Alpha in all Environments: Navigating Through Calm and Crisis

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Investing in the current market environment brings its own unique set of challenges and obstacles, just like every market before it, and likely every market hereafter. To fully prepare a portfolio to weather whatever may come, incorporating investment strategies that can withstand the test of time is paramount. In this piece, we examine how Managed Futures strategies, particularly those utilizing a short-term counter-trend approach, have an ability to generate meaningful alpha in difficult markets, while still offering the potential to generate positive returns in more subdued environments—more so than traditional CTA/trend-followers.

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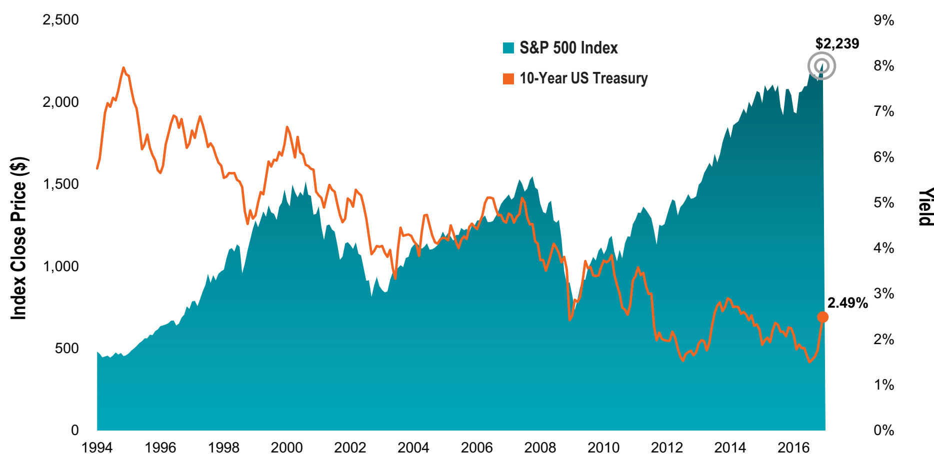
A Less-than-Clear Path

With U.S. equities trading at all-time highs, fixed income yields near all-time lows, and volatility hovering at historically low levels (i.e., on May 8, 2017, the Chicago Board Options Exchange Volatility Index, "VIX", closed at its lowest level since December 1993), one might ask where should investors allocate the marginal dollar.



Source: Morningstar. Data from 1/1/1994-12/31/2016.

Despite the less-than-clear path, there has been no shortage of macroeconomic and geopolitical issues that could give sudden rise to extreme market movements.

One of the earliest alternative investment strategies designed to navigate a myriad of markets is Managed Futures. While cash may be a safe haven that enables investors to avoid the binary decision of allocating to a strategy that will either provide positive or negative absolute performance, Managed Futures, and in particular, short-term counter-trend strategies, seek to generate a steady, uncorrelated return stream in stable environments, while acting as a portfolio-level hedge in turbulent markets—the latter performance feature loosely termed "Crisis Alpha."

KEY TAKEAWAYS

- Managed Futures, and in particular, short-term counter-trend strategies, seek to generate a steady, uncorrelated return stream in stable environments, while acting as a portfolio-level hedge in turbulent markets—the latter feature loosely termed "Crisis Alpha."
- The goal of counter-trend strategies is to exploit irrational investor behavior which manifests itself through markets becoming overbought or oversold in a short period of a time.
- Historically, counter-trend strategies have proven to be an efficient way to gain exposure to Crisis Alpha, more so than traditional CTA/trend followers.

Managed Futures: Volatility Reduction and Uncorrelated Return Streams

The goal of short-term counter-trend strategies is to exploit irrational investor behavior in the market, which ultimately manifests itself through a market becoming overbought or oversold in a short period of a time.

Managed futures are systematic investment strategies that seek to exploit trends in asset classes over varying periods of time by riding the coattails of a sustained move up (investing long) or down (investing short) in a market. Trend-following has evolved through the years in part due to increases in computing power, and with that evolution different sub-strategies within the Managed Futures category have been created. One such nuance within the category is the duration of time a strategy seeks to exploit—meaning it can be days, weeks, months, or any combination thereof. As the name would imply, short-term counter-trend strategies seek to invest in a relatively contrarian manner over a period of days.

The goal of short-term counter trend is to exploit irrational investor behavior in the market, which ultimately manifests itself through a market becoming overbought or oversold in a short period of a time. For example, when a macroeconomic event occurs, a geopolitical situation arises, or other market related issue results in the movement of equity markets up or down, investors tend to overreact in the short term. While an efficient market would suggest that an asset moves to its new fundamental price and remains there until new information causes a subsequent price change, reality is otherwise. Short-term counter-trend strategies thus seek to exploit this movement in the market.

Short-Term Counter-Trend: Harvesting Market Uncertainty

Recent Crises and Generation of "Crisis Alpha"

In equity market environments characterized by panic, as we've seen numerous times over the last 20 plus years, correlations tend to spike toward "1" (across equities and other risk assets) or "-1" (such as precious metals). These periods generally see panic and fear enter the market, equities sell-off (led by the riskiest companies), Treasuries move higher and interest rates fall. Such markets can provide an opportunity for not only trend-following managers, but even more so for short-term counter-trend strategies. The reason is that even though there may be a sustained trend downward, which traditional trend-followers will capture over time, there are often times the market moves up or down intra-trend, which is precisely what a counter-trend strategy thrives on.

In anticipation of any significant amount of market volatility, generally referred to as "left-tail events" because they occur at the left side of a distribution of returns (i.e., negative return periods), holding a short-term counter-trend strategy within a diversified portfolio may be prudent.

The below table shows the performance of a simple short-term counter-trend strategy relative to the S&P 500 Index and the Credit Suisse Managed Futures Index during the most volatile market periods over the last 23-years, from January 1994 to March 2017.

Short-term counter-trend strategies have historically provided significant alpha in difficult market environments.

These periods are:

- The Russian Crisis in the late 90's
- The Dot-Com Bubble in the early 2000's
- The World Trade Center Attacks of 2001
- The Global Financial Crisis beginning in 2007 thru 2009
- Britain's exit of the European Union ("Brexit") in June of 2016

In total, there are 54 monthly observations across those periods. As one can see, a short-term counter-trend strategy has historically provided significant alpha in a difficult market environment, generally delivering a higher average monthly return than either the market (S&P 500 Index) or the peer universe of trend followers (Credit Suisse Managed Futures).

	S&P 500	Credit Suisse Managed Futures	Short-Term Counter-Trend
Correlation	1.00	-0.38	0.45
Monthly Alpha	—	0.67	2.37%
Average Beta	1.00	-0.27	0.38
Avg. Monthly Return	-2.34%	1.31%	1.48%

Source: Morningstar. Data from 1/1/1994-3/31/2017

Given the attractive performance in difficult periods, the question then becomes, "how do these strategies compare in normalized market environments?"

Short-Term Counter-Trend in Less Volatile Periods

In more stable environments, a short-term counter-trend strategy has historically served as a sound diversifier to a portfolio, as shown through a negative correlation. Not only is correlation negative, but average monthly alpha is positive, as is the average monthly return. There are, no doubt, months in such markets where the strategy may lag, but in general, it is not a significant drag to a portfolio. The characteristics in a relatively stable market are shown below, which include all months within the 23-year period from January 1994 to March 2017, excluding the 54 monthly observations considered to be "Crisis Periods."

	S&P 500	Credit Suisse Managed Futures	Short-Term Counter-Trend
Correlation	1.00	0.13	-0.21
Monthly Alpha	—	0.05	0.67%
Average Beta	1.00	0.11	-0.12
Avg. Monthly Return	1.61%	0.28%	0.48%

Source: Morningstar. Data from 1/1/1994-3/31/2017

Conclusion

Beyond the known portfolio benefits of Managed Futures, such as diversification, potential to generate returns regardless of market direction and volatility reduction, short-term counter-trend strategies are an efficient way to gain exposure to Crisis Alpha: the concept that a strategy can generate not only positive alpha, but positive absolute return in a crisis period, thereby hedging other, more susceptible components of a portfolio. The strategy, additionally, also provides correlation and alpha benefits in more muted periods, while not being a significant drag on return. There isn't one silver bullet for every portfolio. However, in times of market stress, an allocation to short-term counter-trend is one of the better Crisis Alpha strategies available to investors.

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Description of Simple Short-term Counter-Trend Models
Three simple short-term counter-trend models were used to create the Short-Term Counter-Trend Strategy (STCTS). The three models were:

1. 10d Hi/Lo: If the market made a new 10 day low the model went long and held the position until the next trading day's close. If the market made a new 10 day high the model went short and held the position until the next trading day's close.

2. 5 Day x 10 Day Simple Moving Average Crossover: If the market's price was below its 5 day simple moving average (SMA) and its 5 day SMA was below its 10 day SMA the model went long and held the position until the next trading day's close. If the market's price was above its 5 day SMA and its 5 day SMA was above its 10 day SMA the model went short and held the position until the next trading day's close.

3. 20 Day Bollinger Band: If the market's price was 1 standard deviation below its 20 day SMA the model went long and held the position until the next trading day's close. If the market's price was 1 standard deviation above its 20 day SMA the model went short and held the position until the next trading day's close. The standard deviation was calculated as the standard deviation of prices over the last 20 trading days.

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