Managed Futures:
2015 Review & 2016 Outlook

621 South Plymouth Court | Chicago, IL 60605 | 312.870.1500
www.rcmalternatives.com | invest@rcmam.com

It's never easy in investing, is it? You're humming along getting paid a nice yield in MLPs, then the bottom falls out of energy prices. You're enjoying the 6-year bull market in stocks, then the FED comes along and cools things down.

In the managed futures and global macro world, performance broke out of a multi-year sleeping period in 2014, to post double digit returns poised for continued growth with commodity prices falling even more in 2015 amidst a choppy year in stocks.

But it's never that easy... And managed futures finished the year around even (just above or just below depending on what index you're looking at), putting them right in line with a bunch of other asset classes' underwhelming performance for the year.

ASSET CLASS	2015
U.S. Real Estate	1.60%
U.S. Stocks	1.34%
Bonds	0.35%
Cash	0.08%
Managed Futures	0.02%
Hedge Funds	-2.52%
World Stocks	-5.73%
Commodities	-33.47%

Past performance is not indicative of future results.

*Please see p. 9 of this report for sources

Where have we been, where are we going next?

So why the flat performance in 2015, and what can we expect in 2016?

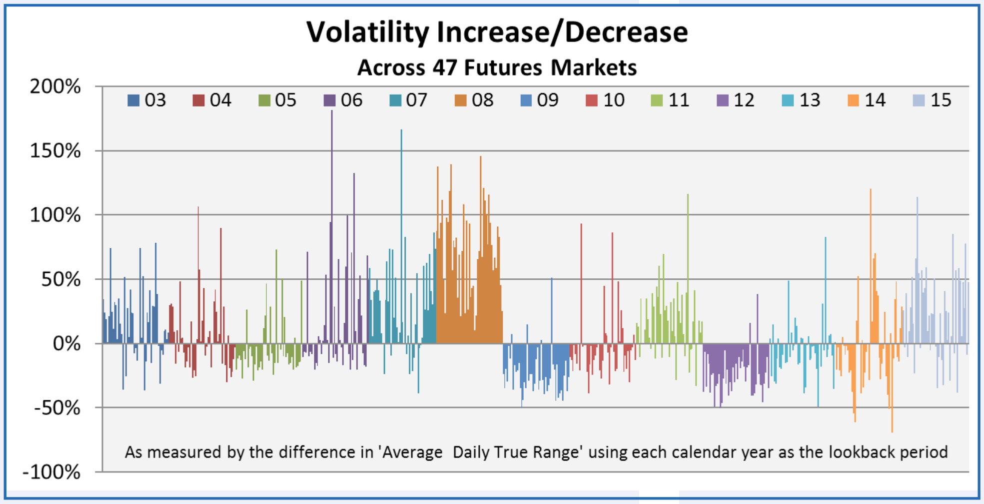
Well, we won't pretend that we can forecast with any accuracy where managed futures will end up over the next 11 months. We're not interested in playing that game. But we are interested in analyzing the conditions which caused managed futures as an asset class to perform the way it did in 2015, and discuss whether those conditions will persist, reverse course, or yield to different conditions in the New Year.

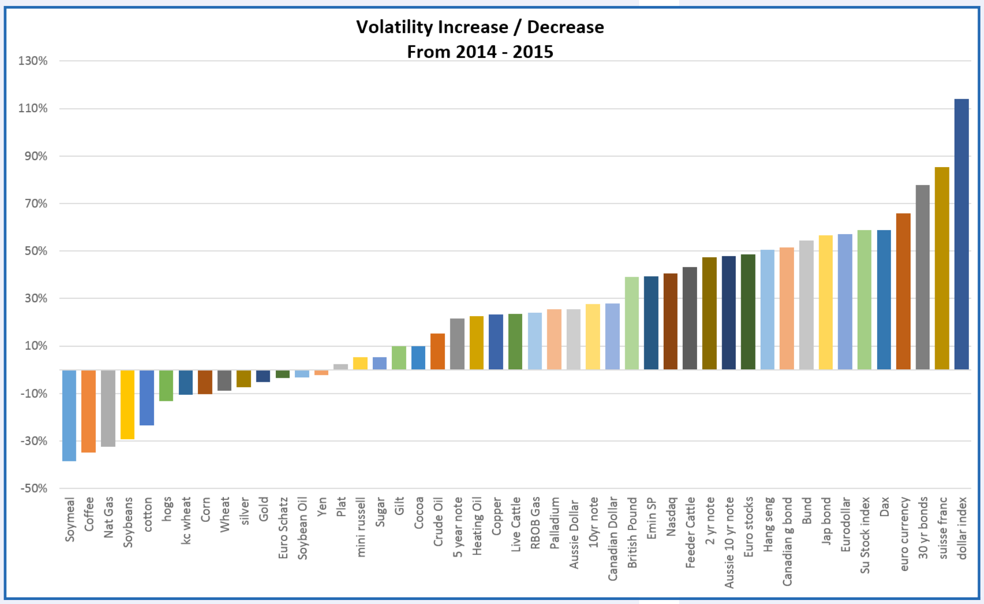
To start that discussion, we look in the engine room of managed futures/global macro programs, we look at volatility in the global markets the asset class tracks – and specifically, whether volatility is expanding or contracting. Managed futures and global macro funds are often referred to as a "long volatility investment" in our materials, simply meaning that they are expected to do well when volatility is on the rise.

So what was volatility doing? Confusingly, it was on the rise in 2015 per our simple year-over-year look at the difference in each market's average daily range (didn't we say this is never easy?). Per our readings below, 70% of markets saw their ranges expand (a rough proxy for volatility expansion), with 33 markets expanding, and 14 contracting.
Why is volatility up, but performance flat? The quick answer is that our volatility/performance link is a little too simplistic. You see, these types of

programs need not only volatility, but directional volatility. Meaning markets moving more, but moving more in one direction for an extended period of time. A market up 4% one day, down 3% the next, then back up 4% is volatile, but not directional. Managed futures and global macro would much rather see volatility which looks like up 3%, up 4%, up 2% (or down those amounts).

You can see this directional volatility versus back and forth volatility in one of managed futures' favorite markets - the U.S. Dollar. The dollar saw its average daily move expand in 2015, meaning increased volatility, but didn't see the directional volatility, with the largest move in the second half of the year just 7% (Jul '15 – Dec'15), contrasted with the second half of 2014 where the U.S. Dollar moved 12% higher in a very "directional" move - and you can see where the environment was not as conducive to gains for the space.





One area which did see directional movement was in commodities, which continued their 2-year sell-off in 2015 with most indices down -27% behind two crude oil losing another -34% {Disclaimer: Past performance is not necessarily indicative of future results}. But, as we said before, it's never easy - and managed futures/global macro didn't participate in that sell-off as much as one might expect.

Why? A few reasons. One, the managed future indices are typically made up of the largest managers in the world, which are forced (because of their size) to effectively trade less and less commodity markets in their portfolios so as to avoid government-mandated position limits. The effect of that is larger, financial-heavy programs underperforming smaller commodity-focused programs.

Secondly, there was a unique dynamic at play in commodity markets selling off for the second straight year. Most longer-term programs were already short commodity markets heading into 2015, and had made money off their short positions in 2015. Being long term, they typically hold these positions until the trend ends. And this is where it gets a little tricky.

Imagine a market that is at $100 and loses 50% of its value, ending the year at $50. If you were short that market, you would make $50 in profit. Now assume the trader maintains his or her short position and that market loses 50% again the next year. Things are great, right? Not so fast. You see, the same percentage move now only equals a dollar gain of $25, with the market moving down from $50 to $25. You can see that for those who were correctly on the right side and had existing positions in those markets - the net gain to the portfolio was that much less than it was in the previous year because of the diminishing returns on the short side profile (note: Managers in this space rebalance at different times, so this doesn't apply across the board).

Finally, there were a few sharp binary moves throughout the year which typically hurt systematic programs. The main one was the Swiss bank bomb, and then there was fed rate raising in December, a month which pulled many programs into the red for the year. Those types of shocks to the system, which come quickly and aren't followed by more of the same in the direction of the shock, cause losses for managed futures/global macro managers.

What could 2016 look like?

Well, if we're cheating, we'll say there's likely to be sharp losses in stocks and energy prices in the first few weeks of the year - pushing managed futures to the head of the line in terms of performers to start the year.

2016 could look a lot like what it already looks like:

ASSET CLASS	JAN 2016
Managed Futures	4.13%
Bonds	1.40%
Cash	0.03%
Hedge Funds	-1.23%
U.S. Real Estate	-4.04%
U.S. Stocks	-4.97%
Commodities	-5.21%
World Stocks	-6.71%

Past performance is not indicative of future results.

*Please see p. 9 of this report for sources

Let's hope it looks like this!

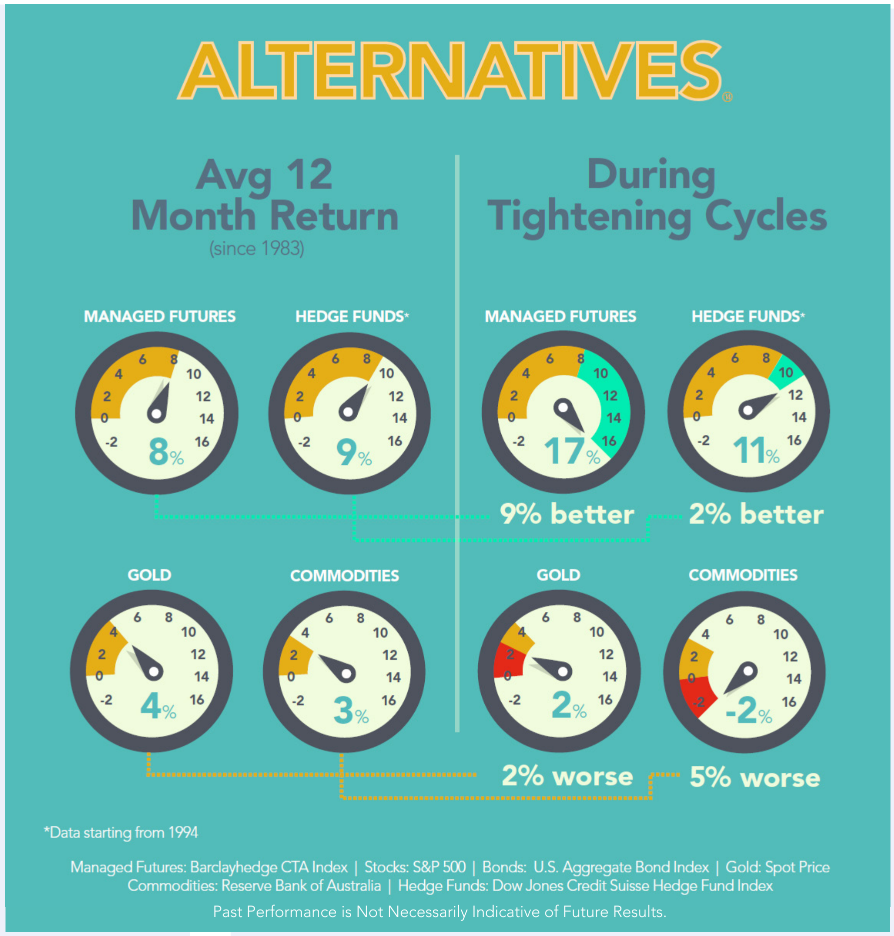
But all of that has already happened, so the real question is what will the next 48 weeks of 2016 look like? And here's where things get interesting, because there are dozens of factors that will be at play in 2016. There's the trajectory of the already mentioned stock and energy prices. There's Fed rate hikes being a possibility for the first time in 9 years. There's El Niño giving way to La Niña, and of course how the U.S. dollar will react to all of it. We see the following main themes working for and against managed futures/global macro investment strategies in 2016:

Potentially Working for Managed Futures in 2016

1. Fed Tightening Cycle

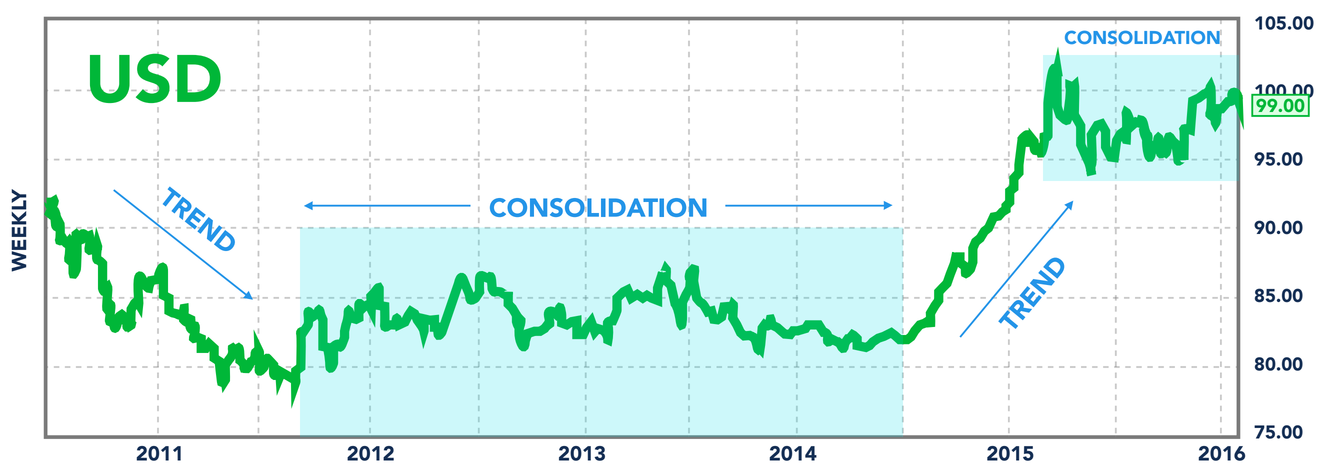
We're in an active fed rate cycle environment for the first time in 9 years, after the Fed hiked rates in December of 2015 with language and expectations that there will be more of the same in the coming year. That's music to the ears of managed futures investors, where the asset class has tended to outperform most other asset classes during Fed tightening cycles.

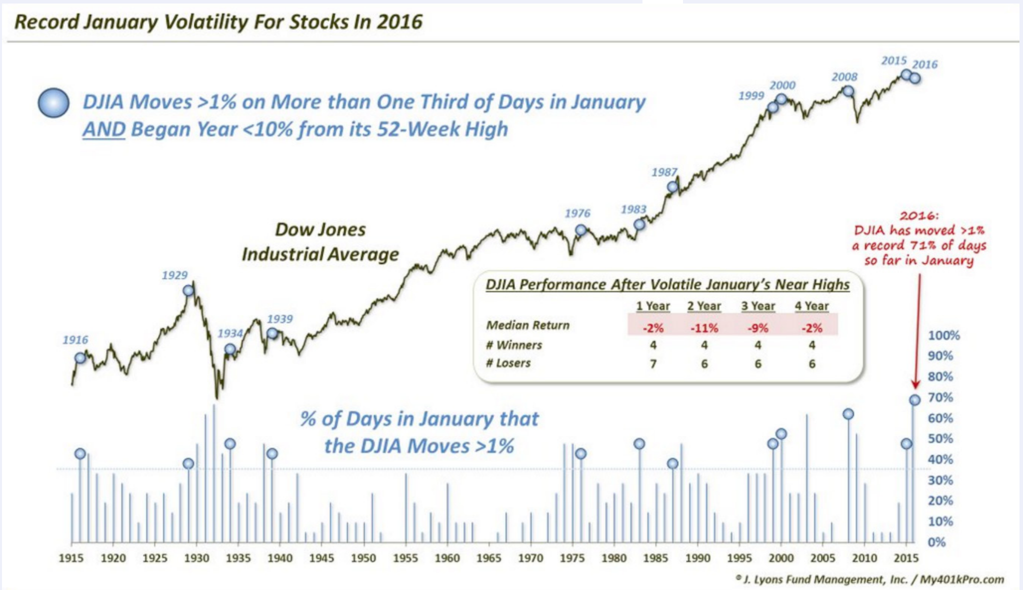
Here's the stats to the right from our recent infographic looking at investments during rising rate environments.



2. A consolidated US Dollar

We've talked before about how a trending US Dollar is one of the main drivers of performance for diversified trend following type programs (see our analysis here), but where do those trending periods come from? Well, the trends that systematic managed futures and global macro programs look to capture typically need to be born out of a consolidation period. You usually don't see a market trend straight up, then reverse course and go straight back down (or vice versa). There's usually a transition phase where markets enter so-called consolidation periods where a market is range bound and not really going anywhere over the long term. Conversely – the likelihood of a trend ending and entering a consolidation period is more and more likely the longer a trend lasts. Enter the US Dollar Index in the second half of 2015, which essentially stayed in a range between 94 and 99 from July through the end of the year (after climbing from around 90 to 101 to start the year). Essentially, we see it as a trend which entered consolidation, and is now primed for the next trend, either up or





down. The trick here is consolidation, and it could last quite some time…

3. US Equities still near all-time highs.

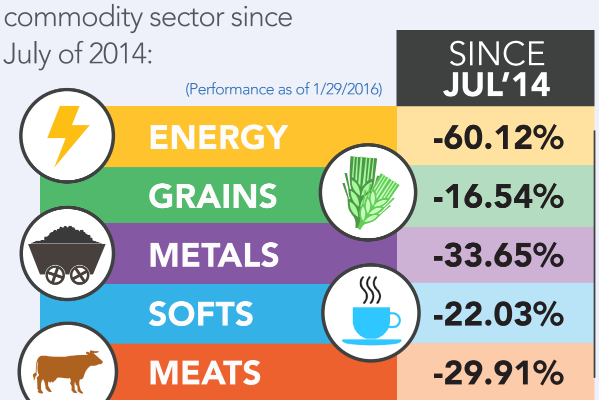
What will U.S. equities do? Will the losses to start the year (the worst start to a year ever, as some reported) mean more of the same throughout the year? Is this the start of another crisis period like 2001 and 2008? History has shown the market doesn't typically like such starts to the year, especially when they happen close to all-time highs. Per our friends at J. Lyons Fund Management, in the graphic above we see that some of the other years which started like this are 1929, 1987, 2000, and 2008. That's the rat pack of market rout years.

Whether this bout of volatility to start the year is a hint of what's to come, or just a blip on the smoothly up-sloping equity markets since 2009, only time will tell. But one thing's for certain, there's a lot of room to the downside in this equity market after nary a 10% move lower for the past 7 years. It is not hard to imagine a move down to the 1600 or even 1400 level in the S&P 500, representing losses of roughly -20% and -30% off the 2015 highs. There have been dozens of such moves in the market's history, yet the same game of complacency and disbelief at how low stocks can go seems to be playing out in real time here. While January has surely given people a taste of what's possible, it seems to us there's lots of unexpected pain available in this equity market. And that sort of unexpected pain is what can cause herd behavior, flights to safety, and more – causing the trends managed futures tend to latch onto. In short – it's more likely to be an outlier move when it is unexpected (or at least when the magnitude is unexpected).

Possibly Working against Managed Futures

1. Commodities

Commodities are sure to be a big part of the story for managed futures in the coming year, but whether they will be praised or panned is yet to be determined. What worries us is their already depressed state. Just look at the losses seen in the commodity sector since July of 2014:



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The first worry is that the sell-off is bound to start petering out at some point. At some point, shuttered oil rigs and slaughtered cattle have to affect the supply (right?). So the contrarian in us thinks the next likely direction for commodities as a whole is up, not further downside. That would pose a problem in the near term for managed futures and global macro programs which are predominantly short commodities and have been for some time. But even if there's plenty more losses ahead for commodity markets, there's potentially a diminishing rate of return for trend followers on the short side. That's because if the sell-off is contained in a single down trend, each 10% move down, for example, will represent less of a move down in dollar terms. And unlike Japanese bonds, apparently, commodity markets are zero bound, so there is a theoretical limit to how much profit can be made on the short side in commodities.

2. Stock sell-off not as contagious

While the high value of stocks, the early year volatility, and so forth in 2016 may look a lot like 2008 for stocks… 2016 looks decidedly different for many other markets. And that may mean less opportunity for outlier gains should there be a massive stock market meltdown. Just look at the chart above to see how different things are now than back in 2008, with the commodity markets having already sold off drastically. In addition, you have bond markets near all-time highs themselves (rates near all-time lows), so there's less room for a flight-to-safety rally in those markets during a stock sell-off.

In short, the likelihood of a stock sell-off having mass contagion elsewhere, seems a much bigger ask this time around. This simplifies things a bit as bonds could still move significantly in percentage terms, and managers can size positions based on current levels. So in theory, the same outlier moves can be captured. But suffice to say this pre-crash environment looks much different than last time around. We could easily see something like commodity prices start to rally off their lows, and stock prices sell off.

Conclusion

One thing is for certain as we barrel along through 2016, it won't be easy. Managed futures won't put up 12 straight months of gains just like stocks won't post 12 straight months of losses. There will be fits and starts and reversals and trends nobody saw coming. But the fact that we can even think about an environment where stocks go down and oil goes up this year is heartening, to say the least. Because for all the talk of managed futures/global macro as a crisis period investment which does well when stock sell off, these investment strategies aren't just making one big bet on the stock market; they are analyzing each market independently and looking to participate in each trend independently.

Now, it just so happens that most markets become correlated in times of crisis and those independent bets act as one bet. But that doesn't mean the inverse is bad for the space. Indeed, markets moving on their own is one of the main return drivers for the space, where moves in a handful of markets can make up for many other markets which aren't moving.

With volatility up in 2015, but the directionality of that volatility down…we could easily see the reverse in 2016, where volatility in commodity markets and bonds shrinks some, but the directionality in a handful of those markets improves. This feels like a different type of year where a few outlier moves will drive the majority of gains, versus the entire macro environment lifting all boats. Of course, we could also see a new environment where bonds stay low, stocks sell off, and commodities rally – breaking our pre-conceived notions of how everything's supposed to interact. That could be some fun, and right up managed futures alley.

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NOTES

2015 Asset Class Performance table (page 2)

Source: All ETF performance data from Morningstar.com
Sources: Managed Futures = SG CTA Index, Cash = 13 week T-Bill rate,
Bonds = Vanguard Total Bond Market ETF (BND),
Hedge Funds= IQ Hedge Multi-Strategy (QAI)
Commodities = iShares GSCI ETF (GSG);
Real Estate = iShares DJ Real Estate ETF (IYR);
World Stocks = iShares MSCI ACWI ex US Index Fund ETF (ACWX);
US Stocks = SPDR S&P 500 ETF (SPY)

JAN 2016 Asset Class Performance table (page 4)

Source: All ETF performance data from Morningstar.com
Sources: Managed Futures = SG CTA Index, Cash = 13 week T-Bill rate,
Bonds = Vanguard Total Bond Market ETF (BND),
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Commodities = iShares GSCI ETF (GSG);
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US Stocks = SPDR S&P 500 ETF (SPY)

Commodity Sector Performance since July 2014 table (page 6)

Energy = WTI, Brent, Heating Oil, Gas RBOB Gas, Natural Gas, and Ethanol
Grains = Wheat, Corn, Soybeans, Soybean Oil, Canola Oil
Metals = Gold, Silver, Copper, Platinium, Palladium
Softs = Cotton, Orange Juice, Coffee, Sugar, Cocoa, Lumber
Meats Live Cattle, Feeder Cattle, and Live Hogs

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Chicago, IL 60605
312.870.1500

www.rcmalternatives.com
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