Decoding the Myths of Managed Futures

Summary

This paper examines five very popular myths and misconceptions held by both retail and institutional investors regarding managed futures. These myths have persisted for several years. As investors are becoming more aware of the potential use of managed futures for asset allocation and portfolio diversification, knowing if the myths are true or false, is critical for an investor's understanding and appreciation of managed futures.

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With the growth in managed futures and commodity investments, many old myths still persist. This is a good opportunity to dispel these myths.

I recently participated in a panel discussion on managed futures at an investment forum for institutional investors. I found many misconceptions and myths regarding managed futures still exist. I thought this would be a good opportunity to examine some of those myths.

Even though managed futures as a sector of hedge funds is the fastest growing sector based on assets under management as reported by BarclayHedge. (See chart). The sector has grown by 600% since 2000. A fair amount of the recent growth in managed futures has been driven by the increasing interest for commodity related investments. Since 2008 many investors are realizing increased portfolio diversification and a decrease of correlation risk are needed components for their portfolios to reduce negative tail risk.

Below are some of the myths and misconceptions of managed futures:

1. *Mysterious "black box" trading systems*
2. *Managed futures are a hedge or insurance against equities*
3. *Only commodities are traded*
4. *Managed futures are risky and volatile*
5. *All Commodity Trading Advisors are the same*

The discussions below are tendencies of the managed futures industry. Results may vary with individual managers.

Black Boxes

Over the years I've heard investors or allocators state "we don't understand or can't get comfortable with the systematic trading models," and "they are black boxes, so we stay away from them." Systematic trading models are quantitative computerized trading models. In earlier years, many CTAs were cautious of fully explaining their models due to replication risk. However in more recent years there is a trend towards CTAs explaining their models. But the transparency by the CTA is not enough. It also involves the investors and allocators to do their research in understanding the concepts and terminology of the asset as they do their due diligence, just as they would for any other investment.

Hedge or Insurance Against Equities

Many believe that managed futures are a hedge or insurance against equities. This is not true. CTAs tend to be non-correlated to equities. This means their returns are independent of equity returns. The independent returns are primarily due to CTAs trading various commodity and financial markets and they can be long, short, neutral or spreading in those markets.

In the last 20 years managed futures have shown moments of having a strong positive correlation to equities and in other moments a strong negative correlation to equities. But they tend to show positive performance when there are "shocks" to the various markets or the economy such as in the early 2000's and in 2008. A CTA does not care about the direction of the market they trade, but only that there is enough of a move to create a profit.

Only Commodities Are Traded

Because the managers who trade futures are called Commodity Trading Advisors (CTAs), there is a myth that only commodities are traded. Some CTAs do trade only commodities or only trade one market or sector such as corn or the grain sector. But many trade only financial futures such as stock index futures, bond futures or currency futures or forwards. Diversified CTAs may trade both financial and commodity futures.

Managed Futures Are Volatile

Some CTAs can be volatile, just as any other investment has the potential to be volatile or risky. However, if you look at volatility in terms of the Sharpe ratio and or standard deviation than you are also assuming the return distributions are a normal (bell-curve) distribution. CTAs may have low Sharpe ratios, high standard deviations, thus one would believe they are very risky and volatile. However, the low Sharpe ratio and high standard deviation are often derived from positive skewness of the return distribution due to risk management policies.

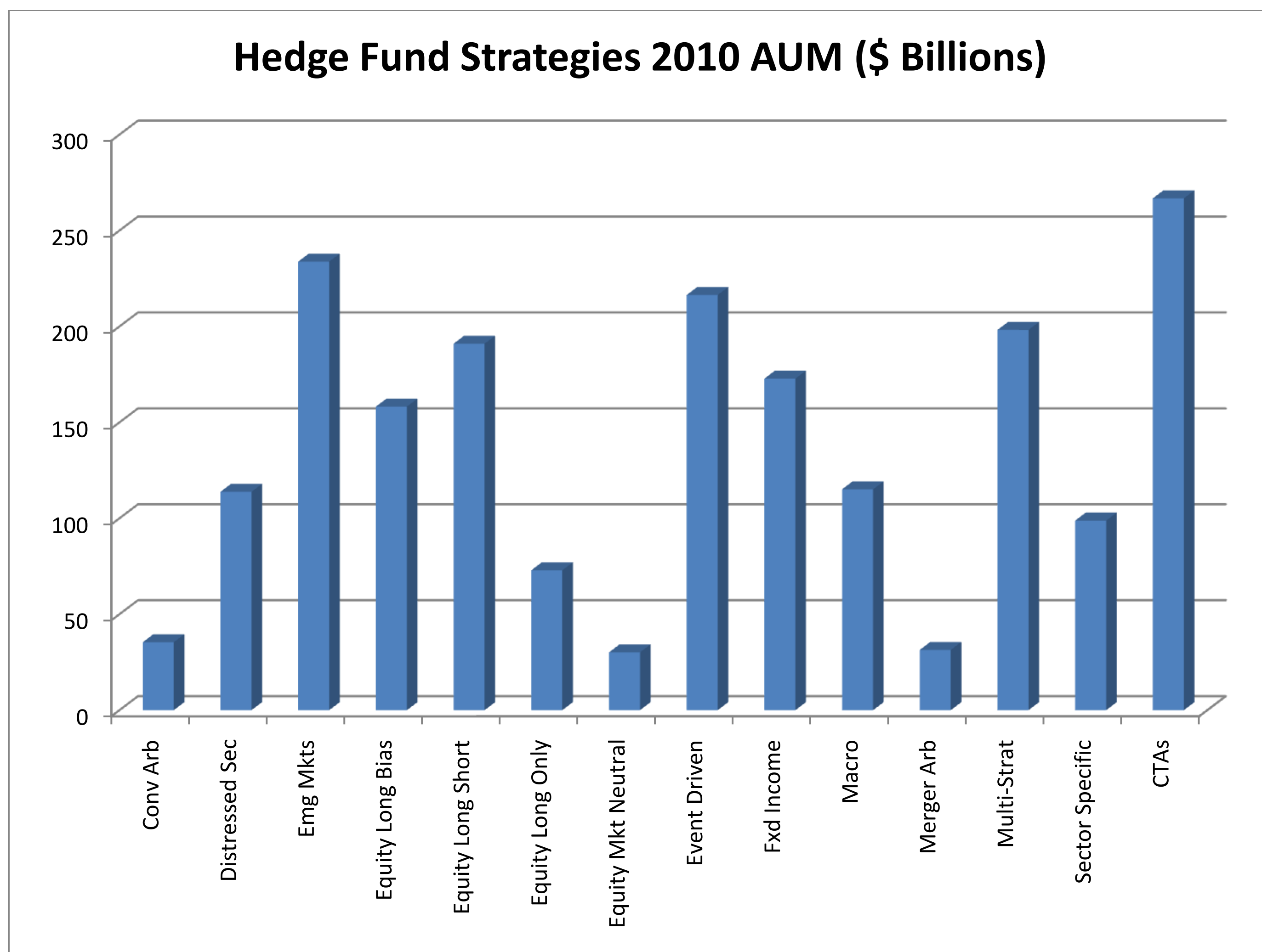
One must understand the source of volatility returns. Volatility is similar to cholesterol; there is good volatility and bad volatility. Good volatility is derived from positive returns and the bad

volatility derived from negative returns. The Sortino ratio and S-ratio are probably more informative in understanding risk-adjusted returns for a non-normal distribution than the Sharpe ratio or standard deviation.

Managed Futures Funds Are All the Same

Some investors will ask "why do I need to invest in more than one CTA? Aren't all trend-followers the same?" The answer to that is NO! This topic can be detailed in a separate discussion, but they are not all the same for some basic reasons: 1) Some CTAs may trade different markets or varying number of markets. 2) Their time horizons or average trade duration may vary. 3) How they get into or out of positions may vary. 4) How they manage risk, one of the most important components of the trading system may vary among the CTAs.

In summary, we have discussed some of the myths or misconceptions that have persisted over the years regarding managed futures. As the industry has become more transparent of their research and demand for non-correlated assets have increased, there is need for investors to do their research, understand the product, as they would with any other asset class they explore to invest in and understand the profile of the managers they investigate.



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