CTA versus Hedge Funds

If you're already struggling to define the difference…… Just wait.

Meanwhile, you might want to consider the following article - in the light of:

CTA v Hedge Fund v Commercial Hedger

Commodities' status as an acceptable investment for mainstream institutions is well under way. Harvard, CalPERS, and numerous other institutions have dedicated meaningful long term asset allocations to commodities (note: supporting articles are linked below). Academic papers, such as "Facts and Fantasies about Commodity Futures" by Gary Gorton of the University of Pennsylvania's Wharton School and K. Geert Rouwenhorst of the Yale School of Management at Yale University, have also boosted interest in commodities. Yet, some investors are still skeptical about commodity investments.

Within "Facts and Fantasies about Commodity Futures," the two authors conclude that commodity futures, from 1959 to 2004, had approximately the same return as stocks with less risk. Further, commodities significantly outperformed bonds and were also a better hedge against inflation than either traditional asset class. As more trustees, directors, portfolio managers, fiduciaries and other accredited investors review this research, commodity allocations will likely continue to grow in institutional and high net worth portfolios.

As more dollars enter the commodity arena, price volatility, and consequently expected risk/reward, will likely increase. And, when those additional investments are coupled with potential long term supply/demand imbalances in commodities, the price impact could be substantial. In particular, Goldman Sachs expects the potential for "super-spikes" in crude oil prices as result of potential supply disruption, especially in the context of where long term demand continues to climb versus available supply. Any commodity or commodity index could experience such price behavior. Such jumps in price and associated volatility pose the following two-fold issue for investors:

1. The investor needs to be long (purchase) the commodity or index that spikes to make money, and
2. If the commodity price or index can increase that sharply, it can also fall like a rock when the supply/demand imbalance corrects or when investors shift allocations and take profits.

Hence, investors need a long term, protected strategy that capitalizes on such volatility—whether that commodity price or index rises or falls dramatically. A fully-covered, market-neutral strategy with net long option exposures in energy and other raw material markets should meet that diversified need for long term investors. Such a market-neutral approach combines two opposing positions, such as a long put & long call, and may make money as one position's gain more than offsets the other's loss regardless of market direction. (Typically, a long call makes money when commodity prices rise, and a long put appreciates when prices decline). Under such combined call & put positions, a loss may be realized if the market remains stable. That potential loss is limited to what you pay for the options (which may only be a portion of the total investment equal to the options' time premium). Comparatively, an outright purchase of a commodity futures contract, forward or index has unlimited risk and will definitely lose money if commodity prices fall—further, if commodities initially trend lower in the short term, your board may become impatient with a long term investment in a commodity futures contract, forward or index with unlimited risk. Remember, such a decline in commodity prices may generate a profit in the market-neutral approach, as the put gains may exceed the call losses. This market-neutral return profile, having the capability to potentially make money regardless of market direction, gives staying power to you, the investor. You can have confidence that your investment horizon will be long term. Who knows when the commodity market will spike or collapse? You just want the opportunity to make money whether commodities move. Now, that is "super".

This article does not address the benefits and costs of rolling options. Nor does this discourse highlight the capability of adding absolute floors to commodity exposures. Shield Plus offers market-neutral strategies with and without floors. For a more complete explanation of these strategies and our market-neutral investment process, please contact Shield Plus.

In conclusion, we believe energy and raw materials are a diversifying asset class with little correlation to traditional asset classes. That is, certain commodities do not tend to rise and fall in lockstep with stocks and bonds. On the other hand, commodity prices tend to rise with inflation. That combination of low correlation to stocks and bonds and a high correlation to inflation has established commodities as a long term investment class for sophisticated investors. As more money flows into commodities, price volatility will likely increase. Investors need a strategy that capitalizes on such volatility and simultaneously protects a percentage of principal—a fully-covered, market-neutral strategy with net long option exposures in energy and inflation-related markets should safeguard and add value for the long term investor.

The author of this article is James L. Mahnke, founder of Shield Plus LLC. Shield Plus LLC is an investment firm focused on institutional energy hedging and protected asset management for endowments, foundations, eleemosynary organizations, corporations and other accredited investors.