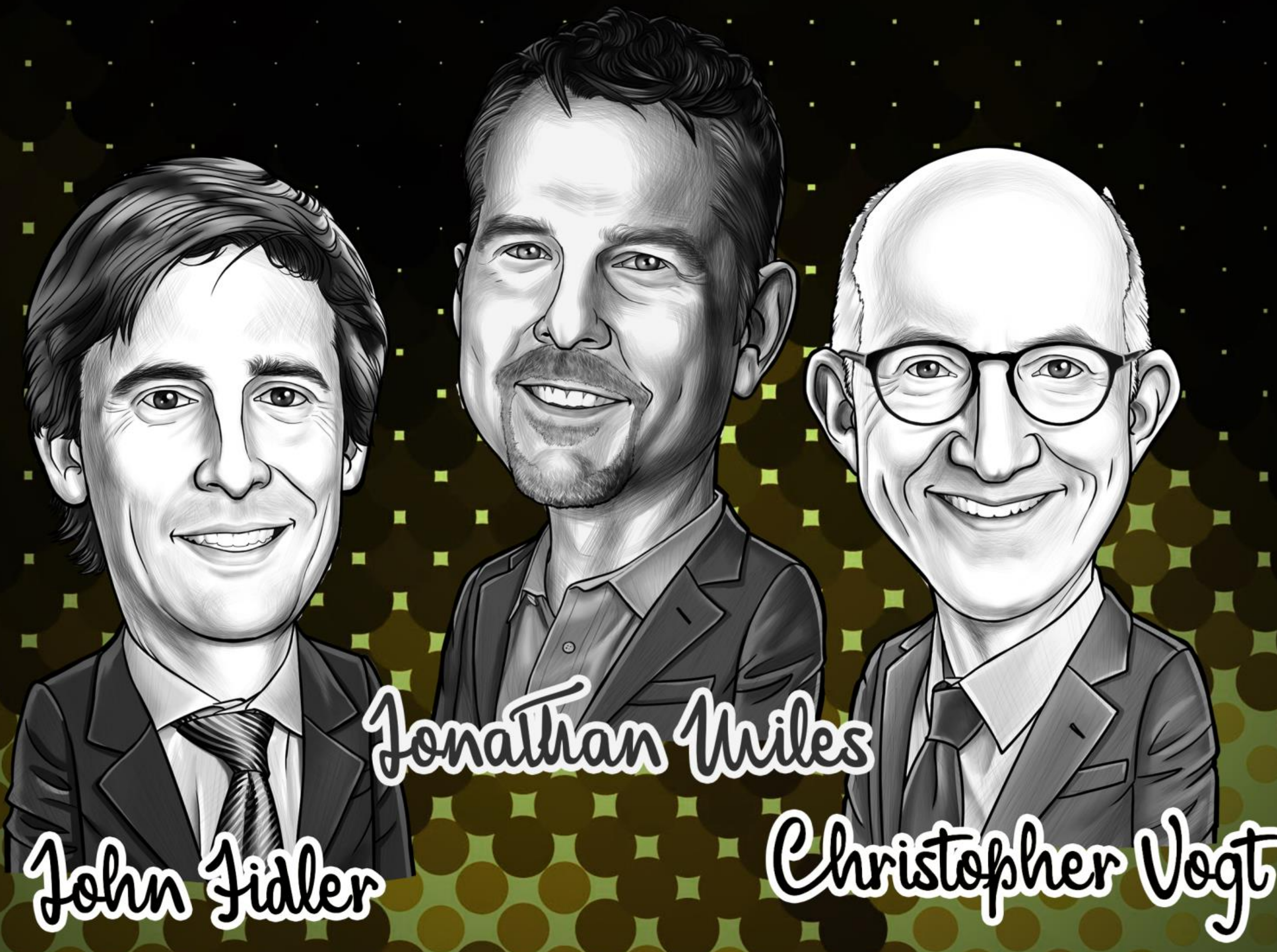
TOP TRADERS ROUND TABLE

EPISODE #24



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"Not all managed future strategies are created equal." ~ ***John Fidler***

The following eBook serves as a detailed transcript of Episode #24 of the Top Traders Round Table Podcast. You can find show notes and more information on this episode right here: toptradersunplugged.com/rt24

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 back 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 brought to you by CME Group.

Your guest host today is Ranjan Bhaduri, founder, President, and CEO of Bodhi Research Group and he's joined by three very interesting guests to discuss how managed futures should fit into your portfolio allocation and the role alternative investments play in today's investment landscape. So, without further ado, here is Ranjan.

Ranjan: Thank you so much, Niels, and I also thank CME Group. This is a very big honor, and we have excellent panelists for this podcast. I'm going to allow each of the panelists to quickly introduce themselves, starting with Jonathan Miles.

Jonathan: Hi, Ranjan. Thank you very much for having me on this podcast today. My name is Jonathan Miles, and I'm a Managing Director with Ascent Private Capital Management down in our Southern California office. Essentially, I am a family CIO for ultra-high net worth families. I have a background in manager due diligence and portfolio construction across alternatives for the last ten plus years at various consulting firms. I specialized in relative value and global macro strategies in that role.

Ranjan: Excellent, thank you. John Fidler.

John: Hey yeah, thanks for having me. I oversee alternative investments for Commonwealth Bank and Trust. We're a private wealth management trust company based in Louisville Kentucky. We run a couple of different multi-manager funds that access a variety of absolute return strategies for our clients who are primarily somewhat similar to Jonathan's client base – family complexes, family offices, other high net worth individuals, some small to medium size endowments and foundations. I started my career trading futures and options back in 2001, and I've been allocating to managers since 2005 in the macro and managed futures space.

Ranjan: Excellent, excellent then. Chris?

Christopher: Thank you Ranjan, and thanks to the CME as well. I'm Christopher Vogt. I'm the Director of Equity Strategies at the Margaret Cargill Philanthropies, which is a large U.S. based foundation. In that role, I manage all of the equity investments at the Philanthropies. That includes long only, passive active, as well as private equity venture capital, and any hedge fund strategies that are linked to equities globally. Before that, I managed a large hedge fund portfolio for a multiline publicly traded insurance company in the U.S. Previous to that, I spent over a decade in managed futures options, both on the floor of the Chicago Mercantile Exchange and well as upstairs for a number of institutions.

Ranjan: Excellent, excellent. Our moderator is Ranjan Bhaduri, and at Bodhi Research Group we're dealing with pensions, family offices, endowments, other financial institutions, assisting them in their investing and alternative investments with various different kinds of projects such as manager research, portfolio construction, due diligence, and special projects.

So, we have a diverse set of panelists here with a lot of different kinds of experience. Again, the theme is how does managed futures fit into an institutional portfolio? Just looking at it from the overall portfolio, how do you feel that managed futures fit into this?

Any of you feel free to jump in and give your thoughts here.

Christopher: Yeah sure, so our perspective is maybe a little bit different from any of the other panelists, but I would say, philosophically, what we think about portfolio construction, at its core, is that we want a bunch of orthogonal diversifying return streams. How do you go about doing that?

So, I'd say we don't view managed futures so much as an asset class as a tool to access those diversifying return streams. So, as all you know, not all managed futures strategies are created equal. A lot of them are capturing very different time frames and capturing very different effects. While a lot of them, historically, tend to be centered around trend, I think the more successful and more interesting managers are gravitating somewhat away from that.

So, our thinking is you don't have that many unique return streams in the liquid investment world. You have stocks and bonds, and then you have some subsets like real assets or commodities that have low correlation or less than a one correlation to those assets, but they're still going to have a pretty clear risk dependency to economic growth, especially in the short run.

When we look at our investors, ninety percent of the client portfolios that come to us (high net worth folks, family complexes, whatever), ninety percent of the time they're getting ninety percent of their risk (or at least the volatility) from U.S. large-cap equities. So, right now, with ten-year yields... What are they this morning, two three, two four? Bonds don't seem like a great risk reward. So, the question is, how do you find return streams that are orthogonal with stocks and bonds, and how do you build a portfolio that's not all piled into a couple of factors?

We've found that, because managed futures strategies can source form hundreds of loosely correlated or, in some cases, uncorrelated markets, and because they can employ a whole bunch of different strategy styles and timeframes, those strategies naturally lend themselves to providing those orthogonal return streams. Our research shows that (this was not born out in the 2015, 2016, 2017 period, but it worked us last year at least), over the long run, if you have, say, ten percent allocation to those types of strategies, they tend to reduce your portfolio volatility by about a percentage point and increase your returns by about the same. Again, that hasn't been true the last couple of years, but that is the long term trend line. So, that's why we allocate to them.

Ranjan: Thank you. There were a lot of nuggets of wisdom and insights that we can take from what you just stated. You mentioned the orthogonal drivers and true diversification, and liquidity. Before we delve into some of those topics and sub topics in more detail, Jonathan or Chris do you have anything to add with regards to your philosophy on portfolio construction and where managed futures fits in an institutional portfolio?

Jonathan: I would love to just make a quick comment. I came from an environment where I was advising pensions and endowments around just alternatives, and now I sit in the seat where I'm advising on a whole portfolio. So, I think one thing that came away immediately is that I go from the perspective of telling clients who the best managers are, or the best ways to combine hedge funds and private credit, versus now I have to say, "Should I even be doing that?" Is it even additive to the relative to the liquidity profile of my clients and their investment horizon?

Diversification for the sake of diversification actually isn't worth it, for us, because most of our clients have such a long-term horizon. They can ride out volatility. So, to put anything into a portfolio, it has to be additive. It either has to provide a positive expected return, and it has to be something that I can use as a ballast in a portfolio if I want to rebalance.

So, in other words, if I'm going to allocate to strategy it has to be a source of liquidity necessarily (excuse me, we're not talking specifically about CTAs), it has to be a source of liquidity if I want to rebalance. That's how the diversification helps me. Otherwise, if I'm not going to rebalance, and I'm putting my capital in a strategy that isn't going to perform as well over ten hears as another asset that my clients willing to hold, then I might as well hold the asset that's going to have the highest return over ten years. But I can't guarantee that.

So, I think that's a very different perspective, and I don't have to report to a board on a quarterly or annual basis. I just have to think about the next five to ten years. So I think that has really changed my perspective in terms of where CTAs fit because I'm a huge believer in the strategies. It just means that the hurdle and their use have to be much more defined.

It has changed the conversation that I have with clients about when to use them, particularly when my clients are usually business owners, who have built businesses, and they have a hard time understanding what a CTA is, to begin with. So, from that standpoint, there are a handful of alternative strategies that we want to employ, and they tend to be ones, like managed futures and systematic macro, which we think, over the long run, can be orthogonal to traditional risk assets.

They take advantage of market inefficiencies, but they don't need a rising, growing economy in order to generate returns. So, that's something that can resonate with clients when we're putting together a portfolio. So I think that's a little different perspective than maybe some other people might have about using them.

Christopher: Yeah, this is Christopher, I tend to agree with what Jonathan just said. We have a macro mandate here, but we don't have a managed futures mandate. Managed futures bit into the macro mandate. I think, likewise, we're less concerned or worried about volatility than we are about permanent destruction of capital.

The other thing that I'd make a note of is that if managed futures or managed futures manager or basket is uncorrelated to risk assets, modern portfolio theory would indicate that there isn't much excess return if any there. So, I think, as a group, it's sometimes challenging to find returns, depending on how many managers you have. This leads me to believe that it's a tactical allocation rather than a strategic allocation.

So, I guess that's where we're at with respect to the role in the portfolio.

Ranjan: So, a lot of very interesting comments there. Jonathan, you stated that, in some ways, with the long time horizon, it changes, and when you view it that changes the philosophy. But, the way that you articulated it, it also shows that, in my view, you're doing a lot of the things... It is somewhat similar in the sense that it's just a different time horizon.

So, you're looking at a ten-year time horizon, so, therefore going into an illiquid investment such as a private equity or venture capital infrastructure can fit in nicely and it can add to diversification. In looking at those kinds of investments, when you make an investment in private equity, and it's a seven to twelve year commitment, once you commit you're committed in the sense that that portion of your portfolio is, in essence, you can't rebalance, you can't reallocate. It's a changing dynamic landscape. So, that portion of your portfolio is paralyzed (not in a bad way paralyzed), but it's just that you are not able to use or deploy that capital or change or change your mind in any kind of way.

Jonathan: A quick comment, we would often say that people are protected from bad decision making when they've committed their capital like that. They can't shoot themselves in the foot because they can't do anything with it so there won't be any of the behavioral biases that are present when you actually do have liquidity.

Ranjan: Yeah, I disagree with that. In fact, I disagree quite a lot on that because then what you're doing, is it's a convenient argument. It's asymmetric, the investor is smart enough to make a good decision when they go in, but they're just not smart enough to make a good decision when they get out.

What is proven in behavioral finance is that people tend to underestimate the value of liquidity. That's not stating at all that one shouldn't go into mass liquid assets, like private equity or infrastructure, but it goes back to what you stated earlier, Jonathan, which I very much agree with, is that you need to be paid properly for that illiquid investment. Therefore, on a liquid scale too, it can't be just, "Hey, it's liquid, and that's good enough." If it's not, over a ten-year time horizon, going to be added to your portfolio, it doesn't necessarily belong. But the other piece of it, and I think that's why we're all here doing these kinds of decisions, that's why it's important to have a process, which I know all of you adhere by. You've spent a lot of time creating a very rigorous process to mitigate the possibility of doing an impetuous kind of decision.

But, that's again, very, very interesting with the different time horizons and the liquidity and the diversity. Therefore with regards to the target volatility, for the longer time horizon it's less of an issue, does that mean that you're willing to be more aggressive on the liquid side of when you do allocate?

Jonathan: Am I willing to be more aggressive on the liquid side when I do allocate? Well, I didn't want to give the impression that we don't allocate to liquid strategies because we run diversified portfolios. It was more that we try to get clients to focus on what are the most important decisions that they should be making.

The idea that (the concept behind) going into private capital structures helps eliminate some of the behavioral biases is that everybody has a tendency to chase performance. So, you tend to invest at the wrong time. Then, when they underperform you redeem, so you redeem at the wrong time. There's no persistency in quartile performance among traditional long-only managers, very little. So, I think that's where the comment comes from. You're right, it is sort of a heuristic crutch to go into private capital because then you don't have to make a decision on getting out, you just have to make the right decision going in. You don't have to worry about the exit.

So, we view the liquid side as more of a place holder of... like liquid could be equities, liquid could be fixed income, liquid could be global macro. So, risk in the liquid side isn't really a factor, per se. I would say, all else being equal, I would love to have a very barbelled portfolio of very illiquid strategies, and then on the other end have very liquid orthogonal strategies, and then use deviations in returns or asset classes to be (I don't want to say tactical), but be opportunistic in how I move capital back and forth between those two. I would probably use the liquid fixed income and liquid equity as ballast in the middle and have that be a diversified part of the portfolio if that made any sense at all.

Ranjan: That makes a lot of sense. The barbell approach can be very, very effective.

Chris, in terms of just looking at emerging managers versus established managers, do you have any viewpoints on that with regards to your portfolio construction and your risk budgeting?

Christopher: I do. Would you mind if a made a few comments on the last topic?

Ranjan: Not at all, not at all, please do.

Christopher: First, as a former floor trader I completely agree that it's always easy to get into a trade or to find something that you like, and it's much harder to get out or to sell the trade. So, I think that is absolutely the heuristic crutch of private equity. You don't have to make the decision to sell. That's been pushed away from you.

Jonathan: And it's made easier by not getting mark to market, right?

Christopher: Exactly, exactly.

Jonathan: That improves your Sharpe ratio.

Christopher: Exactly, and that's where I was going to go with the whole target volatility. While I don't think I have a lot to say in this area, I would say, as I mentioned before that, for us, it's about drawdown and maintaining grant making consistency in any market environment. Then I would also pose a question, what does volatility even mean in the context of a portfolio where a large portion of the investments are illiquid, and thus they're marked in arrears, and there's vol smoothing going on? I think the volatility of the portfolio becomes almost a very difficult thing to put a fine point on.

Maybe I can move over to your comment on emerging versus established managers. This is something that I followed for a long time going back over a decade. There were many pieces, in the early to mid-2000s, that talked about how it's better to be an emerging manager because there are higher alpha levels, etc. While I think there's good economic rationale that supports that from an anecdotal perspective, I'm super, super cautious, at this point in time, about whether that's actually true or not.

I think particularly with selection bias, survivorship, back bill, things along those lines, it's not obvious to me anymore that emerging is always going to be established or that there is a theme there that can be a permanent premia, if you will, that you can latch onto. I think that maybe those papers back then (particularly in the early 2000s) were written at a time when inflows into (I'll call it) hedge funds or managed futures or alternative assets, artificially lowered the operational risks to those funds because there was so much capital flowing in. I think in today's world it's much harder for those groups to raise capital and I think the operational risk perspective is a lot higher.

In terms of how we deal with this or handle it is that we do invest in emerging managers across the portfolio. What we do is we have a risk budgeting approach that takes that into perspective with respect to sizing those investments, but we also document, call it, certain triggers that would call for re-underwriting if there were problems or issues.

I think, separately, with respect to managed futures is that one of the benefits of managed futures is that you can typically achieve a separate account or a managed account where you actually own the asset, and you can see the assets of the specific trades in the account, which allows for position level analysis. That is a very powerful tool relative to just having a monthly or a quarterly statement of what the Funds performance was.

Then lastly, I would say that a strong operational due diligence effort is needed as well, which I think many institutions lack or don't focus on as much because there's an expense to it and it's something that is often overlooked by investment teams.

Ranjan: I think that investment teams that are not doing operation due diligence are really hurting their portfolio. Operational due diligence should not be thought of as a cost center. In fact, there can be a lot of structural alpha. But I completely agree with what you just said, Chris. It's sad, actually, that there are groups out there that are still not paying proper attention to the operational due diligence component.

In terms of looking at how you see the managed futures, and this can also include the macro space evolving, what are your thoughts there? There's a lot going on with machine learning, with new markets in China and so forth, what do you see as the future for managed futures?

John: You know it's interesting, and I think there's... The future, for a lot of traditional managed futures strategies that focus on medium to long-term trend, to me is not great. I think all that's at management full stop whether it's managed futures or hedge funds or long only or ETFs there's fee pressure across the board.

So, if you just think about what's a good business, I don't think there's many managers period, anywhere, that have a lot of pricing power at this point in time. I think there are very few managed futures managers who have any pricing power. I hear that when I talk to managers, they say, "Oh yeah, we can raise money for a trend following strategy for instance. We can raise a lot of money for it, but we can only charge fifty basis points for it. It's not an incentive fee product.

So, I think it's difficult for the vast majority of managers. Things have become... You talked about the operational due diligence, and that's important I agree. [That is important] particularly when you have strategies that run complicated, complex portfolios with a lot of line items, or have multiple portfolio managers, or something. I was at MFA this year, and there was a guy, super emerging manager, sort of a two-man shop, and he had twenty million dollars under management. I heard this guy asking him who his administrator was as though that was a really relevant question like he was interviewing Bridgewater or something.

My point is that the industry has become so institutionalized and you have to be able to check all these boxes (operational due diligence boxes) to raise a lot of money, [and you can] have a situation where five or ten percent of the managers are raising ninety percent of the AUM. So, if you're a start-up manager or you're a smaller manager, you have to sort of grow or die. You have to invest in your organization in order to grow. So, I think it's a difficult business.

From a strategy perspective, you mentioned some of the things I would touch on. It's not clear to me that trend following, per se, is a very good strategy. I think your 'big king' factors of momentum, carry, value, have been pretty commoditized. So, I think managers are going to have to do other things strategy wise to survive. That may mean new markets (like you're talking about), and alternative data.

There was an article, just yesterday, in the FT about how much money hedge fund managers are broadly spending on alternative data. Maybe it's more relative value trading and instrument selection as opposed to directional trading, but I think systematic directional trading based solely on price and volume seems like an increasingly hard way to make money, especially if we're going to be in some sort of 'Japanesque' Central Bank manipulated world where volatility is suppressed. So I think the managers that succeed are going to have to do things that are different from what might have succeeded ten or twenty years ago.

Jonathan: Ranjan, can I make a quick comment on that as well?

Ranjan: Please do. Thank you.

Jonathan: So the first thing (when I think about the evolution of the industry) that I think of (and we haven't mentioned it yet) are our risk premia strategies. This is something that we did a lot of work on when I was a Wilshire Associates. We applied... It really is, for us, at that firm, it transformed how we looked at managed futures and systematic macro managers. In essence, risk premia became a potential source of beta that made it easier and we built models to do this, identify CTA managers who were one, easy to replicate, and two didn't have any alpha versus that replicated beta.

So, I think that is the overarching... And I think John really hit it, he's talking about the end result of that, there's alpha, in essence, the returns can be orthogonal, but there might not be alpha. So, I think that's the situation that we're in right now. These strategies are still additive to a portfolio because they're orthogonal, but we can actually get the beta much cheaper now than we used to be able to. That's why managers are raising trend following products at fifty basis points, they're adapting to that market.

You hit it on the head, John, in term of looking for new data. They're going into alternative markets. They're trying to create premium versions of their products. So I think we're going to see more of that. I kind of thought of it as the barbelling of the market.

You're going to have some managers who will have passive index products, and then they'll try to sell some alpha products next to them, or they might just go all passive. They might just (like AQR) raise all their money in a managed futures strategy that's really a beta product. There was just a panel about this a conference, what is beta in this space?

So, we're begging the question a little bit that there is a beta because how you define the trend following model can determine whether you have alpha or not relative to that - what's your time frame, what markets, what's your risk allocation (things like that)? It's really hard to define a beta. But it's still an arrow in our quiver. It's really transformed how we look at the space.

So, I think that's really important, and that's been the driver of the commoditization of the space and the competitive pressure to lower fees, which is all good for investors because the strategies are still worth investing in.

Christopher: So, I want to just add a couple of things onto that. I've always wondered, looking at different risk premia products, why many (many of them but not all) correlate to CTA or managed futures indices? I haven't spent a lot of time thinking about this. I don't really manage managed futures portfolios anymore. My wild guess is that there is a momentum factor in CTA, particularly for trend following, and that it's picking up on that somehow.

The other thing I was going to say, going back to the original question on how we see the space evolving (again, I don't follow it, so I don't think I have many intelligent things to say about it), and as was already noted [is that] I think trend has become incredibly commoditized (no pun intended). I also think that alpha decay is very real, particularly in the shorter term strategies. I think that that would probably accelerate as machine learning and artificial intelligence becomes more prevalent.

Just think about computing power twenty years ago versus today, take AI and machine learning and forward that another twenty years from now. If I can comment on one area (that I heard another person say recently) that I thought made sense, with respect to value strategies and equities:

- There are more than two thousand books on Amazon on value investing.
- There's something like ten thousand people on 'quantopia' that are basically looking for anomalies in stock prices.
- I think that the number of stocks has shrunk by a lot in the past twenty years or so.
- The number of sell-side analysts divided by the number of public companies is at an all-time high and quant processing is so cheap.

- Quant processing is so cheap
- We can all buy computers for almost nothing today

I think (if I can make the analogy into managed futures) that this might make it much more challenging as we go forward given that there's so much easy, inexpensive quant processing to search for anomalies or for alpha…

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