SMN: Capitalising on Commodity Trends

Niche futures markets and risk overlays drive outperformance

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SMN Investment Services' flagship Luxembourg-domiciled Diversified Futures Fund has received *The Hedge Fund Journal's* CTA and Discretionary Trader award for Best Performing Fund over 2 Years ending in December 2022, in the Trend Follower (AUM $100m to $1bn) category.

SMN has continued to outperform in 2023, because the manager, located away from the major financial centres in Vienna, Austria, also invests in markets that are off the beaten track. SMN nearly always has more commodity exposure, including some "niche commodities", and less fixed income exposure, than do most CTAs. During the long QE era of very low, zero and negative interest rates, SMN did at times lag larger CTAs, which sometimes have bigger weightings in the largest liquid bond markets, but as interest rates have normalized post-Covid SMN has once again been able to demonstrate the advantages of its investment universe.

Since the beginning of 2021, SMN returned +82%, versus the Societe Generale Trend Index +37%, or volatility adjusted to match SMN volatility +68%. In terms or return-to-risk ratios, SMN's was 1.7 versus 1.1 for the Soc Gen Trend Index.

If we telescope into March 2023, the differences become magnified. SMN lost just -1.6% in March, compared with the Societe Generale Trend Index figure of -7.7%. In 2023, SMN's risk management algorithms firstly reduced its short fixed income exposure before the extreme reversal seen in March 2023, and then eliminated it altogether as the mini-banking crisis intensified.

As markets have recovered, SMN has also bounced back further and faster than the Trend Index. It has recovered +9.5% in April, +4.2% in May, and +3.6% in June, taking first half 2023 returns to +15.1%. The best performing sectors have been soft commodities, meats, stock indices, calendar spreads and currencies (in both developed and emerging markets).

Niche commodities

Sugar and cattle have been amongst the most profitable commodity markets this year, and SMN's capacity constraints allows it to size these positions large enough to make a material contribution to returns.

They are examples of niche commodities being part of SMN's "structural alpha" markets invested in since 2016. These niche commodities are more driven by local or regional supply and demand forces than by more global factors applying across most financial markets, such as money flows and risk appetite. SMN determines if commodities are local or global based on their liquidity and patterns of correlation. The manager has identified approximately 35 such "structural alpha" futures markets all being traded on exchanges, rather than venturing into OTC markets. "Niche markets can show stronger trends due to slower diffusion of information, which may in turn be due to fewer participants," says Christian Mayer, co-founder.

Most precious and base metals are in the "global" bucket, but there are two exceptions: iron ore and palladium are deemed to be "local". Most commodities are categorized as either global or local, but for some of them it depends on the maturity. "For instance, natural gas is grouped as global for the front month, but more distant contracts are categorized as less liquid and are therefore local," says Joseph Waldstein who leads a research team of seven.

In commodities and some financials, SMN is distinguished by trading a range of contracts beyond the front month, both for standalone trends at different maturities, and trends in calendar spreads between two or more contract tenors. In total, SMN trades 200 markets but over 300 instruments due to the multiple maturities.

Weather

If natural catastrophe bonds or "CAT bonds" have incurred perennial losses due to extreme weather, related to global warming, trend following CTAs are one strategy that may be able to profit from shocks and surprises in weather patterns. For instance, sugar and meat markets performed well in 2023 due to weather volatility: "Weather anomalies affect harvests and make planning of agricultural production difficult. Bad harvests and uncertainty can lead to low inventory levels, which in turn lead to relative supply shortages. These shortages lead to well-defined trends that may last for a fair amount of time due to the seasonality of harvesting/agricultural production. This happened with sugar, which saw an unexpected rain season last year and the arrival of El Niño this year, and cattle markets in the US, which saw a drought in the last few years make pastures scarce. Rescaling production and cattle inventories is a slow process because of the time needed before slaughtering," explains Michael Neubauer, co-founder.

Weather factors have been important, but as a traditional technical price-based trend follower, SMN is of the opinion that price action should reflect weather data and forecasts and are not seeking to model it directly.

Commodities versus financials

SMN's balance between commodities and financials depends on a range of factors, including signals (trend breadth), volatility, correlation and overall financial conditions. "In theory we could have 100% in either commodities or financials, though this has never happened," says Neubauer.

A typical mix in terms of risk is around 45% financials and 55% commodities, though immediately after the March 2023 bond rally, commodities reached 80% exposure after the portfolio was stopped out of fixed income positions. SMN did not add to commodities but exiting fixed income positions reduced overall exposure and risk, leaving commodities making up a larger part of a smaller book.

Risk overlays reduced fixed income and other exposures
On average, SMN are exposed to any market around 60% of the time. Immediately before the March 2023 bond rally, SMN had short positions in about 60-70% of the fixed income markets that it trades.

The sizing of positions per market also dynamically varies. Prior to the episode, the sizes of these fixed income bond and bill positions had been reduced by around 20% due to both correlation and risk overlays, with the correlation overlay playing a larger role.

In fact, the correlation overlay also led to reductions across other sectors, including a 30% cut in currency exposure, some smaller reductions in equity positions, and additionally some shaving of commodity positions including energy, meats and softs.

The key metric for measuring exposure is risk exposure, and though this will often also go hand in hand with lower notional and margin to equity, they are outcomes rather than targets.

March 2023 fixed income stop-outs
In March 2023, SMN stopped out of bonds and bills as risk budgets had been exhausted and went flat. They did not cut and reverse into long positions.

Although the return reversal within bonds and bills was huge (outside of New Zealand and Australian money markets, the standard deviation across money market rates increased close to 6x during the sell-off as compared to the preceding 12 months), the overall impact on the portfolio was less pronounced, especially in contrast to some other CTAs, which saw their worst month in many years. This was partly because positions had been downsized, but also because the universe of money markets SMN is trading, is rather diverse and includes Euro, Swiss, Canadian, Australian and New Zealand rates. Up to three or four maturities, going out to one year, can be traded for each bill market.

Australian and New Zealand interest rates saw the smallest movement, while Swiss and US rates (depending on the maturity) saw the largest move. No Asian or emerging market rates are traded.

In addition, the portfolio was already allocated to commodities within the softs and meats complex, which experienced less pronounced price reversals and thus were not stopped out and experienced continued strong price trends being the basis for the quick recovery of the portfolio following the sell-off.

Synthetic markets and calendar spreads
Synthetic markets have been roughly flat overall in 2023, though it is a tale of two halves. Hybrid spreads, between sectors or market groups, have seen some losses, while calendar spreads have been profitable.

Higher interest rates have some impact on calendar spreads, but SMN research has found that the convenience yield is much more important. "For instance, non-existent storage led crude oil to trade in deep Contango during the Covid crisis. The slope of natural gas curves depends almost entirely on seasonal demand," says Waldstein. "Inventories are also key for outright positions in sugar and cattle," he adds.

Momentum trades in calendar spreads can contain some implicit carry, as well as price momentum. Though the two return drivers are not exactly broken out, trend following is by far the largest return driver.

Timeframes and models
Though SMN is biased towards medium- and longer-term trends, in common with other CTAs, they trade trends over different timeframes and use various trend signals. "In 2023 to date, longer term signals have performed slightly better than shorter term ones, and more significantly, breakout signals have outperformed momentum signals by a larger margin," says Waldstein.

Outlook for trend following
SMN have been trading trends since the 1990s, through good, bad and indifferent environments for the strategy. It argues that uncertainty over interest rates, inflation and economic growth increases the potential for stronger trends, and this environment is better than markets where direction is easily anticipated. Policy divergence, currently seen most markedly between Japan and the rest of the world, and potential policy errors by central banks, can also spawn powerful trends, which have already been seen in inflation overshooting its targets in all developed countries. Overall, CTAs have recovered strongly from the "lost decade" and made new all-time highs in performance. SMN foresee that, "A return to the pre-GFC environment is more likely than a return to the lost decade environment," says Neubauer.

Beyond returns from trading, higher interest rates are helpful for cash and collateral returns. As is typical for CTAs, around 80% of the SMN fund is sitting in short term Treasury bills, paying over 4% interest, adding a tailwind to returns.

SMN has 26 years of experience, demonstrating strong "crisis alpha" and a consistent commitment to trend following: maintaining its style and return profile has been prioritized over asset growth. Unlike many CTAs, SMN has yet to launch a UCITS vehicle, though could be open minded about doing so. **THFJ**

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