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THE ALTERNATIVE ALTERNATIVE

Managed futures add negative correlation to hedge fund portfolios.

The term 'managed futures' refers to an industry of professional money managers known as CTAs, or commodity trading advisors. CTAs use global futures, options and foreign exchange markets as their investment medium. A true global opportunity, CTAs are able to invest in more than 150 markets around the world.

Contrary to popular belief, futures are not recent phenomena. Rice futures were trading in Japan by the mid-1700s, and tin and copper futures began trading on the LME in 1877. Trading of currency futures began in 1972. The sectors in which CTAs trade include: currencies; interest rates; metals (gold, silver, platinum, copper, etc.); energy (crude oil, natural gas, heating oil, etc.); grains (wheat, corn, oats, soybeans, etc.); meats (live cattle, lean hogs, etc.); 'softs' (coffee, sugar, cotton, cocoa, etc.); and stock indexes.

Futures are among the most liquid financial instruments in the world—daily foreign exchange trading volume exceeds US$1 trillion. Transparency is full and complete, and a futures portfolio can be marked-to-market on a minute-by-minute basis.

Futures have unique characteristics, which make them ideal diversifiers in a managed portfolio. Returns on managed futures are not typically dependent on the same economic factors that drive equity and bond markets. Times of severe economic, political or financial stress normally have an adverse impact on equities and bonds, but historically futures have performed very well in these circumstances. Futures can benefit from both rising and falling prices, and typically have a low to slightly negative correlation to equity and bond markets.

Not only are futures virtually uncorrelated to equity markets, but also the greater the dislocation on equity markets the higher the outperformance by futures. Over the last 20 years, every time there has been a sharp decline in the S&P 500, managed futures delivered strongly positive returns. Managed futures have a correlation of -.40 (with 1.0 being perfectly correlated) to the S&P 500 in the 10% best and worst months for the S&P. As a general observation, the greater the stress, the better the return from managed futures.

Over the last 20 years, the S&P had an average monthly return of 1.17%, a minimum monthly return of –21.54% and a maximum monthly return of 13.47%. In contrast, managed futures, as represented by the Barclay CTA index, had an average monthly return of 1.20%, a minimum monthly return of –9.81% and a maximum monthly return of 29.26%.

Managed futures are particularly well-suited as a complementary asset class to a hedge fund portfolio. When looking at the return distribution for hedge funds it is clear that, as an asset class, hedge funds tend to exhibit negative skew and high kurtosis, or fat tails. High kurtosis is not always undesirable: if high kurtosis is present with positive skewness, an investor may have little risk of extreme negative returns in the future. As skewness becomes negative, high kurtosis becomes increasingly significant.

Managed futures exhibit high kurtosis and positive skewness. As a result, managed futures and hedge funds together are a better diversifier than either asset class alone. The combined portfolio exhibits no excess kurtosis, slight positive skewness and a normal left tail.

Managed futures are a better stand-alone diversifier than hedge funds over all timeframes. Managed futures are a significantly better diversifier when S&P monthly returns are up or down more than 3%. Adding managed futures to any portfolio of alternatives results in a lower overall standard deviation and a decreased risk of ruin as the fat left tail is reduced.

In addition to the highly desirable effects, the managed futures sector is a highly regulated industry offering high liquidity, full transparency, minimal credit risk and daily mark-to-market. ▮