The Proper Role of Managed Futures in a Portfolio

361 CAPITAL

Managed futures have had a tough 10 years, but they gained much of their glory during the financial crisis as the category was up double digits in 2008 and stocks were down 30% or more. While there were investors who had been in the strategy prior, many joined after seeing that performance and decided to use it as a 'hedge' for their portfolio. While we hadn't experienced any negative years for equities since 2009 (S&P 500 Index), 2018 came along and the long-awaited hedge provided by managed futures delivered what? Putting aside the dispersion issue, if you had invested in the Morningstar category you would have lost -6.02%. Not much of a hedge at all, right?

Turns out while many investors think of managed futures as a hedge, that is not the point of the strategy, instead it is meant to be a source of uncorrelated returns for a portfolio. To be fair, they have historically performed fairly well in tough markets for equities, but that is not always going to be the case, nor is it the goal of the approach. In talking with investors, we think that sometimes they use the words "hedge" and "uncorrelated" synonymously, but the belief that managed futures are a hedge, and the way we sometimes see advisors evaluating the strategies, makes it seem as though there is something being lost in translation.

The OG MPT

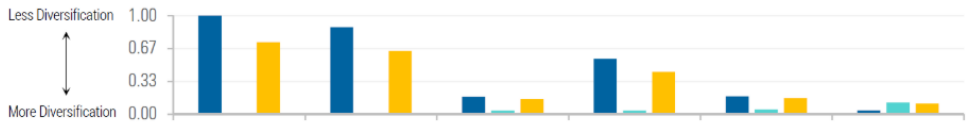
We won't do an investment 101 here and talk about modern portfolio theory (MPT) in detail, but the long of it is that investors using the MPT approach are seeking to build a portfolio of individual assets that together can generate a certain expected return for a given level of risk. The important insight is that each individual asset's risk and return is less important than the combination of each asset's risk, return and correlation characteristics.

> *Quick aside, do you know what the average Sharpe ratio of a traditional 60/40 (two uncorrelated positive return assets) was from 1978 to September 2009? We had guessed it was somewhere around 0.7 – it is actually 0.45! We're thinking a bit of recency bias affected our thinking because do you know what the Sharpe of the same 60/40 portfolio is over the last 10 years? It was 1.25! Clearly the only game in town was S&P 500 and AGG, any other diversification, no matter what you did, would have likely lagged that risk-adjusted result. So, does this mean a mean reversion is due, or that this is the new normal? Only time will tell...*

Back to the matter at hand. If an investor wants to follow the MPT framework, then what an advisor is tasked with doing is constructing a portfolio of uncorrelated assets, regularly rebalancing and making sure a client sticks with it over time to receive the benefit. Besides stocks and bonds, you can potentially use real estate, gold and cash to round out your portfolio of uncorrelated assets. Any of these can work, but investors have another easily investible asset to incorporate—that is managed futures. Versus virtually any asset class, managed futures strategies exhibit little to no correlation and positive expected returns over time so it makes all the MPT sense in the world.

KEY TAKEAWAYS

- Some investors think of managed futures as a hedge, that is not the point of the strategy, instead it is meant to be a source of uncorrelated returns for a portfolio.
- If your goal is to hedge, you can do it using cash, long volatility, or long/short equity strategies for example.
- Managed futures are meant to provide a unique uncorrelated return stream for your clients in the modern portfolio theory framework.



	U.S. Equities	World Stocks	Bonds	Equity REITs	Commodities	Gold
U.S. Equities	1.00	0.88	0.18	0.56	0.18	0.04
Managed Futures	0.01	0.01	0.04	0.04	0.05	0.12
50/50 Portfolio	0.73	0.64	0.15	0.43	0.16	0.11

Source: Catalyst Fund Research

If you truly want to hedge your portfolio, you should be long volatility or own bear market/short-biased funds.

However, after '08 we don't think this is how many investors thought of the asset class or was the reason they incorporated it. Investors were scared so they looked for things to protect their portfolio. Due to the strong performance of managed futures over that time frame, investors assumed the point of the strategy was to provide a downside hedge. But that is not the case. There are examples of when it happens, to be sure, and there are explainable reasons for why—but there are also examples where it doesn't and that is precisely what uncorrelated means, it isn't negatively correlated.

If you truly want to hedge your portfolio, you should be long volatility or own bear market/short-biased funds. These strategies do well in tough environments for equities making them an attractive hedge to some investors, but you pay quite a price for that hedge. For example, in 2018 one long volatility fund was up 66.7%—wow! Wouldn't that be great to show your client after a nearly 20% decline in the market in Q4? Talk about a hedge. Never mind the same strategy is down 57.8% this year and down 47.2% over the 5-year time frame. Most people say they want a hedge, but we don't think that's actually what they are looking for, and in many cases it ends up costing you more over time.

Hedging what?

To then take this to another level, when talking with advisors, we sometimes hear that they want their managed futures fund to have exposure to all kinds of asset classes, so that they can "hedge" all those things out of their portfolio. We understand where the sentiment is coming from, but again, we're not sure it makes sense. How many of your clients have wheat in their portfolio? Are they worried about their long soybean exposure? The reason futures funds trade all kinds of contracts isn't to give you a hedge on those assets; it's because the momentum anomaly exists in all kinds of markets. They include all those asset classes to diversify momentum exposure not to hedge a portfolio's nonexistent overweight to the Swiss Franc.

Diversifying across 200 contracts and multiple asset classes isn't the only diversification game in town though. One of the top performing funds over the last 5 years is a commodity-focused futures fund. We don't know enough about that particular team or fund to know if that is their particular expertise or why they chose to do just that, but if you had a rule that you only wanted a futures fund that had exposure across tons of asset classes, you couldn't even consider them. Meanwhile, some of the more diversified funds out there have a negative five-year return…if you are looking for the best uncorrelated return, why not just look for that regardless of what they are trading? Or, in our case, we have very unique short-term trading strategies that we have found very effective in equities. We diversify by investing in multiple domestic indices for our U.S.-focused fund or in various international and domestic markets for our global fund. We are still diversified, we just aren't trading coffee contracts. Does that mean our uncorrelated return offering isn't appropriate?

Instead of how many different contracts and asset classes you trade, more enlightening questions to evaluate an uncorrelated return stream are: is the strategy getting the return you expected for the appropriate amount of risk? What do the peak to trough drawdowns look like? What are the expenses? What is their correlation to other asset classes? In what market environments do they do well, and when do they struggle?

If your goal is to hedge, you can do it using cash, long volatility, or long/short strategies for example, but that isn't how you should think about managed futures. Managed futures are meant to provide a unique uncorrelated return stream for your clients in the MPT framework (which may be more important going forward than it has in the past). If you choose to incorporate these strategies, think twice before limiting your definition of where that uncorrelated return can come from or requiring all types of asset classes to be included since it only narrows the range of strategies from which to choose—and potentially limits the return potential you can achieve. We're not saying one is better or worse. We're just simply suggesting keeping an open mind when evaluating the asset class, and remember that the aim is uncorrelated, not hedged, because those two are definitely not the same thing.

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About 361 Capital

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