OneRiverDigital
ASSET MANAGEMENT

market notes: Learning to Love – Digital + Systematic Trend

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The trend is your (risk management) friend in digital assets.

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1. Active strategies are crucial in dynamic macro environments. We are in one. How long this dynamic macro environment lasts is an open question. Will the realization of recession lead to policy responses that bring the return of passive trends? Or will structural headwinds lead to macro cycles that bear no resemblance to recent history? Demographic headwinds, government obligations, polarizing geopolitics, and lasting deficiencies in supply chains suggest the latter.

2. The Case for Quantum Change argues for the return of systematic trend following – a strategy that had its worst decade in the past century during the lull between the Global Financial Crisis and Covid. That time coincided with peak policy homogeneity, with central bankers expending extraordinary efforts to produce stability. Unsurprisingly, such strategies had their best decade of the last century in the tumultuous 1970s, producing tremendous returns in a period when inflation devastated most investment portfolios. Systematic trend following profits from great change, and it need not be a repeat of some previous regime.

3. Does this apply to digital assets? The short answer is yes. Bitcoin was not – nor was it ever designed to be – a linear hedge to inflation. It is only at the marginal cost of production – tied to energy inputs – when bitcoin's value should be closely correlated to the inflation rate. When rising well beyond its cost of production, bitcoin's valuation captures other factors such as technological advancements and speculative excess. The same forces that are disruptive to traditional asset markets apply to digital asset markets. Systematic trend-following strategies can prosper. So, we are building them.

4. The downturn in digital asset markets has investors asking for a peek into such strategies. Our initial exploration focuses on bitcoin and ether: two foundational assets for the digital ecosystem that are considered commodities for regulatory purposes and, thus, give us maximum flexibility for investment structures. The nature of continuous-time markets requires great care in infrastructure and tools for managing orders, risk, and portfolio adjustments. Nothing worth doing is ever easy.

5. Let's take simple one-month trends as a toy model. The system can be long and short, with maximum exposure of 50% to each bitcoin and ether. No leverage is deployed – the assets are volatile enough. Trends are measured and then paired with a risk scalar that is especially relevant at turning points when volatility spikes, such that model positions are reduced to reflect the rise in uncertainty.

   What does this simple model tell us? There are four key lessons.

6. **First, the risk characteristics of systematic trend greatly improve upon passive holdings**. A five-year simulation starting in July 2017 shows substantial compression of volatility in the trend-following strategy, to 23% annualized versus 80% in bitcoin (Figure 1). Other characteristics follow accordingly: returns from this toy trend model are 26% annualized versus 74% for bitcoin, with only a 3% beta to bitcoin, and a maximum drawdown of 29% versus 83% for bitcoin.

7. **Second, the trend model adjusts dynamically to drawdowns in bitcoin**. This is front-of-mind for investors given the latest downturn in digital assets. We isolate five sharp drawdowns in bitcoin from the last five years. Figure 2 shows the average decline in bitcoin over those periods is 50.8% with the largest one-day decline of nearly 20%. The trend model averages a gain of 16.7% over those periods with the worst one-day decline at 5.1%. It is not only volatility suppression – trend strategies are well suited to actively manage risk.

8. **Third, isolating performance during bitcoin up-and-down days emphasizes the value of active risk management**. Bitcoin's average daily return on up-days is 2.94%. The trend model averages gains of 0.54% on those days. However, on down-days when bitcoin averages –2.87%, the trend model declines by an average of 0.13%. It is a vast improvement in risk-adjusted performance. Importantly, it is not a free lunch – the simple trend model saw its max one-day loss of 10.11% on a bitcoin up-day.

9. **Fourth, the trend model also neutralizes equity downturns**. We isolate four periods of sharp decline in the S&P 500 Index: Feb 2018, Dec 2018, Mar-Apr 2020, and Jan-Jun 2022. The average return of the trend model is strongly positive in those periods despite an average 20% decline in equity markets and a 12% drawdown in a 60-40% stock-bond portfolio.

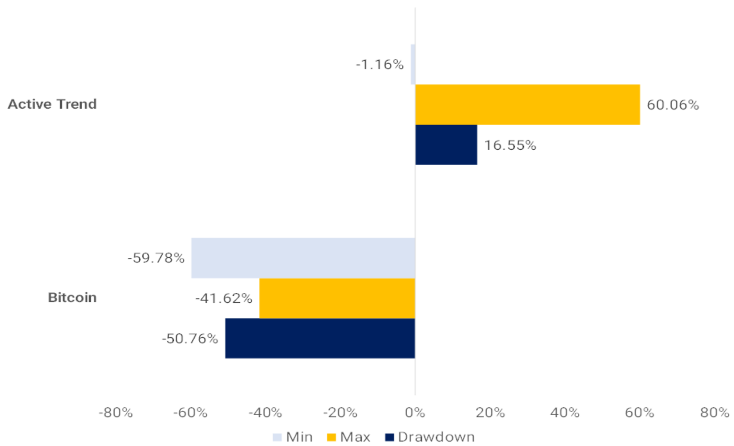
10. The lines between digital and traditional assets will disappear over time. Already, our initial analyses show that tools in traditional asset markets are well suited for active management in the digital arena. We are focused on launching our hedge fund strategy – Digital Dynamix – in Fall 2022 with an initial focus on trend strategies. Assets will broaden alongside regulatory clarity over time, as will strategies. Stay tuned.

Figure 1: Systematic 30-day Trend versus Bitcoin (Annualized %, Jul 2017 to Jun 2022)

	Bitcoin	Trend
Return	74%	26%
Volatility	80%	23%
Max Drawdown	83%	29%
Beta to Bitcoin	1.00	0.03

Source: One River Digital. CoinMetrics. Gross returns for the passive Bitcoin holding and net return for Systematic Trend.

Figure 2: Bitcoin Drawdowns – Average of Five Downturns



Source: One River Digital. CoinMetrics.

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