How can investors participate in a trend before it has ended?

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Few people today would still insist that financial markets are efficient. Financial markets are driven by ideas and ideas do not flow instantaneously across markets. Social scientists have studied the adoption of new ideas by many different groups ranging from the use of a new treatment technique by doctors to the spread of new technology amongst knowledge workers or the general population. Most of these studies show a common pattern. Ideas are first accepted by a small group of innovators who seldom make up more than a very small fraction of the population; ideas are then more widely disseminated by the early adopters before gaining widespread recognition by the majority of the population, followed subsequently by the late adopters and finally by the remaining laggards. Empirical findings suggest that the diffusion of ideas within financial markets follows the same path.

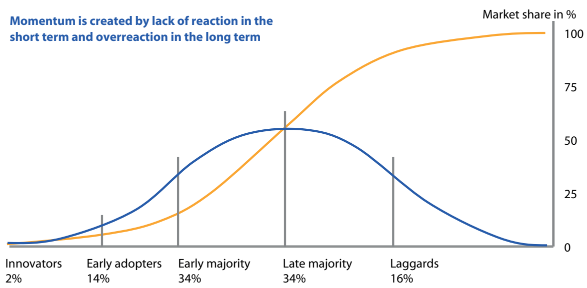
The Spread of Ideas

The majority of institutional investors are comfortable with not being early adopters, but they would certainly not like to be the laggards who would lose out on any benefits to be gained by shifting asset allocations in response to changing perceptions of the macro-economic environment. The problem they face however is that the timeframe for making major asset allocation decisions necessarily has to be long – many months if not years. But financial markets have experienced major changes within the course of just a few months. Changing allocations in response to key developments such as the introduction of "Abenomics" in Japan, which has proved to be a game changer, can too often be just too late to gain meaningful benefits for institutional investors. Economists and market strategists are sometimes well positioned to identify trends early. But they are hardly ever in a position to change asset allocations quickly in a dispassionate way.

To persuade an investor to make a major asset switch requires powerful arguments when it can often be difficult to differentiate between powerful analysis and powerful emotions. Deciding on when to reverse a decision can be even harder as a judgement to change the status quo can be easily clouded by emotions. How can institutional investors hedge their lack of exposure to powerful new ideas, whether the impact is positive or negative?

The diffusion of new ideas that impact financial markets can be seen as trends that push a particular asset class upwards or downwards. Exploiting a trend is straightforward enough and during the 1980s and 1990s, managed futures funds achieved great success by identifying trends and then hopping on with large exposures. However, over the past five or six years such trend following strategies have performed badly – the volatility regimes prevalent in the markets have been very different to those seen historically and the assumptions in the models have struggled to cope with the many different trends being seen, resulting in losses. The problem of how to benefit from a trend can, however, be reformulated to ask the question how can institutional investors protect themselves from the danger of not having participated in a trend by the time it has ended? What the institutional investor requires is the ability to acquire options to participate

When do markets exhibit momentum?



Source: Rogers, E.M. (1962) "Diffusion of Innovations". New York: Free Press. picture: http://en.wikipedia.org/wiki/File:Diffusionofideas.PNG

in a trend, whether upwards or downwards early in its development and to be able to step off the trend without emotions clouding judgement.

Purchasing options on financial markets is clearly possible for institutional investors and a strategy of purchasing call options and purchasing put options at different strike prices above and below the current market price of an asset could generate profits if that asset market moved greater than the implied volatility that the options had priced in. Such strategies can be beneficial when used judiciously, but would require expert judgement to prevent the option premiums from swallowing up more than their capital gains. Institutional investors are faced with a dilemma that whilst purchasing call and put options on a regular basis could theoretically give exposure to new trends, eliminating biases in the timing and maturity of option purchases together with their costs makes such strategies unworkable and uneconomic in practice if applied continuously. Metzler Asset Management ("Metzler") has produced an elegant solution to this problem through the use of a highly systematic application of option replication using liquid futures contracts. The strategy has a track record going back to 2008, when it proved itself by showing that the addition of this strategy to a portfolio would have reduced the overall drawdown of a balanced portfolio by a much higher proportion than the weighting given to the strategy.

Capturing trends systematically

It is perhaps not surprising given Metzler's German heritage, that its strategy is based on a precise engineering approach designed to produce consistent and reproducible behaviour. The strategy is simple in concept, but requires a large amount of IT resources to implement effectively. Empirical analysis has shown that, on average, it takes around 12 months for ideas to be dissipated within financial markets. It can be greater or less, but the evidence has shown that using a 12-month time horizon produces the highest returns on average. As a result, on the 1st of each month, Metzler instigates replication strategies for call options and put options to produce straddle-like option pay-offs across 80 different equity, bond and currency markets, each with a 12-month maturity. At the same time, 80 different option replication strategies that have matured are closed out. Strategy costs are reduced by simultaneously selling extreme-out-of-the-money options ("butterfly" trades). Each subsequent day, each option strategy gives rise to the sale or purchase of a number of futures contracts representing the delta of the option – the theoretical change in the value of the option for a given change in the underlying asset class. Of course, many of the transactions would offset each other, so the net trading in the marketplace would be just the change in the sum of all the 12 call and 12 put option replication strategies for each asset class.

Metzler's approach produces a portfolio that is highly diversified across asset classes and regions, so that trends can be picked up wherever they occur; it is diversified evenly over time, with the rigorous creation and expiry of 12-month options every month; it uses no return forecasts in the alpha-generating process so that it is completely independent of emotion; and it uses only highly liquid instruments enabling the strategy as a whole, to have daily liquidity with no lock-up period and no redemption fee. Perhaps not surprisingly, it has one other key advantage for institutional investors – it produces returns that are uncorrelated to bonds and equities.