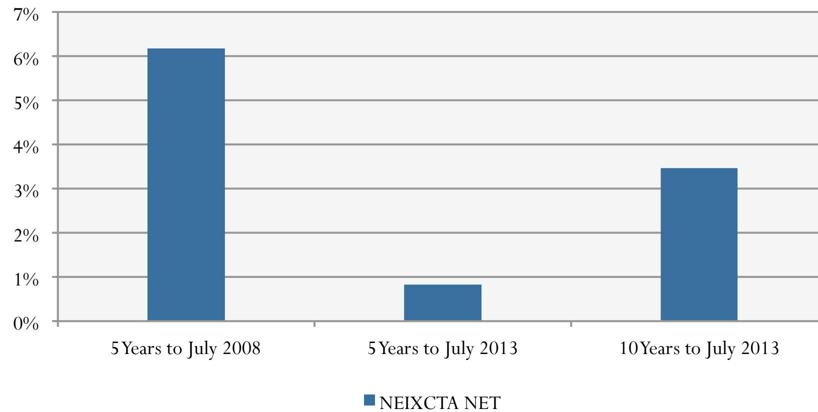
ARE CTAs SIMPLY BROKEN?

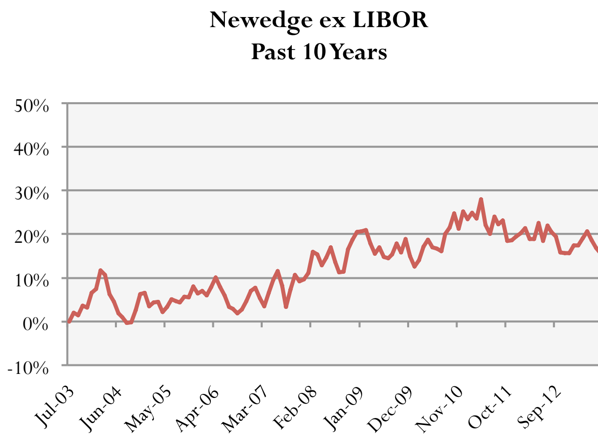
A SHORT CRITIQUE

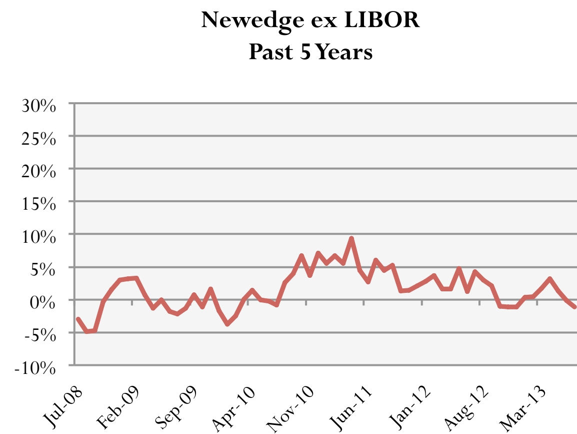
BEACHHEAD
CAPITAL MANAGEMENT

The Newedge CTA index ("NEIXCTA") has returned a disappointing 0.82% per annum over the past five years.[1] Many explanations have been given, including the lack of a trending market. This explanation implies that, as markets normalize, CTA performance should revert to higher historical levels – the 6%+ per annum realized in the five years preceding the crisis.



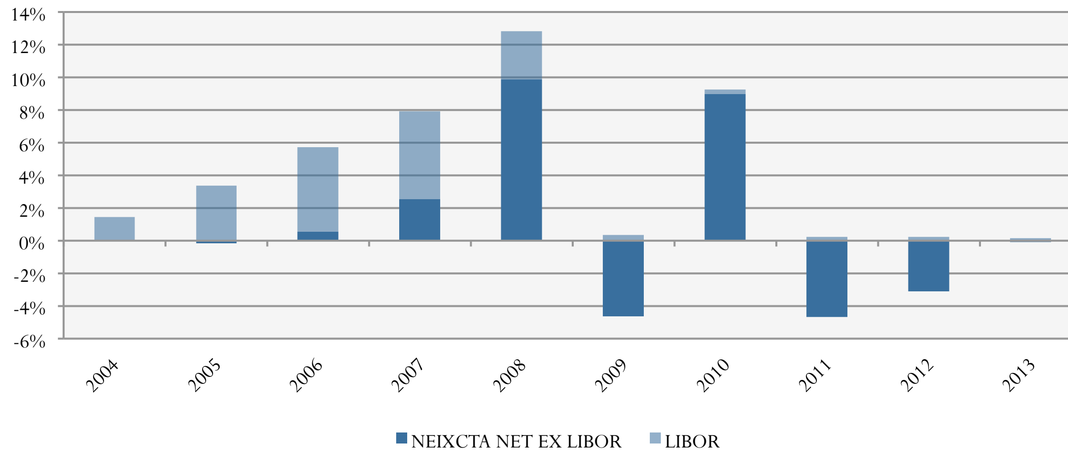
However, this analysis ignores the role of LIBOR in managed futures portfolios: CTAs earn a return on investor cash posted as margin for futures positions. Consequently, an evaluation of CTA returns should account for LIBOR. In this light, the historical performance of the index *excluding LIBOR* over even the preceding ten years is distressingly low: approximately 1.5% per annum, or less than half the reported figures, and slightly negative over the past five years.





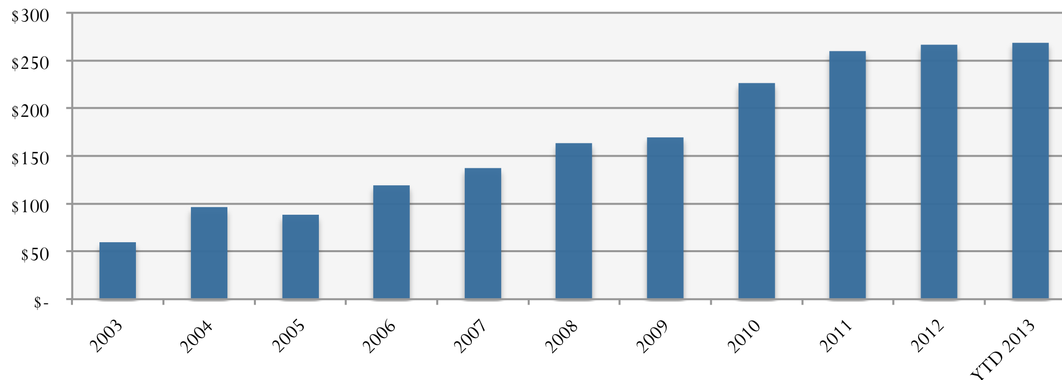
[1] Source: Bloomberg, net returns

Viewed on an annual basis, the impact of LIBOR on pre-crisis returns is strikingly clear:



This analysis suggests that the performance issue for CTAs may be systemic. Despite this, CTA assets under management has increased five-fold over the past ten years.[2]

CTA Assets Under Management ($bn)

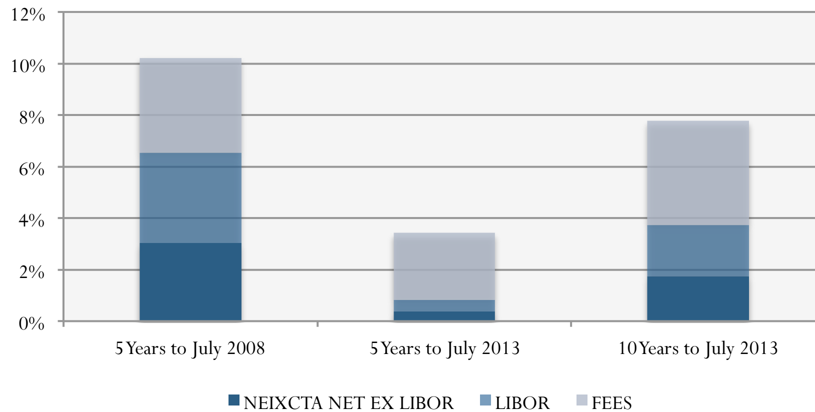


The question is why. The most compelling explanation is that investors place a premium on assets with a low correlation to equity markets. What's often overlooked is that *a key assumption underlying modern portfolio theory is that each asset has the same expected risk-adjusted return*. From the above, it is difficult to conclude that the expected returns for CTAs should be comparable to those of assets with clearly defined risk premia – like equities or credit.

A secondary explanation is that CTAs are often sold as a "hedge" with the expectation that they will perform well in a material drawdown in the equity markets, as they did during 2008. The return standard for insurance-like investments may be somewhat lower than that for others: it may be given a "pass" when it loses money as long as other assets are rising. A third possible explanation is that CTAs generally have lenient liquidity terms, a valuable feature post-crisis.

[2] Source: BarclayHedge

The primary beneficiary of the increase in assets under management appears to be the managers themselves. Using an assumed fee structure of 2/20, slightly less than half of gross returns were paid away to managers over the past ten years. Adjusted for LIBOR, the numbers are more pronounced: fees were roughly double what the managers made above collateral interest. Over the past five years, virtually all of gross performance was paid away.



The figures raise a fundamental issue of fairness in the managed futures space and argue for a material change in the industry fee structure. Simply put, investors should question whether managers should be rewarded for warehousing cash in interest bearing accounts. At a minimum, a LIBOR based hurdle is warranted.

The analysis raises a serious question about whether the pre-crisis returns of managed futures funds were an anomaly or are likely to recur. Given performance over the past ten years, it appears that investors should expect CTAs to earn 1-3% over time in a low interest rate environment. Moreover, the performance of systematic strategies is dependent on the ability to capitalize on market anomalies – such as evidence of excess returns from momentum or mean reversion. Recent poor performance implies that many anomalies are subject to being arbitraged away over time and that the recent underperformance of the industry is likely to persist.