The Role of Managed Futures Strategies in a Durable Portfolio

After delivering for investors in 2008 with a 21% total return, Managed Futures strategies have seemingly struggled, posting negative returns in three of the past seven years and a near-flat return in 2015. Over that same period, the S&P 500 Index has more than doubled, leaving some to wonder if the potential diversification benefits of Managed Futures have amounted to little more than a drag on portfolio performance.[1] Others recommend patience and point out that allocations to certain Managed Futures strategies do provide benefits to a portfolio, even if those benefits haven't been that apparent over the past seven years when compared to the strong performance of equities.

What are Managed Futures?

Many Managed Futures strategies (whose managers are commonly referred to as Commodity Trading Advisors or CTAs) are systematic and trend-following, searching to identify price momentum in futures markets including equities, fixed-income, currencies, and commodities. CTAs typically have the flexibility to go long or short in these different futures markets, thereby giving these strategies the potential to profit even when traditional asset classes are falling. For this reason, managed futures strategies are considered to have time-varying correlations that have the potential to be positively correlated to equities in rising equity markets and negatively correlated to equities in falling equity markets. During the period from 2000 through 2015, Managed Futures had near zero to very low correlations to both stocks and bonds, making them effective diversifiers in a traditional portfolio during this period.[2]

The Case for Managed Futures: "Crisis Alpha"

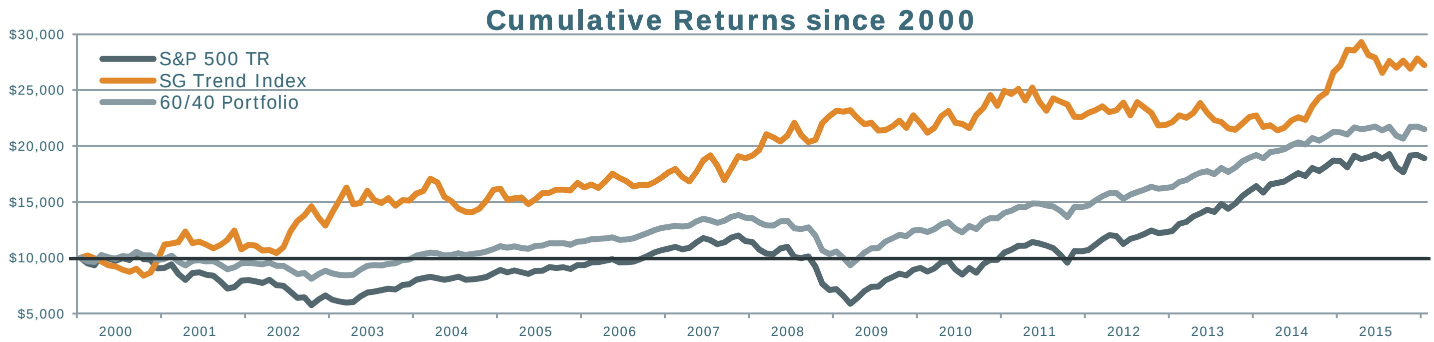
AlphaSimplex believes one of the most compelling attributes of Managed Futures strategies has been their behavior during U.S. equity crisis periods, earning them the moniker that some have described as "crisis alpha." In fact, examining the 10 largest quarterly declines in the S&P 500 Index between 2000 and 2015 reinforces the idea that Managed Futures has the potential to provide positive results precisely when equities are experiencing their more extreme negative outcomes.

Managed Futures outperformed U.S. equities on a relative basis during all 10 of the quarters when U.S. equities experienced their largest quarterly declines, and even posted positive absolute returns in 7 of the 10 periods. Their average level of relative outperformance versus equities was 19% across all 10 periods.[3] On the other hand, during the 10 worst quarters for Managed Futures strategies from 2000–2015, equities posted positive returns in 6 of the 10 periods and outperformed Managed Futures in 9 of the 10 periods. The average outperformance of equities relative to Managed Futures was 9% across all 10 periods.

These statistics bolster the view that Managed Futures strategies can provide crisis alpha for a portfolio, capable of delivering return even when equity markets are in crisis. The test of a crisis alpha or "tail risk" strategy is twofold: 1) Does it provides effective protection when it is most needed, and 2) Is the cost for the protection affordable over the long term? While some tail risk strategies, such as put options, can provide effective protection during equity declines, the cost of keeping the strategy in place, particularly over a long period, can be prohibitive. By adding to a traditional 60/40 portfolio of stocks and bonds as little as 10% of Managed Futures between 2000 and 2015, the portfolio's risk was lowered and its risk-adjusted returns were improved. The portfolio's maximum negative month and maximum drawdown were also reduced. By increasing the allocation to Managed Futures to 20%, all of the above risk metrics were further improved.[4]

Recent Performance

Critics of Managed Futures strategies point to their performance since the financial crisis and question whether the strategy has become less effective over time. The market environment since 2008 has not been kind to many trend-following strategies, including Managed Futures. The risk on/risk off nature of the market has led to a general lack of discernible trends and/or frequent trend reversals in many of the futures markets that CTAs trade. This has led managers to enter trades only to exit them shortly thereafter at little profit or even with losses. However, as is the case for many asset classes and strategies, times change, and in 2014 many CTAs and investors were rewarded for their patience, as trends seemed to persist and extend and correlations seemed to broaden giving CTAs a larger opportunity set. As a result, CTAs overall had their strongest year since 2008, as the SG Trend Index posted a positive return of 20% for 2014. Although Managed Futures posted a near-flat return in 2015, cumulative returns for Managed Futures, the S&P 500, and a traditional 60/40 portfolio suggest that strategic allocations to Managed Futures strategies may allow investors to weather cycles of market underperformance and to stay invested over the long term.



Dealing with Market Anxiety

Since the financial crisis, both equities and fixed income have in general shown strong performance. However, the continued growth of these asset classes is brought into question by the Fed beginning to tighten policy and by changes in market volatility. With these concerns in mind, investors may be seeking alternative sources of return. In an environment of higher volatility and extended trends, upwards or downwards, trend-following strategies like Managed Futures may be able to provide returns that are uncorrelated with equities or fixed income. While we cannot forecast the future, we can say that markets are likely to change, both positively and negatively, and typically from unanticipated sources. For those who are anxious about increased volatility, we believe that some protection against that volatility is worthy of consideration.

(1) Source: SG Trend Index (Managed Futures) and S&P 500 Index (Stocks), 2008–2015. During 2008, the SG Trend Index had a total return of 20.88% and the S&P 500 Index had a total return of –37.00%. The cumulative return for the SG Trend Index from 2008–2015 was 42.17%; the cumulative return for the S&P 500 Index for the same period was 65.71%.

(2) Between 2000 and 2015, the correlations between the SG Trend Index (Managed Futures) and the S&P 500 Index (Stocks), the Barclays Capital Aggregate Bond Index (Bonds), and the DJ UBS Commodity Index (Commodities) were –0.14, 0.22, and 0.17, respectively. Past correlations may not be indicative of future correlations.

(3) Source: SG Trend Index (Managed Futures) and S&P 500 Index (Stocks), 2000–2015.

(4) Source: SG Trend Index (Managed Futures), S&P 500 Index (Stocks), and Barclays Capital Aggregate Bond Index (Bonds), 2000–2015. During this time period, a portfolio comprised of 60% stocks and 40% bonds had an annualized standard deviation of 9.07%, a risk-adjusted return (Sharpe ratio) of 0.54, a maximum negative month of –11.02%, and a maximum drawdown of –32.54%. A portfolio of 54% stocks, 36% bonds, and 10% Managed Futures had an annualized standard deviation of 8.14%, a risk-adjusted return (Sharpe ratio) of 0.64, a maximum negative month of –9.19%, and a maximum drawdown of –28.18%. A portfolio of 48% stocks, 32% bonds, and 20% Managed Futures had an annualized standard deviation of 7.52%, a risk-adjusted return (Sharpe ratio) of 0.73, a maximum negative month of –7.35%, and a maximum drawdown of –23.61%. All portfolios rebalanced monthly. For simplicity, Sharpe ratios have been calculated with the riskless rate set equal to 0%. It is not possible to invest directly in an index. Past performance is no guarantee of future results.