Abbey Capital

Three reasons to consider Managed Futures in 2022

March 2022

Quick-read analysis

5 minutes

What’s included?

This quick-read analysis explores three reasons to consider managed futures in 2022.

It covers:

1. Performance potential in difficult periods for bonds and equities

2. Uncertain outlook for inflation

3. Trends in commodities

1. Performance potential in difficult periods for bonds and equities

Portfolios concentrated in equities and bonds, such as the 60/40 Portfolio[1], have performed strongly over the last three decades.

However, with valuations remaining high relative to history, global inflation at multi-decade highs and Federal Reserve rate hikes expected, the outlook for the 60/40 Portfolio is uncertain.

Given this uncertainty, now might be the right time to consider alternative strategies to complement the 60/40 Portfolio.

We believe that managed futures is one diversification strategy that warrants consideration[2].

Here's why.

Shifts in the equity/bond correlation

The negative long-term correlation of bonds and equities is a bedrock of the 60/40 Portfolio. We saw this correlation turn positive at times as higher inflation emerged in 2021. In fact, US Treasuries were negative in 5 of the last 6 negative months for the S&P 500[3].

Diversification in negative periods for the 60/40 Portfolio

Some of the strongest periods of performance for managed futures[4] have occurred during difficult periods for the 60/40 Portfolio (Table 1). In contrast, many hedge fund strategies[5] have struggled during these periods, potentially explained by the positive correlation that many hedge fund strategies have to equities.

Performance potential in various market environments

Managed futures is a bi-directional strategy than can hold long or short positions across numerous contracts. This means that it can potentially generate returns in both rising and falling markets. In fact, the average performance of managed futures has historically been positive during both positive and negative quarters for the 60/40 Portfolio (Table 2).

1 The 60/40 portfolio is a common industry benchmark representing a portfolio of 60% equities and 40% bonds. For the purposes of this document, the 60/40 portfolio consists of 60% S&P 500 TR Index and 40% JP Morgan US Government Bond Index. Performance figures that combine S&P 500 TR Index and the JP Morgan US Government Bond Index are hypothetical. While based on the actual historical data of each, results are purely the product of simulation and there was no actual trading or actual profits for these scenarios. Actual historical returns of the S&P 500 TR Index and JP Morgan US Government Bond Index can be found on page 9. A detailed description of the indices referenced can be found on page 9. Please see page 8 for information about the inherent limitations of hypothetical performance results.

2 Diversification does not assure profit, nor does it protect against a loss.

3 As at 28 February 2022.

4 The Barclay CTA Index is used to represent the managed futures industry for the purposes of this paper. A description of the Barclay CTA Index is included on page 9. Trading in managed futures is not suitable for all investors given its speculative nature and the high level of risk involved including the risk of total loss of initial investment.

5 The HFRI Fund Weighted Composite Index is used to represent the hedge fund industry for the purposes of this paper. A description of the HFRI Fund Weighted Composite Index is included on page 9.

1. Performance potential in difficult periods for bonds and equities

Table 1

Performance during the worst ten monthly declines in the 60/40 Portfolio: Jan-1990 to Feb-2022

	60/40 Portfolio*	Barclay CTA Index[§]	HFRI Fund Weighted Composite Index[^]
Oct-08	-10.2%	3.4%	-6.8%
Aug-98	-7.6%	5.9%	-8.7%
Feb-09	-6.6%	-0.2%	-1.2%
Jan-09	-6.3%	-0.2%	-0.1%
Mar-20	-6.1%	1.7%	-9.1%
Aug-90	-5.9%	6.7%	-3.5%
Sep-02	-5.4%	2.4%	-1.5%
Sep-08	-5.1%	-0.3%	-6.1%
Feb-01	-5.0%	-0.6%	-2.2%
Jun-08	-4.7%	2.0%	-1.3%
Average	**-6.3%**	**2.1%**	**-4.1%**

Source: Abbey Capital, Bloomberg.

Data is shown for this period as it is the earliest data available for the HFRI Fund Weighted Composite Index.

Table 2

Average quarterly performance of managed futures during positive and negative periods for the 60/40 Portfolio: April-1988 to Dec-2021

	60/40 Portfolio* - average quarterly return	**Barclay CTA Index[§] - average quarterly return**
60/40 Portfolio* positive quarters	4.3%	1.3%
60/40 Portfolio* negative quarters	-3.5%	1.5%
	2.4%	**1.4%**

Source: Abbey Capital, Bloomberg.

Data is shown for this period as it is the earliest quarterly data available for the S&P 500 TR Index.

Indices referred to in Tables 1 and 2 are not directly investible, are not based on the entire population of equities, hedge funds or CTAs and are not indicative of the performance of any particular manager or fund. Furthermore, these indices may not be directly comparable. As a result there are inherent limitations with using these indices for representative purposes and the above is shown for illustrative purposes only.

** The 60/40 portfolio is a common industry benchmark portfolio representing a portfolio of 60% equities and 40% bonds. For the purposes of this document, the 60/40 portfolio consists of 60% S&P 500 TR Index and 40% JP Morgan US Government Bond Index. Performance figures that combine S&P 500 TR Index and the JP Morgan US Government Bond Index are hypothetical. While based on the actual historical data of each, results are purely the product of simulation and there was no actual trading or actual profits for these scenarios. Actual historical returns of the S&P 500 TR Index and JP Morgan US Government Bond Index can be found on page 9. A detailed description of the indices referenced can be found on page 9. Please see page 8 for information about the inherent limitations of hypothetical performance results.*

§ The Barclay CTA Index is used to represent the managed futures industry for the purposes of this paper. A description of the Barclay CTA Index is included on page 9.

^ The HFRI Fund Weighted Composite Index is used to represent the hedge fund industry for the purposes of this paper. A description of the HFRI Fund Weighted Composite Index is included on page 9.

2. Uncertain outlook for inflation

Higher inflation was an important market driver in 2021, with US inflation hitting a 39-year high.

The elevated inflation environment has remained a key focus for investors in early 2022. Concerns that higher inflation may lead to tighter monetary policy has already resulted in increased volatility in equity and bond markets at times this year.

Abbey Capital believes this highlights the need to evaluate alternative strategies as portfolio diversifiers.

For investors who are concerned about the impact of inflation on their portfolios, managed futures may be one alternative strategy to consider. Here's why.

Historical performance during high inflation environments

Managed futures strategies have historically delivered their strongest returns in high inflation environments. Past periods of elevated inflation have been associated with a higher percentage of trends in commodity markets, potentially providing better opportunities for managed futures strategies.

The future path of inflation is difficult to predict

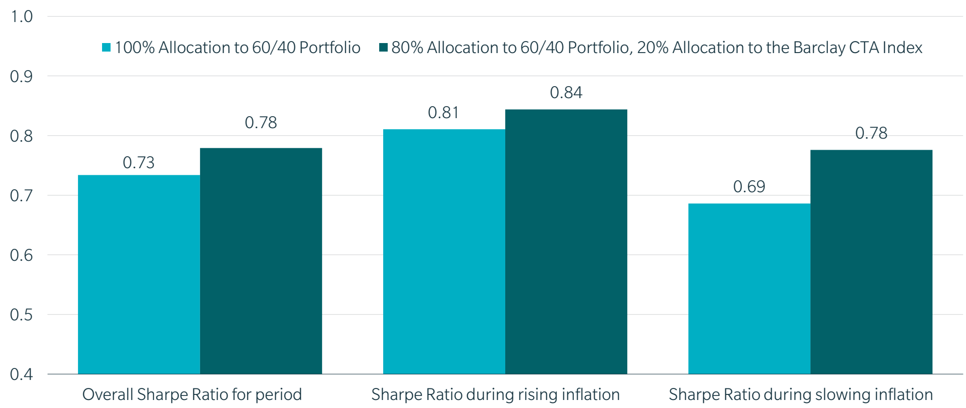
Many commentators have raised the possibility that inflation may accelerate further, while others believe the current environment to be transitory. The track record of economists in forecasting future inflation is decidedly mixed. Realised US CPI consistently undershot expert forecasts for much of the past two decades, before substantially overshooting in 2021.

Managed futures can benefit a portfolio in rising and falling inflation environments

The uncertain outlook for inflation can complicate investment decisions. There are some asset classes, such as commodities, that have performed well in rising inflation environments but recorded negative performance in periods of falling inflation. Managed futures strategies have historically improved a portfolio's risk-adjusted return in both rising and falling inflation environments (Chart 1).

Chart 1

Effect on Sharpe Ratio[6] of adding managed futures to the 60/40 Portfolio in rising and falling inflation environments – February 1988 to January 2022



Source: *Abbey Capital, Bloomberg.*

*6 **The Sharpe ratio** is a measure of risk-adjusted return. The measure subtracts the risk-free rate from the annualised performance of the asset or fund and divides by the realised annualised volatility. A higher (lower) Sharpe ratio is seen as indicative of stronger (weaker) risk-adjusted performance.*

The chart above is based on monthly data, with months categorised as rising (or declining) periods of inflation based on whether the year-on-year change in US CPI (Consumer Price Index) was higher (lower) than during the previous month.

For the purposes of this document, the 60/40 portfolio consists of 60% S&P 500 TR Index and 40% JP Morgan US Government Bond Index. Data is shown for this period as it is the earliest monthly data available for the S&P 500 TR Index. The above chart is for illustrative purposes only. Performance figures shown that combine the indices listed above are hypothetical. While based on the actual historical data of each, results are purely the product of simulation and there was no actual trading or actual profits for these scenarios. For information about the limitations of hypothetical performance results please see page 8. Please see page 9 for description of indices.

Indices referred to in this document are not directly investible, are not based on the entire population of equities, hedge funds or CTAs and are not indicative of the performance of any particular manager or fund. Furthermore, these indices may not be directly comparable. As a result there are inherent limitations with using these indices for representative purposes and the above is shown for illustrative purposes only.

3. Trends in commodities

The recent environment has been strong for commodity markets. The reopening of the global economy after COVID-19 related lockdowns has often seen strong demand coincide with constrained supply.

Cargo delays at major ports, elevated freight costs and labour shortages have all contributed to significant supply chain disruptions, driving prices for many commodities sharply higher.

Heightened geopolitical tensions, as well as seasonally low inventories and OPEC+ supply restrictions, have pushed energy prices higher in recent months, while unusually dry weather conditions in key growing regions have similarly impacted agricultural commodities.

The persistence of this type of environment can potentially create opportunities for managed futures – and trendfollowing strategies in particular.

Here are the key points.

Uptrends in commodity markets

2021 saw major commodity indices record their best year of performance in 21 years. Overall, the managed futures industry saw positive performance over the year, in part from strategies holding long positions across a wide range of energy, base metal, and agricultural commodity markets.

Internal Abbey Capital measure of the percentage of commodity markets trending hit a 12-year high in 2021

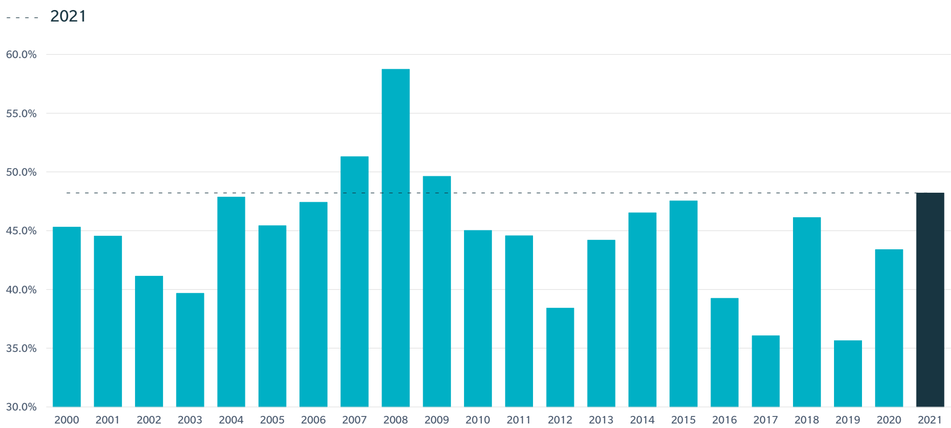
The percentage of markets trending is a proprietary measure used by Abbey Capital to track the number of markets experiencing price trends. This measure has historically correlated with performance for the managed futures industry. On a calendar year basis, 2021 saw the highest the percentage of commodity markets trending since 2009 (see Chart 2).

Managed futures dynamically allocates risk to commodity markets

Managed futures and trendfollowing strategies can allocate risk based on the strength of price trends and other quantitative trading signals. When strong price trends emerge in a sector - as we've seen in commodities in recent times - managed futures strategies can adjust their portfolios and allocate more risk to that sector.

Chart 2

Abbey Capital measure of percentage of commodity markets trending by calendar year – January 2000 to December 2021



Source: *Abbey Capital, Bloomberg.*

Abbey Capital's Percentage of Markets Trending measure examines a diversified set of 75 contracts selected by Abbey Capital to represent the contracts typically traded by trendfollowing managers, covering equities, fixed income, currencies and commodities. This charts looks specifically at the commodity contracts within this dataset. Data above is shown from Jan-2000 onwards. Please see page 10 for information on Abbey Capital's Percentage of Markets Trending measure and how the underlying contracts used to construct the indicators are selected.

For more analysis from the Abbey Capital Markets Team, download our recent content on the 60-40 portfolio:

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Description of Indices

Barclay CTA Index
(Start Date: Jan-1987)

The Barclay CTA Index is a leading industry benchmark of representative performance of commodity trading advisors. There are currently 416 programs included in the calculation of the Barclay CTA Index. The index is equally weighted and rebalanced at the beginning of each year. Data is shown from January 1987 which is the earliest data available for the Barclay CTA Index.

S&P 500 Index
(Start Date: Mar-1957)

The S&P 500 Index is an index of 500 US stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of US equities and is meant to reflect the risk/return characteristics of the large cap universe.

S&P 500 Total Return Index ("S&P 500 TR Index")
(Start Date: Feb-1986)

The S&P 500 Total Return Index is the total return version of the S&P 500 Index. Dividends are reinvested on a daily basis and all regular cash dividends are assumed reinvested in the index on the ex-date. Data is shown from February 1988 which is the earliest data available for the S&P 500 TR Index.

JP Morgan US Government Bond Index
(Start Date: Jan-1986)

The JP Morgan US Government Bond Index is a leading measure of US government bond market performance. The Index measures the total return of US Treasury securities across the whole yield curve.

HFRI Fund Weighted Composite Index
(Start Date: Jan-1990)

The HFRI Fund Weighted Composite Index is a global, equal-weighted index of single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US Dollars and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

Details on historical performance of the components of the 60/40 Portfolio

Historical performance (annualised) of component parts of the 60/40 Portfolio as at 31 January 2022

	February 1988 to January 2022	1 Year	5 Year	10 Year
S&P 500 TR Index	11.2%	23.3%	16.8%	15.4%
JP Morgan US Government Bond Index	5.6%	-3.1%	2.8%	2.0%

Source: Bloomberg These indices may not be directly comparable and are shown for illustrative purposes only.

Abbey Capital's Percentage of Markets Trending measure

To calculate Abbey Capital's Percentage of Markets Trending measure, 75 markets (the Market Data Sample) were analysed and categorised as either (i) Trending, (ii) Consolidating / Reversing, or (iii) No Trend. The results are aggregated (sector averaged) to calculate the percentage of markets in each phase.

Chart 2 shows the average percentage of commodity markets trending during each calendar year. This is based on a subset of the 75 contracts from the Market Data Sample dataset.

Details on how the Market Data Sample dataset is constructed and a description of Market Trending Phases are provided below

Market Data Sample

The sample contract set used in the Percentage of Markets Trending calculations is constructed by Abbey Capital. Based on the managers we allocate to currently and have historically allocated to, we have identified 75 markets split across fixed income, equities, currencies and commodities that are actively traded by a significant number of trendfollowing managers.

Once the contracts were identified, VaR allocations to each contract were assessed over a period of 10 years to ensure that positioning in each contract amongst trendfollowing managers over time was meaningful. Each contract is included in the sample from the date that data is available; accordingly, not all 75 contracts are used throughout the entire period.

Data was sourced from Bloomberg.

Market Trending Phrases

1. Trending

A futures market is Trending if the 20-day moving average is between the price and the 120-day moving average.

2. Consolidating/Reversing

From a Trending phase, if the price moves between the 20-day and 120-day average, the futures market is Consolidating. The market is Reversing if the 120-day moving average is between the price and the 20-day moving average.

3. 'No Trend'

If the 20-day and 120-day moving averages cross when the system is in a Reversing phase, the system will enter a No Trend phase once the price crosses either of the moving averages.