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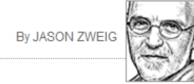
Should Managed Futures Be in the Cards for You?



By JASON ZWEIG

Is your email in-box, like mine, suddenly full of pitches for "managed futures"?

The returns on this commodity-trading strategy don't look good -- they look spectacular. The average managed-futures program, as measured by the Barclay CTA Index, was up 14% last year -- beating the stock market by a staggering 51 percentage points. Run by commodity-trading advisers, or CTAs, these funds manage an estimated $199 billion and may traffic in anything from corn, cotton and crude oil to interest rates, currencies and stock indexes. They often use technical analysis and mathematical formulas to trade on price patterns.

"Last year was a showcase year for managed futures, but I don't think it was a flash in the pan," says Robert Lerner, chief executive of Ruvane Fund Management Corp. in Princeton, N.J. The Barclay CTA Index has gained an annual average of 12.2% since 1980 and lost money in only three of those calendar years. Academic research shows that commodity futures have kept pace with inflation and rivaled the returns on stocks, with the extra virtue of tending to go up whenever stocks or bonds go down.

Louis Stanasolovich, president of Legend Financial Advisors in Pittsburgh, says "you should have some element of managed futures in your portfolio at all times" -- for most investors, 5% to 10% of total assets. Nearly $700 million flowed into managed-futures programs in March.

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But look before you leap. Managed-futures programs are risky, their historical performance mightn't have been as it good as it sounds, they are expensive and their returns looking ahead could be lower than in the past few decades.

There is no doubt that some managers of commodity futures are skilled at what they do; John W. Henry made enough to buy the Boston Red Sox out of his pocket change.

Still, flameouts are common. A 1997 study found 20% of managed-futures programs disappear each year. Sol Waksman, president of BarclayHedge in Fairfield, Iowa, estimates his firm's Barclay CTA Index replaces roughly 15% of its constituents annually.

Furthermore, the historical performance averages are based only on the results of those managers who choose to report their returns to industry databases like Mr. Waksman's. He laudably insists on four years of returns as a precondition for inclusion. But, since many of the stinkiest funds never got into the indexes, overall past returns likely look better than they actually were.

Fees on managed-futures funds make mutual funds seem cheap. Many CTAs charge a 2% management fee, plus 20% of any "net new profits." The fund can incur high trading costs. You may have to pay an "introducing broker" as much as 6% to get into the fund. All told, the costs can hit 6% to 8% annually, says Ruvane's Mr. Lerner. Of course, returns are reported after all fees (except sales charges) are deducted.

To understand why tomorrow's performance may be lower than yesterday's, you need to know the basics of how commodity futures work. A futures contract is an agreement to buy or sell an asset at a specific price at a later date. Futures often expire monthly; to maintain constant exposure, a trader has to renew, or "roll," the old contract by buying a new one. Most futures traders put up 15% or less of the purchase price of the contract as "margin" or cash collateral.

So there are three main ways a futures trader can profit. First, the market or "spot" price of the commodity can go higher than the purchase price of the futures; the difference is all gravy. Second, the "roll return" is positive when a trader can sell last month's contract for more than it costs to buy next month's. By some estimates, the roll return has accounted for more than half of the long-term performance of commodity-futures indexes, although not all CTAs rely on it. Finally, the cash collateral earns interest.

But the roll return has gone negative lately, hurting performance for 20 of the 24 commodities in the Standard & Poor's GSCI index so far this year. And the yield on collateral, which averaged roughly 4% over the past decade, has dwindled below 1%.

These two tailwinds have petered out, for now -- leaving the skill of the managers as the only source of return. In what Mr. Waksman calls "markets without strong trends," it can be hard for managers to turn a profit. It is even harder for their investors to turn a profit after paying something like 6% just to be in the game.

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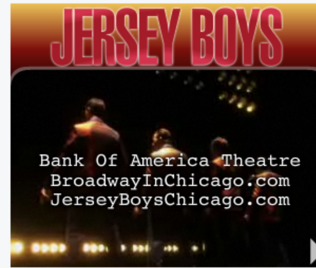

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About Jason Zweig

Jason Zweig writes The Intelligent Investor every Saturday for The Wall Street Journal. He is the author of Your Money and Your Brain, on the neuroscience of investing, and the editor of the revised edition of Benjamin Graham's The Intelligent Investor, the classic text that Warren Buffett has described as "by far the best book about investing ever written." Before joining the Journal, Jason was a senior writer for Money magazine and a guest columnist for Time magazine and CNN.com, and he also spent a year studying Middle Eastern history and culture at the Hebrew University in Jerusalem.

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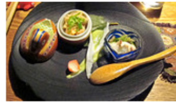
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