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Managed Futures and Liquid Alternatives

"*Americans always do the right thing, but not until they have exhausted every possible* ***alternative****.*" Winston Churchill

Introduction

While traditional asset classes like stocks and bonds have produced good results since the aftermath of the most brutal financial crisis since the Great Depression, it is quite clear that not all is well under the sun. The extraordinary monetary policies implemented by most Central Bankers around the world helped keep markets in recovery mode – from stocks to real estate – and also kept nominal GDP positive on a global scale. However, many dislocations continue to build such as currency wars and collapses in volatility in many markets where the process of price discovery has been structurally altered by institutional intervention. In all fairness, it is not just institutional intrusion that clouds markets' future but a mix of macro-elements such as debt deleveraging, changing demographics and a deteriorating regulatory environment.

With such a backdrop what is an investor to do? Traditional portfolio allocations may end up disappointing and produce returns that, especially when analyzed thru the lenses of risk adjusted models, may not suffice. Investors will need to improve their Efficient Frontier by increasing diversification as suggested in the theoretical work of Dr. Markowitz a few decades ago. However, it is transparent that just adding asset classes will not be the right answer: systematic risk gets only marginally reduced by traditional diversification as the events of 2008 amply uncovered. When the world goes to hell, the only thing that goes up is correlations.

Modern portfolios require diversification by strategies, not only alternative asset classes but alternative strategies. The present macro trends will force investors to intensify the search for alpha and for uncorrelated risk exposures. Investors will have to look for diverse talent and flexible analytical processes.

Such solutions, until recently were usually available only to large investors and mostly institutional players. However, the investing universe is rapidly changing and the industry is responding to a need for accessible and liquid alternatives that is clear and immediate.

Managed Futures have represented one such alternative since the mid -1970s in the form of individually managed accounts traded by CTAs or investment pools such as CPOs. Managed Futures also lowered the barrier of entry for alternatives when compared to Hedge Funds and Private Equity funds by usually having lower minimums; however, a well diversified portfolio of CTAs could quickly amount to a significant level of invested funds. Additionally, investors were required to open different accounts with specialized FCMs to access such strategies.

As a result, new solutions are being made available to overcome the above mentioned obstacles. Mutual Funds structures, often referred to as 40 Act Funds, and alternative ETFs are proliferating in an effort to provide managed futures exposure to a wider audience of investors.

State of the Industry

The mutual fund subsector dedicated to funds specialized in managed futures strategies has been growing at exponential speed in recent years. Only in 2007 an investor could count such funds in single digits while now Morningstar reports about 150 mutual funds in its Managed Futures subcategory. The rise in assets under management since the first mutual fund was launched in 2007 until September 2012 (the latest data point we have from ForwardInvesting) has been a significant $9.2 billion.

The propagation of such funds requires a detailed level of analysis to figure out how closely each fund is really linked to Managed Futures exposure. Some funds seem to rely on one single manager while others have a portfolio built on a multi-strategy platform. Occasionally, some funds would only be invested in Managed Futures related Exchange Traded Funds. Understanding the construction of each fund is paramount in forecasting how closely one investor will track classic managed futures strategies such as trend following or options arbitrage. A study by another brokerage house found that most Managed Futures mutual funds have low correlation to the Barclay CTA Index and only a handful have significant correlations above 50% (with a few names up in the 80% and 90%). This is probably a reflection of including in the sample studied those funds relying on a single manager whom may have low correlation to the overall index. A different fee structure in mutual funds may also contribute to distort net performance numbers.

Overall most mutual funds seem to produce lower returns than the Barclay CTA Index. This is not a fair comparison as the Barclay CTA Index is not investable after all but any underperformance may be a tell for possible misconstruction of the specific fund being analyzed.

For instance, one year, three year and five year annualized returns in the Morningstar Mutual Fund Managed Futures Index (expressed as simple averages) are negative respectively at -6.87%, -3.7% and -4.17%, while the Barclay CTA Index* shows a positive return (as of April 2013). The performance numbers for mutual funds do seem to be partly skewed by a sample that is rapidly changing and growing. This problem requires an investor to dedicate some time to a significant qualitative approach when selecting a fund rather than just relying on quant screens.

Another available option is represented by alternative ETFs. ETFs in general have become the darling of investors thanks to their flexibility, low cost structure and easy access. The ETF boom started with passive replication of broad and narrow indexes and it is now moving into low cost replication of active strategies. In a way this would seem an oxymoron: a passive replication product utilized to commoditize alpha. Without getting into a very complex discussion on beta and alpha, an investor will get what he/she pays for: if an alternative strategy is the result of some structural source of return (beta) the ETF should cheaply capture such risk premium but in the case of a strategy being successful strictly due to a manager’s set of skills, the ETF will fail.

One of the original Alternative ETFs is Ishares sponsored ALT. Launched in 2010, this ETF aimed at maximizing absolute returns from an array of futures based strategies with low correlation among each other. Strategies such as yield and futures curve arbitrage, technical momentum and reversal trading and fundamental relative value are all mixed in the same platform; strangely pure commodity exposure is not included. The performance seems fairly correlated to the Barclay CTA Index but again a little lower in spite of an expense ratio relatively cheap at 95 basis points.

The point on the level of the expense ratio is an important one since mutual funds usually have a fee structure different than direct managed futures investments. Mutual funds are often sold via different classes of shares: A shares, for instance, are often designed for the long term investor since they usually carry a large one time upfront fee. Other classes of shares may have lower but yearly recurrent fees. Additionally when a mutual fund acts practically as a fund of funds, the layers of fees may significantly lower the attractiveness of the investment.

Conclusions

Liquid alternatives represent a new dimension in the investment spectrum and it is reasonable to expect this segment to continue to grow. Eventually consolidation will set in and the best products with the more solid foundations will pass the test of time. For now, a progressive investor needs meaningful analytical resources to identify a specific portfolio need and what product would be the best solution for such situation.

* The Barclay CTA Index does not represent the total universe of CTAs. It is not possible to directly invest in this index and its returns do not reflect the fees and expenses inherent in investing in a vehicle designed to replicate this particular index.