Investor Guide
Managed Futures

Key Ideas

• Managed Futures seeks to take advantage of trends in global asset classes
• These strategies have historically performed best when markets went from good to great or from bad to worse
• Managed Futures has the ability to profit in rising and falling markets
• Over the long term, Managed Futures has offered investors a diversifying source of returns

Please read important disclosures at the end of this paper.
What Is Managed Futures?

Managed Futures is a strategy that focuses on trends in global markets by trading futures contracts — agreements to buy or sell a particular asset in the future at a price set in advance. The assets could be stocks, bonds, currencies or commodities, which are traded on markets around the world. Investors who pursue Managed Futures generally buy contracts for assets that have been rising in value and sell contracts for assets that have been falling. This approach, called trend-based investing, is not new; classical economist David Ricardo (1772–1823) said, “Cut short your losses” and “Let your profits run on.” Hedge funds and Commodity Trading Advisors (CTAs) have formally pursued trends in futures markets since the 1970s.

Why Does Managed Futures Work?

Trend-following strategies work only if price trends continue more often than not. But why should trends continue? One explanation comes from Daniel Kahneman and Amos Tversky’s Nobel-Prize winning work on behavioural economics in the 1970s and a subsequent large body of economic research that links human behaviour to under- and over-reaction in market prices.

We illustrate an example of a trend in Exhibit 1 below. A trend must first start with a catalyst (Point 1). In this example, it is a positive change in the fundamental value of a security. For example, it could be a positive news release about corn prices or a strong announcement from the Federal Reserve Bank. Trends tend to continue as prices slowly move to fully reflect changes in fundamental value (this underreaction is represented as Point 2). These trends have the potential to continue even further to the extent that investors herd, or chase, these trends (Point 3). Herding can cause prices to overreact and move beyond fundamental value after the initial underreaction. Naturally, all trends must eventually come to an end as deviation from fair value cannot continue indefinitely (Point 4). The same example can apply to negative catalysts where the below behavioral pattern would be inverted.

Exhibit 1 | The Hypothetical Life of a Trend

Source: AQR. This graph is a hypothetical example for illustrative purposes only and does not represent an actual investment.

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1 A CTA is an individual or firm who provides individualized advice regarding the buying and selling of futures contracts, options on futures, or other foreign exchange contracts. The CTA registration is required by the National Futures Association, the self-regulatory organization for the industry.
On Average, Managed Futures Has Historically Helped When Needed Most

We believe one of the most powerful attributes of Managed Futures is its tendency to do well in strong and weak markets (depicted in Exhibit 2). When the returns of the Credit Suisse Managed Futures Index are compared with the returns to the global stock market, MSCI World Index, the strategy performs best in extremely strong and extremely weak markets.

Exhibit 2  | Managed Futures Returns in Strong, Weak and Normal Stock Market Environments²
January 1, 1994–December 31, 2013

Based on our analysis, an investment that produced positive returns when investors’ portfolios were down would have been beneficial. The main reason Managed Futures has exhibited this attractive characteristic is because most extreme down or up markets have not happened overnight, but instead have occurred as the result of continued deterioration or improvement in economic conditions. In prolonged down markets, Managed Futures positions itself “short” — that is, the strategy sells borrowed assets — as markets begin to decline and can profit if markets continue to fall. Similarly, in sustained up markets, Managed Futures positions itself “long” — the strategy buys assets — and can profit if the rise continues.

The financial crisis represents a classic example of how Managed Futures is expected to perform in troubled markets. Going into the fourth quarter of 2008, equity and energy prices had been declining; government bond prices had been rising. This led to Managed Futures being positioned short equities, short energy commodities, and long government bonds. These positions profited as the same trends continued throughout the quarter while the stock market and other strategies suffered. The returns during the fourth quarter of 2008 are graphed in Exhibit 3 below.

² “Stocks Weak” represents the worst 30% of the MSCI World Index’s quarterly returns, “Stocks Strong” represents the best 30% of quarterly returns, and “Stocks Normal” represents the middle 40% of quarterly returns
The Goal: A Smoother Ride and a More Resilient Portfolio

Investors seek alternative investments — that is, alternatives to buying and holding traditional assets like stocks and bonds — in order to increase the expected return of their portfolios while improving diversification and reducing the magnitude of losses if global markets suffer. We believe the Managed Futures strategy can meet all of these criteria, which means it has the potential to benefit a wide range of portfolios.

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MSCI World Index: The MSCI World Index is a stock market index of approximately 1,600 world stocks. It is maintained by MSCI Inc., formerly Morgan Stanley Capital International, and is often used as a common benchmark for ‘world’ or ‘global’ stock funds.

Credit Suisse Managed Futures Index: is an index composed of managed futures strategies globally.

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