Alpha capture – the FX initiative
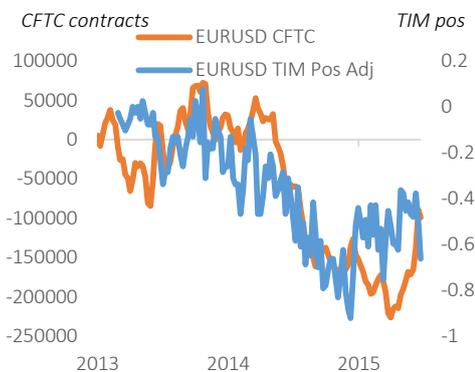
Diversify CTA strategies with TIM Group alpha capture   19 Jan 2016

Understanding market positioning is a crucial part of trading, but the most commonly used positioning data derived from CME futures is only available on a weekly basis. Are there other ways we can understand market positioning in FX? In this paper, we examine TIM Group's FX alpha capture data, which is made up of trade ideas from the sell side. On average, these ideas generate +3.5 bps per idea. We create aggregated indices of this data to represent FX market positioning in an innovative way. We use these indices to trigger FX trades based on the crowding of trades. We create a combined FX alpha capture and trend trading basket which has annualised returns of 3.1% and an information ratio of 1.09 in-sample between March 2013 and June 2015. In the out-of-sample period from July 2015 through December 2015, the strategy generated +35bp of returns, outperforming a benchmark for FX funds (Parker's Currency Manager index), which lost 30bp over the same period. We note that the alpha capture component of our strategy is largely uncorrelated to the trend following element. This suggests that our FX alpha capture strategy will enhance returns for those who predominately follow trends.

Introduction

Understanding market positioning and its relationship with FX spot is an important part of trading. The difficulty is that public positioning data such as that available from CFTC tends to be available on a low-frequency basis. We could also argue that it is not as representative as we would like, since it is based on CME FX futures, which tend to be traded more by CTA-style accounts. Here, we examine how TIM Group's alpha capture data can be used to proxy market positioning (see Figure 1). Our FX basket (see Figure 2), which uses TIM Group's alpha capture data, has an information ratio of 0.81, outperforming a basket which uses CTA-style trend following rules in our in-sample period from March 2013 through June 2015. When combined with trend, the information ratio increases to 1.09.

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This paper has been kindly sponsored by TIM Group. A full version of this paper is available on request for institutional investors.

Figure 1: EUR/USD CFTC vs. TIM Group

Source: Thalesians, TIM Group, Bloomberg

Figure 2: TIM Group & trend baskets
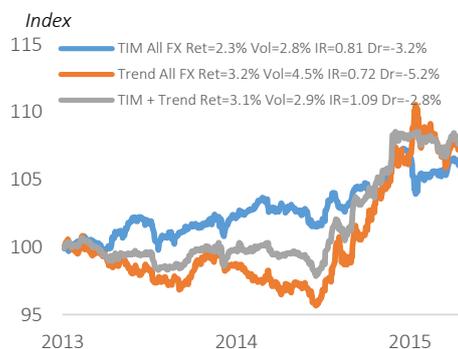
Source: Thalesians, TIM Group, Bloomberg

TIM Group provides a platform for the sell side to submit trade ideas. The process essentially systematises the collection of trade ideas which FX desks send to their clients through other means such as e-mail, in a more easily used format.

This is an abridged version of the full paper.

About TIM Group

Our mission is to provide valuable market insight that is measured and rewarded.

As shown in the diagram below, we fulfil this mission by sourcing market insight from sell-side brokers and other sources, and adding value through our own analytical services. We deliver the resulting insights to investors in the format most suitable for them (integrated with existing services, in a web screen, as a feed). We help investors to reward the sell-side contributors for their insight using appropriate rankings and benchmarks. We measure the value of the insights provided to help ensure a fair reward for contributors.
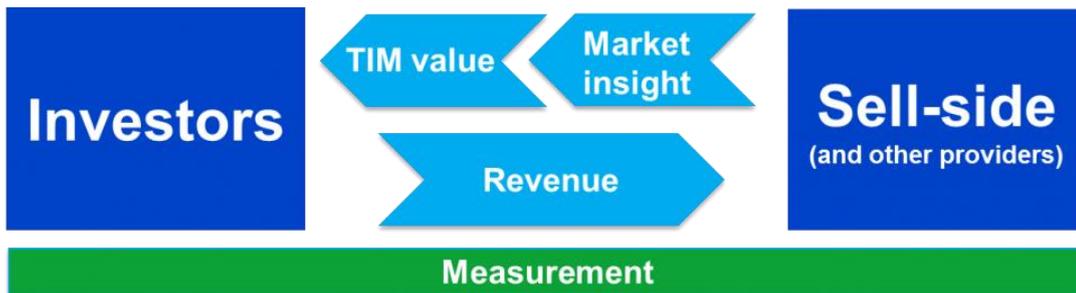
By fulfilling our mission successfully, we contribute to the success of investors, sell-side contributors, and the financial markets:

We help investors make good investment and trading decisions by applying the market insight we provide.

We help sell-side brokers (and other providers) earn incremental revenue from the investors who receive market insight. We measure the value of the market insight and help buy-side investors to allocate commensurate rewards.

We contribute to the health of the financial markets, because markets are more effective when insightful analysis is recognised and rewarded.

We fulfil our mission today primarily by distributing brokers' trade ideas and market indicators. We will further fulfil our mission in the future by tapping new sources of market insight, supplying our analysis to new audiences, and extending the reach of our analysis to include additional asset classes.

About Saeed Amen and the Thalesians

The Thalesians are a think tank of dedicated professionals with an interest in quantitative finance, economics, mathematics, physics and computer science, not necessarily in that order.

We run quant finance talks in New York, London, Budapest, Zurich and Frankfurt. Underpinned by a decade of experience in markets at major financial institutions, we publish research, run workshops and also do bespoke projects on systematic trading. We have specific expertise in understanding how Big Data can be used to trade financial markets.

We have created the PyThalesians Python based financial analysis software library (GitHub code at http://www.github.com/thalesians/pythalesians), which we have partially open sourced. PyThalesians provides the essential backbone for our quantitative analysis. We have also published our thoughts on markets in the new book, Trading Thalesians - What the ancient world can teach us about trading today (on Palgrave Macmillan).

Find out more about the Thalesians at http://www.thalesians.com and follow us on Twitter @thalesians.

Saeed Amen is managing director and co-founder of the Thalesians. He has a decade of experience creating and successfully running systematic trading models at Lehman Brothers and Nomura. Independently, he runs a systematic trading model with proprietary capital. He is the author of *Trading Thalesians – What the ancient world can teach us about trading today* (Palgrave Macmillan). He graduated with a first class honours master's degree from Imperial College in Mathematics & Computer Science.

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