Managed Futures Strategies Re-Position for Trends Outside of Equities

A Sign that Markets May be Ready for Change

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The beginning of 2018 showed the first signs of volatility returning to markets. Following the equity correction in Q1, markets became "choppy," with developed trends reversing in a wide range of global markets (most notably in FX and global bonds). Choppy, sideways markets are difficult to navigate for trend-following strategies, as there are no sustained trends for them to follow. The recent bumpy ride has left some Managed Futures investors frustrated, wondering why markets have presented fewer opportunities and when the strategy might start working again.

CHOPPY MARKETS

Markets in which prices swing up and down often, with no extended or sustained trends.

Counter-Cyclical Performance

For any investor in Managed Futures, it is important to remember that this strategy tends to have counter-cyclical performance. Managed Futures performs best when trends are sustained (in either positive or negative directions); the strategy often struggles when markets are indecisive and choppy. Given this, it may not be easy to hold Managed Futures during these periods of fluctuation. However, many of these indecisive moments tend to precede major market dislocations that have been fertile ground for positive returns in trend-following strategies. The experienced Managed Futures investor knows that when market trends have remained muted, eventually large trends occur again.

One method of visualizing this historical tendency is to examine market "trendiness" using a calculation like the Market Divergence Index (MDI)[1]. This index calculates the ratio of signal-to-noise in markets to determine when trends have persisted. The MDI includes more than 80 futures contracts across global equities, currencies, commodities, bonds, and interest rates. In Figure 1, a look at the six-month MDI since 2000 shows several distinct periods of indecisive markets preceding strongly trending markets.

MARKET DIVERGENCE INDEX (MDI)

The MDI measures market "trendiness" by calculating the average signal-to-noise ratio for a given period.

[1] The Market Divergence Index (MDI) is defined in Greyserman and Kaminski (2014), p. 109.

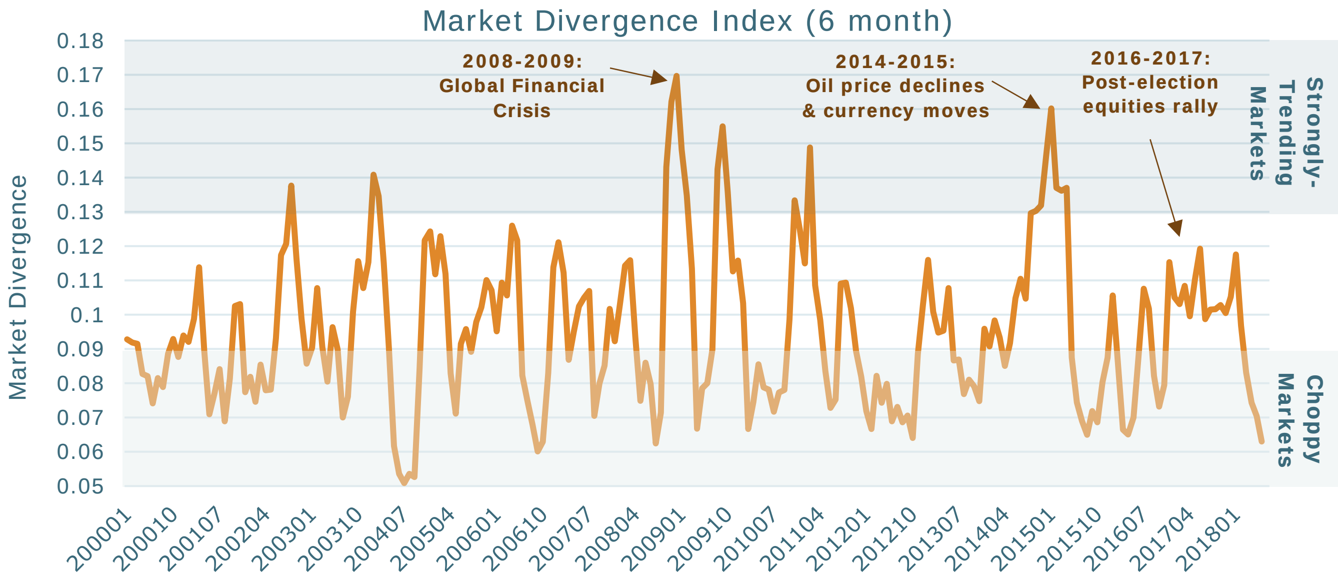

Figure 1: Six-month MDI aggregated monthly, using price returns from January 1, 2000–June 30, 2018. Source: Bloomberg and AlphaSimplex internal calculations.

As shown in the chart above, periods of indecisive markets are often followed by large spikes in "trendiness." Because Managed Futures programs follow these trends, they can experience periods of negative performance (when markets are choppy) followed by unanticipated periods of positive performance (when markets trend). As a result, difficult periods of performance are often followed by more profitable periods. Figure 2 examines the performance of trend-following managers (represented by the SG Trend Index) after these periods of underperformance. After one, two, or three quarters of consecutive negative returns, on average, the subsequent periods tend to be positive. This is particularly true for multiple consecutive quarters of negative performance.

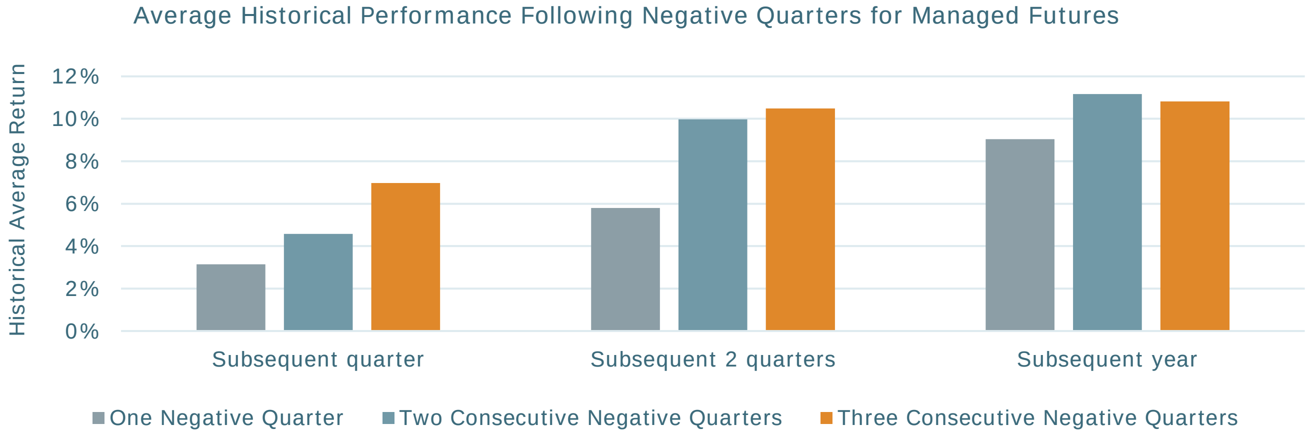

Figure 2: Average historical total return for Managed Futures (SG Trend Index) in periods following one, two or three consecutive negative quarters. The return is equal to the average return for each quarter times the number of quarters in question. Source: Bloomberg.

Poised for new Opportunities

While performance is important, many investors also understand the benefits of uncorrelated and diversifying investments. Managed Futures is a dynamic strategy that is able to buy and sell a broad range of global assets following prevailing market trends. Over the long term, Managed Futures has provided low correlation to global equity markets and a profile that is complementary to traditional portfolios. If prevailing trends are outside of equities, the correlation can be low or even negatively correlated to equity markets. If prevailing trends are in equities, the correlation can be strongly positive or strongly negative to equity markets, depending on the direction of market movement.

Between Q2 2016 and Q1 2018, equity market trends were strong and profitable. During this period, trend-following strategies maintained a strong positive correlation to equities. Following the recent correction in Q1 2018, moves in currencies, commodities, and bonds have led Managed Futures to shift course, tracking new potential opportunities outside of equity markets. For example, as of June 30, 2018 the AlphaSimplex Managed Futures Strategy has primarily shifted risk to long U.S. dollar, long energies, and short agricultural commodity positions, and has maintained its short exposure to the front end of the U.S. yield curve. The overall impact of these developments is a reduced net risk exposure to equity markets going into Q3 2018 with a focus on these new opportunities. This shift has reduced both the correlation and beta of the strategy to equity markets.

To demonstrate the dynamic shift in risk exposures for Managed Futures, Figure 3 plots the estimated beta to the S&P 500 Index for the AlphaSimplex Managed Futures Strategy from 2010 through Q2 2018. In early 2016, the strategy had negative beta to equity markets which ramped up through the sustained equity run. Since the Q1 2018 correction, as new trends in other asset classes have strengthened and market correlations have changed, the net equity

RISK EXPOSURES

Risk exposure refers to the amount of the strategy that is invested in a particular security, market sector or industry, usually expressed as a percentage of total holdings.

BETA TO EQUITY MARKETS

Beta is a measure of the risk arising from the exposure to general market movements. A positive equity beta implies the strategy tends to move in sync with equity markets; a negative equity beta implies the strategy tends to move counter to equity markets.

market beta for the AlphaSimplex Managed Futures Strategy has moved down from almost 1.5 at its peak in 2017 to approximately 0.24 at the end of Q2 2018.

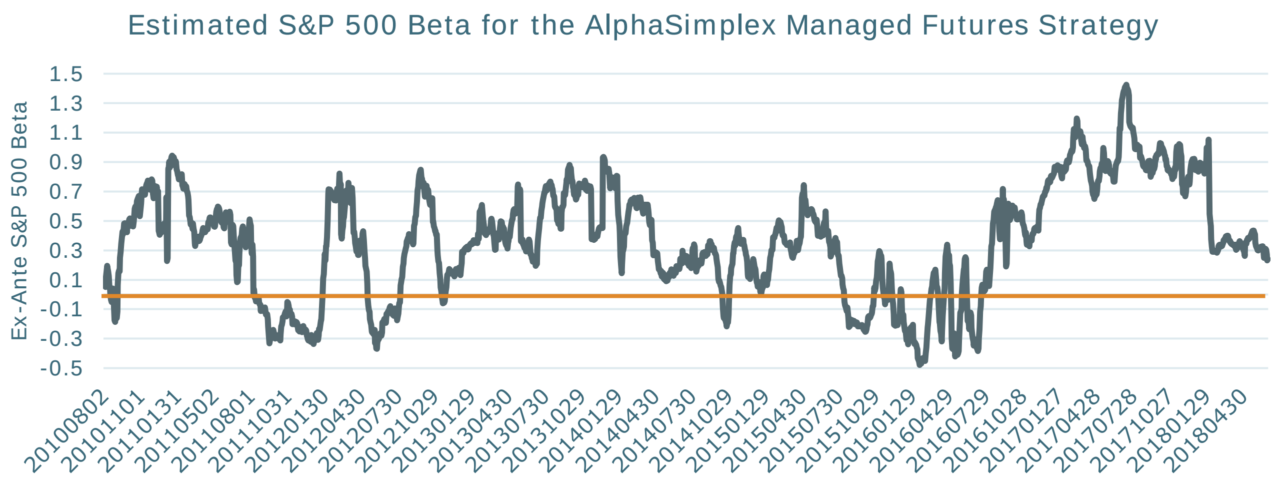

Figure 3: Rolling 63-day ex-ante beta to the S&P 500 for the AlphaSimplex Managed Futures Strategy from Q3 2010 to Q2 2018. Source: AlphaSimplex Group.

In an ever-changing world, rife with uncertainty, it is hard to predict when things will change. However, history tells us that eventually things do change. When we consider the “trendiness” of global markets, the Market Divergence Index indicates that periods of choppy markets are often followed by periods with strong market trends. Given the cycles in market trends, it is important for investors to remember performance in Managed Futures is also counter-cyclical. These strategies may be able to adapt well to whatever changes may lie ahead. Given the shift in risk allocations across global markets and the recent period of choppiness in markets, we are optimistic about future opportunities for strong market trends.

References

Greyserman, Alex, and Kathryn M. Kaminski. 2014. *Trend Following with Managed Futures: The Search for Crisis Alpha*. Hoboken, NJ: John Wiley & Sons, Inc.

About the Authors

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