NATIXIS
GLOBAL ASSET MANAGEMENT

THE HUB
Market Insights
NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

Find out more at www.hub.ngam.natixis.com

Crisis Alpha

Robert W. Sinnott

Senior Research Scientist,

Co-Portfolio Manager

AlphaSimplex Group, LLC

Managed futures may provide shelter from storms and diversified returns in calm markets

Key takeaways:

- The flexibility to invest across a broad set of asset classes and take short positions has proven to be beneficial during periods of market crisis.
- Managed futures strategies can be effective diversifiers in traditional portfolios as they generally have very low correlations to both stocks and bonds.
- By using only highly liquid instruments, Managed Futures strategies avoid liquidity challenges that other alternative strategies can be exposed to.

Memories fade fast

Given the strong performance of both equities and fixed income and the relative calm in the markets since the financial crisis, many investors are relaxed about the risk of a negative market event. But things can change quickly, and from unanticipated sources. While some claim they foresaw the clouds of the financial crisis forming, few actually adjusted their portfolios before the storm hit. Will they react in time if the apparent serenity of the current seven-year bull cycle and historically low interest rates is disturbed? For those in doubt, some protection against volatility is worthy of consideration.

Enter crisis alpha

One of the most compelling attributes of managed futures strategies has been their return during equity crisis periods. Managed futures outperformed the S&P 500 Index on a relative basis during all 10 of the largest quarterly declines in the S&P 500 Index between 2000 and 2015. They even posted positive absolute returns in 7 of the 10 periods, earning them the moniker that some have described as "crisis alpha".[1]

How do managed futures work?

Most managed futures strategies (whose managers are commonly referred to as Commodity Trading Advisors or CTAs) are systematic and trend-following. That is, they seek to identify price momentum in futures markets including equities, fixed-income, currencies and commodities. CTAs typically have the flexibility to go long or short, giving these strategies the potential to profit even when traditional asset classes are falling.

Managed futures strategies are considered to have time-varying correlations that have the potential to be positively correlated to equities in rising equity markets and negatively correlated to equities in falling equity markets. Over the longer term, managed futures strategies generally have very low correlations to both stocks and bonds, making them effective diversifiers in a traditional portfolio.

Managed futures strategies have historically relied on three characteristics to provide positive returns during a crisis. Firstly, they can short an asset or asset class. Secondly, by trading a wide variety of assets and asset classes – stocks, bonds, currencies, commodities – they're able to earn returns from other trends in other asset classes. So if one trend is reversing, the strategy can still provide positive returns by profiting from other trends taking place simultaneously.

Some strategies focus on very short-horizon trend signals, while others track long-horizon trends. Others still, such as those managed by AlphaSimplex, follow short-, medium-, and long-horizon trends, for a more diversified approach. "At AlphaSimplex, we believe that strategies should be adaptive to changing markets", said Rob Sinnott, Senior Research Scientist and Co-Portfolio Manager at AlphaSimplex. "That is why we not only use a number of fixed horizons in our managed futures strategy, but also have signals that can adapt to give more or less weight to different horizons."

Finally, because managed futures strategies mainly trade futures, which are highly liquid and exchange-traded, they are not generally exposed to the illiquidity risks of many other alternative strategies. While it is possible that a futures market might become illiquid, this is much less likely to occur than in most other markets.

Putting tail risk to the test

The test of a crisis alpha or "tail risk" strategy is twofold:

- Does it provide effective protection when it is most needed?
- Is the cost for the protection affordable over the long term?

The first question is addressed above. The second focuses on the overall portfolio costs that the investor must bear. While some tail risk strategies – such as put options – can provide effective protection during equity declines, the cost of keeping the strategy in place, particularly over long periods, is prohibitive. "Since the launch of our strategy in 2010 through the end of 2015, we have generated positive absolute returns on a cumulative basis," said Rob.

"We achieved this during a time period when we have not seen what I would call an equity crisis, so in my view, that is a pretty cost effective approach to providing some diversification to a portfolio." By reallocating just 10% of a 60/40 portfolio of stocks and bonds to managed futures between 2000 and 2015, the portfolio's risk was lowered and its risk-adjusted returns were improved. The portfolio's maximum negative month and maximum drawdown were also reduced.[2]

What's the catch?

Critics of managed futures strategies point to their performance since the financial crisis and question whether the strategy has become less effective over time. The market environment since 2009 has generally not been helpful to many trend-following strategies, including managed futures. The risk on/risk off market has led to a dearth of discernible trends and frequent trend reversals. This has led managers to enter trades only to exit them shortly after at little profit or even at a loss.

Managed Futures, especially trend-following strategies are best used as a long-term diversifier for overall portfolios. "I think having a strategic allocation approach, rather than a tactical allocation approach makes more sense. If you try to time it, you have a good chance of missing the benefits," said Rob. "For example, in January of 2016 the S&P 500 was down 4.96%, while the SG Trend Index was up 3.76%. By the time an investor sees this and invests, current holders of managed futures strategies may already have accumulated most of the gains from that market event."

Confidence in benign markets remains high. Is it justified?

Many investors have bet that Fed policy is likely to stay accommodative for the foreseeable future, greatly reducing the odds of another liquidity crisis. In this type of environment, trend-following strategies like managed futures may deliver only modest returns. However, anything that upsets this vision of the world may work to the benefit of managed futures strategies, potentially providing investors with a rare source of alpha.

[1] Source: SG Trend Index (Managed Futures) and S&P 500 Index (Stocks), 2000–2015. During the 10 worst quarters for the S&P 500 Index, the SG Trend Index posted positive returns in 7 of those quarters.

[2] Source: SG Trend Index (Managed Futures), S&P 500 Index (Stocks), and Barclays Capital Aggregate Bond Index (Bonds), 2000–2015. During this time period, a portfolio comprised of 60% stocks and 40% bonds had an annualized standard deviation of 9.15%, a risk-adjusted return (Sharpe ratio) of 0.56, a maximum negative month of –11.02%, and a maximum drawdown of –32.54%. A portfolio of 54% stocks, 36% bonds, and 10% Managed Futures had an annualized standard deviation of 8.21%, a risk-adjusted return (Sharpe ratio) of 0.67, a maximum negative month of –9.19%, and a maximum drawdown of –28.18%. All portfolios rebalanced monthly. For simplicity, Sharpe ratios have been calculated with the riskless rate set equal to 0%. It is not possible to invest directly in an index. Past performance is no guarantee of future results.

Written on 13 May 2016

DISCLAIMER

Past performance is no guarantee of future results.

The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of 13 May 2016 and are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material.

This material has been provided for information purposes only to investment service providers or other Professional Clients or Qualified Investors and, when required by local regulation, only at their written request. **In the E.U. (outside of the UK)** Provided by NGAM S.A. or one of its branch offices listed below. NGAM S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of NGAM S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. France: NGAM Distribution (n.509 471 173 RCS Paris). Registered office: 21 quai d'Austerlitz, 75013 Paris. Italy: NGAM S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via Larga, 2 - 20122, Milan, Italy. Germany: NGAM S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. Netherlands: NGAM, Nederlands filiaal (Registration number 50774670). Registered office: World Trade Center Amsterdam, Strawinskylaan 1259, D-Tower, Floor 12, 1077 XX Amsterdam, the Netherlands. Sweden: NGAM, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. Spain: NGAM, Sucursal en España. Registered office: Torre Colon II - Plaza Colon, 2 - 28046 Madrid, Spain. • **In Switzerland** Provided by NGAM, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich. • **In the U.K**. Approved and provided by NGAM UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258). This material is intended to be communicated to and/or directed at persons (1) in the United Kingdom, and should not to be regarded as an offer to buy or sell, or the solicitation of any offer to buy or sell securities in any other jurisdiction than the United Kingdom; and (2) who are authorised under the Financial Services and Markets Act 2000 (FSMA 2000); or are high net worth businesses with called up share capital or net assets of at least £5 million or in the case of a trust assets of at least £10 million; or any other person to whom the material may otherwise lawfully be distributed in accordance with the FSMA 2000 (Financial Promotion) Order 2005 or the FSMA 2000 (Promotion of Collective Investment Schemes) (Exemptions) Order 2001 (the "Intended Recipients"). To the extent that this material is issued by NGAM UK Limited, the fund, services or opinions referred to in this material are only available to the Intended Recipients and this material must not be relied nor acted upon by any other persons. Registered Office: NGAM UK Limited, One Carter Lane, London, EC4V 5ER. • **In the DIFC** Provided in and from the DIFC financial district by NGAM Middle East, a branch of NGAM UK Limited, which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients as defined by the DFSA. Registered office: Office 603 - Level 6, Currency House Tower 2, PO Box 118257, DIFC, Dubai, United Arab Emirates.• **In Singapore:** Provided by NGAM Singapore (name registration no. 53102724D) to distributors and institutional investors for informational purposes only. NGAM Singapore is a division of Natixis Asset Management Asia Limited (company registration no. 199801044D), and Natixis Asset Management Asia Limited is regulated by the MAS to conduct fund management in Singapore. Registered address of NGAM Singapore: 10 Collyer Quay, #14-07/08 Ocean Financial Centre, Singapore 049315. • **In Hong Kong:** This document is issued by NGAM Hong Kong Limited to distributors and professional investors for informational purposes only. • **In Australia** This document is issued by NGAM Australia Pty Limited (NGAM Aust) (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only. Investment involves risks. NGAM Aust reserve the right to revise any information herein at any time without notice. In New Zealand This document is intended for the general information of New Zealand wholesale investors only. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. NGAM Australia Pty Limited is not a registered financial service provider in New Zealand. • **In Latin America** This material is provided by NGAM S.A. • **In Chile** Esta oferta privada se acoge a la Norma de Carácter General N°336 de la SVS de Chile. • **In Colombia** This material is provided by NGAM S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors. • **In Mexico** This material is provided by NGAM Mexico, S. de R.L. de C.V., which is not a regulated financial entity with the Comisión Nacional Bancaria y de Valores or any other Mexican authority. This material should not be considered an offer of securities or investment advice or any regulated financial activity. Any products, services or investments referred to herein are rendered exclusively outside of Mexico. • **In New Zealand** This document is intended for the general information of New Zealand wholesale investors only and does not constitute financial advice. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. NGAM Australia Pty Limited is not a registered financial service provider in New Zealand.• **In Uruguay** This material is provided by NGAM Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Registered office: WTC – Luis Alberto de Herrera 1248, Torre 3, Piso 4, Oficina 474, Montevideo, Uruguay, CP 11300. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. • The above referenced entities are business development units of Natixis Global Asset Management, S.A., the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Global Asset Management conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorised. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

The above referenced entities are business development units of Natixis Global Asset Management, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. Although Natixis Global Asset Management believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information. This material may not be distributed, published, or reproduced, in whole or in part.

AlphaSimplex Group, LLC
255 Main Street
Cambridge, MA 02142
www.alphasimplex.com/