ALTERNATIVE INVESTING

Understanding Managed Futures

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Managed futures is an alternative investment that has historically achieved strong performance in both up and down markets, exhibiting low correlation to traditional investments. It was one of the few investing styles that performed well in 2008 as most traditional and alternative investments suffered. As a result, this little understood strategy has attracted much attention.

Hedge funds and commodity trading advisers (CTAs) have pursued managed futures strategies since at least the 1970s, shortly after futures exchanges expanded the set of traded contracts. Still, many investors have shied away from them, perhaps due to a lack of understanding of how and why they work.

The primary driver of most managed futures strategies is trend-following or momentum investing — that is, buying assets that are rising and selling assets that are declining. These strategies are typically applied to liquid exchange-traded futures contracts on various commodities, equity indices, currencies or government bonds.

Trend-following strategies only work if price trends continue more often than not. But why should they? One explanation comes from Daniel Kahneman and Amos Tversky's Nobel Prize-winning work on behavioral economics in the 1970s and a subsequent large body of research that links behavioral biases to underreaction in market prices.

This paper demonstrates the potential strong performance and diversification benefits of a simple managed futures strategy. The simple portfolio shows explicitly how a managed futures strategy can be implemented in an attempt to demystify the asset class. The hypothetical Simple Managed Futures Strategy has produced strong returns in both bear and bull markets, and has performed consistently across markets.