

# Trends with Benefits: The Case for Managed Futures

by **William Marr**, Head of Liquid Alternative Investments, Portfolio Manager—State Street Ramius Managed Futures Strategy Fund and **Alexander Rudin, Ph.D.**, Investment Research, Liquid Alternative Investments, Portfolio Manager—State Street Ramius Managed Futures Strategy Fund

Volatility is generally no friend to most investment strategies. But for a certain type of nontraditional fund, the same shudder-inducing moves in the currency, commodity and equity markets can potentially be positive — even beneficial, you might say — to returns.

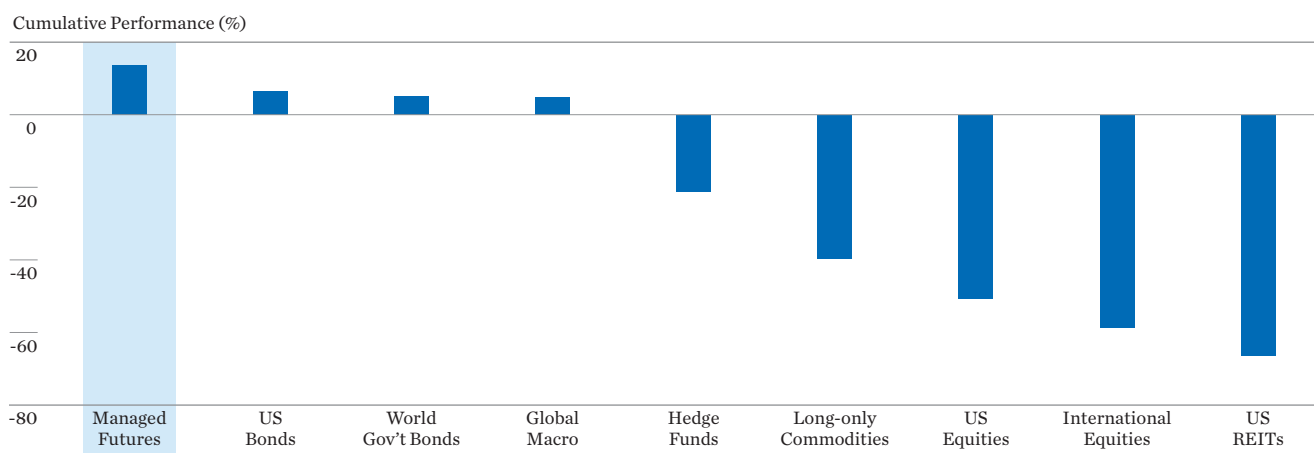
US stocks continue to notch new record highs but investors have a growing laundry list of worries that includes central bank policy divergences, global economic growth disparities, commodity sell-offs, currency fluctuations and ongoing tensions in Greece and Ukraine. In short, the financial world is becoming even less predictable. Equity markets continue to perform reasonably well, but unease is clearly rising. As a result, demand is growing for investment strategies that

can potentially perform in an elevated equity market, as well as deliver potential downside protection should equities encounter a prolonged rough patch.

Managed futures, a systematic approach to trading global futures markets, have historically been that type of strategy. Directional in nature, with an ability to go long and short across multiple asset classes, managed futures have the potential to capitalize on the very sorts of trends now churning markets, while also seeking to generate uncorrelated returns that can provide some protection during an equity drawdown. As such, these strategies have long been mainstays of institutional portfolios, where they are frequently positioned as diversifiers to equities.<sup>1</sup> Yet, individual investors and their advisors have yet to adopt the strategies in a significant way.

Admittedly, managed futures' up-and-down performance in recent years hasn't helped their cause with the advisor community. The strategies did generally post strong returns during the global financial crisis when investors needed protection the most (see figure below). This performance attracted a wave of

## Alternative Investment Performance in the Teeth of the Global Financial Crisis



Source: Bloomberg and State Street Global Advisors, as of December 31, 2014.

The period of the Global Financial Crisis is defined as November 2007 to March 2009. Please see Footnote 5 at end of document for proxy details. Past performance is not a guarantee of future results. Performance of an index is not illustrative of any particular investment. It is not possible to invest directly in an index. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

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clients post-crisis who turned into unhappy customers when the funds stumbled through a period of muted volatility, high correlations and lackluster trends.

Another problem in the space has been the limited availability of high-quality investment products that meet the needs of individual investors. Liquid alternative mutual fund versions of managed futures have existed for nearly 10 years, but haven't necessarily provided access to top managers. While traditional hedge fund structures are another option, high minimums, long lockups and assorted other headaches associated with private investments can often make them unwieldy for the many advisors. Recently, though, a handful of mutual funds have come on line offering daily liquidity and access to the same-caliber managers who work with large institutional clients. We think it's another of the "trends" that happen to be working in managed futures' favor now.

### The Re-Emergence of Trends

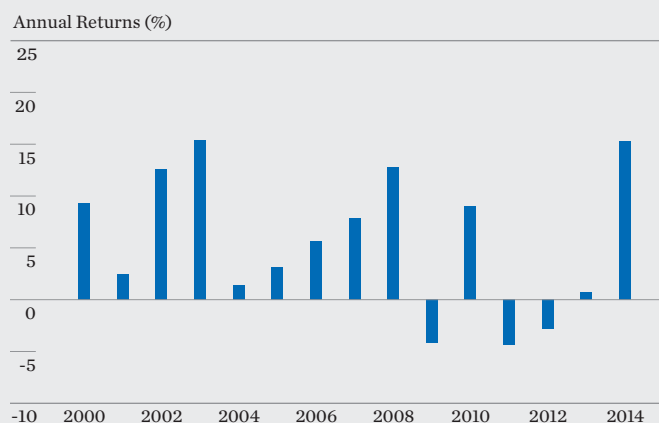
The unprecedented intervention of central banks around the world to support asset prices smoothed out volatility in markets during the first part of this decade. The years from 2011 to 2013 were halcyon days for bonds and equities, as the asset classes marched higher in tandem. But the very same relatively tranquil climate that was conducive for stocks challenged managed

futures by reducing the volatility that is a prerequisite for creating the trends the strategy can ride up or down. Agnostic to upward or downward shifts, managed futures need markets to simply move no matter whether those moves happen in commodities, currencies, interest rates or equities. And there just wasn't a lot of movement in those asset classes during those years.

Last year saw the return to higher levels of volatility, and many managed futures strategies were able to take advantage as the Newedge CTA Index gained 15.7 percent in 2014.<sup>2</sup>

This year has seen the continuation of market turbulence and volatility. Take interest rates and their close cousin: currency exchange rates. After a prolonged period of extraordinary policy coordination, central bank policies are increasingly divergent. The US Federal Reserve, which had already terminated its massive bond-buying program, signaled to markets that rate hikes would come sometime this year even as the European Central Bank (ECB) embarked on a quantitative easing (QE) program. At the same time, multiple central banks around the world lowered rates in an attempt to boost their trade competitiveness via a cheaper currency. Oil prices are another example. With Saudi Arabia-led OPEC no longer willing to support oil prices by throttling back crude output, benchmark crude prices have been gyrating.

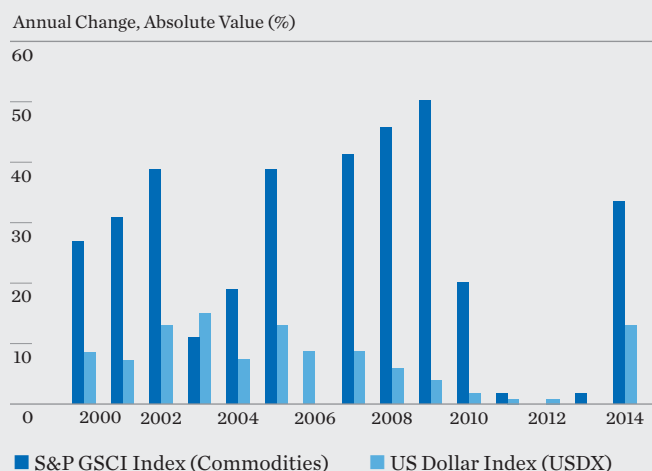
**Figure 1: Annual Performance of Managed Futures**



Source: Bloomberg, as of December 31, 2014.

The Newedge CTA Index is used to represent Managed Futures. Past performance is not a guarantee of future results. Performance of an index is not illustrative of any particular investment. It is not possible to invest directly in an index. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

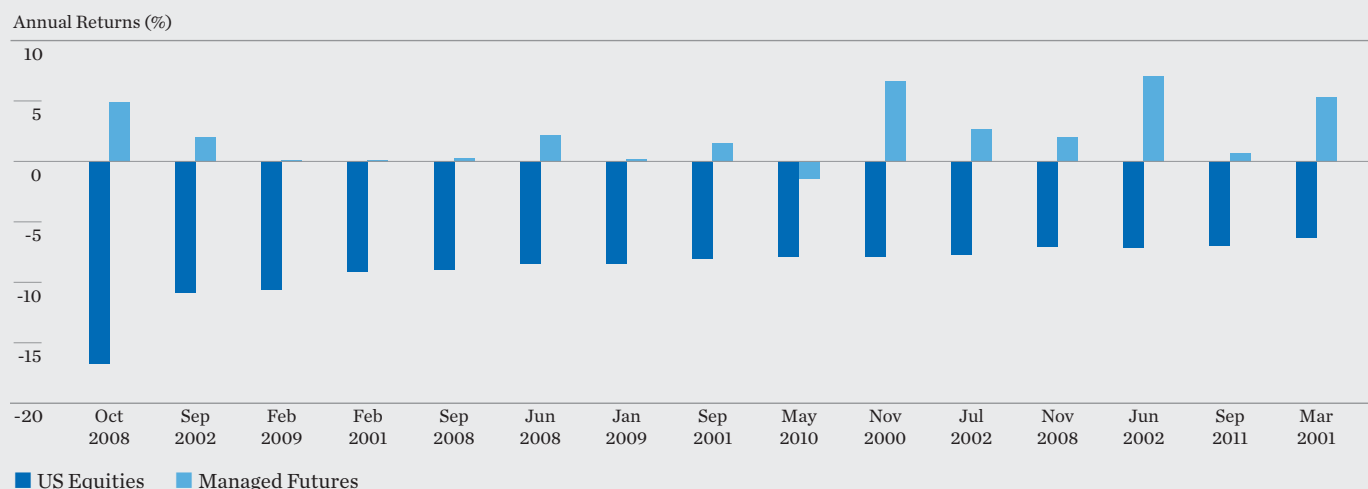
**Figure 2: Absolute Value of Annual Changes in Currencies and Commodities**



Source: Bloomberg, Goldman Sachs, as of December 31, 2014.

The S&P GSCI is a composite index of commodity sector returns representing an unleveraged, long-only investment in commodity futures that is diversified across the spectrum of commodities. Past performance is not a guarantee of future results. Performance of an index is not illustrative of any particular investment. It is not possible to invest directly in an index. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

**Figure 3: Managed Futures Funds Saw Flat or Positive Performance in 14 of the 15 Worst Months for the S&P 500 Since 2000**



Source: Bloomberg and State Street Global Advisors, as of December 31, 2014.

The S&P 500 Total Return Index and the Newedge CTA Index are used to represent US Equities and Managed Futures, respectively. Past performance is not a guarantee of future results. Performance of an index is not illustrative of any particular investment. It is not possible to invest directly in an index. Index returns are unmanaged and do not reflect the deduction of any fees or expenses. Index returns reflect all items of income, gain and loss and the reinvestment of dividends and other income.

The Newedge CTA Index rose 5.8 percent in the first quarter of 2015, followed by a decline of 3.3 percent in April due to a reversal of recent currency and commodities trends.<sup>3</sup> It's an occupational hazard of directional trading strategies that they can occasionally get caught leaning the wrong way. If history serves as a guide, though, as long as commodity and currency markets continue to fluctuate and produce new trends, managed futures funds should be able to adjust and potentially capitalize. Simply eyeballing Figures 1 and 2 together, it is easy to see how closely managed futures' performance tracks the periods characterized by swings in commodity prices and the major currencies.

### Trends Emerge as Market Correlation Diminishes

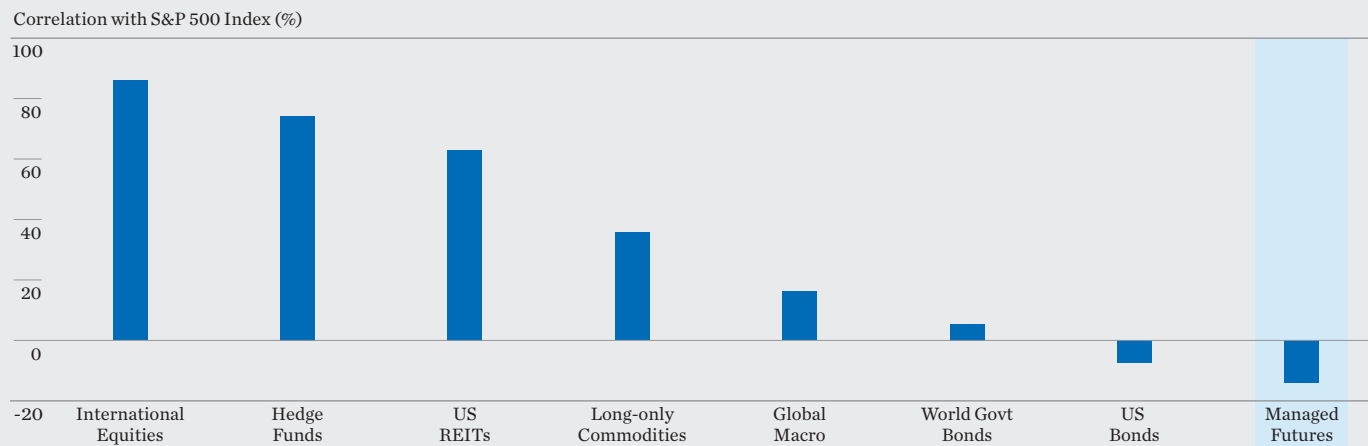
If managed futures tend to do well in volatile markets, they shine brightest during full-blown bear markets. As shown in Figure 3, since the January 2000 inception of the managed futures benchmark Newedge CTA Index, the strategy has performed positively in 14 out of 15 of the S&P's *worst*-performing months.

Although many hedge fund strategies are used as equity diversifiers, most are still correlated to equities. When equities go down, these hedge funds may not underperform as much as a pure long-only equity fund, but they're still not likely to

see positive returns. Managed futures, on the other hand, have a negative correlation with equities that is lower than bonds (see Figure 4).

There are a number of likely explanations for this. When equity markets sink and volatility spikes, managed futures managers are generally able to use their short positions to profit while also continuing to trade on the volatility. Often the biggest risk they face in such environments is that their shorts overshoot the mark and miss the inflection point at which a tumbling market starts to recover. (Although, if markets become too uncertain or volatile, the strategy's active presence in the currency, commodity and interest rate markets at least gives it more places to hide.) The global financial crisis is perhaps the most striking example of managed futures' ability to provide some shelter from the storm. During the 17-month period when the S&P 500 was down more than 50 percent (November 2007-March 2009), managed futures were up 13.5 percent,<sup>4</sup> providing a rare bright spot in investors' portfolios that helped offset losses elsewhere. Of course, there are periods when managed futures performance is generally challenged. For example, the period of 2011-2013 was generally weak due to contracting volatility that squashed any trends that even started to emerge.

**Figure 4: Managed Futures and Global Macro Strategies Have Low Correlation to Equity Markets**



Source: Bloomberg and State Street Global Advisors, as of December 31, 2014.

Please see Footnote 5 at end of document for proxy details. The correlation coefficient measures the strength and direction of a linear relationship between two variables. It measures the degree to which the deviations of one variable from its mean are related to those of a different variable from its respective mean.

### Allocating to Managed Futures

When thinking about taking advantage of these potential benefits and fitting managed futures into a portfolio, we believe the strategy should be bucketed as a liquid alternative trading strategy designed to complement conventional equity and fixed-income allocations. Interestingly, managed futures' standard deviation sits about halfway between stocks and bonds on the risk and volatility scale. They can thus be used to balance out either equities or bonds to potentially reduce risk and boost reward. Of course, managed futures may not perform well during periods of low volatility and trendless markets, so it's important for clients to understand that the diversification the asset class provides bares its own unique risks as well.

A small allocation to managed futures can help realize the asset class' diversification potential, with the ultimate allocation determined by the portfolio risk profile that investors are trying to achieve. In addition, since managed futures can be a reasonable alternative to asset classes that are perceived to be overvalued or have a negative outlook, that allocation could come out of a variety of other exposures. So, if a certain portion of equities, say small caps, appear to have stretched valuations, room could be made by taking down exposures to those frothier assets. Alternatively, if bonds are poised to be a problem — say interest rate risk furls higher — half could be taken out of fixed income and half out of the equity allocation.

Whatever the mix, the mutual fund format helps make it easier to put the pieces together. Unlike traditional hedge fund structures, which often grant withdrawals only once a quarter, mutual funds offer daily liquidity, and there are never withdrawal gates like the ones that hedge funds occasionally throw up to prevent outflows during bad times. Mutual funds also lack the high minimums of their traditional counterparts, allowing for greater flexibility in tactically dialing exposures up or down and periodically rebalancing. There is yet another advantage to the mutual fund format: Come tax time, clients have the ease of filing a 1099 and bypassing the onerous delay of the K1 form required for private investments.

### Trends and Benefits

Geopolitical flare-ups, monetary policy divergence, low interest rates and policy decoupling are just some of the forces unsettling equity, fixed-income, currency and other markets at the moment. As we continue to navigate a world of uncertainty and risk, it is more important than ever to find strategies that can capitalize on these market trends, instead of getting hurt by them. Managed futures, a potential diversifier, offer the prospect of participating in today's trends and providing protection against the downside of a risk-off market. And, with the introduction of high-quality liquid versions of the strategy, the individual investor has a straightforward, accessible way of seeking to potentially benefit from both.

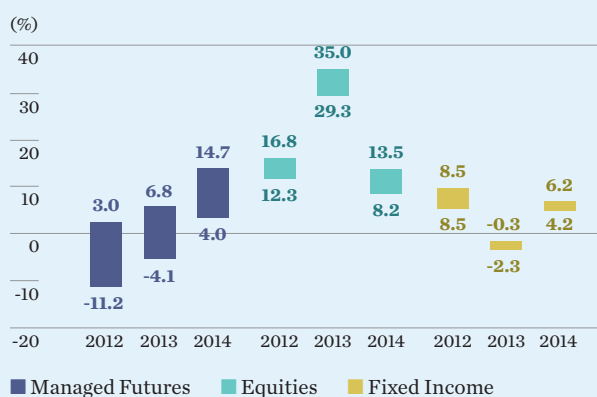
### Single vs. Multi-Manager

There are many types of strategies that managed futures managers can employ. While all tend to take a systematic approach to trading global futures markets, and most can be classified as some form of “trend-following,” within that framework there are a number of important differences and nuances. There are some managers who opt for a pure momentum strategy, some who trade with a value-investing focus, others who exploit the mean-reversion tendency of financial assets and several who exercise a combination of all of the above.

Since it is rare to find one manager who does everything, a multi-manager fund of funds may be more representative of the entire asset class. Another benefit of tapping multiple managers is the access it provides to a wide array of markets. One of the reasons managed futures as a whole exhibits a fairly moderate volatility profile is the sheer variety of trades the strategy typically employs. Although any given managed futures trade may entail a high degree of volatility, the typical manager spreads positions among a hundred or more trades at a time. Even so, there is wide dispersion among managed futures manager performance (see Figure 5), translating to a high degree of single-manager risk within the asset class. A multi-manager approach can help offset this risk, providing another layer of diversification that potentially reduces volatility and seeks a higher level of performance consistency.

**There is wide dispersion among managed futures manager performance, translating to a high degree of single-manager risk within the asset class. A multi-manager approach can help offset this risk.**

**Figure 5: Performance Dispersion of Active Strategies**



This figure illustrates the performance spread between the first and fifth quintile in Morningstar peer groups.

Source: Morningstar, State Street Global Advisors, as of 12/31/2014.

The Morningstar Large Blend, Intermediate Term Bond, and Managed Futures Categories are used to represent Equities, Fixed Income, and Managed Futures, respectively. Past performance is not a guarantee of future results. Performance of a universe is not illustrative of any particular investment. It is not possible to invest directly in a manager universe.

Lastly, the multi-manager approach helps to position managed futures as a strategy for all seasons. There is some debate within the investing community whether managed futures should be accessed as a long-term strategic allocation or only owned when the conditions are most ripe right for the strategy. We at the SPDR ETFs and SSGA Funds Research Team see greater potential benefits to the former since timing the market is notoriously difficult. Utilizing multiple managers, with their even more varied array of exposures, can help investors stay the course and ensure they will be exposed to this asset class when they need it most.

<sup>1</sup> “A Quantitative Analysis of Managed Futures Strategies,” CME Group, June 2014 [http://www.cmegroup.com/education/files/Lintner\\_Revisited\\_Quantitative\\_Analysis.pdf](http://www.cmegroup.com/education/files/Lintner_Revisited_Quantitative_Analysis.pdf).

<sup>2</sup> Source: Newedge, as of 12/31/2014. The Newedge CTA Index is designed to track the largest 20 (by assets under management) Commodity Trading Advisors and be representative of the managed futures space.

<sup>3</sup> Source: Newedge, as of 4/30/2015.

<sup>4</sup> Newedge, as of 3/31/2009.

<sup>5</sup> MSCI All Country World ex-US Index, HFR Weighted Composite Index, Dow Jones Composite All REIT Index, Reuters/ Jefferies CRB Commodities Index, HFR Macro Index (Total), Citigroup World Government Bond Index, Barclays Aggregate Bond Index (Unhedged USD), Newedge Managed Futures Index and The S&P 500 Total Return Index are used to represent International Equities, Hedge Funds, US REITs, Long-only Commodities, Global Macro, World Government Bonds, US Bonds, Managed Futures, and US Equities respectively.

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State Street Global Advisors One Lincoln Street, Boston, MA 02111-2900.  
T: +1 617 664 7727.

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Investing in futures is highly risky. Futures positions are considered highly leveraged because the initial margins are significantly smaller than the cash value of the contracts. The smaller the value of the margin in comparison to the cash value of the futures contract, the higher the leverage. There are a number of risks associated with futures investing including but not limited to counterparty credit risk, currency risk, derivatives risk, foreign issuer exposure risk, sector concentration risk, leveraging and liquidity risks.

Managed Futures use derivatives, primarily futures and forward contracts, which generally have implied leverage (a small amount of money used to make an investment of greater economic value). Because of this characteristic, managed futures strategies may magnify any gains or losses experienced by the markets they are exposed to.

Investing in commodities entail significant risk and is not appropriate for all investors. Commodities investing entail significant risk as commodity prices can be extremely volatile due to wide range of factors. A few such factors include overall market movements, real or perceived inflationary trends, commodity index volatility, international, economic and political changes, change in interest and currency exchange rates.

Hedge funds are typically unregulated private investment pools made available to only sophisticated investors who are able to bear the risk of the loss of their entire investment. An investment in a hedge fund should be viewed as illiquid and interests in hedge funds are generally not readily marketable and are generally not transferable. Investors should be prepared to bear the financial risks of an investment in a hedge fund for an indefinite period of time. An investment in a hedge fund is not intended to be a complete investment program, but rather is intended for investment as part of a diversified investment portfolio

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