

Protecting Against Inflation With Futures Contracts

Which is The Best Course of Action - Active or Passive?

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Introduction

The Conventional Wisdom

- It is common to hear the argument that managed futures offer uncorrelated returns to broad equity and fixed income markets, while at the same time producing solid absolute and risk adjusted returns, with the conclusion being actively managed futures offer a compelling institutional investment.
- Although these assertions are generally true, they have little to do with the role of actively managed futures as a hedge against inflation. Just because an investment strategy uses futures contracts, which are well known to protect against inflation, that does not mean such strategy will necessarily serve as an inflation hedge.
- We must keep in mind what one does with a particular investment instrument is more important than the instrument itself.
- On the following pages we demonstrate how passively managed futures serve as better inflation hedge than actively managed futures. Moreover, we recommend the most efficient passive futures index in order to pursue this goal.

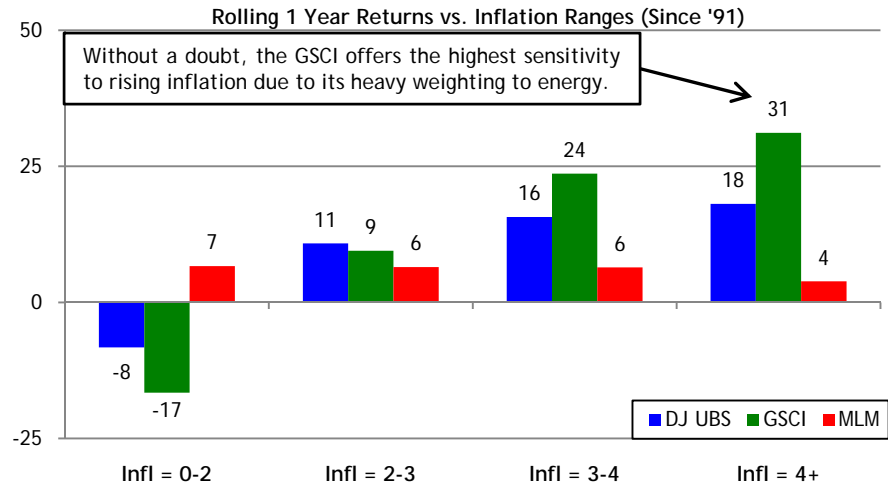
Summary of Indices Used in This Study

- MLM (Mount Lucas Management) - Active Strategy
 - The 'MLM' index is a mathematically derived futures trading strategy incorporating virtually all liquid futures contracts extant. This index was chosen as one of the longest standing representations of an actively managed futures account, and is likely to represent the overall behavior of an actively managed futures strategy using both long and short positions.
- Dow Jones UBS Commodity Index - Diversified Passive
 - The 'DJ UBS' index is a long only production weighted index of 19 major commodities, and is constructed to avoid concentrated exposures. No related group of commodities (e.g., energy, precious metals, livestock or grains) may constitute more than 33% of the index. No single commodity may constitute less than 2% of the index
- S&P GSCI Commodity Index - Concentrated Passive
 - Unlike the DJ UBS, the 'GSCI' is liquidity weighted based on the transaction volume of various futures contracts. It consists of 24 long only commodity futures, and as a result of being liquidity weighted, is approximately 70% invested in energy.

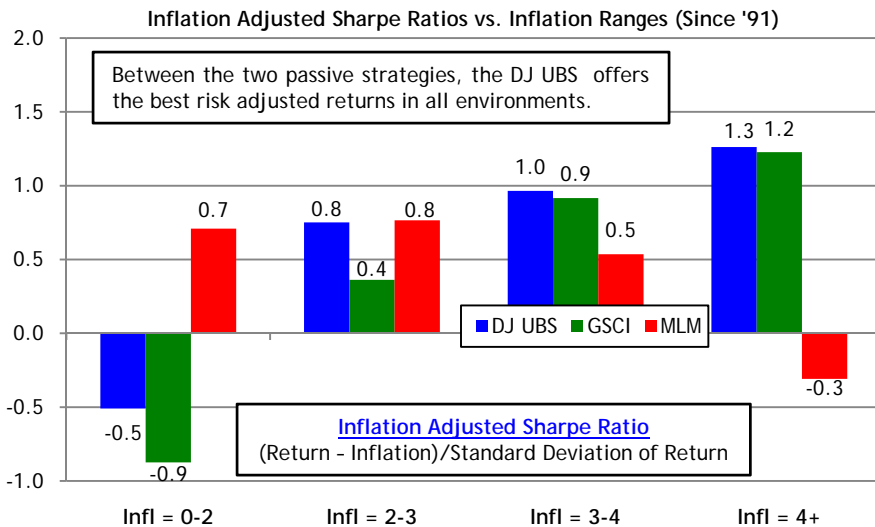


Efficiently Utilizing Futures to Protect Against *Short Term* Inflation

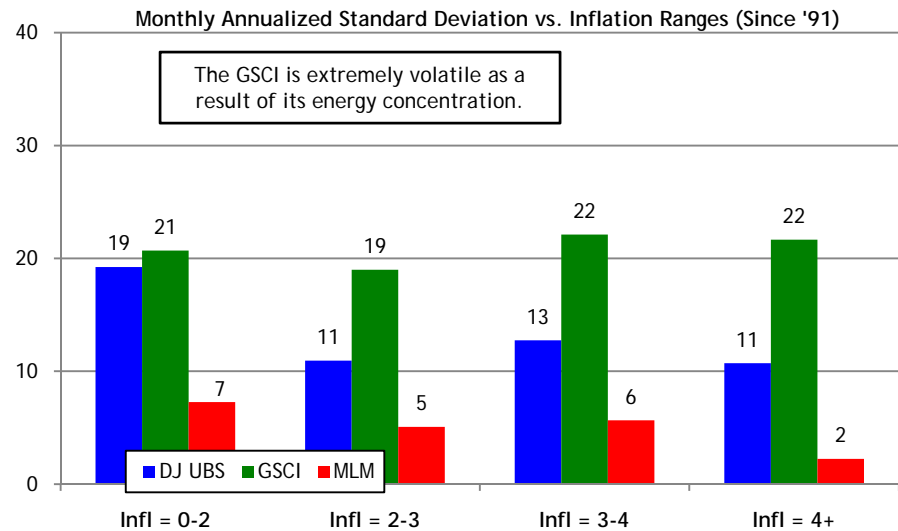
- From the standpoint of an institutional fiduciary, deploying assets in the most efficient manner is of utmost concern.
- Moreover, allocations should be implemented with the greatest likelihood of achieving a specific goal; i.e., hedging inflation.
- Analysis reveals a passive exposure provides not only the best sensitivity to rising (or higher than normal) inflation, but also a far more efficient risk/return profile.
- What is also interesting to note is the DJ UBS offers the best risk adjusted returns (or inflation adjusted Sharpe ratio).
- After all, it is only logical to see the risk adjusted benefits of a diversified vs. a concentrated investment.



Source: Ibbotson, MLM, Wurts & Associates



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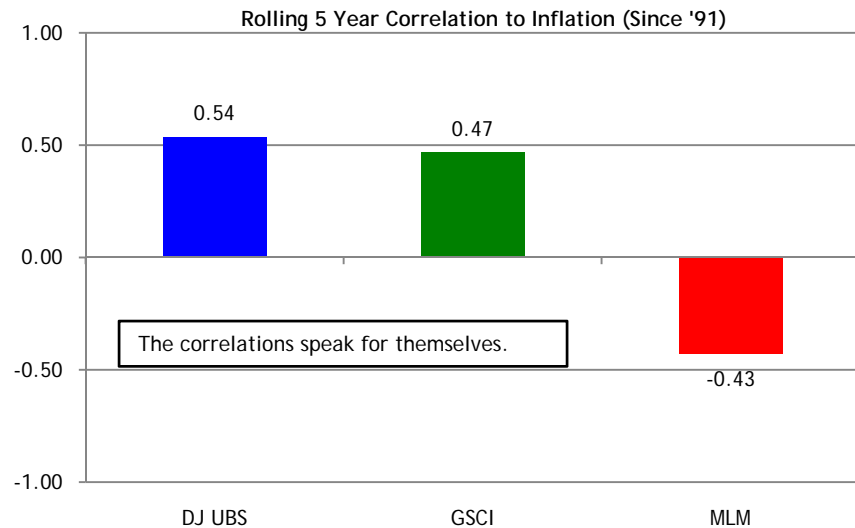


Source: Ibbotson, MLM, Wurts & Associates

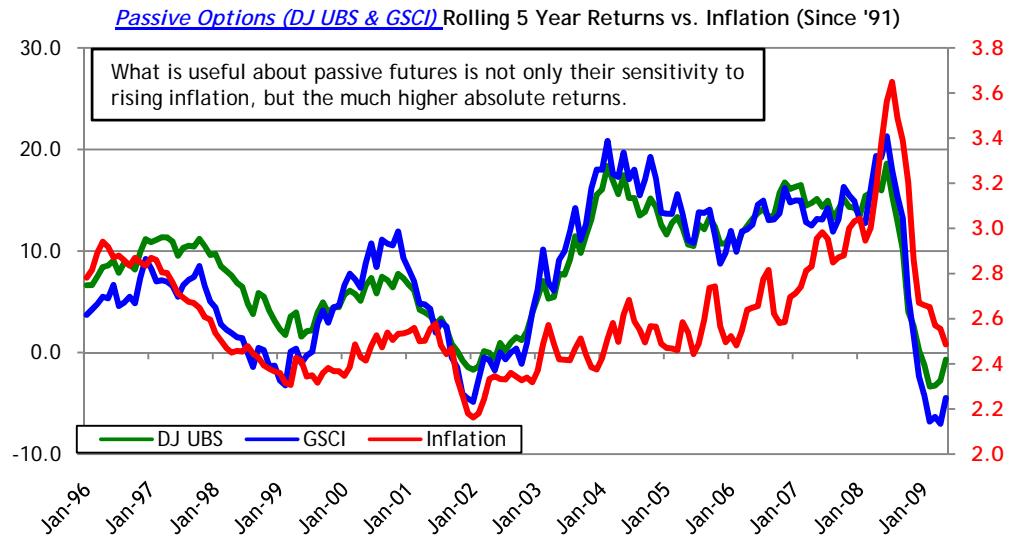


Efficiently Utilizing Futures to Protect Against Secular Inflation

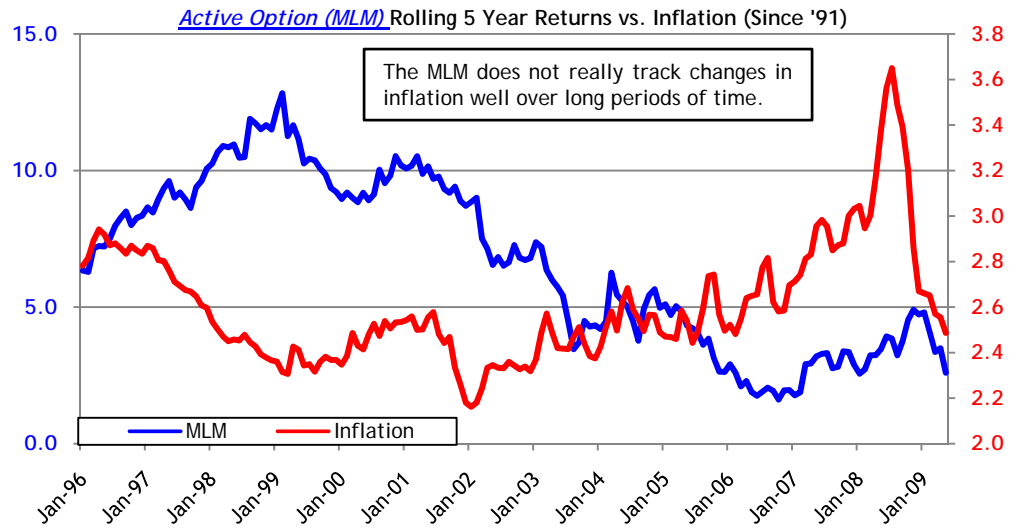
- Because it is very difficult to predict the exact timing of a resurgence of inflation, or the length thereof, consideration must also be given to protecting against a longer term (or secular) rise in inflation.
- Analysis reveals a passive futures exposure is far more likely to track secular movements in inflation than an actively managed strategy.
- In fact, passive futures have a positive correlation to inflation, whereas actively managed futures have a negative correlation over time.
- More importantly though, passive commodities respond strongly to significant increases in inflation, which roll up to enhanced inflation protection at the total portfolio level.



Source: Ibbotson, MLM, Wurts & Associates



Source: Ibbotson, MLM, Wurts & Associates



Source: Ibbotson, MLM, Wurts & Associates



Concluding Thoughts

[Not an Admonishment of Actively Managed Futures](#)

- We cannot stress enough the conclusions of our research are not meant to detract from the potential benefits of actively managed futures in institutional portfolios.
- One must keep in mind that actively managed futures are far more a bet on manager skill with the goal of achieving absolute returns, than one of protecting against inflation.

[Efficiency of Returns is Our Primary Concern](#)

- It is obvious from historic returns, as well as basic logic, to believe the GSCI index will offer the highest absolute returns in the face of rising inflation. Because energy prices filter through all aspects of our economy, it only makes sense that an index concentrated in energy would be more sensitive to inflation than a more diversified approach.
- However though, on a risk adjusted basis the GSCI does not offer a superior return profile because of its lack of diversification.
- Moreover, a concentrated index presents serious rebalancing considerations due to the potential volatility of the underlying exposure (i.e., energy). Investors would be required to exercise far more effort to maintain target exposures relative to a diversified index.
- These factors are why we recommend the DJ UBS as our index of choice for a futures allocation to protect against inflation.

[Let's Not Forget About Implementation Issues](#)

- Because futures contracts are levered, cash management for the collateral in these strategies is an important consideration due to the potential value added/subtracted through implementation.
- Cash management strategies differ from firm to firm in both style and complexity, but can be boiled down to the following options:
 - None - Simply hold cash with no expectation of adding value
 - Duration - Make interest rate bets to beat the cash benchmark
 - Credit - Take credit risk relative to the cash benchmark to achieve a higher yield
 - Inflation indexed -US inflation protected bonds are used to beat cash (also a duration bet)

