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Use managed futures to hedge against more pain

Long track record

David Pett, Financial Post
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With seemingly no end in sight for the current bear market that has cut North American equities by more than half over the past eight months, Canadian investors may want to consider managed futures, an alternative asset class that has proven an almost-perfect hedge in what has been one of the worst periods of stock performance in a century.

But market timers beware: these funds, which thrive during adversity, tend to turn quickly downward when equity markets rebound. They are also harder to come by in Canada than the United States and are prone to manager risk.

"From a timing perspective, if the current environment that we find ourselves in today continues, managed futures are likely to continue to deliver the types of stellar returns they did in '08," says Roland Austrup, president & CEO of Integrated Managed Futures Corp., one of the few investment firms in the country with a managed futures program.

"It's not just the last year and a half that they've outperformed during a downturn. If you look back at every other major crisis over the past 20 years, you'll see outperformance as well."

Often compared to hedge funds, managed futures provide exposure to globally traded futures contracts on physical commodities such as grains, livestock, metals, energies and soft commodities such as coffee, cotton, sugar and cocoa, as well as financial assets such as equity market indices, government bonds and currencies.

With US$190-billion under management globally, managed futures have been able to carve out a sizable niche for themselves, but one albeit, largely skewed towards the United States investment community.

The asset class has struggled to take hold in Canada, and remains something of a cottage industry. In Canada, managed futures are traded by commodity trading advisors or managers (CTAs or CTMs).

In 2008, the Barclays BTOP 50 Managed Futures Index CTA Index returned 14.5%, compared to -35% for both the S&P 500 and S&P/TSX Composite.

Year-to-date the index is down 0.25% compared with carnage in the equity markets. Similar scenarios of outperformance can also be tracked back through the market meltdown from October, 2000, to September, 2002, the Long Term Capital Management and South East Asia Currency Crisis in the summer of 1998 and the downturn in the summer of 1990, when Iraq invaded Kuwait.

Mr. Austrup, whose IMFC Global Investment Program returned 47.56% in 2008, says managed futures benefit from broad diversification, but also from their ability to employ unencumbered long and short positions.

Managed futures were broadly short equity markets in 2008 and continue to be so, he said. They were also long the treasury markets, both short and long term, and long the U. S. dollar and the Japanese yen for the most part against other currencies. And while

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long commodities at the beginning of the year, that turned in August and managed futures turned short.

Mr. Austrup said his positions are smaller at present because he doesn't see the same opportunities in the market that were there in 2008. In particular, he is no longer short the stock market, but instead, neutral.

"Our data says the opportunities on the short side are far less. Not that it can't go lower, but at this point it is susceptible to strong bounces."

Like many investment, investors in managed future are susceptible to a high degree of manager risk, especially given the considerable exposure to frequently volatile stock markets. As Phil Schmitt, CEO of Summerwood Group, puts it: "If you're a manager who follows trends, and there's all of a sudden no trend, then returns will be eaten up pretty quick."

Even Mr. Austrup agrees when the current crisis stabilizes, managed futures could take a dive.

Managed futures tend to do well when a macro event infiltrates markets and drives correlations up. But when that period ends, marked by a bottom in equities and a bear market bounce, all the things that work in favour of managed futures tend to work against them.

Of course, smart investors, Mr. Austrup adds, needn't be worried, because a properly diversified portfolio will get the bounce from the equity market.

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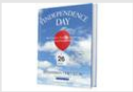

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