Trend Following
A Precision Tool for True Portfolio Diversification

Trend following is an investment style that is systematic in nature and that follows a rules-based trading program. Implemented with futures and other liquid financial derivatives, across a range of asset classes, trend following uses historical price data to anticipate the direction of future price movements. Unintended behavioral biases, like the investor tendency to only focus on information confirming a pre-existing notion, allow predictable trends to develop and diminish through time. These trends strengthen in times of market divergence. As a result, the strategy is specifically designed to benefit investors’ portfolios during periods of dramatic market moves—providing true diversification and the potential to increase overall portfolio efficiency. Because of its potential to capture gains in an up or down market, a trend following strategy may support a portfolio when it is most needed.

Trend’s Historical Track Record During Market Performance

Trend-following strategies act as diversifying assets, namely in times of crisis when correlations rise in extreme up or down markets. As Figure 1 illustrates, during periods of market turbulence the performance of trend-following strategies tends to diverge with falling equity markets.

In our view, this phenomenon is a result of significant fluctuation in investor appetite that occurred during the 2008 Financial Crisis. The SG Trend Index gained 13.52% over the turbulent period while the S&P 500 Index lost 28.58%. If we look back further, going back to the Dot Com Crisis, trend-following gained 13.71% while the S&P 500 Index lost 13.10%.

**FIGURE 1**

Trend-following Strategies’ Performance During Major Market Crises

<table>
<thead>
<tr>
<th>Period 1</th>
<th>Period 2</th>
<th>Period 3</th>
<th>Period 4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Dot-Com Crash</strong></td>
<td><strong>Trend:</strong> 13.71%</td>
<td><strong>Trend:</strong> 4.94%</td>
<td><strong>Trend:</strong> 13.52%</td>
</tr>
<tr>
<td><strong>Stocks:</strong> -13.18%</td>
<td><strong>Stocks:</strong> 15.32%</td>
<td><strong>Stocks:</strong> -28.58%</td>
<td><strong>Stocks:</strong> 17.93%</td>
</tr>
</tbody>
</table>

| **2008 Financial Crisis** | **Trend:** 13.52% | **Stocks:** -13.10% |

Sources: Bloomberg and Salient Advisors, L.P., as of December 2015
Past performance does not guarantee future result. Index performance does not reflect the deduction of fees and expenses. An investor cannot invest directly in an index.
Why and When Trend Following Works

In times of crisis, equity markets experience such severe divergence that the correlations between traditional asset classes start to move towards 1. As the traditional portfolio moves with equities, it often fails to protect investors when diversification—not de-risking—is critical. In contrast, as demonstrated in Figure 2, trend-following strategies become increasingly less correlated to traditional asset classes during crisis periods. It is this persistently low correlation that offers the potential for true diversification and more efficient return.

Furthermore, by grouping performance into quintiles, as seen in Figure 3, returns are strongest during the worst (1) and best (5) equity markets. This phenomenon, known as the trend “smile,” illustrates the diversification benefits when market performance is at its extremes. Because trend-following strategies are just as likely to hold long or short positions, they are able to profit in both up and down markets.

FIGURE 2

The Correlation of Trend-following Strategies to Traditional Asset Classes During Major Market Crises

![Diagram showing correlation between trend-following strategies and traditional asset classes during major market crises]

Sources: Bloomberg and Salient Advisors, L.P., as of December 2015
Past performance does not guarantee future result. Index performance does not reflect the deduction of fees and expenses. An investor cannot invest directly in an index.

Fundamentals of Trend Following

The typical opportunity set for trend following comprises currency forward contracts and financial futures contracts tied to stock, bond and commodity markets. The ability of trend-following strategies to short these markets when prices are declining can counterbalance the potential underperformance of long-only portfolios. An expansive set of market exposures provides breadth to most trend-following strategies, which we believe is critical to the efficiency of a portfolio’s return.

Differentiating within the universe of trend-following strategies starts with signal generation, position sizing and setting risk targets.

- **Signal Generation**: The development of signals may take many forms but is generally based on historical prices of assets and/or trading volumes of those assets. Examples of different types of signals are historical returns, moving average crossovers and relative strength indices.

  - **Position Sizing**: Positions within a trend-following strategy are initiated based on the strength of the trend in the underlying asset class and may benefit from both rising and falling markets. For example, trends in bull markets are followed by taking a long position, while bear market trends are expressed with short positions.

  - **Risk Targets**: Trend-following strategies have the flexibility to operate at different levels of volatility due to the inherent leverage of the instruments it trades. This adaptability affords managers the ability to tailor the risk and return parameters of their strategies to meet the needs of different investors without altering the proportional weights of the portfolio.
The Role of Trend Following in a Portfolio

The potential diversification benefits emerge in a portfolio with a 20% allocation to trend following and an 80% exposure to a balanced 60/40 portfolio. Compared to a balanced 60/40 portfolio, we see an increase to the potential return and a reduction in risk by including trend following. This leads to a higher Sharpe ratio (Figure 4) and tends to decrease the maximum drawdown.

Ironically, the trend-following strategy reduces risk while having a higher volatility than the traditional balanced portfolio. As Figure 5 illustrates, this may encourage investors to reframe their allocation to risk different across market environments.

**Figure 4**
Diversification Potential
January 2000 – December 2015

<table>
<thead>
<tr>
<th>Annualized Return</th>
<th>Standard Deviation</th>
<th>Sharpe Ratio</th>
<th>Max Drawdown</th>
</tr>
</thead>
<tbody>
<tr>
<td>100% SG Trend Index</td>
<td>6.46%</td>
<td>14.37%</td>
<td>0.36</td>
</tr>
<tr>
<td>Balanced 60/40 Portfolio</td>
<td>4.20%</td>
<td>9.46%</td>
<td>0.30</td>
</tr>
<tr>
<td>20% Trend, 80% 60/40</td>
<td>4.91%</td>
<td>7.95%</td>
<td>0.45</td>
</tr>
</tbody>
</table>

Sources: Bloomberg and Salient Advisors, L.P., as of December 2015
*60% MSCI World Index and 40% Barclays US Aggregate Bond Index Past performance does not guarantee future result. Index performance does not reflect the deduction of fees and expenses. An investor cannot invest directly in an index.

Diversifying in the Current Market Environment

The trend-following strategy provides a sophisticated rules-based approach that is:

- **Adaptive:** The strategy is a dynamic tool that can make tactical tilts by “buying into strength” and “selling into weakness.” It adjusts exposure levels based on prevailing market conditions.

- **Able to capture upside performance in down markets:** It increases exposure to asset classes that are trending upward and reduces exposure to asset classes that are out of favor.

- **Truly Diversified:** The strategy is lowly correlated to virtually all traditional asset classes.

We believe we have entered a period in global markets that is likely to present many investors with a multitude of challenges. The agnostic yet adaptive nature of trend-following strategies aims to diversify the typical risks of investors’ portfolios and capture performance during otherwise challenging periods.
This information is being provided to you by Salient Capital Advisors, LLC. It is intended solely for educational purposes. No other distribution or use of these materials has been authorized. The opinions expressed in these materials represent the personal views of the investment professionals of Salient Capital Advisors, LLC and is based on their broad based investment knowledge, experience, research, and analysis. It must be noted, however, that no one can accurately predict the future of the market with certainty or guarantee future investment performance. Past performance is not a guarantee of future results. Certain statements in this communication are forward-looking statements of Salient Capital Advisors, LLC. The forward-looking statements and other views expressed herein are as of the date of this letter. Actual future results or occurrences may differ significantly from those anticipated in any forward-looking statements, and there is no guarantee that any predictions will come to pass. The views expressed herein are subject to change at any time, due to numerous market and other factors. Salient Capital Advisors, LLC disclaims any obligation to update publicly or revise any forward-looking statements or views expressed herein.

This information is neither an offer to sell nor a solicitation of any offer to buy any securities. Any offering or solicitation will be made only to eligible investors and pursuant to any applicable Private Placement Memorandum and other governing documents, all of which must be read in their entirety.

Some information contained herein has been obtained from third party sources and has not been independently verified by Salient. Salient makes no representations as to the accuracy or the completeness of any of the information herein. The information in this material is only as current as the date indicated, and may be superseded by subsequent market events or for other reasons. Any statements of opinion constitute only current opinions of Salient, which are subject to change and which Salient does not undertake to update. Some information in this presentation is based on unaudited information and is subject to change.

Research services are provided by Salient Capital Advisors, LLC, a wholly owned subsidiary of Salient Partners, L.P. and a Securities and Exchange Commission Registered Investment Adviser. Registration as an investment advisor does not imply any level of skill or training. Salient research has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Salient recommends that investors independently evaluate particular investments and strategies, and encourage investors to seek the advice of a financial advisor. The appropriateness of a particular investment or strategy will depend on an investor’s individual circumstances and objectives.

Salient Capital Advisors, LLC does not provide tax advice. Please contact your tax professional to determine how the information contained in this document may apply to your situation.

Salient is the trade name for Salient Partners, L.P., which together with its subsidiaries provides asset management and advisory services. Insurance products offered through Salient Insurance Agency, LLC (Texas license #1736192). Trust services provided by Salient Trust Co., LTA. Securities offered through Salient Capital, L.P., a registered broker-dealer and Member FINRA, SIPC. Each of Salient Insurance Agency, LLC, Salient Trust Co., LTA, and Salient Capital, L.P., is a subsidiary of Salient Partners, L.P.

**RISKS**

There are special risks associated with an investment in commodities and futures including market price fluctuation, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors, all of which must be read in their entirety. No investment strategy can guarantee performance results. Past performance is no guarantee of future results. All investments are subject to investment risk, including loss of principal invested.

**Definition of Terms**

**Barclays US Aggregate Bond Index** provides a broad-based measure of the US investment grade fixed-rate debt markets.

**Breadth** is a technique used in technical analysis that attempts to gauge the direction of the overall market by analyzing the number of companies advancing relative to the number declining.

**MSCI World Index** is a free float-adjusted market capitalization index designed to measure equity market performance in the global developed markets.

**S&P 500 Index** is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy. The S&P 500 was selected as Representative of the U.S. Equity market, which is the largest in the world, and domestic to the vast majority of our client base.

**SG Trend Index (formerly NewEdge Trend)** calculates the net daily rate of return for a pool of trend following based hedge fund managers. It is equal-weighted and reconstituted annually. The SG Trend was selected as an index of other trend following managers which define the CTA Space.

**Sharpe ratio** is a ratio developed by Nobel laureate William F. Sharpe to measure how a fund performs relative to the risk it takes.