

## Investing for the Long Haul? Part 2

### Making Choices along the Managed Futures Trail

By Maggie Finnerty



Last month, in the first of this three-article series, the concept of managed futures was introduced – what they are and how adding managed futures to a portfolio can potentially lower volatility and increase returns. That’s just the start, though. Anyone intending to make use of managed futures really needs to consider several things before building a portfolio.

Two important considerations are whether to consider notional funding and, if so, how much to use, and second, how to structure an account. The understanding of these topics will go a long way in clarifying the process of investing for the long haul with managed futures.

#### The First Consideration: What Is Notional Funding?

Notional funding is the term used for funding an account below its nominal, or face value. Anyone who has been involved in futures, options or foreign exchange knows that an account with a nominal value of \$1,000,000 does not necessarily mean that there is \$1,000,000 cash in the account. Accounts may be funded for less than the \$1,000,000 as long as the cash deposited meets the margin requirements set by the exchange or the futures commission merchant (FCM). The difference between the nominal value and the cash actually deposited is called notional funding.

To illustrate, assume a commodity trading advisor (CTA) has a minimum nominal amount of \$1,000,000, and the margin requirement is \$50,000. The investor can either deposit \$1,000,000 to fully fund that minimum investment requirement or, alternatively, can invest only a portion of the \$1,000,000, as long as that meets the \$50,000 margin requirement.

Assume that the investor decides to fund the \$1,000,000 account with \$100,000. This means that the investor is using leverage of 10X –  $10 \times \$100,000 = \$1,000,000$ , the minimum investment. The difference between the nominal value (\$1,000,000) and the cash deposited (\$100,000) is \$900,000. The \$900,000 is referred to as notional funding.

Investors are interested in using notional funding because the notionally funded amount (in this case, the \$900,000) is not borrowed or deposited—the cash (\$100,000) is a good faith deposit for the full value of the account. In other words, the \$100,000 trades as if it were \$1,000,000, even though the investor only deposited \$100,000 and is not paying interest or has not otherwise borrowed the remaining \$900,000. If the account is doing well, the investor earns money on the full \$1,000,000 – even though he only funded the account with \$100,000. If the account is not doing well, however, the investor is responsible for the amount lost, regardless of the cash the investor originally deposited.

For example, assume that the account has a profitable year, and the CTA reports profits of 20 percent ( $\$1,000,000 \times 0.20 = \$200,000$ ) for the fully funded account. The account that was only funded with \$100,000 also had \$200,000 in gains – but the investor’s profit percentage was 200 percent, because the investor earned \$200,000 on a \$100,000 investment.

Investors must be aware, however, that this is a double-edged sword. If the account has a drawdown, the investor will suffer a significantly larger percentage decline than the fully funded account. If the example above suffered a 20-percent drawdown for the fully funded account, the notionally funded account would have a 200-percent drawdown. In such a situation, the investor would not only have lost his initial \$100,000 investment, but an additional \$100,000 on top of it. Furthermore, to keep the account open, the investor would have to deposit at least enough cash to cover the margin requirement.

In this regard, notional funding significantly increases the volatility of an account. Investors must ensure that they understand how much leverage the CTA is using – and the consequences such leverage might entail.

#### Number Two: Structuring Your Account

One size does not fit all, and there are a number of ways to structure an account. Investors can use a single manager, multiple managers, commodity pools or fund of funds. Below are issues for investors to consider when selecting an account structure.

##### *Single vs. Multi-Managers:*

Investors must decide if they will use a single manager or multiple managers. Because alternative strategies are, by definition, not buy-and-hold strategies, the fact that there may be numerous stocks or other instruments in an account at any given time does

not constitute diversification. Because the manager will trade in and out of those positions frequently, the return depends on the manager's trading skill rather than the longer-term performance of the underlying instruments. So even if a single manager directs the assets into many different positions (stocks, bonds, futures, etc.) in an individually managed account, the account is not truly diversified because all of the positions are controlled by the same

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manager. Investors then might wish to consider allocating a portion of their investments among *several* managers. They also may want to consider whether a fund structure might be more beneficial than individually managed accounts.

#### *Individually Managed Accounts vs. Commodity Pools vs. Fund of Funds:*

*Individually managed accounts* (managed accounts) are an arrangement by which the holder of an account gives written power of attorney to a CTA to buy and sell futures contracts and options without prior approval of the holder.

*Commodity pools* (pools) are an investment trust, syndicate or similar form of enterprise in which multiple participants invest collectively (or pool their funds) in trading commodity futures or options and share ratably in profits and losses. Under this scenario, the pool can be managed by a single CTA or several CTAs.

*Fund of funds* (FoFs) are collective investment vehicles typically organized as limited partnerships or limited liability companies in which a fund invests in other funds or commodity pools versus investing directly in futures and options contracts. Investors in an FoF enjoy instant diversification among numerous funds and CTAs – typically across numerous industries and via numerous strategies. Some FoFs are extremely diversified and allocate their assets to 100 or more managers, while others concentrate their investments among only a few managers. As with other investments, generally speaking, a more diversified FoF will provide smoother (or less volatile) performance than one that is concentrated. Certain FoFs focus on a particular sector within the alternative investments industry (e.g., futures or fixed income) while others allocate across the broad industry.

#### **Other Considerations When Making Important Determinations**

Of course, as with any series of choices, investors will want to look at a number of factors when considering the choices available between investing in a managed account, pool or FoF. The following seven offer investors some considerations worth thinking about.

*Expertise.* Due to the large number of futures markets, it's virtually impossible for an individual investor to be an expert in each sector. Investors do have the option of hiring consultants, however, to assist them in building managed accounts or selecting an appropriate pool or FoF. Consultants typically employ one or more analysts to interview and monitor CTAs and have a thorough ini-

tial and ongoing due diligence process. Many believe that consultants are usually better equipped to build and monitor alternative investment portfolios than a part-time investor with other time commitments or less experience.

*Economies of Scale.* Like most large investors, pools and FoFs may be able to negotiate better fee arrangements with individual managers than an individual investor could obtain on his own. In addition, as industry insiders, pools and FoFs also may enjoy access to information about managers that is too expensive or difficult for smaller investors to obtain on their own. Consultants specializing in managed futures also have industry experience and relationships with many CTAs. As a result, consul-

tant may be well positioned to assist individual investors in negotiating fees and obtaining information.

*Limited Liability.* Because pools and FoFs often are structured as limited liability companies, investors can enjoy the benefits of limited liability. Limited liability can be a huge benefit if an account is notionally funded. Why? – Because in a limited liability structure, the investor is liable only for the amount of cash actually deposited in the pool or FoF. However, it may be possible to limit liability in a managed account by setting up an LLC structure for the investment vehicle.

*Access to Assets.* With a managed account, only the investor and the brokerage firm have access to the cash. The CTA has limited power of attorney to initiate trades, but he cannot withdraw funds for any purpose. With pools and FoFs, however, the investor can not access the cash – only the manager can do so. Due to the potential for misuse of funds, investors in pools and FoFs should be sure to review internal controls and audited results before selecting an FoF.

*Transparency.* With a managed account, investors can see each individual trade made by the CTA. The brokerage firm holding the account will send investors confirmations on each trade, thus ensuring 100-percent transparency. Depending on the brokerage firm selected, investors will likely also have online access to their accounts. Investors in pools and FoFs generally do not have transparency into the fund's underlying holdings. Further, investors in pools and FoFs typically only see the aggregate gains and losses of the pool or FoF as a whole – not the performance of each individual CTA.

*Liquidity/Cash Management.* Managed accounts provide investors with daily liquidity. Pools and FoFs, on the other hand, typically only allow investors to withdraw their assets at the end of a calendar month or quarter, and they typically include lock ups, triggering redemption fees upon withdrawal within a certain period of time. If an FoF has invested only in other funds, the investing fund will have to pay the redemption fee upon withdrawing cash from the pool or fund. If, on the other hand, in addition to investing in a pool or another fund, the FoF has invested in managed accounts, upon a request for redemption the investing FoF can withdraw the redemption from the managed account, thus avoiding the redemption fees imposed by the pool or fund. In this regard, an FoF investing in a pool or another fund can use the managed account to help manage its cash flow.

Similarly, if an investor would like to make an investment, the cash can be deposited into a managed account immediately, whereas the investor would have to wait until the month/quarter-end to subscribe to a pool or fund.

*Fees.* Due to the significant legal, accounting, auditing and other expenses incurred in the organization and operation of pools and FoFs that are not applicable to managed accounts, pools and FoFs generally have higher operating expenses than managed accounts. Further, CTAs charge both FoFs and managed accounts management and incentive fees. However, there is an additional layer of fees with pools and FoFs because the pool or FoF manager charges management and incentive fees as well. Therefore, pools and FoFs must strive to earn a return high enough to cover the CTA fees and the management fees.

### **Summing It Up**

As expressed, investors have much to consider in establishing managed futures portfolios. They may wish to consult with their personal financial planner, tax advisor or a specialized managed futures consultant to assist them in structuring their accounts and selecting CTAs.

Stay tuned next month (February **SFO**) for part three in this series on managed futures, as we address various tips on selecting managers and monitoring a managed futures portfolio.

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