Managed Futures

Cyclical Trough or Structural Impairment? Analysis and Proposed Solutions

By Ryan Davis, CAIA, and Barclay Leib

Systematic trend-followers, commonly referred to as managed futures funds, long have been an important component of institutional and high-net-worth portfolios. These strategies’ unique ability to go both long and short in a vast array of global financial markets historically has produced a return profile highly uncorrelated to traditional markets. More recently, however, many investors have come to question the asset class amid poor performance in the post-global financial crisis period. In this article, we explore the recent struggles of the managed futures industry, discuss what the future may hold for such strategies, and offer suggestions for navigating this space.

Background
The events of 2008 were a startling development for many hedge fund investors; following a near-30-year period of few if any losses, double-digit declines in most hedge fund strategies shattered an aura of absolute-return performance. When the dust settled on 2008, only two segments of the industry generated substantial positive returns: short biased and managed futures funds (see figure 1). More specifically, in a calendar year in which the broad universe of hedge funds fell by 19 percent, the average managed futures fund rose 18 percent. Many individual managed futures funds were up 40 percent or more as they capitalized on the sell-off in equities and extended trends in bonds, commodities, and currencies. This performance opened many investors’ eyes to an asset class previously overlooked because of its intensely technical and quantitative nature.

On the heels of 2008, investors who previously shied away from these quantitative strategies poured into managed futures. Assets in those strategies grew by 120 percent from 2007 to 2011 while the broader hedge fund industry increased just 7.5 percent. As a consequence, the share of managed futures funds as a percentage of total hedge fund assets more than doubled to 9.3 percent by the end of 2011, or $188 billion (see figure 2). Data aggregator BarclayHedge estimates the current size of the managed futures market is even larger, at $260 billion (although those figures are skewed by one extremely large hedge fund, Bridgewater Associates, which BarclayHedge classifies as a commodity trading advisor or CTA).

A spate of industry reports indicate that both high-net-worth and institutional clients entered the managed futures space post-2008 as demand surged for tail-risk protection. Contributing to the growth in managed futures assets since 2008, however, was the fact that retail investors also were given access to these funds for the first time, primarily through 1940 Act structures. Only one managed futures mutual fund existed before the financial crisis; that number has swollen to 51 today. Total assets in the managed futures mutual fund universe now stand at $8.6 billion—still a fraction of its hedge fund peers, but not insignificant.

Unfortunately for new entrants post-2008, the timing of their new allocations was anything but optimal. Managed futures funds collectively posted negative absolute performance in three of the next four calendar years—the worst performance stretch in the recorded history of the asset class. As a result, many of the new investors who entered the space post-2008 have since exited. According to data from ManagedFutures.com, the number of new assets in managed futures mutual funds has fallen by 37 percent since 2011.

Analysis and Proposed Solutions

Figure 1: 2008 Returns—HFRI Indexes

Source: FactSet

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In practice, the performance of popular indexes of managed futures funds supports the academic research. Using a common period since the inception of the Dow Jones UBS Commodity Index in February 1991, the managed futures industry as represented by the HFRI Macro: Systematic Diversified Index has generated the second highest Sharpe ratio of the major asset classes, save for the broad category of hedge funds. Its annualized return of 10.7 percent exceeds that of the S&P 500, and achieves it with approximately half the volatility.

Managed futures’ performance over this time period exceeds every major asset class except that of hedge funds and real estate investment trusts (REITs). The average volatility of CTAs is also lower than every asset except hedge funds and bonds.

The comprehensive risk management inherent to CTAs results in this mitigated volatility profile, but its impact is most evident in the return distributions. Next to fixed income, managed futures display the most attractive drawdown characteristics of the major asset classes (see table 1). During the measured time period, only managed futures and bonds experienced a maximum drawdown in the single digits. Although hedge fund strategies generated a superior return with less volatility than managed futures, they were not necessarily less risky,

class (see figure 3). Between 2008 and the first quarter of 2013, managed futures funds generated an annualized performance of 0.4 percent, compared to 10.9 percent for the S&P 500 and 3.6 percent for the broad hedge fund composite. If one invested in managed futures immediately following 2008, the impact was not devastating on a stand-alone basis; but in the wake of strong double-digit equity market returns, the opportunity cost certainly has been high.

Historical Review
Managed futures investing received its first major academic backing in John Lintner’s 1983 classic working paper, “The Potential Role of Managed Commodity-Financial Futures Accounts (and/or Funds) in

Portfolios of Stocks and Bonds.” Lintner concluded that “the combined portfolios of stocks (or stocks and bonds) after including … managed futures accounts (or funds) show substantially less risk at every possible level of expected return than portfolios of stocks (or stocks and bonds) alone.” Managed futures strategies proliferated in the 1980s with the success of trend-following investors such as John Henry and David Harding.

Since then, a range of academic studies have validated the historical efficacy of managed futures investments and the benefits of including them in diversified, traditional portfolios (McCarthy et al. 1996; Edwards and Park 1996). Edwards and Park (1996), for example, found that an equally weighted portfolio of either CTAs or commodity pools “increases the portfolio’s Sharpe ratio by as much as 28 percent. The primary reason for this result is the low correlation between managed futures returns and the returns on other portfolio assets…” More recent studies such as one by Ibbotson Associates (Chen et al. 2005) of CTA data between 1980 and 2005 illustrated an asset class that generated superior returns to U.S. equity markets with similar volatility levels. Because of the uncorrelated nature of this performance, however, the authors concluded that layering in an allocation to managed futures to a traditional stock-bond portfolio improved the overall risk-adjusted return, i.e., improved the efficient frontier in a mean-variance framework.

Figure 2: Assets under Management

Source: FactSet

Figure 3: Managed Futures Calendar-Year Returns

Source: FactSet

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June 2012 illustrate this phenomenon: Following several decades of consistently low correlations among assets, correlations moved sharply higher in the fall of 2008 and have yet to recede (see figure 5). This provided an extremely difficult environment for systematic and discretionary traders alike, but the result is particularly pronounced for managed futures strategies. The inability to establish independent, uncorrelated trades reduced the efficacy of such approaches, creating return profiles where single-asset drawdowns caused by trend reversals tended to cluster. The tendency for investors to collectively trade in risk on/off fashion during the economic recovery period—in which groups of asset classes move together in rapid fashion—occurred with such frequency that alpha generation by CTAs eroded.

Table 1: Risk/Return Statistics, February 1991–March 2013

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>Annualized Return</th>
<th>Annualized St. Dev.</th>
<th>Sharpe Ratio</th>
<th>Max Drawdown</th>
<th>Skewness</th>
<th>Kurtosis</th>
</tr>
</thead>
<tbody>
<tr>
<td>HFRI Macro: Systematic Div.</td>
<td>10.7</td>
<td>7.5</td>
<td>1.00</td>
<td>−9.3</td>
<td>0.15</td>
<td>−0.3</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>9.3</td>
<td>14.8</td>
<td>0.41</td>
<td>−50.9</td>
<td>−0.63</td>
<td>1.3</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>10.4</td>
<td>19.2</td>
<td>0.38</td>
<td>−52.9</td>
<td>−0.53</td>
<td>1.2</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>5.9</td>
<td>16.9</td>
<td>0.16</td>
<td>−56.4</td>
<td>−0.57</td>
<td>1.1</td>
</tr>
<tr>
<td>MSCI Emerging Markets</td>
<td>10.3</td>
<td>23.6</td>
<td>0.30</td>
<td>−61.4</td>
<td>−0.69</td>
<td>2.0</td>
</tr>
<tr>
<td>Barclays US Aggregate</td>
<td>6.7</td>
<td>3.6</td>
<td>0.96</td>
<td>−5.1</td>
<td>−0.28</td>
<td>1.0</td>
</tr>
<tr>
<td>HFRI Fund Wtd Composite</td>
<td>11.2</td>
<td>7.0</td>
<td>1.15</td>
<td>−21.4</td>
<td>−0.70</td>
<td>2.6</td>
</tr>
<tr>
<td>DJ UBS Commodity</td>
<td>4.9</td>
<td>14.9</td>
<td>0.12</td>
<td>−54.3</td>
<td>−0.58</td>
<td>2.7</td>
</tr>
<tr>
<td>Dow Jones US Select REIT</td>
<td>11.5</td>
<td>20.1</td>
<td>0.41</td>
<td>−70.5</td>
<td>−0.74</td>
<td>9.0</td>
</tr>
</tbody>
</table>

Source: FactSet

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We discuss a few of the main causes of CTA underperformance in more detail below.

Central Bank Intervention and Market Artificiality
Perhaps the most compelling theory for underperformance by managed futures funds is the unprecedented level of central bank intervention that occurred in the wake of the financial crisis. In 2012 alone, central banks changed interest-rate policy 158 times and implemented nonconventional measures such as asset purchasing programs and direct currency interventions, which often have far more disruptive impact than rate policy alone.

Of course, central bank activity always was present in the market. The scope and pace of such events, however, increased dramatically as central bankers took on a more activist role. Compounding this phenomenon is the rise in influence of emerging market central banks: global financial markets now are subject to the competing economic interests of a much wider swathe of sovereigns compared to 20 years ago.

Such intervention presumably disrupted the natural trajectory of many markets. In instances where trends developed—and where managed futures’ quantitative models start to initiate positions—central banks or policy makers intervened and the markets reversed. This created a start-stop arena pitting political will versus true economic fundamentals and natural market trends.

The events of June 2012 were particularly illustrative of this phenomenon.

Through June 5, 2012, managed futures strategies had generated a 3.6 percent quarter-to-date return. The S&P 500 had lost approximately 8.4 percent. The next day, however, European Central Bank President Mario Draghi announced at a press conference that the central bank was “ready to act” in response to deteriorating market conditions. This sparked a sharp rally in financial markets, working against many positions held by managed futures strategies. The group (as measured by the daily HFRX Macro: Systematic Diversified Index) lost 1.7 percent in a single day.

A similar event unfolded on the final day of the second quarter of 2012. Systematic trend-followers slowly crawled back to a positive 2.1 percent quarter-to-date return through June 28. On June 29, though, a European Union summit yielded provisions that directly recapitalized banks in Spain and Ireland and expanded the powers of the European Stability Mechanism. This catalyzed a sharp reversal in risk markets, working against many long-tenured managed futures managers experienced their worst one-day loss ever.

These circumstances are anecdotal, but they underscore a broader phenomenon characterizing the economic recovery. Managed futures funds are designed to capture large portions of a market move, not to identify inflection points. Increased frequency of such inflections whipsawed intermediate trend-followers and caused a protracted period of underperformance.

Asset Growth
Another popular theory for managed futures funds’ struggles is the tremendous asset growth in the industry. As previously mentioned, assets in systematic diversified managers (as measured by Hedge Fund Research) more than doubled between 2007 and 2011. Because the flood of assets
from investors coincided with poor performance, many inferred a causal relationship. As a general rule, the potential for alpha generation erodes in the face of increased assets and strained capacity, holding all other factors constant.

It is true that CTA assets swelled rapidly, but this coincided with an increase in both the number and volume of futures contracts. Between 2003 and 2012, global volume of futures and options contracts increased 161 percent, from 8.1 trillion to 21.2 trillion contracts (see figure 7), according to the Futures Industry Association. Estimates of futures and options volume since 1998 suggest a more dramatic expansion (in the range of 10x). And thanks to the rise in electronic trading, futures markets remain some of the most liquid markets in the world; average bid-ask spreads steadily declined since 2000 because of the automation of transactions.

At first glance, managed futures assets as a share of global futures markets do appear to be quite trivial. Hurst et al. (2012) estimates that CTA assets currently make up 5 percent of commodities markets, 0.2 percent of equity markets, 2.6 percent of bond markets, and 0.2 percent of currency markets. Those figures are not inconsequential but generally reveal an industry that is not dominating the futures markets.

These numbers, however, may not fully illustrate the scope of CTA influence. Managed futures assets constitute a small percentage of overall market volume, but on certain key trading days CTA flows can dominate and impact market pricing. Execution skid and piling-on effects by brokers who see these flows certainly creates short-term serial autocorrelation of pricing, as one manager’s model trips another and a wide variety of CTAs seek liquidity in the same market direction at approximately the same time. In ways, this issue is similar (although of a much smaller scale) to what happened with equity quantitative models in August 2007—where the downsizing of leverage by one quantitative model tripped other models into downsizing and eventually created short-term irrational movement in various equity pairings.

Unfortunately, it is difficult to generate a cohesive conclusion on this topic; the distinction between correlation and causation of recent poor performance is blurred. What does appear more certain is that, at the very least, CTAs had to become more sophisticated in their execution to minimize market impacts and to avoid detrimental front running by other parties.

Collateral
An often overlooked factor on CTA performance is the impact of low interest rates on managed futures funds’ absolute returns. Because futures contracts require only a fraction of the overall notional value of the contract to be posted (known as margin), typically 75–85 percent of a managed futures fund’s assets sit in short-term government bonds or money market securities. Between 1990 and 2008, the average annual return on three-month Treasury bills was 4.4 percent; since 2008, however, that return dropped to just 0.1 percent per annum (see figure 8). The current interest-rate regime imposed by the Federal Reserve eliminated this comple-

**Figure 7: Global Futures and Options Volume by Region**

![Global Futures and Options Volume by Region](image)

Source: Futures Industry Association

**Figure 8: Three-Month Treasury Calendar-Year Returns**

![Three-Month Treasury Calendar-Year Returns](image)

Source: FactSet
mentary source of return, which often cushioned managed futures funds through periodic stretches of underperformance.

One final point on recent performance is that although the scope of managed futures strategies’ recent problems appears unprecedented, new historical research suggests otherwise. Hurst et al. (2012) extends the common research period of managed futures from the 1980s onward back to 1903. The authors reconstructed a time series of common trend-following models based on 59 markets across four major asset classes (commodities, equities, bonds, and currencies). Although such a theoretical construction should be viewed with some level of skepticism, the model does provide a proxy for examining longer-term performance of simple trend-following systems.

Hurst et al. (2012) determined that the drawdown of 13.5 percent (as measured by their model) between February 2009 and July 2011 is the sixth worst peak-to-trough decline in the past 110 years. In the 10 worst instances during the measurement period, the average drawdown was 14.8 percent and the average peak-to-recovery length was 25 months. This places the recent move right around the mid-point of those historical events.

The Case for Managed Futures

The critical question for investors at this juncture is whether managed futures strategies still make sense for their portfolios. Performance during the past four years shook the confidence of many investors in this space, with some going so far as to proclaim the CTA model broken. A number of items are worth discussing that influence the answer to that question.

Risk-On/Risk-Off Trading

The first, and most important, issue at hand is the potential decline in risk-on/risk-off trading dominating financial markets since the European debt crisis erupted in early 2010. Any decline in this phenomenon would be a welcome development for traditional CTA trend-followers because they rely on independent, uncorrelated assets to generate successful portfolio positions.

There is reason to believe that a reduction in risk-on/risk-off trading is indeed occurring. Analysis by HSBC, which utilizes principal component analysis on 34 major assets to create a measure of market correlation, indicates the tendency for a broad group of assets to be influenced by a single primary factor is abating. The firm’s aptly named Risk On/Risk Off Index neared a 0.50 level in late 2006, conditions are substantially improved.

This phenomenon is supported by a number of additional sources. Anecdotally, a broad range of the asset managers that Fortigent Research interacts with pointed to lower correlations between asset classes and between individual securities. This assertion is backed up by hard data indicating that average pair-wise correlations among the predominant asset classes shrank by more than 16 percent since 2011.2 Many financial markets are loosening up as a result, leading to more dispersion within asset classes—particularly in currencies and commodities. These developments are positive for both traditional asset managers as well as systematic trend-followers.

Downside Performance

From an historical perspective, arguably the most important property of managed futures is its negative correlation to risk assets during periods of drawdowns or risk aversion (although this profile could evolve for reasons we discuss in the next section). Schneeweis et al. (1996), for example, examined the downside performance characteristics of managed futures strategies and concluded that CTA strategies do, indeed, offer uniquely positive performance in such environments. An analysis of negative months for the S&P 500 since February 1991 provides additional context to this assertion: managed futures were the only major asset class to exhibit negative correlation to equity markets (see table 2).

This performance profile is critical for investors to remember. The past four years of performance were disappointing, but this period is marked by a near constant climb in equity markets. A decline in equity

| Table 2: Downside Correlation to S&P 500, February 1991–March 2013 |
|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|
| HFRI Macro: Systematic Diversified | Barclays US Aggregate | MSCI EAFE | Russell 2000 | DJ UBS Commodity Index | Dow Jones US Select REIT | HFRI Fund Weighted Composite |
| -0.16 | 0.00 | 0.72 | 0.68 | 0.31 | 0.52 | 0.62 |

Source: FactSet

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markets—particularly a sustained decline—would provide an environment in which managed futures strategies potentially could differentiate themselves from other asset classes.

**Portfolio Diversification**

The most critical evaluation of the managed futures industry surrounds its diversification properties. Much of the academic literature regarding the space makes particular note of these strategies’ lack of correlation to traditional assets and the improved risk-return profile of portfolios that allocate to managed futures. The evidence suggests that in the recent years marking managed futures difficulties, their lack of correlation to other asset classes remains intact (see table 3).

Because this noncorrelation persisted, the portfolio diversification benefits of including managed futures did not suffer a material degradation (see table 4). For example, a traditional 60/40 portfolio of the S&P 500 and Barclays Aggregate Bond indexes since the beginning of 2009 generated 12.7 percent annualized return with a 9.9 percent annualized standard deviation, or a Sharpe ratio of 1.27. Adding a 20-percent allocation to managed futures to this mix resulted in a modest reduction of Sharpe ratio to 1.20 during the four-plus-year time period. Although return is modestly reduced, a comparable decline in volatility occurred due to the uncorrelated nature of systematic trend-following. Also noteworthy is the substantial improvement in maximum drawdown during that period. The simple exercise suggests that, in a mean-variance framework, an investor was only slightly worse off despite enduring the worst performance stretch in the history of the managed futures industry. One could argue this was not a substantial opportunity cost to bear for the continued downside benefits that managed futures offer.

**Futures Market Risk Premium**

Finally, an important, fundamental question when evaluating CTAs is: What is the source of their return and has that source dissipated? Many academic studies have investigated the persistence of alpha generation of CTAs within futures markets. One common and important take away from that work is the fact that CTAs are not solely trading against one another within the futures markets (i.e., a zero-sum game).

| Table 3: Correlation Statistics, 2009–March 2013 |
|-------------------------|----------------------|--------|-------------|----------|---------|------------|-------------------|-----------------|----------------|---------------|
| HFRI Macro: Systematic Div. | 1.00 | 0.12 | 0.02 | 0.16 | 0.11 | 0.19 | 0.31 | 0.33 | 0.09 |
| S&P 500 | 0.12 | 1.00 | 0.95 | 0.91 | 0.83 | -0.07 | 0.83 | 0.69 | 0.81 |
| Russell 2000 | 0.02 | 0.95 | 1.00 | 0.84 | 0.80 | -0.18 | 0.80 | 0.60 | 0.83 |
| MSCI EAFE | 0.16 | 0.91 | 0.84 | 1.00 | 0.89 | -0.04 | 0.89 | 0.74 | 0.76 |
| MSCI Emerging Markets | 0.11 | 0.83 | 0.80 | 0.89 | 1.00 | 0.00 | 0.90 | 0.75 | 0.67 |
| BarCap Agg | 0.19 | -0.07 | -0.18 | -0.04 | 0.00 | 1.00 | -0.15 | -0.03 | 0.11 |
| HFRI Fund Wtd Composite | 0.31 | 0.83 | 0.80 | 0.89 | 0.90 | -0.15 | 1.00 | 0.76 | 0.64 |
| DJ UBS Commodity | 0.33 | 0.69 | 0.60 | 0.74 | 0.75 | -0.03 | 0.76 | 1.00 | 0.46 |
| DJ US Select REIT | 0.09 | 0.81 | 0.83 | 0.76 | 0.67 | 0.11 | 0.64 | 0.46 | 1.00 |

**Table 4: Risk/Return Statistics, 2009–March 2013**

<table>
<thead>
<tr>
<th>Portfolio</th>
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<th>Sharpe Ratio</th>
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<td>60/40 S&amp;P 500/BarCap Agg</td>
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<td>9.9</td>
<td>1.27</td>
<td>-11.5</td>
</tr>
<tr>
<td>60/40 S&amp;P 500/BarCap Agg w/ 20% Managed Futures*</td>
<td>10.1</td>
<td>8.3</td>
<td>1.20</td>
<td>-9.5</td>
</tr>
</tbody>
</table>

*HFRI Macro: Systematic Diversified
Source: FactSet

Many other market participants with their own objectives and preferences provide opportunity for skilled investors to profit. Research by Keynes (1930) famously predicted that a risk premium exists in futures markets because of the presence of natural hedgers (both producers and consumers) who trade with non-economic motivations (i.e., to control risk). Managed futures funds’ roles as liquidity providers in the market allows them to exploit this premium, providing a fundamental basis for why these types of strategies can generate positive absolute returns over time. Hedgers certainly have not abandoned the futures marketplace, leaving this important theoretical source of CTA return intact.

**The Big Caveat: A Rising-Rate Environment**

The counterpoint to the above discussion on risk reduction and diversification is how managed futures strategies will behave in a rising-rate market environment. Much of the historical research on rising interest rates indicates that both traditional equities and fixed-income securities exhibit difficulty in such regimes. Those results are well-documented, but less research exists on the
performance of managed futures in such periods as interest rates generally declined since CTAs gained prominence 30 years ago.

Theoretically, one would be led to believe that CTAs still can be effective in such environments. Studies such as those by Campbell & Co. (2013), which evaluated the results of a simple trend-following system through a variety of interest rate climates, affirmed as much: “CTA performance in relation to the direction of rates suggests that the strategy has not historically been rate-regime dependent.” The rationale for this thesis is fairly intuitive:

1. Managed futures strategies are designed to capture trends both positive and negative. Should a persistent increase in interest rates occur, trend-following strategies should be able to capitalize.
2. Because the majority of actual portfolio assets are held as collateral, increases in cash rates should provide a higher return on that component of the portfolio.

In reality, however, investors have a few other important considerations:

Correlation Impact of Short Bond Positioning
Because CTAs generally trend-followed bonds higher over the past three decades, CTAs may have developed a portion of their historic alpha-producing negative correlation attributes to equity markets due simply to their long fixed-income positioning. Since 1990, U.S. fixed income (as measured by the Barclays Aggregate Bond Index) exhibited a negative daily correlation to the S&P 500. Long bond positioning of managed futures funds entering equity downdrafts proved pivotal in mitigating the initial negative impact of long equity exposure. In the future, a similar scenario where CTA bond exposure is flat or even short (a likely phenomenon in a rising-rate environment), losses would not only be fully felt but also could be exacerbated as a flight to safety trade sends bond prices higher. The historic downside performance and diversification benefits of CTAs, therefore, may be structurally eroded in a new interest-rate regime.

Impact of Negative Carry and Roll Yield
Because yield curves were positively sloped (i.e., a negatively sloped or backwardated futures price curve) during most of the evaluation period, CTAs also benefited from the embedded positive carry roll effects of futures prices slipping down the yield curve across the passage of time (see figure 10). In a positively sloped yield-curve environment, however, a CTA effectively must "pay the points" embedded in the futures market rolldown cost to remain short. A CTA might for example benefit from a 10-percent decline in a given bond, but if it cost 3 percent to carry that short in embedded carry/futures roll costs, then the net return becomes only 7 percent. To the upside of fixed income, this roll cost would have been additive (10% move higher + 3% embedded carry = 13% total return) instead of negative.

In the future, the pace of any bond decline obviously would be important (fast moves overpowering negative carry aspects) and the shape of the yield curve obviously would be important (inverted yield curves would make trend-following far easier to the downside of fixed income). But for now, with a steep yield curve, CTA trend-following to the downside of fixed income will not be as easy as it was to the upside of fixed income. This is a mathematical fact until the time that yield curves invert—an ever so remote possibility at present.

Ultimately, offsetting impacts will be at work in a structurally rising fixed-income environment. Managed futures funds will benefit from higher collateral returns and trend-following bond spot prices lower (if there is a sustained move). However, a decline in diversification characteristics and the negative carry associated with being short a backwardated market will be a new headwind for the industry. This is not an immaterial development and should be considered when investing in CTAs. On balance, a new regime in fixed income should adversely impact managed futures returns and diversification benefits.

Proposed Path Forward
Given the possibility for a structural shift in CTA efficacy, how does one address these issues within portfolios? Fortigent has a few immediate suggestions.

First, do not panic and completely eliminate CTAs from your portfolio. The above issues may mean that CTAs in general are facing a more difficult return-generating environment, but they do not eliminate all of the diversification benefits of CTAs. As long as general market correlations loosen up somewhat—as they appear to be doing at present—CTAs should start to perform a bit better. One of the key attributes of CTAs is their ability to generate profit in a variety of asset classes, not just fixed income; the aforementioned increase in dispersion of individual commodities, currencies, and equity markets.
still should offer fertile ground for alpha capture and returns independent of other traditional portfolio allocations.

However, in the selection of a CTA, it may be increasingly important to choose managers with less embedded fixed-income exposure and more exposure to other assets (soft commodities, metals, energy, etc.). At the very least, investors should seek managers with an appreciation for the above fixed-income issues and a proposed modeling solution to it still either via trade time horizon, sizing, or other methods.

Fortunately, many managed futures firms are taking it upon themselves to adapt to the changes occurring in financial markets. The universe long has been dominated by intermediate-term trend-followers, but asset managers are spending considerable time and effort in developing new alternatives. This may include different time periods of evaluation (shorter or longer term), the addition of new contracts or nontraditional data sets, or the establishment of so-called non-trend strategies. These efforts are designed to increase the efficacy of systematic strategies and to provide diversification to traditional intermediate trend-following. We discuss some of those initiatives below.

Short-term trading: Shorter-term trend-following strategies are gaining greater prominence because of their success in the recent market environment (perhaps because of the shorter half-life of trends due to central bank activity). Increased computing power, the rise in high-frequency trading capabilities, and greater accumulation of intra-day data are contributing to the growth of these strategies. These systems may follow data as short as minutes or hours out to a few months, whereas most intermediate trend-followers trade within a 6–12 month time frame. Many prominent managed futures managers today implement some combination of shorter- and longer-term models to produce more robust signals that succeed in different market cycles.

Non-trend strategies: The proliferation of non-trend strategies has been swift. Such models rely on different systems to generate buy and sell signals and also can rely on non-price data. For example, some strategies quantify fundamental information to identify potential trading opportunities. Counter-trend models rely on price data to predict market trend reversals. Other systems aim to identify similar historical instances of price movement or fundamental data to select the most optimal trade for that environment (i.e., pattern recognition). The algorithms for such models and methodologies can become exponentially complex as researchers refine and add to their techniques.

English wheat prices going back to 1209” (Wilkes and Fletcher 2012).

Non-futures contracts: One other development within the industry is the use of new instruments within CTA portfolios. For example, prominent managers have begun trading cash securities such as individual stocks and bonds, other derivatives such as credit default swaps, as well as more esoteric instruments such as energy power contracts. The risk with such trades is that they are often less liquid, may have higher transaction costs, and can require higher capital commitments than traditional futures and forwards.

Additionally, Fortigent believes that within the CTA space it may be appropriate at this time to include more discretionary managers who potentially are better adapted to handle the current shifting political winds and artificial interest-rate environment created by central bankers. Macro managers only performed marginally better than CTAs over recent years (see figure 11), but they are likely the ones who would first benefit from any initial cracks developing in global confidence in central bankers.

We argue this because discretionary managers are more likely to recognize the unsustainable aspects of certain global fixed-income markets and may be first in line to profit from the initial reversal in
stretched markets. Trend-following CTAs, by comparison, will be slower to react to any such entropic shift. The potential for discretionary managers to capitalize on major market inflection points—either in fixed income, equities, or otherwise—offers a complementary exposure to traditional trend-followers. Investors should consider layering in more discretionary-oriented solutions to add robustness to CTA allocations.

Conclusion
In our opinion, managed futures strategies continue to play an important role in investor portfolios. Although alpha generation has waned in recent years, we believe this is primarily due to cyclical factors in the marketplace. Preliminary evidence indicates that this adverse environment may be dissipating.

More importantly, managed futures strategies continue to provide diversification benefits for diversified portfolios. Correlation levels for CTAs are significantly below those seen in other traditional hedge fund categories and provide a positively skewed performance profile not evident in other strategies. These diversification benefits made up for performance deterioration of the asset class since 2009, resulting in no material decline in risk-adjusted performance for diversified portfolios. This suggests the opportunity cost of holding managed futures allocations is far from unbearable.

With that said, the impending shift in interest-rate regime does present a potential structural issue for CTA performance. One may want to consider managers with less fixed income-centric programs because the correlation benefits of trend-following that particular asset class could become more problematic. Favoring programs with diversifying non-trend exposures and different portfolio time horizons should help mitigate this issue. For the immediate future, we also would favor manager pools with more discretionary influences because they may be better equipped to capitalize on the dislocations caused by overly accommodative central banks.

As always, ongoing manager due diligence is paramount to navigate this new and more complex world. The universe of discretionary and non-trend oriented managers is much more heterogeneous than that of intermediate trend-followers, presenting more potential pitfalls for investors. Careful evaluation of individual strategies, and understanding how they potentially complement an existing portfolio, remains critical.

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Endnotes
1. This information obtained in response to an e-mailed query to centralbanknews.info, June 2013.

References