Crisis or Correction?

Managing Expectations for Managed Futures and Crisis Alpha

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2018 was a year where market events frustrated and stung equity investors, with major equity drawdowns in February, October, and December. Although Managed Futures strategies have had the ability to outperform equity markets during past crises, for much of 2018 they suffered hand-in-hand with equity markets. For investors hoping for portfolio protection, this situation left them scratching their heads. There are several reasons why Managed Futures did not weather the equity storm in 2018, including the difference between a crisis and a correction and prior positioning going into corrections.

When it comes to crisis, severity and duration matter

Every crisis is different and a crisis can be defined by both the length and depth of a crisis event. From this perspective, sustained and substantial periods of losses can be classified as a **crisis** and short term market reversals can be classified as a **correction**. Managed Futures strategies trade predominately medium- to long-term trend following strategies ranging from 3 to 12 months. Given their approach, a severe prolonged crisis is naturally a more favorable environment. To put this into perspective, Figure 1 plots equity drawdowns (using the S&P 500 TR Index in red) and the return of Managed Futures during the same drawdown period (using the SG Trend Index in gray).[1] 2018 saw several equity drawdowns that were smaller and relatively shorter than major historical crises. These events were a market corrections not a major crisis event. Since 2000, we have observed three distinct regimes (1) crisis, (2) recovery, and (3) a period of relatively "calm" equity markets.

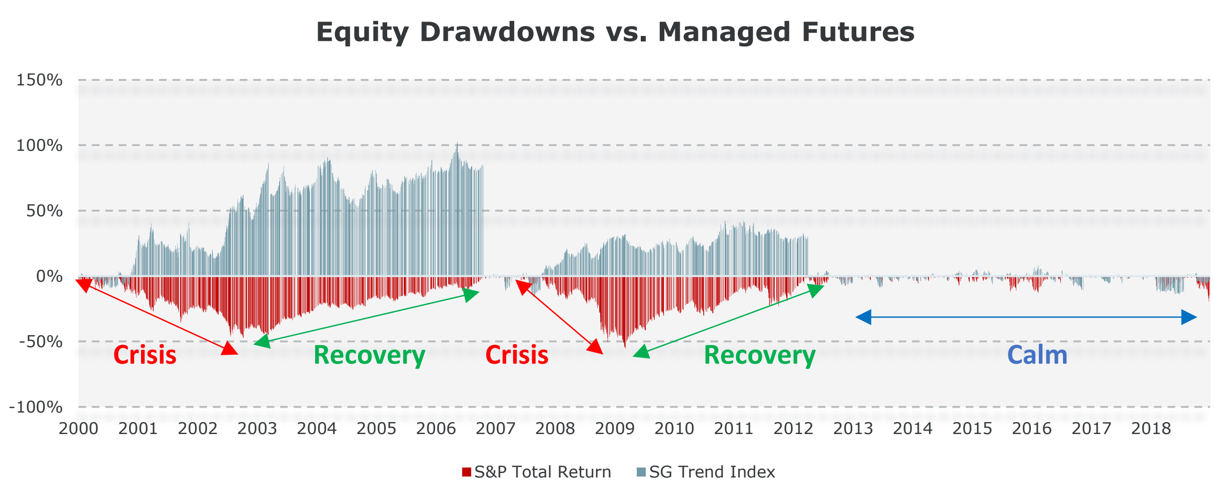

Figure 1: Maximum Drawdown for Equity Markets (S&P 500 TR Index) versus the performance of Managed Futures (SG Trend Index) during the same drawdown period. The data begins at the inception of the SG Trend Index in January 2000 through December 2018. Source: Bloomberg, AlphaSimplex. Index performance is not indicative of an investment product. You may not invest directly in an index. Results may be different for different time periods.

[1] *Intuitively, this graph shows every negative day and the corresponding depth of the largest loss for an equity investor on that particular day looking backwards. The return of Managed Futures is over the same time period to consider how the strategy performed through the same drawdown period.*

During sustained crisis periods, Managed Futures seem to earn their stripes garnering "crisis alpha."[2] During periods of recovery, Managed Futures tends to have relatively lower returns on average.[3] Finally, during the recent period of relatively "calm" equity markets, Managed Futures has been somewhat of a mixed bag during a range of milder equity drawdowns. Since trend following strategies are built to react in medium- to longer-term horizons, they cannot adjust as quickly to short-term events. As a result, for equity corrections the way trend following strategies are positioned prior to an event really matters.

For short-term corrections, prior positioning matters

Short-term market corrections may not necessarily be good environments for Managed Futures. During these events, trend-following strategies either get it right because the market trends were consistent with this event prior to its occurrence, or they get it wrong when large trends quickly change (causing reversals). Focusing only on the beginning of a crisis period and the recent calm period in equity markets, Figure 2 plots the maximum drawdown for equity markets (using the S&P 500 Total Return Index in red) compared with the performance of Managed Futures (SG Trend Index in gray) during the same period.

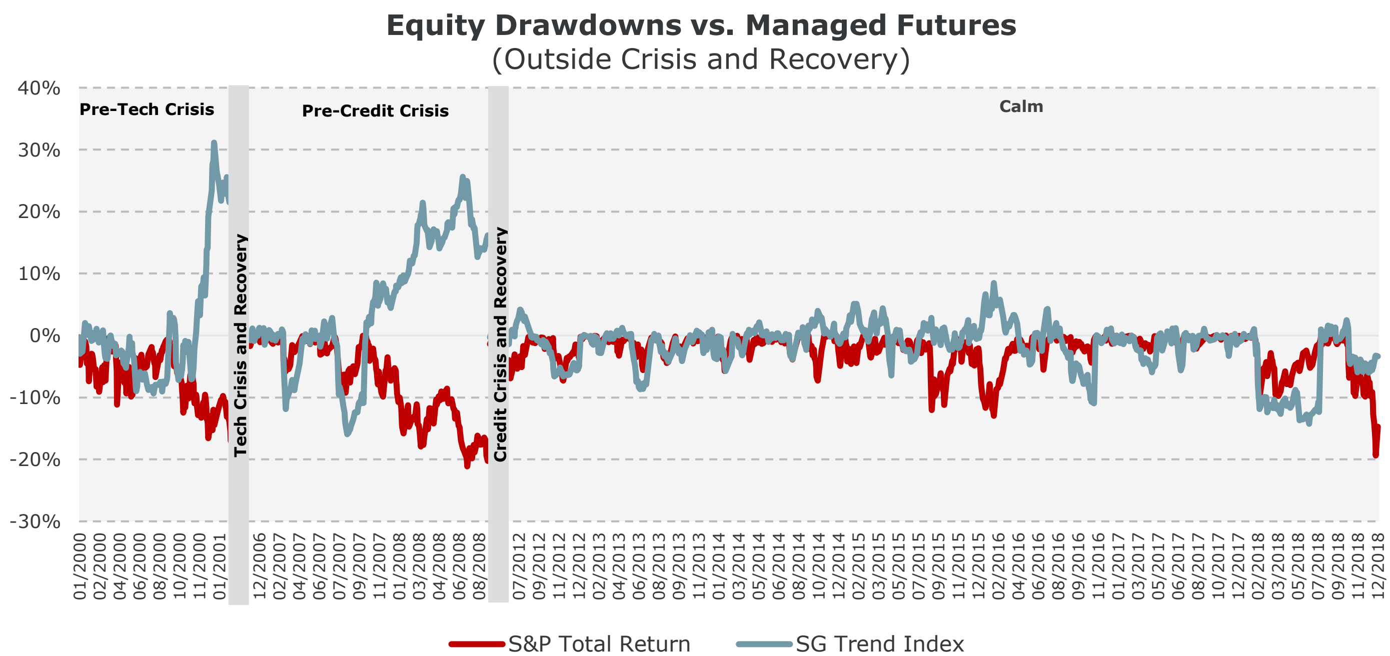

Figure 2: Maximum Drawdowns for equity markets (S&P 500 TR Index) versus Managed Futures (SG Trend Index) performance over the same period. Drawdowns are shown for the beginning of the crisis periods and calm periods in markets. Source: Bloomberg

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[2] *A wide range of papers examine the conditional performance of trend following during crisis, documenting "crisis alpha" properties of trend following over long time horizons. (See also Kaminski (2011), Greyserman and Kaminski (2014))*

[3] *Hutchinson and O'Brien (2014) examine the performance of trend-following strategies during financial crises and post-crisis. They show that trend following tends to underperform post-crisis during the recovery and provide better conditional performance during crisis periods. Kaminski (2017) also discusses this concept by comparing performance of trend following as a function of the number of assets in crisis.*

From this graph, there are roughly 26 market corrections, or events with a drawdown greater than 5%. During the same period, Table 1 lists the 26 equity correction events along with the corresponding equity market and Managed Futures performance during the same drawdown period. Positive returns for Managed Futures during equity corrections are shaded in green (negative are shaded in red). From Table 1, we can see that during equity market corrections Managed Futures performance has been roughly equally positive, neutral, or negative. This list demonstrates how the positioning of trend-following strategies matters. For the equity correction in Q1 2016, trend positioning was roughly in line with future trends that extended when markets took losses in January and February. In February and October 2018, trend-following strategies were long equities following the exceptional trends coming out of 2017 and post the reversal of February 2018. When equities corrected, the move was not in their favor. From Figure 2, we can also see that two difficult simultaneous drawdowns for both equities and trend followers occurred in 2007. After the October correction, trend followers took on short positions in many global equity markets, leading to gains in December 2018 when equity markets dropped precipitously. At the end of December, many trend-following strategies were on route to recovering from the year's drawdowns.

Managed Futures Performance During Equity Corrections

(Outside Crisis and Recovery)

Period	Date of MDD	Duration (Months)	Description	Equity MDD	SG Trend	
Pre-Tech Crisis	2/25/2000	1.9	Beginning of Tech Crash	-9.1%	-1.1%	Neutral
Pre-Tech Crisis	4/14/2000	0.7	Beginning of Tech Crash	-11.1%	-2.5%	Neutral
Pre-Tech Crisis	5/23/2000	2.0	Beginning of Tech Crash	-9.9%	-2.4%	Neutral
Pre-Tech Crisis	7/28/2000	4.2	Beginning of Tech Crash	-6.7%	-7.9%	Negative
Pre-Credit Crisis	10/12/2000	1.3	Beginning of Tech Crash	-12.5%	-1.6%	Neutral
Pre-Tech Crisis	11/30/2000	3.0	Continuation of the Tech Crash	-13.3%	7.9%	Positive
Pre-Tech Crisis	12/20/2000	3.6	Continuation of the Tech Crash	-16.6%	19.2%	Positive
Pre-Tech Crisis	3/12/2001	6.3	Continuation of the Tech Crash	-21.9%	30.2%	Positive
Pre-Credit Crisis	3/13/2007	0.7	Bear Sterns Collapse Greenspan Recession Warnings	-5.4%	-9.4%	Negative
Pre-Credit Crisis	8/15/2007	0.9	Quant Crash	-9.3%	-14.5%	Negative
Pre-Credit Crisis	11/26/2007	1.6	Weakness in Global Equities	-9.9%	8.4%	Positive
Pre-Credit Crisis	1/22/2008	3.5	Weakness in Global Equities	-15.8%	9.7%	Positive
Pre-Credit Crisis	3/10/2008	5.1	Weakness in Global Equities	-17.9%	19.5%	Positive
Pre-Credit Crisis	7/15/2008	9.4	Weakness in Global Equities	-21.1%	24.8%	Positive
Pre-Credit Crisis	9/9/2008	11.3	Lehman Brothers, Start of the Credit Crisis	-20.2%	16.2%	Positive
Calm	6/1/2012	2.0	Poor US jobs report, Weak Euro	-9.6%	3.4%	Positive
Calm	11/15/2012	2.0	US Election 2012, Weak reports	-7.3%	-6.6%	Negative
Calm	6/24/2013	1.1	Gold Prices, Post Taper Tantrum	-5.6%	-8.6%	Negative
Calm	2/3/2014	0.6	Conflict in Ukraine, Poor US Manufacturing Data	-5.7%	-4.5%	Negative
Calm	10/15/2014	0.9	Concerns over QE Globally	-7.3%	4.0%	Positive
Calm	8/25/2015	1.2	Concerns over China	-12.0%	1.7%	Neutral
Calm	1/20/2016	6.2	Equity Correction	-11.7%	6.7%	Positive
Calm	6/27/2016	0.6	Brexit	-5.5%	0.6%	Neutral
Calm	2/8/2018	0.4	Volpocalypse	-10.1%	-11.9%	Negative
Calm	10/29/2018	1.2	Weakness in Global Equities	-9.8%	-3.5%	Negative
Calm	12/24/2018	3.1	Weakness in Global Equities	-19.4%	-3.3%	Negative

Table 1: Managed Futures Performance During Equity Corrections. In this table, a correction is defined as a drawdown that exceeds 5% and that is not part of either a larger crisis or recovery period. The date of the maximum drawdown for equity markets is labeled by the period, the date of the drawdown, a description, the depth of the drawdown in equities (S&P 500 TR Index), as well as the corresponding performance of trend following (SG Trend Index) during the same drawdown. Returns which are greater than 3% in magnitude are labeled as positive or negative and returns less than 3% in magnitude are labeled as neutral. Source: Bloomberg

Keeping Managed Futures investments in perspective

Managed Futures tends to do the best "when things happen in markets" and when the world is structurally changing. Most investment strategies dislike change; this difference in approach makes Managed Futures performance somewhat counter-cyclical. It tends to work when other things don't and it tends not to work when they do—in general, but not in every market environment. Although it can be a great diversifier or risk mitigator, the counter-cyclical performance makes holding the strategy more difficult without a long-term perspective. The key advice for investors in Managed Futures is to focus on its long-term strategic goal in a portfolio and to avoid reacting to short-term performance fluctuations and short-term equity corrections. It is also important to distinguish between a crisis and a correction. While volatility has picked up recently, we have been in a prolonged period of extreme "calm" in equity markets. With the current global potential for rising rates and ongoing political and economic uncertainty, it is important to not mistake the dangers of the calm before the storm.

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