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New **Alternatives** Face Off

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MSR Indices Featured in Futures Magazine

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The DNA of performance

BY DANIEL P. COLLINS

During the last decade there has been a push to create investable indexes offering exposure to the beta of alternative investment strategies including hedging funds and managed futures.

MSR Investments has taken that to another level by creating three core models of positive return drivers they believe serve as the building blocks of a wide swath of traditional and alternative returns.

Those strategies are: Long only, trend-following and reversal. How do you get to 1000 indexes from three core models? By mixing and matching them in different combinations and applying them to some or all of the 32 most liquid futures markets with various weightings. They combine their three core trading strategies to build a family of 1000 indexes that can provide exposure to numerous strategies at a much lower cost — 25 to 150 basis points based on complexity and target volatility — than your typical hedge fund or commodity trading advisor charging a 2% management fee and 20% incentive fee, known as 2 and 20.

Beta: Returns tied to exposure to the performance of an asset class or generic strategy.

Alpha: Returns driven by manager skill or a system's particular edge.

The MSR Investable Index Platform can be used for multiple purposes. A manager or investor can decide what investment exposure he wants and build a portfolio of simple indexes to gain that exposure, he can build a low cost fund of fund by allocating to various indexes of well-defined exposures. He can also test the correlation and performance of a manager they are investigating against an index to determine if the manager is simply providing beta that can be accessed at a much lower cost, or if he is truly offering something unique or if the program is correlated but consistently outperforming its benchmark index (see "Finding a match," page 24).

The trend-following strategy combines various time horizons—from five days to six months—and is based on a combination of the moving average convergence/divergence indicator and a moving average crossover. The long-only strategy is obvious but can be split out to gain broad equity market exposure, global equity exposure, fixed income exposure, commodity exposure or any combination you choose, and the reversal uses a Black Scholes replication options model to replicate the selling of straddles.

"When you replicate the selling of straddles it functions like a countertrend program," says Michael Rulle, founder of MSR and creator of its index platform. "The concept developed as we began to analyze the actual hedge fund industry," he says. "We can create and have created an equivalent to something that can compete with the hedge fund industry. The platform itself is a competitive paradigm to how people and investors analyze hedge funds and make decisions on hedge funds."

"The capability of the platform can use the futures markets to create investment products that are analogues to what you and I would think of as hedge funds even though it is being executed in the futures markets," he adds.

Rulle points out that the alternative investment universe (hedge funds and CTAs) from 2002 to 2007 went from $500 billion to $2.5 trillion. "In an extremely short period we saw massive growth because there was high demand, Rulle says. "When that much new money (therefore new supply) comes into the market in such a quick period, you are going to see a lot of things very similar to each other."

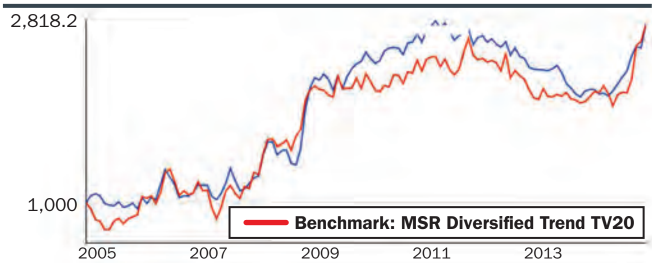
Rulle looked at the Credit Suisse Hedge Fund index as a reasonable proxy for the alternative investment industry as a whole. "Since 2005 its actual return is 5.87%, Sharpe ratio is about 0.5—they are an index so you are getting all the correlation benefits of all the 500 managers," he says.

"If you use our benchmark analysis, that index is [nearly the same] as the MSR S&P 500 index with a target volatility of 10%, which we charge 25 basis points for. This is when we became excited about the possibility of creating a competitive product."

The alternative investment space is about innovation, and a new platform is attempting to break performance down to its basic elements, allowing investors to choose return streams.

FINDING A MATCH

The chart shows one of the top performing CTAs from 2014 compared to its closest MSR benchmark index. The table below shows correlation metrics.



Benchmark	Correlation	Fitness Ratio
1. MSR Diverisfied Trend TV20	0.74	0.78
2. MSR Master Trend TV20	0.67	0.75
3. MSR Diversitfied Trend TV15	0.74	0.69
4. MSR Master Trend TV15	0.67	0.67
5. MSR Global Equities Trend TV20	0.51	0.63
6. MSR World Equities Trend TV20	0.45	0.58
7. MSR Commodities Trend TV20	0.48	0.58
8. MSR Currencies Trend TV20	0.46	0.58
9. MSR Global Growth & Income Trend TV20	0.52	0.57

Source: MSR Analytics

And the same held true as he used their benchmark finder tool to matches with other sub-indexes.

Fund of funds

Pranav Sambamurti, senior VP and partner at SSARIS Advisors LLC, says the tool has interesting implications for fund-of-funds. "If you wanted to have a systematic CTA with medium- to long-term fund of funds, I could go out and hire [a manager at] 2 and 20 or use one of these replication indexes and pay hardly anything," Sambamurti says. "If you are a hedge fund of funds allocator or manager, you can create a business around a platform like this without having to pay the underlying fees of managers."

Esther and Marc Goodman, founders of Conyers Group, have a combined 70-plus years in alternatives and have been kicking the tires of the MSR platform. "There are some great managers in the hedge funds world [but] there are thousands of them; a lot are average," says Esther. "If you can invest in an index that gives you that performance without the fee, it seems like a good deal. It will never replace the stars of the business. But as I look back on our years as a fund of funds manager, there are a lot of average [managers out there]. " Marc adds, "It is not easy to identify the ones that are above average. The amount of time and energy necessary is not always available."

That is a key point and perhaps reveals the value of the tool. There are many tools to measure manager performance but not a lot that tell you where that performance comes from. Institutional investors like to take an analytical approach. There are certain exposures they want and certain risk tolerances they can accept.

"It is a very useful tool because some allocators are going to have specific ideas of what they want and need help putting it together," says Oliver Evans, managing partner for the Apercus Holdings Family office.

It is easier for a manager to select a well-defined style index than to select from among a group of managers who may not be offering that precise exposure. "You have the ability to run your own risk profiles and be able to customize your investment with this type of product and how it fits into what you need for the rest of your portfolio," says Marc Goodman.

Evans points out that most hedge fund managers rarely generate alpha or generates 'dirty alpha' instead. He explains that often a hedge fund is long one factor and short another, such as buying mid-caps and selling the broad market. Such a strategy would be relatively easy to replicate and not truly an alpha driver.

Sambamurti adds, "You could create a business around this. Their value proposition plays pretty well with smaller fund of funds or fund of funds that are trying to differentiate themselves by their ability to offer lower fees. It is huge."

Fees

The alternative space has come under attack because of its fee structure, and MSR, like other investable indexes, offers a more palatable fee structure.

"When returns are good people don't complain so much but when returns are more compressed like in the last few years, many institutions start to [complain] about the double layer [of fees]," Sambamurti says. "It is not to say it can't be defended, but if you feel like you don't necessarily need to have the best alpha of a manager at a particular time—your alpha is really derived from being exposed to a certain strategy type at the right time—then you can build a business with a lower fee base."

Marc Goodman adds, "People are happy to pay for alpha, but why pay for beta if you already have a method to gain the exposures to certain benchmarks you need and want by paying very little by using an index. Then spend the rest of your time looking for truly alpha generating managers."

Building portfolios

Rulle says he is a fan of trend-following even though he thinks his index can replicate much of that sector's performance. He points out that one of the most compelling analyses of its value is a rolling 12-month performance compared to the S&P 500 (see "Performance when you need it," right). The first chart shows how managed futures tend to perform at its best during poor performance periods of the broad stock market.

Rulle says, "I always wondered why [trend followers] have not promoted a 50/50 combination of 60/40 (60% long equity investment with 40% long fixed income) and trend following. Rather than trying to persuade someone that they should put some amount of trend following with their 60/40, we decided to create a product 50% 60/40 and 50% trend following."

MSR offers this index at 100 basis points which provides an investor an all in diversified product. While one can create this with strategic allocations, this offers a pure trend-following approach. A specific manager such as Winton may offer good performance but are you getting the exposure you need? Many managers offer hybrid approaches that combine short-term and countertrend elements to dampen volatility. This may improve the overall return but changes the exposure.

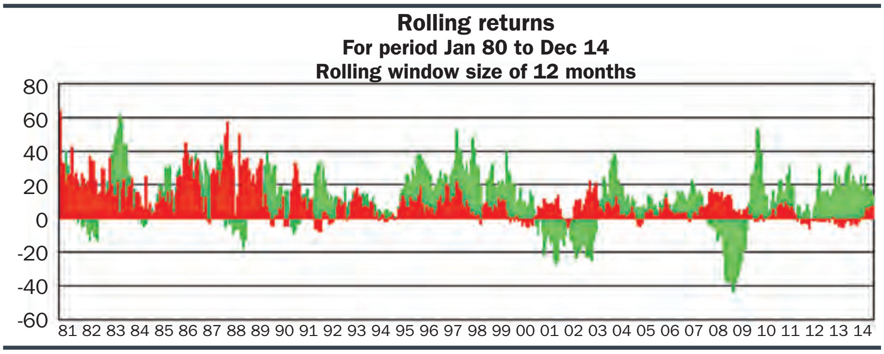
"You get good results but are they 100% trend-following?" asks Rulle. "You wouldn't have known back in 2007 that [Winton was] going to cut their volatility in half. You don't [always] know what you are getting when you invest in other managers. With us you know everything that you are getting because you have daily positions; those that invest with us get the algorithms of the index."

"I definitely think you can build portfolios of diversified CTAs, but unless you can identify the trend followers that really have an edge—and their numbers are better because they are doing something different—then trend following is one of the strategies that you can save money on," Goodman says. "Unless you can find an edge, don't pay for it."

He adds, "In the last few years everyone moved to the largest managers; a tool like this will let people be able to see that the largest managers aren't necessarily the [most unique]."

PERFORMANCE WHEN YOU NEED IT

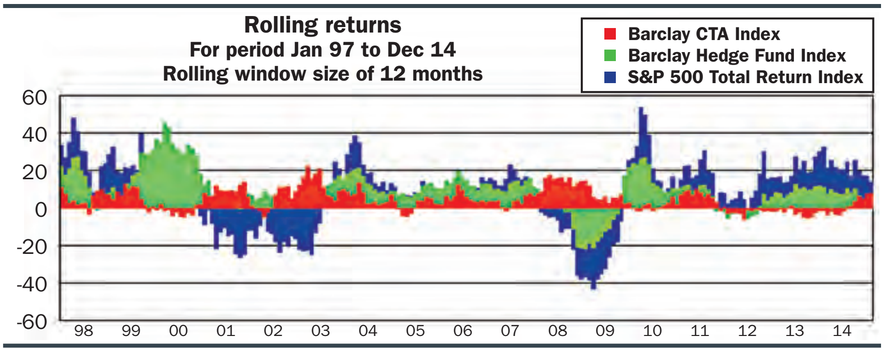
The chart shows how the Barclay CTA Index (red) has performed best in difficult periods for equites as represented by the S&P 500 total return index (green).



Source: BarclayHedge

EQUITIES IN DRAG

While managed futures (Barclay CTA Index) has shown to provide positive return in poor equity environments, hedge fund performance more closely mirrors equities.



Source: BarclayHedge

Hedge fund correlation

While the issue of strategy purity may be a factor with trend followers, the question with the larger equity-based hedge fund world is correlation. When markets imploded in 2008 managed futures did its job of providing non-correlation to equities but hedge funds struggled along with equities (see Equities in drag," right).

"What we believe, and our tool demonstrates, is the hedge fund world today is very much a high fee low performance version of equities," Rulle says. "We want to create a more expansive view and more expansive capability for investors to really achieve alternative returns, which is what the hedge fund world initially promised. They are getting equity returns and they are paying 2 and 20."

Marc Goodman adds, "I have always described a typical equity hedge fund as a long fund in drag. Equity hedge funds are another area that you are paying a lot for beta."

Sambamurti says, "The notice is out there for every hedge fund manager that you need to differentiate yourselves from your peers in this universe."

What's next?

BarclayHedge founder and President Sol Waksman sees this as a great analytical tool but says we may be getting ahead of ourselves. "It gives customers another way to measure manager performance, [but] it might not be predictive at all. This does not say it will replicate [programs] going forward, it is just giving you some understanding," he says. "Because they have so many indexes, intellectually it becomes a little more interesting. I am real curious and that is why I am [involved]."

BarclayHedge manager data is part of the MSR tool and it is the calculation agent for the indexes.

There have been many attempts to create low-cost beta investments for alternatives, but MSR's platform takes an additional step by allowing managers and investors to dig deeper into the drivers of return.

While the goal is to gain allocations to the various investable indexes, the tool itself should help allocators and investors make smarter decisions about what to invest in. "The best benefit is to give people an understanding of what they are investing in," Waksman says.

It also holds out hope to provide retail access to the world of alternatives. While 40 Act alternative products have grown, they haven't exactly knocked it out of the park and they haven't solved the fee issue.

For years alternatives have been firewalled from the retail space even though there is no legitimate reason that retail should not have access to the benefits of alternatives. This may be another step in opening up the world of alternatives and it is proof of the innovative nature of space. F