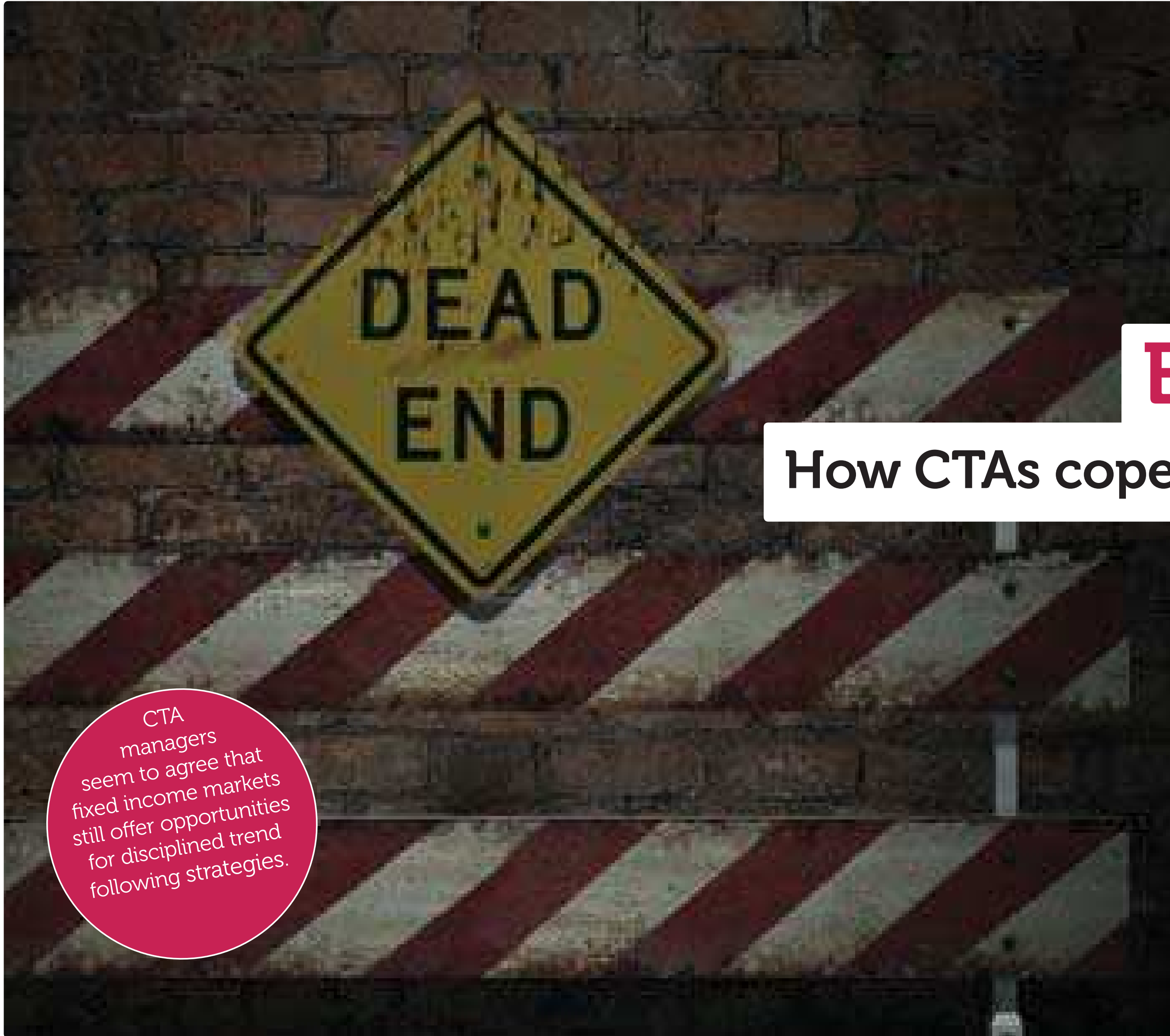

CTA managers seem to agree that fixed income markets still offer opportunities for disciplined trend following strategies.

"According to research by US-based CTA FORT the 7.5 per cent annual returns that were generated by CTAs between 1990-2008 was to a large extent driven by interest earned on excess cash."

by Jonathan Furelid – HedgeNordic

End of the road - How CTAs cope with the nearing end of a bond super-cycle

Systematic trend following futures strategies, formerly known as Commodity Trading Advisors or CTAs, have for the most part benefited from the sustained decline in global interest rates over the past few decades. As bond markets are approaching extreme valuations, and with implied yields trading at rock-bottom levels or even entering negative territory, how are quantitative strategies adapted, if at all, to cope with an interest rate environment never experienced before? HedgeNordic asked CTA managers, both Nordic and international, how they view the current environment and how they look upon the prospects for the strategy going forward.

To trend follow or not to trend follow?

Given the current extreme bond market valuations, are there still opportunities to extract trends from the long side? CTA managers seem to agree that fixed income markets still offer opportunities for disciplined trend following strategies although some point to having taken on a more defensive approach.

"...we have actually seen a number of fixed income markets continue to function completely normally with implied yields below zero..."

Christopher Reeve
Director of Product Management
Aspect Capital

Christopher Reeve, Director of Product Management at Aspect Capital, says that their original approach was a more conservative one but that they have seen markets functioning in an orderly manner even with negative implied yields.

"We originally took the more conservative approach of avoiding markets where rates were at or below zero because we had never really seen this happen before and there were concerns that zero would act as some kind of barrier or that market functioning and liquidity levels would change. However, we have actually seen a number of fixed income markets continue to function completely normally with implied yields below zero, with trends continuing.

Alexander Mende, senior researcher at Stockholm-based RPM, a provider of multi-manager CTA portfolios, says that the way their underlying managers approach fixed income markets in the current environment differ widely.

"Admittedly, the current zero-or-below-interest rate environment is unprecedented in financial history. Thus, our managers' approaches differ from each other. Some managers have introduced caps on fixed income exposures other have not made any adjustments. Obviously, managers without any caps have performance better year-to-date."

Niels Kaastrup-Larsen, Head of European Business of US-based CTA DUNN Capital Management, points to the fact that not only spot prices but also the so-called roll yield plays an important role in assesing the opportunities for trend following systems in global fixed income markets.

"There are two sources of returns on positions in futures contracts. The first and more obvious is the change in spot prices. The second is the so-called "roll yield," which is the change in futures prices due to the necessary convergence of futures and spot prices when time approaches the contract expiration date. In the particular case of interest rates, we have realized gains in the last two years due mainly to the second source of returns. The roll yield will be positive in a long position on interest-rate futures if the expectation of raising rates is not realized. This behavior has been displaying a persistent trend, which has favored disciplined trend-following systems."

"In the particular case of interest rates, we have realized gains in the last two years due mainly to the second source of returns..."

Niels Kaastrup-Larsen
Head of European Business
CTA DUNN Capital

Serge Houles, Head of Investment Strategy at Stockholm-based quant macro firm IPM, says that "making investment decisions based on the rationale that interest rates cannot go lower as they are already too low can lead to sub-optimal decisions."

According to Houles, the drivers that determine the position-taking in fixed income markets for IPM, including the mean reversion tendency of real interes rates, inflation expectations, the bond risk premium, and the shape of the yield curve are valid no matter the absolute level of interest rates.

Are quant models being changed to reflect new environment?

Rather than changing underlying models to adapt the zero or below zero interest rate environment, CTA managers are highlighting the importance of monitoring market dynamics, adding contracts or to adjust the risk exposure to the fixed income sector.

"...it is "impossible to adapt your models to something you dont know anything about. The key to face unknown scenarios is diversification."

Alexander Mende
Senior researcher, RPM

"The key thing is monitoring the market volatility and liquidity levels – which is something which is built in anyway in all markets. But particularly in fixed income we look out for any changes in volatility environment which might show that market functioning is changing and the market is becoming less suitable as a trend following opportunity", Reeve of Aspect Capital says.

According to Reeve, Aspect has also recently added cleared OTC interest rate swap markets to their Programme, which are a synthetic way of gaining exposure to a far broader range of yield curves and maturity points than would otherwise be available in the futures markets.

Alexander Mende of RPM notes that it is "impossible to adapt your models to something you don't know anything about. The key to face unknown scenarios is diversification, Mende argues.

"We apply diversification over trading strategies, time frames, and markets traded. Broad structural diversification is the key to face all unknown scenarios. In our experience, losses in fixed income are often balanced by profits in other sectors."

Despina Xanthopoulou of Stockholm-based CTA Lynx says that they have implemented some risk management changes to adapt to the new environment but that she cannot reveal in what way.

"Lynx have taken certain measures in the program to respond to the changing market conditions within the fixed income sector, the way this is being done is however something we do not share publicly", Xanthopoulou says.

No interest on collateral – does it hurt performance?

Historically, interest earned on cash to cover margin for futures contracts has bolstered the return for CTAs. According to research by US-based CTA FORT the 7.5 per cent annual returns that were generated by CTAs between 1990-2008 was to a large extent driven by interest earned on excess cash. Adjusting for this component, the actual return was only 3,9 per cent annually as expressed by the Newedge CTA Index.

According to Aspect Capital's Reeve, the impact from no return on collateral is easy to quantify as it is "pretty much a direct relationship between the risk free interest rate on collateral and its contribution to performance", he also notes that "the programme has been in a position of not earning anything on our spare cash or collateral for a number of years now".

Lynx´s Xanthopoulou also refers to the direct relationship of interest rates and the return on "unencumbered cash" but highlights that the effect has been small given the volatility profile of their programme.

Kaastrup-Larsen of DUNN says that the zero- or negative-rate environment in recent years has worked well so far for their program, despite that return on collateral has been "a very small fraction of overall return". In fact, the return of the DUNN WMA Program has been significantly higher since

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> Head of Investment Strategy, IPM

2013, compared to the long term average return since inception of the program in 1984. "Reseach improvements are much more important than level of interest rates", notes Kaastrup-Larsen.

Alexander Mende of RPM refers to a research piece that RPM has done on how performance of CTAs is linked to inflation. It shows that the cash interest component has played an important role in times of inflationary pressures.

"Our research shows that CTAs have provided good trading returns in both high and low inflationary regimes over the last 15 years. Looking at industry total returns, however, the high inflationary environment has actually been better, due to the cash interest rate component. This means that even if trading profits has been slightly lower during high inflation, the cash interest rate component has more than compensated for this.

Serge Houles of IPM downplays the role of the cash component for their performance. "It is true that the low level of interest rates has an impact on the absolute level of returns delivered by some strategies. This could be the case for strategies with high unencumbered cash or strategies invested in securities where yields are tied to the level of interest rates. In our case, it has had a minor impact on the absolute level of performance although the alpha generated above the risk free rate has been relatively stable", Houles says.

CTA performance and rising interest rates

The CTAs that we have talked to do not see any major negative impact of a rising interest rate environment, which is often cited as having had a negative impact on the strategy´s performance historically. Instead they are pointing to the diversified approach of their trading programs capturing trends in other markets when interest rates are on the rise.

Lynx´s Xanthopoulou says that the ability of CTAs to generate performance in an environment of central bank interventions has been questioned and also there have been concerns regarding CTAs performance in rising interest rate environments. However, she emphasizes that the Lynx strategy has shown its ability to perform in recent years despite these concerns being ever present and that diversification has been key.

"In 2015, it was currencies contributing the most to our performance, in 2014 fixed income, FX and commodities all contributed strongly while in 2013 equities was the best performing sector. Over time we expect all asset classes to contribute to our performance and on a strategic level we are almost equally weighted to the different asset classes. We have also not revised the return target for the trading of our program which shows we are confident to continue to perform independent of changing dynamics in underlying markets."

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> Despina Xanthopoulou, Lynx