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Regulators' Unintentional Effects on Markets

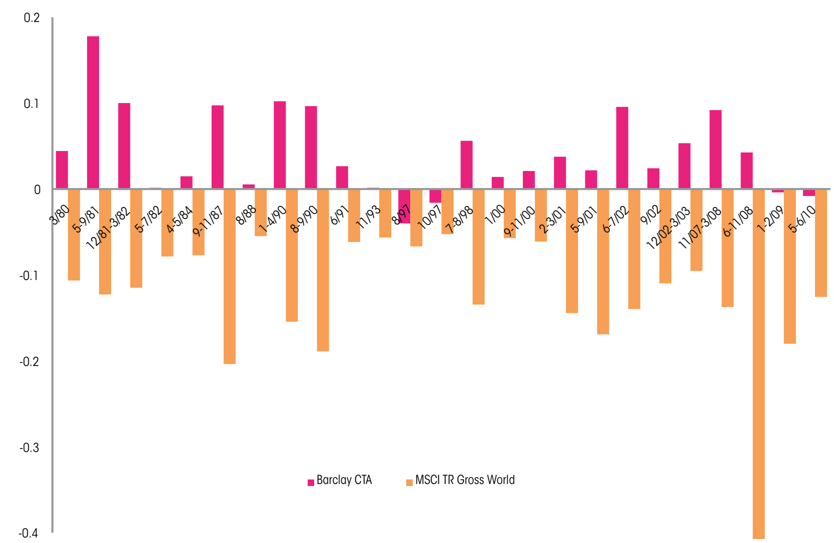
By Kathryn M. Kaminski, PH.D

Systematic, diversified trend following is one of the most popular investment strategies in futures markets.

It is also one of the few strategies that has been able to capture crisis alpha. Crisis alpha is defined as profit opportunities that are gained by exploiting the persistent trends that occur across markets during financial crisis.

When equity markets are in crisis, the vast majority of market participants are long biased to equities. As investors realize losses, many of them act on their emotions. When

FIGURE 1: Trend Following and Equity Losses



Source: BarclayHedge and RPM

this is coupled with the widespread use of institutionalized drawdown, leverage and risk limits — which are triggered by losses, increased volatility and correlation — equity losses will force large groups of market participants into action.

CROWD BEHAVIOR

When large groups of market participants are forced into action, liquidity disappears and credit issues come to the forefront. Fundamental valuation becomes less relevant. This results in persistent trends across markets while many market participants fervently attempt to change their positions, desperately seeking liquidity.

Thus, for both behavioral and institutional reasons, equity market crisis represents periods where the majority of market participants are forced and/or driven into action. This coordination of investor behavior results in systemic shocks to liquidity and an epidemic spread of credit issues across markets resulting in pronounced trends in prices tumbling markets into a temporary state of reduced market efficiency. It is precisely these trends and lack of market efficiency that futures based trend following strategies are able to exploit. See Figure 1.

AVOID LIQUIDITY SHOCK

Market timing a crisis is difficult, if not impossible. Trend following, as a strategy, does not time the onset of a market crisis, the approach simply responds more favorably during times of market stress.

First, a systematic approach and the lack of long bias in futures trading help to avoid the behavioral effects associated with taking losses. Second, futures markets are highly liquid and relatively credit solvent without the asymmetries in margin and transaction costs for long and short positions. This allows traders in these markets to avoid some of the common traps associated with the credit and liquidity shocks.

Finally, trend following in futures is applied to a wide range of financial/nonfinancial sectors, making the approach adaptable enough to take advantage of trends across markets. See Figure 2.

THE ROLE OF FINANCIAL REGULATION

In the wake of the previous financial crisis and infamous Bernard Madoff scandal, lawmakers and regulators are pushing for new regulations to help avoid future financial crises. There also has been a call for the harmonization of these regulations at the international level.

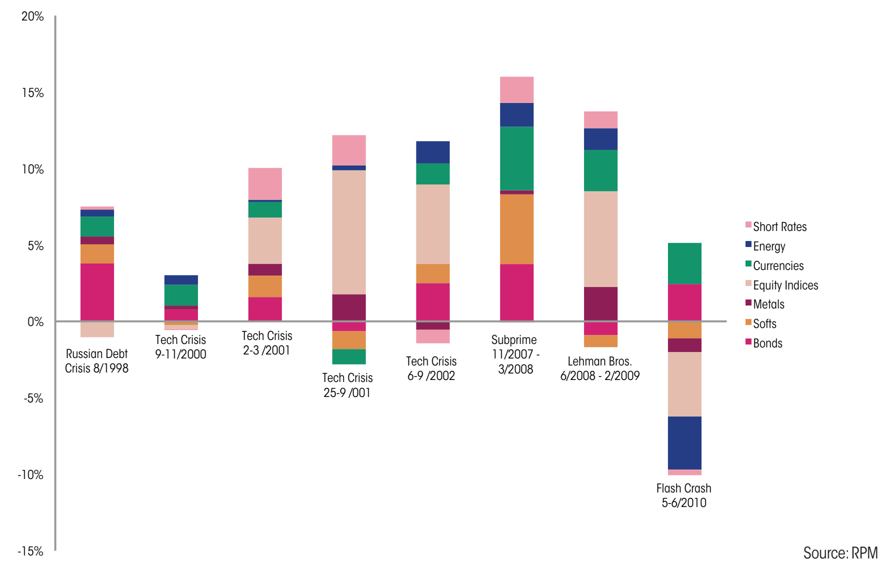
The focus of these regulations has been on:

- increasing transparency vis-à-vis the interconnectivity of market participants, counterparties and contract clearing methods
- regulations to limit and/or control risk taking
- potential bans and further control of short selling, whose myopic goal is to avoid death spirals in prices

THE IMPACT

Although well-intentioned, the push for further regulation may create even more structural reasons

FIGURE 2: Crisis Performance of Trend Followers by Sector



Source: RPM

for why investors will be coordinated in their actions during losses in equity markets.

First, the act of limiting or prohibiting short selling allows fewer investors to alleviate their long bias to equities possibly further exacerbating their need to sell during equity losses.

Second, restrictions in the use of derivatives and commodity markets, such as those proposed for pension funds, can make them less diversified and less flexible in their portfolios in response to stress.

Third, regulations that focus on risk-taking, similar to Basel II, can further force investors into action when they take losses and volatility and correlation spike.

Fourth, regulations for increased transparency in financial markets via the harmonization of regulation, reporting and registration of positions and counterparties might help to reduce some of the problems seen in the banking sector during the last crisis.

When it comes to future crises, many might criticize that harmonization of financial systems and the centralization of clearing and reporting could create new systemic risks financial monsters that also may be deemed "too big to fail."

PAVED WITH GOOD INTENTIONS

As in all past financial crises, new regulation and rules are often well-intentioned. Despite these efforts, financial crises continue to manifest themselves in new areas, seemingly more often.

The global market environment merely adapts to these rules and regulations. As a result, new rules and regulations may exacerbate the driving or forcing of market participants into action by limiting their ability to diversify and be flexible during times of market stress. If this is the case, crisis alpha should and will be found across markets during these moments. Futures based trend following strategies will be, as they often have been in the past, poised and ready to capture it.

Kathryn M. Kaminski is a senior investment analyst at RPM Risk & Portfolio Management.

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