The Power of Commodities in SMN's Trend-Following Approach

By Eugeniu Guzun 2024-09-04

Stockholm (HedgeNordic) – Commodities, known for their cyclical nature, often experience extended price trends due to supply-demand imbalances, geopolitical events, or broader macroeconomic shifts. These prolonged movements, both upward and downward, create opportunities for trend-following strategies that thrive on such directional plays. This is one of the reasons Vienna-based trend-follower SMN Investment Services has historically maintained higher exposure to commodities, including niche commodities, than traditional CTAs.

"The primary reason behind our focus on commodities is their low correlation with other asset classes. Equally important, the correlations within the commodity sub-segments themselves are also low," explains Joseph Waldstein, Managing Director for Quantitative Research and Risk Management at SMN. Waldstein also emphasizes that "a known but often overlooked fact is that correlation is a random variable that fluctuates over time." During episodes like the Credit Suisse meltdown in early 2023, correlations spiked across all asset classes, but not necessarily within commodities. "Commodities offer sensible diversification in such episodes because these spikes might not affect the portfolio as much when you have commodities exposure."

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In addition to the diversity within the commodities market, commodities are also known for their strong trending characteristics due to their cyclical nature. "One notable property of commodities markets is that they face physical constraints on supply and demand," Waldstein explains the cyclicality of commodity markets. For instance, shocks like Russia's invasion of Ukraine can trigger long-term trends in commodity prices. "Substituting the gas from Russia takes a lot of time, capital-intensive investments, and also political will," notes Waldstein. "These shortages create long-term trends, which are particularly beneficial for CTAs," especially those with a focus on medium to long-term trends such as SMN.

A Diverse Universe, Not Just Commodities

Despite the appeal of commodities for trend-followers, Joseph Waldstein stresses that a successful trend-following strategy requires a diverse and expansive universe, not just commodities. "No doubt commodities per se form a valuable asset class for us, offering attractive diversification, correlation, and trend characteristics," reiterates Waldstein. However, "it's crucial to have a wide range of asset classes and instruments in your universe to capture as many trends as possible."

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SMN's Diversified Futures Fund, therefore, trades across various asset classes, including what the team calls "structural alpha" markets. These are markets driven by local or regional forces rather than global factors. These markets, which can include niche commodities such as South African wheat, sugar, or cattle, as well as synthetic markets such as calendar spreads, "have inherent structural rigidities, are exposed to local shocks and not necessarily only the global ones," according to Waldstein. "These niche markets are less liquid, with more rigidities and slower information dispersing, making them exhibit strong trends that may dissipate more quickly in other markets."

SMN distinguishes itself by trading a range of futures contracts beyond the front month, including standalone trends at different maturities and calendar spreads between contract tenors. With SMN Diversified Futures Fund managing $200 million, "we can afford to trade these markets and profit from the slower information dispersion that creates attractive trends," says Waldstein. "Even if we managed $500 million, we would continue trading the same markets in the same way," he emphasizes.

More than Half of Risk in Commodities

SMN does not impose strict upper or lower bounds on exposure to specific asset classes like commodities. "Our only criterion is whether the market is trending or not. It's perfectly feasible for our portfolio to have zero commodity exposure if we do not find statistical signals, although that's rarely the case," explains Waldstein. "We avoid over-optimizing or setting hard bounds on asset class exposures. The only requirement is the presence of signals," he emphasizes. "Our portfolio can be very dynamic."

Although other trend-following strategies might share the same universe, instruments, and trading horizons, Waldstein highlights that SMN trades commodities "in a more significant way in terms of portfolio risk." Over time, the SMN Diversified Futures Fund has allocated more than half of its risk to commodities. The balance between commodities and other asset classes depends on various factors, including trend signals, volatility, correlation, and overall financial conditions.

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"Commodities represent an important contributor to portfolio volatility, but let's not forget the importance of diversifying with other asset classes," underscores Waldstein. Commodities can be highly volatile, justifying the inclusion of a broad range of asset classes and instruments. However, Waldstein emphasizes that "the risks faced in trend-following, such as sudden reversals or liquidity issues, are present in other asset classes just as they are in commodities."

Managing liquidity issues, especially in niche markets, can be challenging. However, "trading experience and a deep understanding of market microstructure can address these challenges," according to Waldstein. Waldstein, who has been with SMN for 18 years, notes that the firm's strategy has a 27-year track record and relies on extensive experience in trading these markets, coupled with the support of experienced brokers. SMN's strategy is "fully automated and systematic, with no human intervention in trading," so the experience can make a significant difference, particularly when trading less liquid markets.

The Role of CTAs in a Portfolio

Trend-following strategies have a proven track record of delivering strong returns and protecting portfolios in risk-off environments, such as the 2008 financial crisis or the market turbulence of 2022. While there is limited evidence on how inflationary periods affect trend-following strategies, their design makes them well-suited for inflationary environments. "The recent period of inflation, which began two and a half years ago, started through commodities mostly," recalls Waldstein. "Exposure to a CTA allows you to pick up the risk in the commodities that are causing inflation," he adds. "Our CTA can serve as a hedge against inflation, though it's not a mechanical payoff like an option, where the payoff increases as the underlying declines."

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This logic also applies to crisis-alpha generation. "It's not a mechanical hedge. An option can provide protection against sharp and fast drawdowns, whereas a CTA typically doesn't. That's a feature, not a bug," Waldstein explains. CTAs generally offer protection in slower, more prolonged downturns or trends. The market environment of 2022 was a prime example, with dislocations in equities, commodities, and interest rates creating a "perfect storm for a CTA," according to Waldstein. "In our experience and based on plenty of evidence from our clients as case studies, adding SMN to their portfolios has allowed them to improve their upside by keeping their volatility rather constant and has reduced volatility without sacrificing expected returns."