

An Introduction to Managed Futures

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Managed futures may be an important investment alternative. However, like any investment choice, it requires careful study and consideration before investing. The purpose of this article is to introduce you to managed futures. Your decision to invest in managed futures should only be made after a thorough analysis of managed futures and the risks and rewards this alternative investment presents.

History and Background

The futures industry has changed a great deal over the last 20 years, including the usage of the term "futures" itself. The industry was not always referred to as "futures," but rather "commodities." The transition from commodities to futures is an important one for investors to understand.

In 1848, Chicago businessmen determined that a central exchange was needed to establish the price for grain, not only for immediate delivery but in the future as well. In that year the Chicago Board of Trade (CBOT) was founded and commodities were first traded on an organized exchange. As a result, commerce in agricultural products was promoted. After the establishment of the CBOT, farmers could know what price they could receive at harvest, prior to planting a crop. Thus, a farmer could determine if a crop was worth planting in the spring for harvest in the fall. Just as the existence of stock markets serves an important economic function, having a "forward" pricing mechanism serves an important economic purpose for commodity related businesses.

Until the late 1970s, the industry was dominated by agricultural markets, and the trading was referred to as "commodity trading." Unlike stocks, where trading is done in shares, commodities are traded in "contracts." Each contract traded represents a specific quantity of a commodity. For instance, each wheat contract represents 5000 bushels of wheat. Market participants consisted of "hedgers," those who used the market to establish prices for commercial reasons, and "speculators," market participants who attempted to profit from price movement.

In the late 1970s and early 1980s, three extremely important events took place: (1) the introduction of contracts that were not linked to traditional commodities; (2) the use of the term "futures" instead of "commodities"; and (3) the development of the "managed" futures industry.

New Markets

Commodity trading was principally limited to grains, meats, and metals until the late 1970s, at which time interest rate and currency trading were successfully introduced. The economic

purpose of trading contracts of Treasury bonds, Treasury bills, Japanese yen, and German marks, or "financial futures," was the same as that of 100 years ago - to establish the price in the future for a commodity. This time the commodity was money.

Futures

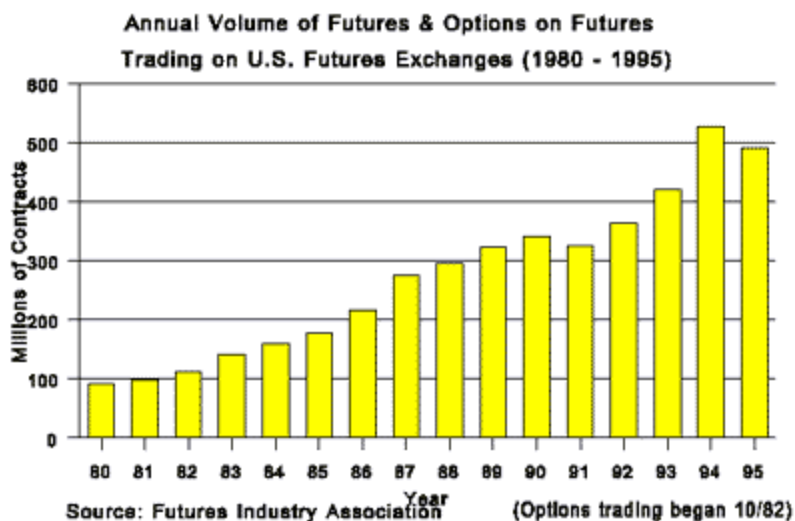
Because these markets establish the price "in the future," the term "futures markets" came into vogue. Today, most market participants refer to "the futures markets" or, sometimes blending the old and the new, "commodity futures markets."

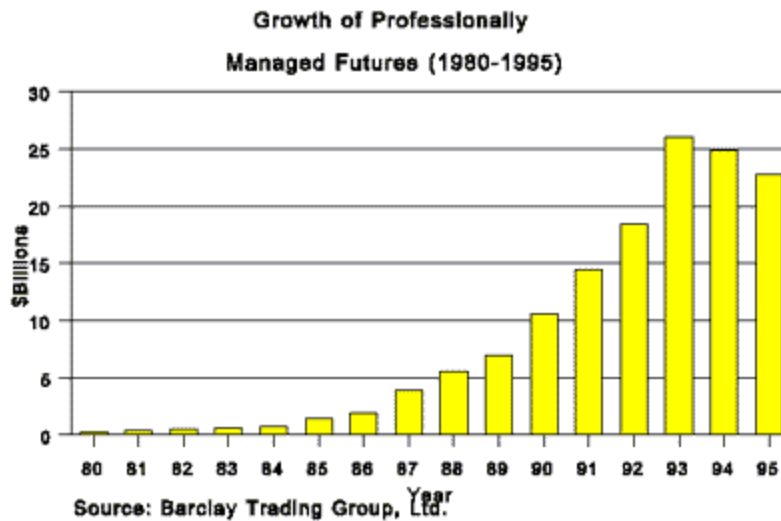
Managed Futures

Until the 1980s, market participants were limited to: hedgers, those whose involvement with the futures markets relates to their commercial requirement to establish a price for raw materials, interest rates, etc.; and speculators, those who trade the futures markets, attempting to profit from price moves. The 1980s saw the development of a third major market participant, the managed futures investor. A managed futures investor, like a futures speculator, attempts to profit from price movement. However, unlike the speculator who makes his or her own buy and sell decisions, the managed futures investor employs a third party or decision maker - a Commodity Trading Advisor (CTA). A CTA is similar to a stock manager or mutual fund manager in that the managed futures investor, through a written agreement employs a CTA to make the buy and sell decisions for the investor.

In the last 15 years, participation in the world's stock and bond markets has dramatically increased in large part due to the growth of mutual funds and individually managed stock accounts. Likewise, investor participation in the futures markets has increased through investor participation in managed futures.

The charts below demonstrate the growth in both futures and managed futures since 1980.





Why Managed Futures?

Investors' willingness to explore opportunities in new global markets has contributed to the growth of managed futures. Another major factor has been investors' willingness to accept the potential benefits of a professional, the CTA, trading their account.

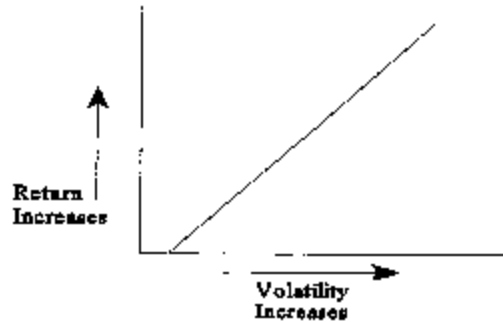
While it is common for individuals to invest in the stock and bond market, it is not as common for individuals to invest in the futures markets. Moreover, it is difficult for an individual to successfully trade on their own in the futures markets. In fact, U.S. Government studies have suggested that up to 90% of individuals who trade futures by themselves -- meaning the individual makes the buy and sell decisions -- lose money. The reasons why are worth exploring.

Knowledge of the investments being traded is essential, and, clearly people who know nothing about corn or Eurodollar trading are likely to be at a major disadvantage against professional traders. Furthermore, the futures markets are volatile and highly leveraged, meaning a small price movement can have a tremendous impact on trading results. Is it any wonder, then, that individuals trading on their own often lose? An experienced CTA trading full time on behalf of an individual may increase the chances of success. However, just as in any other investment, there is no guarantee of profits, and a CTA cannot eliminate the risk inherent to futures trading.

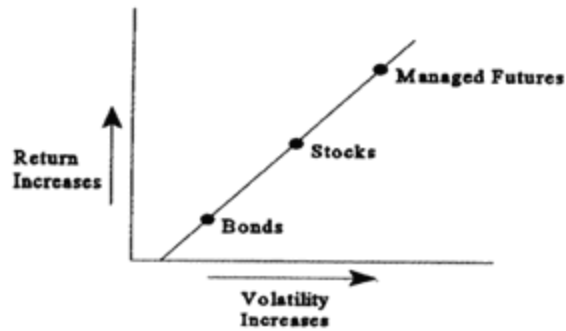
Risk and Reward

The relationship in investing between risk and reward is generally measured by volatility. A careful consideration of volatility is, therefore, crucial to the analysis of any investment, particularly managed futures, because it is a high risk/high volatility investment that may bring with it the possibility of high returns or significant losses. Generally, when you increase return, you increase volatility. An investor should decide his or her "risk/reward comfort zone" and, most importantly, stay within it. The charts below depict stocks, bonds, and managed futures investments in general terms of their risk/reward (volatility) characteristics.

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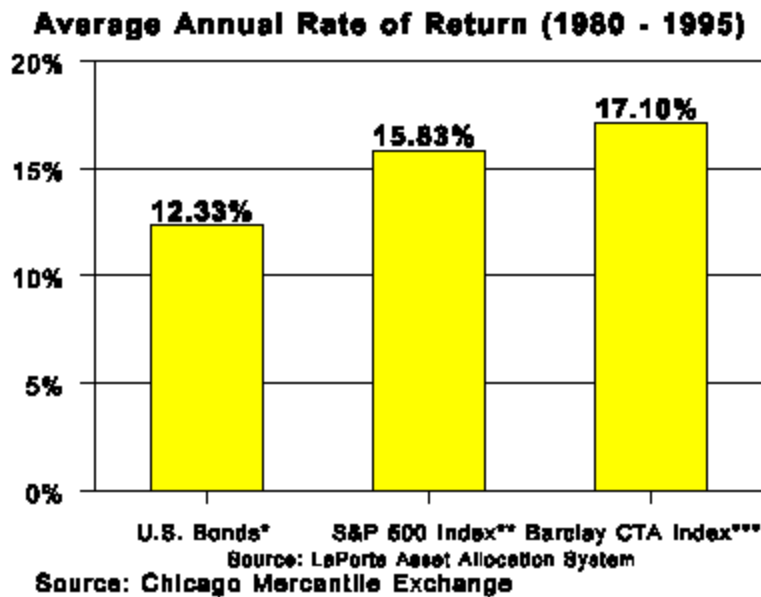


Comparing the Three Investments*

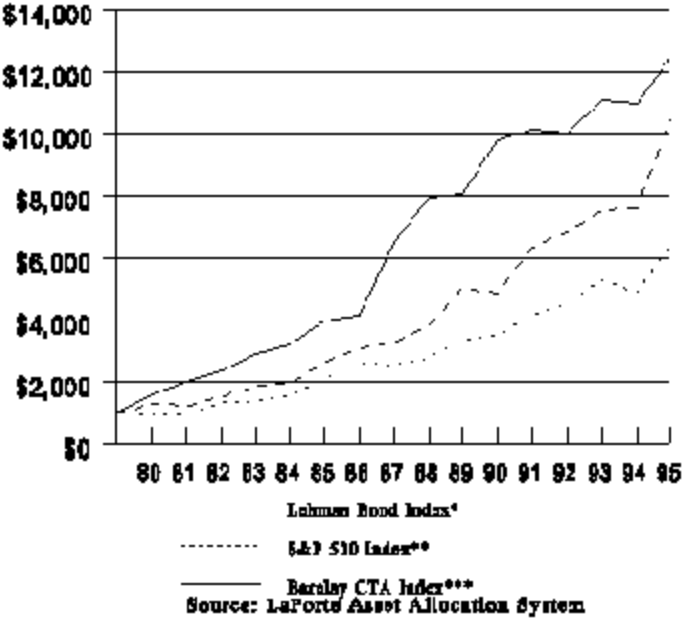


*The above chart is for illustrative purposes only. The points on the graph are not necessarily equal in scale of increased volatility and return.

The charts above point out that as you increase volatility or risk, you generally increase the potential for return. The charts below depict the three investments with respect to their rates of return.



Comparative Performance Chart of Lehman Bond Index, S&P 500 Index & Barclay CTA Index

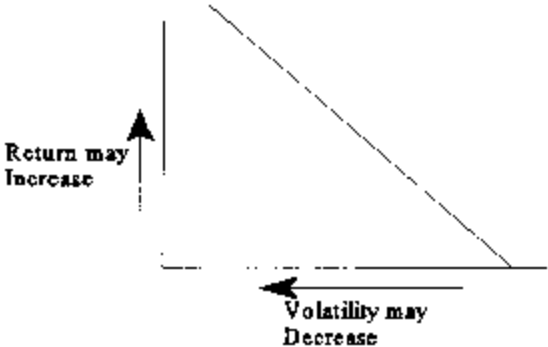


*Lehman Brothers Treasury Bond Index
 **S&P 500 Index with dividends reinvested
 ***The Barclay CTA Index measures the composite performance of established CTAs. For purposes of this index, an established CTA is a CTA who has four years or more documented performance history. Once a CTA passes this four-year hurdle mark, its subsequent performance is included in this unweighted index. The Barclay CTA Index does not represent an actual portfolio in which one could be invested, and therefore, the index performance results should be deemed to be hypothetical in nature and of comparative value only.

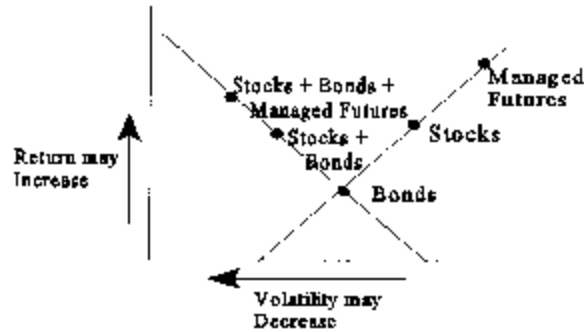
Combining Investments ... Diversification

The analysis gets somewhat more difficult as we begin to combine investments in stocks, bonds, and managed futures. Given the necessity to analyze the impact and importance of diversification, this analysis is critical. The analysis is important because blended or diversified portfolios may reduce the overall investment portfolio's volatility and may increase the overall portfolio's potential return.

Blended Portfolios May Reduce Volatility and Increase Potential Return



Combining the Three Investments*

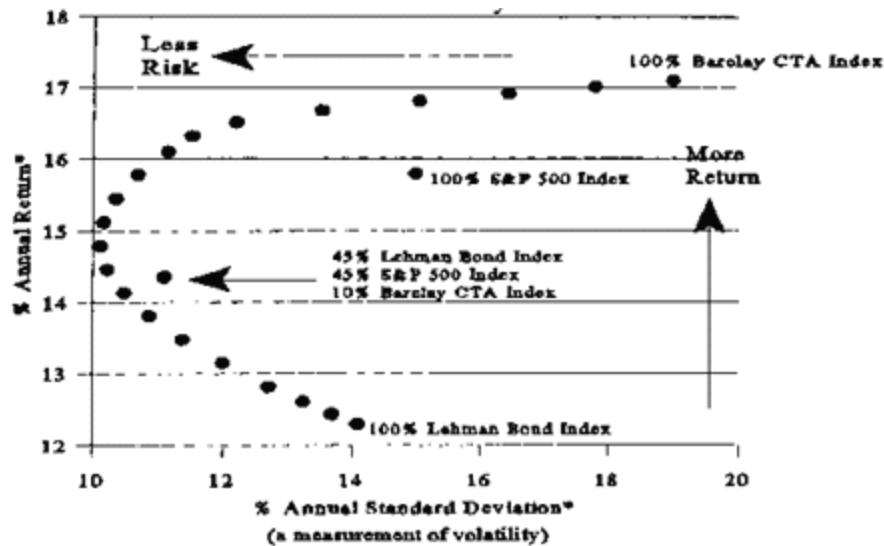


*The above chart is for illustrative purposes only. The points on the chart are not necessarily equal in scale of increased return and decreased volatility.

The chart above illustrates the potential effect of what may happen when an investor combines stocks, bonds and managed futures with the risk reward analysis.

The chart below is an efficient frontier chart which illustrates that as you add a small percentage of managed futures to a sample portfolio of stocks and bonds, you have the potential to reduce the portfolio's volatility, as measured by standard deviation, and increase the rate of return.

Efficient Frontier Chart for Portfolios of the Lehman Brothers Long Term Treasury Index, the S&P 500 Index with Dividends Reinvested, and the Barclay CTA Index



*Based on quarterly data from January 1980 through December 1995.

Source:LaPorte Asset Allocation System

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Correlation Between Investments

Closely related to the concept of diversification is the analysis of the performance of different investments relative to each other, otherwise known as correlation. Combining asset classes with different patterns of return may create a portfolio with lower risk levels than the individual investments themselves. For example, when one asset class is performing well, the other class can be down, and vice versa.

As a reference point, an investment always has a correlation of 1.00 with itself. Two investments that are perfectly correlated, with parallel movement, will also have a correlation of 1.00. Investments that move exactly opposite to one another have a negative correlation of -1.00. The closer the ratio is to 1.00, the more closely the rates of return will move in conjunction with one another.

For example, consider the correlation of two common asset classes: stocks, as measured by the S&P 500 Composite Index with dividends reinvested, and bonds, as measured by the Lehman Brothers Long-Term Government/Corporate Bond Index. According to LaPorte Asset Allocation System, during the period from January 1980 to the second quarter of 1995, these two asset classes had a correlation of 0.36, meaning their rates of return were less likely to move in conjunction with each other. A 90-day T-bill had a correlation of -0.08 with stocks, while managed futures, as measured by the MAR Dollar-Weighted CTA Index, had a correlation of 0.01 with the S&P 500, meaning their performance is virtually uncorrelated to each other.

The effect of combining managed futures in a portfolio of traditional stocks and bonds was first studied by the late Dr. John Lintner of Harvard University. Lintner stated, "correlation between the returns on futures portfolios and those in the stock and bond portfolios [is] ... surprisingly low (sometimes even negative). . ." Expanding the asset mix of an existing stock or bond portfolio with a "judicious investment" in managed futures "shows substantially less risk at every possible level of expected return than portfolios of stocks (or stock and bonds) alone," according to his study. (Lintner, John, "The Potential Role of Managed Commodity-Financial Futures Accounts (and/or Funds) in Portfolios of Stocks and Bonds," Annual Conference of the Financial Analysts Federation, Toronto, Canada, May 16,1983.)

Global Diversification

The table below, which depicts rates of return for managed futures as measured by the Barclay CTA Index and world equities as measured by the EAFE Index (Morgan Stanley Europe, Australia and the Far East Index) suggests that managed futures are also non-correlated with European and other non-U.S. equities. As you can see, in the past, the best periods for the EAFE Index have frequently not been the best periods for the Barclay CTA Index and vice versa.

	EAFE Index	Barclay CTA Index
1983	24.62%	23.75%
1984	7.87%	8.74%
1985	56.75%	25.50%

1986	69.64%	3.82%
1987	24.93%	57.27%
1988	28.60%	21.76%
1989	10.81%	1.80%
1990	-23.20%	21.02%
1991	12.50%	3.73%
1992	-11.85%	-0.91%
1993	32.94%	10.37%
1994	8.05%	-0.72%
1995	11.54%	13.20%

Source: LaPorte Asset Allocation System

Global Participation

The futures markets are no longer limited to New York, Chicago, or London. In recent years, important futures exchanges have been established in Paris, F and Tokyo. The table below is a partial list of global futures and forward markets and contracts traded by CTAS:

Chicago	New York	Paris	London	Frankfurt	Tokyo
Grains	Metals	Bonds	Long Gilt	Bund	Bonds
U.S. Bonds	Oil	PIBOR**	Metals	Euromark**	Euroyen**
Currencies	Cotton	CAC 40*	FT-SE 100*	DAX*	Nikkei 225*

*CAC 40, FT-SE 100, DAX, and NIKKEI 225 are stock indices for the respective exchanges and are similar to the S&P 500 Index.

**Short-term interest rate contracts.

Ability to Sell Short

Unlike the difficulties encountered in attempting to profit from declines in stocks by selling a stock "short," futures contracts are designed to be sold short easily. Thus, much like a CTA's ability to potentially profit from advancing markets by establishing a long position, a CTA can potentially profit from a declining market by establishing a short position in that market. CTAs, therefore, have the ability to participate and possibly profit in bull or bear futures markets.

Conclusion

Many investors all over the world have decided to diversify their portfolios with an investment in managed futures. As a result, the growth of managed futures has been dramatic. In 1981, less than \$1 billion U. S. dollars were invested in managed futures. Today, that number has grown to over \$20 billion U.S. dollars.

The investors fueling this growth have been individuals as well as major corporations, banks, and institutions, who have all been motivated by a desire to accumulate wealth as well as globalize and diversify traditional investment portfolios. While this growth has been impressive, not all CTAs have been profitable. An investment in managed futures should be considered highly speculative and entered into carefully with the assistance of a knowledgeable investment professional.

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