, the US is currently an outlier in terms of equity market concentration, both relative to other core markets and its own history.
- ◆ Concentration in the US is especially impactful given its dominant role in equity markets - now accounting for over 40% of global market capitalisation.
- ◆ The concentration of the US Equity market, coupled with high correlations of the top names within it, has led to an increase in idiosyncratic risks in market cap weighted indices.
- ◆ There may be opportunities ahead to tilt US equity exposures towards certain factors, which should be assessed against the macro and market backdrop.

Trend following may be back in fashion

- ◆ Trend following has become an investment strategy that has historically achieved strong performance in both up and down markets, while exhibiting low correlation to traditional assets on average.
- ◆ Double digit returns in 2022 and positive performance amidst the current bull market are affirming its usefulness, particularly amidst an environment where positive stock/bond correlations have posed challenges to portfolio diversification.
- ◆ At its heart, the idea behind trend following strategies is simple and relies on algorithmic rules that are usually determined ex post and can be easily coded. However, the devil is in the details and many parameters come into play.
- ◆ There is a particular need for a strong focus on balancing reactivity and unnecessary turnover or 'market noise'.

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Should US equity market concentration be a concern?



The top ten names in the US equity market have a cumulative market cap larger than the combined stock markets of Japan, Germany, France and the UK. Such concentration raises challenges related to diversification and drawdown risks.

Lately, market concentration has been a hot topic of discussion in equity markets. While much of the emphasis has been on the gargantuan scale of US megacap market capitalisations, concentration in European equity markets is significantly higher when measured purely by the proportion of market capitalisation in the ten biggest stocks. However, by other, more relevant measures which we will discuss, European equity markets offer better diversification than the US.

Concentration in the US is especially impactful given its dominant role in equity markets - now accounting for over 40% of global market capitalisation. Such a high proportion of global market cap has not been reached since the mid-1970s and the notorious late 1990s dot-com bubble. By contrast, the US economy only accounts for 20% of global GDP, which is much lower than the proportion in the 1970s.

Of course, globalisation means that today's economy is very different to that of the 1970s, with much of the operations and revenue for US megacap stocks derived outside of the US. Country GDP contributions from the manufacturing and sale of Apple's iPhones, for instance, would present an interesting global hodgepodge.

Nonetheless, even sticking to comparisons against strictly US stock market history paints a similar picture. Currently, the top ten names in the S&P 500 account for nearly a third of the index, which is the most concentrated it has been since the 1970s.

Many factors have driven us to this point. The aforementioned economic shifts of globalisation enabled the large tech companies to shed costs and acquire a global consumer base. Separately, sluggish domestic GDP growth and low rates have contributed to the appeal of the growth and free cash flow generation of the megacaps.

However, higher interest rates today could provide a reason for their valuation premium to narrow, but there appears to be scepticism that the macro environment is indeed changing from the low interest rate policies of the past decade.



Lane Prenevost

Global Head of Discretionary Asset Management and head of UK Multi-Asset



Ryan McGARRY

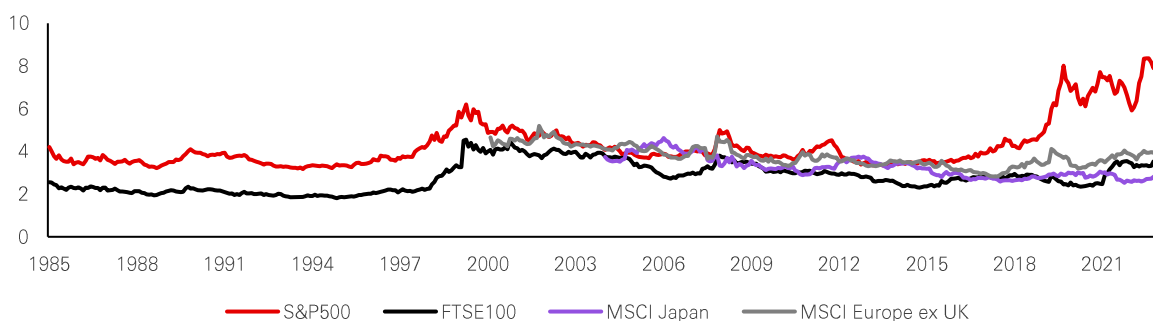
Investment Analyst, UK Multi-Asset

US exceptionalism

A relevant measure used to calculate market concentration is the Herfindahl-Hirschmann Index (HHI). The HHI is the sum of the square of individual market share, which can be applied to index weights to gauge the concentration of a market index. However, the number of constituents in an index differs across the core markets – e.g. S&P500 vs FTSE100 – and can also differ over time. To adjust for this, we divide the HHI by the HHI of an equally weighted index, which adjusts it for the number of constituents and makes it more comparable across markets and time.

By doing so, we see that the US is currently an outlier in terms of equity market concentration, both relative to other core markets and its own history.

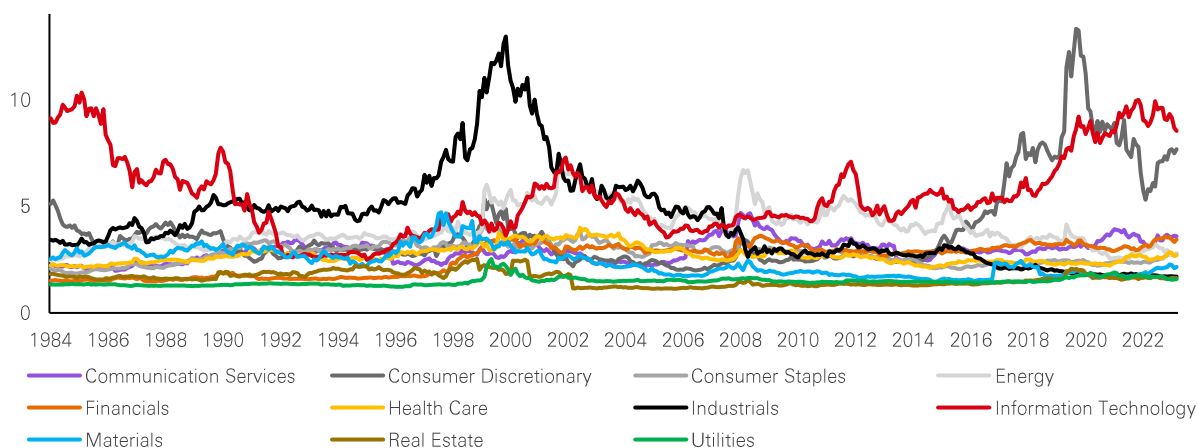
Figure 1: Adjusted HHI by Market Index



Past performance is no guarantee of future returns. Source: HSBC AM, Bloomberg, February 2024.

From a sector perspective, again, the US is an outlier. Technology is dominating S&P 500 sector exposures, while other major markets such as Europe and Japan continue to provide more balanced and diversified exposures. Below, we observe that elevated US concentration levels tend to not be persistent. For example, industrials peaked around the turn of the century, with General Electric being 45% of a sector in which concentration has been divided by seven since.

Figure 2: S&P 500 Sector Adjusted Herfindahl-Hirschman Index

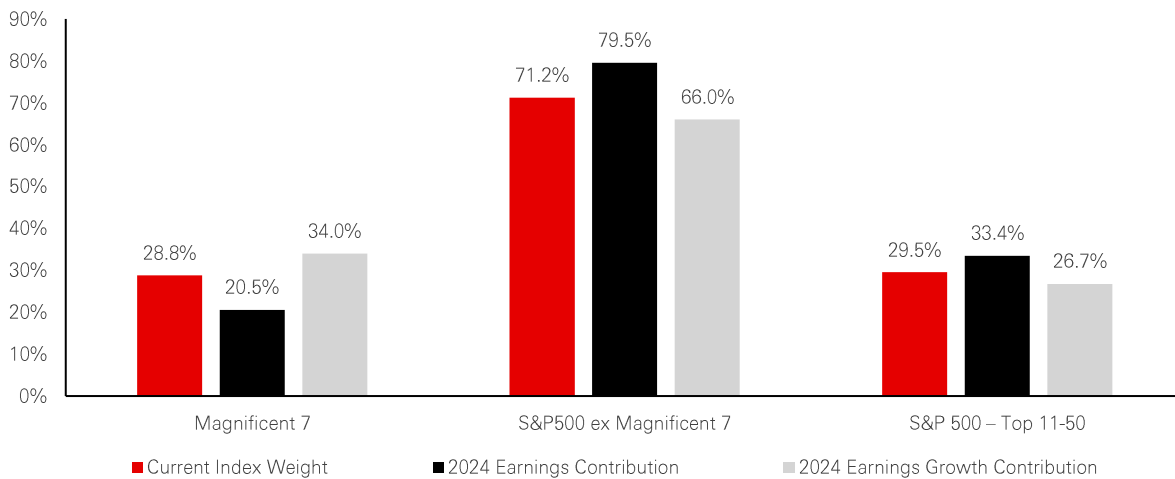


Past performance is no guarantee of future returns. Source: HSBC AM, Bloomberg, February 2024.

Today, consumer discretionary follows information technology as the most concentrated sector. Of course, tech is where most of the Magnificent 7 lies, with only Google and Meta not being in these sectors – instead sitting in communication services. The Magnificent 7's weight in the S&P 500 has grown massively over the past few years, representing 28% of the index at the end of last year, nearly double the roughly 15% at the end of 2018. Microsoft alone now has a weight of 7%.

While the comparison between the current environment and the Dot Com bubble seems inevitable, there is a key distinction that makes the current situation different. The Magnificent 7 are more mature companies that are already backed by solid earnings, so are not just a punt on what the future of technology can deliver. According to IBES forecasts, they are expected to contribute to over 20% of earnings this year, and over a third of overall earnings growth for the index.

Figure 3: 2024 earnings breakdown



Past performance is no guarantee of future returns. Source: JP Morgan Research, Bloomberg, HSBC AM, February 2024.
 *Earnings refers to net income, where growth is calculated as the difference between 2023 actuals and 2024 IBES estimates

In addition to their already solid earnings, the revenue growth potential of the Magnificent 7 from advances in generative AI will play a key role in their forward path.

Another structural factor that is driving more momentum into these stocks is the growth of passive management. Passive strategies have continued to grow while active funds have been experiencing outflows for an extended time. This can contribute to share price appreciation and generate more hype around these stocks, which causes a headache for active managers that are underweight the stocks or hedge funds that are short and may need to close these positions due to stop losses – which generates more share price appreciation.

Implications for portfolio construction

Magnificent 7 stock returns have been positively correlated to the performance of global government bonds since 2020, which has wide-ranging consequences for portfolio construction. These stocks are also highly correlated to each other as they share common risk factors, such as being almost uniformly sensitive to the path of interest rates.

This has important implications, as looking forward, some of the factors that supported the rise of the Magnificent 7, such as globalisation and ultra-low interest rates, are under threat. Additional risks extend to the US stock market and economy. Concentrated equity markets dominated by a small number of very successful firms are associated with less efficient capital allocation, sluggish initial public offering and innovation activity, and slower economic growth¹. Furthermore, risks from anti-trust regulatory action, disruptive competition, de-globalization, and geopolitics are heightened for the largest stocks, and these risks are passed on to the market as a whole due to the elevated concentration.

1 - Bae, K.-H., Bailey, W., & Kang, J. (2021)

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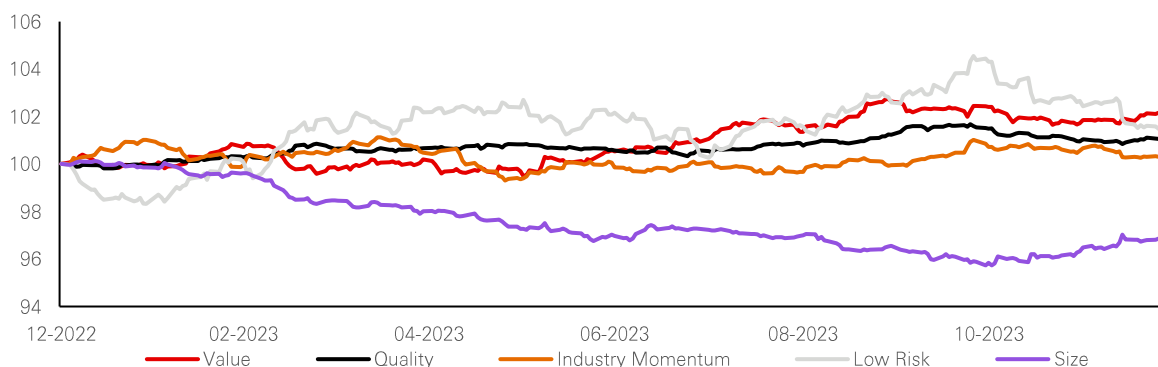
Inevitably, the outperformance of mega-cap tech has led to a sharp narrowing in equity market breadth, reducing diversification potential. The concentration of the US Equity market, coupled with high correlations of the top names within it, has led to an increase in idiosyncratic risks in market cap weighted indices. Implications extend to a balanced portfolio. Our analysis, using a standard 60/40 portfolio, identified higher volatility, a lower Sharpe ratio and deeper drawdowns in prior periods of elevated market concentrations historically.

There may be opportunities to tilt portfolios towards certain factors going forward, which should be assessed against the macro and market backdrop. For example, short-term factor tilts via an equal-weighted index could bring value. Market studies show that an equal weighted equity portfolio outperforms a market cap weighted over the long term². However, in the short-term, the equal weighted portfolio can suffer significant under performance, as has been the case in recent years. These periods have, primarily, either coincided with higher levels of concentration in the cap weighted portfolio and/or lower benefits of diversification due to lower average volatilities and higher correlations among stocks.

Research from Pandey and Sharma (2022) shows us that out of the equity market indices analysed (BRICS and US), equal-weighted indices return a lower Sharpe ratio than both high and low concentrated indices – apart from the NIFTY 100 index. With this in mind, concentration alone shouldn't lead us to adjust strategic asset allocations. Using market capitalisation remains to be the most efficient way to access the equity risk premium in the absence of an active view.

In addition, the current macro environment doesn't support a switch to equal weighted exposures today, as it would effectively introduce a 'size' factor bias towards small caps. This may not be beneficial at this late stage of the economic cycle, given that small-caps tend to outperform when real interest rates drop substantially or after the recession ends. Moreover, mega-cap tech stocks, which historically benefited from falling yields due to the long duration of their cash flows, have also outperformed in the high interest rate environment of the last two years on the back of their strong balance sheets and elevated margins.

Figure 4: Global factor cumulative returns – having an equal-weighted exposure removes concentration but has a size factor bias which has underperformed of late



Past performance is no guarantee of future returns. Source: HSBC AM, Bloomberg, February 2024.

Investors can't ignore the risks associated with current market concentration and the reduced diversification it implies in an asset allocation. However, we think it is a bit too early to consider short-term factor tilts via an equal-weighted index given the current macro and market backdrop. Considering active management within US equity exposures offers another potential consideration, but the environment remains one in which active managers have struggled to outperform. Being prepared for an eventual shift in the market regime that supports a slant towards small caps, or active management amidst more dispersion, appears the most prudent approach today.

2 - (Malladi and Fabozzi 2017, Bolognesi et al. 2013, Plyakha et al. 2012)

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Trend following may be back in fashion



There are many arguments in favour of leveraging trend following strategies as 'new diversifiers' within multi-asset portfolios, but signal design is important to effectively capture shifting trends.

Trend following strategies are based on the phenomenon that sees securities that have performed positively (resp. negatively) over a certain look-back horizon continue on the same positive (resp. negative) path. This market anomaly is well evidenced by academic research and practitioners since at least the 1970s. It has become an investment strategy that has historically achieved strong performance in both up and down markets, while exhibiting low correlation to traditional assets on average.

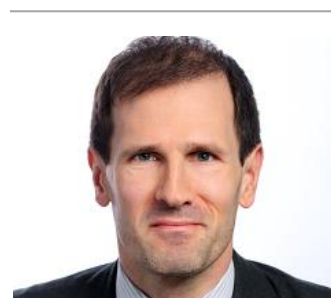
After a muted 2023, trend following strategies are back in 2024, as they turned long on equities and are benefiting from the extended global rally. While performance of trend following strategies has been volatile since 2020, they had a strong double digit run in 2022 when equities and fixed income were down ~20%.

This is clearly attributable to the nature of trend following strategies, which are essentially buying assets that are rising and selling assets that are declining. While the possibility of being short bonds or equities did not help during the golden decade of traditional equity/bond allocations, 2022 showed it could be a very helpful strategy in times of uncertainty. The last 6 months are showing the other side of the coin – it can also deliver during strong uptrends in markets. A systematic approach has meant remaining agnostic to the great economist debate around valuations relative to expected economic growth during the latest rally, avoiding the very reasonable thinking which led many portfolio managers to a defensive stance over the same period and underperforming equity markets.

At its heart, the idea behind trend following strategies is simple and relies on predetermined algorithmic rules that are usually determined ex post and can be easily coded. However, the devil is in the details and many parameters come into play, such as:

- ◆ Which assets are most subject to lasting price trends
- ◆ Which look-back window to consider
- ◆ What types of signals to use
- ◆ How to limit transaction costs and control risk

Our research team looked at all of these parameters in trying to improve portfolio outcomes. Today, we'll discuss some of those findings, including the need to diversify across signal types.



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Background

Trend following strategies are commonly referred to as Commodity Trading Advisors, or CTAs, as at their onset they were mainly invested in commodity futures. The strategy breadth expanded in the 1970s when futures on currencies, interest rates, bonds and stocks became widely available, leading to a new moniker - managed futures strategies. Despite rather untrendy naming conventions, the strategies have since proved to be a valuable addition to traditional portfolios, with over \$350 billion now in dedicated trend following strategies.

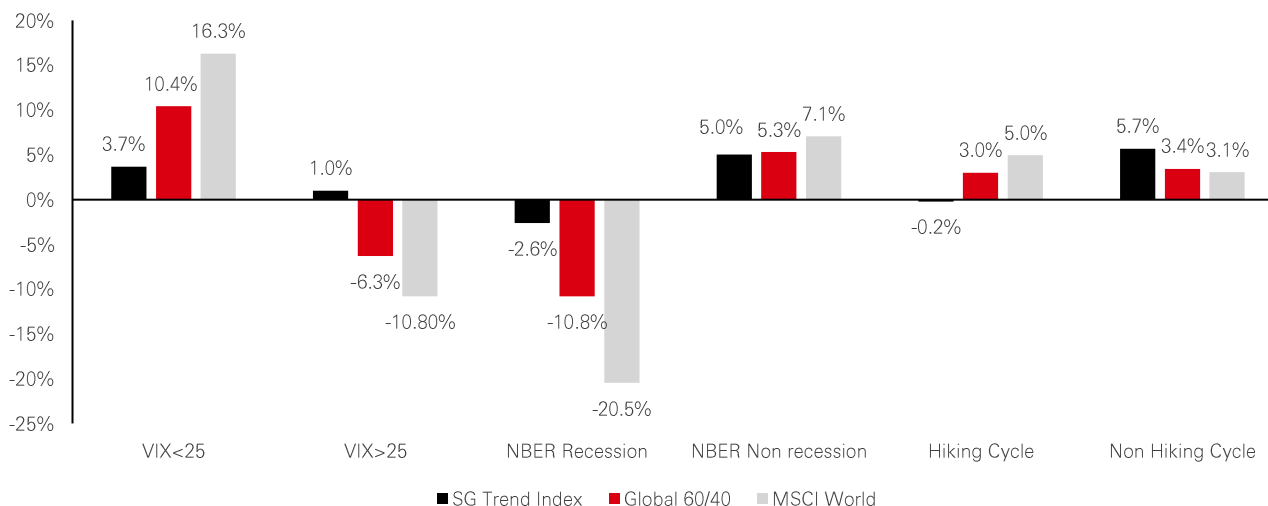
Taking positions in markets, either long or short, solely based on identified price trends following a systematic investment approach only works in practice if price trends – negative or positive – continue more often than not. Historically, this has been the case across many asset classes such as equities, bonds, commodities, and currencies, with the following root causes often identified:

- ◆ Behavioural finance-related criteria such as herding, or the tendency of investors to mimic the decisions of their peers
- ◆ Delays by market participants in adjusting positions following price variations
- ◆ Delays in information assimilation
- ◆ Externalities: impact of government and central banks policies

Trend following has historically been an attractive diversifier to traditional portfolios due to many asset classes exhibiting clear trends. It offers upside potential while tending to perform well during periods of crisis. This was particularly evident in 2022, when trend following strategies benefited from strong downward trends in global equities and bonds and a positive trend in commodities. The performance profile offers true diversification opportunities, as evidenced by low historical correlation to traditional assets.

While the performance of the traditional 60/40 allocation was unparalleled over the last 25 years, amidst persistent negative correlation between stocks and bonds, the new market and macro regime we have entered may continue to challenge its supremacy – 2022 might not be an epiphenomenon. Slightly less anchored inflation expectations, more volatile realised inflation, less supportive monetary conditions, more fiscal support, or any combination of the above could see stock/bond correlation turn positive again and challenge the hedging properties of bonds. In this scenario, incorporating trend-following strategies can have clear benefits. They offer a defensive profile to protect against systemic crisis, with evidence of clear outperformance in an inflation led crisis such as 2022, and the ability to keep up with equity bull markets further supports the case.

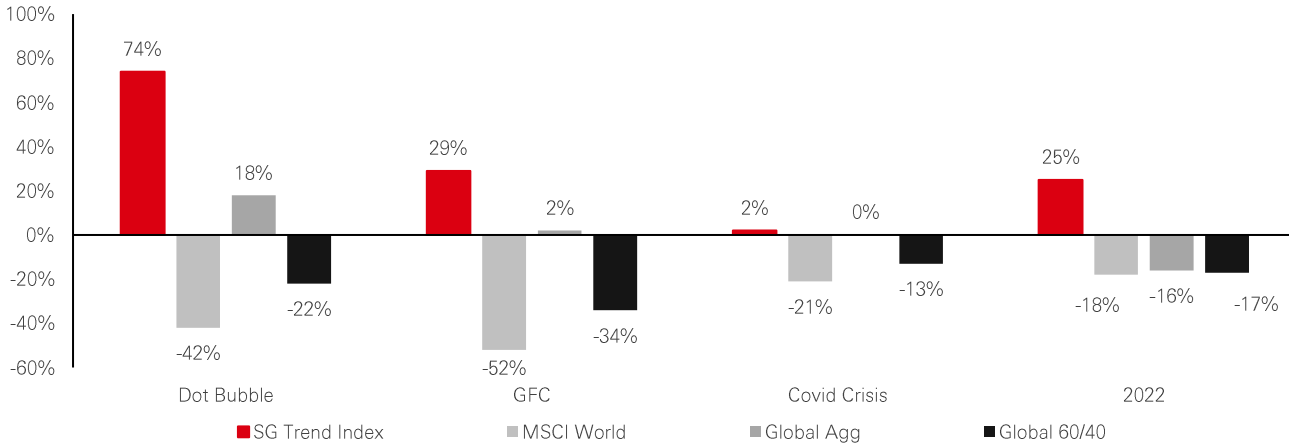
Figure 1: Trend across market regimes



Past performance is no guarantee of future returns. Source: HSBC AM. Data from 31/12/1999 to 31/01/2024. The SG CTA Trend Sub-Index is a subset of the SG CTA Index, and follows traders of trend following methodologies. The SG CTA Index is equal weighted, calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment.

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Figure 2: Trend resilience amidst market crisis



Past performance is no guarantee of future returns. Source: HSBC AM. Data from 31/12/1999 to 31/01/2024. The SG CTA Trend Sub-Index is a subset of the SG CTA Index, and follows traders of trend following methodologies. The SG CTA Index is equal weighted, calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment.

The question then, is when to include a trend following strategy in a strategic asset allocation? Timing such investment has proven to be extremely difficult due to the asymmetric return distribution. Most of the time, trend following generates small losses contrasted by strong gains over short periods. With a positive premium in the long run alongside diversifying properties, a long-term inclusion in portfolios seems more beneficial than trying to time it.

Of course, trend following is not without risks, as it is sensitive to market reversals. When market conditions change over a short period of time, also referred to as 'momentum crashes', trend following models fail to capture the immediate shift. Furthermore, they can struggle in range bound markets when there is no well-established price trend.

Carefully designing the signal to identify trends is one of many steps to take to help mitigate these risks. Our research shows that combining trend signals of different natures, and that span different horizons, tend to improve the ability to detect market trends and adapt to prevailing market dynamics – with trend horizons that are unknown and time-varying. This implies a need for a strong focus on balancing reactivity and unnecessary turnover or 'market noise'.

Time-series diversification for binary signals

Let's examine the approach to designing relevant signals by considering a risky asset with returns R_t such that R_t is iid $N(0, \sigma^2)$. The binary signal $S_{t,P}$ at date t is defined as the sign of the average volatility-scaled returns over the lookback period considered P .

$$S_{t,P} = \text{sign} \left(\sum_{k=0}^{P-1} \frac{R(t-k)}{\sigma} \right)$$

Then the sum $\sum_{k=0}^{P-1} \frac{R(t-k)}{\sigma}$ follows a normal $(0,P)$ distribution. This means the expected value of $S_{t,P}$ is 0, and both its variance and volatility are 1.

In a trend-following strategy, it is standard practice to build positions proportional to the signal and inversely proportional to the volatility of the asset. Hence, using a one-day implementation lag, and not taking transaction costs into account, the returns $TF_{t,P}$ of a trend-following strategy derived from signal $S_{t-1,P}$ are:

$$TF_{t,P} = \frac{R_t S_{t-1,P}}{\sigma}$$

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The correlation between two strategies with lookback periods P and Q (considering P < Q) is then:

$$\text{corr}(TF_{t,P}, TF_{t,Q}) = \frac{2\arcsin\left(\sqrt{\frac{P}{Q}}\right)}{\pi}$$

What is interesting is that the correlation between the two strategies solely depend on the lookback periods used, and more precisely, depend on the ratio of the two lookback periods. For typical periods used in trend-following (i.e. from a few weeks to two years), we can build this theoretical correlation matrix:

Lookback periods (days)	31	63	126	252	504
31		49%	33%	23%	16%
63			50%	33%	23%
126				50%	33%
252					50%
504					

Source: HSBC AM, March 2024.

The theoretical matrix can be compared to this empirical matrix, using equities futures only.

Discrepancies are visible but are increasingly less significant as the ratio between P and Q decreases.

Lookback periods (days)	31	63	126	252	504
31		73%	54%	38%	22%
63			75%	56%	36%
126				79%	59%
252					77%
504					

Lookback periods (days)	31	63	126	252	504
31		23%	21%	15%	6%
63			25%	23%	13%
126				29%	26%
252					27%
504					

Source: HSBC AM, March 2024.

While realised correlation is higher than expected, it is worth noting that the diagonals remain quite stable. Higher empirical correlations can be explained by a couple of reasons:

- ◆ σ is unknown, and practitioners have to standardize returns using estimates of σ
- ◆ returns are typically not iid¹, rather, they display some serial correlation, one of the reasons why assets trend.

There have been periods when market momentum appeared to speed up or slow down: at any moment in time, a strategy using a given lookback period P is going to outperform all other strategies. There is empirical evidence that lookback periods should not be too small (over a few weeks, otherwise trading costs are too elevated) nor too long (a multi-year lookback period resembles more a risk premia capture than a trend-following strategy). Consequently, it makes sense to diversify away parameters risk within the sweet spot that ranges roughly from a few weeks to one year.

1. iid = independent and identically distributed random variables

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Diversification with multiple signals

Interestingly, not many trend followers advertise diversification through different signals. This may seem surprising, as, in a cross-sectional framework, quantitative managers tend to rely on several metrics to define any factor (value, momentum, etc). A possible explanation is that the generalised forms of typical signals, linear in past prices or past returns, are in fact equivalent, and signals mainly differ by how the said prices or returns are weighted over the lookback period considered.

However, this equivalence appears less obvious when non-linear signals are used. Furthermore, it may be interesting to combine signals that are expected to not be very correlated because they are not linear in past prices or returns, like binary signals and the lookback straddle delta à la Fung and Hsieh².

A bit surprisingly, strategies using a basket of binary signals and the delta of a lookback straddle highly correlate: depending on the lookback periods used it can be higher than 90%. Does it make sense to combine these signals?

One has to go beyond a simple correlation of backtests to answer this question, as this is related to the shape of the signals and the rebalancing strategy. When using one binary signal, the final signal is either -1 or +1. When using a combination of binary signals, normalised so that the aggregate signal ranges between -1 and +1, the aggregate signal can only take a finite number of values. With 4 binary signals, the aggregate signal can be -1, -1/2, 0, +1/2 or +1.

Does it make sense to rebalance every time the aggregate signal changes? Probably. Does it make sense to rebalance in case the signal does not change? This is less obvious, as in this case the weight is only altered by other variables, like the covariance matrix.

Also, if the aggregate signal oscillates between two values, does it make sense to rebalance every time the signal changes? One can then understand that combining a discrete, multinomial signal, like a combination of binary signals, with a continuous signal, such as the delta of a lookback straddle, may make most sense.

The design of the signal is an integral part of a trend-following strategy, but is probably more the tip of the iceberg than the key feature of the strategy. The bottom line from our findings is that prioritising a combination of signals spanning different time horizons is most essential to capturing shifting trends while effectively navigating market noise.

2. 'The Risk in Hedge Fund Strategies: Theory and Evidence from Trend Followers', *The Review of Financial Studies*, Vol. 14, No. 2 (Summer, 2001), pp. 313-341

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