FORTEM CAPITAL

FRIDAY NIGHT 'LIGHTS

14th July 2017

Dumb Money vs Capital Protected Products – Backhanded compliments aimed at passive investing

Tennis is a lot like writing an article; your first point is always as important as your last. This week's piece is going to focus on the increasing effects of "dumb money" exchanging hands in finance. Everyone has no doubt read of the pros and cons of ETFs and passive investing, and these flaws are as apparent in the world of equities as in the world of futures and derivatives, perhaps even more so. Much like my tennis game, there are as many aces as faults, and this week we're *serving you up* just a few examples.

Let's first cast our binoculars over the traditional equity markets. One of the challenges for a family business to continue to expand is that to do so often means giving away equity. That leads to a loss of control. Schroders did what a lot of businesses on the continent do – they split up the shares into two classes (voting and non-voting). This way, the Schroders family can control less than 50% of the total equity, but maintain their grip over management. They empowered their staff through equity without diluting control because they continue to hold over 50% of the voting share class. Importantly, the two share classes are identical, including their dividend, however there is a large divergence in the yield, with the non-voters yielding almost 4.5% vs the voting class yielding more like 3.1%. Why? The small discount that the non-voters used to attract, has blown out by 30% in the last few years. There is a theory behind this. The voting class is a constituent of the FTSE 100 (as well as many other major indices across the world), whereas the non-voting shares are listed on a very limited number of indices. One is in effect, far less available to the "easy money". The theory goes that the enormous amount of liquidity pushed into passive investment vehicles has effectively artificially inflated the price of a stock in any majorly tracked index because these trackers are forced to simply pay whatever price is quoted for the constituents of the underlying. *Quite the racket…*

The same logic can be applied to the indices themselves and their inclusions and deletions. Taking the MSCI Europe as an example, every May and November on fixed dates they announce which unlucky constituents are going to be removed from their index and which fortunate few are going to be included. However, they then don't enact the rebalancing for a couple of weeks. As a result of the "dumb money" only ever tracking the constituents (and that money being somewhat sizeable these days), were you to simply…

Recent Launches:

Product	Snowballing Return
Citigroup FTSE 100/Eurostoxx 50 Weekly Accrual Income Note	5.52%

Rates (bps)		
	Current	Week Chge
GBP 1yr	52.90	-1.00
GBP 3yr	76.40	-0.70
GBP 5yr	95.20	-2.00

Equity Indices (%)		
FTSE 100	7,398.94	0.65%
S&P 500	2,345.96	-3.27%
Nikkei 225	19,445.7	-2.43%
Eurostoxx 50	3,530.31	1.92%

Currencies (%)		
GBPUSD	1.2967	0.60%

5yr Credit Spreads (bps)		
Citigroup	53.14	1.91
Credit Suisse	67.62	-1.15
Deutsche	79.10	-4.98
GS	66.52	0.52
HSBC	27.47	-1.63
JPM	47.75	2.24
MS	61.86	0.56

Commodities (%)		
Gold	1219.42	0.57%
Oil (CLA)	46.29	4.66%

3m Implied (vol pts)		
FTSE 100	10.52%	-0.85%
S&P 500	9.82%	-1.57%
Nikkei 225	12.13%	-1.98%
Eurostoxx 50	13.77%	-1.18%

5yr Implied (vol pts)		
FTSE 100	17.61%	-0.11%
S&P 500	19.07%	-0.35%
Nikkei 225	18.23%	-0.01%
Eurostoxx 50	19.29%	-0.17%

Source Bloomberg / Partner Banks
Data as at 14th July, 11.30am

Upcoming events	
18th Jul	UK CPI % y/y and Eurozone HICP % y/y
19th Jul	ECB interest rate announcement
20th Jul	BoJ Policy statement
24th Jul	Eurozone Composite, Services & Manufacturing PMI
26th Jul	UK GDP % y/y
26th Jul	Fed interest rate decision

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"Paradoxically, when 'dumb' money acknowledges its limitations, it ceases to be dumb" – *Warren Buffett*

…short the deletions and go long the inclusions (and then leverage that up) you have yourself a very simple arb taking *advantage* of forced buyers and sellers – basic supply and demand. This strategy when it was developed several years ago had an average performance over 5 years of circa 5.70% per annum, and only ever returned less than 4% on two occasions. Now, "*it spin a long time"*, but the logic still applies.

However, perhaps the best example of "dumb money" can be found in commodities, and there are two avenues for exploration. The first is the impact of inflows into the Goldman Sachs commodity index (GSCI) or Bloomberg commodity index (BCOM) on the back of oil becoming **backwardated** (this is where front month futures cost less than back month futures). Were oil to head into backwardation, this should drive new index flows, which in turn should elevate the price of smaller commodities such as copper, and more importantly, then move some into backwardation. Were you to assume a 10% increase in total index AUM from the flows into the BCOM, this would result in approximately 7,600 contracts being bought in COMEX copper. Suffice to say, using copper as an example, a move into backwardation in oil, analysts strongly believe would create a change in sentiment, initiate renewed interest in the commodity complex, and generate inflows that would elevate commodity prices. This could, in many instances, lift commodities from a state of contango into backwardation. Please see this previous FNL written on the topic in more detail.

The second commodities example is perhaps even more regimented and flawed. The major commodity indices (GSCI and BCOM) have designated periods of time (on pre-defined, publicly available dates) where they roll their underlying positions in the commodity futures. The notional amount of money tracking commodity benchmark indices is estimated to be $150bn and the respective buying and selling pressure generated by futures rolls of these commodity indices presents an opportunity to capitalise on the potential rally of the incoming contract and potential decline of the outgoing contract. Congestion alpha strategies as they are known (of which our partner banks have many variations) establish long pre-roll and short benchmark positions to continually harvest the potential alpha appearing due to the liquidity pressure applied by the monies tracking traditional benchmark commodity indices. These strategies have a beta of nigh on 0% to equity markets and over the last 5 years (while the strategies have been active), have eked out an average of circa 4% per year, with a volatility of just 3.68% and a Sharpe ratio of 1.50. *Game, set, match?*

In a world where there is a dearth of good alternative product, volatility at all-time lows, and where rates are still depressed, capital protected products linked to good quality credits, taking advantage of systematic flaws in the way "dumb money" operates can be very useful. Fortem have developed a range of capital protected products with between 100% and 250% participation in the underlying, depending on which strategy, currency, issuer and tenor you chose. Though some of these underlying ideas can be a *"wild card"* and far too unusual for our clients, we do believe we have found the odd *grand slam* that you're *set to love*. Please get in touch for a full run through of our offering. *No strings attached.*

As ever, *shanks* for reading, and if you require any details or references on the above, please do get in touch via the usual means.

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