STOCK IN TRADE

Managed futures managers are looking to single stocks to increase diversification and improve returns

BY MATT SMITH

While CTAs have long traded equity index futures among their core assets classes, more managers have been looking to single stocks to increase diversification and boost returns – as well as appeal to a wider class of investors.

A trend among managers to apply systematic systems to single stock futures and cash equities has emerged in recent years, and has been noticeable in some of their return profiles of late. The change in the law in the US in 2000 paved the way for trading single stock futures, and as liquidity has increased, more CTAs are dipping their toes. A number of managers have also turned to cash equities where the liquidity is even deeper.

Jerry Parker's Chesapeake Capital was one pioneer in adopting single stock futures. The firm has had a standalone trend-following stock fund since 2009, and has been trading single stock futures

(SSFs) within its flagship diversified program since 2002, using the same pure trend-following strategy it applies to other markets. “Our strategy has been to trade single stock futures on the long trades and then use stock indices for shorts,” says Parker, explaining that Chesapeake’s research has shown that the single stock shorts don’t perform well historically using its trend-following approach.

“Some of the money management CTAs use is to size the positions based on volatility so the lower the volatility the larger the position, and vice versa,” he says. “In single stocks, their volatility has a tendency to be a very high percentage of the absolute price, so on a lot of the stocks from the get go you know if the stock goes to zero it’s not going to be an outlier trade.”

Chesapeake trades a universe of 100 of the largest, most liquid stocks. Last year, the Chesapeake Stock Trend-Following Fund returned 65%, its best year ever, even over back-testing. “It was pretty amazing,” says Parker. The previous highest returns over the past two decades would have been 1995, 1997 and 2002, according to Chesapeake’s back-testing.

Chesapeake has recently lowered its fees to 1/10 in its stock trend fund, which has to date attracted new investors, and others from its diversified program. “The main reason people like it is because it’s made a lot of money recently,” Parker says, but admits leverage was a key reason for its success in 2013. “Any sort of exit we did was probably wrong as stocks kept going higher.”

However, he adds that while buy-and-hold has paid off handsomely as stock indices have risen higher and higher, the risk control in CTA strategies had proved them to be superior over the past 20 years. Chesapeake’s stock trend fund had higher cumulative and annualised returns than the S&P 500 over that period, with a 0.25 correlation, similar 15% volatility and half the maximum drawdown.

Parker says as investors become wary of the equity markets going up he sees limitations in Chesapeake’s stock trend fund becoming a “great sellable product” in the short term, but adds the strategy will be “beneficial to the diversified program”, where single stock futures are roughly an eighth of the portfolio.Chesapeake trades on OneChicago, where Parker says the liquidity is now “very good” in the liquid stocks.

The single stock futures on ETFs also offer further diversification, allowing CTAs to trade markets such as real estate or emerging markets that they do not otherwise have access to, he says. “As the ETFs get more numerous and more liquid this could be a really good avenue for CTAs.”

Like a number of other CTAs, Chesapeake has looked at cash equities, but Parker says his trading strategy needs to utilise the 5:1 leverage single stock futures offer. “If you trade cash equities it’s a 2:1 leverage,” he says, adding some clients prefer to have their cash stock trading with other managers, and avoid the hassle of investing in a managed futures fund or with a CTA manager that would require them to have an FCM and a cash account.

Sunrise Capital Partners incorporated SSFs into the Evolution program it launched in January last year to take a more granular approach to trading the S&P. “We thought we could get more value out of our strategy by taking a deeper dive into S&P and picking the component parts that were likely to be able to perform best,” explains Chris Stanton, Sunrise’s CIO.

Single stock futures are getting bigger and deeper. Volumes are up. That’s a great thing for investors and managers

Sunrise focuses on nine ETFs that represent the sub-sectors of the S&P 500, but anticipates trading more ETFs as research presents further opportunities. “SSFs are getting bigger and deeper. Volumes are up. That’s a great thing for investors and managers. It’s more places to do what we do well. At $200m we are a small player and have plenty of liquidity for what we need to do,” added Jason Gerlach, Sunrise’s CEO.

The use of single stock futures has added diversification, and the opportunity to provide better risk adjusted returns. And last year’s impact on performance of the program was “material”, says Stanton.

“Single stock futures have proven to be a ‘value add’ for our investors, flat out,” he says.

The Sunrise Evolution program was up 21.92% in 2013, according to BarclayHedge. Sunrise has several different approaches to systematic trading and the use of single stock futures further emphasises the firm’s innovation and progression, according to Gerlach.

To the extent there is any hurdle to overcome with investors there is some education in explaining a slight inflation in margin to equity – single stock futures require a 4:1 ratio compared with the up to 20x leverage inherent in some other futures contracts, but Sunrise says it has not been an issue in deterring any interest in its program.

In a sign that liquidity is growing it is not just smaller managers trading SSFs. The $6bn Dutch managed futures giant Transtrend, whose core focus remains systematic trend following, started trading SSFs in 2004, initially in Europe then in the US since 2008.

It has increased the number of SSF it trades from just a handful two years ago to more than 150 out of the nearly 600 markets traded in its flagship Diversified Trend Program (DTP). “We believe these SSFs are an attractive source of additional diversification to our program and, therefore, we intend to add even more of them in the next year,” explains Transtrend’s Andre Honig. However, he adds that Transtrend’s allocation to SSFs is limited, at less than 5% of the total risk budget in the DTP.

CTAs boost OneChicago

OneChicago, which was formed in 2002 as a joint venture between the CME, CBT and CBOE, started out slowly but has seen volumes increase rapidly in recent years, driven in large part by the CTAs. In 2004, 1.9m SSFs contracts traded through OneChicago. Volume topped 9.5m contracts last year, up 48% on 2012.

CEO David Downey called 2013 a "breakout year" and notes that CTA participation "increased dramatically".

He says the concept was to create the first bridge between two worlds of securities and futures and believes "critical mass" has now been achieved. "We've been the pioneer in bringing these two worlds together. It's something very unique," he says.

"We know it's unique because we have difficulty explaining it to our CFTC regulatory staff. And we have an equally difficult time explaining it to SEC regulatory staff," he adds.

The attraction for CTAs seeking further diversification makes single stock futures a good fit for their portfolios, says Downey. "The futures side of the world like to follow trends. If you give them an unnamed chart of Apple for period of Jan 2012 through July 2013 it looked like natural gas and they would have loved to trade that market. But they had the problem that they couldn't trade the underlying stock because they're prohibited by their charter."

Downey says the trick was to get interest from the futures side by attracting liquidity providers on the securities side, who have the skill set to hedge themselves to take the other side of a CTA trade.

Delta One desks were the answer: effectively allowing participants to carry exposure to stocks synthetically using a future, with zero dividend exposure, and simply carry their position as a "very competitive" interest rate, Downey explains.

"What we've done is introduced a liquidity-seeking group called the CTA community to the securities side lending group. This is really a lending trade," he explains.

OneChicago now offers roughly 2,800 SSFs products, including 500 futures on exchange-traded funds and 1,250 OCX.NoDiv contracts, introduced in Q4 2010 to remove dividend risk. It also launched OCX. Weekly futures in January to broaden its offering. Contracts are cleared through the AA+-rated Options Clearing Corporation and regulated by both the SEC and CFTC.

Downey says CTA interest began with a "nibble" in the summer of 2012, and they expanded their positions around the March expiration the following year. "That's when we really saw it starting to take off," he says. "The real volumes came in in around March 2013".

He says the volume has attracted other CTAs. Not all are trend-followers and have other interests in trading the US equity markets, he adds.

And as CTAs have started to expand the number of names they're trading, OneChicago has expanded the trading firms that are interested in providing financing transactions. "This has been a steep process but we've now reached that critical mass where there is more liquidity than demand, and we're actively marketing to the CTA community that you can tap into this liquidity," Downey says.

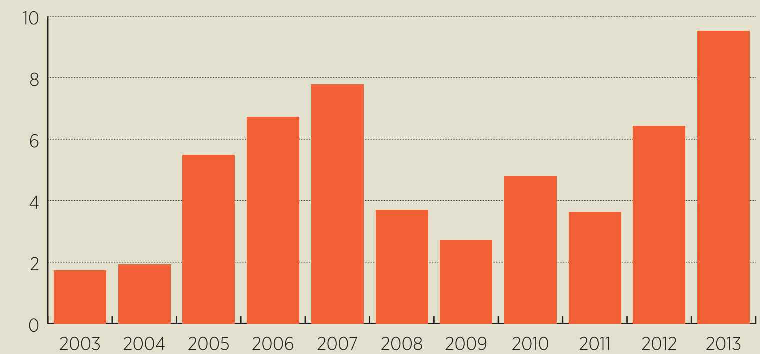
He believes CTAs now account for around 60% of volume on one side, where as five years ago it was zero. "They are a significant part of our business model," he says. Hedge funds on the securities side have also been "dipping their toes", he says.

"Volume begets volume and we have begun to see the securities side traders come in. They don't see any difference between a synthetic position using an OTC swap and a synthetic position using a future in a regulated exchange traded market – except for upgrading counterparty exposure and no longer having dividend exposure."

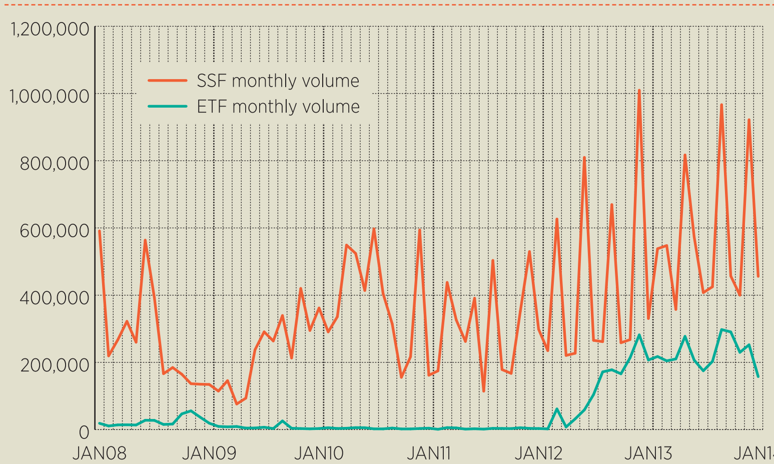
OneChicago, which since 2006 has been part owned by Interactive Brokers, currently operates the only US-based securities futures marketplace, but Downey sees potential competition coming as the OTC swap business migrates to exchanges or SEFs with central clearing when the SEC promulgates its rules under Dodd-Frank.

"Certainly there are no barriers to entry to listing a single stock future product," he says. "But to compare apples with apples we would need to see a Delta One product like ours and there are none on the horizon that we can see. But we fully expect someone to come up with one of these SEFs to offer

ONECHICAGO TOTAL VOLUME (M)



SSF VS ETF MONTHLY VOLUME



Source: OneChicago

this type of activity. They are going to have to do it at some point."

One challenge to OneChicago's growth from offshore clients could come in the proposed regulations from the Treasury and IRS under the Hire Act, which expands the definition of dividend-equivalent payments to foreign entities that will be treated as a dividend from sources within the US and subject to withholding tax. But it won't come into force until 2016.

OneChicago, which is based in the CBT building, is meanwhile focused on replacing the CBOE match engine it has been using, with its own technology. Other exchanges are also increasing their SSFs offerings. More than 900 are tradable at Eurex, which introduced them in 1999, although they are not approved by the CFTC in the US.

Euronext, owned by IntercontinentalExchange (ICE) but expected to be floated later this year, announced an initial 86 SSFs in January, which it will then expand over time to meet growing demand.

ICE also offers more than 55 Dutch, French and Italian blue-chip stock futures through NYSE Liffe's central order books and more than 1,200 underlyings through its Bclear wholesale service, with an initial offering of 25 dividend adjusted SSFs launched in November.

Cash equities

In the quest for diversification, London–based managed futures giant Winton Capital is one of a number of firms that has made significant allocations to cash equities, although it does not currently trade SSFs.

Its standalone Winton Long Only Equity Strategy is now roughly $700m in AuM, although the firm trades billions in its overall equity book, largely through its flagship $23bn managed futures-focused Winton Diversified Program.

The roughly $10bn Winton Futures Fund, which now has a 25% allocation to cash equities, gained 9.4% last year, while the even more equities-focused Winton Evolution fund, with a 40% cash equity allocation was up 14.6%, according to investors.

In the US, Baltimore-based Campbell & Co has a set of strategies trading more than 3,000 cash equities using a statistical arbitrage approach, although this is not yet part of its flagship managed futures offering.

Transtrend launched an Equity Trend Program in 2007, a systematic long/short equity program that overlaps with the firm's well-tested Diversified Trend Program strategies, but also includes some non-trend following components.

The program is running around $13m and trades approximately 2,900 cash equities including some CFDs. The universe consists of constituents of the MSCI World, the MSCI Emerging Markets Index and the MSCI World Small Cap Index.

Smaller managers too are diversifying into cash equities. Austria-based Qbasis Invest officially launched its q Stocks Fund in January, applying the same strategy it has used for over a decade in the futures market, its flagship i Trend strategy, to single stocks, mostly in the S&P. "We trade cash equities because of a larger variety of stocks available," says CEO Philipp Pölzl, adding the liquidity is better when using cash equities, and leverage is possible and available at low costs.

Pölzl says as periods of high volatility and increased price persistence are more likely to occur with single stocks than in any major market indices, single stocks are the ideal instrument on which to apply Qbasis' trend-following strategy. "We think that we can demonstrate significant outperformance vs buy and hold because of a higher upside and a protected downside via the ability to go short," he says. "Also, it is a well-known fact that it is very difficult to find a long-only fund that is able to consistently outperform its benchmark over a long period of time."

Pölzl says applying Qbasis' trend strategy to single stocks results in a return stream uncorrelated to traditional stock and bonds investments as well as broader hedge fund and managed futures strategies.

While the concept is new for most equity investors, Pölzl says explaining the benefits of a systematic approach that trades equities long and short is easier than explaining managed futures, margins and the intricacies of futures trading.

But he says once equity investors embrace q Stocks, Qbasis hopes they will look at its futures strategy, Qbasis i Trend, as well, because "although there may be longer drawdown periods, we believe it is the most effective instrument you can use to insure your portfolio."

Pölzl says interest is coming from long only investors who see the potential of reducing their losses, or even gaining, while markets are going down, as well as managed futures investors and specialist CTA fund of funds looking for strategies that are uncorrelated to their current CTA holdings.

Pölzl expects to see more CTAs incorporate single stocks into their diversified programs, as well as a number launching standalone products. "We feel that for CTA investors the biggest benefit of a standalone product is the low correlation to CTA strategies itself. Long/short equity products generally have a correlation of about 0.5 to stock indices. In our case the correlation numbers are extremely beneficial because they tend to be closer to zero."

Pölzl adds: "It may sound strange but now is the perfect time for a launch. Due to the ability to go short, Qbasis q Stocks is ideal for investors that fear the market may sell-off but also for investors who don't want to miss out if and when stocks continue to rally."

While 2013 demonstrated some of the benefits of adding single stocks, either through futures products or cash equities, it may take another 2008 to reveal their full diversification value to a portfolio. CTA

TOP TRADED SSF/ETFS ON ONECHICAGO IN 2013

Name	Symbol	Volume
Financial Sector SPDR	XLF1D	680099
Oracle Corp	ORCL1D	227455
Pfizer Inc	PFE1D	214302
Energy Sector SPDR	XLE1D	176050
Industrial Sector SPDR	XLI1D	171909
Consumer Staples Sector SPDR	XLP1D	169210
Technology Sector SPDR	XLK1D	169061
Vale SA	VALE1D	163063
Banco Bradesco SA	BBD1D	152347

Source: OneChicago