ABR Dynamic Funds' Series on Stagnation Solutions: Part 6

Managed Futures

Preface

In the first installment, we noted that, at the time this series was written, the S&P 500 Shiller cyclically-adjusted price to earnings ratio (CAPE) was approximately 30 (of course, that can change quickly), and that value has historically indicated a next 10-year annualized return for the S&P 500 of about 3%. The last time the S&P 500 Shiller CAPE was about 30 was near the beginning of 2002. Over the next decade (2002-2011), the S&P 500 annualized return was 2.9%. Therefore, we have chosen that 10-year period to illustrate the equity replacement possibilities throughout this series. That choice reflects neither (1) a prediction that the next 10 years will play out just like the decade from 2002-2011, nor (2) a belief that the Shiller CAPE's forecasts are quite that accurate over time.

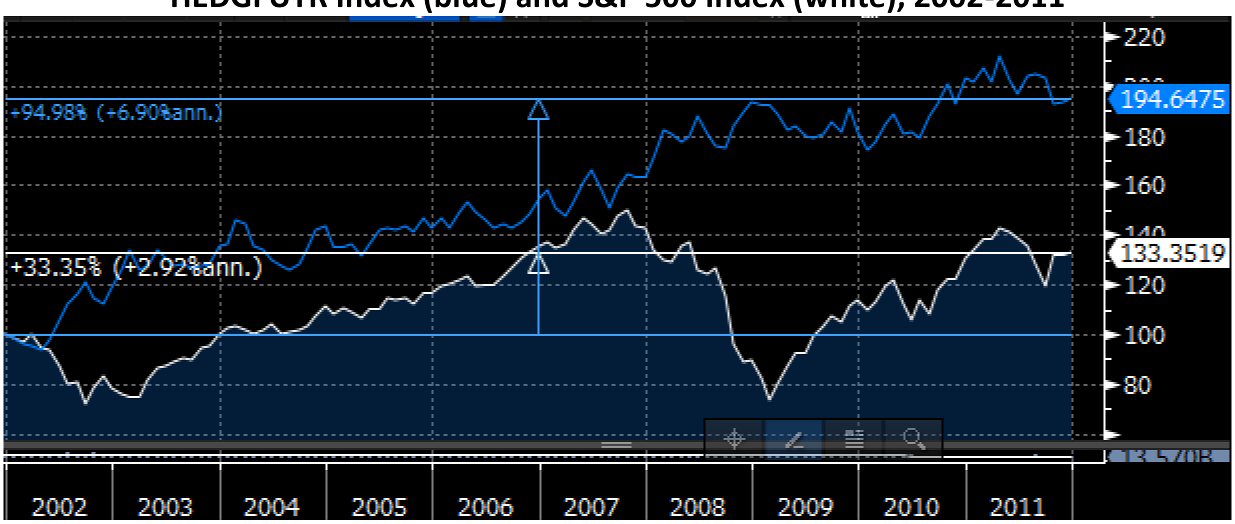
Managed Futures

Trend-following managed futures strategies often have the ability to take both long and short positions in various asset classes, typically including equities, fixed income, currencies, and commodities. Those features have given managed futures strategies the potential to generate favorable returns in various (trending) market conditions, including both upward and downward trending equity markets.

The Credit Suisse Managed Futures Index (HEDGFUTR Index) is an index composed of various actual managed futures strategies. As with all the other choices in this series, it was selected simply for illustration purposes, not as any sort of endorsement.

The following graph shows the HEDGFUTR Index and the S&P 500 Index over the decade from 2002-2011, for reasons covered in the preface. **As the graph shows, HEDGFUTR Index meaningfully outperformed the S&P 500, producing a 6.90% annualized return over this decade (vs. the now familiar 2.92% for the S&P 500 Index). Furthermore, HEDGFUTR generated a return stream which was uncorrelated to the S&P 500, providing the only free lunch in investing, diversification.**

HEDGFUTR Index (blue) and S&P 500 Index (white), 2002-2011



Source: Bloomberg

Additional Observations

- Of course, trend-following managed futures strategies may have trouble in non-trending environments. For example, over the past 4 years, HEDGFUTR is about flat.
    - Furthermore, rapid moves, even if they are large, are often better described as trend changes than as trends. Many trend-following managed futures strategies look back 3-12 months to identify trends. That has meant that they have had difficulty in rapid moves (including large ones) over shorter time frames.

- It is always important to consider and plan for the possibility that an outlook is wrong. If, just as an example but not a prediction, the next decade brings a period of significant and extended inflation, some trend-following managed futures strategies have the potential to help portfolios. The ability of some managed futures strategies to take both long and short positions in equities, fixed income, currencies, and commodities, may provide the potential to generate favorable returns during extended periods of inflation (but likely not in an initial inflationary shock).

- For investors with low expectations for stocks and bonds over the next decade, the opportunity cost of increasing allocations to alternatives, at the expense of those stock and bond allocations, is low. Exploring the alternative space further, including but not limited to trend-following managed futures strategies, is worthwhile. However, it is important to consider alternatives that are truly uncorrelated to the stock and bond exposure already in a portfolio (as well as, of course, blends of those stocks and bonds, which make up the core of most portfolios).
    - So-called “alternatives” that derive their returns from static allocations to stocks and bonds, and are highly correlated to them over time, offer little diversification value and may also offer the same reduced expected returns over the next decade.

Next Week’s Preview: The next installment will address a possible way to increase equity exposure while attempting to mitigate the increased drawdowns of that increased equity exposure.

Notes/Disclosures

Some of the indices may contain some hypothetical results. There are inherent limitations to hypothetical results. Past performance does not guarantee future results. No index presented in this installment is representative of any strategy at ABR Dynamic Funds, LLC. It is not possible to invest directly in an index. The information presented in this installment does not constitute a complete analysis of any index or strategy, and this installment contains no recommendation to buy, sell, or hold any investment. All data was obtained from sources believed to be accurate; however, ABR Dynamic Funds, LLC cannot and does not guarantee the accuracy of such data.