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CORRECTIONS, VOLATILITY MOVES, AND TREND REVERSALS IN 2018:

What this Means for Managed Futures Managers

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Miguel serves as Portfolio Strategist at Altegris Advisors where he is primarily responsible for offering support to client relationships and assisting to build the firm's brand. He works with the firm's analysts and portfolio managers as well as the distribution teams and their clients. Miguel helps in communicating Altegris' investment process and philosophy, as well as portfolio construction, fund positioning and related risk metrics for individual funds.

Prior to joining Altegris, Miguel worked at Wellington Management in Boston, MA. Miguel joined Wellington in 2011 as a Fund Analyst, and most recently was an Assistant Vice President, Hedge Fund Portfolio Specialist. Miguel began his career in finance in a management development program at Fidelity Investments in Boston, MA. Prior to that, he was a Senior Systems Engineer at Raytheon Company in San Diego, CA.

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BACKDROP

It was an extraordinary 2017 bull market in equities. Throughout the year, equity markets moved "up and to the right," with record low volatility levels and record low negative return days. On the other hand, for the first three quarters the three other major asset classes (fixed income, commodities, and currencies) were trendless, which made it a tough environment for trend followers. Fixed income and currencies remained within tight trading ranges, and commodities (specifically, energy and base metals) were choppy with no clear trend as well.

In the fourth quarter of 2017 and through January 2018, trends began to emerge outside of equity indexes; fixed income yields slowly rose, and energy commodities and foreign currencies (versus the USD) moved higher. Trend managers capitalized on these trends and held long positions in commodities and currencies (in addition to equities), and were short fixed income. In addition, position sizes were relatively large in the direction of the prevailing trends due to the unusually low volatility environment.

FEBRUARY 2018: A BRUSQUE CHANGE IN SENTIMENT

However, at the beginning of February markets shifted, and in a very sudden and correlated way. The S&P 500 dropped almost 10% in a week, 10 year yields momentarily reversed their upward trend, oil prices dropped, and the dollar strengthened (weakening foreign currencies). It was a particularly sharp and sudden correction, and one that affected all major asset classes simultaneously.

In retrospect, a degree of euphoria had set in by late December and January, as optimism swirled around the December US tax cut legislation, and how it would positively and enduringly impact company fundamentals and the US economy.

Arguably there were a few factors that caused the sudden change in sentiment, but the one that stood out the most was the Department of Labor jobs report, which reported a surprise increase of average hourly earnings for private-sector workers of +2.9% from a year earlier. This stoked fears that stronger inflation figures would encourage the Federal Reserve to take further action to contain inflation by potentially raising rates more frequently or higher than previously telegraphed. This was compounded by US 10-year Treasuries creeping up past 2.6% in the previous few days, which further boosted fears of unexpected inflation. As markets corrected and trend signals deteriorated, managers reduced their positions into the correction, further exacerbating the sell-off.

Admittedly, trend-following strategies posted negative performance during this time period. They were not immune to the sell-off, as their long positions (substantiated by the trends in January) were negatively impacted. The SG Trend Index, which tracks managed futures trend managers, dropped -9.7% in the first 8 days of February, when the S&P 500TR dropped -8.6%. For the full month of February, the S&P 500TR dropped -3.7%, and the SG Trend Index dropped -9.0%. This was the largest single-month drop for the SG Trend in almost 15 years, going back to March 2003.

FIGURE 1.

SG TREND INDEX SIX MONTH TRAILING RETURNS

October 1, 2017 – March 31, 2018

Trailing six month return of the SG Trend Index, an index commonly used to track performance of trend-following managers. Despite the short-term correction, trend followers in aggregate have performed positively over longer time frames.

Past performance is no guarantee of future results. Source: Bloomberg.

TREND FOLLOWERS, CRISES AND CORRECTIONS: A BROADER PERSPECTIVE

Historically, managed futures managers have performed well in times of crisis or substantial bear markets in equities. This is because the underlying portfolios have time to adjust to the developing market conditions and will often times run short positions in equity markets in order to profit from those crisis period declines. However, those periods are normally multi-week and more often multi-month occurrences, where trend reversals are clearer. These are very different than the short, sharp market *correction* we saw in early February, with no prior signal of a trend reversal.

Furthermore, periods of expanding volatility are typically beneficial for trend followers, as trading ranges also expand and create more opportunities to detect and profit from idiosyncratic trends. However, the move in early February was an "explosion" rather than an expansion in volatility, and occurred over the matter of days, and not weeks or months.

DIVERSIFICATION IS KEY FOR IMPROVED RISK-ADJUSTED RETURNS—OVER THE LONG RUN

Because of this, it is important to maintain a longer-term perspective. Indeed, if we look at a longer time period shown in *Figure 1*, managed futures have performed positively, inclusive of the drawdown. The SG Trend Index remains positive in the trailing six months ending March 2018 [Figure 1].

It is also important to emphasize that managed futures and trend based strategies have a long-term correlation of zero to equity markets. In shorter time periods, the correlation can be somewhat positive or somewhat negative, but over the long term is zero. Additionally, managed futures are non-correlated to equities, but not negatively correlated; this means that over the long-term they tend to move *independently* of equities, but not necessarily opposite of them. One of the most important tenets behind Modern Portfolio Theory is that investors can benefit and reduce their total portfolio risk by holding combinations of assets that are not positively correlated. That is, within a portfolio, risk of loss can be lessened through investing in multiple assets that move independently of one another. Given the pronounced presence of equities and equity-like instruments in many investors' portfolios, managed futures strategies can play a key component of reducing overall portfolio risk through diversification when viewed over a longer timeframe.

While it is certainly disappointing to give back some of the previous gains in a short time frame, the market events of February do not invalidate trend-following strategies as equity diversifiers. In fact, this may be the turning point for a new, more normalized global market environment with volatility closer to long-term averages and with non-zero interest rates. Trend-following strategies have historically performed well during such periods of higher volatility and interest rates, and they may once again find and capitalize on market trends and deliver sustainable, positive returns in this environment.

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All investments carry a certain degree of risk including the possible loss of principal. Complex or alternative strategies may not be suitable for everyone and the value of any portfolio will fluctuate based on the value of the underlying securities. Investing in debt or fixed income securities involves market risk, credit risk, interest rate risk, derivatives risk, liquidity risk, and income risk. As interest rates rise, bond prices typically fall. Below investment grade, distressed, or high yield debt securities are considered speculative and are subject to heightened liquidity, default, and credit risks.

DEFINITIONS

An investor cannot invest directly in an index. Moreover, indices do not reflect commissions or fees that may be charged to an investment product based on the index, which may materially affect the performance data presented.

Managed Futures. The SG Trend Index calculates the net daily rate of return for a group of 10 trend following CTAs selected from the largest managers open to new investment. The SG Trend Index is equal-weighted and reconstituted annually and has become recognized as the key managed futures trend following performance benchmark.

Modern Portfolio Theory. Modern portfolio theory is a theory on how risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward. It shows that an investor can construct a portfolio of multiple assets that will maximize returns for a given level of risk.

US Stocks. The S&P 500 is an Index of 500 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. Companies included in the index are selected by the S&P Index Committee, a team of analysts and economists at Standard & Poor's. The S&P 500 is a market value weighted index, each stock's weight is proportionate to its market value.

ABOUT ALTEGRIS

Altegris is an investment research firm, with deep expertise in alternative manager selection, structuring unique solutions, and providing portfolio management and oversight. Beginning with an analysis of the current and anticipated investment environment, our solutions are based on themes that we believe solve the most important client needs. For more information about the Altegris family of alternative solutions, visit www.altegris.com.

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