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How managed futures can help portfolios

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John Lintner, a Harvard professor, presented the seminal paper “The Potential Role of Managed Commodity Financial Futures Accounts (and/or Funds) in Portfolios of Stocks and Bonds” in May 1983. The findings of his work, namely that portfolios of equities and fixed income exhibit substantially less variance at every possible level of expected return when combined with managed futures, remain as true as ever today.

In this brief paper, we attempt to update Mr. Lintner's work by demonstrating that the beneficial correlative properties of managed futures presented in his research persist today. We also reintroduce managed futures as a diverse collection of liquid, transparent hedge fund strategies that tend to perform well in environments that are often difficult for traditional and other alternative investments.

While many casual observers most closely associate managed futures and Commodity Trading Advisors with trend following, the reality is that the strategies and approaches within managed futures vary tremendously; the one common unifying theme is that these managers trade highly liquid, exchange-traded instruments and deep foreign exchange markets. Counter-trend strategies attempt to capitalize on the often rapid and dramatic reversals that take place at the end of trends. Some quantitative traders employ econometric analysis of fundamental factors to develop trading systems. Others use advanced quantitative techniques such as signal processing, neural networks, genetic algorithms and other methods borrowed and applied from the sciences. Recent advances in computing power and technology as well as the increased availability of data have resulted in the proliferation of short-term trading strategies. These employ statistical pattern recognition, market psychology and other techniques designed to exploit persistent biases in high-frequency data. The countless combinations and permutations of portfolio holdings that these trading

managers may hold over a limited period of time also tend to result in returns that are not correlated to any other investment, including other short-term traders.

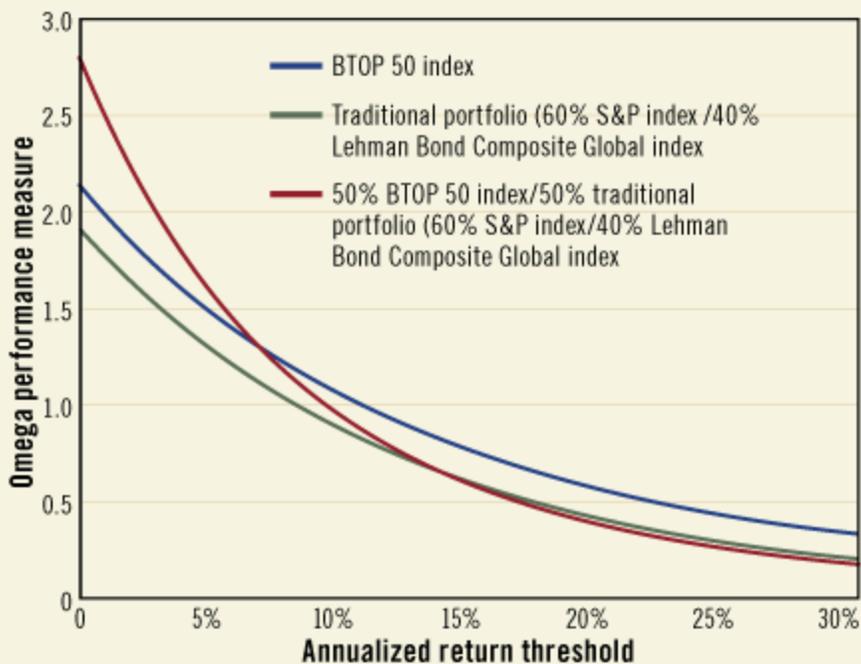
A useful analogy for different managed futures trading programs and styles, as well as for alternative investments in general, consists of thinking of each trading style or program as different radio receivers, each of which tunes into different market frequencies. Simply put, some strategies or styles tend to perform better or “tune in” to different market environments. The diverse and uncorrelated investments offered by managed futures allow institutional investors to access an entire universe of liquid transparent hedge fund strategies to add to their portfolios.

The long-term correlations among equities, fixed income and managed futures remain low even 25 years after Mr. Lintner's study, suggesting its continuing relevance to investors interested in attaining the “free” benefits of diversification. [Exhibit 1](#) illustrates the low and occasionally negative correlations among managed futures and other investments.

Studying the potential role of managed futures in traditional portfolios of stocks with the Omega lens for risk-adjusted performance takes a modern approach to the Lintner study. Mr. Lintner did not have the benefit of the Omega tool during the time he conducted his work, and the Omega function encodes all the higher statistical moments and distinguishes between upside and downside volatility, whereas the Sharpe ratio does not.

The Omega graph in **Exhibit 2** indicates that for low thresholds, the combination of managed futures and a traditional portfolio is best, and for higher thresholds a portfolio of managed futures is dominant. Moreover, a traditional portfolio of stocks and bonds combined with managed futures is superior at every meaningful threshold (i.e. where any of the graphs have an Omega score of at least one).

Exhibit 2: Omega Graph: BTOP 50 index and traditional portfolio equities and fixed income, January 1987 – September 2008



Source: AlphaMetrix Alternative Investment Advisors. Bloomberg data. Note that the Lehman Bond Composite index ceased reporting after August 2008 and therefore return information does not exist for September 2008.

These Omega results yield a very compelling argument for the inclusion of managed futures in an institutional portfolio.

Although managed futures often have produced outstanding returns during dislocation and crisis events, it must be emphasized that managed futures are not and should not be viewed as a portfolio hedge, but rather as a source of liquid transparent return that is typically not correlated to traditional or other alternative investments. Some of the different approaches taken by managed futures managers tend to exploit the sustained capital flows across asset classes that typically take place as markets move back into equilibrium after prolonged imbalances. Others thrive on the volatility and choppy price action which tend to accompany these flows. Others still do not exhibit sensitivity to highly volatile market environments and appear to generate returns independent of the prevailing economic or volatility regime. **Exhibit 3** illustrates the performance of the BTOP 50 index during periods that have historically been difficult for the S&P 500 index. (The BTOP 50 seeks to replicate the broad managed futures universe and is composed of trading advisers representing no less than 50% of the universe's investible assets.)

Exhibit 3: Performance of the BTOP 50 index during 15 worst quarters of S&P 500 index performance

Quarter	Event	S&P 500	Barclays BTOP 50	Difference
4Q 1987	Black Monday - global markets crash	-23.23%	16.88%	40.11%
4Q 2008	Bear market in equities led by financials	-22.56%	8.73%	31.29%
3Q 2002	WorldCom scandal	-17.63%	9.41%	27.05%
3Q 2001	9/11 attacks	-14.99%	4.12%	19.10%
3Q 1990	Iraq invades Kuwait	-14.52%	11.22%	25.74%
2Q 2002	Aftermath of tech bubble	-13.73%	8.52%	22.26%
1Q 2001	Bear market in U.S. equities led by tech	-12.11%	5.97%	18.08%
3Q 1998	Russia defaults on debt, LTCM crisis	-10.30%	10.54%	20.84%
1Q 2008	Credit crisis, commodity prices rally	-9.92%	5.91%	15.83%
3Q 2008	Credit crisis, bailout of banks	-8.88%	-3.71%	5.17%
4Q 2000	DotCom bubble bursts	-8.09%	19.78%	27.87%
3Q 1999	Anxiety during runup to Y2K	-6.56%	-0.67%	5.89%
1Q 1994	Fed begins increasing interest rates	-4.43%	-2.10%	2.33%
4Q 2007	Credit crisis, subprime mortgage losses	-3.82%	3.02%	6.84%
1Q 1990	Recession in U.S., oil prices spike	-3.81%	1.76%	5.57%

Source: AlphaMetrix Alternative Investment Advisors, Bloomberg

Managed futures offer institutional investors actively managed exposure to a truly global and diversified array of liquid, transparent instruments. The returns of many of these do not display correlation and do not appear to be easily explained by traditional or alternative investments. Institutional investors should view managed futures not only as a means to enhance portfolio diversification, but also as liquid absolute-return vehicles with intuitive risk management.

It is remarkable just how solid Mr. Lintner's argument has remained over the test of time. The inclusion of managed futures in an institutional portfolio leads to a better risk-adjusted performance (either through the mean-variance framework, or through the more modern Omega analysis). The results are so compelling that the board of any institution, along with the portfolio manager, should be forced to articulate in writing as to their justification in not having a substantial allocation to the liquid alpha space of managed futures.

It is also fitting that during the silver anniversary of Mr. Lintner's fine work, it survived the ultimate litmus test through the historic financial meltdown of 2008. Managed futures have been one of the very few bright spots for investments (both alternative and traditional) during this recent crisis in the economy.

Indeed, one might argue that Mr. Lintner saved his very best work for last.

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