

Why Are CTAs This Year's Golden Boys?

No secret to our success, managers argue

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One of the stand-out hedge fund strategies this year, if not the only stand-out strategy, has been managed futures. That's no secret. But what is of more interest is why it has done well when so many other strategies have been struggling and conspicuously failing to meet the expectations of hedge fund investors.

CTAs and managed futures funds have a number of successful poster boys: amongst them AHL, Aspect Capital, BlueTrend, Graham Capital Management, Transtrend and Winton. They are all multi-billion dollar outfits which use a highly systematic approach for their trading activities and boast extensive track records in the derivatives space. In addition, they have built up considerable gravitas in the institutional investment market thanks to heavy investment in their infrastructure; something their clients appreciate.

But what has really focused attention on this segment this year has been the uncorrelated performance. According to Hedge Fund Research, its Macro (Systematic Diversified) index is up 16.81% for the year to the end of November and, aside from Short Bias (up 31.54%), is really the stand-out strategy for the year. The average macro fund tracked by HFR is still in positive territory to the end of November, at slightly over 4%, but all other hedge fund strategies lost money, some of them considerably.

Taking October as an extreme example, the S&P 500 shed a staggering 16.79%, the average hedge fund lost 6.4%, the average emerging markets hedge fund lost 13.47%, while the average systematic fund made 5.65%. There are not many decent examples of non-correlated investments out there at the moment, but this has got to be one of them.

The holy grail of negative correlation

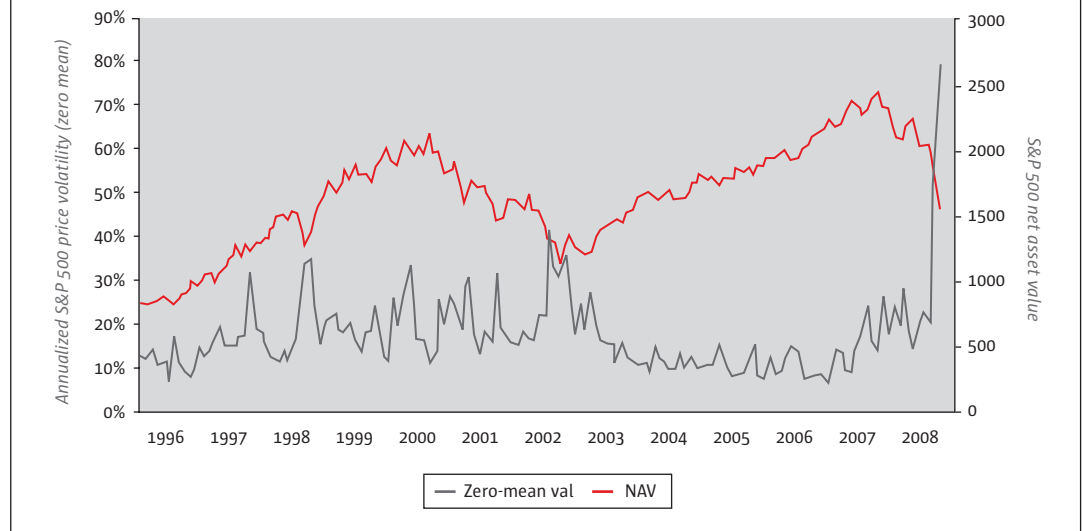
Short, medium, and long term models employed by CTAs are continuing to capture unanticipated trends in multiple asset classes. Of potentially even more value to investors right now is the fact that they are negatively correlated to S&P 500 volatility and that their returns are unrelated to S&P 500 vol.

What has been driving this? Much of it seems to be momentum. The same big shifts in the markets which allowed CTAs to shine in 2001-02, and in 1998 and even 1987, are back with a vengeance. Systematic trading strategies, immune as they are to market sentiment considerations, are simply focusing on the numbers and getting on with the job. Computers don't get depressed about US employment numbers, only humans do.

"It was hard for humans to believe that markets were going to go down as far as they have this

Fig.1 S&P 500 Net Asset Value versus Price Volatility

Source: Bloomberg AlternativeEdge research



year," says Rus Newton, Director of Research at Global Advisors. "It's all about staying in the game, preserving capital, understanding the markets and the volatility, keeping an eye on position sizing and maintaining a consistent framework."

This year's bear market has been accompanied by some of the highest stock price volatility on record [see Fig 1: S&P 500 Net Asset Value versus Price Volatility]. Eight of the ten months through October produced annualised volatilities of S&P 500 returns greater than the 18.75% cut off that would be considered high volatility months. September and October, the two most volatile months, contributed the most by far to this year's decline in stock prices.

According to a research note published by Galen Burghardt and Lianyan Liu of Newedge on 19 November, CTA returns do seem to be unrelated to the forces driving stock returns. Newedge built a net asset value series to represent CTAs using a concatenation of two different strategies, an equally weighted index of returns for 51 CTAs from 1996 to 1999, coupled with the Newedge CTA Index from its inception in January 2000 (see Fig 2: Net Asset Values for Stocks and CTAs on following page). While possibly overstating CTA returns over the period 1996-99, Burghardt and Liu felt the inclusion of the equally weighted index prior to the launch of the Newedge index gives valuable perspective on the end of the great bull market of the 1980s and 1990s.

At AHL, product specialist, Harry Skaliotis, points to the FX and energy markets as two of the areas where CTAs have been able to do particularly well this year. "Some of the most favourable trading opportunities have historically arisen during difficult market conditions, and 2008 was another example of

this," he says. "One explanation is that investors are less focused on fundamentals during market crises, and this can lead to exaggerated market movements which technical traders benefit from."

Bear in mind also that the loss of leverage has had a severe impact on many strategies. Convertible arbitrage in particular has been badly hit. This has not been a problem for the managed futures space however: commodity markets give managers plenty of rope to hang themselves with anyway, without the additional risks of leverage. It has led to the situation where few CTAs employ leverage. This is now working in their favour, as investors look to funds which have not used large amounts of leverage to generate their numbers, and are still relatively liquid.

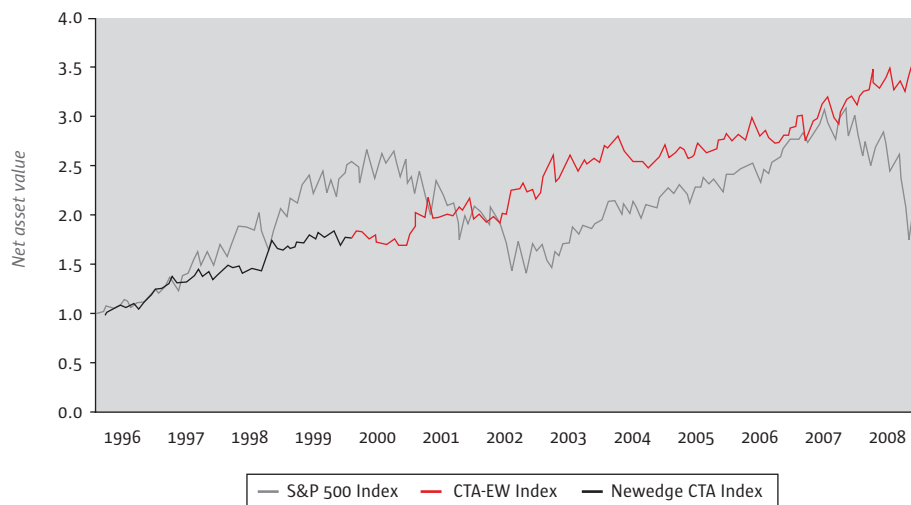
"Leverage has been reduced by CTA managers voluntarily for risk management purposes, but we are still seeing a number of very good trading opportunities," says Skaliotis.

Not everyone has been convinced about the numbers. A paper published by Gary Gorton and Geert Rouwenhorst at the Yale School of Management argued that the performance of CTAs, after fees, was only 85 basis points over US T-bills. Their thesis is based on an in-depth examination of CTAs reporting their performance numbers to the Lipper-TASS database during the period 1994-2007. The headline performance, assuming equal weighting of each CTA, was 12.6%. Compensating for survivorship bias and backfill bias left a return of only 90 basis points above T-bills, net of fees. Before fees, the funds were returning 5.37%. CTAs, the study seemed to argue, were keeping much of the outperformance themselves.

Fig.2 Net Asset Values for Stocks and CTAs

Source: Bloomberg AlternativeEdge research

Indexed in US\$, January 1996 through October 2008



Gorton and Rouwenhorst also designed some crude indices to mimic popular futures strategies. While they accepted that accurate replication remains difficult, doubtless some banks will be working hard to do just that over the first half of next year as institutional interest focuses on this area. The question is whether they will be able to come up with something that can do the job.

Gorton and Rouwenhorst argue that similar passive diversification could be achieved via commodities indices, but could it? Would such an allocation have achieved that this year?

"It is very difficult to benchmark CTAs," says Dr Paul Netherwood, a partner with CTA Beach Horizon. "There is a lot of variability in the composition of the underlying funds. Funds can invest in many different contracts with different weightings to each market which can make each fund difficult to classify and, therefore, difficult to select a comparable index."

He points out that while there may be several established commodity benchmarks out there; these are long only in character, and they all vary in the way they are constructed. These are not useful as a benchmark for CTAs because CTAs can go short as well as long.

At AHL, Skaliotis thinks that the use of hedge fund replication strategies to mimic hedge fund return streams are fine, so long as correlations are stable. However, this starts to break down when markets change. "An alternative approach is to replicate via simple trading rules," he explains. "These can become increasingly complex, but eventually the lines between a hedge fund and a replication strategy disappear."

One of the key points the debate avoids, however, is the lack of correlation. CTAs do well when the S&P 500 does badly. They are an important diversifier in a hedge fund portfolio. To avoid them because of suspicions about systematic programs at a time when much of the rest of the industry is suffering major problems with liquidity, and will no doubt be forced to review its transparency levels, seems short-sighted.

Convincing the sceptics

CTAs have faced ongoing scepticism about what they do. Several institutional investors interviewed by this magazine have said they steadfastly avoid funds which use 'black box' or systematic strategies. They argue that they don't like to invest in strategies they don't understand. CTAs, on the other hand, believe they offer a very high degree of transparency.

The fund managers might not necessarily allow investors to sit down and dissect the algorithms they make use of in their day-to-day trading activities, but they can show them exactly what is sitting in their portfolios.

On top of that, they are dealing in exchange-cleared derivatives contracts, which bring with them those gold dust credentials in today's financial environment: liquidity and transparent pricing.

"A lot of hedge fund strategies have a certain amount of flexibility when it comes to marking to market," says Newton at Global Advisors. "Most managed futures funds have no such flexibility. This has been borne out by the fact that the drawdowns experienced by many strategies in 2008 have vastly exceeded the levels of volatility previously experienced."

Silicon versus carbon

Technology is, after all, an explicit concept, while the human brain is much harder to measure and assess. Managed futures managers can find it difficult to understand why investors are more comfortable backing the unquantifiable elements of an individual manager's brain in other strategy areas, but shy away from the mechanical elements represented in a systematic money management format.

"[Scepticism] can only be overcome with ongoing education and openness by managers," says Skaliotis at AHL. "It is also worth noting there are a number of desirable attributes to 'black box' strategies. These are reputable processes which provide managers with a powerful framework to assess how their funds would respond to different market scenarios."

Aspect Capital CEO, Anthony Todd, argues that CTAs represent a significant part of the alternative investment universe and that scepticism has not retarded the strategy's growth. "I would say that a lot of people do understand the fundamental underpinnings of managed futures, and that it is only a very few investors who have problems with so-called 'black box strategies,'" he says. "How can we tackle the problem? By providing the level of transparency required for the investors to fulfil their fiduciary responsibility, but counterbalancing that by fiercely protecting our intellectual property. It is admittedly a difficult balance to strike, but the fact that so many institutional investors have invested in this sector bears out the fact that it is possible to provide that level of comfort."

Ultimately, the key litmus test will be if CTAs can continue to provide strongly diversified returns in deeply liquid markets, with an absence of leverage. This could dispel any doubts quicker than anything else managed futures funds could do.

Challenges ahead?

Other challenges could potentially lie ahead for CTAs. Top of their list has to be the potential for future regulatory changes which could have a sweeping effect on the hedge fund industry generally. There is currently little to suggest that specific measures will emerge to target derivatives markets per se, but last summer the Commodities Futures Trading Commission testified to the US Congress amidst suspicions that traders, including hedge funds, were colluding to push up oil prices. A major investigation that included the US Treasury, the SEC, the New York Federal Reserve and the Energy Information Administration also failed to turn up any solid evidence of speculation helping to push up oil prices.

Since energy prices went into decline in the second half of the year, the pressure has been off the CFTC, but managers do recognise that there was a demand

on Capitol Hill for some kind of solution to rising energy prices, and an investigation into the role played by hedge funds in these rises was seen as a means to demonstrate that the US government was doing something about it.

“There’s regulatory risk out there for everyone,” says Beach Horizon’s Dr Netherwood. “CTAs are probably better placed to cope with this than other hedge fund strategies, because of the transparency they offer, and the fact that they are trading on regulated exchanges, with fully regulated instruments.”

He anticipates that we could see the SEC requiring that foreign fund managers register with it, and there could also be a thrust towards greater transparency, but in the end, he says, this should be seen as a good thing for the industry as a whole.

“Where regulation is likely to focus is on levels of transparency and levels of leverage,” says Todd at Aspect Capital. “Those will be the two main themes, and it is key that we watch it very closely. Since managed futures funds already operate in deeply liquid markets, which are exchange-driven, I believe we already take into account many of the potential actions which regulators might enforce.”

Other areas of risk include the levels of liquidity in the underlying markets next year, particularly if increased regulation dries this up suddenly. CTAs will need to keep close tabs on transaction costs and on their visibility in the markets.

Volatility

Like other hedge fund strategies, CTAs have seen volatility creeping up. They have had a good year, but it is hard to avoid the implied volatility in the current markets, particularly given the antics in the energy markets since the beginning of this year. “Volatility has increased since last year,” says Beach Horizon’s Dr Netherwood. “You have to realise that many CTAs are macro representations of the global economy so CTA volatility has increased in line with market volatility. Many strategies make adjustments for volatility at the market and macro level, but it really depends on the strategy how quickly that gets reflected in the volatility of their returns.”

Dr Netherwood believes we will see CTA volatility coming down in 2009. Turbulent global markets, nightmare periods in the global economy, can be good news for CTAs, he says. “If you look back at times of stress in the equity markets we can recall events such as the Asian crisis in ‘97, the Russian crisis in ‘98, the equity bear market coupled with 9/11 in 2000 - 2003 and now the subprime crisis. These are all times when CTAs have performed well and can help to protect investors in these difficult times.”

While CTAs have historically had greater volatility than other strategies, during the current turmoil, and while it may have risen within this sector, volatility has simply not soared the way it has in other strategies. The risk/reward trade-off has consequently become more favourable as a result, and has remained so for most of this year.

Another potential challenge is that of ‘market flooding’ next year as many investors chase performance in the managed futures space and start allocating in a big way. Opinions vary as to how much risk this really represents. For starters, it is not easy to launch a proper managed futures fund. It is not something some bright sparks off the prop desk at a big bank can easily achieve.

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“There are some big barriers to entry here,” says Beach Horizon’s Dr Netherwood. “You need the infrastructure, you need the knowledge, you need the experience. The route many start-up hedge funds have travelled in the past is not viable here. The infrastructure needs alone require substantial upfront investment, and with the regulatory landscape changing, this is only going to get more expensive.”

Start-ups aside, futures markets have been adept at absorbing additional capital flows. Since the launch of major commodities indexes like the Dow Jones AIG series or the Goldman Sachs commodities indices, there has been a steady flow of capital into the markets on the back of these products. Estimates attribute an additional US\$10 billion into the futures markets in 2002, up to US\$500 billion in 2006. The fact is; these inflows were easily absorbed. “The underlying markets lead the growth, not the managers,” says Dr Netherwood.

Hedge fund of funds International Asset Management says one of the attractions of the strategy is that

it does not face the same capacity constraints as others. However, while IAM has been investing with CTAs since 1990 (the firm was founded in 1989) and says the CTA opportunity set is likely to expand in 2009, it is also looking closely at the risks of possible market flooding.

At Aspect, Todd says it is more a question of perspective. “If you look at the total size of the managed futures sector – let’s say US\$200 billion – against the total turnover of the markets in which we’re trading, the footprint that managed futures leaves is tiny. Could growth in this strategy erode returns? Possibly. But our response has to be constant evolution of our programs, with the aim of avoiding a crowded space. The leading CTAs are constantly investing in research and development over time, fighting alpha degradation via innovation. The half life of any strategy’s ability to provide alpha is getting shorter and shorter all the time.”

Looking ahead, CTAs see no end in sight for the current conditions. In particular, the commodities markets could see another major reversal in direction. Over at Global Advisors, Newton sees the current commodity environment as an extremely interesting one. The credit crisis and much lower prices have caused a very substantial reduction in capital expenditure amongst producers, while the increased volatility has raised the perceived risk profile of many projects.

“We think in broad terms that what is happening now in the commodities markets will only sow the seeds for another big wave in commodity prices,” he says. “Some producers are already cutting their maintenance projects. It won’t be easy to simply turn the taps back on again.”

Now may be the point when CTAs go mainstream in the European market. With many other strategies seemingly correlated to the equity and/or credit markets to one degree or another, managed futures programs have emerged from the dust clouds of this autumn looking in better shape than ever: 2008-09 could end up being a vintage couple of years. “I think this is a fantastic opportunity for the CTA industry to remind the rest of the world what it is capable of,” says Beach Horizon’s Dr Netherwood.

Many investors and funds of funds, once so sceptical of the ‘black box’ boys, will now be forced to revisit them, if only because the numbers speak for themselves. Funds of funds themselves have been increasing their cash reserves, and in the New Year will need to decide whether to return that money to investors or put it back to work. If they’re going to invest with hedge funds, they’re going to be looking at the strategies that have not lost over 20% this year. They’re going to be looking at CTAs. **THF**