Managed Futures
Characteristics and Considerations

By Kenneth S. Webster, CPA

“Managed futures” are actively managed investment strategies developed and executed by professional trading advisors in the global futures markets. In the United States, these advisors are known as commodity trading advisors (CTAs) and are registered as such with the Commodity Futures Trading Commission (CFTC). While often categorized as a subset of the “hedge fund” or “absolute return” sectors, the managed futures investment category actually includes a broad spectrum of trading styles with unique performance attributes. The historical benefits of including managed futures in a diversified portfolio have been well-documented, but the selection of an appropriate manager or managers is best made with an understanding of the class as a whole and the different strategies within it.

Managed futures began emerging as a viable, scalable asset class in the late 1970s. At that time, investor’s options were limited to technical strategies. Richard Donchian is credited with starting the first managed futures account in the late 1940s. He was followed by pioneers that made managed futures accessible to the retail investor through partnerships with the futures commission merchants (FCMs) such as Morgan Stanley and Smith Barney. Advances in computing and communications resulted in continued improvement in the quality and availability of both fundamental and technical data, the ability to quickly resolve computationally complex problems and multifactor analysis, real-time risk management and reconciliation processes, and increased liquidity in the instruments.

CTAs have been able to take advantage of these advances by increasing model and market diversification.

While commonalities exist among certain substyles, each managed futures program is unique, so trying to apply an overly broad classification to members of the category can result in faulty analysis of both the discrete risks and benefits of any given program. However, some relevant distinctions can be used as the basis for investigation. Independent of the qualitative factors that must be considered when reviewing any investment manager, investors often evaluate the following five characteristics when considering a managed futures product: discretion, inputs, methodology, time perspective, and portfolio mix.

Five Characteristics of Managed Futures
Manager Discretion: The Most Distinguishing Factor

In the day-to-day application of a system, discretion can vary greatly on the scale from completely systematic to completely discretionary. Systematic traders resolve to adhere to a specified set of trading rules at all times. These rules may be dynamic in nature, but they are established and codified prior to implementation. One perceived benefit of a systematic strategy is that it reduces the influence of human emotion on the decision-making process. Discretionary strategies rely on the skills of individuals to generate returns: The manager develops and implements an investment thesis or is able to identify, through continuous participation, favorable trading opportunities in a variety of market conditions. In practice there are no purely systematic or purely discretionary programs; every strategy incorporates some element of discretion by the manager (portfolio design and construction inherently are expressions of the advisor’s view) and discretionary managers utilize systematic processes in the generation of strategy and application of risk management.

Inputs and Related Analysis Drive Trading Decisions

The two primary inputs are fundamental and technical data. Fundamental data is derived from global economic events, geopolitical impacts, supply and demand, as well as the consequences of a changing regulatory environment on specific markets or market sectors. Based upon an analysis of these and other related data, fundamental analysts will try to predict the future of market price moves and establish positions based upon those predictions. Technical data consists of available information related strictly to the price of a market and a view that all relevant information eventually will be reflected in the price. Depending on their disciplines, managers select inputs from one or both categories to make trading decisions.

Methodology Defines How Inputs Generate Trading Signals

Some of the most common methodologies employed by CTAs are the following:

Trend following. Dating to the inception of the industry, trend following likely is the most common methodology. It utilizes algorithms to identify patterns of price migration in the underlying instrument in order to...
participate (long or short) in movements that often are masked by trading volatility.

Mean reversion/momentum. Statistical theory of probability is used to identify overbought or oversold conditions in the market to generate advantaged entry or exit points for trading.

Break out. Prices moving away from existing trading ranges may provide opportunities to capture profit from subsequent price movements.

Relative value/spread. CTAs monitor relationships between related instruments and invest through paired transactions based on a thesis related to the relationship.

Reference scenario/macro discretionary. This method assigns probabilities to the outcomes of global macro issues and tries to identify trades most likely to profit based on the number of predicted occurrences.

Time Perspective
When analyzing a market to determine if its history might support the current position or a new trade, the manager relies on a specific time perspective. The data relevant to one manager focusing on 30-minute time frames may be completely irrelevant to another manager focusing on price activity going back days, weeks, months, or more. Time perspective also can refer to the anticipated holding period for each trade. Managers often are classified by their average holding periods for positions. Short, medium, and long term are the usual designations. Time perspective variations can provide an investor with increased portfolio diversification beyond the individual markets traded and can produce wide variations in performance results.

Portfolio Mix
Increased selection and liquidity in global futures markets provide CTAs with a myriad of options for portfolio construction. Managed futures programs trade in the agriculture, currency, energy, global stocks, metals, and interest-rate markets. Sector-focused programs trade only in specific subsets of the markets; compare an “energy only” alternative with a broadly diversified program that typically will participate to some extent in all of the market sectors available. Sector-focused programs can offer investors exposure to implement a particular trading thesis, complement other existing holdings, or offset unwanted risk. A majority of managed futures programs use the portfolio mix as a critical component of the risk management process. With careful consideration for correlation, managers allocate risk across a broad set of sectors and products to diversify the overall portfolio.

Managing the Nuances
When all of the possible combinations of the aforementioned variables are considered, the number of outcomes may seem overwhelming; however, the majority of managed futures programs generally share a great number of characteristics with some subtle but significant differences. Understanding the nuances, as discussed above, will allow investors to further refine their due diligence and lead to a more successful implementation of this valuable investor resource.

Managed futures as an investment category can be evaluated using an available industry index such as the widely followed Barclay CTA Index (BCTA). While this index is not investible and includes many varied strategies, it clearly shows the long-term benefits of an allocation to managed futures. Extensive research supports the long-term benefits of including managed futures in a diversified portfolio. Lintner (1983) concluded that the traditional pairing of stocks and bonds to create a diversified portfolio resulted in a substantial decrease in risk, at every level of expected return, when combined with managed futures. Abrams et al. (2009) expanded on Lintner (1983), concluding that “the inclusion of managed futures in an institutional portfolio leads to better risk adjusted performance.”

The potential for noncorrelated returns attracts sophisticated investors to actively managed alternative strategies. The frequency and severity of price declines in traditional assets such as stocks and bonds has challenged the efficacy of long-standing buy-and-hold investment techniques. The inclusion of investment products that are managed to adapt to a wide variety of trading environments and that can take short positions in declining markets has demonstrated utility in dampening overall portfolio volatility and mitigating drawdowns. It is important to distinguish between non- and negatively correlated assets and also to consider the context in which correlation is evaluated. Correlation is dynamic; investment strategies will exhibit varying degrees of correlation to a given benchmark over time. Observing rolling correlations can be very informative: Such observation affords opportunity to see how consistently an investment has exhibited identifiable attributes through market cycles. One reason that managed futures are a compelling investment solution is their historical tendency to have positively biased correlation during favorable conditions for other markets and negatively biased correlation during unfavorable periods.

Figure 1 shows the rolling 12-month correlation of the BCTA and Barclays Hedge Fund Index (BHFI) compared to the return of the S&P 500 (S&P) from January 1997 (first available date for the BHFI) through December 2011. Figure 1 shows that BCTA has displayed a high negative correlation to the S&P during periods of decline for the S&P and high positive correlations during periods of positive performance for the S&P. In other words the allocation to managed futures has served to provide portfolio protection with positive returns during difficult periods for the S&P while maintaining the potential to provide positive returns during the best-performing
periods. Table 1 quantifies the portfolio protection attributes by showing the returns achieved during the three worst drawdowns experienced by the S&P over this timeframe. While this shows only the most recent 15-year period, this relationship holds true going back to the early 1980s through crisis periods including the 1987 crash, the breakup of the Soviet Union, the Russian default, and the first Gulf War, as well as the dot-com meltdown, the 9/11 attacks, the Iraq war, and the credit crisis. Note that although investors have sought out hedge funds to diversify portfolios and hedge away risk, table 1 shows that the Barclay Hedge Fund Index has been correlated with the S&P, especially during crisis periods.

The benefits of including a managed futures allocation in a broadly diversified portfolio that includes other alternative investments also can be significant. As an example, consider the endowment-style sample portfolio shown in figure 2. Allocations are weighted to indexes or benchmarks for various investment classes in a manner representative of what an institutional portfolio might commonly hold. By incrementally replacing the alternative investment allocation with investment in the JWH GlobalAnalytics™ managed futures program, a broadly diversified offering providing exposure to currencies, interest rates, energies, metals, agriculture, and global stock indexes, an improved historical and hypothetical investment blend can be created with regard to risk-adjusted returns. Small allocations of 1 percent or 2 percent have a meaningful impact on the overall portfolio’s returns, volatility, and drawdowns (see figure 3).

Volatility is also an important aspect of a managed futures program. While the simple conclusion to draw for an investment portfolio might be that one should strive for the least amount of volatility for every constituent allocation within the portfolio, this would certainly not be the best answer for maximizing risk-adjusted returns. It is often counterintuitive for investors to accept that adding a noncorrelated investment with higher stand-alone volatility and drawdowns has the potential to lower the overall portfolio’s volatility and maximum drawdown while increasing returns. Higher program volatility is often coincident with high returns and can be critical to delivering meaningful diversification benefits from small allocations; the volatility threshold that would be used to screen a more-correlated strategy may not be the appropriate threshold when selecting a managed futures program.
the types of markets traded whether exposed to a single sector or broadly diversified. CTAs generally utilize only the most-liquid exchange-traded products, providing the ability to offer investors favorable liquidity terms depending on the vehicle used to access the manager’s trading program. Daily liquidity is offered for separately managed accounts, which provide the added benefit of full position transparency. Monthly or quarterly liquidity often is provided for fund investments with no lock-up provisions and varying degrees of transparency depending on the manager. The managed futures industry continues to grow in terms of its offerings and in assets under management, currently estimated at more than $300 billion. While no investment comes without risk and the need for adequate due diligence, managed futures offer investors a wide set of unique benefits that should be considered when constructing a diversified investment portfolio.

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References


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