



Intelligent Trading

Commodities, Forex, Futures and Options

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Managed Account Research, Inc. 929 Santa Barbara Street, Santa Barbara, CA 93101
www.ma-research.com research@ma-research.com 800.308.1495

FOCAL POINT CONCEPTS: Separately Managed Accounts Explained

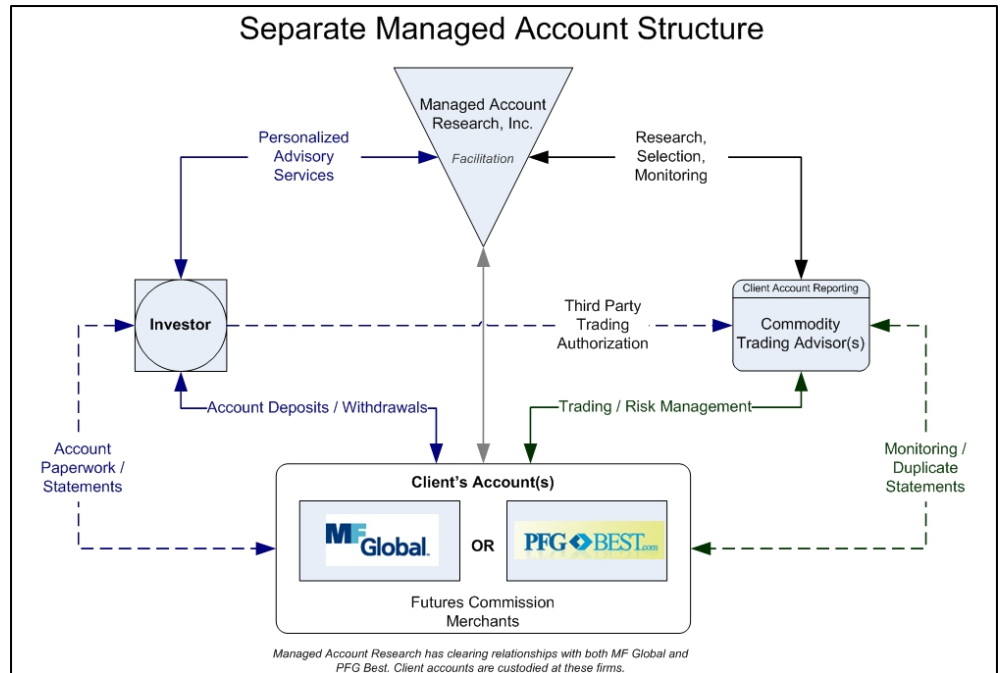
By Mack Frankfurter, Chief Investment Strategist

When you speak with the truly sophisticated fund-of-hedge fund managers, one learns that they often prefer to make allocations through a structure known as “separate managed accounts,” sometimes called SMAs. SMAs are like any other brokerage account established to trade markets except that the responsibility for determining what trades to execute, and at what time, is delegated to a professional money manager. In the futures industry these managers are called Commodity Trading Advisors or CTAs, and their investment advisory services is known as “managed futures.” In this inaugural issue of *Intelligent Trading*, a monthly newsletter focused on the theory of investing in managed futures, we explain some key concepts regarding the pros and cons of SMAs.

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Separately managed accounts have become increasingly accepted as a way to make investments.

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SMA's involve several different parties working together in coordination, and while the structure may seem at first complicated, it has many advantages (as well as a couple of disadvantages, as with anything). But before going into the pros and cons of investing through SMA's, it is first helpful to understand the process.

If you are interested in investing in managed futures, you first need to select a broker who will help facilitate the investment. There are two types of brokers in managed futures: clearing brokers, also known as Futures Commission Merchants or FCMs; and Introducing Brokers, who in the industry are called IBs. Not all brokers specialize in managed futures, some focus on facilitating client trading or trading the client's accounts directly. You want to select a broker who specializes in researching and tracking CTAs, and monitors their trading activity.

"...first select a broker who will help facilitate the investment."



Once you have selected a broker to work with, then the next step is analyzing the various CTA programs that are available, and choosing which one(s) might be an appropriate fit given your return objective and risk profile. This is a whole other discussion, but what we should mention here is that, if you do decide to work with an IB, the IB will clear your account(s) through an FCM. In other words, the actual monies you invest in managed futures are required to be deposited at a FCM, who acts in the capacity of custodian. Note that IBs are not permitted to hold customer cash and can only accept checks in the name of the FCM. However, the IB will be your main point of contact with the FCM for facilitating any requests.

"Before investing in a CTA you are required to acknowledge receipt of their disclosure document..."

After the brokerage account is set up, and you have identified potential CTA programs to invest in, the IB will send you the CTA's disclosure document and advisory agreement. Before investing in a CTA you are required to acknowledge receipt of their disclosure document, as well as having read it. This is an important document to review because it contains information that is material to an investor's decision making process. Guidance on how to analyze a CTA disclosure document will be discussed in an upcoming issue of *Intelligent Trading*.

The next step is to complete the advisory agreement of the CTA, which is forwarded to the broker. The broker will then work with the CTA to make sure the proper paperwork is in place and obtain an account number in which the CTA will trade on



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your behalf. One way to establish multiple CTA accounts is setting up a “cross-margin” account. This type of account structure allows you to have an umbrella “cash account” which funds the trading of multiple CTA “trading accounts.” In fact, it is possible to have \$0 in the trading account, but have it traded at a level that you and the CTA agreed upon. This is called a “trading level agreement” and involves a type of funding called “notional funds.”

By now we have thrown about a lot of terminology that needs to be discussed in more detail at a later time. We can conclude here by saying that a significant advantage of the SMA structure is the transparency and liquidity it provides investors. Because the SMA is effectively a

brokerage account of the investor, all trading activity is immediately reflected and reported to the investor via activity statements. Hence, a CTA’s trading can be monitored closely, and if you decide to terminate the relationship, it can be as easy as revoking the third party trading authorization that is in place.

So what are the disadvantages? Well, some investors don’t like to be so involved and prefer to receive a quarterly NAV summary of how their fund performed, rather than receiving regular brokerage statements which shows both open positions and trades. The other disadvantage is actually from the perspective of the trader—not all traders want customers to see the open positions or the proprietary way they trade...

STATISTICAL INSIGHT: Rate-of-Return (Part 1)



Monthly rate-of-returns (ROR) as reported by Commodity Trading Advisors (CTAs) is often taken at face value by investors. Because other kinds of statistical information are derived from reported rate-of-returns, this is the most important piece of statistical data in managed futures. But beyond the admonition that “past performance is not necessarily indicative of futures results,” what else should an investor know about the rate-of-return calculation?

The calculation is based on a very simple formula: net monthly performance of all accounts managed (NP_i) divided into the beginning net asset value of all accounts managed that month ($BNAV_i$). [Formula: $NP_i \div BNAV_i = ROR$]

But there are complexities within this calculation that are not readily apparent. First, rate-of-return percentages are based on the composite of individual separately managed accounts. Each account in the composite may have a different commission rate, different negotiated fee structure, and may have different BNAVs due to accrued profits or losses. In addition, varying size accounts may trade slightly different based on something we call “granularity,” which results when accounts receive split fills, partial fills, or one size account trades a different multiple than another size account.

Other complications occur when new accounts are added to the composite. Again, there is granularity. This happens when the CTA aligns the new account to the positions of the old accounts. There may be different fill prices or perhaps there is discretion on part of the CTA to not place the new client in all existing positions.

Also, new accounts, and for that matter accounts that are closing, create a question as to how to calculate the BNAV. There are a variety of methods which are prescribed and approved by regulators, including the “Time Weighted” methodology (“TW”) and the “Only Accounts Traded” methodology (“OAT”).

In a follow-up issue of *Intelligent Trading*, we will explore these rate-of-return methodologies in further detail. However, if you are interested in learning the more advanced concepts now, call or email Managed Account Research and request a copy of our *CTA Confidential* piece titled “Managed Futures: Pitfalls in Performance Evaluation.”



CONTRACT SPOTLIGHT: NYMEX Light Sweet Crude Oil Futures (Symbol: CL)

Crude oil is the most actively traded commodity in the world, and the NYMEX light sweet crude oil futures contract is the world's most liquid medium for crude oil trading. It also is the world's largest-volume futures contract trading on a physical commodity. Because of its liquidity and price transparency, the contract is used as a principal international pricing benchmark.

Light sweet crudes are preferred by refiners because of their low sulfur content and their ability to produce sizeable yields of high-value products such as gasoline, diesel fuel, heating oil, and jet fuel.

The contract trades in units of 1,000 barrels, and the delivery point is Cushing, Oklahoma, which is also accessible to the international spot markets via pipelines. The contract provides for delivery of several grades of domestic and internationally traded foreign crudes, and serves the diverse needs of the physical market.

In addition, NYMEX lists financially settled futures contracts which trade electronically, including Dubai crude oil; differentials with the light sweet crude oil futures contract and Canadian Bow River crude at Hardisty, Alberta; and differentials of the light sweet crude oil futures contract and four domestic grades: Light Louisiana Sweet, West Texas Intermediate-Midland, West Texas Sour, and Mars Blend.

The Exchange also provides additional risk management instruments and trading opportunities through options on the futures contract; calendar spread options; crack spread options on the pricing differential of heating oil futures and crude oil futures, as well as gasoline futures and crude oil futures; and average price options.

In recent years this futures contract has become a key benchmark to watch, especially with prices near \$100 and given crude oil's importance to the economy.

Contract Specifications

Trading Unit	1,000 U.S. barrels (42,000 gallons)	Price Quotation	U.S. dollars and cents per barrel; \$0.01 per barrel (\$10.00 per contract)
Trading Hours (US Eastern Time)	Open outcry trading is conducted from 9:00 AM until 2:30 PM. Electronic trading is conducted from 6:00 PM until 5:15 PM via the CME Globex®, Sunday thru Friday. There is a 45-minute break each day between 5:15PM (current trade date) and 6:00 PM (next trade date).	Trading Months	Crude oil futures are listed nine years forward using the following listing schedule: consecutive months are listed for the current year and the next five years; in addition, the June and December contract months are listed beyond the sixth year.
Last Trading Day	Trading terminates at the close of business on the third business day prior to the 25th calendar day of the month preceding the delivery month.	Deliverable Grades	Specific domestic crudes with 0.42% sulfur by weight or less, not less than 37° API gravity nor more than 42° API gravity.
Settlement Type	Physical: Cushing, Oklahoma. Pipeline access to TEPPCO, Cushing storage, or Equilon Pipeline Co.	More Information	http://www.nymex.com/index.aspx http://www.nymex.com/CL_marg.aspx

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Managed Account Research, Inc. 929 Santa Barbara Street, Santa Barbara, CA 93101
www.ma-research.com research@ma-research.com 800.308.1495

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