Choosing a Managed Futures Fund

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If you are invested in managed futures, you know how difficult the past decade has been. Low interest rates, low volatility and the lack of significant trends have led to muted returns. However, it has not changed the historical profile of the strategy i.e., being additive as an uncorrelated component of an investor portfolio. But like long/short equity, dispersion in the managed futures category has been wide and could have made your experience exceptionally painful or more tolerable. Here are some things to consider as you are choosing a managed futures fund.

Approaches

There are several specific time frames and markets that can be traded, but the universe of strategies generally falls into three main groups:

Trend Following: These strategies use proprietary trading strategies to take long and short positions in various futures markets. They typically use intermediate or long-term signals to initiate trades.

Counter Trend: A short-term strategy that takes contrarian positions in markets seeking mean reversion. Importantly, this is not the opposite of trend following. It just capitalizes on a different time frame.

Global Macro: Often known as relative strength modes, these strategies seek out areas of the market that are outperforming and invest heavily in those exhibiting the most positive momentum.

Volatility Targets

Some funds in the category have specific volatility targets, often matched to the long-term volatility of stocks. This is one of the reasons that these funds do well when markets panic (i.e., as volatility rises, they begin decreasing their exposure so that the overall portfolio volatility is at its target). However, in lower volatility environments, they may lever up their exposure to reach its target. This is all within expectations, but at times can lead to performance that investors aren't expecting. For example, near the end of 2017 (a historically low volatility year for equities), many trend followers had long equity exposures and they levered those portfolios up to reach their overall portfolio target. Thus, when markets corrected early in the year, these funds had levered long-only exposure to down markets— perhaps disappointing investors who wanted them to perform differently than equities. This question is an important one to ask so that you understand how the potential risk profile can change over time and affect your overall portfolio.

KEY TAKEAWAYS

- Managed futures serve as an uncorrelated component of an investor portfolio.
- There are three main groups of managed futures funds: trend following, counter trend and global macro.
- Understanding what different managers are doing allows you to set expectations with your clients during the inevitable outperformance or underperformance that comes from a category that moves unlike anything else in your portfolio.

Single Manager vs. Multi-Manager

Some strategies in the space will implement just one approach, while others will incorporate multiple styles (often hiring multiple subadvisors to provide the desired exposures). A benefit of the multi-manager approach is that it reduces some of the dispersion risk we've discussed. If you are exposed to multiple styles, you don't have to worry about picking the "correct" one. Rather, you can spread out your risk and collectively achieve the uncorrelated return you want, and with less variability than if you owned a single manager fund.

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One drawback of this approach is that the fees can often be much higher. Not only will you pay a fee to the manager of managers, but you will be paying each of the underlying managers, as well. Often these arrangements are somewhat opaque and don't show up in the management fee but will certainly affect returns. When conducting due diligence on a manager of managers, it is prudent to move a level beyond the stated fee and ask the firm what the fees are for the underlying managers; only after that information will you know what kind of return will be needed to deliver value over fees.

When measuring single manager versus multi-manager, it would make sense to measure the multi-manager strategy versus the category broadly. Conversely, for a single manager you may be better off evaluating it based on similar funds, or stated fund targets, to assess its efficacy. The single manager may have a very specific approach that by design makes it differ from the category. This doesn't it make it 'better' or 'worse', however, it should be evaluated in that sense rather than alongside the group.

Market Traded

Many funds in the category trade equities, fixed income, currencies and commodities, while others zero in on one specific asset class. Why does this matter? If a fund invests in commodities, for example, they have likely outperformed the category by a wide margin over the last couple of years. Is it because they are a better managed futures fund? Or, is it because there have been many more exploitable trends in commodities than equities and fixed income? I would argue that it is the latter, and it's why we don't evaluate stock funds and gold when we are selecting a manager for large cap U.S. stocks.

Understanding what markets are being traded can help you understand the drivers of performance, so it can accurately be compared to other funds in the space and help you make sure you have the types of exposures you are seeking. If you are using futures to 'hedge' you may want something that is exposed to a variety of asset classes. If you are coming to the category for returns uncorrelated to stocks and bonds, (while it shouldn't really matter) you will still want to understand what markets are being used so you can judge the performance appropriately.

Holding Periods

Besides having multiple markets to trade, there can also be a variety of holding periods which can greatly affect returns. Some strategies have time frames of a year or more and are slower moving. Should they be compared to funds with signals looking at days? Absolutely not. A choppy market may be advantageous for the strategy looking at days, but terrible for the one looking at years. This is not because the latter is a bad managed futures fund, but because the

market isn't ideal for it at that moment. As you select individual strategies, this matters.

If you implement multiple strategies you will want to make sure time frames vary, because if they all have intermediate signals, the only diversification you are getting is in name, not style. You will also want to take a look at this for multi-manager strategies. If the strategy has four long-term managers, and one short-term manager representing only 10% of the portfolio, an overwhelming majority of returns are coming from the long-term managers and it won't make sense to pay additional fees when you could just buy a single long-term manager. You just need to prepare yourself for the fact that the return profile may have more variability.

Just as in long/short equity, the variety of styles, markets and signals can cause wide dispersion in the category. If you just look at recent performance to pick a fund, you are only seeing what trends and markets were working—and not necessarily evaluating if the manager is providing you with the exposures and approaches you want. There is no wrong or right approach in the space, but by understanding what different managers are doing, you can set expectations with your clients during the inevitable outperformance or underperformance that comes from a category that moves unlike anything else in your portfolio.

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