

# The Strategic Role of Systematic Investing in Asset Management

(when the Sharpe ratio fails)

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The academic literature has given plenty of evidence about the benefits offered by “blending” managed futures into portfolios of stocks. The key diversification role offered by managed futures is made possible by the empirically verified low or null correlation between managed futures and stocks. This theoretical approach so far has been studied and developed within traditional portfolio theory.

Nethertheless there could be a less academic and more pragmatic angle under which all the matter of the benefits of managed futures could be analysed.

First of all, let’s take notice that the low correlation between managed futures and the major stock indices has three main sources:

- 1) many futures traded by futures traders are commodities lowly correlated to stock indices: gold, oil, currencies etc. may offer an exposure to “alternative” asset classes even though the applied investment philosophy is long-only or long-out;
- 2) most futures traders apply *systematic* investment methodologies which, even if applied only to stock index futures, represent by themselves a form of style diversification;
- 3) this is particularly true in the middle-long term if these systematic methodologies have a trend following nature because the joint features of “systematic” and “trend following” may allow significant gains in downside markets.

Point one does not require any special comment, having been broadly treated by the traditional portfolio theory.

Point two is still not fully understood even by many sophisticated investors.

First of all, let’s try to define what a systematic investment model is: it is a model which does not try to forecast the future of the markets but fits their current behaviour on the basis of rules defined after a backtesting process. The key feature of a systematic model is avoiding the “strategic” mistakes of discretionary portfolio management (typically caused by fear, greed and personal ego), such as maintaining an important long position in a *primary* bear market. Avoiding investment mistakes due to the psychological fragility of the human nature is itself a form of “behavioural” diversification in investment styles. We could draw a picture parallel to the art of chess playing: computers, even though programmed by men, very often defeat men playing chess. Some (few) champions beat computers, but computers usually defeat men. Computers do not have emotions and can store all the possible game combinations. The same occurs in systematic investing.

Let’s come to point three. The trend following investment philosophy typically is based on the idea that nobody can forecast market turning points with systematic accuracy but that market trends somehow may be ... “followed”. John Henry, a famous futures trader who was a pioneer in trading futures with systematic trend following techniques, once explained this concept in a very clear way:

“I don’t believe that I am the only person who cannot predict future prices. No one consistently can predict anything, especially investors. Prices, not investors, predict the future. Despite this, investors hope or believe that they can predict the future, or someone else can. A lot of them look to predict what the next macroeconomic cycle will be. We rely on the fact that other investors are convinced that they can predict the future, and I believe that’s where our profits come from. I believe it’s that simple”

If you start from the assumption that markets' turning points can not be predicted with accuracy but that markets follow middle-long term trends which can be "followed" and exploited through systematic methodologies, these methodologies may be strategically used in order to balance the losses coming from traditional investments during downside trends in stock markets.

Look at the picture here below: it represents the composite performance of seven famous futures traders (including John Henry) who adopt trend following methodologies. Up to the end of year 2000 the comparison between their pro-forma composite return and S&P 500 return was not positive because their composite volatility was clearly higher than the index volatility, being the return about the same. A selection of asset classes based brutally on the Sharpe ratio, Treynor index and the like would have brought to the choice of an index fund rather than a basket of these traders because of the same return but higher volatility compared to that of the S&P 500.

You have to understand that higher volatility is the price you have to pay in order to catch the next unpredictable primary/secondary bear market. Middle to long term trend following systems are the best in this task and that is what really happened since the end of year 2000.

If you look at systematic investments as a form of "insurance" against ruinous losses of your traditional (long only) investments, then you may understand their "strategic" value and role in asset management. For example, you can blend systematic managed futures with private equity investments which, by their nature, can not be sold at the discretion of their managers even though they were able to foresee the turning points in equity markets.

Systematic investment methodologies may do (better: *must* do) mistakes which are intrinsic to their operating philosophy, which is the bad side of the story. The nice side is that these systems are self-correcting so that, if properly created by experienced model builders, they are able to recognise mistakes and reverse their positions on the markets without any emotions.

These self-correction capabilities and abilities of systematic investment models in catching middle-long term downside markets have a special strategic value for those asset managers who want to protect the value of their assets without giving up superior compound returns.

