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ALTERNATIVE INVESTMENTS

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Riding the Right Wave with Managed Futures

by Stephen Todd Walker

The overlooked or misunderstood areas of investing often present the best opportunities. Investors fear the unknown though it might benefit them. One area where misconceptions are found is with alternative investments. Alternative investments might simply be viewed as the third leg of the investment stool: equities, fixed income, and alternative investments.

Managed futures, in particular, are an alternative investment that intimidates many investors and some advisers. Historically, the majority of investors summarily dismiss this asset class without really understanding anything about it, but this appears to be changing.

The Good and the Bad

One primary reason to use managed futures in a portfolio is their compelling risk/reward characteristics. However, there are advantages as well as disadvantages to using managed futures:

Advantages

- Potential for reduced portfolio volatility
- Ability to earn profit in any economic environment
- Possibility to reduce downside risk in times of crisis in traditional markets
- Global diversification
- Historically low to slightly negative correlation with traditional investments (equities and bonds)

Disadvantages

- Commodity markets are subject to temporary distortions or other disruptions
- No guarantee that an investment of this type will achieve its objective
- May use leverage
- Commodity prices can be affected by a variety of factors at any time
- Costs can be high for certain vehicles

The primary asset classes—fixed income and equities—had lackluster returns in the past two market debacles, losing investors a lot of money. As a result, investors have become much more open minded to new asset classes and strategies that help lower volatility. Years ago, I noticed that one could increase returns while simultaneously lowering risk by adding managed futures. Unlike other asset classes, managed futures are a strategy that can help take advantage of adverse market conditions when times are tough; managed futures tend to perform well when the overall market is sour. They zig when the market zags.

Correlation and Risk

Ideally, an adviser does not want a portfolio of securities to be highly correlated. The goal is to have assets that do not act the same. Asset classes have become much more correlated with the equity market in recent years. Managed futures, however, have a low correlation with equities and other asset classes. From 1991 until 2011, managed futures had a negative correlation with the S&P 500 of –0.35. Likewise, returns for managed futures did well when the market corrected. For instance, the managed futures Barclays CTA index returned 14.09 percent during 2008, while the S&P 500 was down –36.58 percent. In 2002, managed futures returned 12.36 percent, while the S&P 500 declined –21.97 percent.[1]

Equities have a relatively high standard deviation. Over the past two decades, the S&P 500 had an average standard deviation of 18.94 percent, compared with managed futures, which had a standard deviation of only 6.40 percent. For comparison, Barclays Cap Aggregate Bond had a 4.94 percent standard deviation. Managed futures were only slightly higher than bonds over the past two decades, making them worthwhile to consider. If a client makes a blank statement such as, "Managed futures are far too risky," one needs to define risk.

There are new measurements of risk a planner might consider, especially when designing asset allocation models for extreme volatility due to black swan events. Value at risk (Var) is a measurement used to estimate the probability of portfolio losses. Newer forms have evolved that might be used to help design better portfolios for clients interested in adding alternative investments, such as modified value at risk (MVaR) or conditional value at risk (CVaR). MVaR takes into account the non-normal aspect of return distributions, while CVaR can be used to help assess the possibility that a specific loss will exceed the value at risk. Different risk assessment techniques can be used depending on which alternative investment is being added, such as managed futures, venture capital, hedge funds, real estate, or commodities.

Managed Futures Becoming More Accessible

Managed futures are gaining in popularity. According to *Morningstar & Barron's 2011 Alternative Investment Survey of U.S. Institutions and Financial Advisors*, "For the second year in a row, advisors again cited managed futures as the asset to which they were most likely to increase their exposure…." As of the end of 2011, the amount invested in managed futures was about $320 billion, with a 30-year history.[2]

Institutions have used managed futures for years, but only recently have more options been geared toward individual investors. According to the National Association of College and University Business Officers *2010 NACUBO-Commonfund Study of Endowments*, investment pool assets of greater than $1 billion allocated an average of 60 percent of total assets to alternative investments and had an average annual return of 5.0 percent over the 10-year period ending June 30, 2011. Investment pool assets of less than $25 million allocated an average of 12 percent of total assets to alternative investments and had an average annual return of only 2.8 percent over the same 10-year period.

Vehicles for managed futures also have evolved and are being offered courtesy of many mutual funds. These funds provide easy access to investors and do not require millions of dollars that a large institution would deploy. According to Altegris Advisors' *The Case for Liquid Alternative Investments*, "Alternative investments and mutual funds have historically existed in separate realms—where high-net-worth and institutional investors have been beneficiaries of access to the former, and a broader range of investors have taken advantage of the strengths of the latter. However, recent years have seen a blurring of the lines between the two worlds—and that shift has gathered momentum in the wake of the financial crisis."

Diversification and Liquidity

Managed futures can involve up to 150 global markets and many different assets classes, such as currencies, energy, agriculture, metals, interest rates, or equity indices. Very few asset classes are this diversified, let alone nimble.

Managed futures are also highly liquid compared to many alternative investments. Private equity takes years for investors to get all their money back. And as we have seen, fixed income such as municipal bonds (adjustable-rate preferred stock) proved extremely difficult for investors to exit during the last downturn. The Great Recession that started in 2008 resulted in the illiquidity of a number of asset classes—managed futures, on the other hand, provide immediate liquidity.

But Remember: There's No Free Lunch

One might be inclined to put all their money into managed futures with such compelling returns. However, when the market is on an upswing, managed futures typically trail the market. For example, in 2010, managed futures returned 7.05 percent while the S&P 500 returned 15.06 percent. Cost is another consideration. Depending on the vehicle used, commodity trading advisers (CTAs) and certain funds can be expensive. Likewise, one needs to perform due diligence just as they would when considering a hedge fund, money manager, mutual fund, or any other actively managed account. Performance can vary widely. Lastly, managed futures funds can use leverage, which can increase risk. Managed futures, like any other investment, are not without risk and should be carefully studied. Look before you leap!

Overall, managed futures are a worthy asset class to explore when building a well-diversified portfolio. Clients are searching for assets that are not highly correlated with the equity market. Similarly, liquidity has become much more important. Today, there exists a plethora of information on managed futures. New risk measurements have evolved. There are also plenty of vehicles one might access that did not exist or were only available to the largest institutions in the past. When used properly, managed futures can potentially lower risk while increasing returns. Few asset classes are as flexible.

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Endnotes

1. All correlation figures, returns, and standard deviations reported come from author research and calculations during production of his forthcoming book *Understanding Alternative Investments: Riding the Right Wave.*
2. Altegris. 2012. "Guide to Managed Futures" (January).