

the tortoise & the hare



| Research Exchange Part 2

Late last month the investment experts involved in the MASECO Research Exchange met for the second time to discuss recent research that has been undertaken on managed futures and risk premia strategies. The participants' experience in these investment strategies is very deep, ranging from a previous CIO at a managed future fund, developing a momentum strategy for a large UK pension fund and advising ADIA, one of the largest sovereign wealth funds in the world, on their investments in managed futures.

While the conversation was often quite technical, I will attempt to distil some of the key takeaways that are relevant to the way MASECO is investing clients' money.

When discussing portfolios, there was broad agreement on the benefit of having exposure to managed future strategies. This is due to the low correlation with traditional asset classes as well as strong empirical evidence from academia. It was also shown that managed future strategies are a good combination with risk premia strategies such as 'carry' strategies.

Time-series 'momentum' has low or even negative correlation with most of risk-premia strategies.

	BarclayHedge CTA Idx	SIZE	VALUE	CS MOM	QUAL	LOW VOL	VOL-RP	Carry
BarclayHedge CTA Idx	1							
SIZE	-0,11	1						
VALUE	-0,08	0,10	1					
CS MOM	0,19	-0,25	-0,71	1				
QUAL	0,11	-0,54	-0,20	0,42	1			
LOW VOL	0,18	0,02	0,07	0,32	0,32	1		
VOL-RP	0,61	-0,19	-0,21	0,36	0,25	0,11	1	
Carry	0,12	0,20	0,22	-0,22	-0,40	-0,01	-0,18	1

*monthly data since 1990, Bloomberg - Frazzini Data Library / VOL-RP: across assets Short Variance Swaps

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We then looked at the performance of managed future strategies since 2010 and observed that this has been lower in comparison to recent decades. While there was broad agreement that asset flows cannot be the reason for the lower returns, there was also broad agreement that low cash returns were a likely contributor. This is because managed future funds hold a high proportion of their assets in cash and seek risk via derivatives. It was hypothesized that central bank actions following the global financial crises made it more difficult for systematic strategies to earn strong positive returns, but such arguments will remain vague given a lack of concrete evidence.

We looked further at the dispersion of managed future fund returns, which is likely due to different portfolio construction techniques. An analysis was presented that builds a case for differences in the length of 'lookback windows' to be a possible explanation. Lookback windows are periods a trend signal is using to decide if a price trend exists or not, which can vary from short term (1 month) to long term (18 months). This topic raised some disagreement among the participants. It is unclear if and why certain lookback windows that created superior performance looking in the rear-view mirror should continue to be the better lookback windows in the future. I can tell from my own research efforts that most managed future providers don't depend on just one lookback window and thereby address the uncertainty of choosing the best parameter. Research departments with the help of machine learning are testing techniques to vary the use of different lookback windows over time. However, with very limited live history, the jury is still out in regards to whether trend following can be improved with this technique.

In the second presentation, we reviewed the results of an analysis of returns of different risk premia factor strategies. The presenter collected 10 years of weekly return data for a total of 282 risk premia factor strategies from Goldman Sachs, Morgan Stanley, J. P. Morgan, UBS, BNP Paribas and Deutsche Bank. It is worthwhile mentioning that the factors stem from single asset classes like bonds, equity, currency, credit and commodities as well as multi asset classes. It is worth noting that the data sample consists of a big population of equity factors at a count of nearly 100, while credit only has 7 and cross asset only 17 factors.

The first hypothesis posed was that those factors might produce higher returns if they are scaled by volatility (monthly rebalancing using the previous month's realized volatility to increase or decrease the exposure). The data however provides little support for that idea. Sharpe ratios (the return reward for a unit of risk) are better for unscaled factors, particularly when looking at bonds, commodities and credit. For equities and currencies, there was no clear tendency.

The main point of the study was to test the hypothesis that many risk premia strategies work because investors are rewarded for taking on downside risk. In other words, the return of strategies will be most negative at the same time when broad markets are also in a steep decline. This correlation is very undesirable for the average investor, and therefore compensation for taking on such risk should also be higher (like receiving an insurance premium). Much recent academic empirical work has gone into understanding downside risk by applying a downside risk capital asset pricing model (CAPM). Using a downside risk CAPM in the analysis we were presented with explains the cross section of the factor premia returns much better than traditional CAPM. However, interestingly, investors are not rewarded for taking on downside risk in the analysis shared by the presenter. This might be explained by either the relatively short window of time for the data in the analysis or the high level of data mining for 'alpha' by the investment banks.

In conclusion, as a result of this study, what should investors do in terms of allocating to factor premia strategies? The simple answer is not to jump onto the latest shiny factor strategy just because it shows strong back tested returns. Additionally, an investor should not solely invest in strategies that have been identified as carrying a lot of downside risk. Instead, such strategies should be combined in a balanced manner with those that are expected to work particularly well in negative markets, such as trend following strategies.

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