Aon Investment Research and Insights

Managed Futures

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Executive summary

Investors looking to improve the quality of returns in their portfolio often look to make an allocation that has a low correlation to their other holdings as part of their long-term strategy. One such answer is to invest in a managed futures strategy.

A managed futures strategy:

- Takes advantage of trends in prices across a variety of markets
- Generates a diversifying return stream that may improve portfolio returns
- Can perform well in times of market stress
- Generally provides good liquidity and require small minimum investment sizes
- Has reasonable fee terms relative to its value

Managed future strategies have many different names – all used interchangeably. Common descriptors include 'CTAs (commodity trading advisors)' and 'trend followers.'

For consistency, we refer to these strategies as 'managed futures' throughout this paper.

Introduction – what is managed futures?

Managed futures is a strategy within the hedge fund universe that profits from momentum,bor trends, in prices. The phenomenon of momentum is driven by many factors, including investors' cognitive biases (such as herding), and the behaviour of hedgers and speculators in the markets.

Portfolios are unconstrained and diversified, with a broad opportunity set — encompassing global equity, fixed income, commodity, and currency markets.

Managed futures portfolios also tend to be very liquid as the securities used to implement the strategy are primarily exchange-traded derivatives contracts.

Key features

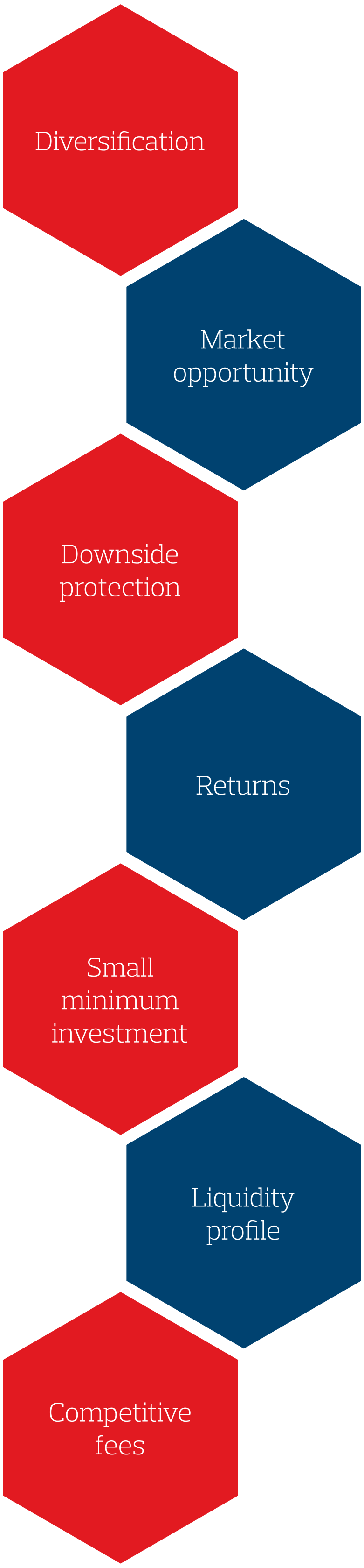
Features	Characteristics
Volatility target	Managed futures managers typically target a specific volatility level (usually between 10% and 18% per annum) rather than a return target.
Risk-return profile	Over the long-term, managed futures funds have returned a Sharpe ratio of around 0.8-0.9.
Liquidity	Managed futures is at the liquid end of the spectrum of hedge fund strategies, with funds being traded anything from daily to monthly with two days' notice.
Fees	Fees can generally range from 1% management with 20% performance fees, to more simplistic strategies that offer lower rates at a 50bps flat fee.

Why invest in managed futures?

- **Diversification**
  Managed futures has historically provided a differentiated return stream, with a very low correlation to traditional asset classes and other hedge fund strategies when viewed over a sufficient time period.
- **Market opportunity**
  Managed futures does not face headwinds due to high valuations like other traditional risk assets (e.g. long-only equities, investment-grade bonds, and high-yield bonds).
- **Downside protection**
  Managed futures funds have protected capital in times when traditional markets have taken downturns.
- **Returns**
  Managed futures has delivered strong absolute and risk-adjusted returns over the long-term.
- **Small minimum account sizes**
  Minimum investment amount is typically around $1m.
- **Liquidity profile**
  Liquidity is high, as typical implementation is via extremely liquid derivatives markets.
- **Competitive fees**
  Fees are typically lower than other hedge fund strategies. Investors have a wide range of choice when it comes to employing a managed futures mandate, and can choose between simple and more complex managed futures mandates.

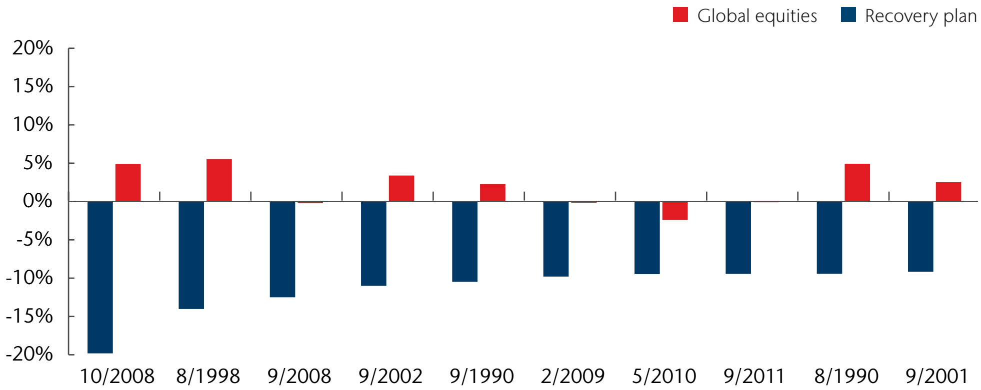
Managed futures' differentiated return profile has acted as a diversifier in volatile periods, often providing positive returns during bear markets. However, the strategy works best in providing return in a sustained market trend upward or downward, as trend followers will buy the market when it trends up and short sell the market when it trends down. Inclusion of a managed futures strategy within an investors' portfolio increases the ability to generate returns within a wider range of scenarios and economic environments.

	Global equities	IG fixed income	High yield	Managed futures
Global equities	1	0.4	0.8	-0.1
IG fixed income	0.4	1	0.5	0.2
High yield	0.8	0.5	1	-0.2
Managed futures	-0.1	0.2	-0.2	1



Over time, managed futures strategies tend to have a correlation of around zero with traditional markets like equities. In a period where you might see an extended equity market drawdown, one would expect a managed futures strategy to be short equities and profit from this movement, and vice versa if the market is heading in the opposite direction. It is also important to note that managed futures are able to provide diversification and positive performance during crisis periods in other asset classes such as fixed income or commodities. Because equity, bond and commodity markets have typically been recurring but unpredictable in the past, we see the ability to perform well in both bull and bear markets as valuable.

Performance during ten worst months for global equities



Source: AHIC, Investment Metrics

Suitability and portfolio construction

Investor objectives

Overall risk and return considerations influence the sizing; investors with significant negative cash flows that would be adversely impacted by a market drawdown may benefit from larger allocations.

Total portfolio composition

Portfolios with limited diversification into other less macro-sensitive assets and strategies can benefit more from a larger allocation. Managed futures can be a standalone allocation within a traditional portfolio or a component of a broader hedge fund/opportunistic segment of the portfolio.

Volatility target

Less capital needs to be allocated to higher-volatility managed futures strategies to achieve the same effective risk allocation.

Source of funds

Allocations to managed futures are typically sourced from other return-seeking asset classes, but could be sourced from fixed income depending on market views or other factors.

Governance

There is limited additional governance, particularly relative to implementing a direct, broad hedge fund mandate.

Potential drawbacks and considerations

Like any investment, managed futures strategies offer certain risks and rewards. Investors should be fully informed before making an investment.

The table below lists a number of considerations for investors as they think about an allocation to managed futures.

Potential drawback	Considerations
Episodic return profile	Performance generally comes in spurts and is subject to periodic negative drawdowns (drawdowns of greater than two times the volatility target are possible) Tend to underperform in range-bound markets or in trending markets that are choppy and prone to quick reversals.
May increase governance / complexity	The level of increase is modest relative to implementing most other diversifying strategies Can be a stepping stone to a broader hedge fund or opportunistic allocation
Require comfort with the use of derivatives	Leverage is embedded in the derivatives used to implement the trading strategies
Importance of manager selection	Large variance in performance across managers Managers typically use trends of 1–12 month, and so correlations between managers can be high
Potentially slow reaction to the market	It takes models different amounts of time to 'realise' the market is in a down trend and adjust positioning accordingly – they will not be short as soon as markets begin to fall Short, medium, and long term trend followers are differentiated by their reaction time to trends and changes in direction of trends

Conclusion

Managed futures strategies take advantage of a fundamental and lasting market phenomenon (trends); can generate diversifying return streams that are additive to portfolio returns; have tended to perform well in times of market stress; generally provide good liquidity; and have reasonable fee terms relative their value added. We feel that an allocation to hedge funds, including strategies such as managed futures, is appropriate for investors looking for an alternative source of return with the intention of improving portfolio efficiency.

An investor may choose to invest in a standalone managed futures hedge fund strategy, or an allocation to a fund of hedge funds strategy. If you wish to learn more about managed futures or how to implement a managed futures strategy, please contact your consultant.

We're here to empower results

For more information visit
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