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The Next Ten Years: Welcome to the Jungle

When in 1983 David Bowie came back to the forefront of pop music with the hit “Modern Love,” he most likely wasn’t thinking of stocks and bonds. However, most investors, after years of disappointments during the stagflation period, were indeed ready to fall in love again with the two most traditional asset classes.

Building portfolios for the next 20 years was not rocket science as classically simple 60/40 allocations (60% equities and 40% fixed income) were getting the job done without too many headaches.

As the chart below indicates during the 1980s and 1990s, the rolling annualized rate of return on any five year period from a 60-40 portfolio ranged from 5% to 25%.

FIGURE 1: TRADITIONAL PORTFOLIO RETURNS OF THE ‘80S AND ‘90S MAY NOT BE REPEATABLE

Source: Bloomberg and Barclays as of 31 March 2013.
BAGG is the Barclays Capital U.S. Aggregate Index.
[1]

However, this period also introduced the era of hyperactive central bankers. At first, this kind of approach to monetary policy extended the level of risk taking investors were willing to take and asset returns continued to be above par. Unfortunately, at the same time the seeds of future instability were taking hold into the system. The era of happy investing and “just be in the market” was eventually replaced by a brutal sequence of booms and busts and even more interventionism by the Fed.

The new century, still in its infancy, has already been marked by a bubble and consequential burst in tech stocks, a similar cycle in real estate which eventually lead to a global financial crisis and a sovereign debt crisis in Europe. It is in our opinion that we may be on the brink of a major reversal of fortune for

[1] Source: Sabrina Callin, John Cavalieri,” *In an Era of Uncertainty and Lower Returns, It’s Time for Alternative Approaches”* PIMCO Featured Solutions, May 2013

bonds after a spectacular bull run that lasted close to 30 years. Global Central Banks exit strategies from unprecedented monetary interventions and we believe swollen balance sheets will probably continue to fuel volatility in financial markets and risky assets returns might continue to produce inconsistent patterns for years to come.

Portfolio construction today must take into consideration how the rules of the game may have shifted during these turbulent years. For example, a traditional risk centric portfolio analysis would determine that a 60-40 portfolio may be dominated by equity related risk yet compensated by higher expected rates of return by the riskier component (stocks). However, risk may be now more pronounced than previously thought due to fixed income fragile status and yet realized rates of return may be below par from both sides of the allocation. Please note that while managed futures can help enhance returns and reduce risk, they can also do just the opposite and result in losses in a portfolio.

Integrating alternative assets and above all alternative strategies during the process of portfolio construction is not an option any longer but, in our opinion, it is a necessity. As we discussed in previous writings, the problem with alternatives is figuring out the real drivers of risk behind the specific strategy and often a better calculation of the illiquidity risk that is usually associated with these kinds of investments.

For instance, in the case of a popular alternative strategy like Private Equity, often the de-correlation benefits disappear during serious contractions because the risk drivers are really not much different than traditional equities. Furthermore, P.E. also suffers from a higher level of sensitivity to fluctuations in the credit markets. Many hedge funds are also vulnerable to liquidity crisis due to the leveraged nature of their structure.

Finding the right hedges require a different level of engagement; strategic asset allocations may end up being too static for an investing environment that is still trying to find its bearings. Yet there are a few solutions available to sophisticated investors; one such answer can be found in the Managed Futures space. The trend following nature of most Managed Futures programs and their inherent high liquidity allows them to provide “crisis alpha,” or that hedging quality which gets unlocked just when you need it.

The Managed Futures advantage during serious financial dislocations is not only confined to its liquidity but also its potential diversification across multiple markets and multiple time frames.

In the table below, compiled by Abrams, Badhuri and Flores for the CME Group, we can see the Managed Futures’ response (measured by the BTOP 50 Index) to the major crises of the last 25 years.

Figure 2: Performance of Managed Futures during Some of the Worst Crises

Time Period	**Crisis**	**S&P 500 Index (%)**	**BTOP 50 Index (%)**	**Difference (%)**
4th Quarter 1987	Stock market crash	−23.23	16.88	40.11

3rd Quarter 2002	WorldCom bankruptcy	−17.63	9.41	27.05
3rd Quarter 2001	9/11 terrorist attack	−14.99	4.12	19.10
3rd Quarter 1990	Iraqi invasion of Kuwait	−14.52	11.22	25.74
2nd Quarter 2002	Aftermath of technology bubble burst	−13.73	8.52	22.26
1st Quarter 2001	Bear market in U.S. equities	−12.11	5.97	18.01
3rd Quarter 1998	Russia default, Long-Term Capital Management Failure	−10.30	10.54	20.84
1st Quarter 2008	Credit crisis	−9.92	5.92	15.84
3rd Quarter 2008	Credit crisis	−8.88	−3.40	5.48
4th Quarter 2000	Dot-com bubble	−8.09	19.78	27.87
3rd Quarter 1999	Y2K worries	−6.56	−0.67	5.89
1st Quarter 1994	Increase in interest rates	−4.43	−2.10	2.33
4th Quarter 2007	Subprime crisis	−3.82	3.02	6.84
1st Quarter 1990	U.S. recession, oil spike	−3.81	1.76	5.57
1st Quarter 2003	Second Gulf War	−3.60	4.68	8.28

This exhibit shows discrepancies in performance between managed futures and the S&P 500 Index as well as the BTOP 50 Index during the worst crises of the previous 25 years [2]. Please note that due to the low and often negative correlation of Managed Futures to traditional assets, they may underperform equities during positive periods for traditional assets.* The Barclay CTA Index does not represent the entire universe of all CTAs, that individuals cannot invest in the index itself, and that actual rates of return may be significantly different and more volatile than those of the index. [4]

Furthermore, a recent study [3] of different asset class correlations for the past ten years revealed that 15 of the 24 most common asset classes in institutional portfolios (including 10 alternative strategies) had a correlation to the S&P 500 of 0.65 on average. The study also found that Managed Futures correlation to stocks was a negative 0.16 (measured by the Newedge CTA Index). Please note that while managed futures can help enhance returns and reduce risk, they can also do just the opposite and result in losses in a portfolio.

The key to healthy long term portfolio returns is in the ability of the investor to insulate as much as possible the assets from extreme volatility. Portfolios that are especially vulnerable to shocks will inevitably underperform as the compounding advantage will lose effectiveness. The table below shows the difference in returns between two portfolios. The table merely shows how volatility eats up returns; it is a textbook example of the difference between arithmetic and geometrical averages whose arithmetic average annualized rate of return is the same, 10%, but the return of portfolio B – the most volatile is almost 20% lower. Please note, The 20% difference refers to the difference between 33% and 24.8%. 24.8% is over 20% lower than 33%: (33-24.8)/33 = 24.85% delta.

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[2] Source: Abrams et al. (2010) in "*Alternative Investments,"* Chapter 19 by Davide Accomazzo, 2013, Hoboken, Wiley

[3] Source: Kris Devasabai, *Managed Futures on the Rise as Investors Chase Diversification,"* Risk.net, April 2011

[4] Source: http://www.barclayhedge.com/research/indices/cta/sub/cta.html

Portfolio A	Portfolio B
Return Year 1: +10%	Return Year 1: +20%
Return Year 2: +10%	Return Year 2: -20%
Return Year 3: +10%	Return Year 3: +30%
Arithmetic Yearly Average = 10%	Arithmetic Yearly Average = 10%
Realized Return = **33%**	Realized Return = **24.8%**

High volatility also retrenches the boundaries of investors' tolerance to risk and raises the possibilities of irrational actions to be implemented to the ultimate detriment of portfolio performance.

Along this line of thought, incorporating futures in a modern portfolio can take many shapes. CTA programs are not the only solution; pro-active investors should think of utilizing futures and options as tailored hedges for specific portfolio risks. So called tail risk hedging, or the implementation of hedges designed to protect positions from unexpected and significant break-downs, are an efficient way to mitigate the effect of financial Black Swans (refer to the writings of Nassim Taleb for more on Black Swans). At this economic juncture, two common risks investors should think about hedging are possible inflationary pressures and heightened dislocations in global fixed income.

The end of the secular bull market in equities in 2000 ushered in the era of the Jungle, where agility and preparation for the unexpected supersede static and traditional behavior. Modern investors must learn to question all assumptions; like fireman in the field they must be ready for sudden "burn overs" and find life-saving cover.

Alternative strategies can be a strong line of defense.