

# The long and the short of it

Managed futures are among the favored vehicles for investment in commodities – but what type of exposure is best suited to a high-net-worth investor's portfolio structure?

BY STEPHANIE BARTUP

Commodity index returns have, in general, been poor over the past year. In a low-inflation environment, the Bloomberg Commodity Index Total Return (BCOMTR:IND) has a one year return rate of -26.03%.

One of the most commonly invested in commodities, crude oil, sunk to a new low in January when it fell below \$30 a barrel for the first time since 2003.



INDIVIDUALS SHOULD HOLD COMMODITY FUTURES AS AN INFLATION HEDGE, BUT ONLY WHEN INFLATION EXISTS

JASON LEJONVARN, MELLON CAPITAL



In this volatile and uncertain market, one strategy has been gaining traction with affluent investors and their advisory teams. By using futures contracts to determine a position based on the anticipated profit, investors are seeing higher return potential. For example, LoCorr Funds' four long/short commodities managed futures products (LCSCX, LCSAX, LCSAX.LW, LCSIX) currently have one-year return rates of between 27.9% and 29.22%.

Managed futures are essentially a subset of hedge funds, a collection of liquid strategies focused on exchange-traded futures, options, and foreign exchange markets, and can take either a long (betting on the price increasing) or short (betting on a drop in price) position.

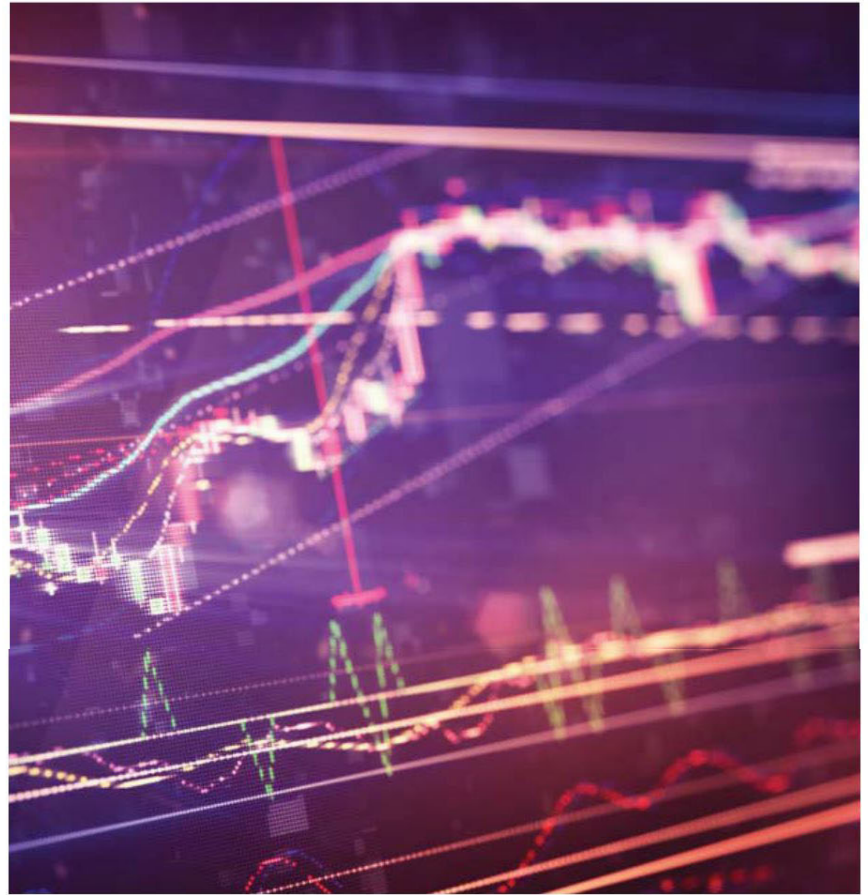
"Trading programs can take both long and short positions in as many as 400 globally diverse markets, spanning physical commodities, fixed income, equity indexes, and currencies," says Tom Rollinger, managing partner, chief investment officer at Red Rock Capital.



He added that daily participants in these markets include hedgers, traders, and other investors. “These conditions allow most managed futures programs to accommodate large capacity and provide the opportunity to diversify across many different markets, sectors, and time horizons.”

Most managed futures strategies show very low correlation to the movement of the stock market, making them an ideal hedging mechanism for an investment portfolio in need of diversification. Additionally, studies have shown this type of program can increase the overall return of an investor’s portfolio while decreasing its volatility (Dr. John Lintner, Harvard University, 1983).

Commodities are one of the few liquid asset classes that have a high sensitivity to inflation; therefore, investors do not need a large percentage of assets in commodities to hedge inflation, experts suggest. “An allocation of up to 5% is usually adequate for individuals,” says Jason Lejonvarn, investment strategist at Mellon Capital, a BNY Mellon investment boutique. “Individuals should hold commodity futures as an inflation hedge but only when inflation exists. Otherwise individuals could wait for inflation and be very tactical or look for a solution that can be net short commodities during periods of low commodity returns and long during periods of inflation.”



## THE BIG SHORT

Rollinger points out one of the main characteristics that separates managed futures from other asset classes is the ability to bet on prices dropping and rising with equal ease. “With the ability to go both long or short in global markets, managers have the potential to profit from market moves regardless of direction,” he points out.

But taking a short position, and profiting if and when the price of the futures contract goes down, is a more favorable approach with some. Blending as part of a long/short commodities strategy, or even taking a short-only approach, can reap high returns in a low-inflation market.

Lejonvarn advises against a long-only commodities position and says he would not recommend purchasing individual commodities, for example in the form of gold or oil: “To hedge inflation, a diverse exposure is more prudent than single commodities,” he adds.

MANAGED FUTURES ARE A GREAT DIVERSIFIER... IT BRINGS HOME THE POINT THAT SHORT POSITIONS IN COMMODITIES, LIKE CRUDE OIL, PROVIDE REAL PORTFOLIO BENEFIT.

TIM RUDDEROW, MOUNT LUCAS

“Commodities are only one component of a portfolio – an experienced manager will have a better sense of the right time to go long/short, and work many other market elements into their decision making.” Of the current market environment he says commodities equities may represent more attractive value than commodity futures.

Tim Rudderow, president and chief investment officer at Mount Lucas, says that a long-only approach to commodities “makes no economic sense”, and says that investors are more frequently jettisoning these positions.

“Ongoing market volatility has really put the nail in the coffin for long-only investors,” he adds. “Managed futures are a great diversifier against the traditional stock/bond. It brings home the point that short positions in commodities, like crude oil, provide real portfolio benefit.”

There are of course other strategies one can select when investing in commodities. As Lejonvarn alluded to, there are prospects in physical metals, agriculture and energy, as well as purchasing stocks in the commodity firms themselves –but this again, comes with drawbacks.

“An investor can always own part of the resource companies, but this move is not the same as buying an exchange traded product or managed futures contract; you’re buying the company not the commodity which makes it less diverse and trickier to own,” says Rudderow.



When it comes to choosing the intricacies of a managed futures allocation, Rollinger says that his firm has seen a difference in the approach by high-net-worth (HNW) and ultra-HNW investors when it comes to investing in commodities— an approach which he says he prefers.

“Generally these are people who have done well in their particular industry – and they want to diversify their net worth and investment portfolios via one of our two strategies (or other managers’ programs). They are the decision-makers... they are more agile than institutions in that if they see something they like, they are able to open an account a week or so later,” he explains. “Institutions, on the other hand, often have layers of due diligence personnel and decision-makers.”

#### SIDESTEPPING A SLIP-UP

When selecting an allocation to commodities, Lejonvarn warns against a mistake frequently made by investors – which is assuming that commodities investments work the same as equities and bonds.

“Many investors look at cheap equities and buy them because they are low-price – but with oil, for example, the valuation is different as there are

no specific cash flows. The catalyst for price rise is inflation, and it looks pretty benign over the next year,” he says.

“Commodities move through cycles – [they go] from an investment to an exploitation phase. The best time to buy is during the investment phase when supply is tight or towards the end of the exploitation phase when demand is rising. Currently, we are only 18 months into a multi-year exploitation phase in crude markets.”

Rudderow says he is ‘not particularly bullish’ on commodity pricing in the near future, but says that as a ‘tried and tested’ strategy, managed futures should still have a place for the commodities investor.

“Managed futures worked during the market volatility in 2008 and in this cycle,” he says. “But the question is how much money they can absorb. Capacity is nowhere near as large as the equity markets, and investors will have to be wary.”

Rollinger adds that amid the current market volatility, there are still long and short opportunities to be found in the space. “Many managers within managed futures thrive when the markets they trade exhibit ‘trending’ behavior or ‘directional volatility,’” he explains. “The strong downward moves in oil and many of the other energy futures markets were beneficial to many managers across the space.”

“The barriers to entry [to managed futures] are nice and low for a HNW or UHNW investor to gain access to a couple of CTA managers of their choosing. I believe if the managed futures industry can collectively ‘connect’ with, and effectively educate, HNW and UHNW investors, that the sky is the limit for the space.” ■

## THE STRONG DOWNWARD MOVES IN OIL AND MANY OF THE OTHER ENERGY FUTURES MARKETS WERE BENEFICIAL TO MANY MANAGERS

TOM ROLLINGER, RED ROCK CAPITAL

### THE IMPACT OF MARKET VOLATILITY ON OIL-RICH STATES

**How has the oil market volatility affected investment in commodities, particularly in oil-dependent states such as Texas? Mike Krach (top right), senior vice president and regional portfolio advisor, and Colter Lewis (bottom right), head of Northern Trust Houston, give their opinions.**



“Texas is a more diversified business environment than we were in the early 1980s, and to date, falling oil prices have not been as catastrophic as in years’ past. That said, energy is clearly a large part of our economy and the prolonged effect of the current downturn is still looming. The decline in oil can have several effects in wealth management. First, it can lead to expanded M&A that can result in significant “liquidity events” for UHNW

prospects. Second, it can (and has) led to layoffs for the energy complex as a whole.

The volatility in the energy sector can cause clients to become more conservative with their liquid assets for a couple reasons; first, there is a tendency to take a wait-and-see approach by allowing implications from recent belt tightening from energy companies to take root. Second, many Houston clients know the sector well and expect to see significant opportunities in the future due to the enormous disruptions that have occurred.

The current environment has led to a new thematic view that has shifted to a greater focus on the strength of the balance sheets instead of a strong focus on the income statement. The market has moved from a strong focus on aggressive earnings growth to a higher emphasis on evaluating the strength of balance sheets that will enable companies to weather the downturn effectively. This uncertainty explains why so many

respected companies have seen their stock price go down 70% or more.

In our view, we believe that the best way to invest in the sector is by owning companies with the strongest balance sheets, those that will cut capital spending instead of dividends should benefit during the inevitable consolidation. For the long term, demand continues to increase, so it appears at this point the dramatic fall in the price of oil is more associated with an increase in the supply rather than a global recession leading to weaker demand.

Commodities have had a low correlation to other asset classes in the past and have been a good diversifier. The current problem is that markets are viewing the weakness in commodities as a precursor to a weakening global environment. That combined with confusing signals on monetary policy and weaker earnings are presenting a challenging start to the year.”