What are Managed Futures?

361 CAPITAL®

The algorithms underpinning managed futures strategies may be complex, but the strategy's purpose is simple. In a single word: diversification.

The following article shares the basics about managed futures strategies, explaining what they are, how they work, and most importantly, their role as a diversifier within a broader portfolio. It also explores why the current market environment makes it more challenging—and more important—to find truly diversified assets.

KEY TAKEAWAYS

- Managed futures strategies have a substantially different return profile from most other asset classes.
- Managed futures and bonds are the only assets with low correlations to equities, thus offering true diversification.
- Managed futures have the potential to provide "crisis alpha" or positive returns when other assets are struggling.

Managed Futures Strategies Exploit Broad Market Trends

Managed futures strategies seek directional market trends, relying on proprietary, quantitative signals to identify when different asset classes are poised to rise or fall. The strategies use futures contracts to take long positions when signals indicate an asset class will rise, and short positions when signals indicate the asset class will fall. A managed futures strategy can take advantage of directional trends in nearly any asset type, inclusive of fixed income, currency, equity and commodities markets.

The strategy's ability to track different assets and take advantage of both rising and falling markets has led to a substantially different return profile from most other asset classes. That uniqueness has its benefits.

Uncorrelated Assets are Hard to Find

Market crises often deliver a painful lesson: Diversification may not always work when investors need it most. That's because most asset classes within a "diversified" portfolio are highly correlated, and don't really behave that differently. If equity markets experience large losses, returns from most other assets are often equally disappointing.

Managed futures strategies are a rare and welcome outlier, however. The indexes in the table below show how correlated most assets are, and how few stand out as different.

March 2001 - December 2018	Russell 3000	MSCI EAFE	Russell Emerging Mkts	Bloomberg Commodity	Barclays US Corporate High Yield	Barclays US Agg Bond	JPM EMBI Global Diversified	Credit Suisse Managed Futures
Russell 3000	1.00							
MSCI EAFE	0.87	1.00						
Russell Emerging Mkts	0.77	0.86	1.00					
Bloomberg Commodity	0.40	0.52	0.55	1.00				
Barclays US Corporate High Yield	0.69	0.71	0.70	0.43	1.00			
Barclays US Agg Bond	-0.12	0.01	0.03	0.02	0.17	1.00		
JPM EMBI Global Diversified	0.49	0.60	0.64	0.37	0.71	0.54	1.00	
Credit Suisse Managed Futures	-0.06	0.01	0.03	0.14	-0.10	0.29	0.05	1.00

Correlation is a statistical measure of how two securities perform relative to each other. A 1.0 means two securities are in perfect correlation while a negative number means the securities are moving in opposite directions. A zero implies there is no relationship at all.

As the chart shows, bonds and managed futures strategies, represented by the indexes above, are the only assets with low correlations to equities. Typically, bonds have played the role of the uncorrelated asset in a traditional portfolio, and have done an admirable job. But in today's market environment, their returns may not be enough to meaningfully offset a downturn in equities. The 10-year Treasury is currently at 2.69%, as of December 31, 2018, well below its historical average. Low yields imply little room for further price appreciation, and correspondingly, little protection if equity markets sell off.

High correlations among most asset classes have serious implications for investors. If a portfolio carries only the highly correlated assets, the supposed diversification will do little to reduce portfolio volatility. For example, an equally weighted portfolio of two assets with like volatilities and a correlation of 0.7 would still exhibit 92% of the volatility of either asset in isolation. Translation: Unless multiple assets with truly low correlations to each other are included in a portfolio, diversification will offer scant protection in a market downturn.

Crisis Alpha: Capital Protection at Critical Points

One of the main reasons investors maintain a long-term allocation to managed futures is the strategy's potential to provide what is referred to as "crisis alpha," or positive returns when other assets, especially equities, are struggling. As the chart below shows, managed futures strategies have a history of serving investors well during those critical pain points.

	The Russian Crisis	**The Dot Com Bubble**	**The World Trade Center Attacks**	**The Global Financial Crisis**	**Brexit**
Index	**8-01-1998 9-30-1998**	**4-01-2000 9-30-2002**	**9-01-2001 9-30-2001**	**6-01-2007 2-28-2009**	**6-01-2016 6-30-2016**
MSCI World Index	-11.83	-46.80	-8.82	-51.88	-1.12
S&P 500 Index	-8.98	-43.75	-8.08	-50.00	0.26
Credit Suisse Managed Futures Index	17.50	32.61	3.65	19.50	4.19

Past performance is no guarantee of future results. It is not possible to invest directly in an index.

The performance of managed futures strategies during equity market corrections may offer some long-term advantages. First, holding a strategy that produces stronger returns when equities are in free fall reduces portfolio drawdowns. Lower drawdowns make it easier for the portfolio to recover from losses and improve compounded returns over time. There is also a psychological advantage: By reducing large swings in a portfolio's performance, investors are more likely to stay the course with their asset allocation, and avoid dropping out of the market and missing its rebound.

To reap these potential benefits, investors need to allocate a meaningful portion of their portfolio—generally 10% or more—to managed futures strategies. With a smaller allocation, investors are less likely to experience an impactful reduction in volatility or drawdown.

Managed Futures Strategies Require Commitment and Understanding

While managed futures strategies dampen total portfolio volatility, that doesn't mean they aren't volatile. Historically, the downside tends to be significantly less than for equities, but the risks are still present. The key is again, low correlation. The strategies will suffer losses at times but typically help provide ballast to portfolios in volatile or falling equity markets.

Another point to remember is that different managed futures strategies have different aims. Some trend following strategies seek to exploit longer-term market trends. Other strategies, such as counter-trend strategies, seek short-term trends to capitalize on volatile markets with a lot of back-and-forth price movements. Before selecting a managed futures strategy, investors need to understand how the strategy fits within the rest of the portfolio and what it seeks to provide.

Current Market Climate Calls for Better Diversification

U.S. equities are experiencing the second-longest bull market in history. For much of the past year, volatility has remained historically low. In such periods, it's easy to get complacent. No one can predict when volatility will pick up, or a bear market will begin, but long-term investors should always be prepared for it. Preparation starts with diversification.

Unfortunately, many investors may not be as diversified as they believe. Most asset classes are highly correlated. The one traditional diversifier—fixed income—may provide less protection going forward. After four decades of declining rates, the upside in fixed income markets is limited. Going forward, investors will need to add assets that not only provide diversification, but that also improve upon the paltry return potential of investment grade debt. Managed futures strategies can help.

For additional viewpoints:
Call 866.361.1720 or visit 361capital.com.

About 361 Capital

361 Capital is a leading boutique asset manager focused on alternative and behavioral-based equity solutions that seek to deliver meaningful alpha, manage risk and offer diversification potential to investor portfolios. Founded in 2001, we offer a suite of investment products including Long/Short Equity, Managed Futures, Market Neutral, Macro, as well as Small, Mid and Large Cap Equity.

Investing involves risk, including possible loss of principal. Investment strategies employed by an Advisor in selecting investments may not result in an increase in the value of an investment or in overall performance equal to other investments. The use of derivatives include instruments and contracts that are based on and valued in relation to one or more underlying securities, financial benchmarks, indices, or other reference obligations or measures of value. Major types of derivatives include futures, options, swaps and forward contracts. Depending on how they are used could increase or decrease the exposure to the risks of the underlying instrument. Using derivatives can have a leveraging effect and increase volatility and be less liquid. Futures prices may be very volatile. The small margin required for futures contracts magnifies the effect of market volatility and allows the loss from a contract potentially to exceed the initial investment. With short contracts, the loss is theoretically unlimited since the appreciation of the underlying asset also is theoretically unlimited. Certain transactions, including entering into futures contracts and taking short positions in financial instruments, may give rise to a form of leverage. Leverage can magnify the effects of changes in the value of an investment and make it more volatile.

Diversification does not guarantee a profit or protect one against a loss.

The S&P 500® Index is a commonly recognized, market capitalization weighted index of 500 widely held equity securities, designed to measure broad U.S. equity performance. **The Credit Suisse Hedge Fund Index** is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The index uses the Credit Suisse Hedge Fund Database, which tracks approximately 8,000 funds and consists only of funds with a minimum of $50 million under management, a 12-month track record, and audited financial statements. **The MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The index includes reinvestments of dividends, net of foreign withholding taxes. **Russell 3000 Index** measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. **Russell Emerging Large Cap Index** measures the performance of the largest investable securities in emerging countries globally, based on market capitalization. **Bloomberg Commodity Index** is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. It is composed of futures contracts on physical commodities. **JPM EMBI Global Diversified Index** is a comprehensive global local emerging markets index that consists of regularly traded, liquid fixed-rate, domestic currency government bonds. **Credit Suisse Managed Futures Index** is a subset of the Credit Suisse Hedge Fund IndexSM that measures the aggregate performance of dedicated short bias funds. Managed futures funds (often referred to as CTAs or Commodity Trading Advisors) typically focus on investing in listed bond, equity, commodity futures and currency markets, globally.

International Equities is represented by the **MSCI EAFE Index** which is a free-float adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets.

US Investment Grade Debt is represented by the **Barclays Aggregate Bond Index** which is a broad bond index covering most U.S. traded bonds and some foreign bonds traded in the U.S.

US High Yield Debt is represented by the **Barclays US Corporate High Yield Index** which measures the USD-denominated, high yield, fixed-rate corporate bond market.

The views expressed are those of the authors at the time created. These views are subject to change at any time based on market and other conditions, and 361 Capital disclaims any responsibility to update such views. No forecasts can be guaranteed. These views may not be relied upon as investment advice or as an indication of trading intent on behalf of any 361 Capital portfolio.

This 361 Capital article is not intended to provide investment advice. This paper should not be construed as an offer to sell, a solicitation of an offer to buy, or a recommendation for any security by 361 Capital or any third-party. You are solely responsible for determining whether any investment, investment strategy, security or related transaction is appropriate for you based on your personal investment objectives, financial circumstances and risk tolerance. You should consult your legal or tax professional regarding your specific situation.

Data and other materials appearing that are provided by third-parties are believed by 361 Capital to be obtained from reliable sources, but 361 Capital cannot guarantee and is not responsible for their accuracy, timeliness, completeness, or suitability for use.

April 2019

361 Capital | 4600 South Syracuse Street, Suite 500, Denver, CO 80237 | 866.361.1720 | 361capital.com | Follow us: