DYNAMICBETA investments

iM Global Partner

The Case for Managed Futures in an Investment Portfolio

February 2023

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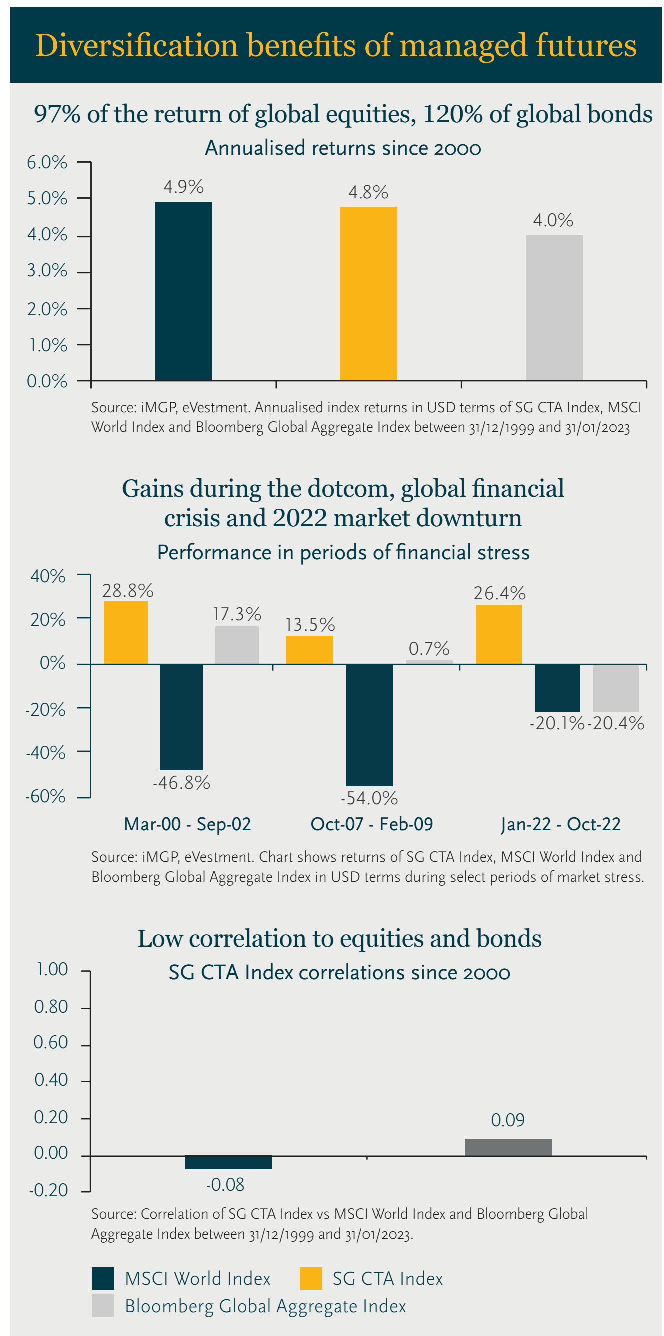
At Dynamic Beta investments, we are convinced that managed futures is the single most valuable diversifier investors can add to a portfolio of stocks and bonds. We believe it provides more "bang-for-your-buck" than private equity, private credit, REITS, commodities and many other widely used alternatives.

Since 2000, managed futures – as measured by the SG CTA Index[1], which in our view is the best source of long-term data on the space – have demonstrated 1) strong relative returns, 2) a low correlation to equities and bonds, and 3) an ability to deliver positive returns during periods of market stress.

With stocks and bonds moving in tandem for the first time in decades in 2022, the diversification benefit was even more acute: a 10% allocation in 2022 would have cut losses in a global 60/40 portfolio[2] by more than a fifth over the calendar year.

It is important to pay attention to the allocation in a portfolio, of course. Some investors have expressed nervousness about these strategies or have had issues with hedge funds in general in the past, but we believe that times have changed.

The managed futures mutual funds and ETFs of today are far better than they were a decade ago. Nevertheless, there still are a few major pitfalls that can trip investors up. This paper is a starting point to support our clients in building a durable strategy to invest in managed futures while avoiding as many of the drawbacks as possible.



1. The SG CTA Index is designed to track the largest 20 (by AUM) CTAs and be representative of the managed futures space. The index is not representative of the entire population of CTAs or hedge funds. The index's performance may not be indicative of any individual CTAs or hedge funds and the index may not have been adjusted for fees/commissions. The index cannot be traded by individual investors. The actual rates of return experienced by investors may be significantly different and more volatile than those of the index.

2. The calculation assumes a portfolio with 60% invested in the MSCI World Index and 40% invested in the Bloomberg Global Aggregate Bond Index.

1.

It's not as complicated as it sounds

Managed futures is an investment strategy that hunts for trends in dozens, or hundreds, of assets for which there are futures contracts, such as crude oil, bonds, equities and Japanese yen. In other words, if crude oil is rising (or falling), a hedge fund manager might go long (or short) with a futures contract and bet that this trend will continue. Firms use quant models to study past prices to decide what to buy and sell, and then diversify across commodities, rates, equities and currencies.

As markets (and prices) shift, these managers tactically move around – hence 'managed', unlike buying and holding gold. They use futures because this is an extremely liquid and efficient way to bet on these price moves.

Think of it this way: managed futures funds take advantage of market waves. The best time to do this is when significant market movements cause extreme volatility, like in 2022; other times markets are choppy and they bounce around but don't make much forward progress. The good news is that there are always waves, and managed futures funds are a potential way to make money from them.

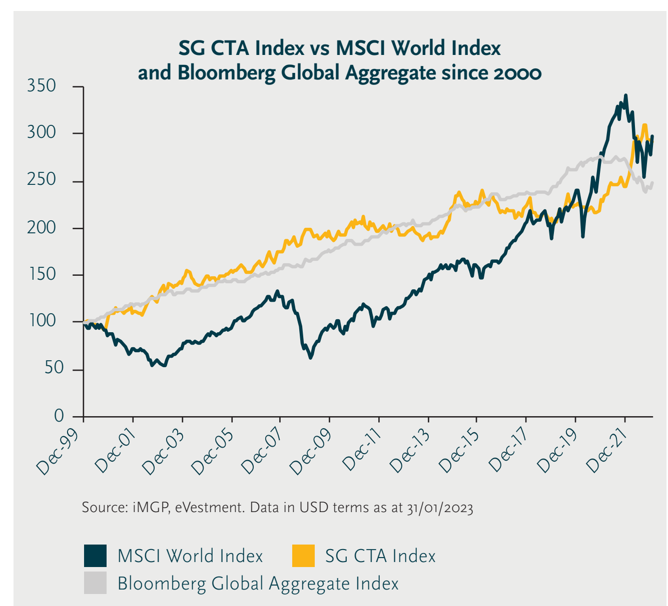
2.

Long-term returns are better than many realise

The return statistics illustrated in the charts above (97% of the return of equities, 120% of the return of bonds) can shock a lot of people. Many learned of the strategy during the recent "long winter" of 2015-20, when a combination of the Fed put and near-zero interest rates meant low returns, especially relative to soaring stocks and bonds.

Chart 4 provides more historical context. Since 2000, the managed futures asset class, as represented by the SG CTA Index, has offset equity risk during all three prolonged bear markets and managed to keep up with fixed income during most of the great bond bull market – only to flip to an inflation play and make money from the recent rise in yields.

From a more technical perspective, low correlation to the rest of a portfolio means more alpha – 300-400 bps per annum to each of stocks and bonds – which is unusual for a diversifier.



3.

There's a simple and clear reason why it should work

Like the illiquidity premium, value factor, etc., trend-following has the ability to generate alpha because most investors are not set up to make money this way. In general, we're trained to think markets revert and then buy the dip. Like Buffett's trope about cutting flowers and watering weeds, we often sell winners too soon and hold losing positions too long.

We've found that model portfolios based on 10- or 20-year assumptions will not always be profitable. Wall Street strategists that touted "low rates forever" won't retract that advice based on a few datapoints. Biases and these kinds of constraints mean many investors leave money on the table. Managed futures funds try to sweep it up.

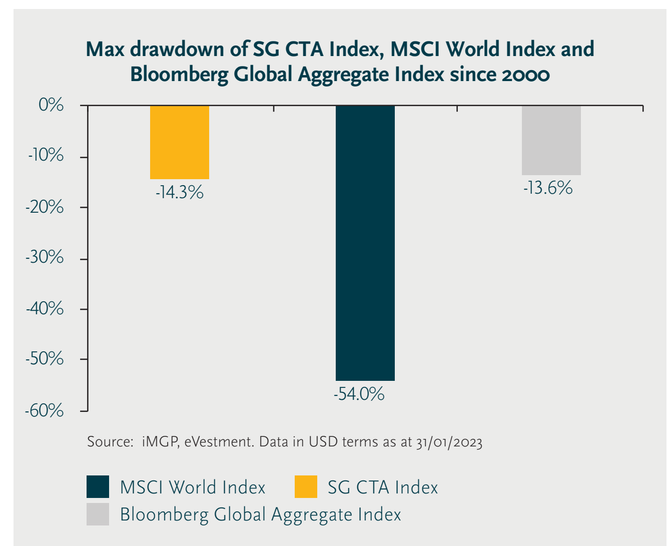
In 2022, most managed futures funds detected the signs of inflation early, repositioned portfolios quickly and rode the wave. That kind of alpha generation, we believe, is not going away any time soon. You can think of managed futures as outsourcing a portion of your portfolio to a tactical strategy that might find trades – in 2022, shorting Treasuries and the yen – that many investors may not be able to do on their own.

4.

It has been less risky than you may have feared

A "quantitative, long and short, leveraged derivatives-based strategy" conjures up images of blow ups, yet the SG CTA Index has had volatility of around 9% since 2000, about halfway between equities and bonds. More tellingly, over the same time period, the maximum drawdown is -14%, less than a third of equities and now, even less than bonds.

There is a good reason for this. Managers diversify across markets and size positions prudently – after all, they don't want to blow up either. Their models also ruthlessly cut losing positions to avoid a white-knuckle ride, which some fundamental investors can go through. Finally, futures contracts are highly liquid, so funds can exit positions when they need to. The short explanation is that many fears about managed futures are overblown.



5.

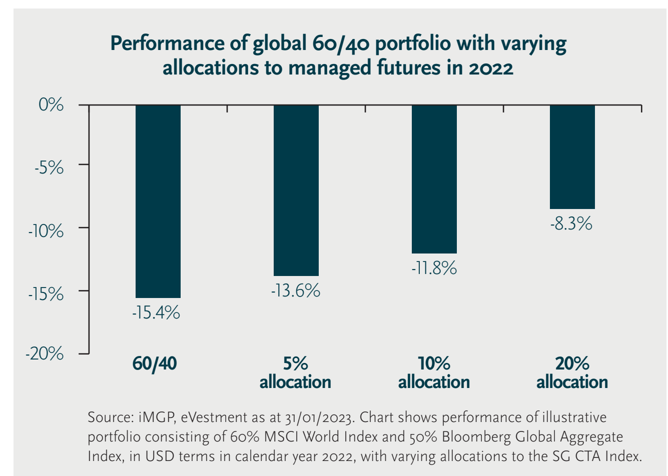
Unfortunately, you probably cannot time it

If you can, you may know something that we don't. We entered this space in 2015 to hedge a portfolio for a crisis that hit in...2022. Some of the smartest allocators to hedge funds bailed out just before the rebound. We believe the right thing to do is to pick the right allocation size and stick with it.

6.

So how much should investors allocate?

Chart 6 shows the impact on drawdowns in a global 60/40 portfolio consisting of the MSCI World Index and Bloomberg Global Aggregate Index in 2022. iM Global Partner's research found that adding a 5% allocation to managed futures would have reduced drawdowns by more than 20%, while a 20% allocation would have reduced drawdowns by more than 40%. The ideal allocation for any given portfolio will of course depend on a number of factors and variables, including current holdings, investment time horizon and attitude to risk.



Source: iMGP, eVestment as at 31/01/2023. Chart shows performance of illustrative portfolio consisting of 60% MSCI World Index and 50% Bloomberg Global Aggregate Index, in USD terms in calendar year 2022, with varying allocations to the SG CTA Index.

7.

Investing is a lot trickier than it seems

We do need to address the big issues. If the SG CTA Index were available as a mutual fund or ETF, investing in these strategies would be significantly easier. The fact is that the index just represents the average performance of 20 leading managed futures hedge funds – and you can't invest in it. Of course, an institution could invest directly in half a dozen constituents of the index to approximate it, but it's not easy to do.

Given accreditation and other issues with hedge funds, most investors today are likely to gain exposure via mutual funds or ETFs, which offer much more attractive options than a decade ago. That said, the pickings are still relatively slim compared to the hedge fund world.

Most investors, in practice, can choose from four strategies:

- Single Manager
- 2-4 Single Managers
- Multi-Manager
- Replication.

To build a durable long-term strategy to invest in the space, we believe that the primary goal of fund selection should be to reliably match or outperform the index. During the 2010s, many early adopters chose the single-manager path and selected funds they believed would accomplish this. For reasons described in the next section, we think this approach is too risky and explains, in part, why many grew frustrated and abandoned the space.

Table 1: The pros and cons of hedge fund investing

	Single Manager	2-4 Single Managers	Multi-Manager	Replication
Mutual funds/ETFs	**Both**	**Both, but few ETFs**	**Mutual Fund only**	**ETF/UCITS only**
Pros	• Single line item • Brand names • Always a few good options to choose from • Fees (usually) lower	• Same as Single Manager, but • More diversified/ predictable	• Single line item • Brand names • More diversified/ predictable • Tendency to match index	• Single line item • Potentially more diversified/ predictable • Designed as "index-plus" • Can be less expensive
Cons	• Extreme dispersion • Recent outperformance often luck, not skill • Difficult as long-term hold	• Cluttered bucket • Difficult to track/explain multiple funds	• Expensive • Unlikely to outperform	• Can seem too simple

Source: DBi, iMGP

8.

Single-manager risk can be a huge landmine

Single-manager risk means you may pick a fund that underperforms everybody else (the index) by a lot. That makes it hard to explain why "the best guy in the space" is suddenly the worst. This can be a significant risk.

Last year, the managed futures asset class was up 20%, but around a fifth of mutual funds and ETFs actually lost money, according to Bloomberg[i]. In the 2010s, the most popular single-manager fund underperformed the index by 20% over five years. Some investors have told us that dealing with a single manager problem child can mean a 5% allocation consumes 30% of your time through the work required to justify the decision and deciding if or when to redeem, for example.

This landmine is particularly tricky because most mutual funds today look better relative to the index. Unfortunately, that's largely a function of the fact that the industry regularly shoots the wounded; 40% of mutual funds and ETFs from five or six years ago are gone today. The dead funds, obviously, mostly underperformed.

The cold statistical reality is that recent stars are no more likely to outperform, and just as likely to end up near the bottom of the pack at some point. Plus, given how this industry works, investors can get barraged with calls about a top performer, not the fund that lost money last year, and the pitch will be "we built a better mousetrap" rather than "we got lucky." Caveat emptor.

Many battle-hardened investment veterans have figured this out and today pick two to four single managers. It takes more time to monitor, but we hear it's worth it to reduce the so-called problem child risk. For those who want a single line item to fill the strategy bucket – in essence, outsource single manager diversification – we encourage you to consider one of the few available multi-manager mutual funds or replication.

The multi-manager pitch is that they can provide valuable diversification and select managers who, on average, will outperform the index enough to offset higher fees. The replication approach is to mimic the core positions of a representative basket of leading hedge funds and potentially outperform through fee and expense savings.

From an asset allocation perspective, we believe that the asset class has potent long-term diversification benefits; single manager funds generally will not due to idiosyncratic risk. That distinction is critical when formulating a strategy to invest in the space.

[i]2022 performance of constituents of the Morningstar US Systematic Trend index. Bloomberg data.

9.

Fees and expenses can increase the risk of dead money

Few care about fees in good years and fees often seem secondary when evaluating a fund on a hot streak. But as a long-term allocator, they can matter a great deal. In particular, it's the tough years when people start asking questions. In choppy seas, the asset class might deliver 3-5% per annum over cash, but no better than cash after fees and expenses.

That was a huge problem during the "long winter" in the late 2010s, when cash was earning roughly zero and, hence, clients made zero. Mutual funds generally have higher management fees than the hedge funds in the index, but no performance fees; ETFs tend to be less expensive.

There's no perfect answer here. Some of the better performing mutual funds in 2022 had high fees, as did some of the worst. Lower fees in some products were cold comfort after years of persistent underperformance. We think the fee question plays out in a few ways.

First, lower fees can matter a great deal when investors are judged in part on the all-in cost of investing. Second, investors may be more patient during those inevitable lower return periods, it just grates on people when it looks like everyone is making money but them. Finally, all things being equal, capital grows more over time. By way of analogy, at the institutional level, the largest allocators rarely pay headline fees and hence typically outperform the index, which gave rise to our expression, "in hedge funds, fee reduction is the purest form of alpha."

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Summary

In 2022 the volatility that we witnessed left few areas of the market unscathed and made many investors feel exposed. Managed futures proved to be one of the few bright spots, offering positive returns that bucked the broad market trend. Indeed, over the long term, managed futures as an asset class have delivered steady returns, capturing most of the upward movement of markets during good years, and mitigating the downside in bad years. As these strategies become more accessible to a wider group of investors, managed futures can be increasingly viewed as a potential diversifier in a portfolio, offering low correlation to equities and bonds.

DBi manages a range of liquid alternative strategies. iM Global Partner's managed futures strategy has been recently launched as a UCITS fund offering daily liquidity. For more information contact **client_services@imgp.com.**

About the author

Andrew Beer has more than 25 years of experience in the hedge fund industry. Over the past decade he has focused on identifying strategies to outperform leading hedge fund portfolios with low fees, daily liquidity and fewer downside risks.

Andrew is Managing Member of Dynamic Beta investments LLC, a pioneering replica hedge fund firm, and co-manager of the firm's strategies.

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