

## Financial Advisor Magazine

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### Seeking Alternatives

*Managed futures generate interest as people pick up the pieces of their shattered stock and bond portfolios.*

By Jeff Schlegel

What's an easy way to lose money in the markets? Try investing in futures. According to one oft-quoted statistic, somewhere between 66% and 90% of individual investors who speculate in commodity futures lose money.

Yet one area that's generating recent buzz is managed futures, complicated investment vehicles managed by commodity trading advisors (CTAs) who invest in a range of global futures markets. CTAs are individuals who get paid for advising others about buying or selling futures contracts or commodity options. They're regulated by the Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA), the self-regulatory organization of the futures industry.

Alternative investments in general are in demand these days as people pick up the pieces of their shattered stock and bond portfolios and seek other investment solutions. Managed futures have been around for about 30 years, mostly within the domain of large institutional investors or accredited individual investors who can afford the sizable initial minimums, which often hit the six- or seven-digit range for individual accounts.

But a growing number of private and public investor pools in the form of limited partnerships or limited liability corporations have made managed futures more accessible to others, with lower minimum investments and, in theory, less risk because it is spread among a larger group of investors. And the recent rollout of mutual funds pegged to managed futures indexes could even open up this market to Main Street investors.

Assets in managed futures ballooned from \$31 million in 1980 (when stats were first kept) to \$206 billion by year-end 2008, according to Barclay Hedge Ltd., a Fairfield, Iowa-based company that tracks the alternative investment universe.

And the performance track record looks impressive. According to Bloomberg, managed futures gained roughly 5,000% from 1980 to May 31, 2009, while the S&P 500 gained only about 750%. The compound annual return since 1980 on the Barclay CTA index is slightly more than 12%, and it posted negative returns in only three of those years.

CTAs invest in a broad universe comprising six major markets—currencies; interest rate products such as government bonds; stock indexes; metals; energy; and agricultural commodities.

Managed futures are pitched as a way to lower portfolio risk by investing in asset classes with low correlation to stocks and bonds. And their ability to take both long and short positions makes them nimble in either bull or bear markets. "We like managed futures because they can go long on anything from a couple of hours to a couple of years, or you can do a combination of both in the same market," says Lou Stanasolovich, president of Legend Financial Advisors in Pittsburgh. "For example, they can short oil for the next few weeks if they see a negative trend, but they can buy long contracts if they think oil will rise in the next few years."

#### Going Against The Flow

The managed futures industry likes to tout a 1983 study by the late Harvard professor John Lintner concluding that "judicious" investments in leveraged managed futures can decrease the risk and enhance the returns of traditional portfolios of stocks and bonds.

Of course, leveraged managed futures can result in hefty losses, too, because investors can lose more than their initial investment. But at least one measure of historical data seems to support the non-correlation claim. According to Barclay Hedge, since 1980 managed futures have had a zero correlation with the S&P 500, a 0.14 correlation with U.S. bonds and a 0.16 correlation with global bonds.

"Non-correlation isn't the same as negative correlation," says Ken Steben, president of Steben & Co., a Rockville, Md.-based investment advisory firm specializing in managed futures. "It doesn't mean that every time the stock market goes down that

we're up, or vice versa. It means they march to a different drummer."

Still, in each of the six worst market downturns since 1980, managed futures as an asset class produced gains (as measured by the CISDM Trading Advisors Qualified Universe index). That includes the recent crash from October 2007 through February 2009, when the S&P 500 lost 52.6% while the managed futures index gained 28.3%.

Sounds too good to be true. "We're not a miracle, we don't have Madoff-type numbers," says Steben, whose company evaluates and hires CTAs to trade accounts for its managed futures funds. "We go up and down. But if you took the industry's long-term track record and called it something else, we'd have a bigger audience. It's just that people don't really understand what we do."

Indeed, many investors are uneasy with the concepts of futures and limited partnerships (and in investor pools, managed futures are funds wrapped in limited partnerships). While the track record of managed futures looks appealing, these complex beasts can be dangerous for the uninitiated—and sometimes, evidently, for the supposedly initiated, too.

Sol Waksman, president of Barclay Hedge, estimates that 15% to 20% of CTAs drop out of the business annually, thus his firm's CTA index replaces about 15% of its constituents every year. Barclay's database keeps track of nearly 1,000 CTA programs, but the Barclay CTA index tracks only half of that number because it includes only those CTAs with at least a four-year track record.

Waksman attributes the high failure rate to undercapitalized firms lacking the funds to go the distance. Critics contend this creates a survivor bias that skews the Barclay CTA index toward the better firms.

"Imagine if the S&P 500 never included all of the negative returns this year," says Christopher Van Slyke, partner and co-founder of Trovena LLC, a multi-family office in La Jolla, Calif. "You're purposefully biasing your index toward the survivors and not reporting abject failures, which totally distorts the numbers."

Naturally, Waksman disagrees. "If GM and Chrysler are removed from the Dow or S&P, does that introduce any kind of bias into those indexes?" he asks. Waksman adds that the Barclay CTA index's systematic construction means that it includes dogs as well as winners, just like any stock index. "There are managers in the index you wouldn't want to give money to," he says. "But they keep reporting, so their numbers are in the index, and that drags it down."

Van Slyke isn't a fan of managed futures. "This is the same active-management shell game you see all over Wall Street, but I think it's particularly egregious in managed futures because there really isn't any intrinsic value in futures," he says. "If you want to go long in commodities, buy a gold fund or ETF. At least that has some intrinsic value."

His doubts are shared by others. "An asset class should be different from other asset classes without the need for an active manager to be successful," says Michael Dubis, a certified financial planner in Madison, Wis. "If it requires a human being to make the decision on correlation offset and he gets hit by a bus, then we're S.O.L."

### **Active Management**

For sure, a bet on managed futures is a bet on the skill of the CTA who's calling the shots. "It's not a question of whether managed futures work—the overwhelming evidence says they do," Steben says. "But the issue is you could buy the wrong manager if you don't know what you're doing."

Along with being regulated by the CFTC and the NFA, CTAs must pass the Series 3 exam on futures proficiency administered by the NFA. They must have clean records; they're fingerprinted and the results are run through the FBI database.

Evaluating CTAs isn't an easy process, particularly since many of the best ones run private funds with sparse disclosure. Barclay Hedge has an in-depth CTA database that's available for a fee. But as Waksman indicates, some CTAs could be dangerous to your financial health. So, what to look for?

"If you rank, examine and parse the CTA universe, you'll find the top 10% are significantly superior to the rest of the pack, and the top 3% are even more so," says Milton Klein, director of futures investments at Reliance Capital LLC, a Harrison, N.Y.-based guaranteed introducing broker of the clearing firm R.J. O'Brien.

Klein helps clients establish managed futures accounts and select a CTA to run those accounts. He says investors should look for CTAs who have a credible track record of three or more years and who use a systematic, computer-based trading system with a rules-based approach. "The idea," he says, "is to have preset stop-losses and maybe preset profit targets to let the profits run and keep the losses short to minimize drawdowns [volatility.]" He adds that the best CTAs tend to have strong backgrounds in mathematics and engineering, and some have physics degrees.

CTA investment strategies fall into two main groups: trend followers and market-neutral traders. The latter seek profits by arbitraging the spreads between various financial and commodity markets. One example would be trying to trade differences between similar markets such as the Brent Crude and West Texas Intermediate oil classifications.

But most CTAs are trend followers. Some use discretionary systems based on fundamental data and the CTA's discretion. Most employ automated technical trading systems based on objective, preset rules.

"What makes money in managed futures is when you have a number of markets in clear upward or downward trends," Steben says. "But after huge trends in 2008, there haven't been any clear trends this year." Based on initial reports, the Barclay CTA index had forecast slightly negative returns for the first half of 2009.

### **Risk/Reward**

Drawdown, or the amount a fund dips into negative territory, is one of the key gauges of CTA performance. As measured by the Newedge CTA index, the worst drawdown rate suffered by managed futures in any measurable period from November 1990 through June 2009 didn't exceed -10%. Meanwhile, the worst drawdown rates for some of the major indexes during this time included -51% for the Dow, -55% for the S&P 500, -57% for the MSCI World and -79% for the Nikkei 225.

"We look at how CTAs manage their risk in tandem with their track record," says Peter Pacult, director of managed futures at Futures Investment Co. in Fremont, Ind., a company that helps place investors in managed futures accounts. "We look at how often they're up, and how much do they go down when they drop."

They also analyze a CTA's operations to make sure it has sufficient backup systems. "A lot of CTAs are really bright guys who put together a small team," he says. "But you want to be careful that they aren't just a few guys and an office because if they lose power when they have open trades, then they can't see those trades."

And depending on the program, CTAs can make hundreds of trades a day. By contrast, the few available mutual funds in this area track managed funds indexes and rebalance their positions monthly. The Rydex/S&P Managed Futures Strategy fund tracks the S&P Diversified Trends Indicator index, which is evenly divided between commodities and financials. In June, the company launched its Long/Short Commodities Strategy fund based on a JPMorgan long/short commodity index. Both require \$25,000 to open an account directly, or \$2,500 to invest through a broker-dealer.

Other funds include the Direxion Financial Trends Strategy Fund (which debuted in March and tracks the S&P Financial Trends Indicator) and the Direxion Commodity Trends Strategy fund (which follows the S&P Commodity Trends Indicator). Both funds have a \$2,500 minimum.

Doug Lockwood, chief investment officer at Cornerstone Wealth Management in Auburn, Ind., began using the Direxion Commodity Trends Strategy fund last year as a commodities play that can capitalize on both inflationary and deflationary environments. "It made us quite a bit of money last year," he says, "but it hasn't done so well this year."

The fund gained roughly 10% last year after its June debut, but was down 10% in this year's first half.

"These funds are a simplistic version of a very complex investment style, but they're not more or less risky than other managed futures vehicles," says Nadia Papagiannis, a hedge fund analyst with Morningstar.

### **Fees**

Managed futures aren't meant to be trading vehicles—most provide liquidity only at the end of each month. As for taxes, these are Section 1256 contracts with earnings taxed on a percentage basis of a 60% long-term capital gains rate and a 40% short-term capital gains rate every year—even if nothing is sold.

"Depending on the person, they may or may not be best suited within an IRA," says Lou Stanasolovich of Legend Financial Advisors.

Because of their complexity and high-risk margin accounts, individual managed futures accounts are limited to institutions and accredited investors. Investment minimums for these accounts can range from the low six figures to \$5 million. Investment pools, or limited partnerships, often require minimums of \$25,000, and some are less.

But fees are onerous across the board. CTAs typically charge a 2% management fee, plus a 20% performance fee based on any new profits. And annual fees from introducing brokers, or from a manager of managers that oversee managed futures accounts for investors, can range from about 1% to 6%.

"The fees are high," says Ken Steben. "But all reported returns are net of fees."

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