

John Locke Investments

Reinventing Trend Following

By Dan Collins

François Bonnin, CEO and Founding Partner of John Locke Investments started his trading career as a proprietary trader for a French investment bank where he managed arbitrage between equity warrants, convertible bonds & equities.

As he developed his trading approach, Bonnin understood that the edge in the type of arbitrage he was engaged in would eventually wear thin; the edge would be arbitrated out and he would need to find another strategy.

He spent a lot of time building technical indicators and spotting trading opportunities with the goal of eventually starting a trading firm. "I created software applications that would take advantage of inefficiencies," Bonnin says. "[I] stopped my personal trading to concentrate on constructing trading systems and a research platform. That is how I came to be a systematic trader."

"Trend following works because there is a small bias towards trendiness rather than noisiness."

After leaving the investment bank, Bonnin became in charge of Research and Alternative Investments at ING France and then was Managing Director and Founding Partner of a regulated asset management company, specializing in alternative systematic strategies.

This, along with his experience as a proprietary trader, provided him with the necessary background to launch John Locke in 2000.

In its early stage, John Locke employed breakouts, moving averages and volatility expansion methodologies which produced solid trend following returns. It earned positive returns every year from 2000 through 2008.



“The bias toward trendiness is still as strong as it ever was [...] Trendiness is a bias that exists on the same scale as before. The new difficulty is that most assets behave similarly. The world has become a village...”

When the post 2008 credit crisis depression in trend following returns hit, Bonnini researched what had changed. “Trend following works because there is a little bias towards trendiness rather than noisiness,” Bonnini says. “This bias is small but positive. For a trend following approach on an isolated instrument, the Sharpe ratio is rarely going to exceed 0.1, which is not an attractive investment proposition — it is too small, but it is positive. If something brings you little, you’d better have a lot of those.”



According to Bonnini, this is what brings clarity to what the second most important element for trend followers is: diversification. “One must not only implement trend systems that exploit this small bias towards trendiness over noisiness,” he says, “but also diversify the approach across de-correlated assets, corn, aluminum, Nasdaq, 30-year bonds, Yen/\$...”

“If you had asked me 10 years ago why our trading approach was different from others, I would have said ‘we are longer-term or we are shorter-term than our peers, and this is what creates the difference with them,’ but having been longer or shorter term was more luck of being at the right place at the right moment,” Bonnini explains. “Today, I feel like we have

innovated our trend following approach. We have constructed an approach that tries to understand why trend following works that should over perform in a more robust way.”

While trend following has been going through a tough period since the end of the 2008 credit crisis, Bonnini does not think that trends are less common, just more difficult to exploit. “The bias toward trendiness is still as strong as it ever was; trend following on each instrument taken individually still delivers similar streams of returns as it did in previous years. Trendiness is a bias that exists on the same scale as before. The new difficulty is that most assets behave similarly. The world has become a village where moves in coffee futures are linked to those of S&P 500 and 10-year bonds. This was not the case 10 years ago,” Bonnini says. “It is amazing to notice that the average pairwise correlation has risen from 0.35 to 0.65. All assets are driven by news about the next easing, inflation, jobless claims, etc.,” Bonnini says. “The markets are trading one or two themes, and all the instruments are behaving more or less the same.”

“So, it has become important to find those instruments that don’t follow these themes,” notes Bonnini. “We have developed tools that dynamically measure these independent markets and take advantage of the diversification they offer. Trends have not gone away, but diversification has. We have reworked our allocation method to embrace this new given by allocating risk to diversify it dynamically” he says. “And we have also introduced composites.”



The composites Bonnini refers to are groups of markets that represent a theme that can be traded as a single market. John Locke trades 40 of the most liquid-diversified futures markets and an additional 110 composite markets.

For example, John Locke have created composites such as the “Transatlantic Spread”, which is a measure of how the US stock market performs relative to the European markets. It is a long position on the S&P 500 against a short position on the STOXX Europe 600.

“Imagine there is a big uptrend in the stock market. Both indices, S&P 500 and STOXX Europe 600, are going up. Every single trend follower is long. But if these two markets reverse, every trend follower will start experiencing losses until they have gone short and start making money again if the bear trend persists,” says Bonnin. “But, if you look at the difference of the progression of the S&P 500 relative to the STOXX Europe 600, at the moment both markets reverse, that difference may not reverse: it is a different trend.”

“We are trading this composite as an uncorrelated asset built with these two indices,” Bonnin continues. “We are no longer playing a trend in global equities, but the overperformance of the U.S. markets versus the Eurozone markets. This theme has little to no correlation with the two former markets.”

“You need to have a rationale for why this particular combination means something. Without a rationale, we don’t incorporate the composite. Whatever it is, something simple must explain the behavior of the composite.”

Bonnin goes on to say that John Locke “have created 110 composites. These composites have a completely different behavior than outright futures; they have a life of their own that reflects something else than what can be seen through a single major future market. For example, the S&P 500 or the STOXX Europe 600 reflects how good each local economy is doing but they don’t reflect how good they are doing relative to each other. Is one doing better than the other? This is an entirely different question; this theme has a life of its own and it is uncorrelated to these standalone instruments.”

John Locke treat their 110 composite markets as separate instruments that reflect unique themes. “What are we trading? A fear of a recession, inflation... These are themes that are expressed by a collaboration of markets,” Bonnin says. “We are grouping instruments together, so they reflect an idea that has a behavior of its own. We apply trend following strategies and allocate to these with the same methods used for outright futures. Our dynamic correlation approach maximizes diversification.”

In addition to the composites and dynamic risk allocation, Bonnin has upgraded his trend-following approach over the last five years. Instead of employing multiple time horizons and multiple trend-following approaches with several models, he has combined timeframes and models into a single system that kicks out a trading signal capable of running anywhere between five days to two years.

“It is all worked out in a continuous rather than discrete approach,” Bonnin says. “We don’t have one short-term, one medium-term and one long-term [signal], we have only one signal. It is completely automated. Therefore, we removed a lot of overfitting problems. We have a generic approach which computes the cost of trading, the expected return, and compares

these to make a decision to enter the trade or not. We have defined metrics that indicate if there is value in entering a trade or not.”

“If you are wrong in that causality, you are picking the wrong composites; you are picking those accidental winners. If you pick accidental winners, you are going to have a problem.”

John Locke apply that same trend following approach to all 150 markets—the 40 outright futures and the 110 composites. While the composites can be as simple as the Transatlantic Spread example noted above, they can be more complex. They can involve multiple markets. John Locke have tested many composites in order to settle on the 110 they are trading. These composites go through a thorough screening and must exhibit a performance reflecting a comprehensible fundamental economic rationale.

“The composite instruments themselves must have a fundamental hypothesis; they must represent something that is going on as a theme,” says Bonnin. “For example, the Transatlantic Spread represents the idea that the United States and Europe have a different approach to society and businesses. That is the fundamental theme behind it. We created the composites technically, but we only [trade them] if they represent a fundamental explanation we can comprehend.”

“You need to have a rationale for why this particular combination means something. Without a rationale, we don’t incorporate the composite. Whatever it is, something simple must explain the behavior of the

composite.” “We can create many composites mathematically and sort those that make money with trend following from those that don’t. But once we find those composites that make money, we have to find those that make sense,” Bonnin says. “This is [tedious] work. If you are wrong in that causality, you are picking the wrong composites; you are picking those accidental winners. If you pick accidental winners, you are going to have a problem.”



John Locke’s composite markets have increased portfolio diversification and improved its performance versus other trend followers. “The program remains correlated to trend followers, although at times the behavior is not the same, but provides additional alpha” Bonnin says. “For example, January 2019 was a big down month [for trend followers]; we experienced a very small drop because the model was not so active on the outright markets and had identified more opportunities in the composites.”

“We started as trend followers and we are even more so today than before. The approach to trend following had to be understood and modified to navigate new conditions.”

While John Locke have produced solid returns over two decades; their performance did suffer along with other trend followers in the year following the credit crisis. Bonnin’s research indicated that increased correlation among markets was a main driver of that underperformance, and his composites are the solution he created in late 2014 to address that. Judging from his recent performance—

double digit returns in three of the last four years—he has hit on something.

“I am not a believer that trend following is over. The herding effect that humans exhibit is still very much there. It’s just finding where it is expressing itself,” Bonnin says. “We started as trend followers and we are even more so today than before. The approach to trend following had to be understood and modified to navigate new conditions.”

Simply put, when many markets became so correlated trend followers lost a great deal of diversification and, as a result, the expected Sharpe dropped. John Locke went out to find where trends continued to express themselves and capture these moves. “Trends have not disappeared; they are just somewhere else.” So far it is working pretty well.



Company Name: John Locke Investments SA
Strategy Type: Diversified Systematic Trend/Momentum
Portfolio Manager: François Bonnin
Location: Paris, France
Inception Date: July 2000

About Coquest Traders Research:

Coquest Traders Research is an online portal that is home to Coquest’s proprietary database of managed futures program profiles and investment performance summaries, powered by Coquest Advisors. Hundreds of Commodity Trading Advisor (CTA) profiles and program statistics are available to users considering alternative investments.

In addition, Coquest Traders Research provides industry insights and educational resources to investors to further advance their knowledge of the managed futures industry.

To gain access to Coquest Traders Research, go to coquesttradersresearch.com



**For more information or redistribution, please contact Coquest at
(972) 330-2210 or info@coquest.com**