

## Justifiable Confidence

Wouldn't a managed account holder feel more comfortable during a drawdown if he or she knew that over any 18-month period a CTA never suffered losses so large that the he didn't subsequently recover and post new equity highs while averaging (say) 20% per year for at least a three-year period?

Moreover, wouldn't that investor feel even more comfortable knowing any current drawdown was in line with historical norms? Further, that such periods have previously been recouped and overcome to the point of return to profitability (sometimes referred to as: *reversion to mean*). Never forget however, the possibility always exists any given CTA might fail to recover from a drawdown notwithstanding past experience - "past performance represents no guarantee of future returns".

This is the foundation and reason for seeking what some call "**Justifiable Confidence.**" *Justifiable Confidence* in a CTA should provide the requisite intestinal fortitude to weather the inevitable drawdown periods all CTAs experience. We believe the absence of such "**Justifiable Confidence**" precludes capital allocation to the manager in question.

## Investment Game Plan

Once a CTA is selected based on **Justifiable Confidence**, the investor is now ready to develop an **Investment Game Plan.**

We believe the *Investment Game Plan* should consist of the following:

1. Only risk capital should be utilized. Risk capital is defined as those funds which, if lost, would not materially affect one's existing lifestyle. Funds marked for a down payment on a house, a child's education, or core retirement funds should not be used.
2. Establish a drawdown cutoff point of 50%. Close the managed account only if that level is reached. If an investor isn't prepared to adhere to this guideline, we believe he/she/they is/are not suitable for managed futures as a genre'. The 50% cutoff may not limit losses to the amount intended. Extreme market conditions may make it difficult or impossible to exit existing positions with only a 50% loss.
3. Maintain realistic expectations. The average annual return for the Dow Industrials over the past century has been around 11.95%. A CTA who can provide average annual returns approaching 20% over a three-year period is outperforming the Dow's average by nearly twofold! However, CTAs operate with the ever-present risk of potentially losing all of your investment and you could be called upon to make up any deficiency due to the high degree of leverage available in futures transactions. On the other hand, few futures market participants fully appreciate that though leverage ratios approaching 19/1 are available, no "rule" exists forcing the maximum use of such extreme gearing. Indeed, viewed without leverage, volatility in futures is often no greater than that seen in equities markets.

Accept drawdowns and flat performance periods as inescapable components of futures exposure. As long as predetermined cutoff points aren't reached, stay with the CTA through "thick and thin."

Look at the big picture, not the meaningless episodes. Evaluate performance over a three-year average (big picture) not week to week or month to month (meaningless episodes).

Now that a CTA or group of CTAs has been selected based upon **Justifiable Confidence** (rather than emotion), and a specific **Investment Game Plan** has been outlined, one should be psychologically prepared to weather the periodic drawdowns inherent in commodity investments.

## Investment Policy Statement

We believe the proper attitude should be: "Potential risk of loss is the price I'm willing to pay for the opportunity I seek. I don't want to lose, but the capital I have invested is risk capital that I don't need to live on and wouldn't in any way change my lifestyle in a worst-case scenario. I understand that the past is not an indicator of the future. Even so, I believe that over time my investment should do well because the CTA I have chosen has an excellent performance record, and has a demonstrated ability to recover from drawdowns to recapture previous high-water marks in equity. Being human, I realize that CTAs will place both losing and winning trades. This is part of futures trading. I will not lose confidence or fall prey to my emotions during drawdown periods. I will stay tough and hang in there! I will have patience and, so long as my account doesn't fall below 50% of my initial investment, I will grant the CTA a three year time window in which to perform."

## Conclusion

While these suggestions cannot guarantee the success of any allocation to futures markets, we firmly believe they can assuage the anxiety, second-guessing and loss of confidence associated with drawdown periods. Given that reality, in our opinion, the adoption of these suggestions should substantially enhance your probability of success!

### Note:

Studies have shown that professional CTAs do experience returns greater than the individual investor. Nevertheless, the risk of loss exists in futures trading and past results are not necessarily indicative of future returns.... regardless of who manages your money.



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## IMPORTANT RISK DISCLOSURE INFORMATION:

The risk of loss in trading futures, options, cash currencies and/or other leveraged transaction products can be substantial. Such investment medium are thus not suitable investments for everyone and should be viewed only in light of your personal financial condition – seek independent third-party advice should you be unsure of your suitability. The valuation of these trading/investment vehicles fluctuates continually which, while creating opportunity for profit, also carries commensurate risk of loss. As a result, clients may lose more than the amount originally invested. Consider carefully your financial condition before deciding to participate in leveraged transactions of any type.

Monthly data used to illustrate past performance is obtained from third-party sources believed reliable. However the accuracy, completeness, timeliness or correct sequencing of said third-party information cannot be, and is not, guaranteed by either Interconti, Ltd., it's officers or agents.

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Finally, the above suggestions are intended primarily for stand-alone allocations to the asset class. For (securities) portfolio diversification purposes, different parameters would likely apply. For example, to balance a traditional securities portfolio of 60% equities and 40% fixed-income, an allocation between 10% to 20% of the total valuation represents a reasonable starting point. In such instances one might reasonably seek CTAs possessing lower volatility in return for halving the optimum ROI target. A 10% cumulative average return might well suffice provided the correlations between stock/bond indices & futures portfolio components are low or even negative.