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Managed Futures with Active Fixed Income

Since managed futures provide a return stream uncorrelated with equity markets, they can be a good portfolio diversifier. Matt Osborne, CIO of Altegris and portfolio manager of the Altegris Futures Evolution Strategy Fund, believes that investors often neglect the potential of managed futures due to their volatility. The fund aims to combine the best trend following and active fixed income managers in a diversified portfolio with predictable volatility.

Would you provide an overview of Altegris and the Futures Evolution Strategy Fund?

Altegris is a boutique alternative investment specialist with a long legacy in managed futures. Altegris was established in 2002, but our predecessor had been offering managed futures as managed accounts since the 1990s. We are experienced in identifying the best managed futures manager for the specific client needs and in bringing them to clients in a variety of different packages.

The Futures Evolution Strategy Fund came to market in November 2011, when the delivery of managed futures in a mutual fund format was still relatively new.

What is unique about your fund?

To understand the unique features of the fund, it is important to understand the nature of the typical managed futures fund, which would have 10% to 20% of its assets invested in futures contracts at any time, because futures contracts are inherently leveraged. Prior to the existence of the mutual funds for managed futures, or when managed futures was in a hedge fund format, it was common for a fund to have up to 80% of its assets in liquid assets, essentially in cash.

Typically, that collateral was managed in Treasury bills or cash equivalents, with average yields of 300 basis points pre-crisis. However, in the post-crisis environment, we face zero interest rate policy and environment, and that approach was no longer viable.

The genesis of the Futures Evolution Strategy fund was based on the idea of bringing together the best trend following and the best active fixed income at the same fund. The evolutionary piece from our title is essentially the active fixed income part. Our goal is to invest with an active fixed income manager who could bring that additional 200 or 300 basis points per annum, which was previously common, through active fixed income management.

For the fixed income part, we reached out to Jeffrey Gundlach of DoubleLine to be our sub-adviser and we are pleased that he agreed to be an exclusive partner for managed futures mutual funds.

For the trend-following part, we reached out to Winton Capital Management in London, whom we have known since 1998. We paired them up with another trend following manager called ISAM, also located in London, to round out the trend following piece of the portfolio.

How do you blend different managers in the portfolio?

The key differentiator is the actively managed fixed income allocation, but the fund is also unique on the futures side. We identified Winton and ISAM independently as best of breed trend-following managers and the key differences between the two are also the reason why they work so well together in a portfolio.

Matt Osborne
Founder and CIO, Altegris Advisors

Matt Osborne has more than 25 years of international business and financial market experience. As CIO of Altegris, he is responsible for product development and is co-portfolio manager of several Altegris mutual funds. He is a member of the Altegris Investment Committee, responsible for qualification, approval and ongoing review of all investment strategies and managers on the Altegris platform.

Prior to Altegris, Matt was Director of Research for the Managed Investments Division of Man Financial with responsibility for manager selection and research. Previously, Matt had a 12-year career with a preeminent family office in his native New Zealand. In his role as Investment Manager, he was responsible for formulating investment policies and implementing a global asset allocation program that specialized in alternative investment strategies such as hedge funds and managed futures. He also gained significant trading expertise in foreign currencies, stocks, fixed income, global futures and options.

"The managed futures space has a fairly high degree of dispersion between the best performer and the worst performer. Often you may need more than one managed futures allocation to get the full benefits of the strategy."

Winton is recognized in the industry for its research engine. It typically has a long-term strategy, or a slower trend following approach, and a stringent focus on risk management. Its constant volatility target leads to a fairly predictable risk profile and to one of the best risk-adjusted return profiles in the industry. Therefore, Winton plays a good defense role in the context of managed futures.

In contrast, ISAM has a medium-term trend following approach. The timeframe difference between Winton and ISAM impacts their market allocations. While Winton allocates to financial markets about 75% to 80% of its portfolio and only 20% to 25% in commodities, ISAM can allocate up to 50% in commodity markets.

ISAM has an ultra-diversified portfolio, which can contain up to 200 different markets, including some really small markets that many managers neglect. ISAM approaches the futures markets on a daily basis with an appetite for significantly higher level of volatility that Winton. If Winton typically targets a volatility of 10%, ISAM is willing to accept up to 20% volatility, and that makes it a good offensive player.

Combining the two represents a blend between the market leading defense in managed futures with one of the best offenses. The combination of their return streams, as well as our weight of their allocations, targets volatility of about 12% for the Futures Evolution Strategy Fund.

Overall, this is a risk-managed portfolio and we adjust the allocations between Winton and ISAM depending on a variety of factors.

What role does DoubleLine play in the portfolio?

DoubleLine is managed differently and independently from the managed futures allocation. We have a close collaborative relationship with the DoubleLine investment team. We form an internal view on interest rate direction and duration risk, and we also assess our duration risk within the managed futures component before deciding the DoubleLine allocation.

We have access to three different strategies at DoubleLine: core, low duration, and opportunistic. The core strategy is a multi-strategy fixed income with two to eight years of duration. The low duration is also a multi strategy, but has zero to three years of duration. The opportunistic strategy has no duration constraint and can invest anywhere, but is focused on mortgage securities, which is DoubleLine's core competency over the years.

While we can invest 100% in the core and low-duration strategies, our allocation at the opportunistic strategy is capped at 30% of our DoubleLine allocation.

Right now we are invested 50% in low duration, 30% opportunistic, and 20% in the core strategy. That's partially because we have a lot of duration risk in managed futures through long positions in sovereign bonds and we are comfortable having an emphasis on low duration in the DoubleLine portfolio. We are looking for a steady income stream from the DoubleLine portfolio; we are not looking to hit a home-run.

Overall, we look at both sides of the fixed income risk spectrum to determine the DoubleLine allocation.

Where does your manager selection process start?

We start with a high-level assessment of the investment environment. We consider the problems and needs of clients and then we develop investment themes around those needs. After creating that high-level matrix, we run it through the three Altegris core competencies - manager selection, product structuring, and portfolio management.

Our manager selection process begins with the research team, which identifies potentially suitable managers for our platform, regardless whether private or public. Then our investment committee evaluates the investment thesis of the research team. If the investment committee green-lights the ideas, the research team goes through a complete investment and operational due diligence process, which may take several months, before a final decision is made.

Once a manager is approved by the investment committee, it is available to the portfolio management team for multi- or single-manager solutions. In the context of the Futures Evolution Strategy Fund, we were looking to combine the best of trend-following with the best of active fixed income.

What are the key elements of the due diligence process?

The investment due diligence process is vigorous. It involves on-site visits, a deep dive into the manager's philosophy, process, risk management, portfolio construction, and trade execution. The operational due diligence focuses on the valuation procedures, makes background checks, reviews service providers, the administrative business systems continuity, and the regulatory policies. Those two efforts result in a detailed report for each case, which is submitted back to the investment committee for final approval.

On a monthly basis, the investment committee reviews all of the underlying approved managers. There is a continuous monitoring on the Altegris platform by the research team, which involves at least a quarterly call and evaluation of the performance drivers and sources of returns of the managers.

We are continuously doing quantitative analysis about performance, particularly peer-to-peer comparisons, as well as market expectations for performance. The monitoring also follows any material changes, including corporate events, changes in personnel, or service providers. Any red flags are brought to the investment committee and a manager could be put on a watch list.

Could you give some specific examples that would highlight the process?

The years 2012 and 2013 were difficult for managed futures in general and for this strategy. The contraction of global volatility affected the ability for trend-following managers to find and participate in trends with any degree of persistence.

In this difficult period, ISAM underwent a large-scale drawdown, which was vigorously debated and evaluated by our investment committee. Despite the problems, we determined that the drawdown was not uncommon when compared to peers given their specific volatility target. As a result, we maintained high conviction in ISAM.

That turned out to be a good decision because in 2014 the ISAM strategy was up in excess of 60%. Our patience and the discipline of our investment process paid off even though the manager was in deep drawdown.

In terms of portfolio construction, how do you determine the allocations between the managers?

We take both a top-down and a bottom-up view. The top-down view is an assessment of what the trend-following market environment is, where the volatility levels and the intermarket correlations are. If volatility is low and rising, while intermarket correlations are low, that would be a good time to increase risk in trend following by adjusting the weight to the ISAM allocation.

In other words, when we want to be more aggressive on trend following, we would increase the allocation to our offensive manager, ISAM, while in other times would be more defensive. The top-down assessment targets an overall portfolio level volatility of 12%.

We also have complete transparency of the underlying managers, so we perform aggregate position level analysis to determine the total risk in the portfolio on any given day.

The bottom-up component focuses on the individual contribution from the managers. We aim Winton to contribute 60% to 80% of the risk and ISAM to be responsible for 20% to 40% of the risk. That translates into a dollar allocation of Winton in the 75% to 85% range and ISAM in the 15% to 25% range, because ISAM is taking more risk on a daily basis.

We also examine the position of individual managers in their return cycles, because there is some evidence of mean reverting return profiles between managers, especially managers with a correlation. If the manager is at a period of underperforming the other, there is a tendency for that trend to move to the other direction, and we take that factor into account for the relative weightings.

What would trigger a change in the managers that you work with?

This is a focused fund, so we don't seek to add managers. Our investors are typically familiar with both Winton and DoubleLine and we educate them on the less well-known manager ISAM. Since our philosophy is to combine the best of active fixed income and trend following, we don't foresee any changes, given the quality of the managers we have chosen.

Nevertheless, we remain open to that prospect. If in extreme circumstances a change is needed, we have worked with and know plenty of managers that could be approved. Again, we don't expect such a development in this particular fund, but we could make a change if necessary.

We want to remain true to the core philosophy of blending the best trend following with the best active fixed income. If there is capacity limitation on behalf of one of the managers, we would rather close the fund to keep the integrity of the strategy for investors rather than expanding the manager reach. That is how strongly we feel about the mandate of the fund.

The current mix is ideally suited to handle market changes, such as a rising rate environment, for example. When rates are rising and we minimize our exposure to duration risk, we can move to 100% low duration in DoubleLine. If rates start to trend higher, the trend followers will begin to get short on fixed income instruments by definition. A trending environment is arguably ideal, because a trend of higher rates is something that these managers are able to capture.

Of course, in such a scenario, there is a potential for higher volatility. The decline in interest rates has been a long-term trend, which managers have captured. In the event of an uptrend in interest rates, a flight to quality will be in the opposite direction of the trend, thus creating more return volatility and requiring the best managers to deal with it. By working with Winton and ISAM, whose track records go back to 1997 and 2001, respectively, we rely on the managers with the research and development capability to deal with a high-volatility environment.

Altegris Futures Evolution Strategy Fund

Company	Altegris Advisors, LLC
Subadvisor	DoubleLine Capital LP
Symbol	EVOAX (Class A)
Address	1200 Prospect Street, Suite 400 La Jolla, CA 92037
Phone	888-524-9441
Website	altegris.com/mutualfund

Source: Company Documents

What is your approach towards risk management?

The strategy of managed futures represents a return stream that is completely uncorrelated with the equity markets. Its long-term correlation with S&P 500 is zero. I believe that investors are typically underweight managed futures in their portfolio and do not take enough risk to access the diversification benefit they can provide.

The main difficulty for advisers and investors is that managed futures can undergo long periods of sideways performance, as in 2011, 2012, and 2013, when the index lost about 15%. Although the drawdown was not that steep, it was the length of the underperformance that was frustrating. Some investors gave up on the strategy at exactly the wrong time, because in 2014 managed funds did phenomenally well.

When evaluating risk at a portfolio level, managed futures represent a great diversifier, but need to be professionally managed. Investors have to spend time on their own due diligence, because the managed futures space has a fairly high degree of dispersion between the best performer and the worst performer. Often you may need more than one managed futures allocation to get the full benefits of the strategy. In other words, there is risk in a single-manager selection because of that high dispersion factor.

Forward looking, the portfolio risk will have even a greater impact, because of the prospect of low returns in fixed income. Over the next five years, I wouldn't expect the same historic returns from a 60/40 portfolio; it is almost a mathematical impossibility. So, investors should be looking for diversification and managed futures is one of the few strategies that can go long and short in a huge variety of markets and provide that diversification benefit.

How do you manage risk at the portfolio level?

At the portfolio management level, we look at risk in terms of volatility and value at risk, or VaR. We track our VaR on a daily basis, aiming for aggregate volatility of 11% to 13%. We have the tools to adjust our portfolio mix to either increase or decrease volatility by allocating between the managers, depending on our view of the opportunity set and market correlations.

It is important to note that in managed futures, a volatility target of 12% means that you can have a losing period of 15% or even 20%, and investors should be prepared for this. Historically, such periods are ideal time for adding to the strategy. I have often advised investors to allocate half of the amount they have planned right away, and wait for a losing period to invest the other half.

Overall, investors need to be comfortable with managed futures returns, which can sometimes go sideways for a long period of time, and then make a lot of money very quickly. To benefit from that trend, you need to be invested take a long-term strategic viewpoint, because the strategy of managed futures cannot be tactically timed very effectively. T

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Potential investors should carefully consider the investment objectives, risks, charges and expenses of the Altegris Futures Evolution Strategy Fund. This and other important information is contained in the Fund's Prospectus and the Summary Prospectus, which can be obtained by calling (888) 524-9441. Read the prospectus carefully before investing.

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