

Institutional Investor Interest in Managed Futures

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June 1999

Many institutional investors have become convinced over the last several years that a portfolio limited to stocks and bonds is not sufficiently diversified to withstand the damage that a significant financial market reversal can inflict, even if the portfolio includes a broad range of sectors and international issues. The short-lived financial crisis of late summer 1998 confirmed that, under conditions of extreme pressure, almost all asset correlations increase sharply, including those of many hedge funds that had been considered market neutral.

The nearly uniform reaction of traditional asset classes to severe market stress should not have been a surprise, but many investors were disturbed by the failure of their stock and bond diversification strategies to provide substantial non-correlated relief. Hence they feel that additional means must be identified to achieve true diversification.

When investors search for effective diversifying assets in the world of alternative investments, as many do, they may recognize that managed futures offer unique diversification or even insurance-like portfolio properties. Academic and empirical evidence shows that managed futures is *positively* correlated to traditional portfolios when they do well and *negatively* correlated when they do poorly. This property results in superior protection in extreme market environments and, overall, offers true non-correlation and improved risk adjusted returns in a portfolio with the addition of managed futures. A recent study from the Center for International Securities and Derivatives Markets at the University of Massachusetts, Amherst, titled "Alternative Investments in the Institutional Portfolio" by Thomas Schneeweis and Richard Spurgin, documents these diversification properties.

Dr. Schneeweis, a professor of finance at the University of Massachusetts, also edits a new *Institutional Investor* journal, *The Journal of Alternative Investments*. The Summer 1998 edition included the article "Dealing With Myths of Managed Futures", that addressed the myths about managed futures relating to performance persistence, benchmarks, exaggerated perceptions of risk, and the impact of survivorship bias on historical data.

There has been considerable progress in the last few years in educating institutions about managed futures. The Alternative Investment Management Association (AIMA), based in London, the Managed Funds Association (MFA) in Washington, D.C., and several exchanges have conducted research-driven educational programs for institutional investors. The New York Mercantile Exchange hosts an ongoing series of investor roundtables that bring together institutions, family offices, and consultants to learn about managed futures, commodity-indexed investments, and hedge funds, in a marketing-free environment.

Clearly, there has been no headlong rush into managed futures across the institutional world. There are distinct signs, however, that serious interest is growing. The summer of 1998 may have planted the seeds for the acceleration of this trend, with a variety of institutions now looking seriously at managed futures. Fiduciaries in the midst of making recommendations to their investment committees and boards about managed futures are understandably reluctant to speak on the record. Some have, however, shared their views informally for this article, along with those who are quoted. In addition, the 1998 National Endowment Study, an annual survey by the National Association of College and University Business Officers, lists several endowments currently allocating funds to managed futures. They are Norwich University and Bowdoin College.

Several events converged in the last nine months to set the stage for increased institutional investment in managed futures over the next few years: the financial market stress of summer 1998; important academic papers¹ that strengthen the case for this strategy; and the increasing trend toward the financial engineering of managed futures products into more institutionally attractive investments, either on an absolute return basis or indexed to a passive benchmark.

THE EXPERIENCE OF INSTITUTIONS ALREADY IN MANAGED FUTURES

Some institutions have long considered managed futures to be a suitable investment strategy. "We view managed futures as a legitimate asset class and therefore it belongs in our asset allocation," says Richard Huddleston, investment analyst for the City of Detroit Retirement Systems, which has allocated funds to this strategy for 11 years. Mr. Huddleston points out that when the S&P 500 was down 10% in the third quarter of 1998, the Detroit system's managed futures component was up 32.2%

Chris Caswell, director of corporate financial services at VIA Rail Canada, an institutional investor in several types of managed futures products, reports that it has been a "favorable experience" for VIA Rail. The program is in its fourth year and has delivered "solid, competitive returns at low risk". Mr. Caswell says that his institution benefited from exposure to this strategy in late summer 1998 when VIA Rail's portfolio overall was down 10.3% and the managed futures component was up 7.6%. He feels that with this degree of negative correlation under market stress, even a relatively small allocation to managed futures can provide meaningful relief to a portfolio.

The San Diego County Employees Retirement System has 5% of its assets in managed futures. Its approach is to use the strategy as an overlay, to exploit the transportable alpha generated. The overlay approach means that no specific allocation of cash is required, and the return is applied to the portfolio as a whole. SDCERS managed futures component, like that of the City of Detroit Retirement System and VIA Rail, provided positive returns that were negatively correlated with equities in the third quarter 1998.

1 The papers are "Pricing Trend-Following Strategies: Theory and Empirical Evidence" by David Hsieh and Bill Fung, described later in this article, and "Managed Futures as an Asset Class", by Franklin Edwards and Jimmy Liew of Columbia University. The Hsieh & Fung paper was awarded a prize by the International Association of Financial Engineers, funded by the Fisher Black Memorial Foundation.

Thomas Conroy, chief investment officer at Children's Hospital of Philadelphia, ran a portfolio that included managed futures in his previous position at ConRail. ConRail first began including managed futures in 1994 and remains invested. Mr. Conroy notes that the performance of managed futures last summer certainly helped to strengthen its appeal.

THE EFFECT OF 1998'S MARKET TURMOIL ON INSTITUTIONAL ACCEPTANCE

The August through September 1998 financial turmoil proved to be a major real-time "stress test" for managed futures, in the view of Barry Goodman, executive vice president of The Millburn Corporation, a large alternative asset manager. Commodity Trading Advisors (CTA's) as an industry passed the test with flying colors. When the S&P 500 was down 15% in August, the Barclay Diversified Traders Index was up 10% (the index had a compounded annual return of 14% from its January 1987 inception through 1998).

The result, according to Goodman, is that "although the focus shifted back to equities with the recovery in that asset class, some large institutions are starting their due diligence process and laying the groundwork to enter managed futures." The strong performance of this strategy was not lost on the institutions that already had managed futures on their radar screen.

James Little, executive vice president of Campbell & Co., a large CTA, sees growing interest from institutional investors, but he finds it hard to pinpoint the reason for the increase, other than good returns.

Some plan sponsors go the route of allocating to one or more fund of funds, which diversify by allocating to hedge funds of various styles and strategies and are increasingly considering adding managed futures to the mix. A large corporate plan sponsor in New York, one whose name is a household word, has its alternative investment allocation, about 10% of assets, in 10 fund of funds encompassing 25 to 30 strategies, including managed futures. It has used this approach to alternatives since 1994.

INSTITUTIONAL QUESTIONS ABOUT THIS ALTERNATIVE STRATEGY

Philip Halpern, chief investment officer at the University of Chicago, said three years ago that unless managed futures overcomes several specific obstacles it would not be likely to be widely accepted by institutions. One obstacle he saw was the perception that "there is not a sustainable, exploitable reason to invest in the underlying instruments." Another obstacle was "the absence of a universally accepted benchmark that can act as a default position and as a performance measurement tool."

Since that time, several academics have done research which has clarified the underlying source of returns to managed futures, and a passive commodity index that has been around for years has become more widely recognized as meeting the criteria of a legitimate, investable benchmark. Other benchmarks are sure to follow.

Recently, Mr. Halpern said that fiduciaries are increasingly open-minded about non-traditional investments and their diversification value. Other CIOs agree, noting that endowments have collectively been the leader in moving into alternatives, though this generally means private equity and real estate. Certain major endowments, such as Yale University, have large allocations to alternatives.

Anne Casscells, chief investment officer of Stanford Management Company, which manages the Stanford University endowment, feels that the managed futures discussion is being taken more seriously now than in the past, as the events of 1998 suggest it should. She remains skeptical, however, of the inherent return argument that some CTAs and academics make about managed futures and about the concept that these managers take on the volatility of commercial market participants.

There is no guarantee that the strong and growing interest in the more well-established alternatives like private equity and equity hedge funds will translate into allocations to managed futures, but with alternatives in general enjoying much broader acceptance among institutions, it is more likely that investors will consider this strategy. This is especially true for institutions that look for transparency and liquidity at both the instrument and fund level.

At an alternative investment conference in London in early 1999, Mr. Halpern, the University of Chicago CIO, said that some of his counterparts have a wait-and-see attitude about absolute return strategies, including managed futures products that aim to deliver unbenchmarked returns. But he feels that if several major institutions were to invest in the strategy, it could lead to more widespread interest.

THE STATUS OF INSTITUTIONAL INTEREST

A balanced assessment of why managed futures has not yet captured the imagination of a majority of institutions must consider the general as well as the specific obstacles to wider acceptance. It should be noted that institutional acceptance of *any* non-traditional asset class or strategy is an inherently slow process. If a 'needs assessment' is done, followed by re-formulating the investment policy and then conducting an asset allocation study, the overall process can take years. Even when a decision is made to allocate, the process of manager selection itself can require an extensive and time-consuming search.

Why have institutions not embraced managed futures more aggressively? Some specific criticisms are reasonable, while others are based on misperceptions.

Fees Institutions have often said that CTA fees are too high. Tom O'Donnell, managing director of Chesapeake Capital Corporation, says that while managed futures fees are higher than those of traditional institutional products, this is just as true of hedge fund and private equity fees. He adds that managed futures returns are reported net of all costs, while other investments are less inclusive, perhaps giving an unbalanced sense of how they compare. Amy Hirsch, chief executive officer of Paradigm Consulting Services LLC, points out, "Numerous hedge funds allocate expenses directly to the fund that would normally be absorbed by the management fee. When you identify these, it can drive the management fee up to a level of 2 to 3%, which is comparable to or exceeds CTA fees."

The Mystery of the Black Box Institutions have long said that CTAs as a group have not adequately explained how their strategies work, how they make money. This can leave the impression with investment committees and CIOs of a black box system. Coupled with the traditional institutional bias toward discretionary managers, this can do more than just torpedo any allocation to a given manager. It can leave a mistaken impression about managed futures in general. Most institutional investors would not consider allocating funds to a strategy they do not fully understand. Thomas Conroy, the foundation CIO, and another endowment executive, recently commented that CTAs

in general have to do much better in explaining their own strategies if they want institutional allocations. It is often *not* intuitively clear to many institutions what drives the returns. This is a common theme in the comments of investors: Explain your strategy clearly to us and make us comfortable with it.

Source of Returns: Are managed futures returns skill-based or inherent?
Some investors have asked: What is the source of returns of trend managed futures? This goes deeper than asking a manager how he or she makes money. This goes to the heart of this or any strategy. One view is that returns are a result of manager skill, making anything over the risk-free rate pure alpha. The difference in performance between the top and bottom quartile of CTAs is far greater than the difference between traditional managers, suggesting that skill plays a larger role than in traditional markets.

Another view is that there are inherent returns in futures markets that good managers consistently capture. As with every debate, the truth is often between the extremes. A strong case can be made that good managers apply skill in risk control and trading system design to markets that have inherent returns. This is not different in principle from traditional money managers applying skills in stock selection to beat their benchmark, adding their own alpha to the long-term systematic return of owning equities.

An investment executive for one of the largest U.S. corporate plan sponsors believes there is a good chance his institution will allocate funds for systematic trend following CTAs. He believes that there *is* an inherent return in the futures markets, after considering why the consistently good returns and relatively low volatility of momentum approaches, like the MLM Index, for example, should persist for so many years if there were no sustainable economics underlying the returns. This investor believes these results are evidence of the inherent returns generated over time when commercial market users seek to shed the volatility they are faced with in their business by transferring it at a discount to investors who accept and then become long the volatility.

Alan Kaufman, president of Trilogy Capital Management, is a long-time advocate of the view that there are inherent returns in futures markets. He has found that institutions are more comfortable with this than the concept that managed futures is a skill-based investment. Mr. Kaufman developed the Barclay Futures Index, which like the MLM Index (developed by Tim Rudderow in 1988 at Mount Lucas Management) is a passive, long/short, unleveraged, diversified approach to futures markets.

The plan sponsor views trend followers as owners of disaster insurance, who make the bulk of their returns in extreme market moves. Investors who include these trend followers in their portfolios thus purchase protection from financial market disasters. He contends that investors should not go chasing the star managers, but rather establish a portfolio that is broadly diversified and that includes trend followers, many of whom are adept at systematically positioning themselves to exploit major market dislocations like that of summer 1998. Many CTAs were ideally exposed in a variety of markets, including being long U.S. Treasuries and short physical commodities, leading to significant positive returns at a time of near panic in financial markets.

The paper referred to earlier, by David Hsieh, professor of finance at Duke University's Fuqua School of Business, and William Fung, a principal of Paradigm Financial Products, aims to answer the question, "How do 'trend followers' generate returns which are uncorrelated with stocks and bonds, yet have positive returns during downturns in the world equity markets?" The authors develop a simple trend following

option model that “captures essential features of ‘trend following’ CTAs” and addresses the source of returns issue. They characterize CTAs as ‘active’ trend followers, since they typically outperform the options-based benchmarks described in the paper.

Some investors and CTAs view managed futures as a skill-based strategy entirely. Although many institutionally popular hedge fund strategies are acknowledged to be skill-based, the criticism that skill is not a sufficient reason to invest has been, perhaps unfairly, limited to managed futures. This may in part reflect the fact that most hedge fund managers, even when applying non-traditional strategies, do so in traditional markets, whereas many CTAs employ derivative-based strategies almost exclusively. In addition, hedge fund managers are more likely than CTAs to have come out of the institutional world and to speak its language. The language of managed futures is in some respects different, but the identical quantitative tools and framework can be used to measure and compare performance.

Is there a managed futures benchmark? The issue of a managed futures benchmark that was mentioned by Philip Halpern may be resolving itself with the increasing acceptance of the MLM Index as a proxy for the passive returns inherent in futures markets. This index has seen an increase in institutional interest in the last year, according to Raymond Ix, senior vice president at Mount Lucas Management. MLM has nine institutional clients investing in the MLM Index and is receiving an increasing number of inquiries from others in the wake of last summer’s market turmoil. The investor list includes Oklahoma Police Retirement System, Detroit General Retirement System, San Diego County Retirement System, National Westminster Bank, Ashbridge Corp., VIA Rail, Detroit Edison, and the Bank of America.

Mr. Ix points out that “investing in an index such as the MLM Index is a way for institutions to walk before they run with managed futures.” He says that the portfolio diversification properties of the index are illustrated by the fact that, in every year in which the S&P 500 had a loss in the 1961 through 1998 period, the MLM Index showed substantial profits. The most recent year in which the S&P 500 was down was 1990; in that year the MLM Index was up 16%. In 1994, a notoriously treacherous year for hedge funds and any strategy tied to fixed income investments, the MLM Index was up 11.3%. The S&P 500 was up 1.3% that year.

THE ADVANTAGES OF MANAGED FUTURES OVER OTHER ALTERNATIVE INVESTMENTS

Mark Yusko, chief investment officer at the University of North Carolina, believes that institutions sometimes accept serious risk in more widely held asset classes, such as small cap equities or emerging markets, while overlooking strategies that exhibit sound returns and lower risk, like managed futures. Sol Waksman, president of Barclay Trading Group and author of an industry newsletter, gives an example of Yusko’s point. The Barclay CTA Index had about half the volatility of the EAFE index (Europe, Australasia, Far East), while exhibiting a much lower correlation with the S&P 500 (.03 vs. .48) for the period of 1980 through 1998. It is thus a better diversifier with lower risk. Yet investors more comfortably embrace EAFE.

Yusko has been observing managed futures for five years. He likes the risk/return profile, and he cites their good liquidity as well as the positive skewness of their return volatility. He believes continued education is the key to conveying the message to fiduciaries.

Tom O'Donnell, prior to joining Chesapeake, ran the managed futures allocation at the Virginia Retirement System, and he therefore brings plan sponsor experience to the effort to educate institutions about this strategy. He sees in his own contact with institutions that acceptance is growing, but investors still struggle with how to characterize managed futures, with which asset allocation box to put it in. He believes that the way to make managed futures more widely accepted is to make it more "tangible." When the strategy is packaged within a structured note that offers a principal protection guarantee from a major financial institution, investors can put managed futures into their fixed income portfolio. The source of the yield would possess the diversification properties of managed futures, yet the instrument would not degrade the credit quality of the investor's fixed income portfolio, as high yield or emerging market debt might. In fact, it might enhance it. "The beauty of managed futures is in its flexibility – the ability to transport alpha across a portfolio, to create total return swaps or enhanced index products," says Mr. O'Donnell.

He contends that when investors focus on volatility without taking skewness into account, they get a very misleading picture of managed futures. UNC's Mark Yusko agrees. Research has shown that managed futures volatility from 1980 through 1998 was *lower* on the downside than that of the S&P 500. In their profitable periods, CTAs had higher volatility, but the volatility was exploited to their advantage.

Jerry Harris, a principal of the Welton Investment Corporation, agrees that it is the flexibility of managed futures products that will be the key to their eventual acceptance by a wide range of institutions: "AA-rated bank-issued principal guaranteed notes whose returns are tied to one or more CTAs are an efficient way to generate alpha on what is actually a fixed income product. These products can be financially engineered into structures that have great appeal to traditional investors." And, Mr. Harris says, "On a qualitative level, managed futures satisfy several investor criteria: liquidity, transparency, and lack of counterparty risk. These points come up again and again with institutions in the aftermath of various high profile hedge fund losses."

According to Virginia Reynolds Parker, president of Parker Global Strategies, institutions that were following managed futures "out of the corner of their eye," suddenly took greater notice after last summer. "Strategies that many investors had counted on to deliver consistent absolute returns turned out in a time of crisis to be alarmingly correlated to the equity markets and to be subject to spread risk that was previously unrecognized."

Ms. Parker, who travels frequently to Asia and has raised substantial capital in the region, observes that Japanese institutions have taken a hard look at managed futures and they like what they see. They find it significant that specific return targets can be established because notional funds can be calibrated. If an investor is satisfied targeting a 10% return instead of 15 to 20%, they can overfund their investment and get more diversification benefits.

WHAT WILL THE FUTURE BE LIKE FOR MANAGED FUTURES?

Alan Kaufman of Trilogy believes that there is huge untapped potential for institutional investment in alternative investments. But he argues that the industry must evolve to tap the potential.

Mr. Kaufman's vision of the future is based on the growing institutional appetite for indexed investments of all types. Managed futures products that are indexed and feature institutional-type fees will be the focus of interest over the next several years, as the blue chip investment management firms move into this area, recognizing that they can charge fees higher than what they are used to getting and still offer products substantially cheaper than conventional managed futures programs. Kaufman thinks these investment firms and banks that already have strong relationships with institutions will structure principal guaranteed products whose returns are tied to the MLM Index and the Barclay Futures Index. This will be the "dominant dynamic of the future."

Mr. O'Donnell of Chesapeake points out that another possibility is for CTAs to embrace the concept of enhanced indexing and compete directly with traditional money managers on performance and fees. There are a number of equity and bond futures contracts that can be used to generate the investor's benchmark returns. For example, "by equitizing a managed futures investment with S&P 500 futures contracts the investor can establish a tangible benchmark return. The historical evidence shows that managed futures returns are not highly correlated with equity and bond market returns and therefore represent a unique, and perhaps complimentary, source of active management. When you combine a CTA's returns, on a de-leveraged basis, with S&P 500 futures contracts, the result closely resembles an active, U.S. equity manager."

As with all active money management products, the end result will depend on the manager's ability to generate alpha. Finally, using enhanced index products, investors can align their cost of investing with performance, by paying the CTA an incentive-only fee based on the performance they generate in their active managed futures account. Mr. O'Donnell believes that institutional investors who educate themselves on managed futures may ultimately have a difficult time rejecting it because the positive evidence for the strategy's role in a portfolio, in combination with its unique flexibility, is compelling.

Interview with Verne Sedlacek, President & C.O.O., John W. Henry & Co.

Verne Sedlacek spent fifteen years as the chief financial officer and executive vice president at Harvard Management Company, which serves as investment manager of the \$14 billion Harvard University endowment. He left Harvard in July 1998 to become chief operating officer at John W. Henry & Co., the largest CTA, with \$2.4 billion under management.

Sedlacek's experience at Harvard, combined with his current position in the managed futures industry, gives him a unique perspective, as well as a personal knowledge of how institutions view alternative investments, including managed futures.

While at Harvard, he discussed managed futures with various CTAs, trying to understand how they make money. He came to the conclusion that managed futures is the "most intellectually pure strategy" out there. His interest was piqued by several managers who argued that there were inherent returns to futures markets, independent of manager skill that flowed from capturing volatility in times of market dislocations. Investors, they said, provide a traditional risk transfer service and should expect to be paid for assuming price volatility.

Sedlacek thinks there is a reasonably substantial increase in investors' willingness to pay attention to the managed futures argument. But he too believes the burden is on the managed futures industry to make their case clearly and persuasively. CTAs must explain where they fit into a diversified institutional portfolio and how return patterns are generated.

He thinks structured notes are an effective way to bring institutions into this alternative strategy, to "get their toe into the water."

After thinking about managed futures while at Harvard and then studying the strategy very close-up at JWH, Sedlacek concluded that, "The pattern of returns generated by managed futures differs substantially from any other readily available investment vehicle in the marketplace today. The diversification benefit of managed futures relates directly to the fundamental underpinnings that drive returns; that markets are unstable and will seek new levels of equilibrium in enough cases to generate significant returns. This concept of divergence investing used by the managed futures industry is in direct contrast to most other approaches to investing which depend on mean reversion, convergence, and stable markets to generate profits."

