market notes: Digital Trend – Building Momentum

21 OCTOBER 2022

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ASSET MANAGEMENT

Systematic trend following in digital assets can produce a persistent return opportunity complementary to traditional trend strategies and other digital allocations. Digitally native trend strategies can turn market risks, unique to digital markets, into active advantages. Institutions have asked for additive liquid complements to their illiquid crypto exposure– and we built it: Digital Trend.

Paul Ebner and Sarah Schroeder, One River Digital

1. The (active) trend is your new friend. Passive trends dominated investment performance in the past two decades and led to unprecedented valuations of bonds and equities. Investors stretched into longer-duration assets as valuations rose and were rewarded with outsized returns. Inflation changed everything. Active strategies that were dormant are now gaining ground. Foreign exchange. Commodities. Local bond markets. Equity sectors. Active trend is the right tool for these times of unprecedented change.

2. Digital asset markets are no different. It is widely recognized that digital assets are a transformative opportunity (here). But they have a big barrier to entry for investors – 100%+ annualized volatility and routine drawdowns of more than 50%. Active strategies, like systematic trend, turn these negative characteristics into positive ones. They allow investors to benefit from the volatility and boom/bust cycles with a much lower risk profile and limited correlation to broader portfolios, as we have documented in the past (here).

3. Our digital asset investment strategies focus on institutional-grade solutions across the risk spectrum, covering Income, Credit, and Indices. Digital Income plays the role of risk mitigation. Demand for US dollars in the digital ecosystem rises as excesses build, driving higher income rates. Digital Income is defensive. On the other extreme, the One River Core and Size Tilt Indices aim for passive long-only exposure that dynamically expands with maturing assets – set it and forget it. Active strategies, like Digital Trend and Digital Credit, are the center of this risk sandwich. They are stabilizers through an investment cycle, dynamically adjusting to bullish or bearish conditions.

4. Over the past month, we activated discussions with global investors on Digital Trend. Our initial two-asset strategy's historical simulation revealed appealing characteristics – more than 50% of monthly upside capture and only 17% of monthly downside capture relative to bitcoin, with less than 30% annualized volatility. It also shows limited correlation to both digital asset markets and traditional trend strategies (Figure 1). Digital Trend is a portfolio diversifier, even more at this stage of the traditional asset cycle than previous ones. There were several recurring themes in our discussions.

5. Trend is designed to benefit from asset volatility. Our attention is on an intersection of short-to-moderate horizon trends rather than higher-frequency arbitrage that we believe will be short-lived. We see trend benefiting from large moves up or down in assets, a characteristic of options strategies. The persistence of trends is supported by empirical analyses that reveal meaningful correlations over various time horizons. The emerging nature of the asset class contributes to some of these effects.

6. Trend strategies are indifferent to fundamental equilibrium. This is especially important for digital asset markets, given a larger retail presence than most asset classes. Factors like investor sentiment are far more relevant, capitalizing on both large overshoots and their reversal. As directional strategies, trend models also allow assets to be modelled individually, rather than on relative valuation. Risk capital can expand or contract alongside the conviction in the trend.

7. The faster speed in digital asset trends differentiates from traditional markets. Typical CTA portfolios tend to converge on models shared across asset classes. Digital assets cater to different horizons and structures – the continuous, global nature of trading minimizes delay in price reaction to new information or sentiment shifts. Being a global asset without direct

policy intervention also increases the timeliness of any response to prices – trends range from very short to moderate horizons.

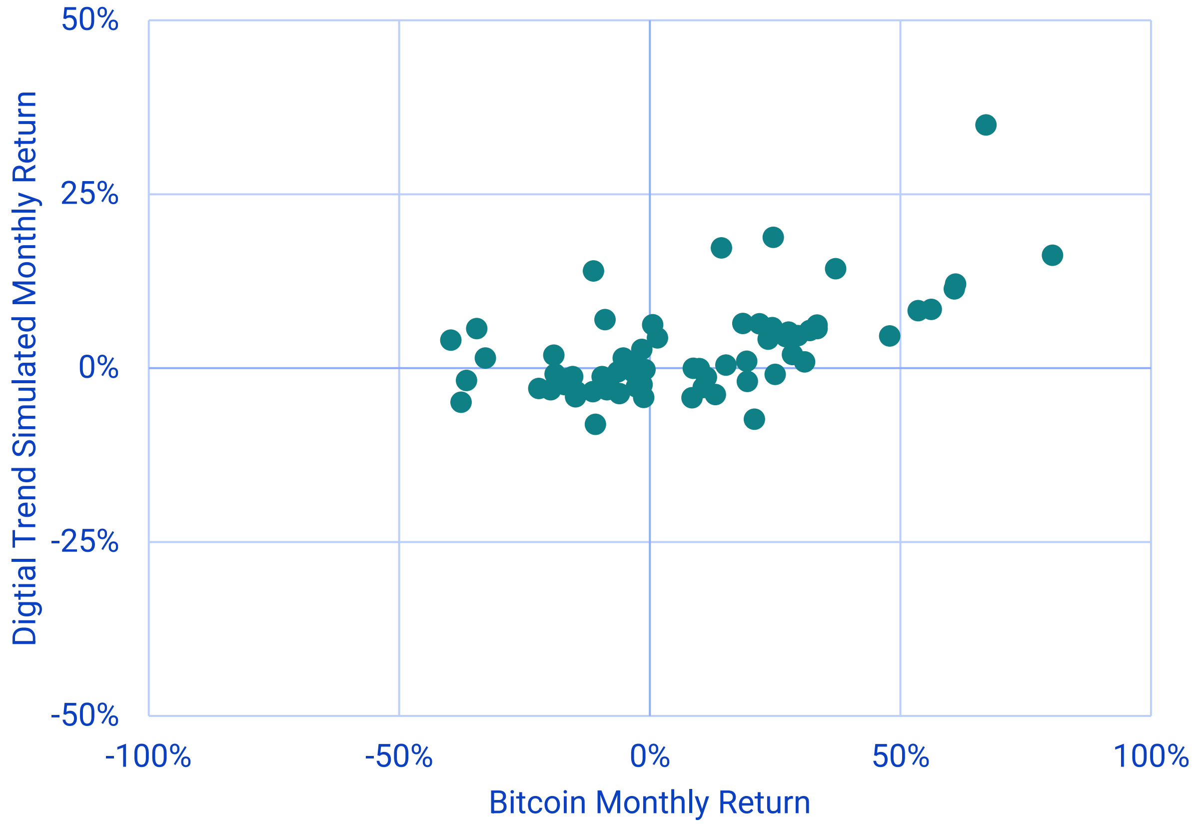
8. Digital assets are more prone to two-way jump risk, crashing on the way down…and up! The tendency towards high correlation across assets today means there is a limited diversification benefit with the inclusion of broader assets (Figure 2). Jump outcomes are a threat to both longs and shorts. This is critical to risk management practices. Tools like covariance matrices used for volatility targeting are inappropriate over longer horizons. Risk management must be endogenous, determined by the conviction of the signals, and must also vary over time. A whole host of other risk metrics are required, including network distribution, downtime, and regulation.

9. Turning these trading signals and risk management features into portfolios demands more fluid risk management and infrastructure than traditional finance. It requires expertise native to digital assets. Digital strategies can respond in real time, and so too must the tools that allow our portfolios to rebalance. Operational support, ranging from margin calls to capital movements, needs to be continuous. Our activities in Digital Income and Digital Index have allowed us to transfer knowledge for Digital Trend.

10. Investors familiar with active trend in traditional markets are precisely the ones keen on evaluating digital alternatives. But it begs the question. Is digital just a correlated version of shovel-ready strategies? Definitively not. Rolling 52-week correlation between the SG Trend Index and our Digital Trend averaged 17% over the past 5 years, with only brief periods above 25%. Most recently, Digital Trend exhibited a notable negative correlation to its traditional peers (Figure 3). There is unique information in digital asset markets that will only grow as the ecosystem matures, correlations decline, and more nuanced portfolios emerge.

11. The secret to getting ahead is getting started. And that's what Digital Trend does – it gets us started in active strategies and our trading and operational infrastructure. Investor discussions have helped immensely – we are grateful for the engagement. It helps to borrow lessons from traditional finance as it is relatable. Still, there is no substitute for native digital architecture. Where do we go from here? More assets, lower correlation, broader signals, unique risk tools, fundamental strategies – Digital Trend is the unlock for our active strategy research. We're ready when you are!

Figure 1: Bitcoin Monthly Return versus Dynamic Trend Simulation

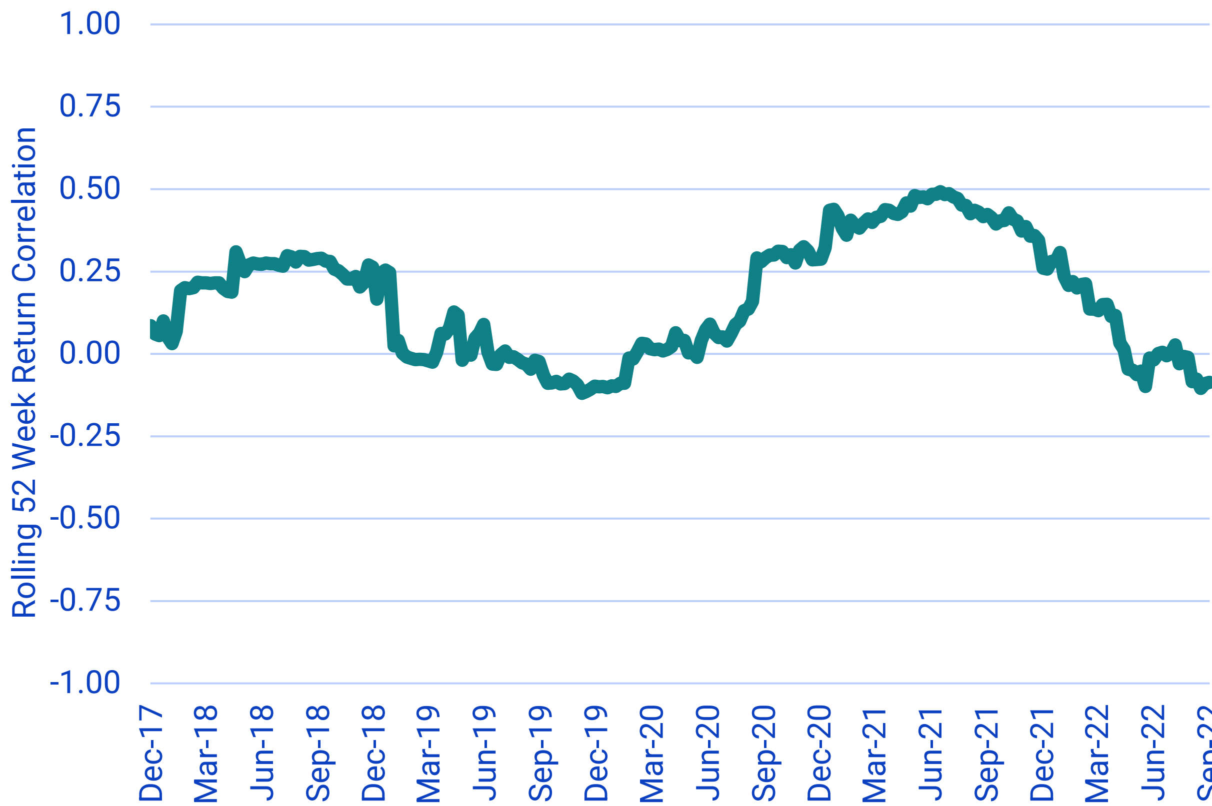


Source: One River Digital, Bloomberg. Bitcoin Monthly Returns based on Bloomberg Bitcoin Reference Rate Index. Digital Trend Simulation Returns are monthly and net of costs and fees. Time period Jan 2017 to Sep 2022.

Figure 2: Digital Asset Rolling Mean Pairwise Correlation

Source: One River Digital. The rolling mean pairwise correlation depicts by day the average realized correlation across trailing 60-day returns for 18 representative digital assets. Data input period inclusive of Nov 2019 to Sep 2022.

Figure 3: Rolling One Year Return Correlation, SG Trend and Digital Trend Simulation



Source: One River Digital, Bloomberg. Digital Trend Simulation returns are monthly and net of simulated costs and fees. Time period for data inclusive of Jan 2017 to Sep 2022.

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