

DISCUSSING MANAGED FUTURES WITH TRADER VIC AND MEB FABER

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Last week I spoke with Victor “Trader Vic” Sperandeo, CEO of Alpha Financial Technologies, and Mebane Faber, CIO of Cambria Investment Management. We talked about elements of systematic investment strategies, the prevailing macro landscape and the relevance of employing managed futures in portfolio allocation.

The Mechanics of Managed Futures Sperandeo described [managed futures](#) as a strategy that focuses on [volatility](#) and [momentum](#). These include indicators that vary in their look-back lengths—he prefers intermediate trends that last weeks to months. These indicators then create trend-following algorithms that use prices to systematically determine [long, flat](#) or [short](#) signals. If the trend is above the moving average, it signals a long position, if it’s below, it signals a short position. The more complex managed futures strategies also identify how to weight positions in light of volume and relative size and importance considerations.

Market Context for Managed Futures Sperandeo believes the returns for managed futures are highly [correlated](#) to [gross domestic product \(GDP\)](#), [inflation \(CPI\)](#) and [interest rates](#). From 2008 to the present, GDP has compounded at a nominal rate of 1.3% per year; this is the lowest growth rate in an economic recovery. Interest rates have been pegged at zero for this entire period—leaving no returns to be earned on the invested collateral. Furthermore, the CPI has averaged 2.2% since the hyperinflationary times of the 1970s (vs. 4.25% if we were to include the 1970s).¹ Sperandeo believes that this macro backdrop presents a challenge for managed futures. Managed futures typically need volatility and trends to perform well. There has been no recession, but also no robust growth, so this created an environment lacking in volatility that can establish strong trends for managed futures strategies to capitalize on.²

Managed Futures—an Alternative to Buy and Hold An issue investors have when employing a buy-and-hold equity strategy is the ability to sit through long drawdowns such as those in the 1930s and two distinct periods of 50% drawdowns in the last decade. It is difficult for a lot of people to stomach such returns. Faber believes that trend-following strategies have the potential of avoiding long [bear](#) markets; while they are not perfect, they can help reduce volatility and drawdowns. The basis of modern portfolio theory is to create a portfolio that is diversified and minimally correlated, allowing an investor to have a smoother ride up. Sperandeo believes that managed futures have the potential to offer more efficient returns: when stocks and bonds are down, managed futures have traditionally been able to offer better returns. For example, September 2008 was a great month for managed futures, as was the quarter ending June 30, 2015—thus, [hedging](#) weakness in stocks. This non-correlated feature makes managed futures a desirable asset class. The important thing to realize is that managed futures are an efficient addition to the portfolio—not because they make money all the time, but because they offer diversification.

Managed Futures in Portfolio Allocations Both Sperandeo and Faber feel that managed futures should be a part of anyone’s portfolio, given their potential for diversification. Sperandeo believes that an allocation to managed futures would depend on how heavily one is allocated to stocks and bonds. As a baseline, he suggests a 5% allocation for any portfolio. If one is over-weight in stocks, a higher allocation to managed futures may be warranted. Faber, on the other hand, believes that for their diversification potential managed futures ought to make up

as much as 30% of a portfolio. While bonds have been a great diversifier in the past, yields today are at an all-time low globally, and managed futures can be a wonderful allocation. Faber sees one of the biggest obstacles to managed futures allocations in their historically exorbitant fees—typically a 2% average annual expense ratio and 20% of profits. The more recent development of lower-priced strategies should make this asset class more appealing. **Managed Futures and Short Oil** while short oil is a high-stakes gamble, many managed futures strategies are positioned this way due to oil's large tradable volumes. Sperandeo views the drop in oil prices from \$100 to \$50 per barrel as a political game to possibly punish Russia. Additionally, he believes Saudi Arabia has kept production stable to keep Iran in check and as a strategic move to keep U.S. fracking business at bay. Sperandeo believes that the move from \$50 to \$40 per barrel was most likely due to the Iranian deal, which took the war premium out of oil. Yet he worries that by going short oil, investors would run the risk of ruin. Because oil tends to be a large portion of many managed futures strategies, he is reluctant to be short, given these already large positions and the potential for an upside headline surprise. Not shorting oil is one way Sperandeo lowers his ultimate [risk](#) exposure in managed futures strategies. [Read the Conversations with Professor Siegel Series.](#)

¹Source: Bloomberg, as of 9/11/15. ²Source: Bloomberg, since June 2009.

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Diversification does not eliminate the risk of experiencing investment loss.

Investing in managed futures is speculative and involves a substantial degree of risk. One of the risks is the complexity of the different factors that contribute to performance, as well as the correlation (or non-correlation) to other asset classes. These factors include use of long and short positions in commodity futures contracts, currency forward contracts, swaps and other derivatives. Derivatives can be volatile and may be less liquid than other securities and more sensitive to the effects of varied economic conditions.

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DEFINITIONS

Managed futures: An alternative investment strategy in which futures contracts are used as part of the investment strategy.

Volatility: A measure of the dispersion of actual returns around a particular average level.

Momentum Factor: Characterized by assets with recent price increase trends over time. This term is also associated with the Momentum Factor which associates these stock characteristics with excess return vs the market over time.

Long (or Long Position): The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

Short (or Short Position): The sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value, the opposite of Long (or Long Position).

Correlation: Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Gross domestic product (GDP): The sum total of all goods and services produced across an economy.

Inflation: Characterized by rising price levels.

Cleveland Median CPI: Instead of calculating a weighted average of all of the prices, as the BLS does, the Cleveland Fed looks at the median price change—or the price change that's right in the middle of the long list of all of the price changes. According to research from the Cleveland Fed, the Median CPI provides a better signal of the inflation trend than either the all-items CPI or the CPI excluding food and energy.

Interest rates: The rate at which interest is paid by a borrower for the use of money.

Bear market: A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Hedge: Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Risk: Also standard deviation, which measures the spread of actual returns around an average return during a specific period. Higher risk indicates greater potential for returns to be farther away from this average.