

research

The Benefits of Managed Futures

Data to December 2000

by

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Commissioned by



Alternative Investment Management Association (AIMA)



AIMA is pleased to publish this updated version of the summary of **'The Benefits of Managed Futures'**.

This research paper was originally commissioned in 1996 and, since then, has been updated four times and thousands of copies have been distributed around the world.

This academic research looks at the role of managed futures to maximise the risk/return ratio within a diversified portfolio. As was apparent in the last major market downturn in end 2000, managed futures are negatively correlated with, for instance, the S&P500 in its poorest months but are positively correlated in its best months.

This research paper provides evidence that managed futures:

- Reduce portfolio volatility risk
- Enhance portfolio returns in economic environments in which traditional stock and bond investment media offer limited opportunities, and
- Participate in a wide variety of new financial products and markets not available in traditional investor products.

AIMA is committed to continue providing the industry and its investors with quality research documents to further the understanding of the benefits of alternative investment strategies.

Hans-Willem van Tuyl

Chairman, Alternative Investment Management Association

April 2001

Disclaimer: this report is the update of part of a larger research study 'The Benefits of Managed Futures' authored by Thomas Schneeweis, Professor of Finance, University of Massachusetts and commissioned by the Alternative Investment Management Association (AIMA) in 1996. No quotation is permitted without express acknowledgement from the author and the Alternative Investment Management Association (AIMA). The results of this study represent the conclusions of the larger report and do not necessarily reflect the opinions of various AIMA members.

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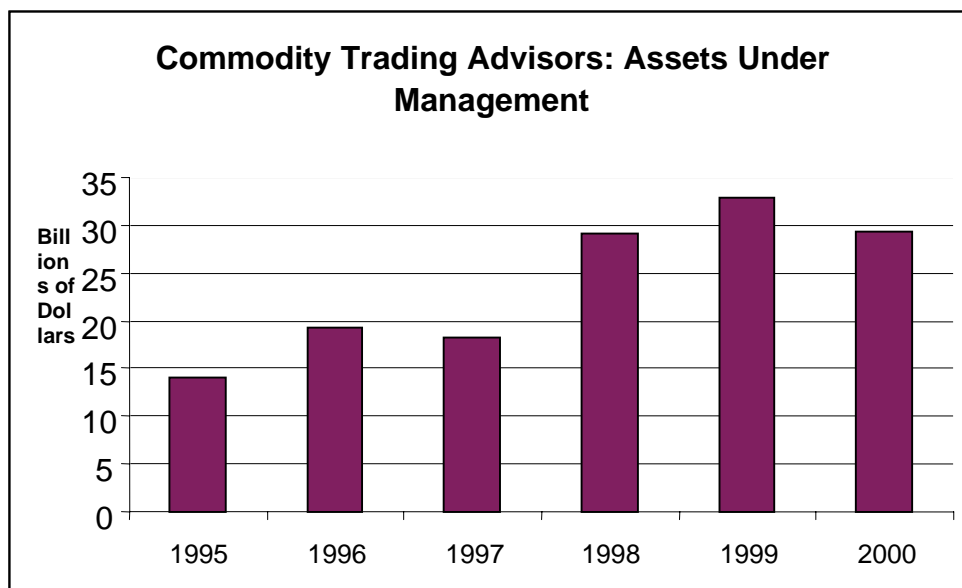
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Overview

The term **managed futures** represents an industry comprised of professional money managers known as **commodity trading advisors** (CTAs) who manage client assets on a discretionary basis, using global futures and options markets as an investment medium. However, for managed futures to grow as an investment alternative, individuals need to increase their knowledge and comfort level as to the use of managed futures in their investment portfolios. Exactly, what are the benefits of managed futures as part of an investor's overall asset portfolio? Basically, managed futures provide direct exposure to international financial and non-financial asset sectors while offering (through their ability to easily take both long and short investment positions) a means to gain exposure to risk and return patterns not easily accessible with investment in traditional stock and bond portfolios. Investors must come to appreciate that the investment benefits in managed futures are well founded in financial theory and empirical evidence. While it is impossible in a short synopsis to convey all the details of the benefits of managed futures, the following exhibits support managed futures as a means to:

- reduce portfolio volatility risk,
- enhance portfolio returns in economic environments in which traditional stock and bond investment media offer limited opportunities, and
- participate in a wide variety of new financial products and markets not available in traditional investment products.

Exhibit 1



The Growth and Benefits of Managed Futures

Futures and options have been used for centuries both as a risk management tool and return enhancement vehicle, yet managed futures, as an investment alternative, has been available only since the late 1960s. More recently, institutional investors such as corporate and public pension funds, endowments and trusts, and bank trust departments have been including managed futures as one segment of a well-diversified portfolio. As shown in Exhibit 1, the dollars under management for Commodity Trading Advisors in the Managed Futures sector has grown from less than \$15 billion under management in 1990 to approximately \$30 billion in 2000. Moreover, this number does not include the billions of dollars under management or in proprietary trading programs of major financial institutions which trade similar strategies but which do not report to traditional data sources.¹

This growth in investor demand for managed futures products indicates investor appreciation of the potential benefits of managed futures (e.g., reduced portfolio risk, potential for enhanced portfolio returns, ability to profit in different economic environments, and the ease of global diversification) as well as the special benefits that futures/options traders have in trading traditional asset classes (e.g., lower transaction costs, lower market impact costs, use of leverage, and trading in liquid markets). In addition, the market integrity and safety of trading on organized exchanges for futures/options contracts provide further assurances of transparency and regulation.

Managed Futures: Risk and Return Performance

While CTAs have often been regarded as high risk investments, over the period 1990-2000 the average annualized standard deviations of individual CTAs and the Dow Jones 30 industrials were similar; that is, approximately 25%.² More importantly, investment theory has shown that assets should be compared on a risk-adjusted basis (e.g., mean return/standard deviation). Also, the potential benefit of adding an asset to an existing portfolio may be measured by an asset's excess breakeven return; that is, the difference between its actual return and the return required to improve an asset's or portfolio's Sharpe ratio. Results in Exhibit 2 show that, over the past eleven years (1990-2000), investment in a portfolio of commodity trading advisors (e.g., Zurich CTA\$) provides stand-alone risk and return benefits generally similar to existing U.S. and world stock and bond investments.³ The individual Sharpe ratios are as follows: Zurich CTA\$ (.60), S&P 500 (.71), Lehman Brothers Government/Credit bond index (.58), Lehman Brothers World Government bond index (.30) and MSCI world stock index (.27).

More importantly, managed futures offer the investor an increased return to risk ratio when considered as an addition to widely diversified asset portfolios. The Sharpe ratio of the portfolios (Portfolio III and VI), which include at least a 10% investment in managed futures, dominate those that invest solely in traditional stock and bond investments or in stock bond, and hedge funds (e.g., Portfolio III vs. II and Portfolio VI vs. V). The individual portfolio Sharpe ratios are as follows: Portfolio I (.79), Portfolio II (1.03), Portfolio III (1.11), Portfolio IV (.36), Portfolio V (.60), Portfolio VI (.65). The benefits of managed futures in diversified portfolios is further illustrated in Exhibit 3 in that when the ZCM CTA\$ is added to a S&P 500, Lehman Brothers Bond index, as well as an S&P 500 and Lehman Brothers bond portfolio, increased risk adjusted investment opportunities exist.

¹ Assets under management in publicly traded funds or private pools has remained in the range of \$8 billion to \$10 billion dollars over the period 1995 to 2000.

² The annual and monthly returns presented in their nominal form. Annualized standard deviations are derived by multiplying the monthly data by the square root of 12.

³ Zurich Commodity Trading Advisor Universe and Managed Futures Pools and Fund Universe returns replace the Managed Accounts Reports (MAR) data used in previous studies. Zurich recently purchase the MAR CTA and Hedge Fund data bases.

Exhibit 2

Performance

	Zurich CTA\$	Zurich Fund of Funds Hedge Fund Universe	S&P 500	Lehman Gov./Corp Bond	MSCI
January, 1990-December, 2000					
Annualized Return	11.8%	10.8%	15.4%	8.0%	9.4%
Annualized Stdev	10.4%	4.7%	13.9%	4.2%	14.1%
Sharpe Ratio	0.60	1.12	0.71	0.58	0.27
Minimum Monthly Return	-6.0%	-6.4%	-14.5%	-2.5%	-13.3%
Correlation With Zurich CTA\$		0.20	-0.06	0.24	-0.09
	Portfolio I	Portfolio II	Portfolio III	Portfolio IV	Portfolio V
	S&P 500 & Lehman Bond	S&P 500, Lehman Bond and Zurich HF Fund of Funds	S&P 500, Lehman Bond CTA\$ and Zurich Fund of Funds	MSCI and Lehman Global Bond	MSCI, Lehman Global Bond and Zurich HF Fund of Funds
Annualized Return	11.90%	11.73%	11.81%	8.62%	9.11%
Annualized Stdev	7.98%	6.91%	6.33%	8.54%	7.26%
Sharpe Ratio	0.79	0.89	0.99	0.36	0.49
Minimum Monthly Return	-6.25%	-6.28%	-5.12%	-5.37%	-5.57%
Correlation With Zurich CTA\$	0.01	0.02		0.00	0.01

Portfolio I = 50% S&P 500 and 50% Lehman Brothers Gov./Corp. Bond

Portfolio II = 40% S&P 500, 40% Lehman Brothers Gov./Corp. Bond and 20% Zurich HF Fund of Funds

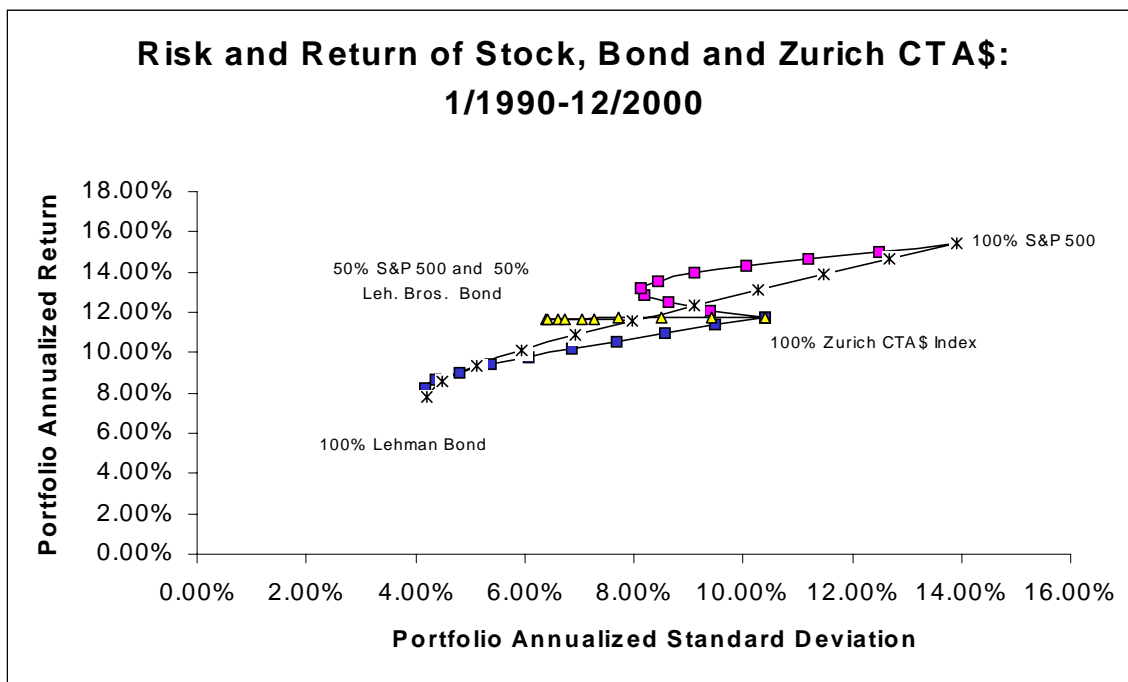
Portfolio III = 90% Portfolio III and 10% Zurich CTA\$

Portfolio III = 50% MSCI and 50% Lehman Brothers Global Bond

Portfolio IV = 40% MSCI, 40% Lehman Brothers Global Bond and 20% Zurich HF Fund of Funds

Portfolio VI = 90% Portfolio V and 10% Zurich CTA\$

Exhibit 3



Alternative Risk/Return Opportunities

Exhibits 4 and 5 display the performance of the Zurich CTA\$ and various Zurich CTA strategy based subsets as well as their correlations with other CTA based investment strategies as well as with traditional assets. In general the correlation of CTA strategies with other CTA strategies is dependent on the degree to which the strategies are trend-following based or discretionary. Since most CTAs follow trend-following strategies, the overall dollar weighted and equal weighted indices are also highly correlated with other CTA strategies dominated by trend-following indices.

On average the correlation of indices, such as the Zurich CTA\$ and various Zurich CTA strategy based subsets with traditional stock and bond indices, are often close to zero on average. While many managed futures programs are often negatively correlated with traditional assets in months when traditional asset returns are negative, they are positively correlated with traditional assets when traditional asset returns are positive. For instance, as shown in Exhibit 6, for the period 1990 through 2000, the Zurich CTA\$ is negatively correlated (-.30) with the S&P 500 when the S&P 500 posted its forty-four worst months and yet is positively correlated (.17) when the S&P 500 reported its best forty-four months. In contrast, as shown in Exhibits 6 and 7, other alternative investment strategies such as hedge funds which may have equity exposure (e.g., event driven or global established) have higher correlation with the equity market when the equity market is falling than when the equity market is rising.⁴

⁴ In the Exhibits in this study, Zurich CTA and hedge fund universe returns are used. CTA\$ is the dollar weighted CTA universe. CTAEQ is the equal weighted CTA universe. The additional CTA indices are segmented by CTA reporting strategy (e.g., currency, financial, diversified) or style (Discretionary, Trend-following). For hedge funds, Event Driven are the median of the reporting hedge funds grouped as distressed and risk arbitrage. The Zurich Fund of Funds is the median of reporting fund of funds where capital allocated among a number of hedge funds. The Zurich Global Established are reporting managers who pay attention to economic changes but are more bottom-up-oriented in that they tend to be stock-pickers. They focus on opportunities in established markets. The Zurich Market Neutral is the median reporting long/short stocks, convertible arbitrage, stock Index arbitrage, and fixed income arbitrage managers. It is important to note that the Zurich CTA and Hedge Fund universe returns used in this study are not the same as the Zurich Hedge Fund Indices which are designed specifically to track particular strategies which meet predefined criteria and which are, by design, more style pure.

Exhibit 4

	Zurich CTA\$	Zurich CTAEQ	Zurich Currency	Zurich Discretionary	Zurich Diversified	Zurich Financial	Zurich Trendfollowing
Zurich CTA\$	1.00						
Zurich CTAEQ	0.94	1.00					
ZurichCurrency	0.70	0.68	1.00				
Zurich Discretionary	0.62	0.52	0.43	1.00			
ZurichDiversified	0.93	0.92	0.56	0.58	1.00		
ZurichFinancial	0.92	0.87	0.63	0.45	0.83	1.00	
Zurich Trendfollowing	0.96	0.95	0.72	0.50	0.92	0.93	1.00

Exhibit 5

Performance: Zurich CTA Universe Strategies and Traditional Assets (1990 – 12/2000)

	Return	Stdev	Sharpe Ratio	Minimum Monthly	Correlation S&P500	Correlation Lehman Bond
CTA\$	11.8%	10.4%	0.60	-6.0%	-0.06	0.24
CTAEQ	9.7%	9.8%	0.43	-5.4%	-0.09	0.20
Currency	10.8%	13.2%	0.40	-8.2%	0.00	0.16
Discretionary	12.9%	7.2%	1.01	-4.6%	-0.05	0.18
Diversified	10.1%	12.1%	0.37	-7.5%	-0.09	0.23
Financial	12.0%	13.6%	0.48	-8.6%	-0.02	0.32
Trendfollowing	10.9%	16.5%	0.32	-10.4%	-0.07	0.24
S&P500	15.4%	13.9%	0.71	-14.5%	1.00	0.37
Leh.Bros.Gov./Corp.	8.0%	4.2%	0.58	-2.5%	0.37	1.00

Exhibit 6

Correlations in Best and Worst Forty-Four S&P 500 Ranked Months (1990-2000)

	All S&P Months	Worst S&P 500 Forty-Four Months	Best S&P 500 Forty-Four Months
Managed Futures			
CTA\$	-0.06	-0.30	0.17
CTAEQ	-0.09	-0.37	0.22
Currency	0.00	0.14	0.26
Discretionary	-0.05	-0.08	0.03
Diversified	-0.09	-0.43	0.16
Financial	-0.02	-0.31	0.22
Trendfollowing	-0.07	-0.35	0.23
Hedge funds			
Zurich Event Driven Universe	0.47	0.64	-0.16
Zurich Fund of Funds Universe	0.52	0.61	0.09
Zurich Global Established Universe	0.78	0.71	0.34
Zurich Market Neutral Universe	0.31	0.55	0.15
Traditional Assets			
Lehman Govt/Corp.Bond	0.37	0.03	0.03

Exhibit 7

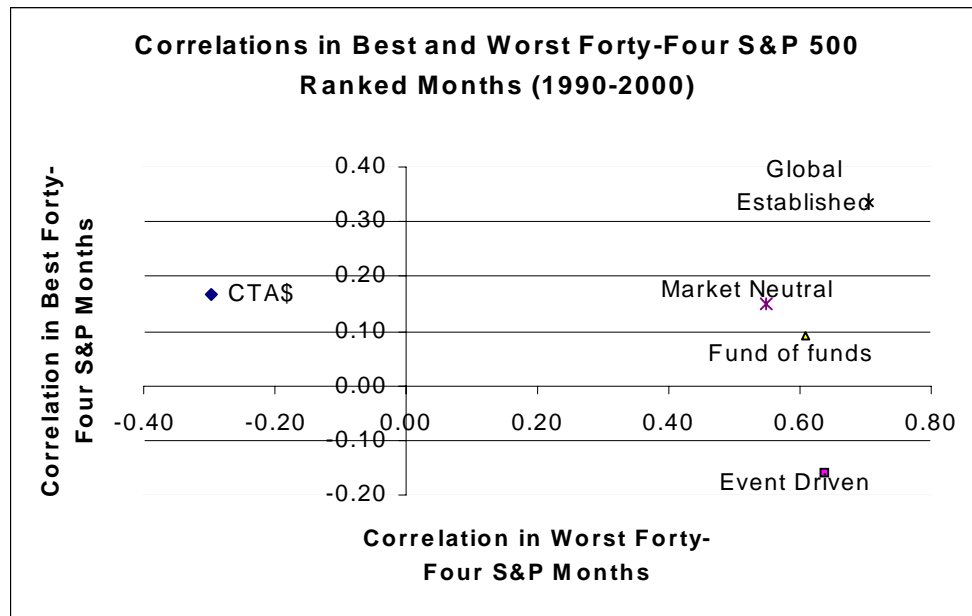
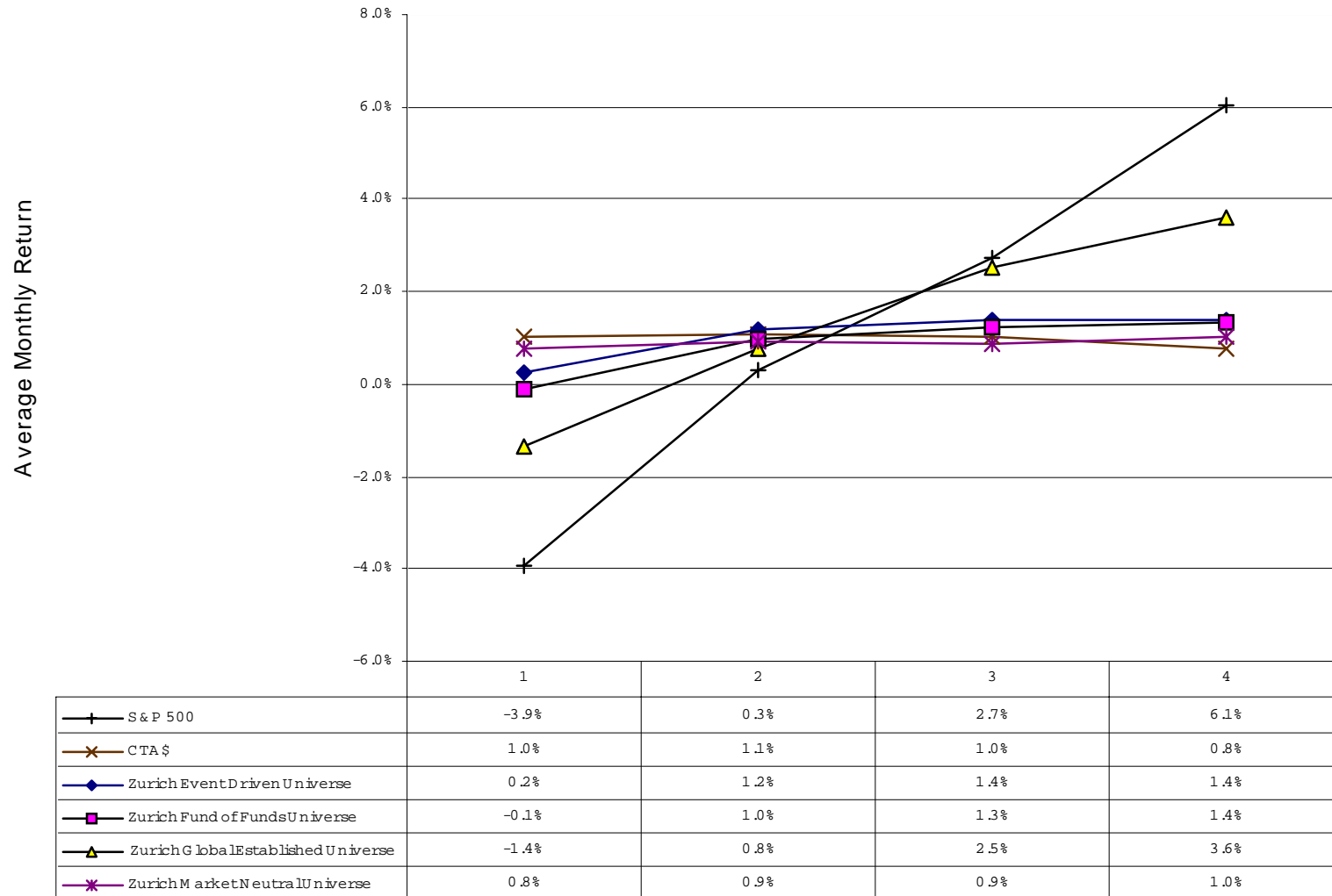


Exhibit 8 indicates that when S&P 500 returns were ranked from low to high and divided into four thirty-three month sub-periods, managed futures offered the opportunity of obtaining positive returns in months in which the S&P 500 provided negative returns as well as in months in which the S&P 500 reported positive returns. In contrast, certain alternative investments such as equity based global established hedge funds had negative returns in just those months in which the S&P 500 performed poorly.

Exhibit 8

Ranking by S&P 500 (1990-12/2000)



Portfolio Groupings

Recent Performance

As shown in Exhibit 9, over the most recent five year period (1996-2000), managed futures have continued to provide benefits as additions to existing stock and stock and stock/bond portfolios. It must be pointed out that over the past six years, the S&P 500 has generally outperformed managed futures as well as many other investment strategies. Investors must also realize the uniqueness of the recent time period. Average annual returns to the S&P 500 in the 1996-2000 period (17.2%) were greater than that achieved in the period 1990-1995 (13.1%) while managed futures had higher returns in the first half of the 1990's (14.4%) than in the period 1996-2000 (8.0%).

Differential Source of Returns to Managed Futures, Hedge Funds and Traditional Assets

The real benefit of managed futures is the provision of sources of returns that are uniquely different from traditional stock or bonds or even hedge funds. For instance, hedge funds have been marketed as offering unique risk and return properties that are not easily available through traditional investment securities or investment products. These return opportunities stem from the expanded universe of securities available to trade and to the broader range of trading strategies.

One reason for the supposedly low correlation and potential diversification benefit is that hedge funds often describe themselves as employing skill-based investment strategies that do not explicitly attempt to track a particular index. Since their goal is to maximize long-term returns independently of a proscribed traditional stock and bond index, they emphasize *absolute returns* and not returns relative to a predetermined index. It is important to realize, however, that while hedge funds do not emphasize benchmark tracking this *does not mean* that their entire return is based solely on manager skill or is independent of the movement of underlying stock, bond, or currency markets. Hedge fund managers often track a particular investment strategy or investment opportunity. When appropriately grouped, these hedge fund strategies have been shown to be driven by the same common market factors such as changes in stock and bond returns or stock market volatility that drive traditional stock and bond market. For instance, in Exhibit 10, the performance of various hedge fund strategies is reported relative to stock and bond markets as well as other factors that have been shown in prior studies to explain returns (increase in risk – i.e., S&P 500 implied volatility). As expected, results show that equity biased hedge fund strategies have high correlation with the same factors as long- equity (e.g., S&P 500). In contrast, managed futures universe returns are not correlated with the stock and bond markets or changes in equity market volatility but track indices that reflect trend-following return patterns. As shown in Exhibit 11, certain managed futures strategies, which are systematic and trend-following in nature, are highly correlated with simple passive trend-following indices. In contrast, managed futures programs that are not trend-following in structure are not correlated with these trend-following indices, such that diversification across trend-following and non-trend-following strategies may offer diversification.⁵

⁵ See www.cisdsm.org for data and description of trend-following indices.

Exhibit 9

Performance

	Zurich CTA\$	Zurich Fund of Funds Hedge Fund Universe	S&P 500	Lehman Gov./Corp Bond	MSCI
January, 1996-December, 2000					
Annualized Return	8.0%	10.9%	17.2%	6.0%	11.9%
Annualized Stdev	8.5%	5.6%	16.1%	3.9%	14.3%
Sharpe Ratio	0.93	1.95	1.07	1.55	0.83
Minimum Monthly Return	-4.8%	-6.4%	-14.5%	-2.4%	-13.3%
Correlation With Zurich CTA\$		0.07	0.03	0.46	0.02

	Portfolio I S&P 500 & Lehman Bond	Portfolio II S&P 500, Lehman Bond and Zurich HF Fund of Funds	Portfolio III S&P 500, Lehman Bond CTA\$ and Zurich Fund of Funds	Portfolio IV MSCI and Lehman Global Bond	Portfolio V MSCI, Lehman Global Bond and Zurich HF Fund of Funds
Annualized Return	11.8%	11.7%	11.4%	7.8%	8.5%
Annualized Stdev	8.6%	7.6%	7.0%	8.0%	7.0%
Sharpe Ratio	1.37	1.53	1.62	0.98	1.21
Minimum Monthly Return	-6.3%	-6.3%	-5.1%	-5.4%	-5.6%
Correlation With Zurich CTA\$	0.13	0.13		0.07	0.08

Portfolio I = 50% S&P 500 and 50% Lehman Brothers Gov./Corp. Bond

Portfolio II = 40% S&P 500, 40% Lehman Brothers Gov./Corp. Bond and 20% Zurich HF Fund of Funds

Portfolio III = 90% Portfolio III and 10% Zurich CTA\$

Portfolio III = 50% MSCI and 50% Lehman Brothers Global Bond

Portfolio IV = 40% MSCI, 40% Lehman Brothers Global Bond and 20% Zurich HF Fund of Funds

Portfolio VI = 90% Portfolio V and 10% Zurich CTA\$

Exhibit 10

Factor Correlations (1990-2000)		S&P 500	Leh. Bros. Bond	Change in Credit Spread Moody's (Baa-Aaa)	Change in Implied Vol. (VIX)
Managed Futures					
CTA\$		-0.06	0.24	-0.06	0.15
CTAEQ		-0.09	0.20	-0.03	0.17
Currency		0.00	0.16	-0.05	0.06
Discretionary		-0.05	0.18	-0.07	0.09
Diversified		-0.09	0.23	-0.05	0.21
Financial		-0.02	0.32	-0.08	0.13
Trendfollowing		-0.07	0.25	-0.07	0.18
Hedge funds					
Zurich Event Driven Univ.		0.47	0.11	-0.33	-0.45
Zurich HF FOF Univ.		0.52	0.20	-0.16	-0.35
Zurich Global Est. Univ.		0.78	0.20	-0.29	-0.48
Zurich Mkt. Neutral Univ.		0.31	0.11	-0.21	-0.15
Traditional Assets					
S&P 500		1.00	0.37	-0.09	-0.63
Leh. Bros. Bond		0.37	1.00	-0.02	-0.15

Exhibit 11

Factor Correlations (1996-2000)	S&P 500	Leh. Bros. Bond	Change in Credit Spread Moody's (Baa-Aaa)	Change in (VIX)	Trendfollowing Interest Rate	Trendfollowing Currency	Trendfollowing Stock
CTA\$	0.03	0.46	-0.09	0.06	0.61	0.53	0.35
CTAEQ	0.01	0.42	-0.05	0.09	0.64	0.58	0.37
Currency	0.07	0.20	-0.01	-0.09	0.09	0.79	-0.03
Discretionary	0.18	0.24	-0.27	-0.07	0.37	0.21	0.26
Diversified	-0.04	0.44	-0.08	0.16	0.62	0.39	0.48
Systematic	-0.01	0.41	-0.03	0.05	0.58	0.53	0.33
Financial	-0.01	0.47	0.00	0.09	0.67	0.50	0.29
Trendfollowing	-0.02	0.46	-0.04	0.13	0.63	0.51	0.39
S&P 500	1.00	0.20	0.07	-0.66	0.04	-0.01	-0.06
Leh. Bros. Bond	0.20	1.00	0.20	-0.02	0.45	0.15	0.28

Summary and Conclusion

The results of this study provide important information to the investment community about the benefits of managed futures.

First, managed futures trade in markets which offer investors the same market integrity and safety as stock and bond markets. Managed futures investment, as for stocks and bonds, provide investors with the assurance that their investment managers work with a high degree of government oversight and self regulation and trade primarily in closely regulated markets.

Second, managed futures are not more risky than traditional equity investment. Investment in a single commodity trading advisor is shown to have risks and returns which are similar to investment in a single equity investment. Moreover, a portfolio of commodity trading advisors is also shown to have risks and returns which are similar to traditional equity portfolio investments.

Third, most traditional money managers (and many hedge fund managers) are restricted by regulation or convention to holding primarily long investment positions and from using actively traded futures and option contracts (which offer lower transaction costs and lower market impact costs than direct stock or bond investment). Thus, in contrast to most stock and bond investment vehicles, managed futures traders offer unique return opportunities, which exist through trading a wide variety of global stock and bond futures and options markets and through holding either long or short investment positions in different economic environments (e.g., arbitrage opportunities, rising and falling stock and bond markets, changing market volatility). As a result of these differing investment styles and investment opportunities, managed futures traders have the potential for a positive return even though futures and options markets in total provide a zero net gain among all market participants. Thus managed futures are shown on average to have a low return correlation with traditional stock and bond markets as well as many hedge fund strategies and to offer investors the potential for reduced portfolio risk and enhanced investment return. As important, for properly constructed portfolios, managed futures are also shown to offer unique downside risk control along with upside return potential.

Simply put, the logical extension of using investment managers with specialized knowledge of traditional markets to obtain maximum return/risk tradeoffs is to add specialized managers who can obtain the unique returns in market conditions and types of securities not generally available to traditional asset managers; that is, managed futures.

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