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CTA Intelligence

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WHAT BASEL III RULES MEAN FOR CTAS

Correlation challenges undone by top investment managers

Chris Thorpe of CTA Financial explores how AHL, Aspect Capital and Fulcrum Asset Management maintain a competitive edge

Chris Thorpe
CTA Financial

Contagion, or high correlation among markets, is the Achilles heel of some hedge funds. Unsurprisingly, 2008 marked the beginning of a very challenging period for trend-followers that struggled to find the typical opportunities they once had Returns in 2014 and early 2015 tell a different story.

Market correlation has returned to historical pre-crisis levels and signs point to an end of monetary easing. Indeed, some of the top players posted impressive returns through 2014 and 2015, with some funds up over 30% in the last year alone.

The lean post-financial crisis years provided an impetus to advance technology and decrease costs across the industry.

For example, since CME Group launched IRS portfolio margining in 2012, total risk reduction achieved for 42 firms using the offering has accounted for over $5bn in initial margin savings. Increased cross-margining across markets is clearly a boon for hedge funds, but what other factors allow top performers to differentiate themselves?

We asked leaders from top-rated investment managers AHL, Aspect Capital and Fulcrum Asset Management what makes them successful.

Chris Thorpe (CT): Why were many trend-following CTAs caught in such a funk through 2013? Is it purely the fact that they cannot perform in non-trending markets?

Fulcrum Asset Management: Our trend-following strategy was indeed positive in each of 2013 and 2014. Pre-2013, central bank policy led both to high correlation between asset classes and a resultant lack of trends in most asset classes. Like most investment strategies, markets without trends tend to be challenging, but trend strategies can certainly perform.

Aspect Capital: Trend-following CTAs suffered in 2012-2013 due to an absence of persistent market trends, but that doesn't mean that trend-following is dead. We believe research is key to maintaining a competitive edge.

AHL: With previously rather uncorrelated markets moving in lock-step with one another and markets hanging off the every word of central bankers during 2009-13, the opportunity set for capturing sustained trends was limited. There were opportunities outside of the standard trend following models, and so funds with a "multi-strat" focus generally benefited from that. Also funds that applied trend-following outside of futures markets were not affected by risk-on risk-off.

CT: CTAs looking outside traditional trend-following are using more alternative strategies in the OTC space. What new strategies are providing a strategic edge?

Aspect: We trade a diversified range of markets, and OTC trading provides us with a wider range of markets than we would have if we only traded futures. There are challenges in trading OTC markets, so our ability to access these can be a differentiator.

Fulcrum: While OTC markets have tended to be less receptive to electronic access for certain asset classes, this is changing rapidly. Thus algorithmic execution in the OTC space itself is becoming more attractive...

AHL: ...you have new model development, using expertise in quantitative trading as a base for technical strategies outside the momentum space or ones that use fundamental rather than price-based inputs. We see an allocation to such strategies as a nice complement to momentum.

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CT: How hard is it to find markets that are more idiosyncratic? When you find them doesn't liquidity become an issue?

AHL: The search for new and diversifying markets is essential for the development of the CTA industry and has been a consistent focus within AHL. Understanding the sources of liquidity may require a little more effort, but this is where strong relationships with brokers and a deep understanding of the markets are essential.
Fulcrum: Introducing new markets tends to be a question of balancing liquidity and opportunity. It is sometimes tricky to find new markets that have the right profiles from an accessibility perspective. Working closely with an exchange such as CME Group can help in this regard. Listed products with dedicated market makers and exchange-cleared OTC products get us past many of the initial barriers.
Aspect: …we only trade highly liquid markets, and we aren't trying to capture an illiquidity premium. But it's not always the case that OTC markets are less liquid than others.

CT: It seems that driving costs down is becoming more important in distinguishing returns. How do you achieve that in the current environment?
AHL: We have invested significantly in managing [costs], both in terms of trading and slippage. We have enhanced our trading algorithms to make them more adaptive, as well as implementing solutions aimed at bringing down costs in the OTC space. However, distinguishing between CTAs should focus as much on how they've developed their offering in terms of range of markets and models as much as it does on costs.
Fulcrum: An efficient trading and execution platform is an alpha engine in its own right. We begin our investment process with careful selection of our investment universe. We then systematically break down strategy costs into fixed costs, slippage and opportunity cost in order to maximise the efficacy of the strategy. Minimising slippage is one of our trading desk's primary functions while opportunity cost is measured and continually fed back into the research process.
Aspect: Ultimately, the return that CTAs deliver to investors after costs is the most important factor.

CT: Exchange-cleared OTC instruments are now a significant part of the market. How do you balance using cleared versus bilateral OTC?
Fulcrum: At Fulcrum we will usually trade exchange-cleared OTC ahead of bilateral OTC, if possible. Of course, margin considerations are the big driver here but having the security and independence that the exchange provides is an additional benefit.
AHL: Where we may once have had an ISDA, cleared OTC means we might now have a FCM agreement instead. The growth of exchange-cleared OTC instruments is certainly welcomed.
Aspect: Centralised clearing does make some OTC markets more appealing to [our management] and our investors. Our experience in trading these instruments and our recent research efforts convince us of their value.

CT: Given the range of off-the-shelf execution platforms and strategies available, how much do you invest in your own execution technology?
Aspect: The range and availability of solutions out there in the FX OTC space in particular is starting to look very interesting. But that has to be balanced against the benefits of a bespoke solution.
AHL: The continued research into execution and the development of our in-house algos helps us not only to enhance our automated execution to best suit our style of trading, but it also allows us to keep a handle on costs. In fact, the realised slippage from our own algorithms is half that of the best brokers that we use.
Fulcrum: Investing in your own technology makes sense and is something to which we have devoted a lot of resources. However, the ultimate decision as to how much to invest has to be based on potential benefit versus build and maintenance costs.

CT: What is the role of the today's trader as algo strategies take a larger share of the market? What does the "ticket to trader" process look like for your fund?
AHL: We maintain a 10-strong execution team at AHL. Their role is non-discretionary, taking the trades that do not get routed to our automated algorithms, and ensuring the best route to market.
Aspect: The majority of our trades are indeed executed in an automated manner. In OTC markets that have genuine CLOB liquidity (e.g. spot FX), the trader acts more as an algo selector and supervisor. Other OTC markets still tend to be single or multi-dealer RFS/RFQ structures – there we prefer to have traders still pulling the trigger.
Fulcrum: The role of a modern trading desk is changing. While the key responsibility is effective execution, our dedicated trading and execution team is modelled on the need for today's traders to produce detailed analysis around the quality of execution, which can then be used as feedback into the research and investment processes.

CT: In terms of execution, how do major futures exchanges like CME provide more edge to funds versus typical OTC markets?
AHL: For a systematic trader, the operational simplicity offered by futures exchanges is clearly a huge advantage compared to traditional OTC markets. This has clearly been one of the barriers to entry to many in the CTA industry from entering the OTC world. However, our understanding of how futures exchanges function has been instrumental in informing how we trade in the OTC space.
Fulcrum: The standardisation of listed products tends to beget liquidity. Building strategies around major exchange-listed products brings additional benefits around data and cost of execution.
Aspect: Exchanges like CME understand CTAs very well and consequently their products tend to be very well designed and suited for our purposes. As regulations change (particularly in cleared OTC), we fully expect they will provide a reliable and competitive alternative to traditional IDB/bank platforms. CTA