

With Inflation on the Horizon, How Can Retail Investors Protect Themselves?

Managed Futures Strategies Might Hold the Key, says Andrew Beer, Co-Portfolio Manager of the iM DBi Managed Futures Strategy Fund (DBMF)

Legendary macro investor Stan Druckenmiller recently laid out a scenario where 4-5% inflation in the near term is possible or maybe even probable.¹ Fiscal stimulus, the “biggest increase in pent up demand globally since the 1920s” and monetary stimulus could converge to drive inflation far above consensus.

Given that Druckenmiller has astonishingly not had a down year since 1981, his warning merits attention. Since he first laid out elements of his thesis last year, Treasury yields have been marching upward², the 10 year inflation breakeven rate now is above 2% (more than triple the low of last March)³, commodity prices have spiked⁴ and housing prices are surging⁵.

Needless to say, this could be a serious problem for retail portfolios. Stock prices are supported by the expectation of indefinitely low rates: in the case of tech stocks in particular, this makes earnings far in the future much more valuable today. But at even more risk are bond portfolios, where a 3% rise in nominal rates could cause a 15% or more drop in prices⁶ - mathematically painful when the expected return today is only a few percent, at best.

The critical question is how advisors can “protect” their portfolios, both from a fixed income and an equity perspective. The short answer: it’s not easy. The default answers are

to buy gold, TIPS⁷ and real estate; all have merits, but none is a panacea. Some are looking to Bitcoin, but crypto is untested and highly volatile. For more flexible investors, however, a return of inflation has the potential to create opportunities: short positions in Treasuries, tactically and strategically long positions in commodities, short positions in the US dollar, and rotation into inflation-sensitive areas of the equity markets are just a few areas of potential windfalls.

Which brings us to managed futures. Like a discretionary macro investor, managed futures hedge funds have the potential to capitalize on these outcomes via their flexibility. Managed futures strategies, simplistically, seek to identify trends and invest, long or short, in futures contracts across rates, currency, equity and commodity markets. Walk into the offices of a managed futures hedge fund, and you might find quants fine tuning models to try to understand which trends are the most stable, which ones are

¹ Druckenmiller was interviewed by Tony Pasquariello, global head of Goldman Sachs Hedge Fund Coverage, on January 29, 2021. References are drawn from that interview.

² The yield on the 10 year Treasury note on February 8, 2021 was 1.2% vs. 0.7% in September 30, 2020. Source: Bloomberg.

³ The inflation breakeven rate represents a measure of expected inflation derived from 10-Year Treasury Constant Maturity Securities and 10-Year Treasury Inflation-Indexed Constant Maturity Securities. The latest value implies what market participants expect inflation to be in the next 10 years, on average. Source: Federal Reserve Bank of St. Louis.

⁴ Crude oil prices had risen 16.8% year-to-date as of February 5, 2021. Gold prices have risen 12.4% year-over-year. Source: Bloomberg.

⁵ As of November 2020, the S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index had risen 9.08% year-over-year.

⁶ Estimated decline in value of the Bloomberg Barclays Aggregate Bond index of a 3% rise in nominal yields assuming a current weighted average yield to maturity of 1.2% and duration of seven years.

⁷ TIPS refers to Treasury Inflation-Protected Securities, or TIPS, are securities whose principal is tied to the Consumer Price Index (CPI). The principal increases with inflation and decreases with deflation.

reversing, how to scale risk, and when to rebalance. If gold has been rising, they might ask the models, is it likely to continue? What about a downward trend in Treasury prices driven by higher yields? Will emerging markets continue to outperform developed markets?

For the asset allocator, managed futures as a *strategy* has two potential benefits: low or no correlation to equities over time⁸ and “crisis alpha”⁹. On the latter point, the claim to fame for the strategy was strong positive performance during the two grueling bear markets of the 2000s¹⁰. During the first quarter of 2020, managed futures funds proved nimble and preserved capital¹¹, but the drawdown was too short and sharp for the funds to truly capitalize; we like to say that if April had looked like the first three weeks of March, managed futures funds likely would have repeated the performance of the 2000s. In each of those scenarios, though, rates declined and funds benefited from being long Treasuries. In the coming period, managed futures fund could just as easily benefit from being short.

Despite these potential benefits, advisors who previously have been invested in managed futures are justifiably frustrated. Over the five years through year-end 2020, the SocGen CTA index of twenty leading managed futures hedge funds returned just 0.5%.¹² However, those returns are after fees and costs that, we estimate, can exceed an astronomical 5% per annum¹³ - a clear example of the heads-I-win-tails-you-lose hedge fund fee structure. Further, the single manager

risk inherent in these funds, can be, as one allocator described to us, “soul destroying”: advisors often throw money at recent outperformers only to find that those funds often are the worst performers in subsequent periods¹⁴. Hence, sky-high fees and single manager risk can overwhelm the diversification benefits of most managed futures strategies.

We believe the solution to unlocking the value in managed futures strategies is to seek to replicate the pre-fee returns of a diversified portfolio of managed futures funds, as discussed [here](#). That is precisely what we seek to do as the sub-advisor to the **iM DBi Managed Futures Strategy ETF** (Ticker: **DBMF**).

With any strategy, there always is a balance between evaluating the past and predicting the future. No one has a crystal ball, which is why diversification is so important. Rather than replace other inflation hedges, we believe managed futures can serve as another valuable complement to an existing equity or bond allocation. Faced with headwinds in traditional portfolios, we believe that diversification into strategies that potentially can benefit during an inflationary environment is prudent.

⁸ The SocGen CTA Hedge Fund index is an index of managed futures hedge funds. The index was launched in January 3, 2000 and has had a correlation to the S&P 500 of -0.07 and to the Barclays Aggregate Bond index of 0.25 since inception to January 31, 2020. Source: Bloomberg.

⁹ “Crisis alpha” generally refers to strategies that have the potential to generate positive returns during equity bear markets. Alpha is a statistical measure of outperformance relative to a benchmark.

¹⁰ The SocGen CTA Hedge Fund index returned 34% when the S&P 500 experienced a drawdown of -45% from August 2000 to September 2002. The SocGen CTA Hedge Fund index returned 13.5% during the financial crisis from October 2007 to February 2009 when S&P 500 return -51%. Source: Bloomberg.

¹¹ During the first quarter of 2020, the SocGen CTA Hedge Fund returned -0.5%. Source: Bloomberg.

¹² Source: Bloomberg.

¹³ Most managed futures hedge funds have fee structures in excess of a 1% per annum management fee and 20% of profits. Based on discussions with industry experts, trading costs are as high as 2% on average. Taken together, these costs can exceed 5% per annum. Source: Hedge Fund Research, DBi.

¹⁴ DBi analysis of the annual rankings of the constituents of the SocGen CTA index demonstrated that top performers in one year are statistically likely to underperform in the subsequent year. Source: SocGen, Hedge Fund Research, DBi.

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