

AHL DIVERSIFIED PROGRAMME

2017 REVIEW AND OUTLOOK

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*The use of the term "solutions" within this material does not constitute or imply any guarantee that any product/strategy will be successful or that its aims or objectives will be achieved.

EXECUTIVE SUMMARY

The Next Edge AHL Fund Class F Units ('Diversified', the 'Programme') returned 3.35%¹ net of fees for calendar year 2017, outperforming CTA indices such as SG Trend (2.0%) and Barclay BTOP50 (-0.9%).

It was a year when equities stole the limelight, with many indices making multi-year or all-time highs and the Programme's equity attribution dominating returns. Attributions in FX, fixed income and commodities were negative, although the non-traditional, broadly over-the-counter ('OTC'), components contributed significantly.

We continued to add more differentiating markets to the range of around 450 traded, and reaped the rewards of our relationship with the Oxford-Man Institute through introducing machine learning to the Programme's array of trend-following models.

If history is any guide, and correlation continues to decline to pre-Credit Crisis levels, it could be a positive environment for trend-following strategies. We enter 2018 trading the largest and most diverse range of markets in Man AHL's ('AHL') history, utilising the widest array of algorithms at our disposal. The Programme's track record suggests that it has offered a diversifying return stream to traditional investments in equities and bonds, and trend-following strategies have the potential to exhibit 'crisis alpha' like properties. As such at this time, with these asset classes trading at elevated levels, we believe the AHL Diversified Programme is worth considering.

MARKETS OVERVIEW

2017 marked a watershed year as interest rates began to rise from their multi-year lows. Despite the US Federal Reserve ('Fed') starting to apply the brakes via three rate hikes, the lure of President Trump's stimulus programme propelled US equity indices to new highs and equity volatility, as measured by the VIX, to record lows. Across the Atlantic Mario Draghi, President of the European Central Bank, signalled he wanted to taper its bond purchase programme in the future but did not hike rates.

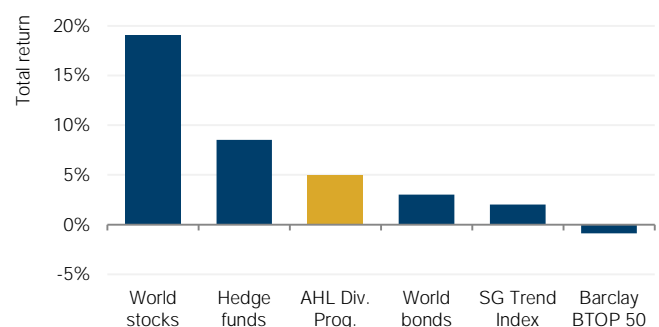
In Japan, Prime Minister Shinzo Abe's decision to hold a snap election was vindicated by both his re-election and the Nikkei hitting 21-year highs. A similar strategy in the UK did not work out quite so well for Theresa May who now faces the twin headwinds of Brexit and a weakened majority in the years ahead.

As will become evident in this piece, equities provided the dominant theme for the year. Indices advanced globally, shaking off concerns of nuclear war as North Korea continued to demonstrate ambitions of launching missiles capable of reaching the US. Corporate earnings were robust, particularly the tech sector. On October 27th alone, on earnings announcements, Amazon, Microsoft, Alphabet and Intel gained more than the market capitalization of IBM².

AHL DIVERSIFIED PROGRAMME PERFORMANCE

As the chart below shows, world stocks top the list of market performers, producing returns of 19% which was the best in four years. The Programme returned 3.35%¹ net of fees, beating both bond performance and CTA indices, SG Trend and the broader BTOP50.

Figure 1: 2017: Performance of various benchmarks in 2017



World stocks represented by MSCI World Net Total Return Index hedged to USD. Hedge funds represented by HFRI Fund Weighted Composite Index. World bonds represented by Barclays Capital Global Aggregate Bond Index Hedged USD. Source: Man Group Database, MSCI, HFRI, Barclays, Societe Generale, Barclayhedge.

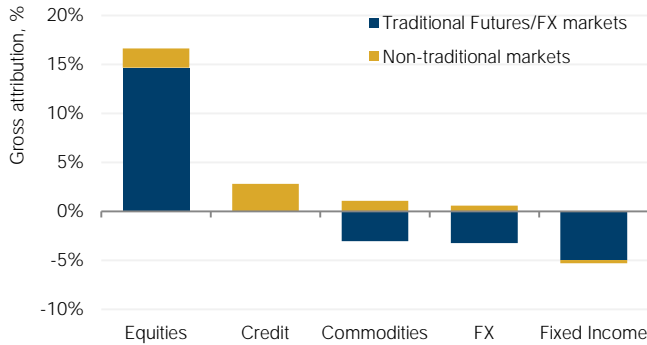
The solid performance of equity markets is reflected in the significant attribution of that asset class in the Programme. In fact, trading from the other main asset classes, FX, fixed income, and commodities, led to losses. We will delve into these in the following section, but it is worth pointing out at this juncture that the performance of what we call 'non-traditional' markets was positive across asset classes. We detailed these markets in last year's review and in the interest of brevity we do not intend to do so again. As a reminder, these are not typically traded by the CTA

1. Past performance is not indicative of future results. Returns may increase or decrease as a result of currency fluctuations.

Next Edge AHL Fund (the "Fund") returns are net of all fees and expenses associated with Class F Units charged from December 28th, 2009 (trading start date.) Returns for 2017 are unaudited. Therefore, performance statistics containing 2017 figures shown in this material are subject to final confirmation. The historical annualized rates of return for the Class F Units are 1-yr 15.81%, 3-yr -1.38%, 5 yr 4.59%, 10-yr N/A, and CARR 2.74%. The Fund obtains exposure to the returns of a diversified portfolio of financial instruments across a range of global markets including, without limitation, stocks, bonds, currencies, short-term interest rates, energy, metals and agricultural commodities (the "Underlying Assets") managed by AHL Partners LLP (the "Investment Manager") using a predominantly trend-following trading program (the "AHL Diversified Programme"). The AHL Diversified Programme is implemented and managed by the Investment Manager. Please note that the performance attribution data is not intended to represent actual past or simulated past performance of an investment product. The data is based on a representative investment product or products that follow the AHL Diversified Programme. An example fee load of 3%+1% and 20% has been applied.

community³ because of their more operationally complex nature, being generally OTC in nature. Examples are interest-rate swaps ('IRS'), cash equities, power derivatives, and options. Trend-following these markets post Credit Crisis has been more fruitful than trading traditional markets such as futures and FX forwards because they have less sensitivity to the choppy macro environment, encompassing diversified price drivers such as emerging market rates and weather patterns.

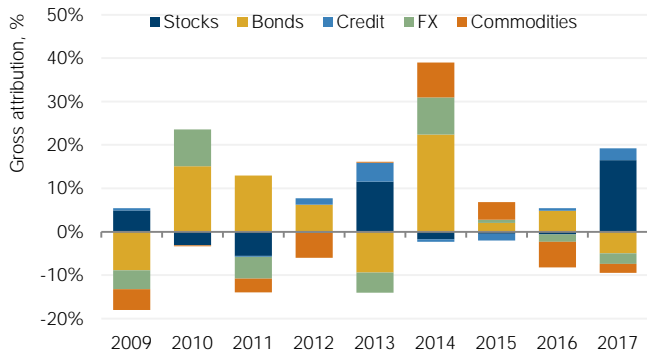
Figure 2: 2017: Gross attribution to the Programme by asset class. Equities is by far the most dominant.



Source: Man Group Database.

The dominance of equities within the Programme is not typical of recent history. In fact, looking at asset class returns by year in Figure 3, 2017 is only the third year in the post-Crisis period when equities have generated positive returns. Predicting which asset class is likely to perform well is an impossible task, and AHL firmly believes that trying to maximise the diversification in the markets traded is also the best way to maximise future potential returns.

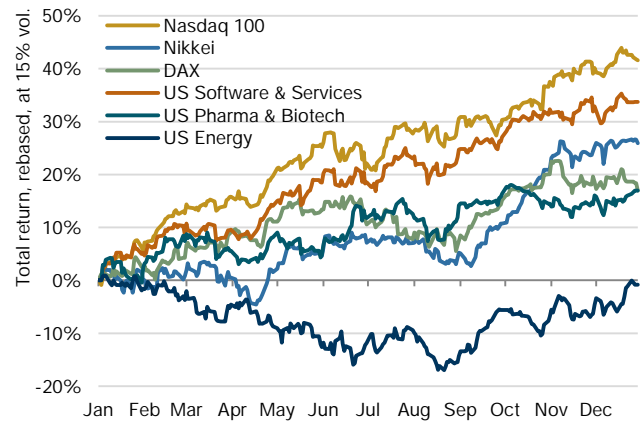
Figure 3: Attribution to the Programme by asset class by year. Equities performed well in 2017, but this happens rarely.



Source: Man Group Database.

Within the Programme, AHL trades both equity indices and baskets of cash equities, with the latter predominantly representing sectors. Risk allocation is shared roughly equally between them but in 2017 equity index trading significantly outperformed sector trading. This is highlighted in Figure 4. With few exceptions, equity indices ended the year in positive territory but sector performance was more mixed.

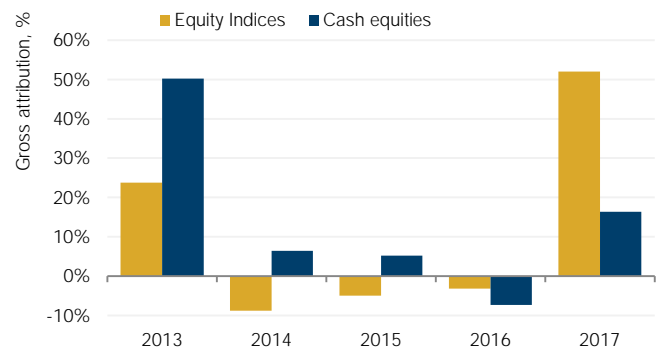
Figure 4: Performance of selected equity markets.



Source: Man Group Database.

Although US software and services exhibited a steady upward trend throughout the year, US Energy prices reversed in September after a notable downtrend and led to losses during that month. As Figure 5 shows, on a like-for-like basis, a strategy consisting of only equity index trend-following would have performed much better than an equivalent one trading 24 GICS Level 2 sectors across the four regions we look at. However, the chart also shows that the additional diversification afforded by trading these sectors has historically played to the Programme's advantage.

Figure 5: 2017 saw underperformance⁴ of cash equities relative to equity index trading, but this has not typically been the case.



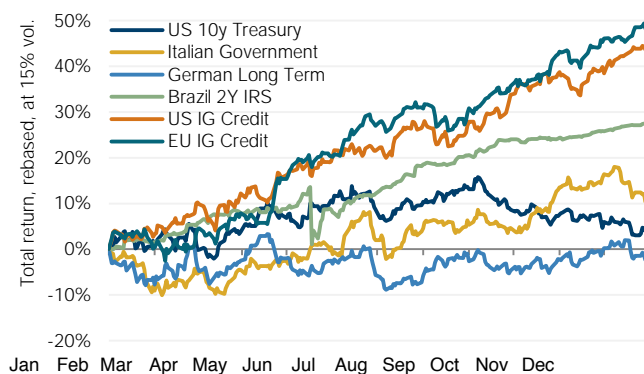
Source: Man Group Database.

In Figure 6 we chart similar price series for selected credit and fixed income instruments. In 2017 the Programme saw gains in each of the liquid CDS indices it trades, which we feel is not surprising given the clear year-long trend evident in investment-grade credit indices below.

3. <https://hfm.global/ctaintelligence/analysis/the-new-frontiersmen/>

4. Represented by gross trading returns of AHL's equity index trading and equity sector trading models with a 15% volatility target.

Figure 6: Performance of selected fixed income and credit markets.



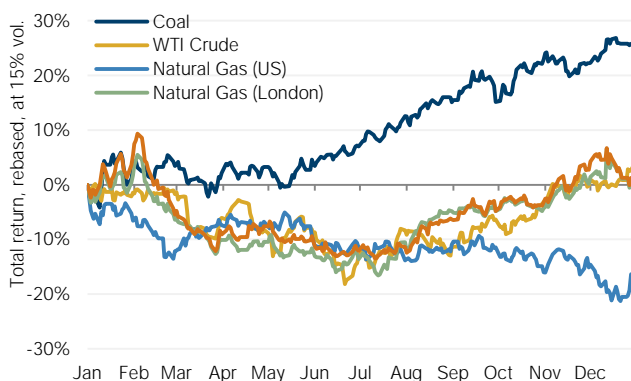
Source: Man Group Database.

In fixed income on the other hand, total returns of key markets were range-bound and profits were harder to find. In general, European instruments such as Italian government bonds fared better than US 10-year Treasuries where yields stayed in a 2.0% to 2.6% range. Once again, however, non-traditional markets such as interest-rate swaps ('IRS') in emerging markets exhibited diversifying behaviour. The total return of Brazilian IRS was hit hard by yet more Presidential impeachment news in May, but trended steadily after that and ended the year as one of the best performing fixed income instruments.

Within FX, emerging markets trading was generally more profitable than in developed markets, with the Mexican peso and Indian rupee being the standout performers. US dollar crosses versus the Japanese yen, British pound, and Canadian dollar proved more troublesome.

As an asset class, commodities was a difficult environment to find trends in 2017. Base metals were the only exception, with prices buoyed by growth in China, but energy markets as a whole performed worst. There were numerous oil headlines throughout the year, from OPEC production cuts to the clampdown of corruption in Saudi Arabia and, as the chart below shows, WTI crude oil finished the year roughly where it started. Although US natural gas was the worst performing market in the energy sector, trading in its UK and Dutch equivalents was positive in the second half of the year as prices rose around 30%. Once again another non-traditional market, coal, was the best performer in the asset class as prices rose fairly steadily post May in response to tighter global supply and decreasing stock levels.

Figure 7: Performance of selected commodity markets.



Source: Man Group Database.

5. For example <https://www.ahl.com/the-rise-of-machine-learning>, <https://www.ahl.com/oxford-man-institute-man-ahl-and-the-direction-of-machine-learning>, <https://www.ahl.com/machine-learning>

NEW RESEARCH

Over the years writing these reports, we have typically reported innovations as being of the market rather than model variety for the simple reason that our analysis has led us to believe that trend-following research is best furthered by seeking new and differentiating markets. Indeed, 2017 was no different with the inclusion of around a dozen new markets, such as off-the-run mortgage bonds, Asian fuel markets, and two new factors to bolster the twelve we already trend-follow across regions. As we showed in Figure 2, these non-traditional markets have contributed positively to almost every asset class.

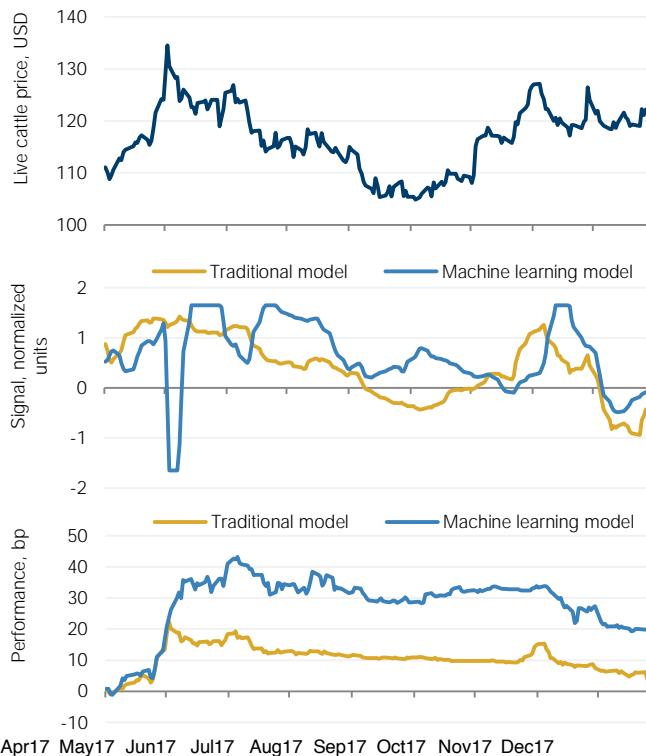
Despite its meteoric rise in both price and trading volume, Bitcoin is not considered suitable for the Programme. That is certainly not because of the nature of the market's price history; indeed price bubbles traditionally offer the best possible behaviour for trend following, both on the upside and the downside. No, it is far more the concerns about both counterparty risks and custody of assets that prevent us from seeing the fit for trading. The approach we have always taken has been to aim at minimising client risks from liquidity and counterparty events, whatever market we are trading in. The regular reports over the past few years of hackers stealing bitcoins from 'wallets' on various exchanges (from Tokyo's MtGox to Bitfinex and more recently NiceHash), make it clear that security of ownership is hard to enforce. Until such issues are resolved, we are unlikely to change our stance.

2017 marked a significant new model milestone, however, with the inclusion of our first machine learning ('ML') model. Despite the media hype, ML is nothing new to AHL; we have utilised these in our multi-strategy funds for over three years and have written on the subject on numerous occasions⁵.

We believe that the beauty of ML algorithms is in their free-form approach. For the past three decades, in effect what AHL has been saying to its computers is "Here is a moving average crossover. This is what a trend looks like. Now go and find some in this dataset". With ML algorithms we are now effectively saying "Go find patterns in the data". Clearly this opens up a spectrum of potential opportunity. The patterns that can be found can be, for example, mean-reverting, seasonal, as well as trend-like. Therefore we believe ML techniques have their most widespread application in multi-strategy programmes where all implementations are welcome.

For the AHL Alpha Programme because of its trend-following remit, however, we implement the algorithms to behave for the most part in a trend-like manner and an example is in Figure 8 shown below.

Figure 8: Example of ML algorithm compared to AHL's traditional trend-following algorithms as applied to trading live cattle futures. Results from simulations.



Source: Man Group Database.

In the Figure we compare traditional trend-following with the new ML algorithm as it was applied to live cattle futures this year. What is hopefully clear is that the signals for the two algorithms (middle chart) are broadly similar for most of the time in that they generally increase when the price increases and vice versa. As the price peaks around the first week in May, however, the ML algorithm wants to take a short position in response to a sharp upward acceleration in the price. In this particular case, the position is warranted as the price re-traces sharply, leading to continued profits for the ML system compared to losses for the traditional system (lower figure). In October, however, the ML system was slower to implement a long position as the price rose, and performed worse than the traditional model.

In the case of the May example, what the ML algorithm is doing is looking for similar price performance in the past and positioning itself accordingly. In this case, it is recognising that periods of sharp price rises are historically generally followed by price relaxation from which the most profitable position is to be short. A similar feature can also be seen in price series where there is an acceleration downward. In this case, the ML algorithm might take a long position in response to past price patterns where a bounce-back has been observed.

Much as trend-following itself is often observed to have behavioural roots (through the behavioural finance findings that humans tend to sell winners early and hold losers too long, for example), these facets found by the ML algorithm can also be argued to be behavioural. Taking profits after a steady run up in price, or the converse 'buy on the dips', are both features that many

discretionary traders might recognise in their own trading styles. ML systems have the potential to pick up these traits because they do not require parameterisation. Instead, we let the data speak for itself and use a ML algorithm to trade it.

A word of caution is warranted here. Astute readers may have noticed that the new ML algorithm's mean reversion behaviour at the turns could be construed as not being trend-like. One of the key reasons that we believe our investors buy trend-following funds is their 'crisis-alpha' like properties; when markets are falling in a crisis, trend-following strategies should be short. It could be argued that this is not a time to be buying on the dips. For this reason, therefore, we do not see the current implementation of these ML algorithms as being a dominant part of the Programme's risk. Instead, with historical correlations of ML to traditional algorithm returns at around 70%, we see this new approach as complementary and diversifying and another component in our tool-kit for attempting to capture trends in markets, whatever their guise.

Trading strategies are not the only domain in which machine learning is applied within the Programme. Indeed, 2017 saw the implementation of a new piece of research that aims to optimise the execution of the Programme's trading by utilising a 'multi-armed-bandit' algorithm.

There are many ways in which a trade can be executed – via internal execution algorithms, by external dealer algorithms, or manually by the firm's trading desk. The new execution framework aims to maximise the efficiency of the process of allocating trades to each of these different trading routes. This is a complicated problem as the efficiency of each execution route will change over time and will diminish as larger and larger flows are directed down it. This is an ideal arena for machine learning techniques, where a model can continuously test each of the different routes, update its prior on the efficiency of each route, and direct trades accordingly.

This project has led to material improvements in the slippage costs incurred by the Programme, which is potentially as valuable as uncovering alpha with new trading signals. This example highlights how the latest research techniques are constantly being deployed to try and improve every facet of the Programme, from initial signal generation, all the way through to trade execution.

OUTLOOK

In previous end of year reviews, we have lamented the task of writing an outlook. After all, as a trend-follower, we do not care whether markets rise or fall. We just care that they do so unidirectionally, and preferably for extended periods of time. How can that be predicted? One pragmatic answer is to say that the more extended prices become in any direction, the greater the potential for them to extend the other way in the future. Trend-following strategies love bubbles. They are long 'things happening'.

From conversations throughout the year, it is clear to us that our clients are increasingly concentrating on trend-following's well-documented⁶ potential to generate 'crisis alpha' returns. In fact, this was one of the main reasons that prompted us to write our white paper 'The Best Strategies for the Worst Crises'. Many investors see extended equity prices and low bond yields and question what they can do to help diversify the downside risks that they foresee. Indeed, flows into AHL's institutional and UCITS flagships have been positive this year, and this is mirrored in investment data for the broader managed futures universe.

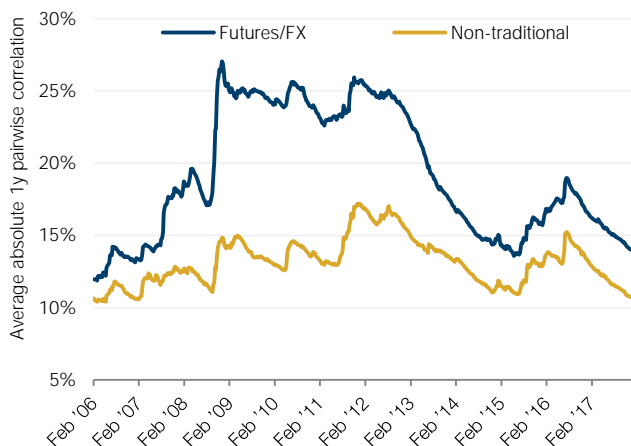
6. "Trend Following with Managed Futures: The Search for Crisis Alpha" (Wiley), Greyserman & Kaminski.

7. <https://www.ahl.com/best-strategies-for-the-worst-crises>

2017 was also a year which we questioned conventional wisdom about trend-following strategies in general. First, it is often postulated that trend-following is 'long volatility', in that strategy returns often are best when markets are at their most volatile, such as in 2008. We would point out, however, that the VIX hit multi-year lows in 2017 and yet equities was by far the best performing asset class. Second, it is often said that trend-followers are unlikely to be short fixed income because of the inherent roll-down and carry of these instruments. In 2017 momentum strategies in the Programme had us short US 10-year Treasuries for around 50% of the year.

We finish off this year's review by examining what we feel is one of the best metrics for evaluating the outlook for trend-following strategies. Broadly speaking, a good market environment for trend-following strategies is one in which there are trends at the single market level, and low correlation between markets so that trends can be found wherever and whenever they occur. In the blue line in the chart below we correlate returns for each market with every other market in the universe of around 150 futures and FX forwards, then take the average. We believe this line is a good proxy for the diversification available to the CTA industry, as this market set broadly defines the CTA universe.

Figure 9: Correlation between markets, both traditional futures and FX markets (blue), and non-traditional markets (yellow).

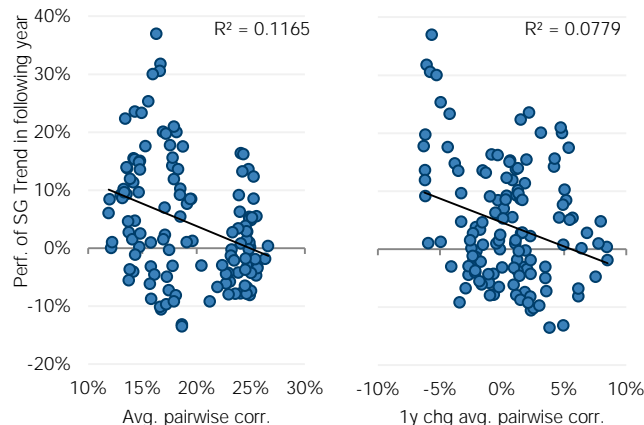


Source: Man Group Database.

It is clear that correlation rose post Credit Crisis in 2008. This is a quantitative illustration of 'risk-on, risk-off' behaviour, as it was termed, where markets which had historically moved in different ways started moving in lock-step, driven mainly by comments by central bankers. This caused a rise in correlation and therefore a decrease in diversification in the portfolio.

Intuitively, therefore, we would anticipate a link between correlation and performance. Indeed this has historically been borne out if we compare both this correlation metric and 1y change in this correlation metric to next year's performance of the CTA industry, via the SG Trend Index. Although the relationships are weak, Figure 10 shows that the following year's performance has historically been better than average when both correlation levels are low, and when correlation is declining.

Figure 10: Next year's performance tends to be better than average when both correlation levels are low, and when correlation is declining. Monthly data points, and date range 2006-2017 as with Figure 9.



Source: Man Group Database.

Of course the analysis for the previous Figure is based on futures and FX markets, as generally traded by the CTA industry and reflected, we believe, in the performance of the SG Trend index. Correlation between the non-traditional instruments traded by AHL, as shown by the yellow line in Figure 9, has historically been lower than futures and FX forwards markets because of their diverse range of price drivers (e.g. emerging market rates, weather). Most importantly, perhaps, correlation hardly rises over the Credit Crisis in 2008. This is the key reason why AHL continues to research new markets.

In summary, if history is any guide, declining correlation to pre-Crisis levels could be a positive environment for trend-following strategies. We enter 2018 trading the largest and most diverse range of markets in AHL's history, utilising the widest array of algorithms at our disposal. The Programme seeks to offer a diversifying return stream to traditional investments in equities and bonds, and trend-following strategies have the potential to exhibit 'crisis alpha' like properties, whether the crisis is defined in terms of equities or bonds⁸. As such at this time, with these asset classes trading at elevated levels, we believe the AHL Diversified Programme is worth considering.

8. 'Trend following: equity and bond crisis alpha' <https://www.ahl.com/trend-following-equity-and-bond-crisis-alpha>

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