HOW ADDING RISK TO A CLIENT'S PORTFOLIO CAN REDUCE OVERALL RISK BY ROBERT J. LINDNER

Subtraction through Addition

ANYONE WHO HAS STUDIED BASIC PORTFOLIO construction understands that it's possible to reduce the overall risk in a portfolio by adding an asset class that has low or negative correlation to the rest of that portfolio's asset class constituents. At least, that's what they taught us in Investing 101.

And lest we forget, it was in Investing 401 (or was it 501?) that we came up with the advanced theories that lie behind Long Term Capital Management's management. Perhaps, then, we are reminded of a very famous aphorism: "In theory, there is no difference between theory and practice. But in practice, there is." In the practice of Long Term Capital Management, a series of negative events was coupled with an ever-increasing leverage ratio in a portfolio that all the mathematical models claimed should be fine. The only difference evidently was that mathematical models aren't forced to make margin calls.

Where does this scenario leave us with the "add risk to reduce risk" concept? Does it, too, fall apart under such extreme circumstances? Before we put 2008 under the microscope, perhaps we should brush up on exactly what we are talking about when it comes to adding risk to reduce risk. We cannot forget that we are looking at adding distinct asset classes—defined as assets that behave similarly in the marketplace and are subject to the same laws and regulations as other alternative investments.

Really, there is a fuzzy line between low-beta and high-beta stocks. Yes, they behave slightly differently, but both kinds are stocks and subject to the same laws and regulations. But then, when the proponents of "add risk to reduce risk" speak, they're wringing their hands in delight when we talk about managed futures, for example. Now that's an asset class.

This alternative investment has (historically) had low or negative correlations to traditional asset classes and has certainly been subject to different regulations.

I think the term 'managed futures' conjures up heartburn for the uninitiated, but it is typical to fear what we don't know or understand. Both investors and their advisors are quickly discovering that there has been a vast amount of scientific research carried on since the Capital Asset Pricing Model (CAPM) was first presented, even though it could be argued that the application of these scientific findings stopped making their way into portfolios decades ago. How many prospective client portfolios have you personally seen that have a 60% stock and 40% bond mix, and that's it?

Sure, each asset class itself is well diversified, but in the information age, it takes about two hours of reading about ETFs before someone gets the idea they can cut out the middleman and live happily ever after, only to discover that human psychology applies to them, too. They bail out of their long-term, self-prescribed Investment Policy Statement at exactly the worst time.

Human behavior trumps sound logic for most investors. However, if you turn to embracing portfolio instruments whose genesis is derived from science-based research and not investment myopia, then the chances are that you will not only keep more clients, but find more clients. It is much easier to defend your recommendations when they are coming from academics whose only vested interest is being able to say they figured the stuff out first, as opposed to industry manufacturers who provide you with slick marketing materials and colorful pinwheels to explain what your bond allocation should be based on the age that you dial up on their online wheel. Their vested interest is getting you to allocate money to their investments and not make the best investment decisions.

ENTER DR. LINTNER

Pardon the tangent here. Let's get back to the wide world of managed futures which had their first serious look over 25 years ago when Harvard professor John Lintner presented his paper, "The Potential Role of Managed Commodity – Financial Futures Accounts (and/or Funds) in Portfolios of Stocks and Bonds," at the annual conference of the Financial Analysts Federation in Toronto in May 1983. The professor essentially asserted that combining managed futures into a standard portfolio of stocks and bonds increased risk-adjusted returns at every point on the efficient frontier. While it all sounded great, there was very little real-world application for retail investors because they couldn't track managed futures indexes.

That's all changed now. What people are really interested in still is how the strategy worked in 2008. So I'll cut to the chase. The Altegris 40 Index tracks the performance of 40 managed futures programs (adjusting for survivorship bias, incidentally). They collectively returned +15.47% for the calendar year 2008. Low- to-negative correlation works both ways: for 2009, the S&P500 rose 26.45% while the Altegris 40 Index returned a negative 7.98%, while the Barclays Capital US Aggregate Bond Index rose 5.93%.

For the nineteen full calendar years that passed between 1990 and 2008, there was not a single year when the Altegris 40 Index and the S&P500 Total Return Index both produced negative annual numbers. More important, if we look at a stress test of the respective indexes, we find that the single worst-month performance for each index was -8.16% for the managed futures (January 1992) and -16.79% for stocks (October 2008). If we further look at the worst overall drawdown periods: we see -15.00 for managed futures between December 1992 and April 1993 (that's five months) versus -50.95% for stocks between October 2007 and February 2009 (a full 17 months). So, is it managed futures that warrant advisor discomfort? Or is it stocks?

Buying stocks seems so very elegant and regal when they are held for the long term. A portfolio of managed futures seems to run counter to that, but I would argue that the benefit is precisely because the assets are uncorrelated. After all, we are looking for distinct asset classes to add to our portfolios, right? If we look closely into the managed futures index, we will actually see a diversification among the various managed futures trading programs, thereby offering a multi-layered diversification benefit to a portfolio. Beyond the multi-manager structure, investing in a portfolio of managed futures programs can provide clients with access to foreign exchange markets, metals, energy, commodities, and interest rates. Futures trading is now even possible on weather derivatives.

One trait that is common between the various strategies is that managed futures are exchange-traded instruments, liquid, and operate through clearing houses. There is no direct counterparty risk, such as you find with over-the-counter instruments. Stop-loss orders are used regularly to limit losses and let profits run.

When we look at certain systemic events since 1987 and return to our drawdown analysis theme, we see that holding managed futures can really save a portfolio. The CME Group reports that during the market crash of 1987 and the days that followed, managed futures reported returns of more than +20%. At the time of the terrorist attacks of 9/11 the U.S. stock market dropped by 16.3% while managed futures added 8.3% during the same period.

ALL CORRELATIONS GO TO 1? NOT SO FAST

So it looks like we actually have a case here where investment theory and practice have proven to be one and the same. Lintner proposed that adding managed futures to a traditional portfolio increases the risk-adjusted returns at every point along an efficient frontier. Significantly, during actual periods of extreme market conditions (which, while improbable, are nonetheless possible), the diversification benefit does not diminish. In fact, the benefit is amplified. It would thus seem that equity correlations do not all approach "1" in a market meltdown after all.

Looking forward, with predictions of heightened inflation now occurring due to record high money printing, it would seem that opportunities abound in hard commodities and currencies. Equities seem poised to make up for a lost decade, but we still have retail consumer credit delinquencies rising. We know that over the long term, however, the markets go up because capitalism works; we just have no clue as to the precise short-term path of the markets.

So while basic CAPM portfolios will gyrate with the markets, the ultimate direction of prices actually doesn't matter to managed futures managers since they are just looking at trends and those trends could be either up or down. And if there are no trends, the market neutral posse still has you covered.

I would argue that the results of adding managed futures to a traditional low-expense asset class portfolio is so compelling that advisors should be forced to articulate in writing their justification for not having an allocation to managed futures. Lintner's argument for introducing managed futures is as valid today as it was 26 years ago.

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