Correction or Crisis?

Managing Expectations for Managed Futures and Crisis Alpha

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Recent market events have frustrated and stung equity investors. Despite the lure of an ability to perform in past crises, during Q1 of 2018 Managed Futures suffered hand in hand with equity markets. For investors hoping for portfolio protection, this situation left them scratching their heads. There are several reasons why Managed Futures didn't weather the equity storm in Q1 of 2018.

When it comes to crisis, severity and duration matter

Every crisis is different and a crisis can be defined by both the length and depth of a crisis event. From this perspective, sustained and substantial periods of losses can be classified as a **crisis** and short term market reversals can be classified as a **correction**. Managed Futures strategies trade predominately medium- to long-term trend following strategies ranging from 3 to 12 months. Given their approach, a severe prolonged crisis is naturally a more favorable environment. To put the recent market events into perspective, Figure 1 plots equity drawdowns (using the S&P 500 TR Index in red) and the return of Managed Futures during the same drawdown period (using the SG Trend Index in gray).[1] In comparison with prior severe crisis events, the Q1 2018 equity drawdown was roughly 10% and was relatively short in duration. By definition, it was a correction not a crisis. Since 2000, we have observed three distinct regimes (1) crisis, (2) recovery, and (3) a period of relatively "calm" equity markets.

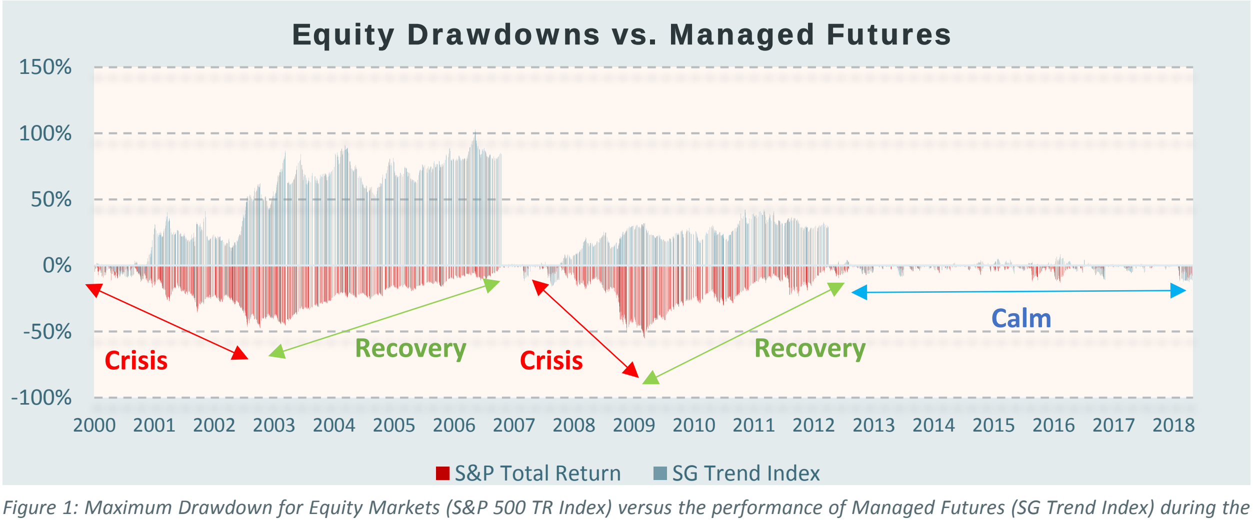

Figure 1: Maximum Drawdown for Equity Markets (S&P 500 TR Index) versus the performance of Managed Futures (SG Trend Index) during the same drawdown period. The data begins at the inception of the SG Trend Index in January 2000 until April 2018. Source: Bloomberg, AlphaSimplex

[1] Intuitively, this graph shows every negative day and the corresponding depth of the largest loss for an equity investor. The return of Managed Futures is over the same time period to consider how the strategy performed through the same drawdown period.

During sustained crisis periods, Managed Futures seem to earn their stripes garnering "crisis alpha."[2] During periods of recovery, Managed Futures tends to have relatively lower returns on average.[3] Finally, during the recent period of relatively "calm" equity markets, Managed Futures has been somewhat of a mixed bag during a range of milder equity drawdowns. Since trend following strategies are built to react in medium- to longer-term horizons, they cannot adjust as quickly to short-term events. As a result, for equity corrections the way trend following strategies are positioned prior to an event really matters.

For short-term corrections, prior positioning matters

Short-term market corrections may not necessarily be good environments for Managed Futures. During these events, trend-following strategies either get it right because the market trends were consistent with this event prior to its occurrence, or they get it wrong when large trends quickly change (causing reversals). Focusing only on the beginning of a crisis period and the recent calm period in equity markets, Figure 2 plots the maximum drawdown for equity markets (using the S&P 500 Total Return Index in red) compared with the performance of Managed Futures (SG Trend Index in gray) during the same period.

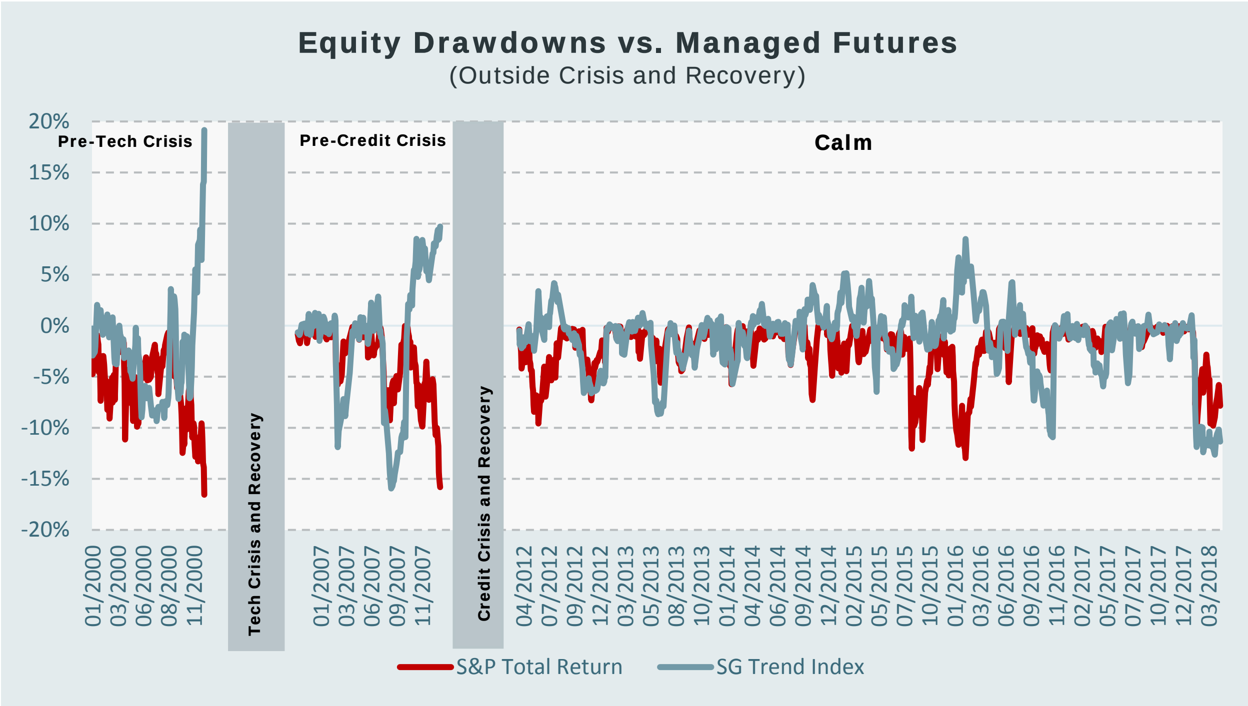

Figure 2: Maximum Drawdowns for equity markets (S&P500 TR Index versus Managed Futures (SG Trend Index) performance over the same period. Drawdowns are shown for the beginning of the crisis periods and calm periods in markets. Source: Bloomberg

From this graph, there are roughly 15 market corrections, or events with a drawdown greater than 5%. During the same period, Table 1 lists the 15 equity correction events along with the corresponding equity market and Managed Futures performance during the same drawdown period. Positive returns for Managed Futures during equity corrections are shaded in green

[2] A wide range of papers examine the conditional performance of trend following during crisis, documenting "crisis alpha" properties of trend following over long time horizons. (See also Kaminski (2011), Greyserman and Kaminski (2014))

[3] Hutchinson and O'Brien (2014) examine the performance of trend-following strategies during financial crises and post-crisis. They show that trend following tends to underperform post-crisis during the recovery and provide better conditional performance during crisis periods. Kaminski (2017) also discusses this concept by comparing performance of trend following as a function of the number of assets in crisis.

(negative are shaded in red). From Table 1, we can see that during equity market corrections Managed Futures performance has been roughly equally positive, neutral, or negative. This list demonstrates how the positioning of trend-following strategies matters. For the equity correction in Q1 2016, trend positioning was roughly in line with future trends that extended when markets took losses in January and February. In Q1 2018, trend-following strategies were long equities following the exceptional trends coming out of 2017. When equities corrected in Q1 2018, the move was not in their favor. From Figure 2, we can also see that two difficult simultaneous drawdowns for both equities and trend followers occurred in 2007.

Managed Futures Performance During Equity Corrections
(Outside Crisis and Recovery)

Period	Date MDD	Description	Equity MDD	SG Trend	
Pre-Tech Crisis	2/25/2000	Start of the Tech Crash	-9.1%	-1.1%	Neutral
Pre-Tech Crisis	4/14/2000	Early Onset of Tech Crash	-11.1%	-2.5%	Neutral
Tech Crisis	12/20/2000	Tech Crash	-16.6%	19.1%	Positive
Pre-Credit Crisis	3/13/2007	Bear Stearns Collapse	-5.4%	-9.4%	Negative
Pre-Credit Crisis	8/15/2007	Quant Crash	-9.3%	-14.5%	Negative
Credit Crisis	1/22/2008	Beginning of Credit Crisis	-15.8%	9.7%	Positive
Calm	6/1/2012	Poor U.S. Job Reports, Weak European Data	-9.6%	3.4%	Positive
Calm	11/15/2012	Poor U.S. Job Reports, Weak European Data	-7.3%	-6.6%	Negative
Calm	6/24/2013	Gold Prices Crash, Concerns Over U.S. Economy	-5.6%	-8.6%	Negative
Calm	2/3/2014	Conflict in Ukraine, Poor U.S. Manufacturing Data	-5.7%	-4.5%	Negative
Calm	10/15/2014	Concerns Over Global Quantitative Easing	-7.3%	4.0%	Positive
Calm	8/25/2015	Concerns Over China	-12.0%	1.7%	Neutral
Calm	2/11/2016	Equity Correction	-13.0%	8.5%	Positive
Calm	6/27/2016	Brexit	-5.5%	0.6%	Neutral
Calm	2/8/2018	Equity Correction	-10.1%	-11.9%	Negative

Table 1: Managed Futures Performance During Equity Corrections. In this Table, a correction is defined as a drawdown that exceeds 5% which is not part of either a larger crisis or recovery period. The date of the maximum drawdown for equity markets is labeled by the period, the date of the drawdown, a description, the depth of the drawdown in equities (S&P 500 TR Index), as well as the corresponding performance of trend following (SG Trend Index) during the same drawdown. Returns which are greater than 3% in magnitude are labeled as positive or negative and returns less than 3% in magnitude are labeled as neutral. Source: Bloomberg

Keeping Managed Futures investments in perspective

Managed Futures tends to do the best “when things happen in markets” and when the world is structurally changing. Most investment strategies dislike change; this difference in approach makes Managed Futures performance somewhat counter-cyclical. It tends to work when other things don’t and it tends not to work when they do—in general, but not in every market environment. Although it can be a great diversifier or risk mitigator, the counter-cyclical performance makes holding the strategy more difficult without a long-term perspective. The key advice for investors in Managed Futures is to focus on its long-term strategic goal in a portfolio and to avoid reacting to short-term performance fluctuations and short-term equity corrections. It is also important to distinguish between a crisis and a correction. While volatility has picked up recently, we have been in a prolonged period of extreme “calm” in equity markets. With the current global potential for rising rates and ongoing political and economic uncertainty, it is important to not mistake the dangers of the calm before the storm.

Selected References

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