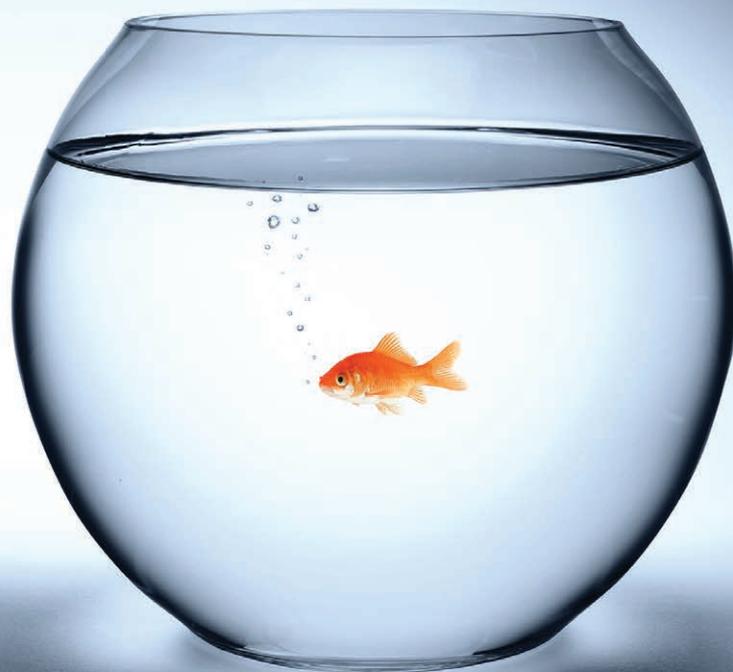
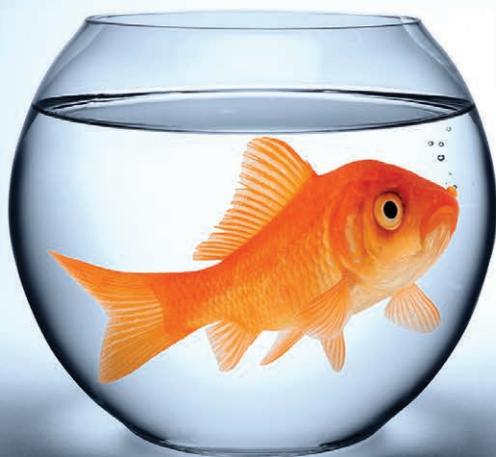


# WHEN SIZE MATTERS



## EXTRACTING ALPHA FROM LESS LIQUID MARKETS

by *Jonathan Furelid* - HedgeNordic

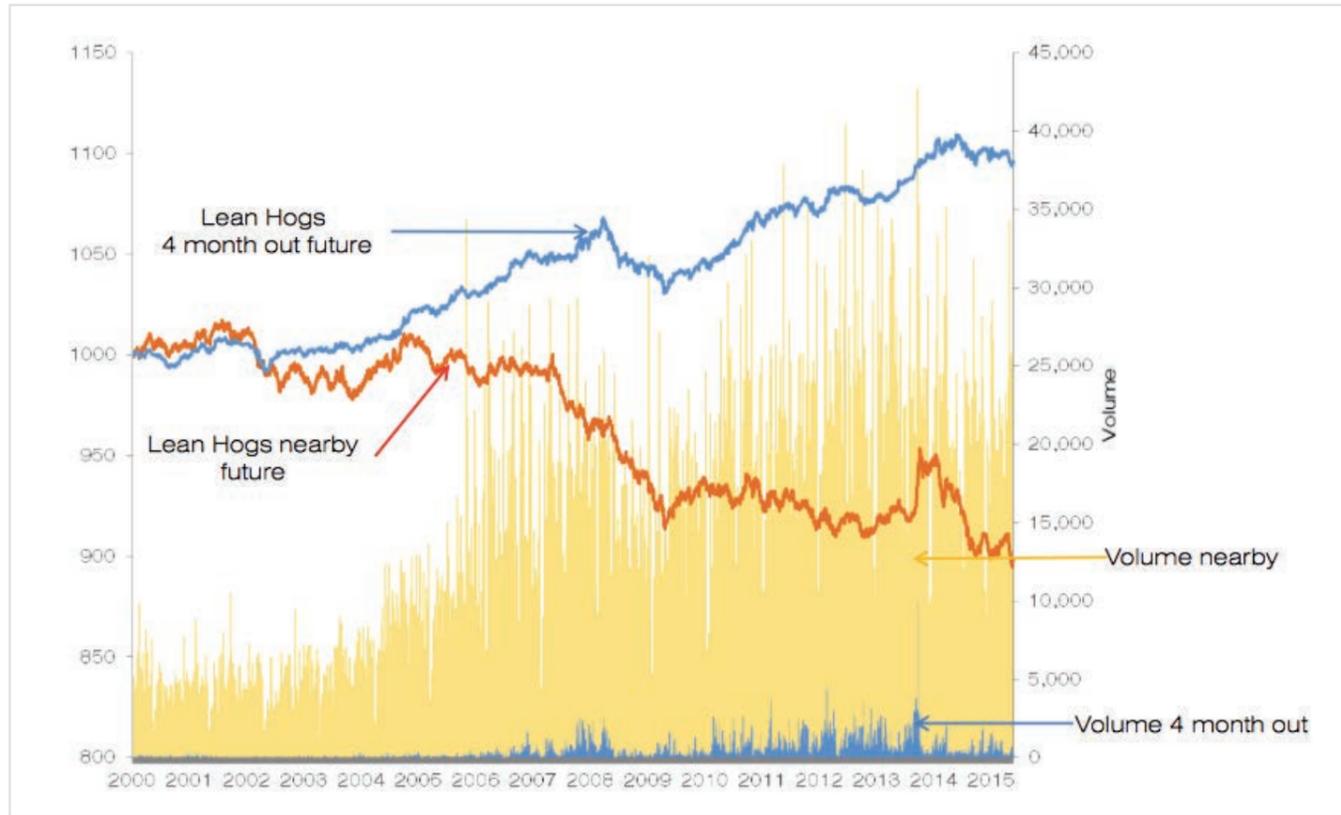
An often debated subject within the CTA industry is the impact of size on returns. Is there a reason to believe that CTAs with larger assets experience a deterioration of returns, simply as a function of them getting too large? Although no clear cut answer has been given to the question, there are thoughts supporting the idea that a different, uncorrelated and alpha generating opportunity-set awaits those CTAs that are small enough to tap into less liquid markets. SMN, a CTA based in Vienna, have put those thoughts to work.

Looking to benefit from their potential size advantage, SMN set up a managed futures program called "Structural Alpha Trend" in June 2016 aiming at systematically trading a multitude of less liquid markets that are largely ignored by the big CTAs. So far results have been encouraging according to Gernot Heitzinger, Managing Director at the Vienna-based CTA. "By focusing on around 50 markets that are outside of the universe of about 120 liquid futures

markets that are traded by most CTAs, we find a completely new opportunity-set for extracting trends and generating uncorrelated alpha. Simply put, big CTAs miss out on half of the opportunities just because they cannot trade illiquid markets efficiently", Heitzinger says continuing:

"Within the less liquid market universe, that have approximately 200 instruments (an instrument can be any delivery month or a synthetic market - which is a combination of markets/delivery months) underlying, we found 40 uncorrelated return drivers, that compare to an equal amount of 40 uncorrelated return drivers within the liquid futures markets portfolio. The nice thing is that the cross correlation of these groups of uncorrelated markets is literally non-existent meaning that there are diversification benefits to be gained by combining them.

The Structural Alpha portfolio has so far been trading as a sub-set of SMN's main program, Diversified Futures Fund



and according to Heitzinger, the fact that smaller markets display some unique characteristics make them a good diversifying return stream.

"In addition to simply trading smaller markets we are also trading far out delivery months of contracts in bigger and smaller markets. This translates into exploitable and very different trends compared to the trends seen in the nearby futures contract", Heitzinger explains showing a graph of the lean hogs future contract comparing the graph four months out to the nearest month. Inarguably showing deviations in underlying price trends.

Another factor playing into the smaller markets story is that they offer the possibility to exploit local trends in the agricultural markets, Heitzinger argues.

"Agricultural markets show strong local weather driven trend characteristics. Those uncorrelated but smaller markets cannot be traded effectively in large size due to volume and open interest. This is definitely a competitive advantage for smaller managers".

The way SMN expands the universe of less liquid markets is to trade 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.

As smaller managers can exploit the full set of sectors, notwithstanding liquidity constraints, means that they will also be able to create a truly diversified managed futures portfolio, Heitzinger says.

"Given that a small market portfolio don't need to take into account accessibility issues due to liquidity, the markets weights in terms of sectors can be determined on the basis of correlations instead and allows for a higher relative exposure to commodities. This provides for a portfolio optimized on risk adjusted returns rather than a liquidity skewed portfolio that holds significant exposure to equities, fixed income and FX."

"With liquidity skewed portfolios having a sizeable exposure to interest rates markets, that also make them more vulnerable to interest rate levels. The smaller markets portfolio however is more or less independent of these levels", Heitzinger says.

With regards to the overall correlation of the Structural Alpha program compared to a broad CTA index, backtested data suggest that it has a correlation of about 0.2 which

is also what the program has delivered in live trading, Heitzinger says.

"That is the beauty of combining a liquid CTA portfolio with a portfolio focusing on less liquid markets, you capture trends but in a very different way. The less liquid market portfolio is for example less sensible to swings in risk aversion, for the simple reason that it trades a lot more niche contracts, typically in the agricultural sector".

Heitzinger doesn't see a major threat in that the larger CTA names will start offering similar products addressing the less liquid end of the futures markets, they will not be able to allocate enough assets to these markets in order for that allocation to have a meaningful impact on the overall portfolio, he argues. The capacity limit of SMN's less liquid markets portfolio is set to 400 MUSD.

"If you run a managed futures program with 20-30 billion USD in AuM, it is very unlikely that you would be able to allocate enough assets to the less liquid part of the market so that it would have any meaningful effect on the overall portfolio. That is the benefit of running a smaller CTA program, incremental improvements could have a significant impact on the performance and risk characteristics of your trading programme, we believe adding smaller markets is one of those improvements.

SMN are seeing good interest for their Structural Alpha program, according to Heitzinger. He takes that as a recognition that CTA allocators are starting to think along the same lines when it comes to concentration risks inherent in only having big names CTAs trading a similar set of markets, that is the most liquid ones.

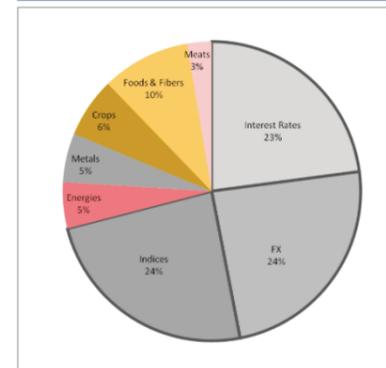
"I think that investors are beginning to recognise that they have too little diversification within their CTA book and that the exposure to financial contracts tends to get the



Gernot Heitzinger, SMN

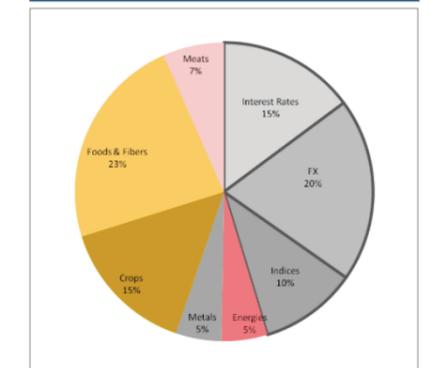
bulk of the exposure. By adding a program that exclusively focus on the markets that are not picked up on by big name CTAs will leave you with a much more balanced portfolio in terms of sectors and markets traded as well as adding uncorrelated trend exposure."

The liquidity skewed portfolio \*



- Overexposure to the most liquid financial markets
- Loss of Diversification
- Market weights based on accessibility
- Increasing OTC exposure (mostly FX)

The truly diversified managed futures portfolio



- Maximum Diversification
- A Portfolio optimized for risk adjusted returns
- Market weights solely based on correlations. High commodities exposure
- As little exposure to OTC markets as possible