DRS vs. Managed Futures

Compare and Contrast Strategies

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Managed Futures - Fad or Innovation?

One of the more esoteric challenges facing today's investors and financial advisors is to keep up with the rapid evolution of the products and solutions available. Some innovations, like exchange-traded funds, are game-changers and have gathered trillions in assets. Others turn out to be nothing more than fads (anyone remember the hype surrounding 130/30 funds?).

Until new investment strategies become more established, the easy way out is to lump them all together in the loosely defined category "liquid alternatives." Since the Financial Crisis of 2007-09, there has been an explosion of strategies labeled "different."

One of the hottest categories in the loosely defined liquid alternative space is **managed futures**. According to Morningstar, there are currently 144 mutual funds with an aggregate $29.5bn dollars in this category, a significant increase from five, or even three years ago.

Date	Fund Count	Total Assets
12/31/2007	3	$ 244,095,563
12/31/2008	3	$ 1,252,311,006
12/31/2009	5	$ 2,329,754,577
12/31/2010	18	$ 3,902,955,164
12/31/2011	54	$ 8,287,974,972
12/31/2012	77	$ 9,109,816,357
12/31/2013	99	$ 11,871,450,624
12/31/2014	125	$ 15,313,328,671
12/31/2015	139	$ 23,576,291,595
12/31/2016	144	$ 29,526,034,738

Source: Morningstar Direct

Swan has been publishing a Strategy Comparison blog series (see links below) on the pros and cons of different liquid alternative strategies. We will discuss:

1. What are the drivers of returns in each strategy?
2. What are the risks in each strategy?
3. What role does a given strategy play within a portfolio?
4. How does the given strategy compare to the Defined Risk Strategy?

Drivers of Returns: When it comes to managed futures, returns are generated in the derivatives market. In fact, many managed futures funds have the majority of their holdings in nothing more than short-term cash positions, used to collateralize their futures positions. The futures themselves can be across a wide variety of underlying assets. Futures-based investing started with commodity futures, given the difficulty of investing in physical commodities. As managed futures strategies have become more popular, some have focused upon equity and fixed income futures. Some strategies cover both capital and physical markets.

Most managed futures strategies are momentum-based or trend-following. In other words, recent short-term direction dictates future short-term positioning. Obviously, not all managed futures are this way, but trend-following tends to be a common trait. The official Morningstar description of the Managed Futures Category is:

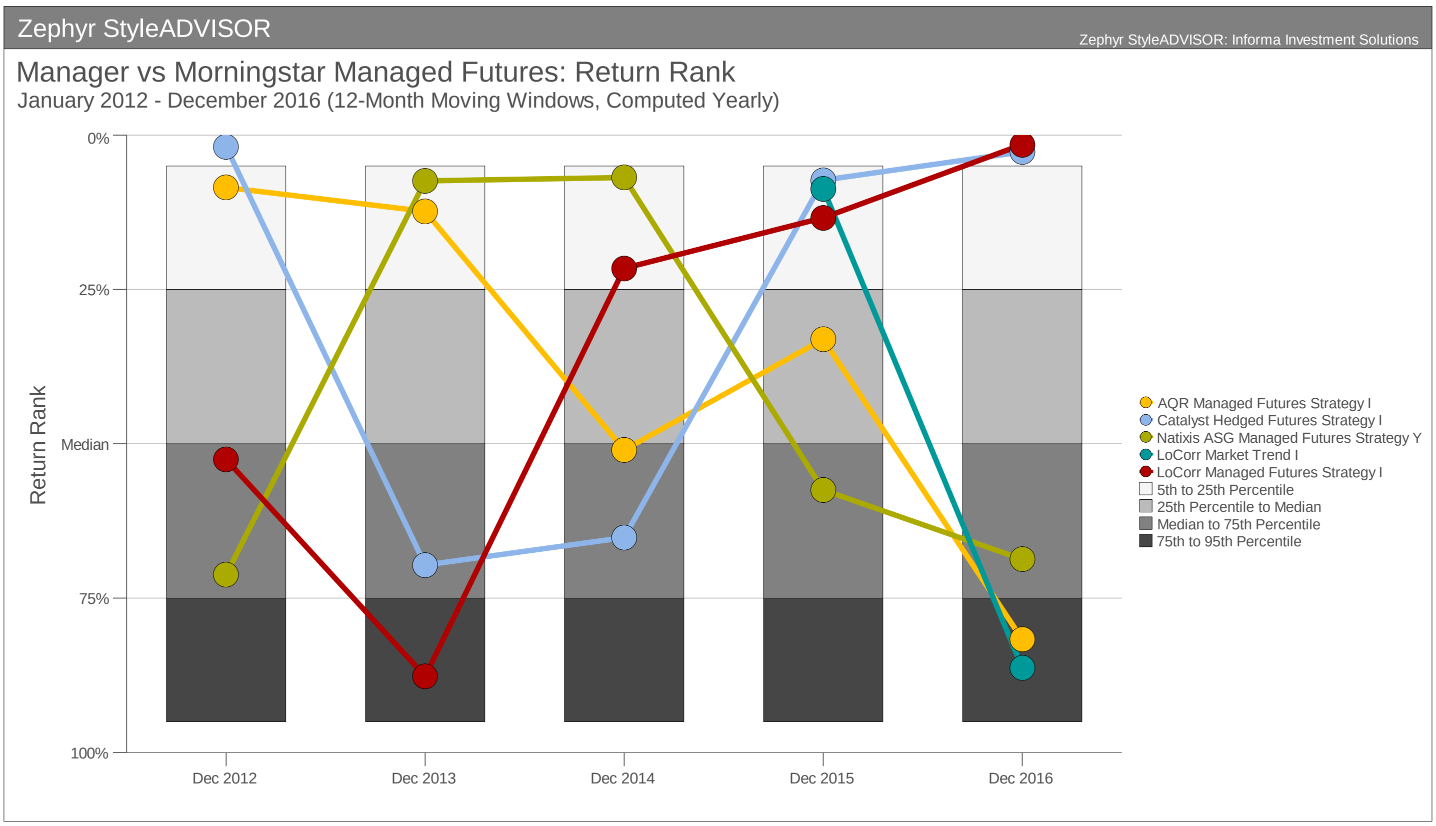
> *"Managed Futures: These funds primarily trade liquid global futures, options, swaps, and foreign exchange contracts, both listed and over-the-counter. A majority of these funds follow trend-following, price-momentum strategies. Other strategies included in this category are systematic mean reversion, discretionary global macro strategies, commodity index tracking, and other futures strategies. More than 60% of the fund's exposure is invested through derivative securities. These funds obtain exposure primarily through derivatives; the holdings are largely cash instruments."*
>
> *Source: Morningstar Direct*

Risks: Any market-timing strategy's success depends upon being one step ahead of the game. The old saying "the trend is your friend" sums up momentum strategies well. The shortcomings of such an approach, however, is that a strategy has to be smart enough to recognize a trend and participate in it as it is running, but also nimble enough to abandon the trend before it reverses or just after. This is easier said than done. While significant profits can be generated if the model is working, a reversal can just as easily erase any or all gains.

Also, the fact that some managed futures funds call themselves "hedged" is a bit misleading. Most managed futures strategies aren't hedging anything - they are making a directional bet on the performance of an asset class. It is true that in the past, many managed futures strategies have had low correlations to traditional asset classes. Added to a portfolio, an uncorrelated asset can lower overall volatility . However, that type of result would be better described as diversification rather than a hedge.

Complicating matters is the fact that most of the liquid managed futures strategies were not available during the last major market meltdown. According to the previous table, only three funds were around during the financial crisis of 2007-09. How these funds will perform during a major market sell-off has yet to be seen.

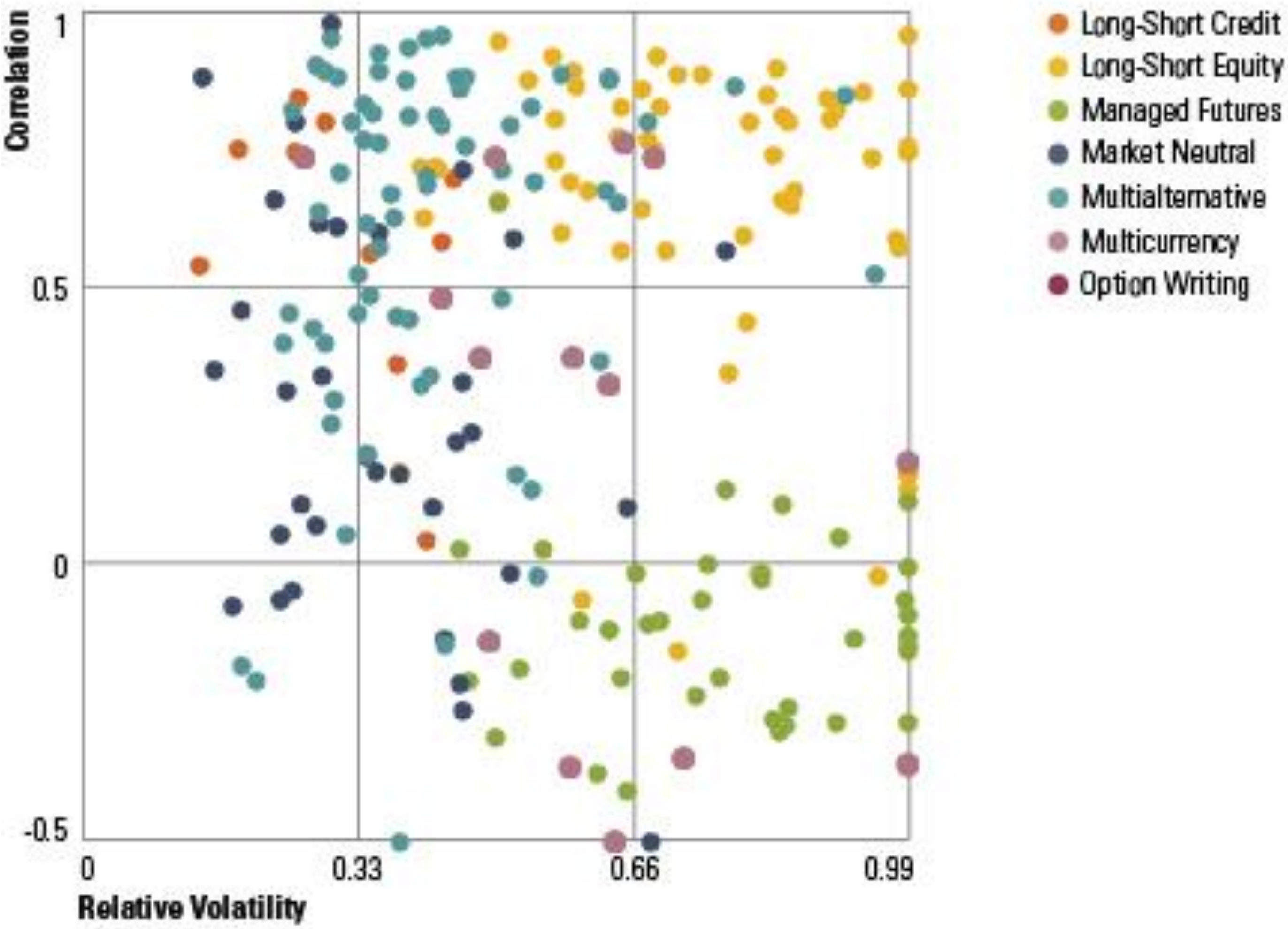
Finally, the performance of individual managed futures funds on a year-to-year basis is fairly erratic. The graph below shows where the five largest managed futures funds in terms of assets plots relative to their peer group. There isn't a lot of consistency.



Source: Zephyr StyleADVISOR

Role in a Portfolio: Broadly speaking, people use alternatives for two purposes - either risk reducers or return enhancers. Most managed futures tend to fall into the latter category, those of return enhancers or alpha drivers. Of course, this comes at a cost. Managed futures tend to be more volatile than other options. In fact, in the context of Morningstar's new alternative style box, managed futures mostly fall on the high side of relative volatility (green dots below).

Exhibit 1 The U.S. Liquid Alternatives Universe



Source: Morningstar

Managed Futures vs. Defined Risk Strategy: At this point it should be clear that the typical managed futures strategy is quite different than the DRS. The majority of the DRS's holdings are long, buy-and-hold ETF positions. Long-term puts are purchased to protect against sell-offs in the ETFs. This "always invested, always hedged" position is established because Swan does not believe that market-timing is a viable, long-term solution. Managed futures are the polar opposite, typically holding the majority of their assets in cash and seeking to outmaneuver the market based upon their short-term predictive models.

That said, because the DRS and the typical managed futures strategy are so profoundly different, one might consider mixing the two together to complement each other. The DRS acts as a risk-reducer, a beta-dampener on the portfolio, whereas an uncorrelated managed futures strategy could be used as more of an alpha-driver and diversifier. Of course, implementation depends upon the individual managed future strategy in question and a client's specific situation, but fundamentally the whole point of mixing and matching managers is bringing together a diverse set of value propositions and skill sets.

For more about how the Swan DRS compares and contrasts with other strategies, check out previous posts in our Strategy Comparison Series:

- DRS vs. Liquid Alternatives
- DRS vs. Covered Call Strategies
- DRS vs. Market Timing and Tactical Strategies

Feel free to review more information on the Defined Risk Strategy performance, or its components, call 970.382.8901.

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly Marc was the Director of Research for 11 years at Zephyr Associates.

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