

The attached, new academic paper, "The Time Variation in the Benefits of Managed Futures", appeared in the Spring edition of "The Journal of Alternative Investments". The report had some enlightening findings for investors. Some of these points were brought out in the August 2003 edition of Managed Account Reports:

- Utilizing even a small allocation of managed futures limits portfolio risk by a statistically significant margin.
- The study confirms earlier findings that managed futures increases return and reduces portfolio risk. A 10% managed futures allocation was allocated for the study.
- More conservative investors may gain from allocating a portion of their portfolios than more aggressive investors.
- Conservative portfolios experienced an increase in return in more than 50% of the years. The study went back 40 years.
- The risk reduction benefits of managed futures were quite pronounced. 98% of the years where managed futures were included in each portfolio, experienced an increase in the portfolio's Sharpe ratio. The Sharpe ratio is a measure of risk management. The higher the ratio, the lower the risk.
- Managed futures highest performance periods were in periods of rising interest rates. Many believe we are now in such a period.

You can read this article from Managed Account Reports below.

Past performance is not necessarily indicative of future results. The risk of substantial loss exists in futures trading.

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Stocks, bonds and futures

Study shows that managed futures are well suited for conservative investors

By Ben Warwick

When compared with their hedge fund counterparts, trading advisors tend to generate relatively volatile returns. This performance characteristic is largely due to the inherent directional bias of their strategy; other reasons include its use of leverage and tendency to follow trends until positions are stopped out. As a result, futures-based products are usually marketed to investors with a moderate to aggressive penchant for risk-taking.

Surprisingly, a recent study has found that staid investors may gain more than higher-flying ones from managed futures. The study suggests that utilizing even a small allocation of futures limits portfolio risk by a statistically significant margin. Overall portfolio returns, however, are only modestly improved.

Extending earlier work

The paper, titled "The Time Variation in the Benefits of Managed Futures," appeared in the Spring 2003 edition of *The Journal of Alternative Investments*. Authors Gerald Jensen, Robert Johnson and Jeffrey Mercer view their work as an extension of other studies that attempt to verify the benefits of managed futures in a diversified portfolio.

Their approach differs from earlier work in a number of ways. First, the study addresses the range of investor types from conservative to aggressive.

The researchers also look at the effects of a managed futures allocation over a variety of holding periods rather than just the life of the study. And to add a practical aspect, they cap futures allocations at 10%, a value that is common among individual investors.

In order to generate as much return data as possible, the authors use the Mount Lucas Management index as a proxy for industry returns. The index goes back to 1961, and roughly represents the performance of a trading advi-

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sor following an objective set of trend-following rules.

Jensen, Johnson and Mercer also point out that the MLM index boasts a positive correlation to most managed futures indices, compared with insignificant correlations generated by the CRB and other long-only benchmarks. The study used 40 years of data, ending in 2000 for the analysis.

It confirms earlier findings that futures returns are uncorrelated with both stocks and bonds. Preliminary findings show that adding a futures component both increases return and reduces risk, although the latter benefit seemed more significant.

Unequal benefits

To examine the consistency of the benefits of managed futures, the authors then look at each year in the 40-year study. For the moderate and aggressive portfolios, the addition of a futures component adds to the return in slightly less than one-half of the years.

The conservative portfolio, however, experiences an increase in return in more than 50% of the years. This is because the managed futures allocation replaces more fixed income than equity in the more conservative mix.

The risk reduction benefits of the asset class were much more pronounced. In fact, each portfolio experiences an increase in its Sharpe ratio in at least 98% of the years.

The authors then turn their attention to determining which type of economic scenario results in the more substantial benefits from a managed futures investment. Jensen and his team separate the months in the study according to whether the Fed was in an expansive or restrictive monetary cycle.

The turning points occur when the Fed changes the discount rate in the opposite direction from its prior change. Over the 40-year period, there were 21 turning points, with the average duration of expansive and restrictive policy changes each lasting about 20 months.

As one would expect, stock and bond returns are highest when interest rates are decreasing, which represents an expansionary phase. Managed futures, however, are shown to be much more robust during periods of higher rates, when futures enhance both the return and the risk components of each portfolio.

Smarter traders

Overall, the results of the study indicate that managed futures can be beneficial for a variety of portfolios, although conservative investors have more to gain than their more aggressive counterparts. However, the use of the MLM index may not be as accurate a gauge for trading advisor performance as it once was.

The MLM has diverged considerably from industry indices over the last few years. And the recent exceptional performance of many advisors has come during a period of expansive monetary policy, which may indicate the traders have become more adept at adjusting to the current economic environment.

If that is the case, timing futures allocations based on economic conditions may have become unnecessary.

An interesting follow-on study could examine the benefits of managed futures in a portfolio of hedge funds. After all, the same environment that favors traditional investing also tends to favor many arbitrage strategies. ■

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