Tool toughened in testing times

Overview

The strategy excels when trends are clear – especially during protracted downturns, writes Eric Uhlfelder

When markets collapsed with the twin towers of the World Trade Center in 2001, managed futures held their ground, gaining 84 basis points for the year, reports industry data-tracker BarclayHedge. and when the bear market sunk its teeth into stocks the following year, with the MSCI World Index having lost a quarter of its value, managed futures gained more than 12 per cent.

Despite there being only $51bn in managed futures at the end of 2002, investors were beginning to take note of this alternative investment strategy.

Six years later when stocks lost nearly 40 per cent, managed futures were up an average of 14 per cent. And industry assets had climbed to more than $206bn.

Compelling outperformance during the most challenging times continues to draw investors into this asset class, with assets as of the end of first quarter 2012 reaching $328bn.

The reason why managed futures (also known as Commodity Trading Advisers or CTAs) can excel during down markets is due to their broad focus and flexibility. During an economic slowdown, for example, they can respond by shorting oil contracts while being long Treasuries. And if managers think demand will increase for higher-yielding currencies as local rates fall, they also can be long the Australian and New Zealand dollars.

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Managed futures trade many distinct segments of the global economy, from stocks, bonds, and interest rates to currencies, agriculture, metals, and energy.

Some CTAs are designed to target these individual assets. But two-thirds are diversified. Taking short or long positions enables managers to profit regardless of the direction in which markets are heading. And they can do particularly well when trends are clear and protracted.

Kenneth Tropin, chairman of Graham Capital Management, whose managed futures programme started in 1994 and which currently runs $3.5bn, believes that well-designed systematic trading (which is the dominant investment approach for CTAs as opposed to discretionary) can consistently deliver positive returns with the least correlation to equity markets. This is achieved through effective trend following and disciplined stop losses to control risk.

While managed futures are thematically comparable to discretionary global macro funds, Mr Tropin says their long-term performance is least correlated to traditional asset classes and other hedge fund strategies, including global macro. This will be under discussion at the Managed Funds Association's annual managed futures and global macro strategies conference in Chicago this week.

In the aftermath of the financial crisis, the liquidity of futures proved to be a major plus. Besides being the most transparent type of hedge fund, Mr Tropin explains managed futures are not exposed to asset-liability mismatching that sank a number of hedge funds during the turmoil and which remains a systemic risk for many funds. Gating (a restriction on withdrawals) and suspension are unheard of in managed futures.

However, the strategy does struggle when markets are trendless and when volatility is choppy, which was evident in 2011. Markets ended the year slightly up after a rough ride. This was anathema to trend followers as managers were getting stopped out of positions in markets that frequently tacked with economic uncertainty.

Despite relative underperformance to equities since markets turned in March 2009, managed futures continued to enjoy net inflows as investors increasingly recognised the benefits of this asset class

"Though two out of the last three years have been difficult for the industry, net assets have increased more than 50 per cent," says Sol Waksman, founder and president of BarclayHedge, a privately-owned Iowa company that is unconnected with Barclays Bank of the UK.

"I think this is due to the lasting shock that the financial crisis has had on investors, that stocks aren't always destined to head higher and realisation that it's always necessary to hold well-managed assets that are uncorrelated to the market."

Since Mr Waksman starting tracking CTAs in 1980, he reports an annualised rate of return of more than 11 per cent, correlation to the S&P 500 of just 0.01 and to US bonds of 0.12. (1.00 means exact performance correlation with a benchmark and a ratio of 0.00 means an asset that moves out of sync with the market.)

While managed future flows are helped by relatively low minimum investment requirements (that can run as low as $25,000 but as high as $10m), the industry is getting a further boost with the expansion of exchange-traded funds, mutual funds and Ucits, which are packaging various managed futures, delivering access to an even broader investor range through lower minimum investment products.

Fund companies offering open-end or exchange-traded products include Natixis, Guggenheim, AQR, Equinox, Grant Park, WisdomTree, Princeton, ForwardFunds, and Direxion Funds.

Altegris Advisors, with a total of $3bn in managed futures assets, provides among the largest access to multi-managed futures funds. Its largest product, Altegris Managed Futures Strategy (MFTAX), has more than $1bn in assets. It comprises six well-known independent CTAs, including Winton Capital and Quantitative Investment Management, which represents 60 per cent of the fund.

Dick Pfister, Altegris' head of global sales and consulting, says his firm's active management of the funds involves consistent monitoring of underlying managers and potential to eliminate any if they fail to deliver. Management also regularly alters fund weighting to keep 75 per cent exposure to medium- and long-term trend followers and a 25 per cent weighting to short-term strategies, a split which Altegris has found corresponds to the most proven funds.

As with other hedge funds, CTAs are not inexpensive investments. Annual management expenses average 2 per cent plus a typical performance fee of 20 per cent earned on profits that exceed a high-water mark. The layering of mutual fund fees and sales loads on top of this may challenge a good part of the advantage these alternative investment vehicles offer.

Further, CTA investors accrue tax liabilities, most of which are taxed at short-term rates, despite profits not being distributed.

Still, according to a recently completed study of alternative investments, Morningstar found demand for managed futures fund products has increased more than five fold over the past three years, from $1.44bn as of year-end 2008 to $7.5bn as of the end of last year.

Scott Burns, Morningstar's director of ETF and alternative research, found that over the next five years financial advisers believe managed futures offer the greatest business growth potential.

He sees this as part of the trend that is likely to transform managed futures from the status of alternative investment to a commonly held asset class, as happened with emerging markets.

Two US oversight agencies, the Commodity Futures Trading Commission and the National Futures Association, promote industry integrity and provide investors with extensive information about investing in managed futures.

There are also several free clearinghouses that track data. These include Altegris' managedfutures.com, BarclayHedge.com, and Institutional Advisory Services Group.

Over a barrel: in a downturn CTAs can short oil contracts while being long Treasuries AP

Managed futures industry
Assets under management

Year	$bn*
1982	0.56
1983	0.63
1984	0.77
1985	1.49
1986	1.96
1987	3.90
1988	5.51
1989	7.00
1990	10.54
1991	14.50
1992	18.50
1993	26.00
1994	24.90
1995	22.80
1996	23.98
1997	33.10
1998	36.00
1999	41.30
2000	37.90
2001	41.30
2002	50.94
2003	86.50
2004	131.90
2005	130.60
2006	170.00
2007	206.60
2008	206.40
2009	213.60
2010	267.60
2011	314.30
2012**	328.30

* At year-end
** Year-to-date

Source: BarclayHedge

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