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Managed futures strategies

These products have low correlation with bond and stock markets

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Financial advisors in search of ways to improve their clients' portfolio diversification should consider managed futures. These strategies provide direct exposure to futures contracts on financial assets such as stocks, government bonds and currencies, as well as on physical commodities such as energy, agricultural, industrial and precious metals, and soft commodities.

Managed futures managers can take long and short positions, trade across a broad range of markets globally and use varying degrees of leverage — strategies that are familiar to hedge fund managers. However, unlike many hedge fund strategies, managed futures strategies tend to be highly liquid and transparent.

Managed futures strategies can be categorized into four groups: discretionary, spread/arbitrage, volatility/options and systematic/trend-following.

Trend-following, which can capitalize on both rising and falling markets, is the dominant strategy, although there is a tremendous variation in the duration of the trend pursued (short-, medium- and long-term), contracts used, entry/exit points and other trading rules.

The primary rationale for including managed futures in a portfolio is the diversification effect due to their low correlation to stocks and bonds. From January 1994 through March 2011, the Dow Jones Credit Suisse managed futures index had correlations of minus 0.003 with the

S&P/TSX composite index and 0.142 with the DEX universe bond index.

This lack of correlation suggests that a portfolio with an allocation of managed futures should be more robust, achieving higher returns for a given level of volatility. In a series of portfolio-optimization runs conducted by our firm, incorporating managed futures did enhance risk-adjusted returns. Interestingly, because of managed futures' low correlation to bonds as well as stocks, these strategies earned a role in conservative portfolios as well as moderate and aggressive ones, albeit with much smaller allocations.

The diversification impact of managed futures can be particularly evident during extreme market events. Because managed futures can go short in falling markets, these strategies can achieve positive returns when equities markets are deep in the red. The ability to go long in other contracts simultaneously can augment this return; for example, the U.S. dollar and U.S. Treasury bonds often rise during a financial crisis. It's worth noting that in the final quarter of 2008, when the S&P/TSX composite index was down by 22.7%, the DJCS managed futures index was up by 10.9%.

There are myriad risks in managed futures strategies, so advisors need to do their due diligence. The futures markets are volatile; sometimes, extremely so. These are active strategies — manager, model and operational risks are present, and these can vary markedly by firm.

The greatest single risk is leverage. Futures contracts have built-in leverage, and firms use varying leverage levels depending on the return and risk targets. Highly leveraged strategies have been known to blow up entirely.

Finally, trendless markets such as those in 2009 can create prolonged, painful drawdowns.

In Canada, Man Investments Canada Corp., Integrated Asset Management Corp. (both of Toronto), Acorn Global Investments Inc. of Oakville, Ont., and Calgary-based Auspice Capital Advisors Ltd. offer managed futures products. **IE**

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