Cliff Asness: Understanding Managed Futures

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In a portfolio with equities and fixed income, managed futures offer strong diversification value and high returns, according to Cliff Asness. Asness is the founder and Managing Principal of AQR Capital Management, a provider of managed futures products. He spoke at the Schwab IMPACT conference on Wednesday.

Asness briefly described the managed futures asset class. He said it is trend-following, which is closely related to a momentum strategy. Over the long term, he said, it has performed as designed and has exhibited negative correlation to the equity markets. Furthermore, managed futures have been positively correlated in up markets and negatively correlated in down markets. AQR's approach is highly liquid and utilizes up to 100 different futures contracts, including commodity, currency, equity and fixed income futures.

AQR's approach is very simple, Asness said. It follows individual futures contracts and, if they are up over the last year, it goes long. If they are down, it goes short. He warned that his is a highly simplified description, but it "captures a lot" of their fund's behavior. Its funds are rebalanced monthly.

AQR uses short-term (one month), medium-term (three month) and long-term (12 month) signals, as well as counter-trend and relative strength indicators. Asness said bets are spread across short-, medium- and long-term trends.

This strategy succeeded in being negatively correlated during the five worst quarters for S&P 500 since 1985. However, it did not perform as desired in Q4 of 2008 because events unfolded too quickly to be captured by a trend-following strategy.

Asness provided extensive empirical data to support his claims of superior returns and uncorrelated behavior in relation to equities. Empirical data alone, however, is not sufficient to justify a strategy, and Asness also offered a theoretical explanation as to why trends exist.

Behavioral finance provides the basis for that theory. The "anchoring bias" means that people do not update their views often enough or fast enough when new information becomes available to them. When news comes out, prices move but don't go all the way – there is an under-reaction. Eventually markets overreact, and Asness said that both under- and over-reaction are "our friends" in creating trends.