Investing for the Long Haul?

Managed Futures Can Provide Key Diversification

By Maggie Finnerty

[Editor's note: In the first of a three-part series, author Maggie Finnerty introduces the concept of futures trading and professionally managed futures as part of a long-term investment portfolio. For those not overly familiar with futures markets or the benefits of their inclusion within a diversified portfolio, this article can offer an ever-so-quick rundown on the basic concepts and the inherent opportunities and challenges associated with this asset class. Part two of this series, scheduled to run in January, will assist investors in understanding the concept of "notional funding," multi- versus single-manager portfolios, individually managed accounts versus commodity pools versus fund of funds and, finally, allocation strategies. Part three in February will focus on how to evaluate and select CTAs and how to monitor CTAs on an on-going basis.]

In this day and age, portfolio managers have a surplus of choices when it comes to portfolio management. There are a variety of markets to trade, various risk profiles and time frames to suit every type of trader. But even with all of these mind-numbing choices, there is one core strategy on which almost every investment advisor will agree, and that's the need for diversity within the portfolio.

Historically investors have implemented so-called diversification by investing in various stocks, bonds and mutual funds. What many individual investors may not realize is that according to modern portfolio theory, portfolios consisting only of stocks, bonds and mutual funds are, in actuality, not adequately diversified.

In an article published more than half a century ago, the 1990 Nobel Laureate in Economics' Professor Harry Markowitz illustrated that holding stocks, bonds and mutual funds does not adequately lower an investor's risk because each of those types of investments move in concert with one another. He summed up his research with the conclusion that diversification "reduces risk only when assets are combined whose prices move inversely, or at different times, in relation to each other."

Non-Correlation Is Key

Markowitz's message is crystal clear. Individual investors can properly diversify their portfolios only when investing in *different asset classes* that have no correlation with each other. Because stocks, bonds and mutual funds all belong to the same asset class and generally move in line with one other, an alternative investment solution is needed to properly diversify a portfolio. While there are many alternative investments out there, one idea that individuals can explore is managed futures. [***Editor's note****: Also see the November* ***SFO*** *article entitled "Commodities: Ivy League Study Plants Them in the Mainstream - Finally!" for more information on a recent Yale study on the benefits of futures market exposure in a long-term investment portfolio.*]

Even after the stock market meltdown of the early 2000s and a sideways market hovering about for all too long, most investors still cling to their old investing habits. Investors historically have been leery of the futures markets because they have had little experience with them, and a number of urban legends regarding futures scare investors away from an asset class that should not be ignored. Futures markets, however, have earned their legitimacy stripes over the years, and institutions have increasingly embraced their risk-averse properties.

Thus, for those who need the basics of futures, there's some educational work to be done – the explanation of basic terms and definitions of the differences between futures, managed futures and other forms of alternative investments. This article also will top-line the basics of futures (though indeed there's a need to dig deeper) and highlight some benefits of managed futures, including the opportunity to reduce risk and enhance returns, the ability to profit in any economic environment and the expansion of market exposure and global diversification.

The Basics

Those who understand the basics of futures can certainly skip this section and hop down to the section on what managed futures offer. But for those who are die-hard buy-and-hold investors, read on.

While trading futures may be new to some, they are not as mysterious as they appear on the surface. A futures contract is simply a standardized agreement between two parties to make or take delivery of a specified quantity of a commodity, currency or index, at a specified time in the future at a price determined today (or in advance). Although the actual delivery of the commodity can take place in fulfillment of the contract, most futures contracts are closed out or offset before delivery.

Investors do not necessarily need a professional money manager to invest in futures. Anyone can log onto his home computer and start trading away. However, futures markets are so vast that it is difficult, if not impossible, for an individual to master more than a small segment of trading. Investors may, therefore, want to consider hiring a professional money manager specializing in trading futures and forward contracts to manage their futures accounts. These professional money managers are called commodity trading advisors, or CTAs. The term managed futures simply describes a managed approach to futures market participation in which CTAs trade futures and forward contracts pursuant to a power-of-attorney or limited trading authorization for their investor clients.

It's Much More Than Oats and Cattle

Individual traders who are unfamiliar with these markets may not realize that the term CTA is actually a misnomer. While futures and forward contracts may represent agricultural products, energies, cattle, hogs, metals and other "commodities," many CTAs also focus on trading currencies, financial instruments and stock indexes. Thus, don't get bogged down with the term commodity.

When trading managed futures, the goal is to profit from moves in the contract prices of commodities, stocks, bonds and currencies, etc. – not an appreciation in value of the underlying asset – and each CTA employs his own strategy for profit maximization.

Just as an individual can write a check to a mutual fund manager, investors may engage a CTA to trade individually managed accounts or invest collectively with other individuals in a commodity pool or fund. The latter example is similar to a mutual fund concept as it can result in the sharing of potential risk and rewards of many different markets among different investors in the pool or fund.

Suitability

Although managed futures can provide badly needed portfolio diversification for many portfolios, only investors with risk capital who understand and appreciate the risks and rewards involved in trading futures should invest in managed futures. And investors should not treat managed futures as a short-term trading opportunity. Because futures markets tend to be cyclical, investors should plan to hold an individually managed account, commodity pool or fund investment for at least two to three years.

IRAs and other self-directed plans also can invest in managed accounts, commodity pools and funds as long as the plan permits such investments. However, if the plan's custodian does not accept alternative investments, the investor will have to open an account with another custodian that does.

TABLE 1: Annual Rate of Return (3)

	2000	2001	2002	2003
S&P 500	-10.1%	-13.0%	-23.4%	26.4%
Nasdaq	-39.3%	-21.0%	-31.5%	50.0%
CTAs	10.63%	5.39%	15.22%	15.99%

TABLE 2: Drawdown Analysis

	VAMI Change	Term Mths	Peak Date	Valley Date	Recovery Months
S&P 500	-46.25%	25	08/2000	09/2002	N/A
Nasdaq	-75.04%	31	02/2000	09/2002	N/A
CTAs	-11.97%	6	10/2001	04/2002	3

What Benefits Do Managed Futures Offer?

Growing numbers of corporate, institutional and individual investors have been allocating a portion of their portfolio's assets to managed futures accounts. In fact, the amount of money invested through managed futures during the second quarter of 2004 increased to $117.7 billion, an increase of $13.1 billion from the previous quarter. This represents a 36-percent increase in assets since the beginning of 2004. Some of the reasons for the increased interest in managed futures include:

- ***The opportunity to reduce risk and enhance returns.*** Over the long term, managed futures have been negatively correlated to traditional stock and bond portfolios when they have experienced prolonged losses and positively correlated when they have experienced prolonged gains. That means that investors who add managed futures to their portfolios may benefit by reducing overall volatility and enhancing overall returns. (For an illustration of how managed futures can enhance returns and reduce volatility, see the sidebar, "A Hypothetical Portfolio," within this story.)

  In addition, take a look at the data illustrated in ***Table 1***, which further illustrates the benefits of managed futures over the S&P 500 and NASDAQ for 2000-2003. The data shows that the average rate of return for managed futures was negatively correlated with the NASDAQ and the S&P 500 during the down years of 2000, 2001 and 2002 and positively correlated with the NASDAQ and the S&P 500 during the recovery in 2003.

  Both the S&P 500 and NASDAQ experienced significant losses from 2000 through 2002. As of December 2003, neither the S&P 500 nor NASDAQ had recouped those losses. Managed futures, on the other hand, experienced a relatively small loss which was recouped in only three months. This data supports the conclusion that there is little or no correlation between managed futures and traditional equity markets, adding much-needed diversification to traditional portfolios.

A Hypothetical Portfolio

Contrary to popular belief, research shows that portfolios including managed futures generate higher returns and have less volatility than portfolios that do not include managed futures. ***Table 3*** shows the returns, volatility and Quick Sharpe Ratio for stocks, bonds, and managed futures from January 1990 through December 2003. The data clearly shows that managed futures generated a higher return than stocks and bonds and had lower volatility than stocks during that 14-year period.

Based on this data, we can calculate returns in hypothetical portfolios allocating various amounts to stocks, bonds and managed futures, enabling investors to compare the performance of portfolios including managed futures to those that do not. Consider the three hypothetical portfolio allocations in ***Table 4*** one with only stocks, one with 70 percent stocks and 30 percent bonds, and one with 45 percent stocks, 30 percent bonds, and 25 percent in managed futures.

Based on the returns from January 1990 through December 2003 in ***Chart 1*** and ***Table 5*** it is clear that hypothetical Portfolio C, the only portfolio including managed futures, generated the highest reward and the lowest volatility.

TABLE 3: Returns, Volatility and Quick Sharpe Ratio for Stocks, Bonds and Managed Futures, Jan. 1990 - Dec. 2003

	S&P 500	Lehman Aggregate Bond Index	CTAs ITR P40
Annual Return	8.53%	7.94%	11.21%
Standard Deviation	15.00%	3.91%	12.99%

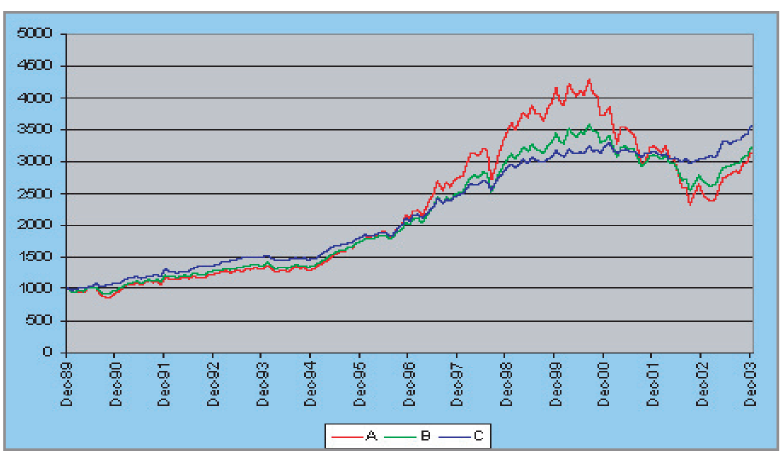
TABLE 4: Composition of Three Hypothetical Portfolios

	Stocks	Bonds	CTAs
A	100%	0%	0%
B	70%	30%	0%
C	45%	30%	25%

TABLE 5

	APR	VOL	QS
A	8.53%	15.00%	0.57
B	8.71%	10.64%	0.82
C	9.60%	7.24%	1.31

CHART 1: Performance of Three Hypothetical Portfolios, Jan. 1990 - Dec. 2003



Note: This composite performance record is hypothetical. Hypothetical performance results have many inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. In fact, there are frequently sharp differences between hypothetical performance results and the actual record subsequently achieved by any particular trading program. One of the limitations of hypothetical performance results is that they are generally made with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or to adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actually trading results. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the preparation of hypothetical performance results and all of which can adversely affect actual trading results.

- ***Ability to profit in any economic environment.*** CTAs can take advantage of price trends. During periods of inflation, they can buy futures contracts in anticipation of a rising market. Conversely, they can sell futures contracts if they anticipate a falling market. As shown from the data in ***Table 2***, the potential for profit exists regardless of the overall direction of traditional markets.
- ***Expanding markets and global diversification.*** During the last few decades, the futures markets have expanded to include stock indexes, debt instruments, currencies, options, and single stock futures, in addition to more traditional commodities. These new categories created global markets, expanding the scope of investment opportunities even more. In fact, as of September 30, 2002, there were approximately 900 futures and options contracts authorized for trading by the CFTC.

Managed Futures Versus Other Alternative Investments

In actuality, there are many similarities between managed futures, hedge funds and a fund of funds. All of these investments provide diversification to a typical portfolio of stocks and bonds, professional investment management and access to different investment strategies, styles and markets. Of course, returns are dependent on the talent and skill of specific managers instead of general market appreciation.

But managed futures offer greater accessibility, transparency, liquidity and security than most other alternative investments.

Investors can open individually managed accounts and add more capital to or redeem capital from that account any time they so desire. Not so with hedge funds and fund of funds (think hedge funds with $1 million minimum entry points). Most hedge funds and fund of funds accept subscriptions from new investors and additional capital contributions from existing investors' capital only on a monthly basis. Additionally, many hedge funds and fund of funds are simply closed to new investment, and the open funds only accept new capital contributions monthly or quarterly after they begin trading. And typically, hedge funds and fund of funds only allow for monthly or quarterly redemption.

Another point to consider is that managed futures provide greater transparency than other alternative investments. This means that investors can see each individual trade made by a manager. The brokerage firm holding individually managed accounts will send investors confirmations on each trade—ensuring 100-percent transparency. And depending on the brokerage firm the investor selects, investors in individually managed accounts also will likely have online access to their accounts. This is not the case with hedge funds and funds of funds, which often trade exotic over-the-counter (OTC) instruments that cannot be easily priced because they are traded in unregulated, non-public markets. Further, many hedge funds and fund of funds do not report trading activity to investors on a daily or even on a monthly basis.

Additionally, managed futures may have greater liquidity than hedge funds and funds of funds. Generally, futures contracts in a managed fund are highly liquid and can usually be bought or sold in a matter of seconds. The only exception to this rule is when prices are extremely volatile; sometimes a contract trades through its daily price limit, or stock prices trigger a circuit breaker between the equities markets and futures markets. Because the interbank currency market is one of the biggest markets in the world and is open 24/7, it also is highly liquid. Therefore, it is usually easy to open, roll or offset a futures contract or currency position. OTC derivatives contracts, on the other hand, may be complicated and costly to close out early if a hedge fund manager needs to liquidate a position before it is due to expire.

Finally, managed futures may provide investors greater security than hedge funds and funds of funds. Capital invested in managed futures accounts is held in customer segregated funds accounts (seg accounts). CFTC regulations prohibit futures commission merchants (FCMs) from using seg account funds in the conduct of their business or commingling those funds with the FCM's own funds. Consequently, seg accounts may provide greater security for customer assets than many bank or securities brokerage accounts used by hedge funds and fund of funds. Further, investors control assets in a managed account, whereas the general partner controls assets in a fund.

Summing It Up

Managed futures offer an alternative investment strategy that can offer more diversity, lower volatility and higher returns than traditional investments. They have greater accessibility, transparency, liquidity and security than hedge funds and fund of funds. However, to be successful in the managed futures industry, investors must understand the risks involved and be able to select managers that truly add diversity to their existing portfolios.

Maggie Finnerty is the vice president of business development at TraderSource, Inc., and an adjunct professor of business law at Portland State University. For more information on these topics, please contact Maggie Finnerty at TraderSource, Inc., maggie@tradersource.net.

SFO Stocks Futures & Options