RESEARCH SPOTLIGHT

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How many trades are there currently?

Using the positioning data available to us through the Newedge Trend Indicator it appears the answerto this question is "Not Many." We observed that for the period 3rd February 2011 to 28th February 2011 there does not appear to be any difference in the direction of positions within each of the asset class sectors for our proxy of long term trend following. During this period:

- **All 15 equity index positions were long**
- **All 8 currency futures positions were long**
- **All 5 interest rate positions were long**
- **All 10 bond future positions were short**
- **All 17 commodity markets were long (excluding natural gas1)**

Depending on how one calculates the number of trades, this could range from one to four namely; long risk assets (equities and commodities), short the dollar, a yield curve steepener, and short natural gas. Although people comment that markets may become this binary fairly frequently, the extent of this struck us as being highly unusual and further begs the question: How frequently does this actually happen?

Our analysis leads us to conclude that whilst it is actually fairly common for all contracts within a sector to have the same direction (e.g. all be either long or short), it is extremely unusual for this to occur to all market sectors at once. We acknowledge that our analysis only covers a (relatively) short period; being performed using the daily data available for the Newedge Trend Indicator which began in October 2002 till the 25th of February 2011.

For this analysis, we have used the daily position history for the Newedge Trend Indicator2. This data tells us for each day, whether the model was positioned either long or short for each of the individual markets included in the calculation (currently 55 markets). Long positions are indicated by +1, with short positions indicated by -1. For each sector (commodities, equity indices, currencies, bonds, and interest rates) we calculate the degree of position concentration as follows:

$$\text{Sector Position Concentration (SPC)} = \frac{\text{ABS}\left(\sum \text{market positioning}\right)}{\text{count of sector markets}}$$

For the equity sector, which includes 15 equity index markets, the denominator would be 15. If the trend following model were long 10 of these markets and short 5, the numerator would be +5 (simply the sum of +10 and -5). The sector position concentration value would be 0.33. Please note that if the model were short 10 of these markets and long 5, the resulting value of SPC would still be 0.33 because the numerator would be the absolute value of -5. As calculated, SPC does not provide any information as to the direction of the positions in a given sector; rather a value of +1 indicates

For more information please click here.

[1] The Newedge Trend Indicator has been short natural gas for the last 936 calendar days. This is in part a result of a shift in the fundamental dynamics of this market due to the significant improvement of technology for extracting natural gas from shale deposits.

[2] For full details of the calculation methodology for the Newedge Trend Indicator, please refer to Two benchmarks for momentum trading, AlternativeEdge Research Series, August 2010.

that all markets within that sector are positioned in the same way e.g. all long, or all short. Likewise a value of 0 indicates that the positioning of individual markets is not concentrated in any one direction. Exhibit 1 presents summary data illustrating that it is fairly common for all the markets within a sector to have the same direction. The equity index and bond sectors spend over 45% of their days with positions in all individual markets in the same direction, in stark contrast with commodities, where this has only occurred once in the past 9 years – September to December 2008.

Exhibit 1

Sector Position Concentration

Sector	Average SPC Value	% of Total Days with SPC = 1	Number of times SPC = 1	Average Time (Days)
Commodity	32.74%	3.42%	1	74.86
Equity	76.77%	47.99%	15	70.01
FX	56.41%	20.26%	13	34.09
Bonds	76.46%	45.57%	21	47.48
Rates	53.04%	21.85%	13	36.78

Source: Newedge Prime Brokerage

Of particular interest to investors is in understanding how frequently all of the sectors exhibit high concentration at the same time. In order to calculate this, we calculate the degree of portfolio position concentration as follows:

$$\textit{Portfolio Position Concentration (PPC)} = \sum SPCi \times I$$
$$\textit{where } i = \textit{sector weight (by number of individual markets)}$$

PPC should be interpreted in a similar manner to SPC (having a value between 0 and +1).
Exhibit 2 shows the PPC calculation since October 2002.

PPC = 1 Indicates all sectors have a sector portfolio concentration of +1 (all markets positioned the same)

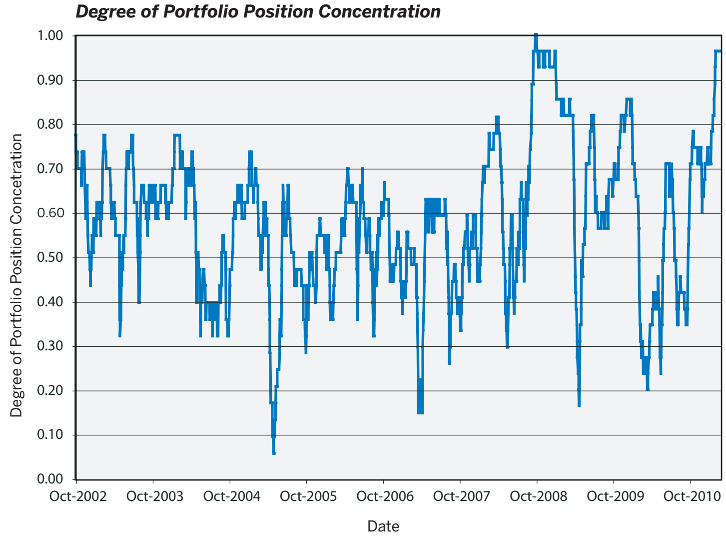
PPC = 0 Indicates all sectors have a sector portfolio concentration of 0 (no bias towards any positioning)

Of particular note is how infrequently a PPC value of nearing 1 is achieved. Other than currently, the only other example is during the extreme stress market environment of September to December 2008. This is particularly noteworthy, as current market conditions cannot be considered as "stressed."

Of key interest for investors is to understandwhat impact this has on the future return and volatility characteristics for these strategies, though unfortunately there are too few instances to make any meaningful conclusions. In the period following the last time we observed a PPC of 1 (September 2008) long term trend following strategies experienced a period of strong returns without any appreciable increase in return volatility (Newedge CTA Trend Sub Index returned 14% over the following quarter).

Exhibit 2

Degree of Portfolio Position Concentration



In conclusion, it appears there really is only one trade at the moment, and we find this extremely interestingbgiven the rarity of this phenomenon. Diversification is often said to be the only "free lunch" in investing, and by allocating to a wide variety of different assets, investors can reduce the risk or volatility of a portfolio. It is worth pointing out that having a diversified portfolio means having a diversified portfolio on average, and our current observation does not imply that there is anything wrong. Indeed, our observation should also be put in context with cross sector correlations, and we have a number of future snapshots in the hopper in which we intend to explore this in more detail.

For more information please click here.