Managed Futures (CTA) & Systems Trading "seasonality"….. .. fact or forlorn hope??

Clearer market trends set to boost black-box funds

The below article from Reuters plays up the benefits of Managed Futures during "trending" markets. But equities and, by inference, stock indices (which now make up a large part of the financial futures sector in which many CTAs participate) have been "trending" all year while CTAs have underperformed.

At the same time volatility (as evidenced by the CBOE Volatility Index (VIX)) has smoothed substantially from the wild west rodeo seen in 2H of 2008.

Recent conversations with Sol Waksman of BarclayHedge reveal that he's been thinking about the subject of CTA "seasonality" for some time now and had noticed a few isolated tendencies over the last few years which he'd not yet researched in any detail. So we decided to delve into the possibility to see what we could find.

His data analysis runs from 1998 through 2008 inclusive and includes 158 of his tracked CTAs with minimum 10-year performance records (see fig1). March and July are the only two months showing consistent drawdowns with July by far the worst month of the year averaging 60-65 bp lost.

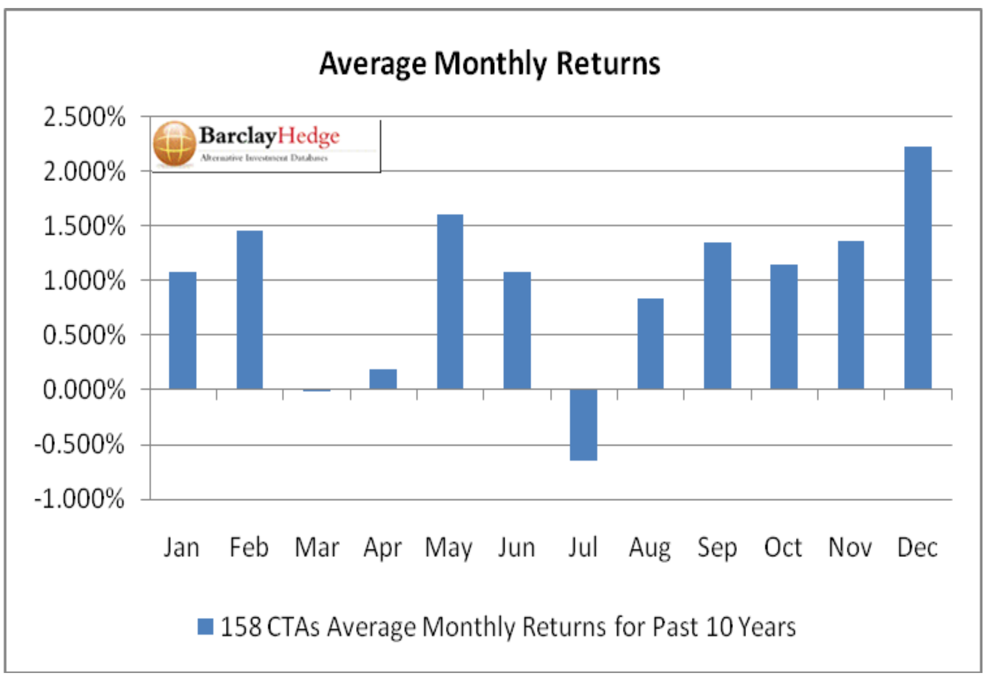

Figure1

Walt Gallwas and his crew at **ATTAIN CAPITAL** in Chicago have this to add:

1. Trends tend to emerge more in the latter part of the year, as investors flock to what's working and dump what's not (causing trends to extend) This is backed up slightly by the **S&P Diversified Trends Indicator** seeing an annualized gains of 10.32% in the 2nd half of the year, versus annualized gains of 8.40% in first half.

2. Due to volatility tending to pick up in the Sep-Nov period each year in anticipation of another October 87 crash This is backed up slightly by the average monthly VIX in the 1st half versus 2nd half of year back to 1990.
   - 1st half average monthly VIX reading = 18.39
   - 2nd half = 20.82

   (see fig2).

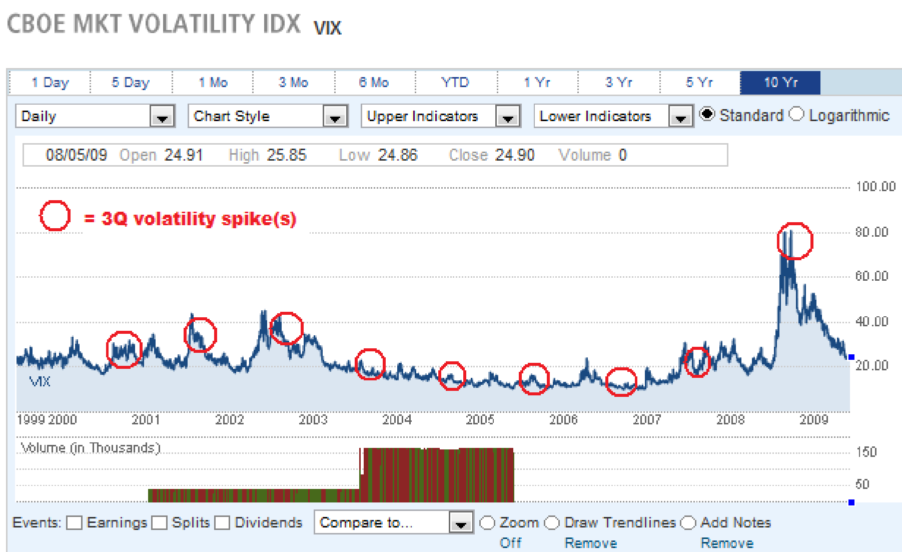

Figure2

3. It is possible that stock markets are less efficient in the 2nd half of the year, as stock market volume tends to be lower in the summer months under the long-standing "sell in May then go away" rule, resulting in a greater opportunity for systematic models.

The guys at Attain also feel that July's closing VIX level, representing a -74% drop in the VIX since its October 2008 peak is a somewhat significant number. The VIX has only declined that much two other times in the past 20 years. Both times signaled a volatility spike was in the not too distant future, but knowing just when that spike will happen is anyone's guess. The first time saw a spike 156% higher just 5 months later, and marked the low in volatility for the next 10 years as volatility steadily increased for the first 8 of those. The second time saw volatility basically stay at those low levels for another two and a half years (with a 114% higher spike 18 months later) before spiking dramatically to the all time highs in October 2008.

What will this time bring?

Date	Drop	Spike	
Sep 90 - Dec 93	-74.49%	156%	9 months later
Aug 02 - Dec 04	-75.29%	114%	18 months later
Oct 08 - Jul 09	-74.31%	??	??

What is the VIX? The VIX is a measurement of sentiment on U.S. equities that the CBOE introduced in 1993. Derived from S&P 500 index options prices, the VIX is designed to reflect investors' consensus view of stock market volatility over the next 30 days. For the more technically inclined, the VIX represents the implied volatility of a hypothetical at-the-money OEX option.

Because investors buy protective puts in droves when the market is in a steep decline to protect from further declines in their portfolio's value, a high VIX reading usually represents increased investor fear and occurs during times of market turmoil. A low VIX reading implies everything is rosy, and investors are getting complacent in their need to buy protection against declines

Of more long-term concern is the positive correlation of commodities in general to equities in general along with the negative correlation of the greenback to both. This juxtaposition is both unusual and (according to historically-accepted laws of economic physics) unsustainable. But that's another issue not directly germane to discussion of longer-term seasonality at hand..

Of more immediate import is a palpable increase in interest in both black box and hi-frequency trading amongst professionals as well as retail investors. Long considered the exclusive territory of "systems" and auto-executed computer models, the two areas have long been employed by Commodity Trading Advisors who often leaven the mix by adding a dash of "discretion" and/or "opportunistic trading" to come up with a value-added product justifying the 2%/20% management & incentive fees which wouldn't apply to off-the-shelf systems employed on a leased or subscription basis. Recent discussions of such have already appeared on Reuters, Seeking Alpha and a plethora of other trade-centric news services as evinced by the following excerpted piece as recently as last week…

Reuters on "black box" trading:

Wed Aug 12, 2009 1:02pm EDT
By Martin de Sa'Pinto and Laurence Fletcher - Analysis

ZURICH/LONDON (Reuters) - After a stellar 2008, trend-following hedge funds have struggled this year with many finding thinly traded markets hard to negotiate, but say a resurgence in market trends is set to improve their fortunes.

Commodities trading advisers (CTAs) are "black-box" funds that use computer programmes to exploit trends in asset classes ranging from interest rates to equities indexes. These trends have been too short-lived in recent months for investors to identify and profit from them.

Managers are now turning bullish as stronger trends show signs of re-emerging in certain markets, said Umberto Loschi, a CTA manager based in Padova, Italy: "Things will take off again in the fourth quarter on increased volatility in energy and agricultural commodities."

While no similarly authoratative data exists covering the "systems" genre', even compu-centric writers have noticed the trend toward systematic trading, as can be seen from these few lines recently penned by Tom Steinert-Threlkeld, a published author and prolific blogger specializing primarily in computer-related issues, who within the past two months has moved into a senior position at Securities Industry News…

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Automation Slowly Taking Over Investment Management, Report

August 12, 2009
Tom Steinert-Threlkeld

Machines are taking over management of equity assets, just as automation took over automobile assembly, notes a report issued Wednesday by Wall Street research firm Tabb Group.

Approximately 34% of U.S. equity investments are managed by a broad set of strategies that can be classified as "quantitative" or automated methods, the group estimated in the report, "The Investment Assembly Line.''

That compares to 14% in 2000. But there was a significant dip last year, coincident with the arrival of the global financial crisis and recession. In 2008, the amount of equity assets managed by computer-driven calculations fell to $2.67 trillion, from $3.17 trillion in 2007. Tabb estimates a more than full recovery this year, with equity assets under quantitative management rising to $3.47 trillion.

Hedge funds have been actively managing assets through automated means for decades, the firm notes. Mutual funds joined the game in the last five years. Next up: Exchange-traded funds and index futures.

What is occurring is "the gradual automation of the entire investment management process across a comprehensive spectrum of investment strategies,'' the report, authored by Paul Rowady Jr. and Adam Sussman, said.

Conclusion:

While data indicates futures money managers and systems traders alike tend to benefit from longer-lived trending tendencies normally experienced in the third trimester, and volatility tends to spike during the same period….

One mustn't lose sight of the reality that THIS super-cyclical correction has been and will probably continue to be, unique in modern history. That said, historical tendencies have probably not been entirely negated even in these extreme conditions. Further, almost as if "on queue", volatility spiked on the 17th of August as can be seen in the below chart . Thus, odds are that this is an opportune moment to strongly consider portfolio allocations to the genre', either as a hedge or as an Alpha-generation enhancer.

CBOE MKT VOLATILITY IDX VIX