



Intelligent Trading

Commodities, Forex, Futures and Options

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FOCAL POINT CONCEPTS: System Safeguards in the Futures Industry

As presented by the National Futures Association (NFA)

Our financial system at its very core is built upon the foundation of credibility and trust. However, market volatility and the failure of large financial institutions erode that confidence. The best way to restore confidence is by gaining knowledge about the situation, double-checking system safeguards and reviewing if risk taken is in line with the level of risk one wants to assume. From there you can make intelligent choices.

The following is from the National Futures Association website. The National Futures Association (NFA) is the self-regulatory organization that oversees professionals who operate in the futures market. The NFA does a great job of telling the story behind the financial integrity of the U.S. futures markets, and so we have republished it here.

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The Story Behind the Financial Integrity of the U.S. Futures Markets

Trading volume in futures contracts and options on futures on U.S. markets has risen to more than 500 million contracts annually. And the dollar value of futures contracts traded currently exceeds several-fold the dollar value of common stocks traded on all U.S. stock exchanges.

A requisite for this growth has been the financial integrity of futures markets. While trading in futures contracts obviously involves risks related to price changes, market participants have historically had little reason to be concerned about the security of their funds. *Customer losses due to the insolvency of a futures brokerage firm have been virtually non-existent. Indeed, such losses have totaled less over 50 years than the Securities Investor Protection Corporation has paid, on the average, to reimburse customers of the securities industry for member firm insolvency losses each year.*

For anyone who is thinking about participating in the nation's futures markets as either a trader or managed futures investor, the reasons behind this continuing and impressive record of financial soundness are worth knowing about.

(Focal Point Concepts continued on page 2)

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“Margin deposits provide protection for all market participants.”

Daily Cash Settlement

As futures prices move upward and downward, the market value of customers' open positions increases and decreases. Resulting gains and losses from futures trading are credited or charged to each customer's account each day following the close of trading. Subject to existing margin requirements, all gains deposited to a customer's account through this procedure become immediately available to the customer.

Margin Requirements

Buyers and sellers of futures contracts are required to at all times maintain sufficient funds on deposit in their brokerage accounts to cover losses that might be incurred as a result of price changes. Margin deposits provide protection for all market participants. In volatile markets, the exchanges increase margin requirements accordingly. The availability of such funds is what makes daily cash settlements possible under all market conditions.

The Exchange Clearing Houses

Once each purchase of a futures contract is precisely matched to the corresponding sale (a process which occurs each day), the clearing organization of the exchange where the contracts are traded becomes the "buyer to every seller and the seller to every buyer." The purpose: provide a mechanism that assures the payment of all gains and collection of all losses on a daily basis.

Capital Requirements

Every firm that conducts business with the public as a Futures Commission Merchant must have and maintain sufficient capital to meet its financial obligations to its customers. These requirements are subject to continuous audit and stringent enforcement. Regulatory agencies have the authority to determine compliance on a daily basis and in volatile markets a clearing organization can demand that a firm provide additional capital on one hour's notice!

Segregated Accounts

Firms and principals of firms in the futures industry are required to maintain their customers' funds and margin deposits in bank accounts which are totally separate from their own. Rules further stipulate that such funds can be used only for the purposes the customers intended and can at no time be commingled with the firm's funds or the funds of the firm's principals. Compliance is strictly enforced and regulators possess power to take such immediate action as is considered necessary to protect the security of customers' money.

[It should be pointed out that not all futures accounts are segregated. Accounts or sub-accounts which trade contracts on foreign exchanges, or accounts or sub-accounts which are denominated in a currency other than the US dollar, may have funds in a “non-segregated” or “non-regulated” account or sub-account. If you have any questions about this, contact your representative at Managed Account Research, Inc.]



“...in volatile markets a clearing organization can demand that a firm provide additional capital on one hour's notice!”



Focal Point Concepts from page 2

Transfer of Market Positions

Should a firm be determined to be in a financial situation that could potentially jeopardize the safety of its customers' funds, it can be directed to immediately cease operations and transfer all open customer positions in the market to a firm which is financially sound. This is to ensure that adequately margined positions with a troubled firm will not be liquidated at a time when the customer may not wish for them to be liquidated.

Regulation

Regulation of the U.S. futures industry is primarily self-regulation, with the role of the federal Commodity Futures Trading Commission being principally an oversight role (to determine that self-regulation is continuous and effective). Of the total expenditures on futures regulation, more than three-fifths of the cost is presently being paid by the exchanges where futures contracts are traded and by National Futures Association (NFA), the industry-wide self-regulatory organization authorized by Congress and established in 1982. The purpose of self-regulation is to assure that those who

conduct futures trading business with the public do so in a professional, ethical and honest manner.

NFA's responsibilities include screening, testing and registering persons applying to conduct business in the futures industry. NFA and the exchanges have responsibility for auditing and enforcing compliance with industry rules. These rules encompass financial requirements, segregation of customers' funds, accounting procedures, sales activities and, in the case of the exchanges, floor trading practices.

Although there is no guarantee against customer losses due to the insolvency of a futures brokerage firm, the above mechanisms are designed to ensure the financial integrity of this nation's futures markets, and have in fact minimized the risk of customer losses.

Additional information

For more reading about the industry's system safeguards, download the following PDF from the CME Group:

<http://www.cmegroup.com/clearing/files/financialsafeguards.pdf>

STATISTICAL INSIGHT: OAT Returns (Part 3, Series Final)



Over the last two issues of *Intelligent Trading*, we have been explaining the subtleties of CTA performance reporting, specifically the various issues involved with calculating that most important number—the rate-of-return. In this last of the series we explore the “Only Accounts Traded” methodology (“OAT”), and the pros and cons of this calculation variation.

Certain issues with the time-weighted methodology for calculating rate-of-return can be eliminated with the use of the OAT method. But unfortunately this method has its problems too. The OAT method calculates the monthly rate-of-return in the conventional manner except that accounts that have traded for only part of the month, or accounts that witnessed “material” additional/withdrawals during the reporting period, are excluded from the calculations.

By excluding these accounts, it is assumed that the remaining result will reflect the rate-of-return that would have been realized by an investor with an account that was active at the start of the month, and held until the end of the month. In theory this approach removes the influence of intra-month additions/withdrawals yielding an “undistorted” return.

However, there can be situations when because of position alignment or other reasons, accounts which may be more representative of the fully implemented trading program are underweighted in the composite due to the mechanics of this methodology. The problems are more pronounced with CTAs who have only a few accounts under management.

In the next issue of *Intelligent Trading*, we will begin to explore risk measurement statistics, and how these quantitative techniques can be helpful in analyzing CTA returns. Your feedback is much appreciated. Call or email Managed Account Research and let us know how we're doing, and what statistical idea you would like to see explored.

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CONTRACT SPOTLIGHT: NYMEX COMEX Division Gold Futures (Symbol: GC)

Perhaps no other market in the world has the universal appeal of the gold market. For centuries, gold has been coveted for its unique blend of rarity, beauty, and near indestructibility. Nations have embraced gold as a store of wealth and a medium of international exchange; individuals have sought to possess gold as insurance against the day-to-day uncertainties of paper money.

The United States first assigned a formal monetary role for gold in 1792, when Congress put the nation's currency on a bi-metallic standard, backing it with gold and silver. During the Great Depression of the 1930s, most nations were forced to sever their currency from gold in an attempt to stabilize their economies. Gold formally re-entered the world's monetary system in 1944,

when the Bretton Woods agreement fixed all the world's paper currencies in relation to the U.S. dollar which in turn was tied to gold. The agreement was in force until 1971, when President Nixon effectively cancelled it by ending the convertibility of the dollar into gold.

COMEX Division gold futures and options provide an important alternative to traditional means of investing in gold such as bullion, coins, and mining stocks. Commercial concentrations of gold are found in widely distributed areas: in association with ores of copper and lead, in quartz veins, in the gravel of stream beds, and with pyrites (iron sulfide). Seawater contains astonishing quantities of gold, but its recovery is not economical.

Contract Specifications

Trading Unit	100 troy ounces	Price Quotation	\$0.10 per troy ounce; \$10.00 per contract.
Trading Hours (US Eastern Time)	Open outcry trading is conducted from 8:20 AM until 1:30 PM. Electronic trading is conducted from 6:00 PM until 5:15 PM via the CME Globex® trading platform, Sunday through Friday. There is a 45-minute break each day between 5:15PM and 6:00 PM (next trade date).	Trading Months	Trading is conducted for delivery during the current calendar month; the next two calendar months; any February, April, August, and October falling within a 23-month period; and any June and December falling within a 60-month period.
Last Trading Day	Trading terminates at the close of business on the third to last business day of the maturing delivery month.	Deliverable Grades	In fulfillment of each contract, the seller must deliver 100 troy ounces (±5%) of refined gold, assaying not less than .995 fineness, cast either in one bar or in three one-kilogram bars, and bearing a serial number and identifying stamp of a refiner approved and listed by the Exchange.
Settlement	Gold delivered against the futures contract must bear a serial number and identifying stamp of a refiner approved and listed by the Exchange. Delivery must be made from a depository licensed by the Exchange.	More Information	http://www.nymex.com/GC_spec.aspx http://www.nymex.com/gol_fut_margin.aspx

Intelligent Trading is a newsletter publication of Managed Account Research, Inc. Its purpose is to educate investors on managed futures investing and discuss general concepts related to the trading of commodity, forex, futures and options markets. To subscribe or unsubscribe, contact us at 800.308.1495 or email: research@ma-research.com.

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