Discretionary vs. Systematic: Two Contrasting Hedge Fund Approaches

Graeme Terry takes a detailed look at hedge funds employing discretionary and systematic trading styles, including their performance over time and which approach is most utilized by fund managers.

There are two distinct investment approaches employed by hedge fund managers: discretionary, where the strategy relies on the skill of the fund manager when making investment decisions, and systematic, where the fund utilizes computer models for the majority of its trades. Discretionary funds offer the potential for greater returns when managed effectively, but systematic funds are often seen as a less risky option as they are not subject to changes as a result of human emotions. These two trading approaches have many different characteristics and in this article we compare the performance of these two trading styles, in addition to analyzing which approach is most utilized by fund managers in the market today.

Discretionary Funds Provide Higher Absolute Returns

A comparison of the performance of discretionary and systematic hedge funds across various time periods is presented in Fig. 1. The discretionary hedge fund benchmark has achieved superior performance in recent times, posting **10.81%** over the last 12 months (as of 31 May 2014), compared to the **6.59%** returned by the systematic hedge fund benchmark over the same time period. Discretionary funds have also outperformed systematic funds on an annualized basis over the past five years, posting average returns of 11.56% compared to 7.85%. As discretionary funds rely on the skill of their investment manager, it is perhaps unsurprising that these funds, on average, deliver higher returns than their systematic counterparts when markets are rising.

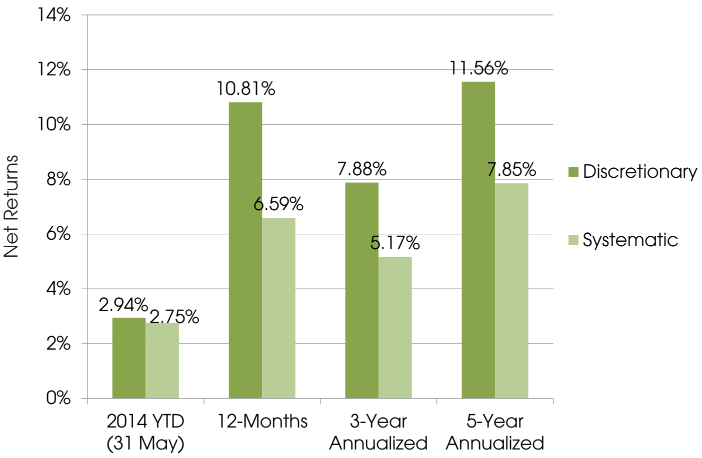
Although Fig. 1 indicates that discretionary funds have significantly outperformed systematic funds over the past three years (with three-year annualized returns of 7.88% compared to 5.17%), this does not hold true for all hedge fund strategies. Systematic funds with a relative value strategy have outperformed their discretionary counterparts on an annualized basis over the past three years, with returns of 6.84% compared to 5.69% (Fig. 2). Meanwhile the returns of macro funds following a systematic approach also outperformed discretionary funds following this strategy (4.81% vs. 3.91%). Therefore the outperformance of discretionary hedge funds over the last three years is mainly as a result of the performance of long/short funds, with discretionary funds outperforming systematic funds in this category by almost six percentage points.

In contrast to hedge funds, the majority of CTAs use a systematic approach in order to exploit trends in the market; however, systematic CTAs have found successful trends hard to come by in recent times, with these funds returning an average of 1.14% on an annualized basis over the past three years. This compares unfavourably to CTAs with a discretionary approach over the same period, with these funds returning 4.18%.

Systematic Funds Exhibit Lower Volatility

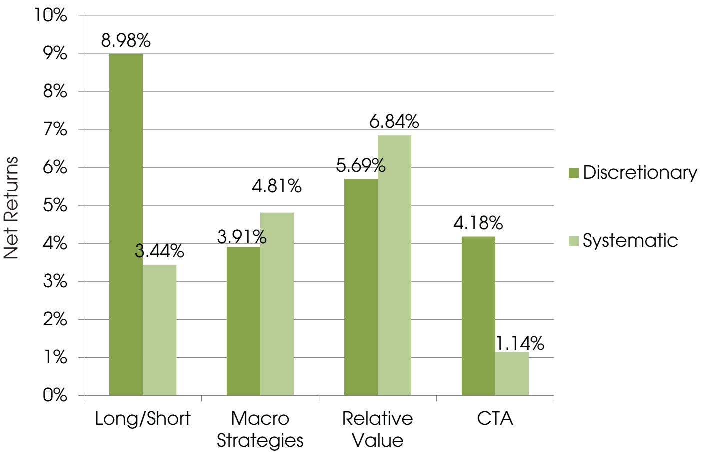
A factor in the higher absolute returns of discretionary funds is the increased volatility of these funds compared to those with a systematic approach. As shown in Fig. 3, funds with a discretionary approach have consistently exhibited higher volatility than those with a systematic approach over the past five years (6-11% vs. 3-5%). In general, systematic funds are more consistent in terms of performance, avoiding the highs and lows posted by discretionary funds. When considering risk-adjusted returns, systematic funds have fared better than discretionary funds over the last five years; the Sharpe ratio (risk free rate = 2%) over this time period is **1.54** for discretionary funds and **1.82** for systematic funds.

Fig. 1: Hedge Fund Performance: Discretionary vs. Systematic (As of 31 May 2014)



Source: Preqin Hedge Fund Analyst

Fig. 2: Three-Year Annualized Returns of Hedge Fund Strategies by Trading Style (As of 31 May 2014)



Source: Preqin Hedge Fund Analyst

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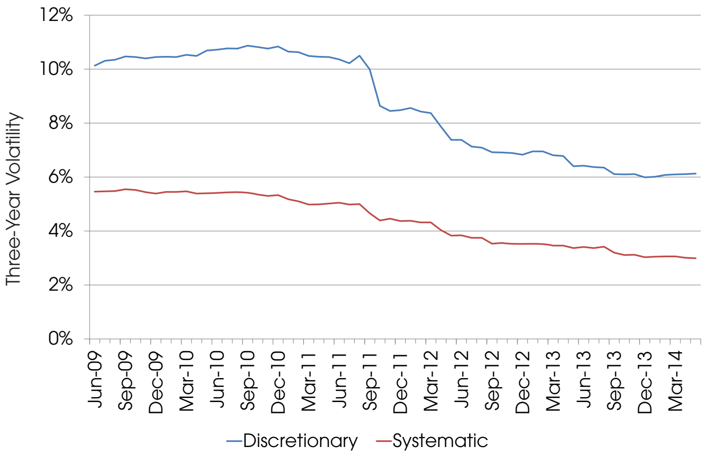
As a result of their lower volatility and superior risk-adjusted returns, systematic funds often outperform discretionary funds in times of market trouble. This was most evident in 2008, when discretionary funds suffered a loss of 18.65%, while systematic funds were broadly neutral (-0.03%). Similarly in 2011 (when the overall hedge fund benchmark suffered a loss of 1.68%), systematic funds delivered positive returns of 1.81%, while discretionary funds were down 2.83%. This suggests that systematic funds can provide protection for investors in times of market turmoil.

Fig. 3: Rolling Volatility of Discretionary and Systematic Hedge Funds, June 2009 - May 2014



Source: Preqin Hedge Fund Analyst

Fund Launches: Systematic vs. Discretionary

Following the analysis of the performance trends of these two trading styles, it is interesting to look at how these are affecting fund launch activity. The majority of hedge funds adopt a discretionary approach to investing in order to utilize the ability of their portfolio managers; therefore, it is unsurprising that the number of discretionary fund launches exceeds the number of systematic fund launches in each year (Fig. 4). However, there is a suggestion that this gap may be narrowing; since the beginning of 2013 there have been 108 discretionary fund launches and 67 systematic fund launches, whereas in 2012, there were 138 discretionary fund launches and 66 systematic fund launches.

In contrast to hedge funds, the majority of CTAs utilize a systematic trading approach with the aim of following trends in the market. However, trend-following CTAs have struggled to post positive performance over the past year and this has led to a reduction in the number of systematic CTA launches, from a record of 60 in 2012 to 46 in 2013. In contrast, the same year saw an increase in discretionary CTA fund launches, with this number more than doubling from seven in 2012 to 15 in 2013. The lack of significant trends in the investment market may have led to CTAs adopting a discretionary model in a bid to improve performance.

Outlook

Discretionary funds have outperformed systematic funds in recent years in terms of absolute returns, taking advantage of the fact that markets during this period have generally been rising. However, it has been shown that systematic hedge funds outperform discretionary hedge funds in troubled markets, which was the case in 2008 and 2011. Establishing which type of fund is right for investors very much depends on the fund strategy, the risk profile of the investor and the general market conditions. The majority of hedge fund managers continue to utilize a discretionary approach while most CTAs focus on a systematic strategy, although there is some evidence in both of these cases of more fund managers adopting the alternative approach.

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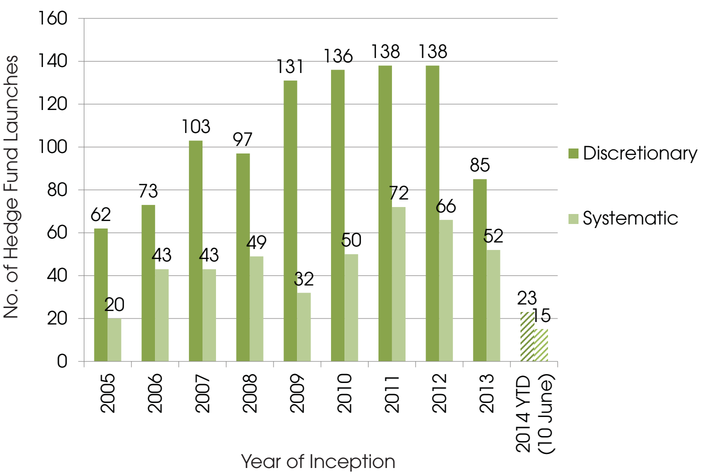
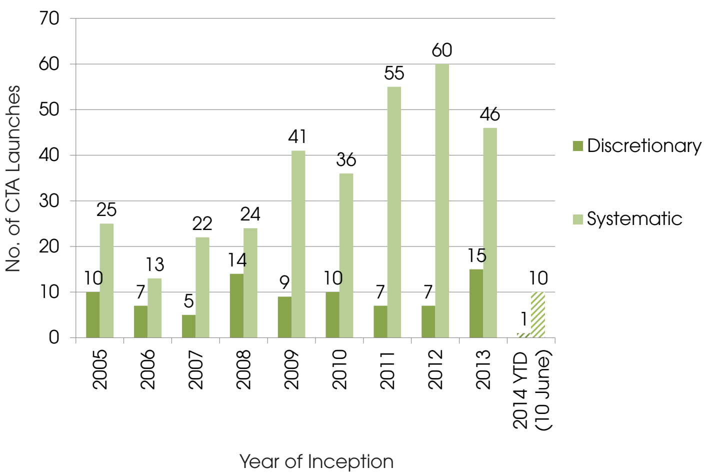
Fig. 4: Hedge Fund Launches: Discretionary vs. Systematic, 2005 - 2014 YTD (As at 10 June 2014)



Source: Preqin Hedge Fund Analyst

Fig. 5: CTA Launches: Discretionary vs. Systematic, 2005 - 2014 YTD (As at 10 June 2014)



Source: Preqin Hedge Fund Analyst

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As of 2 June 2014

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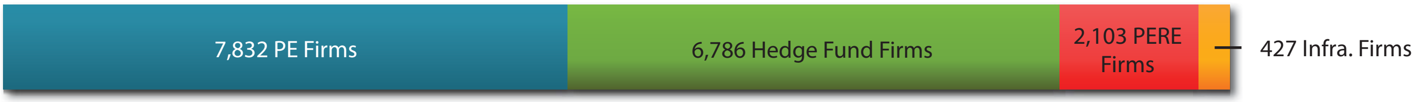
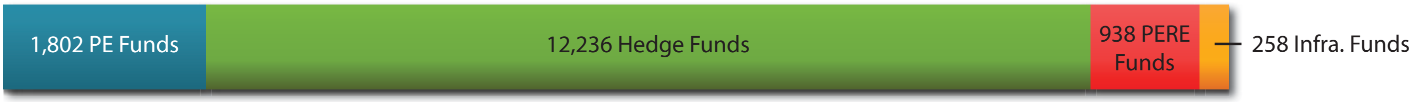
Firm Coverage: 17,148 Firms

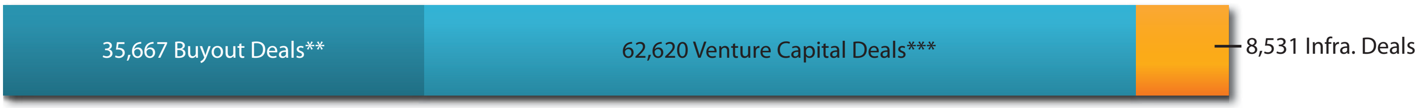


Performance Coverage: 16,416 Funds (IRR Data for 5,424 Funds and Cash Flow Data for 2,582 Funds)

Fundraising Coverage: 15,234 Funds Open for Investment/Launching Soon Including 2,209 Closed-Ended Funds in Market and 368 Announced or Expected Funds



Deals Coverage: 106,818 Deals Covered; All New Deals Tracked



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