

A Better Managed Future

Excerpted from the *Alternative Investment Analyst Review*, Volume 7, Issue 2

The Alternative Investment Analyst Review is the official publication of the CAIA Association. Access to the most current issue is an exclusive benefit of CAIA Membership while archived issues are available to the public in the Perspectives section at CAIA.org.

[The full article may be accessed here.](#)

Central Issue of the Paper

Recent developments have not only driven numerous financial markets to record highs, but also significantly increased correlations between various asset classes. Following one of the longest bull markets in history, current price levels and the co-movement behaviors of traditional asset classes suggest reduced expected returns and diversification benefits in the future. The question, therefore, is whether investment strategies exist that still provide an attractive risk/return profile and consistent diversification benefits.

The hypothesis and aim of "Managed Futures and the AC-DC Effect or Highway to Prosperity" by Urs Schubiger, Egon Ruetsche and Fabian Dori is to demonstrate that the unambiguous answer is yes! The risk premia of - as well as correlations between - asset classes are time varying, and strategies that dynamically adjust to changing attractiveness and co-movements can harvest positive returns in various market environments.

Approach Employed by Paper

Data and Methodology

Using a broad set of different asset classes and a long data history, the authors analyze the risk/return profile of a long-only managed futures strategy alongside two classical, statically balanced portfolios. They simulate a long-only managed futures strategy (LOMF) that combines momentum and carry with a risk budgeting engine. The idea is that various asset classes provide long-only, yet time-varying risk premia. The strategy measures the current attractiveness of these risk premia based on momentum and carry. The more attractive an asset class, the bigger the position in the portfolio. In order to spread market risk evenly, a risk budgeting engine adjusts the positions by examining both the volatility of and co-movements between the individual assets. The more risk a specific asset exhibits, the smaller its position in the final allocation. To dynamically adapt the exposure to a specific target risk, leveraged positions are allowed. Rebalancing is daily, factoring in transaction costs.

The benchmark consists of a classical capital-weighted portfolio that is always fully invested 60% in bonds and 40% in equities. They call this portfolio the traditional benchmark (TB). While it still represents the point of reference for many institutional investors, its focus on only two asset classes foregoes significant diversification benefits. Therefore, they additionally simulate a portfolio invested 50% in bonds, 40% in equities and 10% in commodities and call it the diversified benchmark (DB).

Interest Rate Scenarios vs. Empirical Risk/Return Characteristics

Empirical evidence confirms a negative correlation between the change in the overall interest rate level and returns from the different asset allocation strategies. From a relative perspective, it is the long-only managed futures strategy that copes best with both falling and rising interest rates by dynamically and adequately adjusting its exposure to changing market conditions. The traditional benchmark (TB) exhibits the highest interest rate sensitivity, due to its significant bond exposure and lack of diversification into other asset classes. Therefore, its returns almost match the gains of the long-only managed futures strategy when yields plummet, but it suffers the most when they increase. Finally, the diversified benchmark (DB) exploits diversification effects from its commodities exposure when interest rates advance and performs comparably to the long-only managed futures strategy in an environment of rising yields. However, unlike the latter, it only partially benefits from its bond exposure when yields decrease, thereby losing relative return in comparison to the long-only managed futures strategy.

Equity Scenarios vs. Empirical Risk/Return Characteristics

Empirical evidence highlights that equity performance considerably impacts the different asset allocation strategies. However, in a similar vein to the interest rate analysis, it is the long only managed futures program that, due to its adaptive nature, copes best with turbulent equity market conditions, while not falling behind unduly when equities rally. The two capital-weighted benchmarks exhibit a very strong sensitivity to equity markets, caused by their significant equity exposures and lack of diversification into other asset classes. Even though the diversified benchmark (DB) benefits in all scenarios from its commodities exposure, it is not able to fully exploit the diversification benefits, given that it holds its asset allocation steady across all scenarios.

Findings of the Paper

The authors demonstrated that a long-only managed futures strategy that focuses on balancing the risk contributions within a portfolio and accounts for both momentum and carry effects, is well suited to withstand adverse market conditions, whether these conditions are experienced by bonds or equities. It not only stands up well from an absolute perspective, but also against traditional capital-weighted portfolios over a period that dates back as far as the 1970s.

- The long-only managed futures strategy invests in the broadest investment universe
- The high dynamism of the strategy better exploits the diversified characteristics of the different asset classes
- The definition and targeting of a specific volatility level ensures that the strategy continually adapts its total exposure to the current risk climate by pro-cyclically reacting to opportunities

Bear in mind that to adequately mitigate the impact of all types of events, it appears advisable to additionally allow for short positions within this strategy. The authors leave this point open to be addressed in a future research note.

.....