TOP TRADERS ROUND TABLE

EPISODE #20

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"Being a mid-twenties analyst during the 2008 financial crisis was a very eye opening experience, and it showed me the importance of being methodical and critical, and not quick to make decisions whenever you're faced with adversity in investing." ~ ***Steven Wilson***

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I sincerely hope these interviews serve as a useful resource for you in your career and endeavors in the world of trading. If you have indeed enjoyed these shows, please consider giving the podcast a rating and review on iTunes. It would help spread this knowledge to traders everywhere.

As you read this transcript, remember to keep two things in mind: all the discussion that we'll have about investment performance is about the past, and PAST PERFORMANCE DOES NOT GUARANTEE OR EVEN INFER ANYTHING ABOUT FUTURE PERFORMANCE. Also understand that there's a significant risk of financial loss with all investment strategies and you need to request and understand the specific risks, from the investment manager, about their products before you make investment decisions.

Niels: Welcome to another edition of Top Traders Round Table, a podcast series on managed futures. My name is Niels Kaastrup-Larsen, and I'm delighted to welcome you to today's conversation with industry leaders and pioneers in managed futures, which is brought to you by CME Group.

Today's conversation is taking place at one of the most important events of the year, namely the MFA Network 2019 Conference in Miami. It's a great event where hundreds of investors and managers meet in a wonderful setting that allows for some very productive conversations. One of them is my conversation today, with Steven Wilson, who is a senior portfolio manager in the Public Market Group at The Teacher Retirement System of Texas; Trent Webster who is the senior investment officer at Strategic Investments for the State Board of Administration of Florida; as well as Jake Barton, who is a senior portfolio Manager at Promus Capital, which is a multi-family investment firm.

First of all, welcome and thank you for taking time out of your busy schedules to join me for this conversation where we will cover many aspects of the investment process. So, I thought a really fun way to start would be to go back, earlier in each of your careers - specifically with your experience in the investment world and how that lead to where you are today. And, perhaps, also how those experiences along the way have influenced the way you think about investing today. So, [this was] just to frame our conversation a little bit.

Steven, why don't we start with you? Tell us about your investment journey and how that lead you to where you are today at TRS.

Steven: Sure, so the first thing that comes to mind is in 2008, during the global financial crisis I was working at a private wealth shop that catered to very wealthy high net worth individuals. I have a very vivid memory; I think it was March 8th or 9th, 2009. As we all know, it was the troughing point, but nobody knew that then, obviously. We had one client that had been wanting to sell and get out of their investments for a really long period of time and we had been successful in convincing them not to for a while and then, finally [it was,] "I can't take it anymore, I'm done, go to cash," and obviously, the rest is history.

Later, as I progressed in my career and I was looking for a more long term place to develop as an investor, going to a place like TRS was a no brainer because, given the duration of capital that we have, we knew we could be the strong end of the market and not make decisions like that. Being a mid-twenties analyst during a financial crisis was a very eye-opening experience, and it just showed me the importance of being methodical and being critical and not quick to make decisions whenever you're faced with adversity in investing.

Niels: Absolutely, and how about you, Trent? You seem to have found your dream place to work right out of the gate since you spent quite a few years at the Florida State Board.

Trent: Well yes, being a Canadian citizen, living in Florida has always been a dream of most Canadians. So, now that I'm down here I'm quite happy. My background is that I took an interest in investments at a very young age.

My father was a stockbroker for many years, so I had an understanding, maybe where other people didn't' when I was young. I started reading books about stocks when I was in high school, as a teenager.

I eventually wound up at a firm in Toronto called Spruce Grove Investment Management, where I was working and found a job when I was in my MBA at the Florida State Board of Administration, where I worked for several years as a portfolio manager in equities. The State Board actually got caught up in the Enron scandal. Not that it was involved in any way with the Enron scandal, but we ended up losing a lot of money in it.

Because of that, amongst other things, I transitioned over away from active management, managing my own portfolio, which had done well, into the oversight of managers. In 2008, 2009, I was transferred over to this new fandangled creation that they had developed at the state board called Strategic Investments.

Strategic Investments is the asset class where, if everything doesn't fit nice and neatly into the other asset classes, that's where it comes. So, it's typically hedge funds, a lot of private market structures that aren't... equity, private, real estate, and then any other thing weird thing that is eclectic or different from the rest of the fund.

So, my background, because of that, growing up reading Buffet as a teenager, and starting at Spruce Grove and the like is that I have a very value-oriented, contrarian philosophy. That's actually one of my pathways into managed futures, was coming here to the MFA, several years ago, and experiences or seeing a lot of pain amongst the CTA managers because they'd gone through one of their worst times ever. I thought, hmmm, that's really interesting.

It was around that time that we started to get interested in it. So, as an equity fundamental guy, who has, probably, the least amount of math around this table, I've actually become one of the biggest proponents of it as a diversifying tool. It's done OK for us since we started to invest, but it has done better than our other hedge funds. So, we're quite happy to be here, and I always come to be here to MFA and thinks it's a great event.

Niels: Absolutely, I appreciate that. Jake, I know you have spent a few years on the managed futures side of the business. Tell us about your early investment experiences and how that shaped your future journey to Promus Capital?

Jake: Sure, thank you. If you talk to some trading firms and you ask them what they look for in a trader, they often like somebody who actually doesn't come from a trading background. They want to have somebody, maybe with the analytical skill sets and so forth. They want to be able to train them in their way of thinking and their way of viewing the markets.

So, in a way, my first foray into finance was immediately into a company called Efficient Capital Management which focuses exclusively on managed futures. So, I didn't have to be reprogrammed or forget efficient market theory or anything like that. I was brought straight into managed futures after getting my MBA from Kellogg. So, I had some financial background, and that was helpful.

To your question about what other financial experiences did I have? My Dad had me buy some stock in high school just to see what that's like. That was exciting. I like to see the compounding effect of making an investment in public markets and so forth and holding it for the long term. Then I was a nuclear engineer in the navy, actually for seven years. I've always had that more analytical, problem-solving side to me.

Then working at Efficient Capital Management, I started in 2007, 2008, so this is kind of the heyday, at least in people's recent memory, when managed futures were really hitting it out of the park. That was, "J. K. come on, join Efficient, we'll learn about managed futures. 2007, 2008 were incredible years." I was, "This is great!" Every day you'd walk in, and all the spreadsheets were lighting up with huge returns. I was convinced that this was the place to be if you're going to be in finance. Markets were tanking everywhere except in managed futures. That was a good way to get started in the space.

Niels: Sure, absolutely. So, to kick things off in a slightly different way, I think it could be really useful if all of you share just a bit of the investment landscape, as you see it right now, early 2019, and how your portfolio is allocated across major asset classes. Perhaps, talk a little bit about the changes you may or may not have made from what can only be described as a difficult 2018. Trent, maybe we can start with you and just see how you see the world right now.

Trent: So, just a bit of background. So, I oversee, roughly, thirteen billion dollars for the State Board of Administration in Tallahassee Florida. What's unique about us (or somewhat unique about us) is that I have a flexible pool of capital where I'm running an alternative portfolio where I don't have to put any money to work at all if I don't want to. I can, in theory, liquidate the entire portfolio and give it back to the rest of the organization if there's nothing that I like. In practice that won't happen. What it does is it creates a mindset, in the department or the asset class, that if there are things that if you do not like them, or do not want to allocate capital to them, you do not have to force it in.

So, we have this flexible pool of capital. Also, understanding that being a large state plan, we're about as nimble as a battleship. So, it takes some time for us to turn in any appreciable manner. For the last three or four years, I haven't been particularly enamored by credit or equity markets because of a lot of financial engineering and quantitative easing by the Central Banks. That became very, very expensive in risk assets. So, we spent the last several years investigating things with low correlation to equities such as relative value, managed futures, global macro, those things.

Now we're starting to switch away from that because we're starting to look through. We're in a bear market, and we think we are in a global bear market with risk assets, whether the United States is or not, the rest of the world is. What we're starting to do is starting to get interested in risk assets because we want to be buying things when things get cheaper. So, it takes us a while to maneuver. But, when asset markets come down, we started to look through the valley and started planning what we want to do into the bear market. It may or may not happen. We don't know, but we're trying to look out three to five years.

So, we're now getting more interested in risk assets, and we will do more research in risk assets. In higher beta equity we'll start looking at some credit where we're setting up some structures. We're looking at some riskier infrastructures, say in emerging markets, so a variety of other things. So, for the last three or four years, we've been defensive. Over the next year or two, we expect to get more aggressive.

Niels: Ok, interesting. What about you, Jake, how do you see the world right now?

Jake: As a multi-family investment office we're somewhere in between a pension fund and an endowment, which have really long term horizons that they can plan strategically around; versus a prop desk or CTA, doing shorter-term strategies or even some hedge funds where you're really reacting more to the markets and thinking on shorter-term horizons. We have some ability to think long term for certain clients, and other clients might have shorter-term needs. Then there's the added complexity of also needing to listen to the clients.

As a fiduciary, you're trying to guide them, as the expert, in investing in certain asset classes, but you also have a relationship that you're managing. So, if those clients, for whatever reason, want out of an asset class, even if it doesn't make sense, you try your best to convince them otherwise. There's some give and take that needs to be done if you want to maintain that relationship. So, it's a tricky balance to play. It's a science and an art.

So, managed futures, as many of us have experienced, has been a tough space to be invested in unless you can just put your money in and look away for ten years or so. There's been a tough environment when volatility is low. Things are picking up now, and we'll see how it goes. But, it's cultivated a little bit of negative sentiment amongst our clients.

So, while we believe in the diversification there, we have to balance how our clients feel having this in their portfolio. Many of them have asked to have it reduced. But, I think we're starting to get to that turning point where you see equities don't just go straight up all the time, and volatility is something that you have to be prepared to have a response to in your portfolio, also, in an uncorrelated and diversified way.

So, I think we're reaching the position where we can start engaging our clients again in discussing managed futures and uncorrelated assets. I think they might be a little more receptive in hearing it when seeing what's going on in equity markets. So, that's one way we're positioning ourselves and also, I think, we do think that drawdowns are going to happen. We don't know when, we don't know if there is going to be a recession in 2020, or who knows when. But, we want to have cash available to respond when valuations reach a level where we think it's attractive to enter. So, we're trying to be invested in things that are yielding, where we can build up a cash position because cash, finally, is actually returning something to clients. So, it's actually not a bad thing at two and a half or three percent in a very, very low-risk position in cash.

So, we're looking at private debt. We've done some real asset investing that's yielding something. We're trying to be in spaces that aren't correlated to build up the cash so that we could respond when markets tank. But then there are also those things that we want to be proactive about like managed futures.

You can't wait until there's a move, necessarily, because often it's over a long gamma profile. You don't want to wait until it happens and then say, "Oh, we should have been in." We see the outside of the biggest growth in the CTA space in 2009. It wasn't the best time to invest. If somebody had been more proactive ahead of that and seen what was happening in the mortgage space and so forth it would have been prudent to have been invested before that. So, you can't always wait and be reactive.

Niels: Sure, absolutely. Steven, what does your portfolio look like, right now, in this environment that we're in right now?

Steven: Sure, so at Texas Teachers we've got about twelve billion dollars in hedge funds. The hedge fund group has the luxury of really saying that we're just going to go hunt for where the best alpha is, and we'll let the other smart people at the pension determine which betas are the best combinations to have at any one point in time.

So, my job isn't necessarily finding what is the right equity market to be in, necessarily, or somewhere else. It's really to find different shaded models of investments that generate orthogonal returns to the rest of the portfolio and to betas. So, what we've been focused on recently is finding areas of the hedge fund market where we can allocate capital where there is some sort of complexity premium to understanding that type of investment, and where there are managers that have very significant barriers to entry that aren't conceptual but are real things on the ground.

So, some of the areas that we've been focusing on, within the hedge fund portfolios, is that we've been making a lot of highs in Asia; those markets are less efficient. They are earlier in their development, and there are still a lot of people there that have the capabilities and skills to extract a lot of value out of those inefficient markets.

We've made a lot of headway into things like volatility arbitrage. That's an area that is not well understood, and we think we can add value to the portfolio by selecting managers that do that well. For example, we created a reinsurance portfolio in 2013 and have recently made big moves into retrocession, which is a type of reinsurance. We believe there's a complexity premium there.

Then, maybe more relevant to our discussion on managed futures, we've been in a pretty long process of transferring the bulk of our risk into alternative CTAs, which has been an area where people are able to sustain the return that they're generating much better than, it seems like, in the traditional programs. So, fortunately, like I said, I don't have the hard job of forecasting betas, but we do recognize that you can't just scattershot into hedge fund land and pick the blue-chip folks and think that you're going to have a sustained advantage. It takes a lot of work, and that's what we've been working on.

Niels: Before we move on, and as a follow-up question, I'm interested to know, as you go about structuring these portfolios, what are the core beliefs or principles that govern how you do your asset allocation?

Maybe we can start with you, Jake, on this one. Are there any core beliefs that you have that play a major role in the way you structure the asset allocation?

Jake: Yes, absolutely. We like to think that we're opportunistic. But, that's always hard to do because it might sound like the crystal ball or something, and it is hard to do. But, we try to look and see where are we in the business cycle? Where are we in the credit cycle? Where are we in the various cycles that, whatever that asset class may go through, where are we in that process? Is now a good time or a bad time, or are we not sure?

If we have strong conviction then maybe this is a good time, a space has been beaten up, and there aren't any underlying economic or global reasons that valuations are depressed and should continue to go down, but just in terms of looking at regular ebbs and flows in prices. We try to evaluate if it's a good time or not, and buy it cheap and sell high if we can. So, that's one thing that we look for.

We kind of agree that smaller is better. In most cases, it's not always going to be the case, but with managers, sometimes you find the smaller managers are hungrier, they're really trying to prove themselves. They're 100% devoted to their product. They're not worried about their fifth house, or their yacht. Once they've made it big and they're bringing the money, it brings other complexities to their life and also to their business. Then there's partnership and succession planning; there are all these things that can muddy the waters with them just focusing on what they do best.

Also, when you're smaller, and you don't have as many slippage issues you can get in and out of markets much more efficiently and cleanly. You're not leaving a footprint where ever you go. So that's another thing that we look at is the size of a manager.

We really value ethics and moral behavior in our managers. So, that's something that we try to spend a lot of quality time with the people that we invest with to really understand them as best we can, or have really strong references from people that we trust. I think that's important.

There's a lot of brilliant people out there who can be brilliant making money but they can also be brilliant about pulling the wool over your eyes, so we have to take that into account. I think, generally, we're sort of in between markets that are efficient and inefficient and trying to find where they are inefficient, can we capitalize on that in some way?

Why is it inefficient? Why is there a dislocation? Why is there an arbitrage opportunity there? Why is this a niche space that few have discovered yet? If you can find something like that and understand the economic principles that are underlying the opportunity that is there.

If it's all legitimate and it comes from sound economic theory, we try to find things that are lesser discovered areas that aren't plating as well and then find the best person or the best team, in that space, to partner with and come alongside to try and extract some value. I'm sure that there are many more. We put a lot of thought into this. I don't want to monopolize the conversation, but that's probably something that we spend quite a bit of time on is, what is our philosophy and how do we want to be good stewards of the capital that our clients trust us with.

Obviously, the easy one is diversification; we want most of our clients coming to us with a great deal of money already that they have worked hard to obtain or to maintain and we don't want to take high risks or speculative or concentrated positions with that money. With that, we want to be respectful and diversified as possible to make sure that we're only growing and compounding what they have already brought to us.

Niels: Sure, very interesting. Trent, do you have core beliefs that you follow in your way?

Trent: So, in our asset allocation we pretty strongly believe that markets tend or trend towards efficiency over time. In some markets, efficiency can be bang, immediately. Sometimes it can go for months and months, if not longer, for years in inefficiency.

I think that one of the gravest mistakes (and I say this as somebody who majored in economics and got an honors degree in finance) that academia ever made was assuming and communicating that human beings were like automatons that instantly calculated all the volatilities, whether it is as individuals or groups, to always get to the right answer on pricing. We, fundamentally, do not believe that.

It certainly happens over time because if it didn't then capitalism wouldn't work, right? Sometimes it happens immediately. Sometimes markets are highly efficient. But, often times, human beings are human beings, and human beings come to behavioral aspects and trades which create these inefficiencies which allow opportunities to arise.

The way we implement that is that, again, being a large plan with several billion dollars that moves relatively slowly, we look out three to five years and then implement a value/contrarian philosophy. So, in terms of asset prices, valuation is not all that hard to figure out if something is cheap or expensive. But, from a contrarian standpoint, in strategies where the contrariness isn't represented by valuation, you can see that in capital flows.

So, is an industry out of favor and in favor? For example, again, one of them is on managed futures. We started looking at this space; I think it was in 2015 when this was really getting hit pretty hard. I think that in managed futures it's a really good example that this is not a strategy you want to go into when things are great, and they've had several years of good performance. Like Jake said earlier, after 2009. You want to go into it where there's been a lot of pain in it.

If you go back, and you look, using the Credit Swiss Index, or the Managed Futures Index, we're in the midst of the seventh pullback of mid-teens returns in managed futures. This is driving on a little bit longer than usual, but at some point in time, things will change.

The greatest trader I had ever studied is Jesse Livermore. He has a quote that I'm probably going to mess this up a little bit, but he said, "Wall Street never changes, the pockets never change, the stocks never change, the suckers never change, but Wall Street never changes because human behavior doesn't change." So, we try to, when we're implementing our asset allocation, take advantage of those anomalies in human behavior which can draw us into discrepancies in valuation and capital floats.

Niels: Yeah, Absolutely. Steven, I want to hear your views on this and any core beliefs that TRS has.

Steven: Sure, at the very core our core belief is that we have a mission, and the mission is that when the Teachers of Texas retire, that they are able to do so with the dignity and resources that they deserve after, many times, thirty to forty years of public service and the pursuit of educating the people of Texas. So, that's a really important thing. We're always talking about it. It weighs on us as we work every day. That's the backdrop.

We believe that through a prudent implementation of a hedge fund portfolio, it's a critical part of the asset allocation that allows you to mitigate some of the rougher times, whenever risk premia expands, markets sell off, that kind of thing. So, from a long term perspective, having something like a hedge fund portfolio as you again to be that strong hand in the market like I mentioned earlier.

That being said, the goals of the portfolio are to be zero beta, as I mentioned, outperform HFRA, outperform treasuries, and to be an absolute return vehicle. So, whenever we think about how do we make sure that we meet those goals, we have to set up partnerships that are meaningful, both to our portfolios and to the managers. We need to be significant enough that we're able to drive economics in our favor, and we also need the investment to be significant enough to the portfolio that it drives enough risk to be noticed. Otherwise, it's not necessary.

So, in general, when we're constructing our portfolios, we're looking for structural alpha that's uncorrelated to betas and to the rest of the hedge fund book and we seek to balance that among each other so that you have a holistic portfolio of orthogonal return that's not overly exposed to any one risk factor.

Niels: Now, I don't know. This question is probably more relevant for you, Trent, and for you, Steven. I don't know much about the specifics of your two plans. I'm curious whether you have experienced this, or whether you know from other plans, how the level of funding of a pension plan... If it's very underfunded, or it's close to being fully funded, whether that impacts the decisions or the risks that they take, meaning, do people who are very underfunded say, "We're going to go fully in and really hope to make it up." Or, does it make them more cautious because we can't afford to lose anymore? Is that something that you've come across? As I said, I don't know the specifics of your plans, but it's a big issue in the U.S. I think, and in Europe, for that matter about pension plan funding.

Trent: It's an excellent question. As it pertains to the State Board, the answer is no. We are one of the highest funded pension plans in the United States. I think around 85% or 86%. But, this is going to be an issue, without a doubt, there is a pension crisis coming in this coming in this country, probably sometime in the next decade or so.

There's going to have to be some very hard decisions made, whether that's at the political level or at the asset level or at the recipient level. Something is going to have to change. It might be that funds which are underfunded but aren't so far gone that they'll never come back, which is where some pension plans are at, then maybe you do have to change the asset allocation. Maybe you do have to take more risk.

I don't know. Fortunately, I don't have to answer that question, at least not right now. But, without a doubt, there's an issue coming in the future, sometime down the road. It's a question that you've asked, which is probably about ten years ahead of its time because it is a question that people will be asking in the not too distant future from now.

Niels: What about your experience, Steven?

Steven: I'm lucky, just like Trent, where, not only are we in a good spot relative to our peers from a funded status. We have a fantastic governance structure that allows us to be insulated from political type things that can interfere with other plans. I will say, talking to some of my peers at other funds, a lot of times when you get to a level where the funded status is so low that there is clearly something that needs to be done, what ends up happening is you get this very vicious cycle where someone new comes in, they say they can fix it, it's too hard, they don't get it done; three years later somebody else comes in, they say they can fix it, then you are constantly in a state of trying to restart.

It's like if you've got a favorite college football team, or an NFL team, if you get a new coach every three years, you're not going to the Super Bowl. It's not happening. So, once the funded level gets too low people run a real risk of it becoming a toxic environment and then it never gets fixed. Fortunately, I don't have experience with that, but I have talked to people where that's been problematic.

Niels: Yeah, absolutely. Thanks for that.

Ok, so, let's turn to some more specifics. You have already indicated and guessed which asset class or strategy I am keen on exploring a little bit further, and that is, of course, managed futures. I want to kick it off to talk more about how that fits into your strategy even though we've touched upon it a little bit earlier.

A couple of years back, also here in Miami, we did a podcast with three of the largest consultants in the industry. I'm sure you know all of them. One of the things that we discussed was what they thought was the optimal allocation to managed futures or trend following very often was much higher than the pension plans or other institutional investors are able to do in a practical matter.

Also, there has never been a white paper written, as far as I'm aware, that does not prove the point that there is a benefit of blending managed futures with stocks and bonds. Of course, we know from other conversation in this podcast series with CalSTRS embraced the strategy in a quite healthy way. So, I'm interested to hear what you're doing, specifically, in this space at this time and what your thoughts are, in general.

Let's start with you, Jake. You touched upon it already. I'll just follow through with my line of thought here.

Jake: Sure, thank you. Well, academically you can look at numbers, you can go back through history. I know AQR has done a bunch of studies on this putting together some synthetic markets, going back close to a hundred years. Academically, you can see that managed futures should have a very significant piece of a well-diversified portfolio. I think that's part of the language that they like to use.

That's true. It's very difficult because of the volatility in this space. What does an allocation of managed futures look like? There are a lot of different ways to achieve that in that volatility for people who are doing weekly meetings, or quarterly reporting, or whatever the cycle is. A lot of investments are probably best just to be made, and then you look away and go carry on with the rest of your life for five to ten years and then come back and look at them.

But, we're such a short timeframe society now. You can be on vacation and pull out your cell phone and look at any market in the world that you want to and I think that has bred this culture of obsessing over every tick that happens in the markets to a detriment. There are some advantages to having that kind of visibility in the market, but it doesn't make people better investors, necessarily. So, that's one thing that makes having properly sized allocation of advanced futures is problematic is that some people perceive it as being more volatile. Sometimes it can be, depending on how you structure it. That's hard to look at on a frequent basis.

Something that came to mind while these guys were talking too. People heard the phrase, "Well, correlation is great. Having uncorrelated assets is great except when there's a crisis, then everything correlates to one." It's easy just to say that and not really think about what that means. I was having a conversation with our CIO last week, and we were pondering this thing. Really, diversification, we think, falls on a spectrum.

So, if markets are calm, then the market participants are happy to differentiate between Shell and Exxon. They're happy to differentiate between Brent and WTI. So, when markets are calm, there's a lot of differentiation and diversification that can be seen in things that, otherwise, might seem to be fairly similar. They're willing to go to the details and say, "Well, how are these two things different even though they're in very similar industries." Once markets start to get a little bit more volatile now, the markets will differentiate between an energy stock and a tech stock, or a tech stock and a utility.

So, as the volatility increases, or the calmness starts to break down and things become a little more hectic, the markets look further, and further away for what diversification looks like until you do have all assets seeming to correlate to one, including stocks and bonds, which are suddenly are both being sold off at the same time. Academically, people would say that shouldn't happen. So, what you have left, and we saw this in 2008, we saw so many charts during that time period, where all these very diversified asset classes all had the same profile and chart. They all fell off the cliff.

What didn't do that was managed futures. I think there are some really valuable aspects of it that you can trade pretty much any global or macro theme in the world that you can conjure up, you can find a futures contract to trade that and on a very safe exchange with great counterparties, great liquidity. So, when markets are falling apart, and a lot of asset classes start to correlate to one and volatility spikes, you can, within managed futures, very easily find things that are going in the other direction that make great hedges or make great alternatives in building that diversified portfolio.

So, being conscious of that, it's when markets have been... So take three rounds of quantitative easing and extraordinarily low interest rates put out by the government. You have this outside force acting on the market and suppressing volatility, that created this calmness, so it was hard to really structure diversification for to do it. When that period ends, and we're starting to see that volatility come back again, I think managed futures is going to start crying out for a larger piece of the asset allocation pie because it's just, mathematically and conceptually it's a better place to have your money when everything else is correlated.

Niels: Sure. How about you, Steven, is managed futures part of your line-up?

Steven: Sure, absolutely. So, in the Absolutely Return Hedge Fund Portfolio TRS, CTAs are about 12% of the capital, which doesn't sound like a lot, but if you look at the amount of risk that they contribute to the portfolio, it is, at any given point in time, between 35% and 40%. That's really in recognition that it's not a profile that we get naturally like the rest of the trust. It is extremely diversifying for reasons that we've discussed, and people know.

That being said, I think there's a good way to have a managed futures allocation, and then there's a lazy, bad way to do it. The lazy, bad way is, as everybody knows, is just finding the thing that did well recently. As we know, most managed futures investments are not greater than 1 Sharpe. They tend to be between .5 and .8, and if someone had a plus 25% year last year, they're probably going to revert to a .5 to .7 Sharpe, and you're not going to get much going forward.

So, you really just have to (I like the way Jake put it) invest in it and then come back in a few years. But, you still need a few principles to do that. The way that we've done it is to have as few managers as you need, but also to diversify across as many facets as you can in order to make sure that you pick up that one environment where some random markets are trending really hard, and that particular manager picks it up, and you get some nice performance.

As we know, there can be longer outs between highly trending markets. So, the way that we've done it is we've restricted the managers that we invest into those that don't pick up equity beta, because that would go against the goals of the portfolio. The longer you set your trend program, the more equity beta you pick up, for fairly obvious reasons. So, we've kept it really inside, sort of a three month time horizon for the managers that we have.

Then, at that point, we've tried to have faster managers, slower managers within that timeframe and then diversify as many markets as we humanly can. So, a typical futures based CTA might bring you 150 to 200 markets. We move pretty heavily into the alternative markets, CTAs, going down CAP, so having a lot of capital there, and that adds in an incremental, probably 300 to 400 markets. You know, 2017 was a case in point where futures, trend following didn't do that great, but there was a huge trend in credit that the alternative market CTAs picked up in CDS and those managers were all up close to 20%.

So, the way that we've done it is stick to trend following because it's a known and understood risk profile, we know what it's going to do, it's not a black box. Then have as many differentiations as you think you need without doubling up. We don't want people doing the same thing. So, that's how we've done it.

Niels: Sure, fantastic, great. Trent, how does managed futures fit into your portfolio at the moment?

Trent: Yeah, I'll make two comments, and the first one is as it pertains specifically to the State Board. In my group, in these strategic investment asset class, we divide up the alternative investments into five groups: we've got equity, we've got dead equity, real assets, diversifying strategies and flexible mandates. Managed futures fall into what we call diversifying strategies. That also includes global macro, relative value, and insurance. So, these are things which should have a very low correlation to equity. That's currently about 20% of my book. Eventually, we want to get it up to 30% to 40% over time. So, we think that that's one of my... I've got multiple policy objectives, and one of them is to diversify the FRS or the Florida Retirement System, and that's the easiest way to do it.

The other comment that I'll make is more a broader one. It is that some of the changes that the managed futures industry has undergone over the last two or three years are enormously beneficial to the managers and to the industry unto itself. By offering a stripped down more beta version of trend following at a much lower price point opens up the possibilities enormously.

There is no reason why a large pension plan shouldn't have a sizeable allocation to managed futures. If you think of someone like the CalSTRS, which I think is nine percent of this diversifying strategy. That's a huge amount of money which managed futures is part of that. There's no reason, in my mind, why large pension plans can't have five, ten, or fifteen percent allocations. Perhaps the only one being is how big could the market really be? I don't really know, but the person who works to get in there will do very, very well.

If I were somebody sitting on the other side of the table in managed futures with some of these big funds, I would set out educating the investment community on the benefits of managed futures. Going to the consultants and going to the plans and telling them that this is why it's beneficial to you and why you should be investing in it. Plans already know this intuitively because they have a big allocation to bonds. Bonds which are going to return very little over the next several years provides a diversifying element to a portfolio. So, you can do the same thing with managed futures.

Just on a risk basis, the work that we've done says that you should have 30% to 40% in managed futures. That's probably too high. It is too high. But whatever the number is it's nowhere near that. I think there's an enormous opportunity for the industry to take advantage of what they're offering.

Niels: If we broaden the scope and say, "Let's just talk about managed futures and hedge funds overall." We know that hedge funds and managed futures are in the press and not always with the best headlines. Does this change, in terms of the way you look at that? Do you actually prefer (more specifically) managed futures or trend following because that has a specific role? Is it really something where hedge funds, you still like to have that as an (obviously you worked specifically with a hedge fund) but in the broader scope of some of the pension allocation?

Steven: Yeah, what's a hedge fund anyway? It's just a fee arrangement. It's a common fee arrangement. Managed futures are definitely on the more diversifying end. I think if you looked at the universe of equity long/short managers in Q4 I think they all had a beta of one. You're not getting as much diversity from that end of hedge fund land as you are getting from people that are doing things like fixed income, relative value, managed futures, insurances certainly are not equity sensitive - vol, that kind of stuff. That end of it is certainly much more useful from a diversification standpoint at a trust level than an equity long/short manager.

Niels: Anything you want to add to that?

Trent: Again, you wouldn't want to not invest in something for the wrong reasons. I think that a lot of investors make a mistake by creating this bucket called "hedge funds." To my knowledge, and correct me if I'm wrong, but nobody has ever had a conversation on whether or not they want to invest in custodial public markets funds. There's never, ever been that discussion, but I just described to you the equity markets and the bond markets. People think, well, equity and bonds, those are different things, why would you group them together?

Well, the hedge fund industry is so much more diverse, if you look at it from that perspective: equity long/short, structured credit, discretionary global macro, CTAs, it's just a wide array of risk factors. So, the way we think about it is that we don't have a hedge fund program, but we have a program that includes hedge funds. Instead, we look a wide variety of different strategies and risks and how does it all fit into the portfolio.

So, I think the hedge fund industry is under pressure for a variety of different reasons, but I think if people approach the hedge fund industry in a way that can be shown to be a beneficial additive to a portfolio and not just in terms of equity returns. I think it has a future, but I don't think most plans are like that. You're seeing it shifting away a bit, but there are still too many equity long/short funds, in my opinion, and not enough managed futures funds. I tell you that as a died in the wool equity guy. I think that it's more beneficial, just broadly having strategies, in hedge funds, that you can't get cheaper elsewhere, which you easily can in equity and in bond markets.

Steven: I have a funny anecdote about that. When our former CIO came in the 2000s, he wanted to ramp up the amount of hedge funds we had in our asset allocation, and the State Legislature in Texas took notice and said, "OK, we want to have a limit on the amount of hedge funds." So, initially, we had a 5% limit then it eventually got expanded to 10%. But, then everyone was saying, "OK, we've got a 5% limit on hedge funds, now, what is a hedge fund?" So, there's not a definition.

So, we had to create a nine-point definition that says what a hedge fund is and, I think Trent is right. A lot of things fall into hedge funds that you need less of that, and you need more on the more diversifying end. That being said, there is a reason that a lot of people are having conversations about the role of managed futures in their portfolios, because, look a the SG Trend Index, which is pretty representative. It's flat for the last ten years. The questions that everybody has to ask themselves is, if I believe this is going to be some kind of hedge, what is the carry that I'm going to get? Is it positive? Is it negative? Is it flat? So, that's a tough thing right now.

Niels: I'm curious to go off script a little bit when you say that. Do you think that we, as an industry, have done a bad job in trying to sell trend following? For example, you mentioned that the SG Trend Index, as a hedge, or should we have done better in actually saying, "No, it's not a hedge, it's an uncorrelated strategy. That means that it's not always going to be negatively correlated".

Steven: Well, the later is certainly the most truthful thing, right? Because, if you understand what a trend follower is doing, which is the most normal expression of a managed future. You know if you have a very sharp instant reversal in risk assets you're going to lose money. It's not a hedge. Having said that, I'm pretty sure there were a lot of managers out in 2010, 2011, 2012 saying, "Oh, look what we did in 2008." I'm not going to totally excuse the allocators for looking at it as a hedge.

Niels: No, I think it's the industry.

Steven: Maybe people weren't saying, "It's a hedge," but if people were going around saying, in 2008, up 15%, OK, that's what I'm hearing.

Niels: That's why I think the industry, maybe we should have done better.

Trent: Let me counterpoint to that. So, over the last ten years, you're right, they haven't performed all that well. Well, from 1966 to 1982 the Dow Jones Industrial Average, I think, went up one point. So, for sixteen years the Dow Industrials was flat, and you put dividends in there and few other indices, it's a little more than that. But, stocks for long periods of time have also been disappointing.

So, what you're really looking at is that at this time in 2009 you were at the nadir of the market. Literally, you were a month and a half away from bottoming in the worst financial crisis that we'd been in and the prior year's stocks were down 40% and managed futures were up 18%. So, you were measuring from a high. Today we're at a low or just coming out of a low for managed futures. So, what you're looking at is endpoint sensitivity.

So, you're right, but the truth is that in the real world that's the board you're looking at are what consultants are looking at, saying, "Oh my gosh, there's been no return over ten years." But, time will shift, and you either believe in this or don't. I happen to believe in it. I am hearing people throwing the towel in on these types of basic trend following strategies, that makes me kind of bullish on them.

Steven: Yes, I agree now would be a terrible time to take down this part of your portfolio, that being said, you have to be able to stay in the game, right? You have to have some prospect of not just printing year after year of negative. The last three years have been negative every year for us to trend. If you're a firm and you're doing that you're going to go under.

Niels: And that's true, but I would also say to that, that it's true for the index, but you will find some trend followers who have actually done well, and that's exactly it.

Trent: When we started investing in 2015, we're off. I'd say three or four percent. It's not "blow the lights out." But, that's with us, that's not far off, in fact, it's a little higher than the rest of our hedge fund portfolio.

Niels: To your point, Trent, you mentioned an old example of equities being flat for a long period of time. I think this week there was, in the news, an article about Italian equities that actually have returned zero in the last twenty-five years.

Trent: And, I think in the UK market the FTSE has seen the last eighteen or nineteen years...

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