Gaining Commodities Exposure for Passive investors

History shows that the best reward-to-risk trades are in the direction of the long-term secular trend. Government intervention has made trading with this trend a frustrating task as the very rationale for intervention is to reverse the prevailing trend of a market. One consequence of this activity has been a sharp rise in the correlation between typically less correlated markets. Many programs have been whipsawed more than once on positions driven by dollar weakness and accompanied by commodity and stock index rallies while the long end of the yield curve struggles. Global Strategies have been down with foreign exchange and long-term interest rates proving the most difficult sectors. Cross rates have been particularly troublesome as the Swiss National Bank has intervened several times to weaken its currency against the Euro. This intervention has caught many discretionary traders on the wrong side causing that sector to be a drag on returns.

During such times fundamentals must be utilized with more skepticism than usual, leaving technical analysis a more prominent part of a classically balanced approach, given it is always a more quantitative means by which trader sentiment can be gauged sans the cacophony of both Governmental and Guru rhetoric.

Passive Investment and Asset Allocation:

Retail Investors, Hedge, Mutual and Pension Fund Executives alike were shocked when the long-only commodity allocations made shortly after the turn of the century as a hedge against inflation on their securities portfolios began to break down just as they were needed most in the latter half of 2008. The normal negative correlation between commodities and securities evaporated as the world economy froze up and then began to melt down only to be slowed (we stop short of using the term “saved”) by throwing the spigots of monetary stimulation wide open.

Yet during the upheaval only two investment medium managed to eke out gains for the year 2008. Those two were Government Bonds (the natural recipient of “flight to safety” cash flows) and actively managed futures accounts as indicated by the various Managed Futures indices. Still the managed futures accounts TRIPLED the returns of bonds even though commodities markets dropped in lock-step with all others.…

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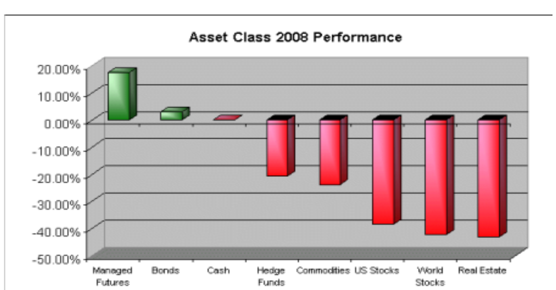


Managed Futures = Credit Suisse/Tremont Managed Futures Index, Cash = 3 mo T-Bill rate, Bonds = Vanguard Total Bond Market ETF, Hedge Funds = Credit Suisse/Tremont Hedge Index Commodities – Reuters/CRB Commodity Index, Real Estate = Dow Jones Wilshire Real Estate Securities Index, World Stocks = MCSI World Index, US Stocks = S&P 500 Index

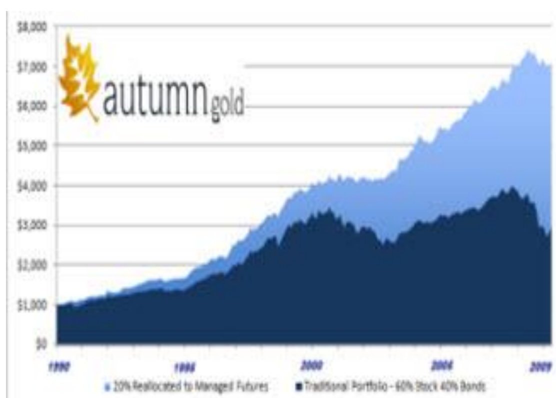
Managed Futures or Auto-Execute Systems?

Managed Futures as a genre' essentially replicate automated trading systems in that the vast majority trade the markets bi-directionally just as did those CTAs who managed the gains illustrated in the above graphic.

Perhaps the primary difference lies in the fact individual managed accounts require minimum investments far beyond the 20% allocation capabilities of the majority of retail investors – even before the 60-odd percent portfolio decimation of 3&4Q 2008. While we know of no authoritative studies on the average account minimum for CTAs operating outside a securitized fund structure, anecdotal evidence indicates $1mm is by no means unusual and a $250k minimum seems to be the lower end of the norm for CTAs with reasonable performance, risk parameters and longevity. At a 20% allocation level, even the lower number presupposes an overall investment portfolio on the order of $1.25mm. Auto-execute trading systems are available in plenty with account minimums often as low as a 10^{th} of that.

So – how would a securities portfolio with a relatively standard 60/40 mix of stocks/bonds have fared during the recent downturn if the same portfolio had been leavened with a 20% allocation to actively managed (CTAs or Auto-Execute Systems) futures (50/30/20)?

The below graphic illustrates just such a hypothesis with dark blue representing the former and light blue, the latter.



Click the chart to view in full size and you'll see the representation goes all the way up to the end of 1Q 2009 and indicates that while both portfolios would've shown losses, the one with the futures component dropped a mere 25% while the standard portfolio suffered losses on the order of 58%.

How much to Allocate for Best Diversification?

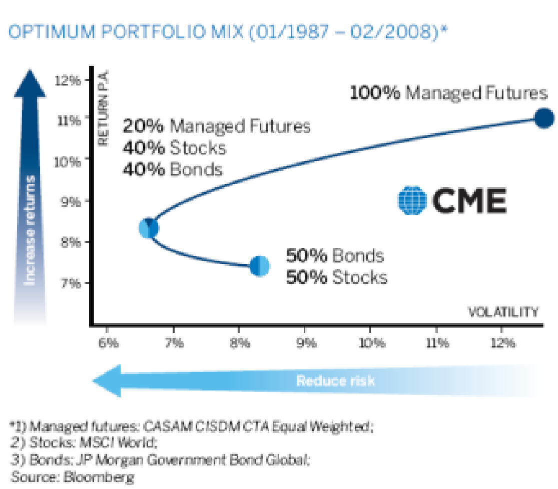
On the Institutional level, portfolio managers and Pension Plan Administrators watch the indices monthly to continually assure optimum portfolio balancing.

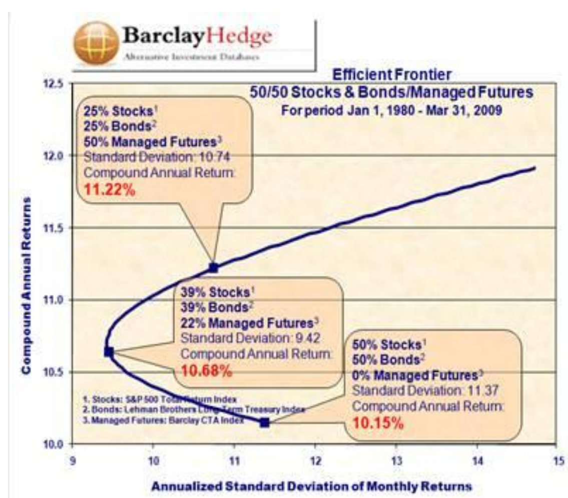
Such studies are rarely seen in the public domain and when they are, the reporting periods tend to run an average of 3Q behind the times. For example, no less authoritative source than the Chicago Mercantile Exchange (the world's premier derivatives exchange), in its most recent academic study of Managed Futures as a portfolio diversifier (published September, 2008) features an efficient frontier analysis based on data through only February of that year (left graphic below – click the chart to view full CME study). This study fails to capture the effects of last year's second half market meltdown.

This writer believes deeply in the primacy of current data and has thus made it a key point to obtain and maintain the most relevant analyses possible – this is done on a quarterly basis with the most current data depicted in the graphic on the right which runs through the end of 1Q 2009, (click the graphic to view full size).

The data shows the optimum allocation balancing risk versus reward to lie in the middle data point indicating a portfolio made up of 39% stocks, 39% bonds and 22% futures (CTA managed or auto-executed systems trading) yields a 10.68% average annual return with a standard deviation (risk factor) of only 9.42%.

Optimum Asset Allocation:





While these show allocations to MANAGED FUTURES – you should be aware MF can be considered clones of auto-execute systems and a viable argument can be made that systems trading is better than MF because it obviates the discretionary aspect of MF which is the Achilles Heel of CTAs as a genre'.

Drawdowns

All trading strategies are prone to drawdown during suboptimal conditions and unpredictable Government interventions. However, the recent environment is the exception rather than the rule, and this too will pass….

Adopting a contrarian approach to systems trading by investing in good programs currently in Draw Down, can be a way to get into good program "at a discount".

Most investors don't think like a contrarian – and instead are momentum players, usually wanting to get into the program which has done really well recently rather than one which has underperformed. This is one key reason true success eludes most investors in our opinion.

Big drawdowns are still a worry of course, but here's another piece of good news - you don't have to come close to that DD number if you don't want to. You can set a stop trade point/line in the sand at any reasonable level below the current level. You could set a stop trade point at losses for the program of -50%, for example, or compute an average of the last three to five DD and set your exit point there.

Reversion to Mean

In the end, if you believe in any given system's long-term viability, DD periods which are beginning to turn around are a great time to get involved with a program. If you believe volatility is here to stay due to the continuing credit crisis, trillions of dollars in US debt, North Korea, and so on – systems with a proven penchant to excel in periods of higher volatility might well deserve your close attention..

Quant Trade is a proprietary trading solutions firm that specializes in derivative investment strategies and the development of managed Automated Trading Systems and educational software products. QT specializes in trading technology that focuses on unique alternative investment solutions in markets around the globe. QT's business has been built upon the belief that trading systems can help reduce overall risk to an investors' portfolio by using systems that have negative or zero correlations to equity investments.

The firm offers a customer-focused approach that leverages hands-on algorithmic trading expertise with technology-driven trading. QT offers the most efficient tools of the future of automated trading in today's future and commodity markets.

Our approach: Through the use of strategy automation, we strive to pick the highest probability trades while at the same time implementing reasonable stops to mitigate risk.

Why use Trading Automation?

Systematic trading removes the elements of fear and greed from your trading efforts. This allows for precise entries and exits that aren't clouded by emotional baggage. Most of us have very busy lives; systematic trading effectively unchains you from your computer while still allowing you to participate in the more sophisticated trading markets.

Whether you are an absolute novice or a seasoned trader, our prime directive is to serve your needs and do our utmost to provide the choices and supply the very best service in the industry.

As such, systemic trade automation offers the perfect choice for many passive investors seeking portfolio diversification at low barrier-to-entry with near-instant liquidity and full transparency on top of full control whereby a stop-loss level can be set in advance and implemented on a moment's notice should those pre-set stops be hit.

Finally, through the judicious use of diversification across several independent futures trading strategies within an overall broad portfolio diversification across several asset classes (commodities, fixed-income, equities, etc.), auto-execute systems trading may well represent the ideal choice for investors who actually work for a living in a professional capacity.

Trading Systems

"Trading Systems" are technical analysis based computer models which generate specific buy and sell signals in one or more futures markets by analyzing historical and real time price data. Systems guarantee your trading decisions are consistent and disciplined by making them for you automatically.

Example

A simple example of a trading system would be the following 'trading rules'

1. If the current market price is higher than the 200 day Moving Average of prices,

   Buy at market.

2. If the position is losing more than $500,

   Sell at market.

Technical Analysis:

The grand majority of trading systems are based upon technical analysis rules, strategies and indicators which aren't fully disclosed to the investor. This type of system, in which the code is not disclosed is called a Black Box system - as no one knows what's inside. The technical analysis inside of the system can be as basic as moving averages, oscillators, and relative strength indicators; or very complex with the use of Fibonacci retracements, Gann Fans, Elliott Waves, artificial intelligence, chaos theory, and more.

System Assist Brokers

Most systems are developed by third party scientists or market specialists. While they used to sell the system to investors in the old days, the norm now is for the developer to simply lease the use of the system to clients on a monthly basis through a system assist broker. The system assist broker runs the system software on its machines on behalf of the client and monitors the system signals minute by minute throughout the trading day, entering any buy and sell signals issued by the system into client accounts, while a monthly fee for the system comes out of the client account.

Types of Systems:

There are hundreds of different futures trading systems which operate on everything from Crude Oil to stock market futures like the e-Mini S&P. Systems generally operate on one of three time frames:

Day Trading:

The most popular type of systems, these usually operate on highly liquid markets like S&P 500 and e-mini S&P futures. A day trading system's defining characteristic is it will NOT hold a position overnight. All positions for day trading systems are exited by the end of the day. On common misperception about day trading systems is that they trade very frequently. This is not necessarily the case, as many wait for the optimal market "set up", and therefore do not trade on several days each month.

Swing Trading:

These types of systems hold positions for several days to weeks, and again operate mainly on highly liquid markets like the stock index futures, bond futures, and more recently energy futures. There general approach is to ride market "swings" for a few days, then exit or reverse the position and ride the swing the other way.

Trend Following:

The "old man" of trading systems, trend following is the classic approach employed by some commodity indexes, billion dollar hedge funds, and the infamous "Turtles". Trend following systems generally operate on a portfolio of commodity markets across the grains, energies, metals, softs, interest rates, and currencies. They continuously monitor each market, waiting for each one to "break out" of its normal trading range and begin a long term trend. The system attempts to ride these trends as long as possible. With huge, multi-year trends like Crude Oil going from $20 to $70 and Euro Currency futures moving from .85 all the way to 1.35 - the allure of trend following systems is easy to see.

Transparency & Liquidity.

Two big advantages a trading system investment has over alternative investments in vehicles such as hedge funds or real estate is full transparency and nearly instant liquidity. Investors can see all of their positions at all times marked to the market, and per the limited letter of direction will not see any surprises. Should an investor need cash for any reason, wires can be processed the same day if received by 11AM.

Tax Benefits

Futures based Trading System accounts are taxed based on their value at the end of the year. This is good news for investors, as futures gains or losses are treated as 60% long term capital gains and 40% short term capital gains, NO MATTER the holding period. For example, an investor who holds a futures position for just a few minutes, or hours, can book 60% of the profits on that trade as long term gains - even though the trade was anything but long term. What a deal!

There is also no trade by trade accounting in futures, no wash sale rules, and losses can be carried back three years on futures based investments.