Managed Futures: A Real Alternative

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Managed Futures investments performed well during the global liquidity crisis of August 1998. In contrast to other alternative investment strategies, the performance of Managed Futures was good in that year and had once more demonstrated their diversification potential. More assets did subsequently flow into Managed Futures, but 1999 did turn out to be one of the worst performing years for the industry. Since then, the performance as well as the acceptance of Managed Futures has improved. As the global stock markets are declining, an increasing number of investors is getting attracted to the strategy. The following article will take a closer look at this asset class.

History of Futures Trading

In the U.S., the futures markets have been in existence since mid-nineteenth century. Almost exclusively, grain producers and dealers used them as protection against adverse future price movements. As the volume rose, beside the commercial hedgers, the risk transferred had to be assumed by a third group of market participants, the speculators. They actively traded the contracts, but had no interest in the underlying commodity other than profiting from expected price changes. The growth in futures trading increased substantially in the late nineteenth and early twentieth century; new exchanges were established which introduced a variety of different commodity contracts over the years.

In 1971, the U.S. ended the gold standard and it was foreseeable that the policy of fixed currency rate fluctuations would soon come to an end. Due to this new and changing global financial structure, the futures industry began to expand its contract offering to allow financial institutions to hedge their currency risk. In 1972, the Chicago Mercantile Exchange created the world's first financial futures contracts by introducing futures on seven foreign currencies, which became even more appealing to institutions as in 1973 the western countries allowed currency exchange rates to float free. Later in the 1970s, interest rate-, and in 1982 stock index futures were launched and trading has expanded rapidly into many new financial futures instruments.

The successful introduction of these contracts opened new global market opportunities; a new type of trader started to emerge. These were traders that applied new trading concepts and combined them with innovative risk control mechanisms. The era of more sophisticated futures trading was launched, and as these traders started to manage other people's assets, they laid the foundation to emerge as new, major market participants.

A variety of investment approaches

Professional money managers who manage the assets of their clients using derivative instruments (futures, forward contracts and options) are known as Commodity Trading Advisors (CTAs). As an asset category in the alternative investment industry, they are classified as «Managed Futures». A broad spectrum of different trading models can be applied by CTAs and Table 1 illustrates in a simplified way the universe of strategies available to gain market exposure. As seen on top of the table, CTAs either use a systematic model, a discretionary approach; or a combination of both.

The systematic approach is the most commonly used approach; trading is mostly automated. Technical analysis is applied to evaluate the momentum. The sentiments of the markets, and the information generated by them (such as changes in price and volume), are used as input factors.

In contrast, the non-systematic CTAs are known as discretionary traders. Personal experience and judgment are the basis of the trading decisions. They tend to trade more concentrated portfolios and use fundamental data to assess the markets, and also technical analysis to improve the timing.

What is in this black box?

As the applied trading approaches are mostly quantitative and perceived to be complex, some investors hesitate to invest in Managed Futures as they find it hard to understand the strategies applied. Because of this difficulty, made even more challenging due to the fact that many CTAs are reluctant to describe more detailed how their systems work, the investors have started to label these investment models as «black boxes».

It is understandable, and the nature of the industry, that

Picture: Corn Field | USA | Corbis Images

CTAs regard their trading models as proprietary and believe that their system is superior than any other. In reality, and because of my own experience of speaking to more than hundred CTAs, most strategies are less complex and, at least conceptually, rather simple.

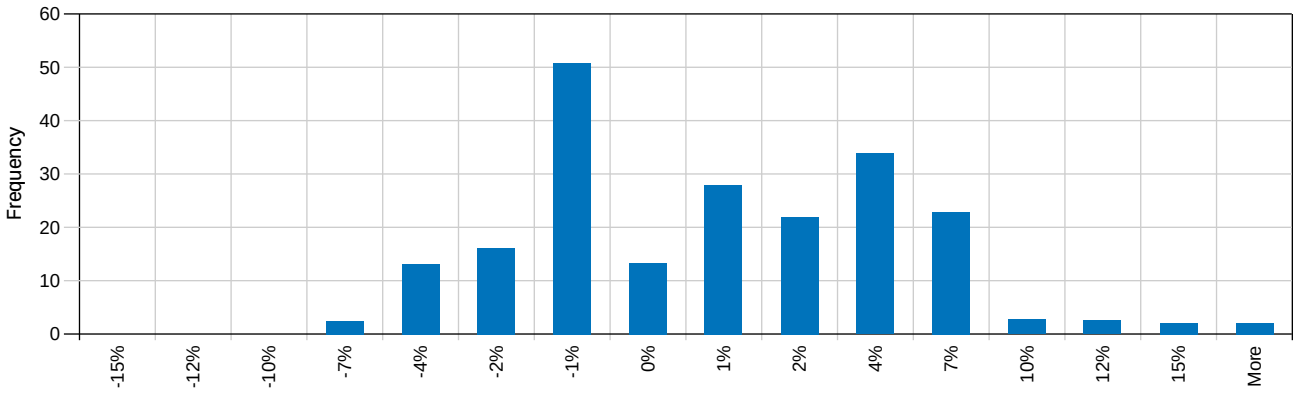
Let's have a quick look at the primary trading strategy employed by CTAs, which is **systematic trend-following.** The approaches among trend followers differ, but let's nevertheless shed a bit of light into these so-called black boxes.

In general, systematic trend-followers maintain positions throughout the long-term trends that take place in the markets, but might seek to identify trends across a spectrum of different time frames. The trading is based on the systematic application of quantitative models that use moving averages, break-outs of price ranges, or other technical rules to generate the «buy» and «sell» signals for a set of markets.

Table 1 | The various Investment Approaches of CTAs

Trading Approach	Systematic	Discretionary	Systematic/Discretionary
Analysis	Technical	Fundamental	Technical/Fundamental
Trading Style	Momentum	Countertrend	Spreads/Others
Time Frame	1-5 days	6-20 days	› 20 days
Markets Traded	Broadly diversified		Single sector or market

Figure 1 | Histogram of Monthly Returns of the Barclay CTA Index



Source: Barclay Trading Group Ltd.

Multiple models with different entry and exit points can be applied simultaneously. Once the trade signals are generated, then the next crucial aspect is risk management, which forms an integral part of the trading system. Strict risk control of the positions is vital due to the leverage of the instruments applied. The initial risk taken for each trade is determined by the trading system and usually averages between 0.5%-1.5% of the total portfolio equity. Protective stops are adjusted daily, and more positions might be built up if the trends are stable, or quickly reduced during adverse or highly volatile periods. Also, the amount of risk on groups of related markets and on the total portfolio is controlled. Further risk reduction is achieved by means of market diversification.

Most trend-based CTAs are globally diversified and trade a portfolio of forty or more markets. This is one of the reasons why Managed Futures are interesting for investors as they provide diversified exposure to a wide range of markets.

This was a brief description of how this type of CTAs generally operates and you probably agree that it is not rocket science.

A second important argument against the black-box perception is that most CTAs do offer individual managed accounts to institutional investors and high net worth individuals. All positions are disclosed on a daily basis and provide the investor with the highest possible transparency level, as well as liquidity, in the industry.

Since **discretionary CTAs** are rare and no two are alike (differing by markets traded and trading approaches), a unified description is not possible. Specialization is common among discretionary CTAs. Some focus on a sector (e.g. interest rates, grains) and some trade exclusively in a narrow market (e.g. interest rates in a single country). Familiarity with the factors that can potentially move the market(s) is crucial for discretionary CTAs and the capital is directed to the markets that exhibit the greatest opportunities. The investment process of discretionary CTAs is less complicated:

Many base their trading decisions on fundamental/economic factors with which the investment community is more familiar. Once the fundamental inputs from various sources are analyzed and a significant price move is to be expected, the timing of the entry/exit is done in conjunction with technical analysis techniques. The degree of risk management applied can range between very sophisticated models and traditional money management methods.

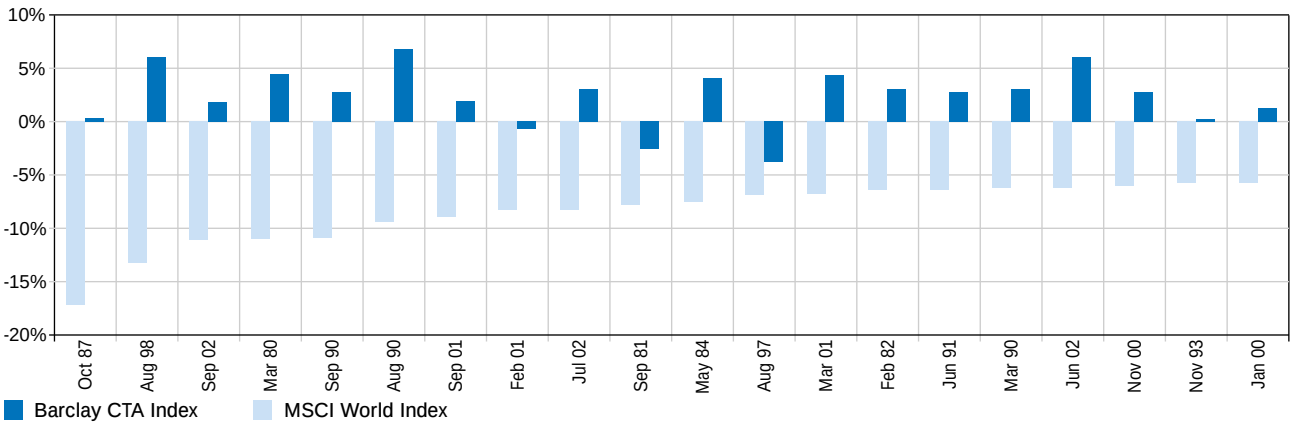
Portfolio diversification with Managed Futures

Let's have a look at the returns of Managed Futures. Figure 1 shows a histogram of the monthly returns of the Barclay CTA Index covering the period from Jan-1985 to Aug-2002. It can clearly be seen that the returns are positively skewed. Almost like a long call option, the downside risk is to a certain extent limited, and the upside potential rather open. Why is that? This is due to the fact that approximately 70% of the CTAs have a trend-based approach. This dominating strategy will generate strong returns in times when the markets are trending, and during sideways markets the risk management guidelines will try to limit the losses.

Another important characteristic of CTAs is how they perform during extreme moves in world equity markets. Figure 2 shows the behavior of CTAs in months when the MSCI World Index is down. We see that CTAs can provide protection during sharp stock market corrections as they often perform strongly in these months.

CTAs outperform the stock markets not only during single losing months, but also during extended periods of declining global equity markets. As can be seen on Table 2, CTAs suc-

Figure 2 | Barclay CTA Index Performance vs 20 worst MSCI World Index Months



Source: Barclay Trading Group Ltd.

cessfully provided downside protection and performed well during the five largest drawdown periods of the last 22 years. Historically, Managed Futures have shown low or negative correlations to stock and bond market returns, and this low correlation is expected to continue. Some of the factors that have a negative impact on the stock markets, such as economic and political uncertainty, can cause moves in the prices of currencies, energy etc. and create profit opportunities for CTAs. It is also the broad diversification of markets traded that contributes to the non-correlation to stocks. As result of the low correlation, Managed Futures investments offer the potential to reduce the downside risk of a traditional portfolio during losing equity periods and improve the overall performance of the portfolio.

But Managed Futures do also provide diversification value in non-traditional portfolios. They have, in conjunction with the short-only and short-biased equity hedge funds, the lowest correlation to all the other hedge fund strategies. Again, in periods when stock markets provide negative returns and other hedge fund strategies (e.g. long/short equity) or fund of hedge funds do not perform well, CTAs are likely to perform positively. This makes Managed Futures the ideal candidate for being included in any fund of hedge funds.

Table 2 | Five largest MSCI World Index Drawdowns

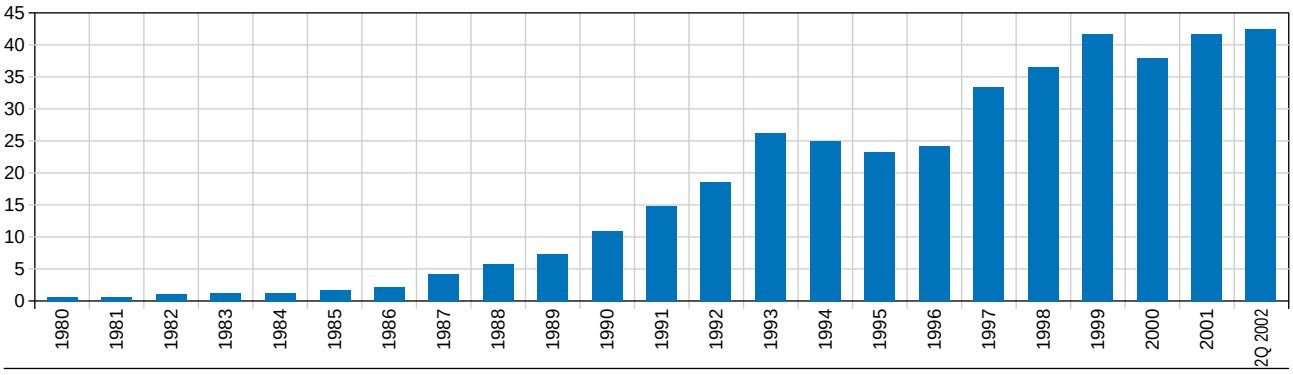
Peak	Valley	MSCI World Index	Barclay CTA Index
Mar 00	Sep 02	-48.5%	21.0%
Dec 89	Sep 90	-25.4%	22.1%
Nov 80	Jul 82	-23.8%	38.8%
Aug 87	Nov 87	-20.8%	9.7%
Jun 98	Aug 98	-13.7	5.6%

Source: Barclay Trading Group Ltd.

The growth of Managed Futures

The stock markets in the U.S. are moving toward the first consecutive three-year decline in 60 years. Because of the disappointing equity returns and a current economic environment which we believe to be favorable for CTAs, investors are drawing their attention again to Managed Futures. The

Figure 3 | Money Under Management in Managed Futures 1980-2002 ($ billion)



Source: Barclay Trading Group Ltd.

allocations to this asset class have increased, and the total assets under management have finally broken the 1999 peak (see Figure 3). The CTAs are not concerned that the capacity in the markets could not absorb the increase of assets. Several bigger exchanges have reported all-time volume records in recent months and the global trading volumes on futures and options exchanges are on their way to another record year.

Conclusion

The ability of Managed Futures to offer a potential protection in periods when the stock markets are not performing well is one of its main strengths. This is the most important and valuable contribution and is the main factor that attracts institutional investors.

CTAs often perform well during times of instability and uncertainty. Now is such a time, and these managers can potentially benefit from this climate.

Managed Futures provide a true hedge for traditional portfolios and institutional investors should consider having an exposure to this asset class.