Q & A

More bull less alts: Is history repeating?

INTERVIEWED BY **DANIEL P. COLLINS**

It has been a strange environment for investing since the markets imploded in 2008. That was the year the credit crisis came to a head, tanking equity markets, and managed futures proved their worth as a diversified investment. Since then equities have embarked on one of the greatest bull moves in history despite the lack of a genuine sustained recovery, and alternatives have struggled. Not all investors took advantage, as many were overinvested in equities and lacked non-correlated investments going into the crash and were underinvested in equities at the trough.

Are investors repeating the same mistake? That could be the case. *Futures* talks to Salient Partners Chief Investment Officer Lee Partridge about portfolio construction and the state of alternative investments. Partridge founded Integrity Capital LLC, which spanned traditional and alternative investment strategies, and was deputy chief investment officer of the Teacher Retirement System of Texas that was at the forefront of using alternative products to diverisify pension investments. At Salient, which managed roughly $19 billion, Partridge spearheaded the development of Salient's asset allocation funds, actually creating investment products as well as selecting managers to allocate to as part of an overall portofolio selection.

FUTURES MAGAZINE: Lee, when we spoke a couple of years ago you were at the forefront of pushing for a greater allocation to alternatives in portfolios. Since then alternatives, managed futures in particular, have underperformed equities. Have you had some pushback?

LEE PARTRIDGE: The one thing that I would set the stage with is equities have had a great five-year run. This has been the most impressive bull market in quite some time, since maybe the 1960s. Alternatives, particularly managed futures strategies, are not there to protect you when equity markets are performing so exceptionally well; they're there to provide diversification for periods when equities aren't performing as well and you need something else in your portfolio. Investors inevitably have the lowest allocation to alternatives and diversifiers at the top of the equity market. It is a little counterintuitive but it is [the way] we are wired to think.

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FM: Has it been hard to convince people to maintain an allocation to alternatives?

LP: Yeah. People have gotten a little disenchanted with alternatives generally, and managed futures strategies in particular have come under fire for a couple of reasons. Definitely there has been some pushback.

FM: What do you attribute the poor performance in managed futures to? Is it all because of risk on/risk off or is there something else at play?

LP: That has exacerbated it. [Also], so many trend-followers have tried to diversify the returns that are being generated in their portfolio so that [they] got away from pure long-term trend-following and took on short-term trend indicators and are even doing some countertrend strategies. The reality is when I look at the markets and look at stocks and

Investors burned by equities in 2008-2009 may be warming up to—and exiting alternatives—precisely at the wrong time.

commodities there have been some incredible trends that have been established over the last 36 months, so this diversifying signals that a lot of managed futures guys have added to their portfolios, which has caused their overall Sharpe ratios to break down.

FM: Do you still allocate to other managed futures programs?

LP: We do. When we are allocating to outside managers, we think about that with the same hat that we are wearing when we are managing our own strategies. We ask, 'is the manager providing something that is purely systematic that isn't a classic definition of skill?' If they are, we don't want to pay the incentive fees because we as the asset owner are housing that risk so we don't think the incentive fee structure is appropriate. The second thing that is key when allocating to outside managers [which goes counter to traditional thinking] is we prefer more volatile managers in the portfolio. There are two reasons for that. You have to have a reasonable amount of volatility to have any impact on your overall risk budget, particularly with a strategy like managed futures that is going to show no correlation to your principal risk factors in a portfolio. The second thing is, and it is just as important, if someone is charging a 1% to 2% management fee and they are running at 5% volatility, it's much more difficult to make that math work than if you are running at 10% to 15% volatility, where the fee to volatility level is running much lower.

FM: Has the entire investing process been distorted by the love affair with the Sharpe ratio?

LP: The Sharpe ratio is a good tool at the portfolio level. You are not as interested in the Sharpe ratio of each component of the portfolio on a standalone basis; what you are really interested in is the marginal impact that a particular strategy will have on your overall portfolio Sharpe ratio. If I have [strategy] A or B, which one has the biggest impact on my risk adjusted returns or absolute returns? Maybe it is a strategy that has a lower standalone Sharpe ratio. Let's say manager B has a [better] Sharpe ratio than manager A, but manager A (because it is negatively correlated with everything else in the portfolio) can have a more positive impact on the overall portfolio Sharpe ratio despite the fact that it looks inferior to manager B if all you are looking at are those two managers on a standalone basis. The point is that Sharpe ratio is not really a bad measure; it is that people are misusing it. They are using it as the single measure of success for each individual manager in their portfolio and that is absolutely the wrong thing to do.

FM: Is there a risk that once bonds reverse their long bull trend, managed futures will lose its non-correlation to equities?

LP: In the 1970s when you had this rising rate environment, stock and bonds were much more correlated with one another. Right now people have come off of this 20-year period where correlations were at their lowest level for the whole century. People say, if you were long bonds it drove the negative correlation in the strategy but in reality if you get into an environment like the 1970s when stocks and bonds are very correlated, then having a long position in bonds may not be lowering correlations, it may be increasing correlations where a short position in bonds can actually be the source of diversification in your portfolio. There are so many different outcomes that managed futures can take advantage of that it is hard to predict how it is going to play out.

FM: Where do you see interest rates going?

LP: Yields have come down since the high of last year. The 10-year note/30-year bond spread had a high of 155 and now we are at 80. That is almost an 80 basis-point move in the 10/30 spread over the last nine months while the Fed has withdrawn $40 billion in purchases of mortgages and Treasuries so the long end is telling you something. The Fed really wasn't the one driving down interest rates, they were actually the ones adding inflationary concerns to the long end of the curve; now we are in an environment where the economy is going to have to stand on its own and you are seeing this great rotation in central bank activity where now the Fed is more hawkish and the Central Bank of China and a lot of Asian countries are becoming more dovish (see "Is Fed pushing or pulling?" right).

FM: Is the market now moving off of fundamentals instead of every Fed move?

LP: That is what is going on right now. The question will be whether the Fed keeps its hand off of the trigger. We know Janet Yellen as a dovish Fed Governor, but she was there in 2003-2006 for all the increases that crushed the subprime market. She had shown herself to be pretty heavy-handed in that episode. It will be interesting to see what happens if we hit a soft patch. How much tolerance for pain will be exhibited?

FM: Equity-based alternatives have performed well. Are the folks at AQR doing something right or are they simply collecting equity beta?

LP: First of all AQR is doing something right, but whether or not

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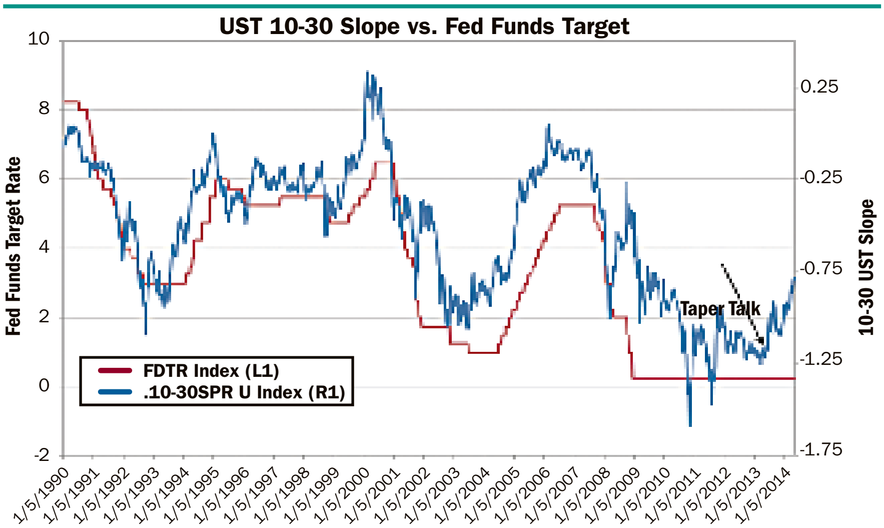
it's beta or alpha or alternative beta, I don't know. They can have a better exposure to fundamentally market-based returns and still have a big advantage. AQR had a bit of a soft patch in 2007 on their quant equity funds but they are very smart and very adaptive so they learned a lot from that experience. AQR's thinking, a lot of the quant equity guys' thinking, has continued to evolve and they differentiated vs. other players in the market where they are all not doing the same thing so there is less of a tendency that they all run to the exit door at the same time.

FM: Did you create your own program to replicate systematic trend-following and then select discretionary managers to allocate directly to?

LP: Absolutely. We think of ours as being alternative beta and we look for guys that we really think have an information edge over the market and those are almost all discretionary macro.

IS FED PUSHING OR PULLING?

Analysts assumed the Fed was keeping long rates down with QE but they were also creating inflationary fears.



Source: Bloomberg

FM: With Salient you have changed your focus from managing pension money to building investments. Why did you launch these series of funds?

LP: The basic reason we launched our funds is that there were things we wanted to do as allocators that we didn't find good products to do them through. We wanted to fill a hole that we saw in the set of offerings out there and decided we would do it ourselves. We want to be efficient in the marketplace. We want to have a tremendous amount of liquidity, low fees and transparency in an investor-friendly structure.

FM: There have been a raft of alternative 40-Act products launched since 2010. How do you expect to compete in this space? Are you offering them to pensions or bundling them in diversified products?

LP: What we are doing is definitely different but it is different in a counterintuitive way. Rather than come up with the most complicated structures, we are trying to create things that [offer] pure access to these return streams. So with trend-following we're offering access to a pure trend-following strategy across 40-50 futures markets. We don't have overly engineered stop-loss program or signals that use a combination of RSI and MACD and reversals. Ours are very simple signals that identify trends and then we risk-weight everything. What defines systematic is that it is rules-based, and we find that a lot of the industry has over-engineered its portfolios and they haven't taken in enough [data] in terms of economic environments to really backtest those strategies. Futures and commodity markets beg for active management but that is the discretionary side. All the guys that we [allocate to], and had success with are fundamentally different from what we are doing. We are taking what the market gives us on the trend-following side.

FM: It sounds like you are trying to create a pure systematic trend-following beta because managers have hurt themselves by trying to smooth out the rough edges of trend-following.

LP: Exactly. If we have a choppy market that is why we have high yield in the portfolio. It is not too dissimilar to selling volatility, in that in choppy markets high yield generally outperforms equities and generally outperforms trend-following. For example, last year was a pretty bad year for emerging market debt, which is our carry strategy, but that was a bad trade last year. But managed futures, the way that we define it, more than offset that because trend-following really kicked in. It is all portfolio construction from our perspective. We are trying to create building blocks that are not readily available to help managers construct portfolios that are more efficient. None of them are the Holy Grail.

FM: Do you think ultimately the 40-Act fund structure is where retail investors will and should get their exposure to alternatives?

LP: We don't have many constraints. For us the managed futures side is really easy. The only meaningful [glitch] that we run into is a [Registered Investment Company] can only warehouse so much of what is considered bad income and commodities are considered bad income so you have to run it through an offshore group. That is the only piece of it you have to adjust for inside of a RIC. Other than that, leverage is not an issue, the instruments themselves are not an issue, you have 60/40 tax treatment so it works if someone has it through a 401K. It also works if someone has a normal brokerage account. The 40-Act structure is pretty well-suited for this.

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FM: In the past year alternatives, both hedge funds and managed futures, have come under attack for a lack of performance and high fees. Has this attack been fair? What is behind it?

LP: There were some shortcomings with that Bloomberg article but the reality is that managed futures have carried very high fee loads with them. There are not only the incentive fees that the manager charges, but if you have two funds and one is up the other is down, your incentive fee is going to be 1% on total portfolio because you paid 20% to the manager that was up 10%, which is completely eliminated by the guy that was down 10%. You are still net down 1% on the portfolio level. That is the drag that is created by the incentive fee. When you layer on top of that a lot of front-end loads that the big distributors charge [it gets expensive]. These aren't meant to absorb 5% to 8% front-end loads plus a 2 and 20 structure.

FM: Are you suspicious that some criticism of alternatives comes from the long-only equity world and any allocation to alternatives is going to come from traditional investments?

LP: That is exactly right.

FM: Are you worried that such criticism will reduce exposure to alternatives, particularly managed futures, when it is needed most?

LP: Absolutely. People are going to have minimal exposure to alternatives when they need it the most. It is just the way the markets work. That is what drives the equity price up, everyone is buying equities and they can't go down and they sell alternatives to fund it.

FM: A few months ago we interviewed Mark Spitznagel who thought QE was forcing people into risk assets, which will create a greater risk of a market crash because of the heavy government intervention. Do you agree?

LP: I think so but the downside was a depression in 2009. Absent QE we were heading toward a complete breakdown of the financial system and more banks were going to go under. So yes, it definitely increased speculation as we got into the later stages of QE but if we didn't have QE we wouldn't have an economy as we know it.

FM: People tend to forget that.

LP: Yeah, they do forget that.