

Are Managed Futures Here to Stay?

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Introduction

Over the last four years managed futures have generated a return of 39%¹ while global equity markets have suffered a drop of 40%². Despite this stunning performance, managed futures are often shunned by investors in favour of other asset classes. Perhaps the main misconceptions are that managed futures are significantly riskier than traditional equity investments and that any returns are a temporary result of some market inefficiency which will disappear in time. Periods of poor performance during 1994 and 1999 are pointed to as further reasons for suspicion.

This article will examine what drives managed futures returns and will compare the risk profile with that of equities. The central theme is that trending price action is a natural consequence of herd behaviour and that managed futures have a very favourable risk profile when compared to a typical equity index. The poor performance during 1999 will also be examined and we will build on the argument that periods of poor performance have coincided with tight monetary conditions which have denied the markets liquidity.

Managed Futures and 'Efficient' Markets

It has been argued that much of the market behaviour which hedge funds aim to exploit may disappear due to the vast number of new players entering the industry coupled with the increased use of electronic trading. Increased competition for profits, compounded by the fact that futures and options markets provide a zero net gain among its participants, might lead an investor to conclude that the double digit returns which have characterised managed futures in the past are far from certain. It is, however, important to realise that the medium to long term trends exploited by a typical managed futures Commodity Trading Adviser ("CTA") are not strictly arbitrage opportunities that will disappear as markets become more 'efficient'.

Trending price action is an inherent characteristic of the market where different participants act over different time horizons. A key reason for trends is the so-called 'madness of crowds'. Irrational pricing driven by herd behaviour has been a constant feature of global futures markets. Though markets are often quick to correct such excesses in human behaviour, the appropriate strategy can successfully exploit the associated trends. Furthermore, the major futures markets are highly liquid, with only a small proportion of pure speculators. It could be argued that speculators assist other market participants by providing liquidity and accepting risk. Even by adopting a strategy as simple as a moving average, managed futures CTAs can provide attractive returns. The return could be viewed as payment for servicing the demands of hedgers by taking the other side of their positions.

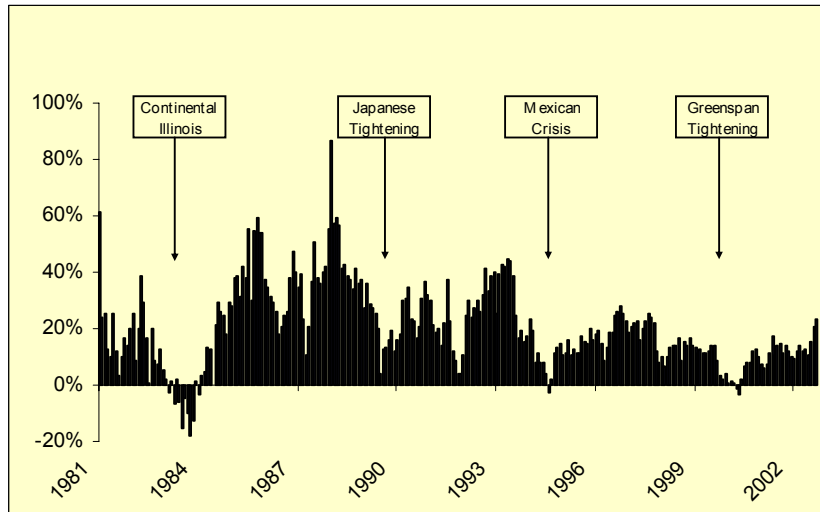
¹ Marhedge - www.marhedge.com

² MSCI - www.msci.com

1999 - A Troubled Year for Managed Futures

The MAR Trading Advisor Qualified Universe Index of rolling 18 month returns (refer Figure 1) shows clearly defined cycles of strong returns lasting between five and eight years with occasional troughs in performance.

Figure 1: MAR Trading Advisor Qualified Universe Index (18 month rolling returns from 1980 to February 2003)



Source: Marhedge

Research by Cross Border Capital and Aspect Capital³ suggests that past and future liquidity conditions can be used to assess the likely performance of managed futures. The premise being that tight levels of liquidity gave rise to the period of poor performance throughout 1999 and much of 2000 and that the conditions towards the end of 2000 were right for a return to strong performance. The key point is that in each episode of lean performance, once liquidity began to improve, managed futures programs began to perform.

There is an important caveat to the poor performance of CTAs during 1999. Very fast trend-following and counter-trend strategies have performed well in both 1994 and 1999. Such systems tend to operate over the short term with an average holding period of 1-2 days. Such short-term strategies spend a significant amount of time out of the market, entering only when a trading opportunity arises and exiting shortly afterwards. Though research indicates that such systems are just as prone to periods of poor performance as traditional CTA strategies, their lack of correlation with CTA trend-following strategies makes them a valuable diversifier, particularly in periods of low liquidity.

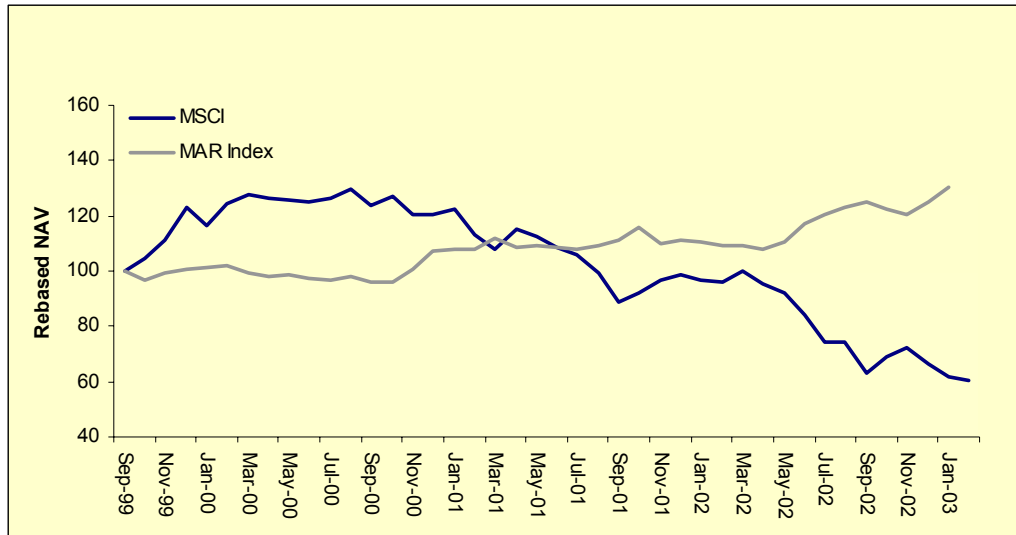
Comparing Managed Futures Returns to Equity Markets

It should be noted that like equities, managed futures returns are not guaranteed. An analysis of the track records of some of the leading CTAs show that drawdowns (a percentage measure of the maximum loss an investor could have incurred in the past) can be significant. While managed futures are rightly viewed as risky investments, the risk-adjusted returns of many CTAs compare favourably with stock indices such as the S&P and MSCI Index. The annualised volatility of returns over the period in Figure 2 is 19.36% for the MSCI and 9.46% for the MAR Index. Indeed, as managed futures are margined investments, the volatility of returns can be chosen by setting the margin to equity ratio appropriately. Therefore, for a given strategy the standard deviation of returns can be set within client

³ 'The Return of Managed Futures' by Martin Lueck, Alastair Smith and Anthony Todd, Aspect Capital, AIMA Newsletter, December 2000; and 'Tactical Style Selection' by Michael Howell, CrossBorder Capital, AIMA Newsletter, September 2000.

requirements. Also, the correlations of CTA indices are typically negative in periods where stock indices have performed poorly. In Figure 2, the performance of the MAR index is strong throughout 2002 despite the fall in global equity markets. Throughout the period from September 1999 through to January 2003, the correlation between the MSCI and Mar Index is strongly negative.

Figure 2: Zurich Trading Advisor Qualified Index versus the MSCI Index



Source: Marhedge and MSCI

For a portfolio consisting of stocks and bonds, allocating to managed futures is a highly cost effective way of achieving a superior risk-adjusted return. Furthermore, return characteristics such as positive skewness (increased likelihood of positive returns) and low kurtosis (decreased likelihood of very large negative or positive returns) make managed futures an ideal means of diversification.

Conclusion

The fact that CTA indices have generated positive returns in periods where stock indices have performed poorly, as illustrated in Figure 2, demonstrates how an allocation to managed futures can improve the return statistics of a portfolio consisting of just stocks and bonds. The returns from managed futures are cyclical - most hedge fund strategies are; and it is believed that this is linked to the interest rate cycle. However, the opportunities that exist when trading a wide range of global futures markets, from agricultural to metal markets driven by irrational participants, along with the ability to hold either long or short positions in response to a change in sentiment, will no doubt continue. Managed futures are indeed here to stay!