INVESTMENT WEEK

How managed futures can help diversify client portfolios

Darran Goodwin | 09 November 2017

Increasing correlation between bonds and equities, rising interest rates, increased geopolitical risk and potentially overheating markets appear to have eroded many of the diversification benefits of the 60:40 balanced portfolio.

The traditional asset management portfolio, long considered a low risk, default option, may no longer be a match for today's markets.

As the traditional portfolio framework looks increasingly vulnerable, uncorrelated strategies such as managed futures are now considered by many to help provide the necessary diversification to achieve long term investment goals.

Among the strategies employed by managed futures managers, also known as CTAs (commodity trading advisors), trend following is by far the most commonly employed, a strategy which when included as an allocation in a diversified portfolio may help protect portfolios against downside risks, reduce volatility and improve risk adjusted returns.

A recent research paper published by AIMA and Societe Generale supports this theory. Riding the Wave describes what managed futures are, how they work and concludes that "adding managed futures to a diversified portfolio has the result of increasing both the total investment portfolio's return and reducing its risk, consequently improving its risk-adjusted return".

What are managed futures/CTAs?

CTAs generally use a combination of futures, options and forward contracts to be long or short of an index or individual market, including equity indices, government bonds, currencies and commodities.

The point at which a trade is initiated or exited, and how much exposure is taken, depends entirely upon price data and a systematic trend following CTA's own proprietary strategy for analysing and interpreting this data.

These strategies are developed and usually tested before being employed by the fund manager. Human emotion and guesswork are then generally removed from the investment process.

Low correlation, directionally unbiased

A traditional portfolio of stocks and bonds can be transformed by an allocation to managed futures.

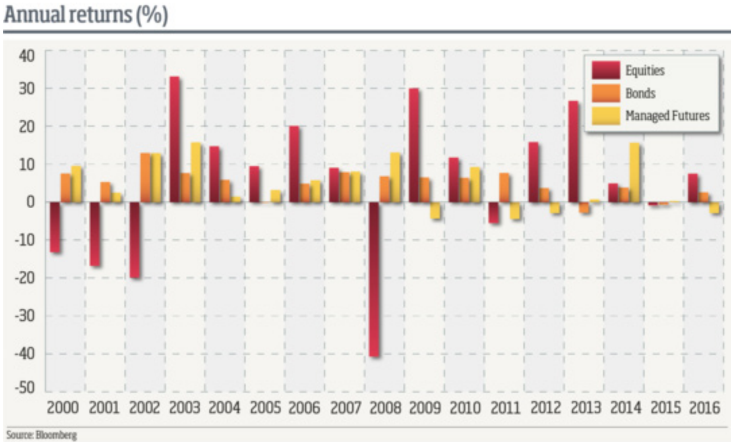
While managed futures may lag during periods of strong equity performance, they can provide stability to a portfolio, reducing risk whilst enabling any drawdowns to recover more quickly than a traditional stocks and bonds portfolio.

One of the main benefits of managed futures strategies is that they are directionally unbiased.

In periods of turmoil, managed futures strategies have the ability to take short positions, meaning that the strategy can capture profits from negative price trends as well as positive ones.

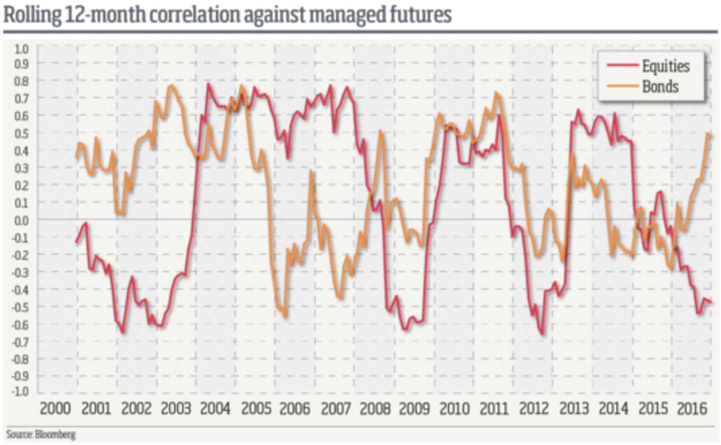
With low correlation to equities, it also means that they can perform well in adverse market conditions.

If we analyse the annual returns and look at the seven years when they were negative for either equities or bonds, we can see that, with the exception of 2011, managed futures were profitable in each of these years (2000 to 2002, 2005, 2008 and 2013).



Looking back at some specific periods of financial turmoil; after the dot-com bubble burst (2000-02), during the global financial crisis (2007-09) and during the eurozone sovereign debt crisis (2010-12), it is possible to track the correlation between equities and managed futures.

On each occasion, the correlation between them plunges sharply and managed futures showed strong positive performance.



As the charts show, managed futures strategies have historically offered an attractive return and correlation profile in falling and rising markets, and in times of market stress they also took advantage of significant price moves driven by the flow of bad news and investors' fear.

Therefore, replacing part of a long-only allocation equity or credit position with an allocation to managed futures, not merely as a substitute but as a stand-alone strategy, can reduce the volatility of the overall portfolio holding and improve risk adjusted returns.

Accessibility via UCITS

The features of managed futures, such as being benchmark unconstrained, non-correlated and well-positioned for opportunities in times of market stress, have historically been available only to institutional investors.

But via the UCITS structure these funds are increasingly available via a number of platforms, meaning they are now much more accessible to wealth managers looking for greater portfolio diversification and higher risk-adjusted returns.

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