# Top 5 List - Why Managed Futures?



Futures may be used to manage the risk of volatile investments and to capitalize on speculative opportunities associated with that volatility. But the fast-paced and increasingly sophisticated nature of futures markets sometimes renders it difficult for all but the most adept institutional and retail investors to take full advantage of these markets.

Thus, many prospective investors have turned to managed futures as a means by which to harness the best professional trading talent in the pursuit of profitable futures trading opportunities. The managed futures industry has flourished from the 1980s through to the present day as a logical outlet for such investment demand. This article describes that growth and discusses our "top 5 list" of reasons why investors should be interested in managed futures investments.

**Top 5 List - Why Managed Futures?**

1. **Potentially attractive returns**
2. **Superior reward/risk ratio through diversification beyond traditional stocks and bonds, reducing portfolio volatility**
3. **Possibility of returns in both bull *and* bear markets**
4. **Exposure to all major asset classes around the globe including interest rates, equities, currencies, energy, agricultural commodities**
5. **Invest with confidence that industry is regulated and trades largely on regulated futures exchanges**

***Origins*** - Investors have accessed managed futures for over 60 years. The first managed futures account is attributed to the noted technician Dick Donchian dating back to perhaps 1948. Much of the early interest came from retail investors who would open up separately managed accounts with particular professional commodity traders, commonly referred to as Commodity Trading Advisors (CTAs); or, by investing in commodity pools administered by Commodity Pool Operators (CPOs).

In more recent years, institutional investors such as corporate and public pension funds, endowments, trusts and banks have driven the expansion of the managed futures industry, recognizing the managed futures represent an important component of a well-diversified portfolio.

The trading activity of CTAs is often guided by technical trading systems. These systems are based on historical price patterns, and may include moving average, price channel, and momentum systems. Generally speaking, these systems may be thought of a trend following in nature – the ability to detect reversals in market momentum, *i.e.,* successfully to apply contrarian systems, being rather rare and extraordinary.

***Investment Structures*** - While one may retain the services of particular CTAs by opening separately managed accounts, it has become more commonplace to participate in a fund or limited partnership designed to administer futures investments and managed by a single or multiple CTAs under the direction of a CPO.

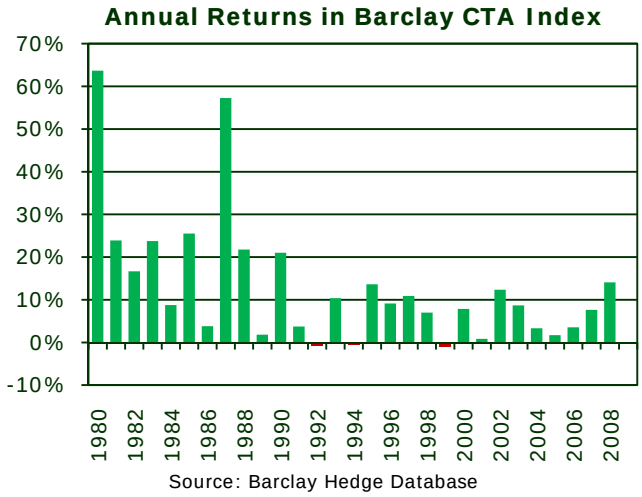
Managed futures funds, commodity funds or commodity pools (these various terms may be considered synonymous) aggregate the monies of multiple investors for the purpose of speculating in futures and options markets. These funds or pools are organized and managed by CPOs. CTAs may be employed by the CPO to direct the day-to-day trading of the fund or a portion thereof. This leaves the CPO free to concentrate on other significant activities including fund raising, accounting, evaluation and on-going monitoring of CTA performance, relying upon the professionalism and experience of CTAs devoted to trading activities.

A CTA may be thought of as performing the same function as a stock manager or mutual fund manager. The investor effectively employs, or assigns power of attorney over his funds to, the CTA to manage his investment on a discretionary basis. CTAs typically utilize the global futures markets as their primary investment or trading vehicles in the pursuit of profitable opportunities.

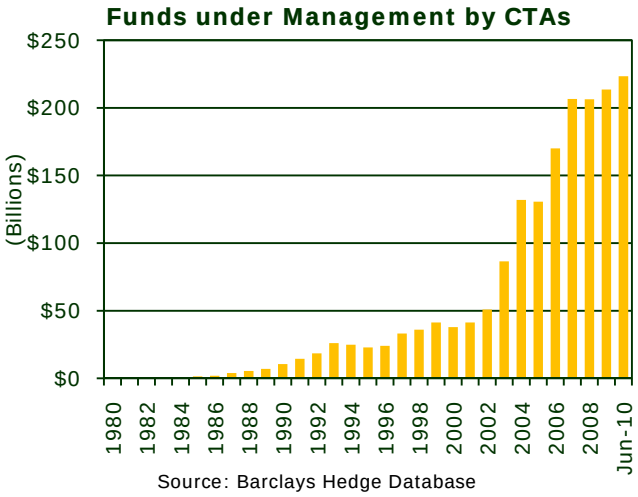
Managed futures investments may also be referred to as commodity funds, futures funds or commodity pools. The terms "CTA," "CPO" and "commodity pool" originate with the United States Commodity Futures Trading Commission (CFTC) – and may generally be applied to describe these specialized endeavors. However, other regulatory jurisdictions may apply somewhat different nomenclature to describe these activities.

***Industry Growth*** - Concomitant with the growth of the futures industry in general, investment in managed futures skyrocketed since the early 1980s. Barclay Hedge, formerly The Barclay Group, is a research organization specializing in monitoring the

performance of CTAs and hedge funds. Barclay Hedge follows the performance of the managed futures industry as a whole, by various categories and on a granular basis by following the progress of specific CTA programs. [1]




Barclay Hedge produces, amongst many other indexes, its flagship Barclay CTA Index, which may be referenced as a benchmark of CTA performance. As evidenced by our graphic depicting annual returns in the Barclay CTA Index, the industry has generally produced attractive returns on an annual basis. The year 2008 saw a decline of -0.10% in the value of the index but this was after a +14.09% return in 2008 when stocks were declining sharply.




Because of the generally attractive performance posted by the industry, Assets under Management (AUM) held by the CTA community has grown nicely over the years. As of the conclusion of the 2nd quarter of 2010, the industry held some $233.4 billion in AUM.

***Attractive Returns*** **-** Professor Franklin Edwards of Columbia investigated the performance of managed futures in order to assess their utility as an asset class. His conclusion was that managed futures "make both attractive stand-alone investments and portfolio assets."

In order to test that proposition, we examined the returns associated with investments in stocks, bonds and commodities during the twenty plus year period from December 31, 1979 through October 2010. Specifically, we used the following indexes as measures of returns in the U.S. equity, fixed income and managed futures markets, respectively…

- *Standard & Poor's 500* - Is widely recognized as the leading benchmark for measurement of domestic equity investments. We reference the total return version of the S&P 500 that is inclusive of both price fluctuations and accrued dividends as a proxy for equity returns.

- *Barcap U.S. Aggregate Bond Index* – Or simply the "Barcap Agg Index" represents a composite index aggregating the total returns associated with U.S. Treasuries, agency obligations, corporate bonds and notes, mortgage instruments and other investment grade U.S. dollar denominated fixed income securities. This Index represents the leading benchmark by which one might measure returns associated with domestic fixed income investments. Note that the Barcap Agg Index was formerly known as the Lehman Bros. Agg Index.

- *Barclays CTA Index* - Is a leading managed futures industry benchmark of representative performance of commodity trading advisors. There are currently 533 programs included in the calculation of the Barclay CTA Index, which is unweighted and rebalanced at the beginning of each year. To qualify for inclusion in the CTA Index, an advisor must have four years of prior performance history. Additional programs introduced by qualified advisors are not added to the Index until after their second year. These restrictions, which offset the high turnover rates of trading advisors as well as their artificially high short-term performance records, ensure the accuracy and reliability of the Barclay CTA Index. The Index includes traders who are diversified

[1] See website at www.barclayhedge.com.

using all major futures contracts worldwide as well as traders who specialize in agricultural, currency and financial/metal products. The Index further represents discretionary traders as well as systematic traders. Table 1 below provides a summary of the components of the Index. Note that Barclay Hedge, as the publisher of the Barclay CTA Index, is not affiliated with The Barclays Capital, the publisher of the Barcap Agg Index.

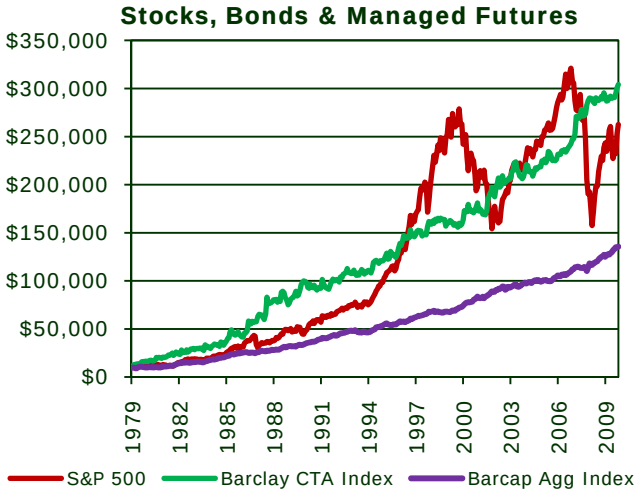
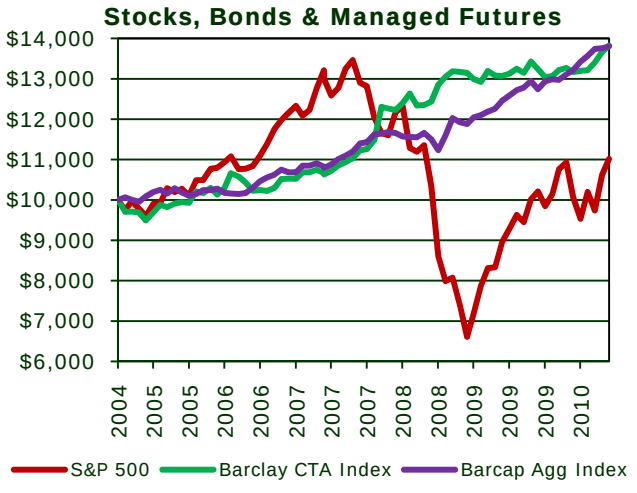



Table 2 provides a summary of monthly returns experienced in stock, bond and managed futures investments as represented by the three indexes over the period from December 31, 1979 through October 2010.




The average monthly return associated with the Barclay CTA Index was 1.02% and superior to the 0.99% return associated with stocks; and, the 0.72% return associated with bonds. If one had invested $10,000 in stocks, bonds or managed futures on December 31, 1979, one's investment might have grown to $262,532; $135,547; or, $304,128, respectively.

Of course, returns are always very "period dependent." For example, if one had invested $10,000 in stocks, bonds or managed futures as of December 31, 2004, one's investment might have grown to $11,013; $13,805; or, $13,822 by the conclusion of October 2010. See Table 3 for details.

***Reduced Portfolio Volatility*** **–** The argument in favor of managed futures as an investment vehicle was perhaps best and most succinctly stated by Professor John E. Lintner of Harvard who found that inclusion of futures in an investment portfolio "reduces volatility while enhancing return." Further, such portfolios "have substantially less risk at every possible level of return than portfolios of stocks, or stocks and bonds."

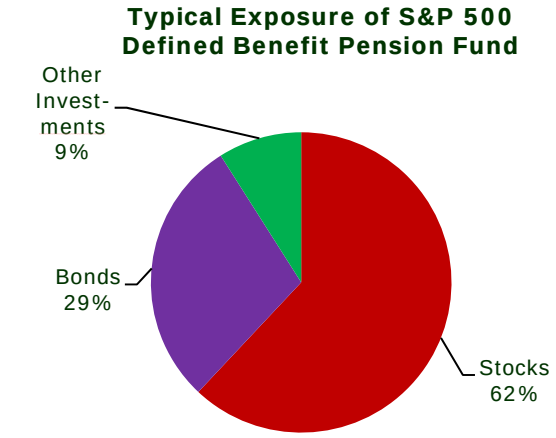
As might be expected, the volatility of managed futures investments … as represented by the standard deviation of monthly returns … likewise exceeds the volatility associated with a bond investment but is somewhat less than the standard deviation of stock returns. Further, the maximum monthly drawdown of a managed futures investment has generally been less than that associated with stock investments albeit a bit more than that associated with bond investments. (See Tables 2 and 3 below for performance information from Dec-79 through Oct-10; and, from Dec-04 through Oct-10, respectively.)

When a managed futures investment is combined with investments in "traditional" asset classes such as stocks and bonds, the portfolio diversification generally results in reduced portfolio volatility. This phenomenon is attributable to the fact that managed futures tend to carry a very low or slightly negative correlation with traditional stock and bond investments.

Note that monthly returns in managed futures, as represented by performance of the Barclays CTA Index were not correlated with returns associated with the S&P 500; or, with the Barcap Agg Index during the periods Dec-79 through Oct-10; or, from Dec-04 through Oct-10. (See Tables 4 and 5 below for detailed correlation information.)

The central premise of Modern Portfolio Theory, as articulated by the Nobel Prize winning economist Dr.

Harry M. Markowitz, is that efficient investment portfolios may be created through the process of diversification amongst asset classes with low or negative correlations.

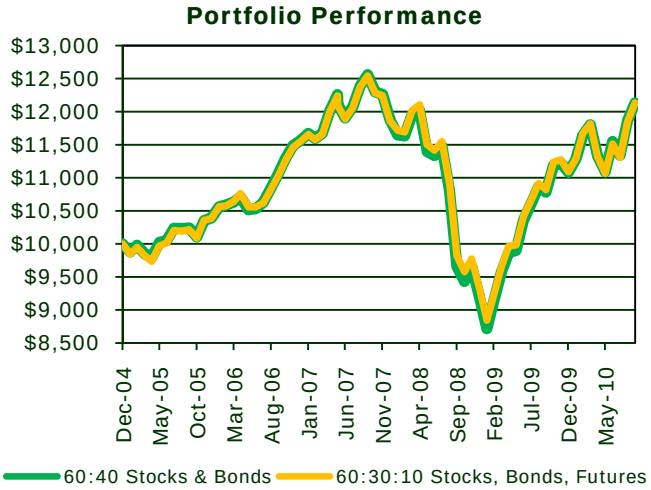



Source: Credit Suisse Asset Management, "Alpha Management

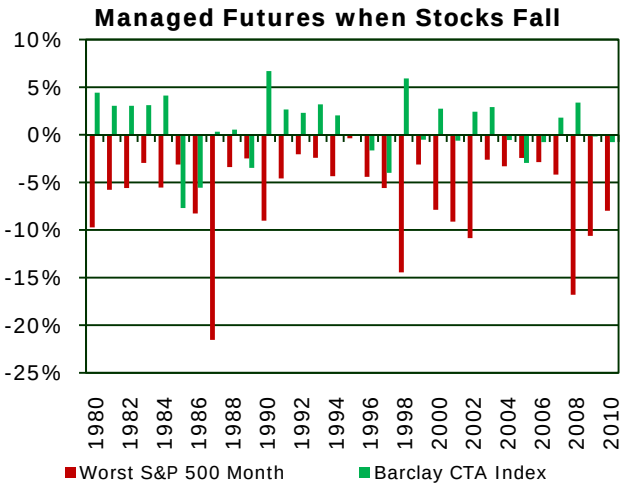
Diversification has, in fact, become a well established investment strategy practiced by institutional pension plans. For example, the defined benefit pension funds of the corporations which comprise the S&P 500 is typically comprised of approximately 60% stocks; 30% bonds; and, 10% "other investments," including commodities and real estate.

***Testing the Proposition*** – In order to test the diversification powers of managed futures investment, we tested two pro-forma portfolios. The first portfolio consisted of a 60% allocation to equities and a 40% allocation to bonds. The second portfolio was comprised of a 60% allocation to equities; 30% allocation to bonds; and, a 10% allocation to managed futures. We tracked the hypothetical performance of these two investment strategies from Dec-04 through Oct-10.

Table 6 below summarizes the performance of these two portfolios. An investment of $10,000 in the 60:40 stock:bond might have grown to $12,130 from Dec-04 through Oct-10. A similar investment of $10,000 in the 60:40:10 stock:bond:futures portfolio might have grown to $12,131. While the average monthly returns of these two portfolios at +0.31% are essentially equivalent, it is noteworthy that the variability associated with the portfolio inclusive of a relatively small 10% allocation to managed futures was notably less than the portfolio that did not include managed futures. Further, the maximum monthly drawdown of the portfolio that did not include managed futures was significantly greater than the maximum drawdown of the portfolio that was inclusive of managed futures.




It is further intriguing that managed futures investments often perform well when "mainstream" equity investments perform poorly. For example, managed futures reported a return of +14.09% return in 2008 when stock returns were -36.99%. Following this premise, we discovered that managed futures investments frequently post an attractive return during the single month of the year when stocks experienced their worst drawdown of the year.




Lintner reinforces these notions … "combined portfolios of stocks (or stocks and bonds) after including judicious investments…in leveraged managed futures accounts show substantially less

risk at every possible level of expected return than portfolios of stocks (or stocks and bonds) alone."

***Bull or Bear Markets –*** CTAs have the capacity to go long or short any particular commodity traded in the form of a futures contract. As such, CTAs may profit in either a bullish or bearish economic environment. During periods of high inflation, for example, hard or tangible or physical commodities including items such as gold, silver, crude oil may rally significantly. During periods of deflation or recession, one may very well take short positions in the same markets to profit from anticipated price declines. Finally, it is very possible to utilize options on these and other commodities to seek profit opportunities in flat or non-trending markets.

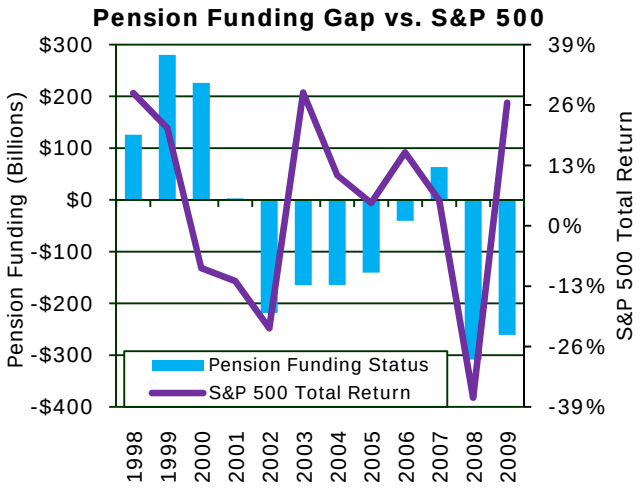
***Global Diversification*** – Globalization is a term that applies readily to today's futures markets. International futures exchanges invite diversification on the part of CTAs amongst a wide variety of products and currencies. A typical managed futures portfolio may hold positions in upwards to fifty different markets worldwide, covering stock indexes, interest rates, currencies, agricultural products, energy products, precious and base metals and others. Thus, CTAs have much opportunity to partake of the risk reducing benefits and profit potential associated with diversification as a stand-alone investment.

Note that CME Group offers the widest array of futures contracts of any exchange worldwide. Our offers span the gamut from short- and long-term interest rates, stock indexes, currencies, energy products, grains, livestock, metals and alternative investments. These products are distributed on a global basis through our state-of-the-art CME Globex® electronic trading platform.

***Regulated Industry*** – It is further noteworthy that the managed futures industry is strictly supervised in the United States by the Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA). In fact, the entirety of the futures industry is similarly regulated in the United States. Other jurisdictions in which futures may be traded usually are similarly regulated.

***Future of Managed Futures –*** We expect that the demand for aggressive and leveraged investment strategies, as might be pursued by CTAs, will be strong in coming years. This is underscored by the persistent gap between pension fund assets and the present value of their obligations.

Despite the fact that the S&P 500 posted an impressive total return in 2009, the funding gap between the present value of future obligations and assets held by the pension funds of the corporations that comprise the S&P 500 remains critical. The gap stood at $261 billion at the conclusion of 2009, an improvement from the $308 billion gap observed at the conclusion of 2010 but still a difficult gap to plug.




Source: Standard & Poor's

As such, we believe it is safe to conclude that these pension funds and other institutional and retail investors will continue to turn to levered trading and investment strategies as might be offered by the managed futures community.

*For more information, please contact …*

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**Table 1: Categorizing CTAs**

| | Assets Under Management (Jun-10) | Performance thru Oct-10 | No. of Programs |
|---|---|---|---|
| **TOTAL** | $223.4 billion | 4.10% | 533 |
| ***Markets Traded*** | | | |
| **Agricultural Traders** | $0.63 | 10.38% | 30 |
| **Currency Traders** | $17.48 | 3.57% | 119 |
| **Diversified Traders** | $104.01 | 5.01% | 335 |
| **Financial / Metal Traders** | $73.18 | 3.23% | 101 |
| ***Trading Style*** | | | |
| **Discretionary Traders** | $16.89 | 3.51% | 154 |
| **Systematic Traders** | $175.07 | 4.48% | 417 |

Source: Barclays Hedge Database

**Table 2: Monthly Returns**
**(Dec-79 thru Oct-10)**

| | S&P 500 | Barclays CTA Index | Barcap US Agg Bond Index |
|---|---|---|---|
| **Average** | 0.99% | 1.02% | 0.72% |
| **Standard Deviation** | 4.51% | 4.40% | 1.67% |
| **Maximum Return** | 13.47% | 29.26% | 11.34% |
| **Minimum Return** | -21.54% | -9.81% | -5.92% |

**Table 3: Monthly Returns**
**(Dec-04 thru Oct-10)**

| | S&P 500 | Barclays CTA Index | Barcap US Agg Bond Index |
|---|---|---|---|
| **Average** | 0.25% | 0.48% | 0.47% |
| **Standard Deviation** | 4.78% | 1.55% | 1.02% |
| **Maximum Return** | 9.56% | 7.17% | 3.73% |
| **Minimum Return** | -16.79% | -2.95% | -2.36% |

**Table 4: Correlation of Monthly Returns**
**(Dec-79 thru Oct-10)**

| | S&P 500 | Barclays CTA Index | Barcap US Agg Bond Index |
|---|---|---|---|
| **S&P 500** | - | | |
| **Barclays CTA Index** | 0.0045 | - | |
| **Barcap US Agg Bond Index** | 0.2143 | 0.0139 | - |

**Table 5: Correlation of Monthly Returns**
**(Dec-04 thru Oct-10)**

| | S&P 500 | Barclays CTA Index | Barcap US Agg Bond Index |
|---|---|---|---|
| S&P 500 | - | | |
| Barclays CTA Index | -0.0852 | - | |
| Barcap US Agg Bond Index | 0.1603 | 0.0195 | - |

**Table 6: Monthly Portfolio Returns**
**(Dec-04 thru Oct-10)**

| | 60% Stocks & 40% Bonds | 60% Stocks, 30% Bonds & 10% Managed Futures |
|---|---|---|
| Average | 0.31% | 0.31% |
| Standard Deviation | 2.74% | 2.68% |
| Maximum Return | 4.77% | 4.87% |
| Minimum Return | -10.65% | -9.92% |