Alternative Markets Amidst Covid Turmoil

Stockholm (HedgeNordic) – Since 2016, Austrian CTA SMN has been trading its Structural Alpha Trend program as part of its flagship SMN Diversified Futures Fund, which was founded in 1996. The program aims to add alpha through trading in less correlated and – most of the time – less liquid markets and make use of synthetic markets as a means of capturing trends that are not exploited by traditional trend following systems. The recent turbulent market action, amid the coronavirus outbreak, has proven the alpha capture abilities of SMN's alternative markets approach.

"The structural alpha trend program has benefited from the fact that there have been some consistent moves in the relative price action of commodities and its underlying expiry months. While at the same time traditional trend following strategies overall have not been able to profit from the violent market moves seen during the COVID turmoil," Gernot Heitzinger *(pictured),* Managing Director of SMN says.

The Structural Alpha Trend program has been trading live since June 2016 and focuses on approximately 50 markets that are outside the universe of about 120 liquid futures markets that are traded by most CTA's. It has identified around 200 instruments within this space and about 40 different uncorrelated return drivers. What has been particularly successful during the recent market turmoil is the programs ability to trade the relative price action of expiry months, the energy sector being an obvious example, according to Heitzinger.

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"While the price of oil has crashed, it has nevertheless been difficult for many medium-term trend following systems to capture the move given its speed and the short-term price swings experienced in this market. However, the fact that the term structure of oil has trended consistently into contango (prices for future delivery rising above the spot market) has created profitable opportunities for the structural alpha program", he says. By the end of May, the program had gained around 4,7% on the year, significantly outpacing the SG CTA Index which was down 1,1 percent since the start of 2020 at the time.

"It shows the correlation benefits of Structural Alpha as compared to a medium-term trend following system. Although using a similar average holding period as our Diversified Futures Fund of around 100 days, the cross correlation of the return drivers in Structural Alpha to those in Diversified Futures is literally non-existent, adding significant diversification to the overall portfolio."

Heitzinger recognizes that there is an inherent dependence on the most liquid futures markets among the world's most allocated to CTA programs, the simple reason being that they need liquidity to turn around large-sized orders, this creates what Heitzinger refers to as a "liquidity skewed portfolio".

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"Instead of creating a truly diversified portfolio of uncorrelated return drivers, optimized on risk-adjusted returns, today's CTA's have overexposure to the most liquid financial markets which results in a loss of diversification as market weights are primarily based on accessibility. In addition to that, larger CTA's are forced into trading OTC contracts in order to find enough liquidity", he says. Rather than turning to OTC-markets to expand the number of uncorrelated return drivers, the Structural Alpha program instead trades a number of so-called synthetic markets. Synthetic markets refer to a combination of different contracts, this might be spreads between two markets, calendar spreads and baskets of different contracts.

“Synthetic markets expand the opportunity-set while at the same time introducing exploitable and alternative trends not being captured in traditional managed futures programs”, Heitzinger says.

He further argues that the Structural Alpha Trend program, which has a set capacity limit of 800 MUSD, has a number of advantages going for it, especially in the current market environment.

“We have a significant allocation to the commodity sector, which is a result of optimizing on correlations rather than seeking liquidity. There is good reason to believe that commodities will exploit some interesting trends as the pandemic unfolds. We have already seen demand-side disruptions in energies, but the supply side in certain markets could face serious disruptions as well, should the situation turn for the worse”, he says continuing:

“Additionally, with a truly diversified managed futures portfolio, you are less dependent on the fixed income sector, which in the current market is likely to be a good thing. Bond yields are likely to remain low for quite some time given depressed economic data and continued low inflation and inflation expectations. This is just not the time to be heavily allocated to fixed income from a trend perspective.”

SMN have yet to offer the Structural Alpha program as a stand-alone fund, but he continues to see good interest for the approach as allocators around the world are starting to think along the lines of concentration risks in their CTA portfolios. However, there are opportunities to co-invest the program via an existing vehicle on the Irish AMX platform.

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“I think that investors are beginning to recognize that they have too little diversification within their CTA book and that the exposure to financial contracts tends to get the bulk of the exposure. This gets particularly obvious in the current market environment. By adding a program that exclusively focuses on the markets that are not picked up on by big-name CTAs will leave you with a much more balanced portfolio in terms of sectors and markets traded as well as adding uncorrelated trend exposure."

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