Covenant Optimal: Coming full circle

BY DANIEL P. COLLINS

As the managed futures space attempted to become house trained and more palatable to institutional investors it may have lost a bit of what made it special.

During the last two decades, as managed futures have attempted to move from a niche investment product to a mainstream one, the space has changed — and not necessarily for the better. Aided by a distribution and sales network that rewarded low volatility and convergent strategies, and one that produced better Sharpe ratios as opposed to absolute returns, managed futures has been pushed to justify its inherent volatility that is more due to its divergent nature than underlying risk.

Low volatility vs. low risk
Exploiting fat tails

Scot Billington, co-founder of Covenant Capital Management [along with partner Brince Wilford] has reversed the process and decided to embrace the early tradition of managed futures by targeting outsized returns. And they're not apologizing for it.

In February 2014 Covenant launched its Optimal trading program, which mirrors it original program, launched in 1999 and its aggressive program, launched in 2004 but at several times the gearing: 4X the original and 3X the aggressive. In just under a year the Optimal program delivered with an eye popping return of 226.67% (see "Hitting a grand slam," right).

Covenant's core strategy is a diversified long-term trend-following approach, which has earned a compound annual return of 19.84% in its aggressive program since Feb. 2004 with a worst drawdown of 20.41%.

"The underlying philosophy of the Optimal program is that the industry has been institutionalized," says Billington. "Most of the money allocated, whether alternative- or equity-based investments, are done through fiduciaries whether they are institutional pooling, pensions or brokers, and these fiduciaries have a different set of goals than somebody whose money they are managing. In a quest to reduce volatility, which theoretically reduces risk, you have seen a squeezing of profits and volatility that doesn't necessarily reduce risk."

> **"The way to keep assets under management is to not lose any of it, and if I do lose I have to lose with the herd."**

The key term there is "theoretically," as numerous low volatility strategies have produced higher losses than theorized without the ability snap back with high double-digit (or even triple-digit) returns.

For Covenant research go to futuresmag.com/Cov.Optimal

The idea came to Billington after asking an institutional fund manager about access to very aggressive programs. The manager had none to offer, which he saw as odd. "What is the point of investing? It is to profit; and to profit a lot," Billington says. But outside of private equity there were no vehicles. "Where is the program attempting to make me a lot?" he asked.

He looked around and saw it didn't exist, which looked like a vacuum to Covenant. After all, it is the way most managers trade their own money. "Why am I not offering this to other people? With that you are going to have a program that is very unique," Billington says, adding, "There is going to have to be some education around that. We have to get out of the mindset of percentage drawdown and think more about dollar drawdowns. Because with a super high return product, the key advantage is I can get the same punch, the same potential long-term return for far less of an initial investment."

Covenant began to examine risk more closely and discovered some fundamental flaws in common risk factors (see "Deeply flawed risk benchmark," *Futures*, October 2014). Standard deviation measures tend to underestimate the risk at the most critical times. For instance, five standard deviation events are supposed to happen once every 100 years when assuming a normal distribution, but we have seen several five standard moves in the S&P 500 since 2000. What their research confirmed is that markets exhibit fat tails. This means that high standard deviation moves occur more often than would be predicted by normal distributions. Covenant chooses to exploit that rather than be a victim of it by offering a program targeting high returns with less money at risk.

In a recent study, Covenant wrote: "The effect of a high volatility investment on a portfolio can be mitigated by the allocation size given to that product. By normalizing for volatility, theoretically, high and low volatility investments can have equal effect on a portfolio's total return. This leads us to a different way to view risk, defined as the difference between the anticipated worst loss and the realized worst loss. When viewed through this lens, lower volatility equals higher risk (see "Smarter allocation," right).

The tables illustrate this by having more money allocated to low volatility strategies, the portfolio has more at risk. It would be safer to allocate less to high return strategies.

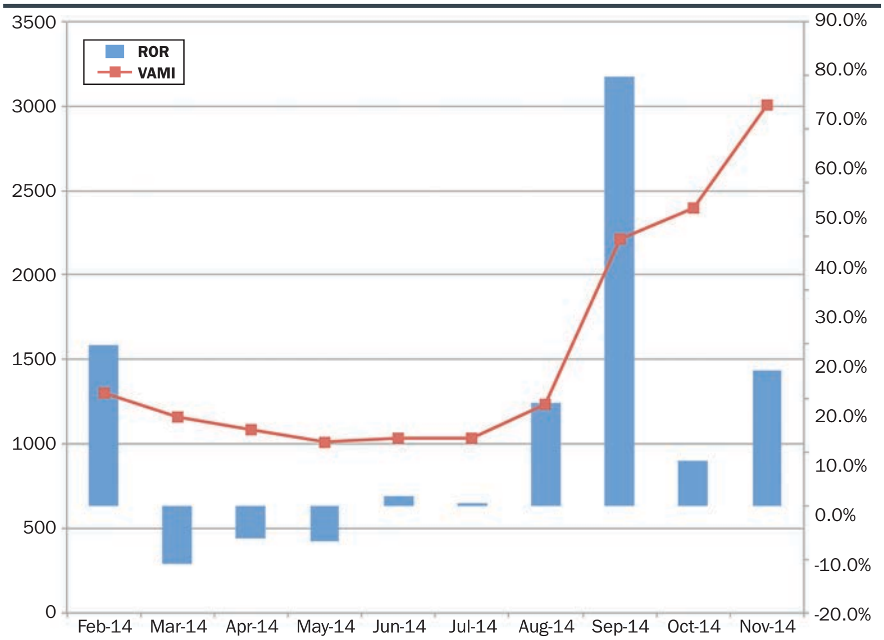
"These alleged low-risk investments have low volatility but that does not necessarily mean low risk," Billington says. "At the end of the day, every dollar you invest in is at risk. You can lose all of it; no matter what the track record says, no matter how safe it feels, you can lose it."

Billington says the system benefits the asset managers. "You give us a little bit of money each year until you retire, pretty good deal if I am making money on my assets. Over time we compound at about 8-10% and over 40 years you can end up with a nice amount of money."

Billington acknowledges the value of this but says a small portion should be invested in something capable of earning high returns. "I am not saying that there isn't a place for that." Nassim Telab talks about the barbell investing strategy where you take the majority of your money and put it in the safest thing you can imagine and you take what is left and put it in the most aggressive thing you can imagine. That is more our philosophy."

HITTING A GRAND SLAM

Covenant's Optimal program vami chart for 2014



Source: BarclayHedge

SMARTER ALLOCATION

An allocation to high return strategies put less overall money at risk.

Investment	Vol.	Worst DD	Allocation
Conservative fund	5%	5%	79%
Aggressive fund	25%	25%	15.75%
High return A	75%	75%	5.25%

Investment	Vol	Worst DD	Allocation
High return A	75%	75%	5.25%
High return B	75%	75%	5.25%
High return C	75%	75%	5.25%

Source: Covenant Cap.

How did we get here?

Billington says that asset managers deliver what the big allocators look for. "If I am a massive allocator and making 1% a year on all this money, what I want is to make sure I don't lose this money," he says. "The way not to lose this money is for me to do okay. If I do awesome, I might get a little more money but not really, and if I do average, I am still going to keep this money. My goal is to keep my assets under management and the way to keep assets under management is to not lose any of it; if I do lose, I have to lose with the herd. Those are very sane reasonable goals to have."

While the goals are sane, Billington's research shows that a high return strategy offers less risk.

Cover: Collins continued on page 31 ►

Collins continued from page 27 ►

SCOT BILLINGTON

PHOTO: COURTESY OF SCOT BILLINGTON

"I can promise you that at [major business schools] they are not teaching you that you can put less money in at a higher return," he says. "That is by far a less risky way. I reduce third-party risk, I reduce my fees. My downside is not capped by some theoretical past worst drawdown; it is capped with that is all I can lose, and my ultimate upside is far higher."

With high returns comes high risk and Covenant is under no illusion it will earn 200% every year. In backtesting, the strategy's worst drawdown was 75%. Billington says investors should expect that.

"When somebody is investing I say let's size this as though you are going to lose 100%," he says. "In deep drawdown like that—compounding is an interesting thing—not only does compounding accentuate the good periods, there is a de-compounding effect that tends to mitigate bad periods. If we get down 75%, if I [lose] another 50%, that is only going to be a 12.5% drawdown."

Of course, a 75% drawdown means the program must earn 300% to get back to even.

"Now you have hit on it. The high return model has to have enough power because of that. A big year has to be way north of 100% because you have to be able to recover from 50% drawdowns. If we lost 50% next year in Optimal, we are still going to be up 140%."

The strategy makes sense on a portfolio level. "It has to mean something in a portfolio," says Pranav Sambamurti, senior VP product specialist and partner at SSARIS Advisors. "Obviously you put some constraints on it. If there is higher leverage there are higher drawdowns, [but] if you are going to add a non-correlated diversifier asset into a portfolio, you need to have enough leverage in it to make a difference."

Sambamurti adds, "If you are a pension fund with very little exposure to these types of strategies, putting something like that in your portfolio could help because it has to make a difference. If you have 5% of a multi-billion dollar pension fund in something like this, it better be 5% that can make that 200%; it has to give you the diverse pop when you need it."

While this investment may make more sense inside a diverse portfolio, Covenant has seen more interest from individual investors than from institutions. "To me, the argument is very strong. It is not difficult to see or comprehend, but very difficult to break the norms of an entrenched industry," Billington says.

Longtime fund-of-fund manager Marc Goodman says it is a matter of human nature. "We have found over time that even sophisticated investors who understand the logic of having a more volatile instrument that yields you higher rates of return and/or performs better when the rest of your portfolio is hurting, and have this great macro vision of their portfolio, when your component is down they revert back to being a micro thinker and say 'I can't live with the volatility,'" he says. "It is illogical but it is human nature and I have seen it in some sophisticated investors."

"You can't go down to the Mercedes dealership with a Sharpe ratio, you are going to need money."

Billington says that when he talks to allocators about Optimal and they hear about 50% and 75% drawdowns, "they throw up on themselves, but as soon as the conversation turns from their clients' money to their own money, they get very interested."

"At Covenant, we have a very good estimate of what our optimal level is. And we are trading a little beneath optimal level so we are getting the most return for each extra unit of risk we take," Billington says, adding, " If you attempt to do that yourself through notionalization, you don't know what that amount is. You don't know if you are risking too much or too little."

He adds that if you are allocating $2 million to trade as $10 million, "You are going to pay a management fee on the nominal account size, not the notional. You are going to pay a management fee on the $10 million."

Be not afraid

In the end Covenant is offering a program that has the potential to change people's lives by taking a different view of investing.

"In my mind, managed futures needs to not be afraid to stand up and say for anybody interested in making money, 'come look at us,' because you can't go down to the Mercedes dealership with a Sharpe ratio, you are going to need money," he says, "There are lots of people who say, 'I don't care about making money, I have lots of money.' And they are correct. But this is also the safest way to invest. You could put $3 million in the optimal program or you can put $30 million in the stock market. You have a hard time convincing me that that $3 million is a greater risk."

Next month we will run our annual Top Traders of the Year feature but Covenant already is on the list for the third time. Not only did it earn strong returns in all its programs but it is offering a new way to think about investing and risk.

The Optimal program is not for everyone but it deserves a look. Investors owe it to themselves to examine Covenant's research and perhaps not accept at face value the common investing wisdom of the day. Most alternative investment disclosures include a qualification that you should not put money at risk if you are not prepared to lose it. If the investment is a risk it should offer an appropriate upside. F