Financial Crisis Investing

Thursday, June 25, 2009

Managed Futures Can Put Investors in the Black – Even When Stocks Are Deep in the Red

By Ron Brounes
Contributing Writer
Money Morning
www.moneymorning.com
www.ronbrounes.com

While every investment asset class struggled mightily during 2008 - the U.S. stock market alone eradicated $7 trillion in shareholder wealth in its worst year since the Great Depression - managed futures provided investors with a significant bright spot last year.

Managed futures programs - alternative-investment vehicles that enabled professional money managers to take positions in a wide variety of securities and derivatives - posted strong returns in a year that was marked mostly by investment losses. The average managed futures program returned about 14%, according to the Barclay CTA Index, and 11.4% as measured by the Stark 300 Traders Index. By comparison, the Standard & Poor's 500 Index and the tech-laden Nasdaq Composite Index each plummeted nearly 40% in 2008, while the Dow Jones Industrial Average nosedived 33.8%.

"Managed futures funds like drama and volatility, so 2008 was a banner year," said Curtis Lyman, managing director of HighTower Advisors LLC and principal of its West Palm Beach, Fla.-based Alpha Wealth Division. "While I don't know what is going to happen tomorrow, some of the major dislocations in the marketplace still exist, which could offer the potential for a good environment for this strategy moving forward."

While investors who participated in managed futures programs reaped significant performance benefits both on an absolute and relative basis last year, many retail investors and even some institutional players are still unaware of this product and the characteristics that contributed to the lofty returns. And while the entire asset class still only holds about $225 billion, according to Barclay Trading Group, it has grown significantly over the past two decades as investors learn about its performance history and strong diversification features.

"Managed futures, as an asset class, is still relatively unknown," said Paul Wigdor, president of Superfund USA Inc., a public managed futures fund that oversees $1.7 billion in assets apportioned across 18 countries. "We are trying to build this asset class by educating advisors, investors, and the media about this product. We are not trying to replace the more traditional asset classes, but merely to educate people about the need to diversify beyond just stocks and bonds."

The Lowdown on Managed Futures

Before making an investment in a managed futures account, an investor must first develop some insights on the overall futures market. A futures contract is considered a derivative instrument, whose value is determined by the movement of the underlying asset or market. The contract represents an agreement to buy or sell an underlying asset at a predetermined price and date in the future.

Managed futures funds are managed by commodity-trading advisors, or CTAs, who monitor and trade in up to 150 to 200 different futures markets that range from equities to fixed income to currencies to agricultural products to energy to metals. The positions can either be "long" (buy the underlying asset) or "short" (sell the underlying asset) based on expectations of future price movements. These managers often employ "leverage" - using borrowed funds to buy on margin - which allows them to maintain larger positions in the underlying assets than they otherwise would be able to if they paid upfront in full. Buying on margin is a tactic that can dramatically increase returns when the manager has made the correct market call, but which likewise magnifies the losses when the investment manager is wrong.

CTAs typically charge investors management fees in the range of 1.5% to 2%, and may also earn incentive fees of 20% to 25% on any new profits generated by the managed-futures fund. While some investors may claim that such fees seem excessive, performance is always quoted on a "net of fees" (after fees have been paid) basis, so the returns these funds generate can be accurately compared to the gains or losses generated by more-traditional investment vehicles.

Other factors that are important to note:

- The managed-futures industry is highly regulated by the U.S. Commodities Futures Trading Commission (CFTC).
- The future exchanges offer tremendous liquidity,
- And the existence of clearinghouses to guarantee transactions reduces the counterparty risk.

"Our fund is publicly registered and regulated by the SEC and CFTC," said Superfund's Wigdor. "In light of Madoff and other scandals, our clients take great comfort in its transparency. We file 10-Ks and 10-Qs; our auditor is Deloitte & Touche and our [net asset value] is computed by PNC Bank."

A Look Back at the Beginning

While managed futures remain an untapped market in many investment circles, the earliest futures market was actually formed in the mid-1800s when the Chicago Board of Trade was established to provide an outlet for Midwest farmers to sell their products to East Coast merchants. The farmers were able to lock in prices and often hedge their operations against poor weather conditions or other situations that could adversely impact future sales.

In the early days, agricultural-based contracts dominated the futures markets and the first financial futures were not introduced until 1975. Today, more than 70% of all futures transactions are based on financials as their underlying securities, with contracts related to stocks and interest rates among the most frequently traded, according to Man Investments.

The Joys of Non-Correlation

For most investors, the main appeal of a managed futures account is its ability to provide significant diversification to a well-balanced portfolio. Because the managed-futures asset classes are largely non-correlated with stocks and fixed-income products, an allocation can reduce the overall portfolio risk, while offering the potential for yield enhancement, particularly during challenging times for traditional assets like those experienced in 2008.

Hightower's Lyman agrees that non-correlated assets can be a welcome addition, which is why he incorporates managed futures into portfolios of his more-sophisticated clients. He believes managed futures play an important role in his clients' overall risk-adjusted returns.

"The addition of managed futures offers the potential to smooth out portfolio performance because of their low correlation with equities," Lyman said, noting that he builds client portfolios that are designed to provide consistent returns over time and that are broadly diversified across various asset classes.

Managed-futures assets can be particularly beneficial during some of the stock markets roughest stretches, he said.

"Since we are always looking to reduce volatility through the inclusion of low-correlated asset classes, managed futures represent an investment we need to consider," said Lyman. "From a performance standpoint, if you look at the 10 worst months for stocks since 1987, managed futures on average have dramatically outperformed."

However, it's important to note that investors use managed futures as only one piece of a well-diversified portfolio. In fact, due to the highly regulated nature of the futures markets, most investors will limit this part of their portfolio to no more than 10% of their total assets. And as the various asset classes rise or fall in value over time, investors will need to periodically rebalance their holdings to make sure that they do not exceed that 10% allocation limit.

Lyman has not experienced any problems working within the regulatory framework and says the portfolios of his most-aggressive clients tend to allocate an average of 5% to 7% of their holdings into managed futures.

Computer-Based Trading

CTAs typically trade managed futures using a systematic investment process based on the pricing trends of the underlying markets. Most traders do not consider overall market fundamentals. Nor do they study reports that depict the latest statistics on the global markets or the supply-and-demand dynamics for the various commodities. Instead, they use computer-based algorithms to create models that detect pricing trends and look solely at technical factors behind the numbers.

Linus Nilsson is a senior analyst within the Managed Futures Team at Man Investments, a global "fund-of-funds" manager that allocates about $2 billion to externally managed futures funds. Nilsson points out that virtually all underlying manager trades are directional in nature using an unbiased strategy and says that CTAs are just as likely to be short as long in any given market.

"The computer-driven model tells them what to trade, when to trade, which side to trade, and when to get out of those positions," Nilsson said. "Managers look at technical price trends, rather than fundamentals, and then manage the risk around those trends. Everything is price-based and we generally focus very little on macro issues."

According to Nilsson, managed futures perform very well during prolonged crisis situations, though high volatility is not imperative for trends to be established and profitable trades to exist.

"As long as you have trends that are exploitable, managed futures funds will make money," said Nilsson. "Looking at the equity markets from 2002 to 2006, basically we had a very smooth non-volatile trend and CTAs were able to take advantage. Likewise, crude [oil] rose from 2006 to mid-2008, a nice trend that saw prices continue to print new highs all the time."

By contrast, Nilsson claims that managed futures funds also benefited from the dramatic reversal in the prices of energy and other commodities over the second half of 2008.

"After a little pain, CTA models recognized the shift in prices, realigned fund allocations, and went short to the end of the year to take advantage of the new trends. It was a beautiful environment for managed futures."

Paul Wigdor, president of Superfund USA Inc., confirms that his firm's managed futures product incorporates no fundamental overlay and the traders' personal views do not influence buying or selling decisions. They seek price trends in the marketplace and rely on technical factors which suggest whether markets should go up or down.

"We use a fully systematic trading system that is all computer-driven, black box-driven, quant-driven … whatever you want to call it," Wigdor said. "We don't care about embargos or what news may be coming out of the Middle East or China. Our systems look only at price and consider such factors as volatility, resistance and support levels, relative strength indicators, moving averages, and how they all interrelate."

Wigdor also points out that his firm's fund has an exit strategy every time a trade is made so the managers are better able to control the risk.

"We put a 'stop limit' in each time we take a position," Wigdor said. "When a trade moves in our favor, we may ratchet up or down our stops as appropriate. When the models pick up that the trend has reversed, we get stopped out of trades and losses are limited."

Removing Emotion From the Investing Equation

Hightower's Curtis Lyman recognizes the need for some trend-following quant-driven modeling as part of his asset-allocation process. He believes that rules-based computer-driven trading often makes the most sense and is comfortable including managed futures within his clients' portfolios.

"Frankly, the 'black box' is one of the reason we use managed futures," said Lyman. "We like the fact that a portion of our portfolios loses the human element altogether and we would be far less comfortable if a manager had the ability to swing from a chandelier and load up on one position or another based on emotions."

In Lyman's opinion, quantitative trading allows for a pretty good control of risk, at least for that allocation of the portfolio.

2008: A Study in Stock Market Chaos

For investors who want to gain an understanding of managed futures as an asset class, Superfund's Wigdor believes that 2008 stands as an effective case study for how managed-futures programs are supposed to work.

"In the first half of the year, we were long commodities across the board – everything from gold, oil, corn, soybeans, wheat, and oats," Wigdor said. "We were also long currencies from commodities-oriented countries like Canada and Brazil. If you remember, money was flying into long-only commodities products and they did very well during the first six months of 2008."

Wigdor is quick to remind his investors that these positions were established because of the pricing trends of these commodities markets and the computer-driven models did not consider fundamental issues whatsoever.

"In July and August, we experienced a big correction in commodities," he added. "Oil plummeted; others markets followed. Our stops got triggered, though not until we suffered sizable drawdowns, or peak to valley declines."

Wigdor explains that computer models never try to pick the absolute top or bottom of any market, but are merely trying to capture the majority of the price movements. He notes that portfolios will always experience some giveback when markets reverse as the models attempt to validate that the trend has ended. While long-only funds may also recognize the price shifts, they are not set up to take advantage of the reversal.

“There is always going to be some lag time as the models determine if the trend has reversed or this shift just represents noise in the markets,” Wigdor said. “By October, we reestablished positions and this time were short many of the same commodities markets that we had previously been long. We continued to be short equities and interest rates and finished the year with returns of 30% and 46% in our two U.S. funds.”

Likewise, Nilsson said that Man Investment’s investors benefited from exposure to managed futures in 2008, since that asset class was one of the few that actually delivered positive value to investors.

“A large number of CTAs did very well in 2008 and managers who were short equities throughout the year, and were fortunate to be long commodities early and shift to short positions late, were greatly rewarded,” Nilsson said.

Investors have seen a number of “false starts” this year, but Nilsson says he sees several promising possible trends and said the fund is slightly short the U.S. dollar and generally short sovereign debt.

A Competitive Comparison

Nilsson also believes that many investors have shied away from managed futures because of the misconception that it’s an especially risky asset class. In reality, he believes that CTAs are actually better able to control risk, particularly in volatile environments like those experienced last year and in the first part of 2009.

“Dating back to the 80’s, managed futures actually have similar risk profiles to equities and, at times, they are much more stable,” Nilsson said. “Plus, they often outperform the more traditional asset classes over time.”

Hightower’s Lyman admits that volatility, at times, can be quite high in managed futures funds, though these days, everything is relative, especially given the intense price movements in traditional stocks and bonds over the past year.

“Investors really must look at managed futures from a longer-term perspective of at least five years,” Lyman said. “You have to give [the programs] time to work. In fact, during periods of big drawdowns in managed futures, other asset classes are probably doing well because of the non-correlation characteristic. Bear in mind, the addition of managed futures to a well-balanced portfolio will most likely lower its volatility and enhance its returns over time.”

The following chart with data from both Stark & Co. and Bloomberg LLC depicts the risk/reward profiles of both managed futures and U.S. stocks.

Higher Returns, Lower Risk?

Managed futures accounts – alternative-investment vehicles that enable professional money managers to take positions in a wide variety of securities and derivatives – can outperform more-traditional investments, such as stocks, while posing less risk, statistics show. The following chart demonstrates the risk/reward profiles of both managed futures and U.S. stocks.

MANAGED FUTURES vs U.S. EQUITIES (Dec. 31, 1986 to April 30, 2009)

Description	Managed Futures *	Domestic Equities **
Annualized Return	9.7%	8.4%
Annualized Volatility	12.3%	15.7%
Investment Return, Calendar 2008	11.4%	-37.0%
Annualized Return, Past 3 Years	4.9%	-10.8%
Annualized Return, Past 5 Years	4.5%	-2.7%
Annualized Return, Past 10 Years	5.9%	-2.5%

* Stark 300 Trader Index
** Standard & Poor's 500 Total Return Index

Sources: Man Investment database, Bloomberg LP, Stark & Co., Money Morning Staff Research

Not Just for the "Rich and Famous"

Historically, managed futures has been an asset class reserved almost exclusively for institutional players and high-net-worth investors qualify as "accredited investors" – meaning they have an income of several hundred thousand dollars and a net worth of more than $1 million. Lyman believes that certain liquidity issues still prevent many smaller investors from participating.

"While the underlying futures markets are very large and liquid, most of the managed futures products themselves trade in L.P. (limited partnership) structures which often do not provide the daily liquidity that is important for many investors," Lyman said. "Instead, participants typically can access their money by selling units on a monthly or quarterly basis, as predefined by the managers of the fund."

Lyman sees some opportunities for traditional retail investors to diversify into managed futures through mutual funds that may provide daily liquidity, but he does not believe that many of the biggest and best managers will offer access through investment vehicles of that type.

"To get daily liquidity, these managers may have to disclose insight into their trading methodologies," Lyman said, noting that most managers would be reticent to share such closely guarded proprietary information. “Through mutual funds, retail has certain tools available to access this asset class, but the products are not exactly the same as those available to accredited investors.”

Superfund’s Wigdor likes the idea that the asset class has been democratized and that more investors now have the opportunity to invest in managed futures.

“What sets us apart from other managed futures firms is that we concentrate on providing greater access to many types of investors.” said Wigdor. “Right now, we offer monthly liquidity with no holding periods, no lockups, no short-term redemption fees. We continue to work on making this alternative investment more mainstream and therefore available to previously uptapped markets.”

And given the recent risk-adjusted performance relative to more traditional asset classes, greater access may be a pretty good thing.

[**Editor's Note**: Ron Brounes, CPA, is a regular contributor to *Money Morning*. A technical financial writer, Brounes, is president of Brounes & Associates, a Houston, Tex.-based consulting firm that provides writing, communications, and educational services for financial services professionals.