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Crisis Alpha

Managed Futures have shown, over the last fifty years, the kind of uncorrelated returns that investors would want to incorporate in their allocations to improve their Efficient Frontier. No assurance can be made that they will continue to provide this uncorrelated return aspect and there is a risk of loss associated with managed futures. Many studies have analyzed such dynamic asset allocation, from the seminal Lintner study in 1983 to the Peters work in 1992. More recent evidence of such characteristics in Managed Futures was highlighted by their aggregate performance in 2008, when most asset classes collapsed globally while the Barclay CTA Index* recorded a positive 14% for the year.

One has to understand crises to fully comprehend why Managed Futures, above other Alternative Investments solutions, can provide such an edge during “edgy” times.

During a significant market crisis, there are objective limitations to those elements that usually keep markets orderly. There are limits to arbitrage actions, forced liquidations push large and leveraged players into unwanted and inefficient de-leveraging and of course major technical glitches mar trading action. Many crises often center on credit issues which can very quickly engulf many other generally healthy parts of a financial ecosystem. And lastly, significant market breakdowns will be accentuated by behavioral inefficiencies. The end result is a disappearance of liquidity resulting in massive increases in volatility.

But I have Hedge Funds to Protect Me from These Crises…

Most Alternative vehicles such as Hedge Funds, Funds of Funds or even Private Equity Funds cannot easily escape the vicious circle of liquidity drying up, de-leveraging and increasing fear due to the nature of most of their strategies and implementations. Most Alternative vehicles are usually highly leveraged and dependent on easy access to funds; additionally, they tend to make money by exploiting illiquid anomalies. These parameters create a toxic combination during major financial dislocations. Please note that increasing leverage increases risk.

In 2008, for example, the Barclay Hedge Fund Index was down 21.63% for the year while Managed Futures were up as previously quoted. The ability of Managed Futures (as represented in aggregate by the Barclay CTA Index) to potentially provide positive returns during major dislocations was termed “crisis alpha” by Kaminsky and Mende in their 2011 work on the subject. But why would Managed Futures work when everything else fails? In order to answer this question we need to understand the nature of most futures based strategies and how they are implemented.

Most CTAs will be highly leveraged but thanks to the structure of futures and options - usually their tools of choice for strategy implementation - they will not be held hostage to credit crises as much as Hedge Funds and P.E. firms. Futures trading only require a small down payment as collateral for the trade as opposed to most other asset classes such as stocks and bonds that require full funding (even in the case

of margin transactions in equities, the investor would have to borrow the additional funds to purchase the extra shares). In the case of Private Equity investments, we can also point out that, besides financing and liquidity factors, the drivers of performance are very similar to traditional equities. After all a successful business will be so thanks to accelerating sales and productivity whether its legal structure were public or private.

CTAs also operate in very liquid markets; if a manager wants to express a particular view on interest rates she will act in the bond futures arena which is one of the most liquid markets in the world. The same can be said for equity bets as index futures are very liquid. Although liquidity has been evident through-out the history of commodity trading, there can be no assurance it will remain so.

This relative independence from sources of funding that can quickly disappear in a crisis and the ability of generally finding rapidly a counter-party for their trades gives CTAs an advantage over many other alternative managers.

Can't Be All Good… Where Is the Catch?

One important element to understand is that all the studies relating Managed Futures to portfolio construction are based on indexes and unfortunately such Alternative Investment Indexes are generally not investable (this is true of Hedge Funds indexes as well). Such indexes usually include hundreds if not thousands of funds or CTAs making it rather difficult to build a portfolio closely resembling the tracked benchmark. This problem can be tackled by utilizing a framework that allows the investor to pick an efficient blend of superior managers.

This process starts by identifying the predominant strategies implemented in Managed Futures; this universe has changed over the years and thanks to the advent of improved technology and more sophisticated managers, the spectrum of strategies available to investors has increased significantly. This growth carries many benefits but also some potential problems which require additional layers of analysis.

The classic strategy remains trend following; a manager would identify, usually by ways of quantitative analysis, a trend in one or more markets (up or down) and would ride it until its reversion.

Improvements in technology, an increase in daily liquidity provided by high frequency shops and a migration of many pit traders to "upstairs" electronic trading has also fostered a surge in short term mean reverting strategies. These models have a different pay-offs than trend following and they should show a high win/loss ratio with small wins and small losses.

The third major set of strategies is built on utilizing options, sometimes as a stand-alone, sometimes in conjunction with futures. In this segment, volatility selling option strategies are very popular with high Sharpe ratios, consistent profits and usually uncorrelated results until… a major crash. These strategies can be great performance providers but do correlate highly with crises as opposed to Managed Futures in aggregate. There are many other option strategies available such as covered calls and tail risk hedging which sport different risk profiles and pay-offs.

In conclusion, a winning approach to Managed Futures requires analytical homework to identify the needed strategy, to pick the right managers and discipline to fully unlock the investment advantage. Indeed, a sufficient investing horizon should be allowed to maximize asset class exposure; a study by Abrams in 2010 revealed that holding periods of three to five years meaningfully increase the probability of a successful investment.

Sources:

Abrams, Ryan, Rnajan Bhaduri, and Elizabeth Flores, 2010. “A Quantitative Analysis of Managed Futures in an Institutional Portfolio.” Working Paper, CME Group.

*Barclay CTA Index is not an investable index and does not represent the entire universe of all CTAs. This index serves the purpose of providing a general indication of asset class performance. The index does not contain all CTAs nor is the performance of this index indicative of the performance of any individual CTA. Rates of return may differ and maybe more volatile than those of the index.

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