Napoleon AM Newsletter

January 13th, 2020

First, all the Napoleon Team wish you and the markets a wonderful and amazing 2020 year.

On December, 11th 2019, we announced that the Napoleon Bitcoin Fund had been launched one month before and we revealed that it would be managed using listed CME Futures. It has been structured as an FPS (AIF format), a French regulated (but not authorised) vehicle. This choice was made to reduce security risks holding BTC in direct lines and to simplify the structuring of this fund as well as managed to convince a custodian to approve a vehicle with such an innovative exposure. The aim is also to allow institutional investors to be exposed to such an asset within a well-known wrapper.

Holding a Future contract on a particular underlying (equities, govies, commodities, BTC …) is not the same thing as holding a direct exposure on this asset. A futures contract is a legal agreement to buy or sell a particular asset at a predetermined price at a specified time in the future (Future expiry). Futures can either be cash settled or physically delivered at expiry. Futures contracts are also “standardized” to facilitate trading. A range of actors use them ranging from speculators to “commercial hedgers”.

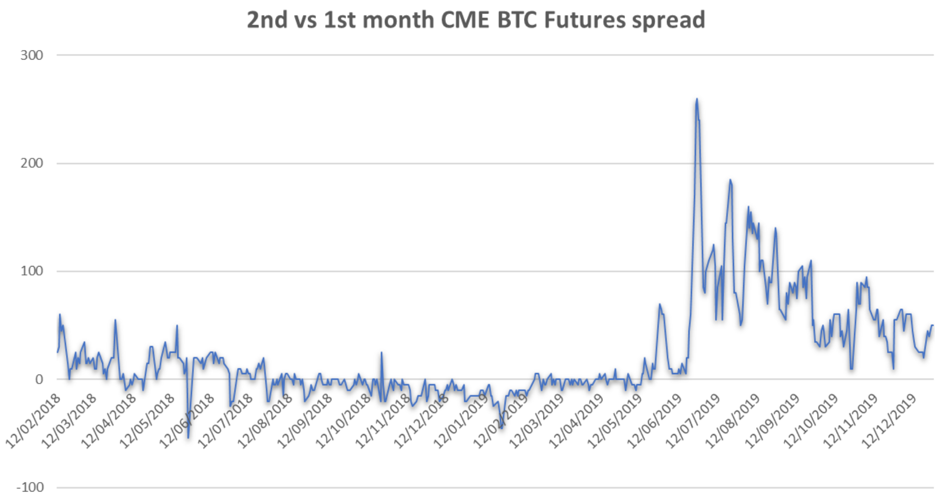
After 2 years of existence, it is interesting to look at the historical behaviour of the CME Futures vs their underlying. In this case, it is the BRR Index, a registered benchmark under the European Benchmarks Regulation (EU BMR) which represents an average of 5 different BTC price contributed by trustable sources (Bistamp, Coinbase, Gemini, itBit and Kraken). In the universe of listed BTC Futures, there are currently 2 Exchanges offering such products: the Chicago Mercantile Exchange (since 18 December 2017), the world largest derivatives exchange and BAKKT, a Singaporean derivatives Exchange owned by ICE (since 23 September 2019). The CBOE, a competitor to the CME discontinued their product last year. The CME BTC Future are cash settled whereas the BAKKT ones started with physically delivered. BAKKT has already diversified its offer proposing now a cash settled version of their products.

In a Future market, it is important to analyse the price difference between a particular Future and its underlying asset. This is called the “basis”. As at a given moment of time, several Futures can co-exist (with different maturities), there is not one but several basis. These basis form what is called the term structure that can present positive or negative values depending on various factors such as dividend anticipation (for equities), interest rates (for all Futures and more particularly govies ones), Repo rates (for all Futures), storage cost (commodities) … This is very complex to determine the true basis value of a particular Future and it changes over time and is equal to 0 at maturity.

In terms of liquidity, it is not spread evenly on all Futures maturities but are often most important on the shortest maturity (called “front month”). The spread between bid and ask price as well as the order book give some elements on the underlying liquidity even though this is also a very dynamic mechanism. For the CME BTC market, there are usually no more than Different Futures that are active at the same time. We have observed over time the spread between the front month and the following ones on a market close basis. As the front month expiries, it is replaced by the 2nd Futures and the 2nd Futures is replaced by the 3rd ones (prior to expiry). These 2 become then 1st and 2nd post expiry.

For some investors that are willing to hold position in the Futures market for a long time, they need to “roll” their Futures position and sell a contract that is expiring and buy at the same time a longer maturity to keep their exposure intact. There is usually a busy activity pick around these expiries. In the Napoleon Bitcoin Fund, we will need to regularly roll our BTC Futures position as the fund intends to offer a passive exposure to BTC price. Therefore a “roll” strategy is needed to minimize its impact on performance. This strategy is a secret sauce that any asset manager would avoid disclosing to avoid being squeezed by some ill-intentioned speculators.

In this Newsletter, we have simply studied the historical spread between 1st and 2nd month Futures as per the methodology described above.



As can be observed, this spread was quite limited as one would anticipate for such an asset without any dividend or cost of carry. However, there was a shock in June 2019 just after the violent 2019 spike which marked the highwater mark of the year. Since then, the spread has started to normalise but has not come back down to lower values. It is not very clear what has provoked this market move but this clearly demonstrate that a “roll” strategy is mandatory to reduce tracking error on the underlying asset.

Another observation that we have been able to make is the market price dynamic just before the expiry date. It seems that prior to the expiries, the BTC price tends to drop starting 3 days before the expiry. We have studied the strategy that shorts the underlying 3 days before expiry and flat the short position back on expiry date. Below, you will see its performance.

One could conclude that some market actors are systematically selling BTC starting 3 days prior to expiry. It could be miners that are just trying to off load their mined BTC, but given the these BTC Futures are cash settled, it seems unlikely. Or it could be speculators that are trying to push down the price during these particular periods and positioned themselves on the BTC markets directly. Also, given the limited number of observations, this should be taken with some caution. We will need to observe more data to confirm our preliminary findings and see whether the recent launch of the BAKKT Futures will have an impact as well.

About Napoleon AM

Napoleon AM aims to support institutional and professional investors in their search for portfolio diversification thanks to its expertise in quantitative management, blockchain and digital assets.

Napoleon AM is a management company regulated by the AMF, registered under number GP-19000015. Its registered office is located at 59 rue Montmartre, 75002 Paris (France). It is a member of Napoleon Group, a French fintech based in Paris. It was founded in 2019 by Arnaud DARTOIS (PhD), Jean-Charles DUDEK and Stéphane IFRAH. The company is amongst the first to offer regulated crypto-asset investments for professional clients and has developed a quantitative trading expertise, especially on the most liquid crypto-assets (BTC, ETH, EOS, LTC, BNB, BCH and XRP) via funds or mandates.

Napoleon AM has been recently awarded AM Tech leader 2019 by Agefi.

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