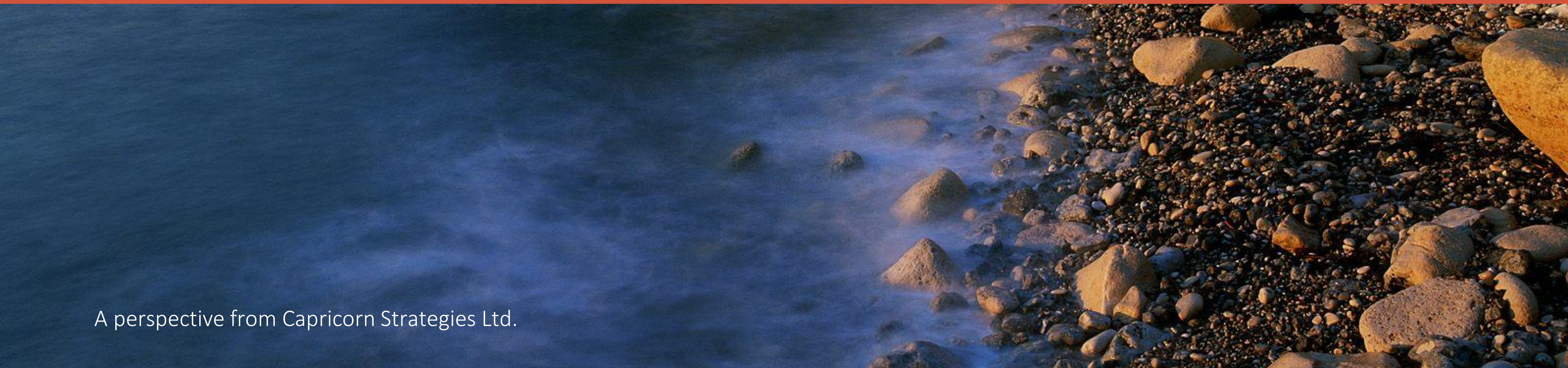
CAPRICORN STRATEGIES

PORTFOLIO PROTECTION

The Case for Multi-Strategy CTA Programs



A perspective from Capricorn Strategies Ltd.

Executive Summary

A multi-strategy program presents a number of key benefits to investors, and this includes a source of uncorrelated returns from equity and fixed income market returns. Therefore as a diversification tool, investing in a selected range of CTA strategies contributes significantly towards portfolio protection.

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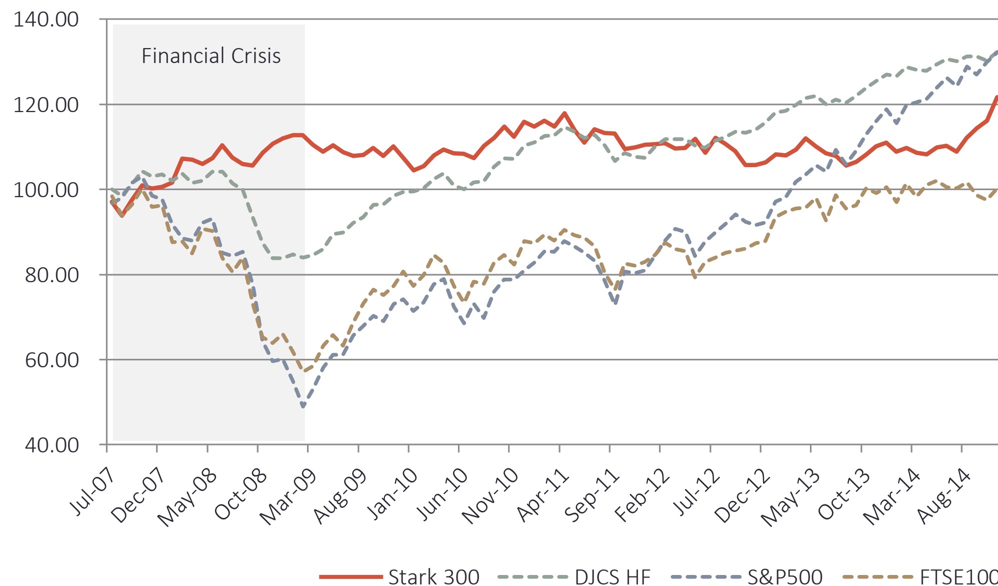
A Changed Environment

Since 2007, the subsequent events which contributed towards the financial crisis have raised questions from investors about the promise of the hedge fund industry. Is it still possible to deliver a risk-return profile that is uncorrelated with traditional markets? At the height of the crisis, hedge funds, taken as a group, broke through the boundaries implied by their historical correlations and suffered along with the rest of the financial industry. Further complicating the situation is a fixed-income conundrum: limited income potential in a low interest-rate environment and the threat of capital losses induced by potentially rising rates.

While some individual hedge funds famously prospered, only a small number of sub-strategies within the hedge fund universe outperformed during this period. One of these groups of investment programs is those which engages in the CTA, or Managed Futures, strategy.

Industry Return Correlations

In charting the returns of the broader hedge fund industry returns (DJCS HF), it is clear that performance has become highly correlated to that of the global equity markets. During the market meltdown CTA strategies (Stark 300) offered diversification from traditional markets by posting positive returns.



Understanding CTA Strategies

Following the aftermath of the 2007 financial crisis that exposed significant flaws in the Eurozone financial markets, CTAs have proven themselves as a sub-strategy that can not only outperform the traditional markets but also the wider hedge fund industry. This is achieved by utilising the high volatility environment to generate higher returns and in the process fulfil their promise of portfolio protection. It is this ability of CTAs to preserve capital in the good years and to provide a portfolio protection response in the bad that makes them of interest to investors and portfolio managers alike.

However, identifying and understanding which CTA strategies can adapt quickly to changing market conditions to deliver outperformance over traditional or market beta strategies, is the key factor which can potentially contribute towards reductions in risk through diversification. The effect of successfully allocating to the optimal CTA strategies in a portfolio by even a modest amount can be very significant.

Using a Multi-Strategy Process

A multi-strategy portfolio consists of several distinct investment strategies that are managed by external investment managers, each specializing in one or more specific trading strategies. Therefore the logic behind this approach is increased diversification, both across hedge strategies and within each strategy. Given the different characteristics of various hedging strategies, a multi-manager approach is intended to alter the risk/return dynamics.

Commonly Used CTA Strategies	
Trend-Following:	Identifying market trends of the current price level relative to a measure of historical prices.
Mean-Reversion:	Observing large dislocations in the current price level to revert back to historical averages.
Momentum:	Analysing the strength behind price movements to extend beyond support or resistance levels.

Benefits of Multi-Strategy Investing

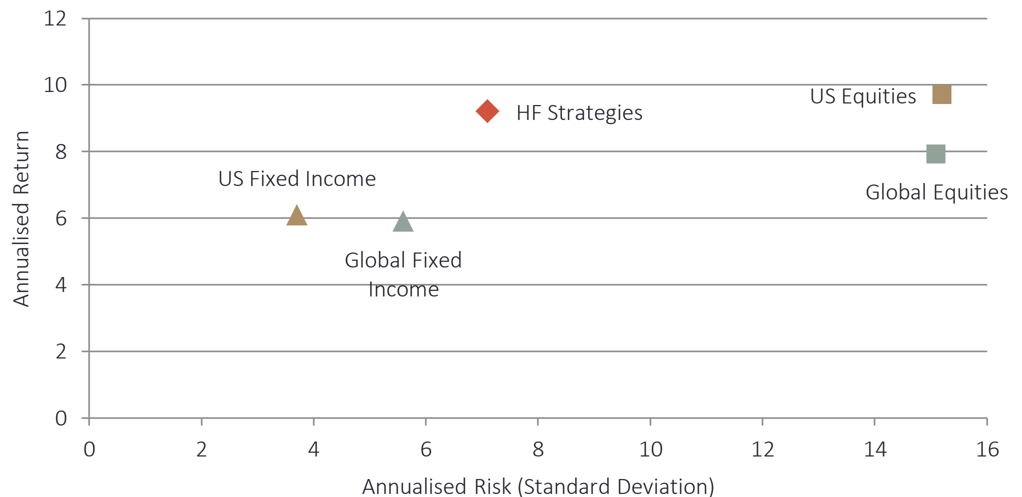
Empirical evidence from research into hedge fund investing has concluded that utilising a multi-strategy investment approach improves the return profile of traditional portfolios through strategy diversification. Allocating to a selection of CTA strategies that exhibit uncorrelated returns to the broader market improves performance opportunities, whilst simultaneously diversifying risk across a range of trading strategies.

Multi-Strategy Allocation Benefits

- Attractive risk/return characteristics
- Reduced downside volatility
- Low correlation to traditional asset
- Enhanced portfolio diversification

Attractive Risk/Return Characteristics

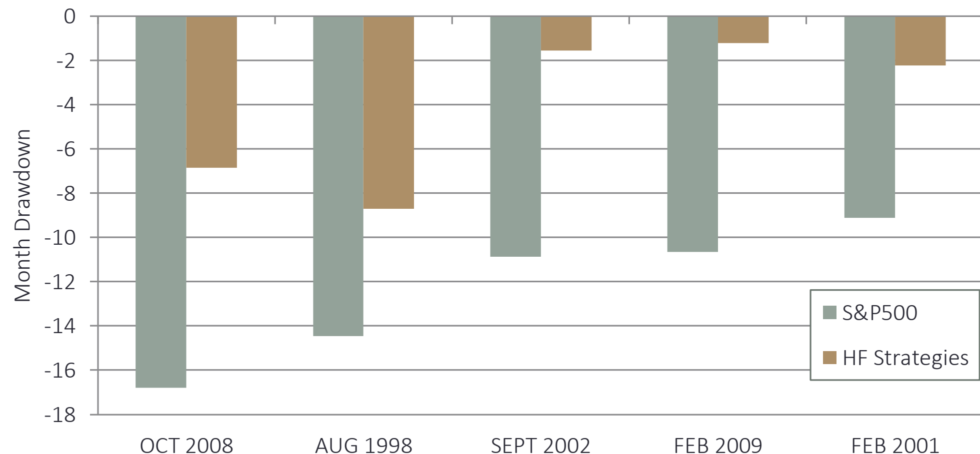
CTA strategies have historically provided attractive returns over the long term when compared to traditional asset classes, keeping pace with equities over a 20-year period which included major swings in the equity markets. According to industry sources these hedge fund strategies have at least equalled if not outperformed other asset classes at lower levels of risk over the same period.



Hedge Fund Strategies represented by the HFRI Fund Weighted Composite Index. US Equity represented by S&P 500 Index. Global Equity represented by the MSCI World Index. US Fixed Income represented by the Barclays U.S. Aggregate Index. Global Fixed Income represented by the Barclays Global Aggregate Index.

Reduced Downside Volatility

The ability of hedge fund strategies to help reduce downside risk was evident in the most extreme negative equity market conditions during the 20-year period ending December 2014. Among the five worst global equity market monthly downturns in the past two decades, hedge fund strategies performed comparatively well.



OCT 2008 ; Lehman Brothers collapse
AUG 1998; Russia default / Asian crisis
SEPT 2002; Bottom of Dotcom crash
FEB 2009; Eurozone crisis / Bank bailouts
FEB 2001; Beginning of Dotcom crash

Hedge Fund Strategies represented by the HFRI Fund Weighted Composite Index. US Equity represented by the S&P 500 (TR) Index.

Low Correlation to Traditional Assets

A research paper produced by The Centre for Hedge Fund Research at Imperial College London, suggested that within all hedge funds strategies CTA investing exhibited relatively low correlations with other asset classes even during recessions. This suggests that hedge funds are unlikely to threaten the stability of the financial system, meaning that even though they exhibit exposures to systemic risk, but they do not cause or contribute to it.

Hedge Funds Correlations (All Observations / During Recessions)

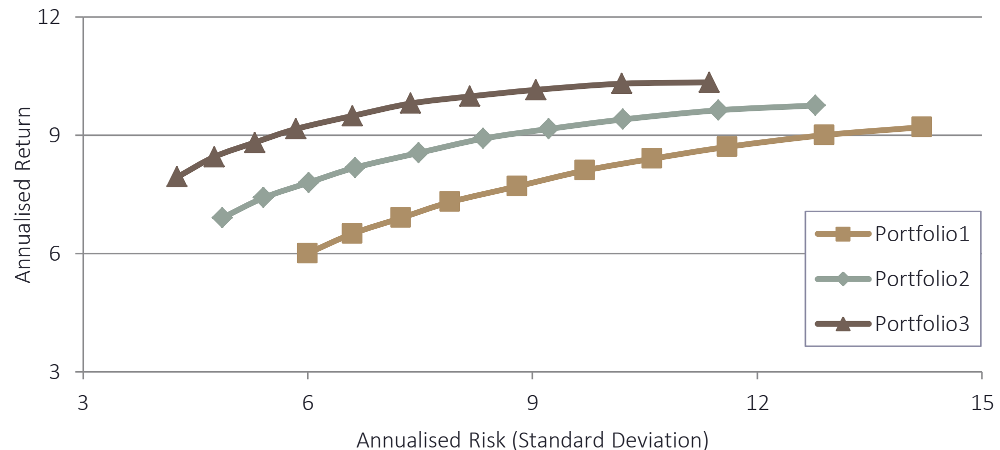
	CTA / Macro	Global Stocks	Global Bonds	Commodities
CTA / Macro	1.00			
Global Stocks	0.37 / 0.07	1.00		
Global Bonds	0.20 / 0.13	-0.03 / 0.21	1.00	
Commodities	0.29 / 0.36	0.33 / 0.63	0.00 / -0.06	1.00

CTA / Macro strategies exhibit a low correlation with global bonds and commodities over the business cycle. This indicates that these strategies may provide diversification benefits when they are needed the most.

Source: Centre for Hedge Fund Research

Enhanced Portfolio Diversification

The core premise of modern portfolio theory, is that risk-adjusted returns can be improved at the portfolio level by allocating to multiple strategies and asset classes that are imperfectly correlated. There are also additional benefits on risk controls during periods of market stress, because the return correlation of many hedge fund strategies with the market tends to gravitate to 1.00 during a crisis, but this has not the case with CTA strategies.



Portfolio1: Equity and Fixed Income only

Portfolio2: Incl. 10% allocation to Hedge Funds

Portfolio3: Incl. 20% allocation to Hedge Funds

Hedge Fund Strategies represented by the HFRI Fund Weighted Composite Index. Global Equity represented by the MSCI World Index. Global Fixed Income represented by the Barclays Global Aggregate Index.

Monitoring and Evaluation

The success of a multi-strategy portfolio involves more factors than simply the quantitative analysis behind results and performance statistics. Applying the optimal leverage and exposure to the appropriate strategy in order to generate pure alpha, requires knowledge and experience in trading a wide range of market environments. Simply put, the investment team must have skills to monitor and evaluate different strategies, processes and investment practices.

Scope of the Investment Team	
Investment Process:	Define manager selection and portfolio construction principles according to investment philosophy.
Program Methodology:	Implement procedures for investment strategy analysis by quantitative, qualitative and operational measures.
Risk Management:	Determine risk levels, controls and compliance checks to protect against adverse portfolio conditions.

Conclusion

There are a number of compelling reasons for professional investors to allocate a portion of their investment portfolio to a Multi-Strategy CTA Program. The investment team managing the program must have a keen understanding of financial markets and the characteristics of the individual CTA strategies, to make any meaningful benefits and contributions to the portfolio.

- Source of returns that are uncorrelated to the broader indices
- Hedge fund strategies have equaled or outperformed traditional assets
- CTA strategies outperform the market during bear markets
- Multi-strategy approach increases portfolio diversification
- Portfolios with CTA strategies exhibit low volatility levels

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