



Managed Futures: An Overlooked Asset Class

By Bruce W. Fraser
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One sector that has proved a bright spot in this ugly market is worth the attention of financial advisors and wealth managers: managed futures. Managed futures are the second-best performing hedge fund strategy in the Credit Suisse/Tremont Hedge Fund Index, delivering 15.6% returns through November. Only dedicated short bias funds performed better (up 16.8%).

For the most part, managed futures are available only through hedge funds and separately managed accounts. These funds are open to accredited investors, who must have an income of \$200,000 and net worth of \$1 million. Separately managed accounts are usually prohibitive for retail investors since most programs, especially higher quality ones, come with high minimum investments — some as high as \$10 million.

In the mutual fund world, only the Rydex Managed Futures Strategy (RYMTX), launched in 2007, falls into the managed futures category, and it carries a mere \$1,000 minimum investment for retirement accounts and a \$2,500 minimum for other account types. The Rydex fund has returned 11.2% this year, through November, compared to -37.7% for the S&P 500 for the same period.

While the hedge fund industry has experienced net outflows, the managed futures strategy has seen positive inflows even during months of negative performance, according to Credit Suisse.

Managed futures can go long or short in futures contracts, including metals (gold, silver), grains (soybeans, corn, wheat), equity indices (S&P futures, Dow futures), soft commodities (cotton, coca, coffee, sugar), and both foreign currency and U.S. government bond futures. Managed futures consist of assets like financials, interest rates, currencies, and commodities, whereas commodities indices for the most part invest in physical commodities and have no financial exposure. Money managers who oversee managed futures funds are known as commodity trading advisors, or CTAs.

How have managed futures shown positive returns when other commodity indices haven't? "Managed futures can take advantage of price trends whether the prices are rising or falling, whereas most of commodity benchmarks can only benefit if commodity prices are rising," explains Edward Egilinsky, managing director of alternative investments at Rydex Investments.



Trading Programs

Trend followers are the dominant trading strategy within the CTA community, but other strategies include market-neutral programs (including option writers) and fundamental programs (who trade based on demand/supply imbalances).

Usually, trend followers track indices such as the S& P Diversified Trends Indicator (S&P DTI), which is composed of half financials and half commodities. The S& P DTI has historically had very low correlations to equities (S&P 500 Index) and bonds (Lehman/Barclay Aggregate Bond Index). The trend-following Rydex fund, for example, aims to mirror the daily performance of the S&P DTI.

Comprised of 14 sectors – with 50% allocated to financial futures and 50% to commodity futures – the S&P DTI uses a rules-based methodology to go long or short based on price momentum. The indicator rebalances monthly, at which time the portfolio resets its commodity-financial weighting.

Other trend following strategies track individual sectors like energy, currencies, grains, interest rates, metals, and meats, attempting to participate in the trends they find. For the most part, these sectors have little correlation to one another, but some groups of commodities, like metals, livestock, and agricultural products, tend to move together. The result of a properly designed program is a high degree of diversification, both within the managed futures fund and in relation to equity and fixed income markets.

Market-neutral traders operate by taking paired positions, generally based on whether spreads are at historically wide or narrow levels. They may take a long position in one commodity and a short position in another, hoping to profit from the movement in the spread rather than from overall market direction.

One of the major reasons for diversifying with managed futures is their potential to lower portfolio risk — serving as an alternative investment to augment traditional asset classes. Credit Suisse research shows that managed futures had positive performance during the last two periods of market dislocation, delivering a 16% return during the Long Term Capital Management Crisis (August 1998 through August 1999) and a 28% return after the end of the Dot Com era (March 2001 through March 2003). That said, Credit Suisse is a large player in alternative assets, and advisors should not rely on only their analysis of the last ten years to assess diversification value. A more extensive study of performance during adverse market conditions is warranted.



Managed futures have gained increasing popularity among the financial cognoscente on Wall Street. According to Credit Suisse, the amount invested in managed futures has more than doubled in the last few years to an estimated \$220 billion, and they expect that number to continue to grow. Since January 2008, assets in the Rydex fund have more than quadrupled, surpassing the \$1 billion mark.

“In this market, more advisors and clients are looking for investments that don’t move in tandem with stocks and bonds, and the managed futures industry is one of the few asset classes in 2008 showing a positive return,” Egilinsky says.

Pittsburgh-based Legend Financial Advisors Inc. has been buying the fund for its wealthier clients since September. “We like it because it’s a trend-following product, which can lead to performance that is not correlated to the regular markets,” says Jim Holtzman, CFP, CPA, an advisor at the firm. “They have flexibility; they’re not locked into being long or short in the market.”

Wealth manager Aaron Skloff, CEO of Skloff Financial Group in Berkeley Heights, NJ, says, “Utilizing futures as a hedging strategy can be an appropriate way to reduce overall portfolio risk. When used as a hedge it can be analogous to portfolio insurance. While you may pay for insurance over and over again, eventually it may provide a benefit during rough times.” Unlike portfolio insurance, which does not provide a diversification benefit and carries a discrete premium, a managed futures program’s primary cost is the fees paid to the fund manager.

Risks

Managed futures can be a risky strategy, but ideally the risk is tightly managed by the program manager. Risks can vary greatly among funds, and investment programs often use consultants to choose the appropriate fund and monitor its performance on an ongoing basis.

Only six quarters of returns are available for the Rydex fund, the only publicly traded fund in this category. More data is available for separately managed accounts and hedge funds, and that data reveals some of the perceived risks inherent in the strategy. According to Credit Suisse, there was a 30% difference between the top- and bottom-performing hedge funds in this sector in 2008, up from 20% in 2007. Still, 32 of 33 managed futures hedge funds have delivered positive returns in 2008.



While a 30% range of returns within a sector appears significant, experts in alternative assets say that this is typical for strategies that incorporate a number of different management styles.

Credit Suisse offers this explanation for 2008 performance: "Managers who have done well to-date this quarter have generally benefited from strong and sustainable trends across all asset classes and have typically had short exposure to equities and commodities and long exposure to treasury bonds and US dollar trades. In general, funds in the sector operate in highly liquid markets, providing them the flexibility to quickly change course in order to capitalize on market trends."

Clearly, the superior performance of this sector during 2008 is partly or mostly attributable to taking short positions in a market where the only positively performing sector has been short term cash. Given this, advisors must ask whether the managed futures sector offers true diversification beyond its short bias. Given the high degree of dispersion of returns among managed futures hedge funds, this question must be answered at the individual fund level, not at the sector level (since it is not practical to take a diversified position across all funds in this sector).

If the goal is to provide downside insurance, a reasonable test is to assess how much diversification a fund offers compared to a simple, low-cost strategy of holding an inverse fund or ETF. This test would not test the diversification benefit during a full market cycle, however. Managed futures, when executed properly, should provide negative correlation to equities during down markets and positive correlation during up markets.

Advisors will want to assess these funds with traditional metrics, such as a beta and volatility. Commodity investors often look at the "drawdown" history, which shows the maximum peak-to-valley cumulative decline, as well as their recovery times. Drawdowns will vary over time, but this provides another data point for assessing risk, based on past performance during a specific period, and shows how long it took the fund to recover those losses.

Some funds utilize derivative contracts and structured notes. In these cases, advisors must carefully assess the counterparty risk inherent in the strategy.



The Rydex fund carries a hefty expense ratio of 1.716%, and its A shares carry a 4.75% load fee. That must be compared to the “2 and 20” that managed futures programs and hedge funds typically charge.

Given this sector’s superior performance during one of the worst years in market history, it cannot be ignored – a small allocation to this sector could pay big dividends if we encounter another year like 2008. But a significant amount of research is required to adequately assess the risks in these funds.

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