

RESEARCH SPOTLIGHT

MARCH 15, 2011

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Got liquidity, volatility and low transaction costs?

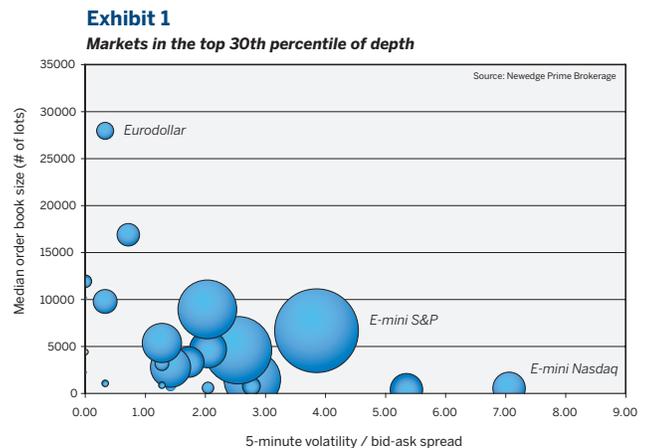
Any market that has these three things is a candidate for trading strategies with short-term holding periods. The frequency with which these strategies enter and exit the market makes it important to have enough volatility to cover the bid-ask spread, which accounts for the majority of transaction costs. In addition, markets that provide sufficient volume and depth help to limit slippage. Using our real-time limit order book histories, we have organized the data set to determine the markets with these characteristics. Not surprisingly, many of the equity index and currency markets ranked high on our list while short-term interest rates did not. While these characteristics will not guarantee profitability for short-term trading strategies, they should offer a fertile ground for managers in this space.

For this analysis we have used our database of historic tick data. We currently have limit order book data with price and size for the best 5 bids and offers on over 80 futures markets dating back to July 2005.

In addition to trades, we record any changes in the limit order book throughout the day such as an update in the quantity offered away from the midmarket. For this snapshot, we have decided to focus on the 6 months from May to November of 2010. In Exhibit 1, the y-axis measures the median order book size (5 best bids and offers), which will give us an idea of each market's relative depth of liquidity. The x-axis is the ratio of 5-minute volatility to the market's bid-ask spread. A high volatility to bid-ask spread ratio would indicate the market exhibits enough volatility to cover transaction costs. Market volume is captured by the size of each bubble and provides a sense of flow.

In Exhibit 1 we have already filtered the data set by including markets in the top 30th percentile of market depth measured by the limit order book size. This chart should give you a sense of the dispersion in market structure. We would expect markets in the lower left hand corner of the chart to present challenges to short-term trading as they have relatively small liquidity and not enough volatility to cover the market's transaction costs. In contrast, markets toward the upper right hand corner of the chart with large bubble size should provide the most opportunities to short-term strategies.

In this example, the E-mini Nasdaq has the highest ratio of volatility to bid-ask spread but is lightly traded compared to some of the other markets in our data set. In contrast, Eurodollars exhibit the deepest order book but do not have enough volatility to cover its transaction costs.¹ The E-Mini S&P market seems to be the most fertile ground for short-term trading strategies. This market has volatility, depth and exhibits tremendous volume.



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¹To be fair, we only analyzed front month futures contracts for this analysis which may understate the market's liquidity found further out on the futures curve. This would have the largest effect on the Eurodollars and most commodity markets.

Exhibit 2 includes the markets in the 50th percentile for both depth and volatility/transaction costs. The table is not a ranking of the most fruitful markets for short-term trading. We simply chose to sort the table by median order book size in descending order. Based on the characteristics described above, the markets included in this set offer the most opportunity for short-term trading strategies and include 9 equity indices, 5 currencies, 3 commodities and two bonds. This analysis coincides with the markets traded by constituents in our Newedge AlternativeEdge Short-Term Traders Index (as reported by each constituent). Although they trade a much broader set of markets with varying risk allocated to each sector, the equity index futures are the most actively traded markets amongst this group of managers.

Exhibit 2

Markets in the top 50th percentile of depth and volatility/bid-ask spread ratio

Market	Median order book size (# of lots)	Volatility / Bid-Ask Spread	Volume
E-mini S&P	6679	3.85	1,695,819
Euro Stoxx 50	4618	2.54	1,110,279
Bund	1507	2.78	783,391
Corn	806	2.76	89,719
E-mini Nasdaq	566	7.05	272,613
OMX	487	2.76	61,559
Euro FX	418	5.35	274,725
E-mini Russell	273	8.08	128,459
Japanese Yen	240	3.54	94,022
Australian Dollar	231	4.21	74,849
USD index	228	4.20	16,003
GILT	218	2.87	85,447
E-mini Dow	215	7.16	121,393
Soybeans	204	3.85	42,845
CAC40	199	5.67	127,978
Canadian Dollar	195	3.82	72,034
Crude Oil	192	11.08	169,149
British Pound	191	5.63	93,621
Aussie SPI 200	166	2.54	23,623
Swiss Market Index	159	3.23	29,728

Source: Newedge Prime Brokerage

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