An enterprise whose time has come

The world's largest hedge funds today are invariably managed futures

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For India's business classes and professionals, expanding their investment portfolio has been a big issue in recent times. Beyond fixed income and equities, traditional asset classes like 'gold' and 'real estate' have not been giving the kind of reward: risk equations and, therefore, new avenues of portfolio risk mitigation are actively being sought. Managed futures in these times could be just the answer they are looking for.

Globally, managed futures, which is as large or slightly larger than the equity long/short hedge fund category everyone in India is aware of, has been used for long by hedge funds and even large institutions, to mitigate risks. The very term 'hedging' means to mitigate risk, which means that futures can be used to lower risk, rather than increasing risk as most people think. In fact, if used intelligently, 'managed futures' present lower risk than normal equity investments and are thereby used to create superior reward: risk equations in investing.

It is no coincidence then that some of the world's largest and most successful hedge funds are managed future funds. For example, Bridgewater, the world's largest hedge fund, ($150 billion) has its original roots in managed futures. It has, over the years, transitioned into more of a global macro fund, though largely systematic and quantitative like a majority of the larger managed futures funds. Winton ($30 billion) is another example of a successful hedge fund, which operates purely on the managed future model.

The beauty of such funds is that they don't need markets to go only up to make money; they can make money even in falling markets, as they try to capture momentum in the markets, irrespective of up or down direction. Due to this nature of such funds, they are the only category of hedge funds that have been positive and delivered strong returns during all major crisis events globally, whether it be the dotcom crash in the early 2000s or the global credit crisis in 2008.

The long-term track record of such funds is quite attractive, which means that, if they are added to a portfolio of equities and fixed income, which are the normal parts of one's portfolio, then they have the effect of increasing portfolio returns, while reducing portfolio risk, because they tend to do well when equities do not, while having good risk-reward ratios.

'Derivatives are weapons of mass destruction' is a quote most people have heard, especially since it was said by Warren Buffet, the famous and much respected father of fundamental investing, who has the best long-term track record at large Assets under management (AUM) in history. However, few are aware that Buffet himself has sold long-term 'put' options on S&P500 Index, with the logic that it is a long-term bet, which will gain as long as US equity markets are stable to upward rising, which is in line with his overall philosophy/thought process/objective for investments.

Of course, such investments can backfire badly, if excessive leverage is used, which was the case in the US credit crisis. This has also been the case with many experiments done in India. However, as is the case with any investment, bad planning and over-aggressive and over-optimistic assumptions are fraught with risks. Risk management for situations, where things go opposite to the expected direction, should ideally be common sense and a lack of it does not take away from the benefits of the instrument itself.

Furthermore, these strategies focus on liquid futures markets meaning that if an investment has to be exited or a position has to be exited, it is easy and fast for such funds to do so unlike many illiquid strategies, where this problem gets aggravated in tough times.

The spirit of enterprise has always taken this country forward and managed futures is an enterprise whose time has come, we believe; one which will fire future private growth investments in the country, which is so lacking today. ◆

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