

TOP TRADERS ROUND TABLE

EPISODE #25



Jonathan Miles



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"Over the years, I have allocated to a lot of short term CTAs... but due to the alpha decay factor to short-term models, not really made any money from it."

~ John Fidler

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Niels: Welcome back to Top Traders Round Table, a podcast series on managed futures brought to you by CME Group, where our guest host today, Ranjan Bhaduri, continues his conversation with Jonathan Miles, John Fidler and Christopher Vogt where they discuss how managed futures should fit into your portfolio allocation and why you should still believe in these strategies even if there have been a few challenging years. So without further ado, let's rejoin the conversation.



Ranjan: So, going back to some of what Jonathan stated about risk premia and alternative beta, I agree that there are cheaper ways to get trend following today, and that has had an impact on the entire managed futures' fee structure, even including managers that are not doing trend following. It's also forcing a lot of trend followers to adapt or be left behind in terms of adapting, in terms of offering more competitive fees, and increasing their suite of products - so, new types of programs or trying to explore via other techniques.

The short-term CTAs (mentioning about the alpha decay) is also a very interesting comment there because that has lasted for... In some ways, the empirical evidence seems to suggest that short-term CTAs have a shorter lifespan than trend following CTAs. The corollary of that is that it might be more challenging in identifying a quality short-term CTA. From an investment lens, are any of you looking at short-term CTAs? If so, what are the kinds of things that you look for?



Jonathan: That's a little granular for us in terms of what we do. We might look at them periodically, but we don't actively allocate to that level of granularity in the space.



Christopher: Yeah, I'd say currently we don't really either. We're sort of in a similar situation to Jonathan. We're building a very broad portfolio of betas and hopefully alphas across different asset classes. Hedge funds are just a small piece, and then managed futures is even a smaller piece. At a given time we may have an allocation to, depending on how you define short-term, one or two short-term CTAs. It's not an area that I focus on now.

In a prior life, I allocated at a family office for about ten years to managers, and I allocated to a lot of short-term CTAs, and I have to say we almost never made money investing with them. I think it was because of the alpha decay factor you're talking about. I can count on one hand the number of really good investment experiences I had with short-term CTAs. I do think it's a lot harder to get right. It's more susceptible to curve fitting. The barriers to entry for new guys, because of transaction costs and speed of execution, are much higher.

I was talking to an equity manager yesterday who is launching a fund, and he's kind of a stock picker type guy - three to six month holds. The point that he made was that he thought that beyond three to six months machines were pretty good at picking winners, because they had quarters, and quarters, and quarters of price data and financial data to look at, and that under about a week, machines were better at picking winners than people. His view was (which I think is probably true) that, in all assets, the under a three-day holding period is owned by the Citadels and the Renaissance and the Two Sigmas. Those guys have a mote because of this huge amount of technology spend and brain power that they have. So, I think, for the vast majority of CTAs who do not have that budget and that scale, it's a really hard thing to make work. You spoke about machine learning earlier, and I know there's a lot of talk about that, For us, those strategies kind of go in the 'too hard to evaluate' pile, for the most part.



Ranjan: Got it, got it. So, we also touched upon fees, with the corollary of the alternative beta, and you mentioned that with fifty basis points one can get some trend following beta. How innovative or not, in terms of the fees in general (and it doesn't have to be limited to managed futures) have you seen the fee compression today as opposed to five years ago or three years ago?



Jonathan: I think we've seen a lot of innovative fee structures just in the last few years. Not only are fees coming down but people are trying to improve alignment of interest between the investors and the managers. I think Texas Tech did the one or thirty approach. Albourne is sort of advocating that as well. That didn't grow that widely. Managers were willing to do it for Albourne clients but not other clients necessarily.

I've seen a few CTA managed account based managers create some more unique structures as well around fee sharing across a portfolio of managers. So, more of a coop approach - all of these managers are in it together, and if they all do well they get paid, but if they don't do well as a group, they don't get paid.

So, ultimately people are adding complexity to try and solve the issue of fees being too high and probably what will happen is we'll end up eventually coming back to a more normalized plain vanilla approach, and fees will just be lower. So, take away the complexity and... Everybody understands management fees and incentive fees; let's just set it in a way that investors won't complain and will feel that it's fair. That's just my two cents. We'll see how it plays out over time.



Ranjan: Got it. That's interesting. In terms of just going back to the portfolio construction, what are some of the techniques that you are using (and this is beyond managed futures) just

in terms of are you doing risk budgeting? Are you doing vol adjusted? How are you building your portfolios?



Christopher: So, on the portfolio management side, we actually have a risk management asset allocation team, and they do the asset allocation kind of work for us. Again, going back to my comments about... I think it can be very challenging in managed futures. I particularly like a low management fee or a zero management fee in the high-performance fee. At my previous employer, we did some studies and looked at this. The break on two and twenty versus zero and thirty-five - so two percent management fee and twenty percent performance; and a zero percent management fee and a thirty-five percent performance is somewhere in the around twenty percent. So, in other words, unless the manager is going to generate over twenty percent, you're better off in a zero and thirty-five strategy - a zero and thirty-five fee structure. That's kind of where we see it. As I mentioned before, we feel that trend has become very commoditized. There's a host of products, which I think some of them have already been mentioned today, that those fees have come down quite a bit.



John: Yeah, I'd agree with Christopher. We tend to, when it comes to fees, our view is that a zero end deal, or at least lower management fee and higher incentive fee, is a better alignment of interest. Now, I've heard the opposite argument would be, "Well it gives a manager incentive to take undue risk, and if they have a couple of great years, they're risking your money, not theirs, and they only share in the upside and not in the downside." Maybe that's true. Hopefully, your due diligence process is going to be good enough to weed out people who are intellectually dishonest enough that that's the way that they're thinking about the business. Luckily, in managed futures, unlike in a lot of discretionary strategies, strategies are taking a constant risk level. You don't have the same sort of maverick risk that you might have in a discretionary commodity fund. So, we're big believers in focus on the incentive fees, and that better aligns interest.



Ranjan: Yeah, fees, absolutely the managers have become asset gatherers and are just enjoying life by clipping coupons and having a management fee and not really striving for the alpha is detrimental to anybody's book.

In terms of discretionary versus systematic, for managers in general, behavioral bias was something that was touched upon much earlier in this podcast. Do you have views? Do you prefer one over the other, or are you open to both the way that it fits into your portfolios? What are your thoughts?



Jonathan: Well, it's certainly been a very tough space, similar to systematic, over the last few years. It's always so trying, as an investor, to meet with really (and we're talking about discretionary macro here) smart people who clearly have a great understanding of the global economy, yet they can't make any money. So, it calls into question what it takes to be good at that in that role and/or are we in a market environment that's very difficult for people who think that way and understand things the way they used to be to make money?

I think one person mentioned earlier that we've essentially been in a Central Bank monetization period for a decade. It has been one of the worst decades on record for macro strategies, while it has also been one of the best decades on record for equities, or near one of the best ones or a very good one. So, in order to like this space in general and to like discretionary in general, you have to be a little bit of a contrarian.

So, I think when you ask the question, I got a little bit uneasy because I've really liked managers and had a lot of conviction in their ability to understand what drives different markets and yet they still don't make money. I think it's one of those where I might wait a little bit before I allocate, though I do think if the Central Banks start shrinking their balance sheets a lot of the things should get back to the way that we understood them in pre-2010 and 2011, or maybe pre 2008. So, that's where it's a little uncomfortable right now to make allocation into that space.



Christopher: I agree with those comments. I built a specific, just macro portfolio for my former employer and it was a blend of systematic as well as discretionary. Some of the famous, most intelligent people out there are running those portfolios. I found the exercise to be one of the most frustrating things that I've ever done in my professional life. I would go further and say that I would only wish that effort on my worst enemy today, so far as given the environment with very low vol, even though we have had some uptick in the past fourteen, fifteen months, it's still a very low vol environment. It's still very affected by the movements of Central Banks, and I feel that it's a lot of wind in the face of macro strategies as a result. As you mentioned, as liquidity comes out of the system, as we normalize, macro could become much more interesting, but until that time I think it's going to be a lot of headwind for those strategies.

Ranjan, you had asked me earlier about asset allocation. I'm not sure it was discussed yet, but the role of alternatives in the portfolio, can I talk a little bit about that?



Ranjan: Please do, yes, I did ask about that, and I'd love for you to comment on that, please.



Christopher: Sure, I just have a couple of comments to make. I kind of say, what are alternatives? I think that that term 'alternative' is a historical construct and I think that it referred to or refers to credit equity, hedge funds, managed futures, etc. But I don't really like that because it truly, in my opinion, is just as a historical construct.

I wrote a paper several years back now called, *Hedge Funds Are Not An Asset Class - Implications for Institutional Investors*. In there we talk about that many hedge fund strategies have betas and they actually need to be placed into the categories, which is a construct we've incorporated here at Philanthropies. So, equity long/short typically has equity beta in it and should be placed into an equity portfolio; particularly when you run asset allocation and mean-variance optimizations, it's important that you bucket in those categories.

So, I would say that alternatives are not long-only equity and not great credit. I would put private equity in that bucket in so far as it's a typically long strategy. So, in terms of what are alternatives? I would actually say that they are macro managed futures, maybe convertible arb, maybe some fixed income relative value, maybe an equity market neutral, maybe merger arb, basically things that have low or no structural premia or betas attached to them.



Ranjan: Insurance would be another one, then, under that definition.



Christopher: Exactly, exactly or short sellers, things like that. The thing that I can't answer is what is the desirable allocation to these? I think that's a very difficult problem to solve for and it starts with the utility function of the investor. Likewise, what's the desirable exposure to managed futures or to hedge funds? Again, it depends on if it is just a managed futures portfolio or if you're going to only include the high net, long edged equity. That's a much harder thing. What I do think you need to do is look through all of that and try to judge or estimate or study or measure how much equity beta, how much rate duration, how much spread duration, etc. you're allocating to.



Ranjan: So, I want to basically ask a wildcard question in the sense that I want each of you to give a nugget of wisdom or insight. All of you have tremendous experience, expertise in the investment space, and just to try to, for somebody who is coming into this space new, say, somebody, him or her, what would you tell a young professional today? Perhaps something that you learned the hard way, or maybe something just through your experience, does anybody want to volunteer to go first?

I tried to spread that question out long to give you time to think just for the listeners out there these three panelists for this podcast were very sportsmanlike in the sense that I did not give them any kind of pre-call practice call. So, all these questions are being done on the fly.



Christopher: I have a couple of comments. This is Christopher. I would say the first thing is that I would urge people to be cynical. What I mean by that is that Wall Street is about product creation not about performance. So, I would be very wary of most investable products. They're often designed to collect fees and to generate fees, and they are, sometimes... Many of those products have come and gone and have died and nobody is the wiser of it, but I would be highly cynical. One key metric there is how much capital is alongside that the manager or that the portfolio manager or the general partner, how much capital are they actually putting in that strategy to ride alongside your investment?

The other thing that I would say (number two would be) that most of my mistakes, the big mistakes I have made, have been in sizing the investment. You can make investments, and you're going to make some that are great, some that are just good, and some that are terrible or not so great, but if you size those investments correctly, you won't experience a really bad event. So, be careful of your sizing.

The third is, I think it's a Mark Twain quote, but I won't get it perfectly right, "It's not what you know for sure that will kill you, It's what you think you know for sure that just ain't so." So, be very cautious and be self-aware. Self-awareness is a big one too so that might be a fourth.



Ranjan: That's very, very true and pessimists only get pleasant surprises. So the cynical comment is definitely a good one as well.

John, do you want to go next?



John: Oh gosh, I don't really have any pearls of wisdom. Those were good, Chris.

I guess specifically in terms of evaluating managed futures managers, so a very narrow kind of idea, is I'll often hear people ask managers, "How do your models work?" To me, that isn't a question that makes a lot of sense because every good model should do the same thing. It should buy low and sell high, or reverse, do the opposite sell high and buy low. It would be to ask why your models work and what is the driver behind them, the intuitive driver behind them? And if there isn't an explanation for that, then I'd be sceptical.

The other concept I think that would go past managed futures and into other investments (and it's probably related to what Christopher was saying about being cynical), there's an

allure to complexity in everything, whether it's a business model or a portfolio. If you look at some big macro fund and they have forty thousand line items, there's an automatic intelligence that is assumed when you see something that is really complex like that or tends to be assumed. To me, in my experience at least, the portfolios that had the most problems where there were unforeseen risks were always portfolios where there was some sort of hidden negative gamma, maybe explicitly through options or maybe explicitly through some relative value positioning. There was some concentrated risk that wasn't obvious because of the complexity of the portfolio. So, simplicity can be a good thing.



Ranjan: I definitely think those are wise statements.



Jonathan: So, yeah, I've got a really high hurdle here to add something to both of those because those are really good. The first thing that came to mind is sometimes the most important decision isn't necessarily a financial or investment one. This is specifically when you're working with clients. Sometimes the most impactful decision isn't necessarily whether you pick the right manager or make the right investment; it's [asking] is the premise behind your decision-making process correct? So, I think that gets to one of Christopher's comments about always question your assumptions, or always make sure you understand the embedded assumptions in whatever viewpoint you have because they have to exist. If you don't understand them, then you're bound to make a mistake. So, that was the first one.

Be cynical was... Christopher took that one, that was always mine too. Then I have a list of phrases that I like to keep. The one that I always like to use when I'm talking to people or working with interns and things is, "Don't let perfection be the enemy of the good." Sometimes an answer that's good enough right now is better than perfection later.



Ranjan: That's well said. All of that is well said. The three of you have really... I'm glad I asked this question because I think every one of those statements was very good. It's also about themes... With regards to the perfection one, I sort of have a similar phrase, "Don't try to build the Picasso, to begin with." If you're just always going for perfection, then you don't get anything done. It's, let's just try to get something good and then keep trying to improve that and set the bar higher and higher. That's usually a more productive way to go about it.

The cynical one is good. Jonathan, the one that you said before the perfection one... Oh, the model risk and basically understanding the assumptions, that's tremendously... I think that model risk is something that's very much underestimated by a lot of folks. It reminds me of what the late Richard Feynman, the Nobel Laureate and physicist (the American physicist) had

stated, "The easiest person to fool is yourself." So, it's very important to be questioning yourself and not fooling yourself. That also ties back into the behavioral biases and so forth.

So, before we hand it back to Niels, I just want to also not be greedy or selfish and just give all three of you an opportunity to address any other topic or question. You can just make any other statement that you want that I didn't ask, because, again, I wanted to be where I think that the CME and Niels have done a great job of getting you all together, so, I want to make sure that we're extracting the maximum opportunity here. Is there anything else that any of you want to state to the audience?



Christopher: Hey Ranjan, I think I actually misquoted the Mark Twain quotes. It goes, "It's not what you don't know that will kill you, it's what you think you know for sure." I think I said, "It's what you know..." So, I think I may have misquoted that.

Then the other point I was going to make is just a kind of a funny comment on the whole model risk, and that is a former colleague of mine, a very bright guy, a Ph.D. level, he said to me once, with respect to models, "We call it a model and by definition it's fake because it's a model." It reminds me of when I was a little boy, and I used to build model airplanes, and I said that to him, and he said, "Yeah, and nobody is going to sit in the model airplane and try to fly it." And so I think that's something that is important to keep in mind.



Ranjan: Absolutely. With model risk I would also state this, is that model risk is always there just as you just stated. By definition no model is perfect, and there's always going to be model risk, but model risk gets magnified if it's an illiquid investment and the reason for that is just if it's exchange-traded there are no accounting issues, there are no valuation issues, and basically whatever the models inaccurate it's getting caught, like the markets, in the P&L because everything is mark to market and you can't hide. But the model risk can be more hidden when it's illiquid. An example of that was the great financial crisis in 2008 with mortgage-backed securities, there was a lot of model risk in some of those MBS strategies, and it took a long time before it got exposed. So, it's just another advantage with regards to liquid and exchange-traded instruments strategies that involve that.

But, for any of the others, are there any other statements that you'd like to make for, again, Chris you're welcome to state more.



Jonathan: Yeah, this is Jonathan, I'll just clarify, I made a comment earlier about being a believer in these strategies in systematic macro strategies, but it kind of begs the question why. I didn't really answer that question. This comes up a lot, and it came up at the

conference a few weeks ago, and it's, "Why do you believe in a strategy that's done so poorly for so long?" I think we explained a little bit about the macro environment being wrong, but there's a comment that I like to make which is, "The players may change, but human behavior doesn't." Most of these strategies are designed to take advantage of human behavioral biases. So, as long as we're human, and humans are the ones driving the market, then there will be opportunities for systematic macro strategies. That's a belief of mine.

All you have to do is look at what happened in December and January (January of this year and December of last year) to say, "OK well, if the markets were truly efficient things like that wouldn't happen." So, that, to me, is why I still believe in these strategies in that the poor performance that we've seen is actually a three or four standard deviation event. So, I'm willing to say, (I'm a contrarian by nature) I'm willing to bet that the three or four standard deviation event is a good signal for things to be different in the future.



John: Yeah, I'd agree with that as well, Jonathan. These things are all cyclical, and I remember a period in '06, '07 hearing exactly the same thing, that trend following in currencies was a strategy that just didn't work, and you had to trade carry. Then 2008 was a phenomenal year, probably the best year ever for trend following in currencies and rates.

I think it's also important to remember, we talk about all these hedge fund asset classes as though they're, not we, but there's a temptation to talk about them as though they're extremely homogenous. Certainly, all trend following CTAs are relatively homogenous, but within the managed futures space, quantitative macro space, there are all types of strategies. The index, I don't think has made a new equity high since 2014, is that right? But there's plenty of managers (not within that index, necessarily, but within the space) that have made money every year since 2014. So, manager selection and picking the right people and the right models is important and a big deal. So, yeah, that would be my last comment.



Ranjan: Wow, thank you to all of you, to Jonathan, John, and Chris. Thank you to those listening and to Niels and the CME Group for putting this all together. I do encourage you to go to the CME website where they have an excellent educational center with a lot of information, and also to encourage you to listen to other podcasts that Niels has put together. So, Niels, I will hand it back to you, and I thank all of the panelists again.

Cheers.



Niels: And there you have it. Thank you so much, Ranjan, Jonathan, Chris and John for a great and insightful conversation about alternative investments, why you should still believe in them, but also some of the challenges we have in this space at the moment. I hope you were able to take a lot of useful information from today's conversation onto your own investment journey. If you did, please share these episodes with your friends and colleagues and send us a comment to let us know what topics you want to bring up in the upcoming conversations with industry leaders in managed futures.

From me, Niels Kastrup-Larsen and our sponsors CME Group, thanks for listening and I look forward to being back with you on the next episode of Top Traders Round Table.

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