SQM RESEARCH

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Managed Futures – Catastrophe Insurance or just Catastrophe?

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Alternatives are a challenging asset class. Very diverse, very complicated and often, misunderstood. If you watch the show *Billions* (streaming on Stan) you will see the (entertaining) turbo-charged stereotype of a hedge fund manager. With many pop-culture references like this in the modern world it is not surprising that some investors and financial advisers approach alternatives with caution, if not outright disdain.

The reality is that alternatives have a legitimate place in many portfolios. In the institutional space, this has been established practice for many decades now, both globally and (over the last 10-20 years) domestically. The retail space in Australia has been somewhat more hesitant to embrace alternatives in investor portfolios, but adoption and growth has been picking up over the last 5-10 years.

A segment that has seen a reasonable degree of acceptance is managed futures. This note takes a quick look at one of the key claims made for these funds i.e. they are good "catastrophe insurance". Essentially this means that while they may not be the best performers when traditional markets are "running hot", they will hold their ground or even thrive when there is a severe downturn in risk markets. This is often described as zero or negative correlation to equity markets.

Investopedia has a simplified description which says..."A diversified managed futures account will generally have exposure to a number of markets such as commodities, energy, agriculture, and currency. Most managed futures accounts will have a stated trading program that describes its market approach. Two common approaches are the market-neutral strategy and the trend-following strategy."

The chart below shows the development of managed futures FUM since 2007. The total size has shrunk somewhat over the last couple of years but nevertheless remains over $2.6 billion today.

2020 has presented itself as a useful case study for looking at how the managed futures sector has performed in a severe market downturn.

The coronavirus pandemic unfortunately provides multiple perspectives on the term catastrophe – humanitarian, medical, social, economic and financial. All these words and more can be placed in front of the word catastrophe and applied to the current pandemic.

It is the financial market aspect that we will explore. The chart below shows the path of the ASX300 since the start of 2020 (indexed to 100 at the beginning)

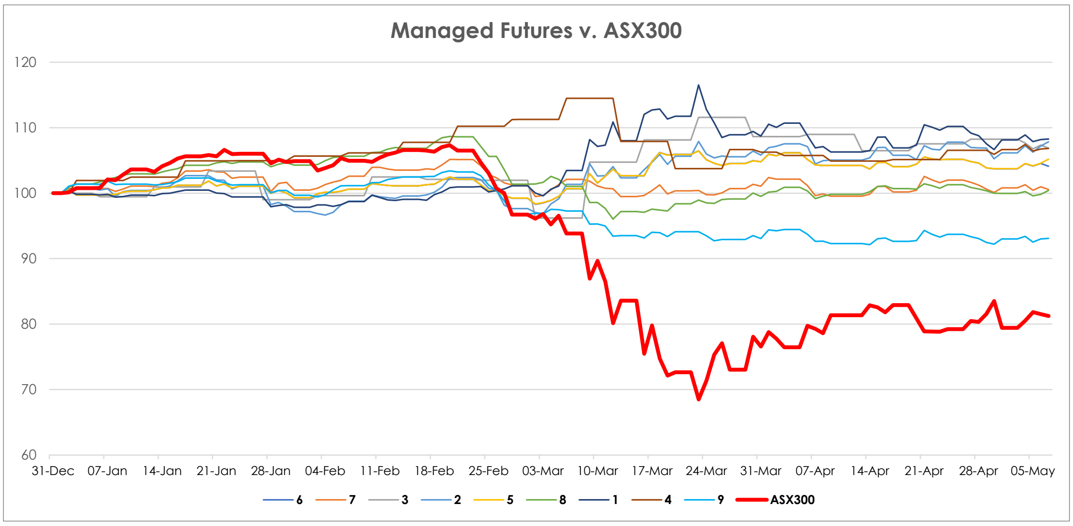
The market peaked on 20th Feb, up +7.32% from the start of the year. It hit the low point on 23rd March, down a full 31.5% from the start of the year and down 36.2% from the peak. The recovery from this low point to 7th May has been +18.6%. The speed of the collapse and the sharpness of the (partial recovery) are unprecedented and a real test of "truth in labeling" for managed futures.

We reviewed the performance of 9 major managed futures funds which for practical purposes represent the entire sector. They won't be named in this note (it's not a beauty parade).

The chart below shows the 9 funds plotted against the ASX300. What is immediately obvious is they have done pretty well collectively.

For a brief period from the peak (20th Feb) to the end of Feb, the funds fell in a correlated fashion along with the ASX300, but not as steeply. Over that time the ASX fell -9.87% while the average of the 9 funds fell 2.73%. None of the funds fell as far as the ASX300 and one managed to **rise +3.23%**.

From that time (the start of March) the managed futures funds generally held their ground while the market fell dramatically further.

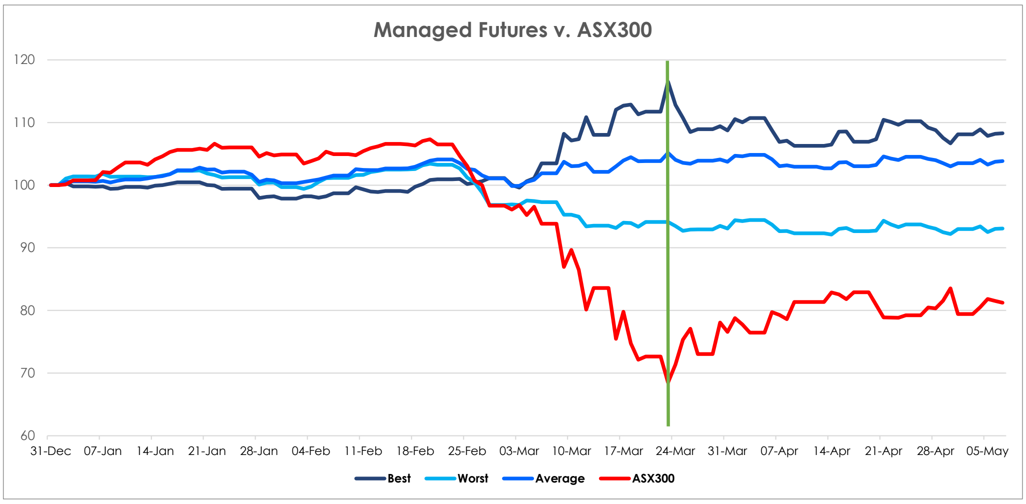


The next chart is less busy and allows us to tease out some additional detail. It plots 3 lines for the managed futures group – the best fund (i.e. highest return), the worst fund, and the average of the entire group.

The difference in performance relative to the stock market is stark. At the low point (23rd Mar) the ASX300 was down -31.5% from the start of the year. The best managed future fund was **up +16.5%** and the average of the funds was also **up at +5.1%**. Even the worst fund was only down 5.9%.

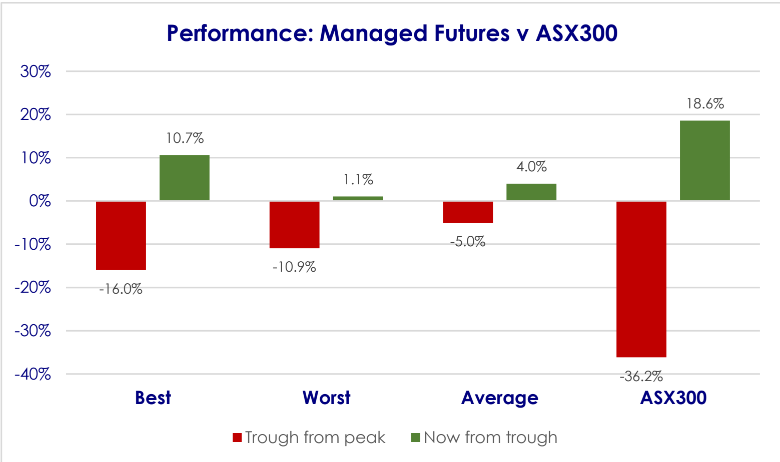
From this point the funds largely travelled sideways and roughly maintained their return profile while the ASX300 recovered around one third of its lost ground.

This means that as of 7th May the ASX300 was down -18.8% from the start of 2020 while the average managed futures fund was up +3.8%. The best fund was up +8.3% and the worst was down -6.9%.



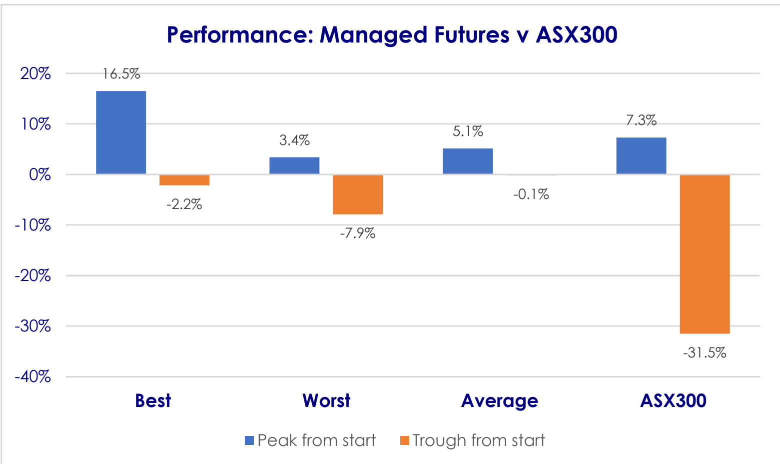
The chart below looks at the peak-to-trough performance in red (20th Feb to 23rd Mar) and the subsequent recovery (23rd Mar to 7th May) in green. The clear pattern is that managed futures **significantly** outperformed on the downside while underperforming in the recovery.

Downside (drawdown peak to trough) and Recovery



Another view (below) is to measure returns from the start of the year to the ASX300 peak (20th Feb) in blue and then carry returns through to the trough (23rd Mar) in orange. The pattern is similar – much better downside protection with more modest upside participation. The exception is the best managed futures fund did also outperform the ASX on the upside.

Upside then Downside (measured from start of 2020)



Correlation – Managed Futures v ASX300

The tables below speak for themselves – frequently negative correlations in a time of crisis. This is the hallmark of the alternatives sector value proposition.

Correlation of Price Levels	31/12/2019 7/05/2020
2	-83.7%
3	-84.6%
4	-4.8%
5	-86.8%
6	-86.7%
7	55.9%
8	84.1%
Best	-96.4%
Worst	94.9%
Average	-68.1%
ASX300	100.0%

Correlation of Daily Returns	31/12/2019 7/05/2020
2	-28.6%
3	-38.6%
4	-24.0%
5	-28.1%
6	-27.9%
7	-2.5%
8	37.8%
Best	-61.7%
Worst	26.8%
Average	-35.0%
ASX300	100.0%

Conclusion

While we have only looked at one market crisis in this note, it is the most severe of the century and provides interesting evidence in making the case for the alternatives sector. Simply put, the most common propositions put forward for alternatives (managed futures in this case) are supported by evidence:

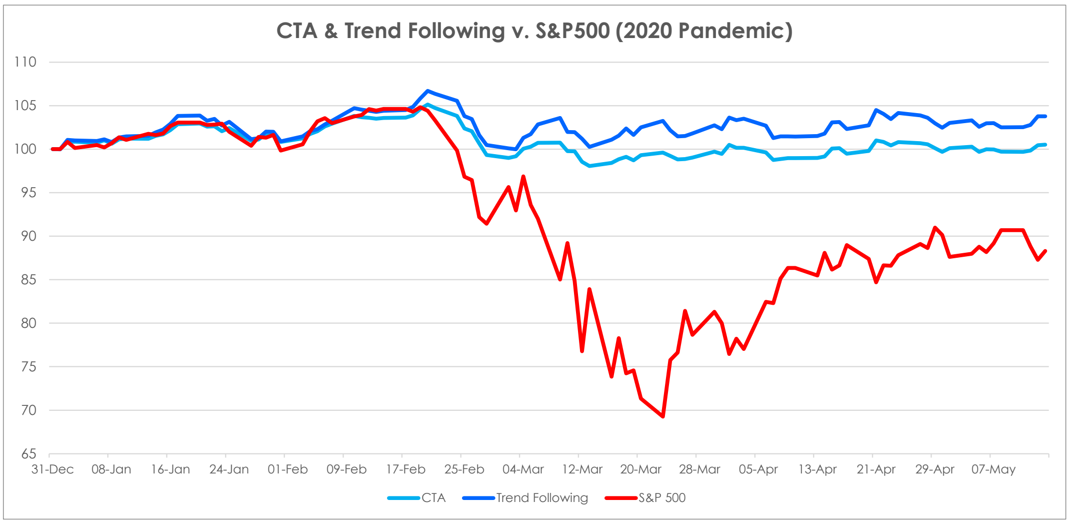
1. Tend to Underperform when Risk Assets are Running "Hot" **Confirmed**
2. Downside Mitigation in Market "Crisis" **Confirmed**
3. Low to Negative Correlation to Market when you need it **Confirmed**

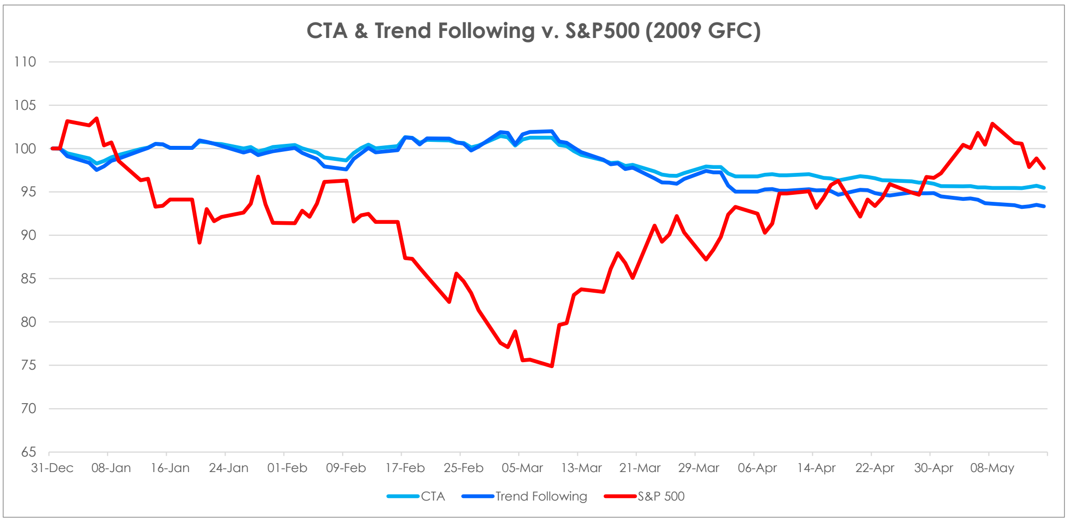
And the key question can be answered with a reasonable degree of confidence.

Q. Managed Futures – Catastrophe Insurance or just Catastrophe?
A. **Catastrophe Insurance**

Postscript:

In case you were wondering, these results aren't confined to Australia, or to the current market crisis. The two charts that follow look at managed futures in the US versus the S&P500. The patterns described in the note above can be seen in the US for both the pandemic crisis and the GFC.





Glossary

The **SG CTA Index (CTA)** provides the market with a reliable daily performance benchmark of major commodity trading advisors (CTAs). The SG CTA Index calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment.

The **SG CTA Trend Sub-Index (Trend Following)** is a subset of the SG CTA Index, and follows traders of trend following methodologies. The SG CTA Index is equal weighted, calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment

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