



Intelligent Trading

Commodities, Forex, Futures and Options

February 15, 2008
Volume 1, Issue 2

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FOCAL POINT CONCEPTS: Frequently Asked Questions (FAQ's)

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This month we are going provide some answers to “frequently asked questions” about managed futures. This is just a high level overview, so in later issues of *Intelligent Trading* we plan to touch upon some of these topics again in greater detail.

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What are “managed futures?”

Managed futures refers to professionally managed assets in commodity and financial exchange traded derivatives, including futures, options on futures, and to a lesser extent, forward contracts. Management of client assets is directed by Commodity Trading Advisors (CTAs) and Commodity Pool Operators (CPOs) under the regulatory auspices of the Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA), a self-regulatory body. Accounts are custodied with clearing firms called Futures Commission Merchants (FCMs), and Introducing Brokers (IBs) serve as guaranteed or independent correspondents.

Why invest in managed futures?

Broadly speaking, managed futures represent a class of “alternative investments” which provide the potential for diversifying traditional stock and bond portfolios. However, the uniqueness of each CTA program needs to be analyzed in accordance with its particular style matrix and risk-return objectives. For example, there are CTAs who only invest in financial futures contracts such as the S&P 500, treasury bonds and currencies, whereas other CTAs invest only in commodities such as corn, crude oil, gold, sugar and wheat. Investors should first consider their personal risk tolerance and objectives before making any kind of investment. That said, futures trading is *not* appropriate for all investors and should be traded with risk capital only.

How are managed futures different from hedge funds?

Managed futures and hedge funds share a similar history and legacy—the first commodity fund was started in 1948, and the first hedge was fund established in 1949. Technically, hedge funds are privately organized pooled investment vehicles which operate under various exemptions related to securities regulations. Interestingly,

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CPOs are a hybrid between managed futures and hedge funds, and it is noted that while some hedge funds actively trade futures they can avoid CFTC registration. Admittedly, hedge funds are better known and have more assets under management. Yet despite the size and status of hedge funds relative to managed futures, the latter’s impact upon the alternative investment space is writ large in two significant and related ways: first, managed futures unlike its brethren hedge funds operate in a highly regulated environment; second, this same regulated environment which imposes disclosure and reporting requirements, compelled the data on managed futures to be made public, which in turn helped academics advance early studies on alternative investments, prior to developing any substantial research on hedge funds. In effect, managed futures were key to institutionalizing alternative investments.

What is the difference between a CTA and a CPO?

Both commodity trading advisors (CTAs) and commodity pool operators (CPOs) provide advice to the public with respect to investment in commodity and financial futures, and options on futures. CTAs typically provide advisory services in the form of a separately managed account, which is just like any futures brokerage account except that the account is managed by a third party—the CTA. On the other hand, CPOs commingle the assets of investors into a pooled vehicle, usually a limited partnership, and then subsequently allocate client assets to be traded by CTAs or by the CPO itself. The managed account vehicle utilized by CTAs is a more transparent and liquid investment by its very nature/structure. Whereas a commodity pool is less transparent and usually provides only monthly or quarterly reporting; further, it is less liquid in that redemptions are facilitated on a monthly or quarterly basis. There are advantages to the commodity pool structure though, including the ability to invest in CTAs with high minimums, as well as professional selection/oversight of CTAs.



What is the difference between managed futures and commodity ETFs?

This question is worthy of a book. Briefly, commodity exchange traded funds (ETFs) are a new type of investment vehicle which allows investors to invest in commodities as if the instrument was a stock. Just a few years ago, the only way to invest in commodities was either through the futures/derivatives market or through a pooled investment vehicle. Commodity ETFs are usually long-only, and marketed on the basis of three types of returns: (i) “collateral return,” which results from investing monies into fixed income instruments which collateralize the derivatives that provide commodity exposure for the ETF; (ii) “spot return” which is the change of price in the underlying commodity exposure; and (iii) “roll return” which supposedly results from the “rolling forward of futures contracts.” The “roll return” is a hotly debated concept within academic circles, but Wall Street markets the idea nonetheless. There is a fourth source of return, less often stated, which is the “strategy return” that comes from rebalancing the portfolio. Managed futures differs from commodity ETFs

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in that “strategy return” is the main focus, and most CTAs will go long and short a market taking advantage of “spot returns” either way. With respect to “roll returns,” certain CTAs employ calendar spreads which effectively arbitrage for this particular source of return. At the same time, managed futures accounts can be invested in fixed income allowing an investor to obtain “collateral return.” However, it should be noted that managed futures involves leverage whereas commodity ETFs usually invest on a fully collateralized basis.

How do I invest in managed futures?

Investing with a CTA involves two distinct steps: first, is setting up a futures brokerage account(s); second, is selecting a CTA or combination of CTAs who will advise your account(s). An intermediary knowledgeable about managed futures can be immensely helpful in the research, selection and ongoing monitoring of CTAs.

How does one choose a CTA to invest with?

This process starts by first educating yourself, and by putting parameters around your risk tolerance and return objectives. Remember that potential upside returns is

linked to potential downside risk. Analysis of CTAs should include both the quantitative as well as the qualitative. Insight into the qualitative aspects of a CTA program comes from due diligence and understanding the context in which past performance was achieved.

Can IRAs invest in managed futures?

Yes, but an investor must ensure that his/her plan permits such investments. If not, an investor may alternatively open an account with another custodian.

What is the minimum investment to start?

CTAs have different minimums with some ranging as high as \$5 million, while others permit accounts as low as \$25,000. Varying account sizes can pose an issue when building a robust multi-advisor portfolio.

Prudent words of advice...

The best recommendation is to ask questions and do your homework. Find a managed futures advisor who is educationally oriented, and works with you in a collaborative way to help you achieve your goals. When investing in managed futures, be sure to consider the context of your traditional investments.

STATISTICAL INSIGHT: Time Weighted Returns (Part 2)



In last month’s issue of *Intelligent Trading*, we explained that monthly rate-of-returns (ROR) as reported by CTAs are too often taken at face value by investors. In this issue we explore the “Time Weighted” methodology (“TW”) for calculating rates-of-return, and how this formula smooth additions and withdrawals as well as create other distortions.

Previously, we introduced the basic formula for calculating rate-of-returns, which is $NP_i \div BNAV_i = ROR$. However, this method can sometimes result in distortions under certain circumstances. Because this is well-recognized, regulations allow CTAs to adjust the BNAV upward by prorating additions and downward by prorating withdrawals.

While using this method will certainly smooth out distortions generally, it can also obfuscate accurate reporting. This happens when the introduction of a large new account, which is not immediately aligned to the CTA’s full set of positions, alters the composite return in comparison to the returns of older accounts with legacy positions.

In some cases, and it happens from time-to-time, a CTA will report a lower negative composite return in relation to volatile market conditions, then what that CTA would have otherwise reported had a large addition not been made. Likewise, it should be recognize that the opposite can occur too, and a CTA’s composite positive return is impacted.

In the next issue of *Intelligent Trading*, we will explore the “Only Accounts Traded” methodology for calculating rate-of-returns. If you are interested in learning 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: Chicago Soft Red Winter Wheat Futures (Symbol: W)

Though there are many different varieties of wheat grown throughout the world, such as soft, hard, white and red, there are actually only two main classifications of wheat: winter and spring. Winter Wheat is planted in the winter and Spring Wheat is planted in the spring, hence the names. Each particular type of wheat, Hard Red, Soft Red, Durum and White, requires slightly different climatic conditions best suited for growth.

The first modern futures contract is the Soft Red Winter Wheat. The contract trades on the Chicago Board of Trade (CBOT), and it is still the most actively traded wheat futures contract. Chicago Wheat, as it is called, is grown in diverse areas of the country, such as central

Texas, towards the northeastern Great Lakes, and east to the Atlantic. Unlike Hard Red Winter Wheat which trades on the Kansas City Board of Trade, Chicago Wheat is grown in humid environments not suited to hard grain production. The flour from Soft Red Winter Wheat is used to make cakes, cookies, snack foods, crackers and pastries.

The contract trades in units of 5,000 bushels, and regular facilities for the delivery of Chicago Wheat may be located within the Chicago Switching District, within the Burns Harbor Indiana Switching District, within the Toledo Ohio Switching District, or within the St. Louis-East St. Louis or Alton Switching Districts.

Contract Specifications

| | | | |
|--|--|---------------------------|--|
| Trading Unit | 5,000 bushels of wheat | Price Quotation | The minimum fluctuation for wheat futures is ¼ cent per bushel (\$12.50 per contract), including spreads. |
| Trading Hours (US Eastern Time) | Open Auction: 9:30 a.m. - 1:15 p.m. Central Time, Mon-Fri.; Electronic: 6:32 p.m. - 6:00 a.m. and 9:30 a.m. - 1:15 p.m. Central Time, Sun.-Fri.; Trading in expiring contracts closes at noon on the last trading day. | Trading Months | July, September, December, March, and May |
| Last Trading Day | The business day prior to the 15th calendar day of the contract month. Last delivery day is the eventh business day following the last trading day of the delivery month. | Deliverable Grades | No. 2 Soft Red Winter, No. 2 Hard Red Winter, No. 2 Dark Northern Spring, and No. 2 Northern Spring at par; No. 1 Soft Red Winter, No. 1 Hard Red Winter, No. 1 Dark Northern Spring and No. 1 Northern Spring at 3 cents per bushel over contract price. |
| Settlement Type | Every delivery of wheat may be made up of the authorized grades for shipment from eligible regular facilities provided that no lot delivered shall contain less than 5,000 bushels of any one grade in any one facility. | More Information | http://www.cbot.com/cbot/pub/page/0,3181,1322,00.html http://www.cbot.com/cbot/pub/cont_detail/0,3206,931+53432,00.html |

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