Intelligent Trading

Commodities, Forex, Futures and Options

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Theory Topics:

FOCAL POINT CONCEPTS: Beyond Long-Only Commodity Exposure

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> *"Behold, the fool saith, 'Put not all thine eggs in the one basket' which is but a manner of saying, 'Scatter your money and your attention,' but the wise man saith, 'Put all your eggs in the one basket and... watch that basket.'"* — Mark Twain, Pudd'nhead Wilson (1894)

A well embraced tenant of prudent investing is to diversify your investment portfolio among different types of assets which may respond differently to various economic conditions. Diversification is an effective risk management tool in helping reduce investors' exposure to a downturn in any one sector.

Notwithstanding the spirit of truth in Pudd'nhead's maxim, a sentiment echoed by Warren Buffet who once said "Wide diversification is only required when investors do not understand what they are doing," proper diversification is a proven method to improve the long-term probability of upside performance, as well as downside risk exposure. The key is to know how to diversify properly.

Securities based on capital market assets (stocks and bonds) are intrinsically different from commodities. This is underappreciated... Indeed, there is an established theoretical basis and considerable empirical evidence that link equity or fixed income investments to positive expected returns over time. This structural source of return/systematic risk is often referred to as the "beta" of an asset.

In recent years there has been a proliferation of benchmarks and indices which purportedly represent proxies for beta. Financial innovation, in turn, has converted these proxies into investment products such as ETFs. As a result, investors can now, more than ever, easily diversify their investment portfolios across multiple sectors, in what has been termed by Goldman Sachs as the "multiple beta" approach. But do these investment vehicles, often employing a predefined passive portfolio, always serve investors' best interest with respect to constructing well-diversified portfolios?

The ironic twist is that the multiple beta paradigm has ported skilled-based investment decisions to the investor. Further, we contend that securitized products based on long-only exposure to commodities (e.g., mutual funds such as the PIMCO Commodity Real Return Strategy, Rogers International Commodity Index Total Return, or ETFs such as the PowerShares DB Commodity Index Tracking Fund) will prove over time to not be the reliable and consistent source of positive expected returns as is proposed.

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The inherent problem is that commodities are not capital assets. Rather, commodities are consumable, transformable and perishable assets in which physical ownership does not generate a yield, but a cost-of-carry. Since owning hard assets is not convenient unless one is a "commercial," exposure to commodities as an asset class usually takes place through derivatives trading or investment vehicles which trade derivatives.

"…on an inflation-adjusted basis, long-only exposure to commodities likely results in "zero systematic risk."

Derivatives are risk management tools, a "zero-sum game," fundamentally different from the "rising tide raises all ships" concept of the capital formation markets. The conundrum is that for every buyer of a commodity futures contract there is a seller—sine qua non, there is no intrinsic value—they are simply agreements which commit a seller to deliver an asset to a buyer at some place/point in time.

Correspondingly, notwithstanding the recent surge in commodity prices, a legacy of disagreement and inconsistent conclusions by academics buttresses the claim that, on an inflation-adjusted basis, long-only exposure to commodities likely results in "zero systematic risk." Hence, commodity investing facilitated for financial rather than commercial reasons is considered speculative.

Our research arrived at the following conclusions with respect to the various sources of return from commodities as identified by the mainstream financial services community: (1) collateral return is available via both index funds and managed futures, however, managed futures offers leverage as an additional factor; (2) the fundamentals underlying spot returns is more complicated than what commodity bulls suggest, commodity prices do not only go up—if they did than the source of return would be from consumers' pockets in the form of inflation; (3) roll yield is a source of return subject to academic debate, moreover, "premium" term structure conditions are detrimental to long-only positions; and (4) managed futures is the traditional forum for strategy returns.

The current popularity of commodities reminds us of the everlasting debate between investors as to the extent passive asset class exposure is the primary driver of risk and return, versus to what extent does a tactical approach to investing play a positive, negative or neutral role in managing risk and return.

To be unambiguous, the term "asset class" is typically ascribed to a group of securities that share similar risk and return characteristics such as cash equivalents, fixed income, and equities. Additional diversification can be achieved by blending different categories contained within each asset class. For example, equities can be divided into large-, mid- and small-capitalization stocks; economic sectors such as energy, healthcare or technology; geographic regions (domestic vs. international); or investment styles (growth vs. value). Fixed income is typically separated into groups designated by type of issuer, credit quality and maturity.

"Additional diversification can be achieved by blending different categories contained within each asset class."

However, beyond asset class distinctions there are several approaches to investing which require differing levels of active management based on assumptions about an investor's risk tolerance and changes in market expectations. Popular forms include the "buy and hold" strategy in which an investor determines an initial allocation and then holds this portfolio throughout market fluctuations without making adjustments. Another approach is "strategic asset allocation" which requires the investor to make periodic modifications to restore the portfolio to the targeted mix. And then there is "tactical investing" where the investor actively changes investments to reflect his or her own shorter-term capital market expectations.

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In the not-so-distant past, the demise of the unprecedented 1980s/1990s bull market in equities left many investors disputing the case for a pure “buy and hold” strategy. Accordingly, investors increasingly turned to investment alternatives, particularly “absolute return” programs that generate “alpha” or skilled-based returns that exceed the performance of financial markets. This change in practice has been further validated by the growing institutional demand for active management via hedge funds.

We believe that passive long-only commodity investment is at a similar juncture, one where investors will come to realize that strategy returns in commodities is the primary return driver. Managed futures fills that gap as its returns are primarily based on a broad range of strategies, styles and blended approaches. The key is the skill of the trader.

But knowing whether a portfolio manager is doing a good job can be a challenge. The reason why it's difficult is because it depends on how the rest of the market is performing. For example, in a bull market 2% is a horrible return. But in a bear market, when investors are down 20%, just preserving your capital would be considered a triumph. In that case 2% doesn't look bad.

But this is where things can get complicated. Who is to say what the “market” is? The S&P 500 index is often cited as the benchmark for the stock market but in actuality it represents mostly large-cap stocks. The Russell 2000 serves as a benchmark for small-cap stocks, while the Lehman Aggregate Bond Index is comprised of fixed income securities to simulate the universe of bonds. For the commodity markets this question is an infinitely more difficult one to answer.

Accordingly, while it is wise to look at relative returns to see how an investment's return compares to other similar investments. The trick is finding an appropriate benchmark in which to measure your investment's return before making a decision of whether the investment is doing well or poorly.

For these reasons, we note that managed futures is vastly different from most other types of investments. Investing in general, particularly managed futures, is a combined craft of art and science best learned by experience. Qualitative analysis is required to balance quantitative models. Accordingly, a practiced guiding hand can be very helpful in constructing portfolios.

STATISTICAL INSIGHT: Sharpe Ratio

Last month we looked into a method of measuring risk using standard deviation. A non-technical way to think of standard deviation is to imagine a car driving consistently in the same lane, versus a car which zigzags across the lanes of the interstate. The second car has a higher standard deviation or variability then the first car.

The Sharpe ratio, named after William F. Sharpe who invented the measurement in 1966, measures the excess return per unit of risk in an investment asset or a trading strategy. The formula is actually quite simple: take the return on the asset or trading strategy less the risk free rate, and divide that number into standard deviation. The Sharpe ratio is used to characterize how well the return of an asset compensates the investor for the risk taken.

Sharpe ratios, along with Treynor ratios and Jensen's alphas, are often used to rank the performance of portfolio or mutual fund managers. Sharpe ratio has often been challenged with regard to its appropriateness as a fund performance measure during evaluation periods of declining markets.

The non-technical way to think of the Sharpe ratio is to imagine a car driving 60 miles-per-hour without lane changes, versus a car driving 120 miles-per-hour with lane changes every few minutes. The miles-per-hour is representative of the rate-of-return, whereas the lane changes measures risk. Question: is it worth the risk of getting somewhere faster?

$$S = \frac{E[R - R_f]}{\sigma} = \frac{E[R - R_f]}{\sqrt{\mathrm{var}[R - R_f]}}$$

CONTRACT SPOTLIGHT:
CME Live Cattle (Symbol: LC)

The CME Live Cattle contract, first introduced in 1964, has proven to be an important tool for both cattle producers and packers to effectively manage price risk. The seasonal aspects of meat production and consumer's desire for meat products make this contract an attractive commodity contract to trade.

Cattle production begins with a cow-calf producer or rancher who breeds cows to produce calves using natural service with a bull or an artificial insemination program. Most cow herds are bred in late summer and thus produce a spring calf crop. The actual gestation period for cattle is approximately nine months. The majority of producers breed their herd to calve in the spring to avoid the harsh weather of winter and to assure abundant forage for the new calves during their first few months. Stocker or backgrounding operations place weaned calves on summer grass, winter wheat, or some type of harvest roughage, depending upon the area and the time of year. Cattle producers have three options when their cattle reach the feeder stage. They can: 1) feed the cattle at a home operation, 2) place the cattle in a commercial feedlot to be custom fed while retaining ownership, or 3) sell the cattle to another cattle feeder or feedlot. No matter the option selected, when cattle reach this stage, they are fed a mix of high energy feed to promote rapid weight gain. Feeding continues until the animal is "finished" or has reached some optimum combination of weight, muscling and fat.

Contract Specifications

Trading Unit	40,000 pounds	**Price Quotation**	1 point = $.01 per hundred pounds = $4.00
Trading Hours (US Eastern Time)	Floor trading: 9:05 a.m.-1:00 p.m. LTD(12:00 p.m.) central time. CME Globex platform Mon-Thurs 9:05 a.m.-4:00 p.m. Central time. Shutdown period from 4:00 p.m.-5:00 p.m. Re-open 5:00 p.m.-4:00 p.m. Friday Close at 1:30p.m. LTD (12:10 p.m. If the LTD is on a day that the market closes early, then the time is 11:10 a.m.)	**Trading Months**	Nine (9) months in the Even Monthly Cycle: Feb, Apr, Jun, Aug, Oct, Dec. No person shall own or control more than: a) 5,400 contracts long or short in any contract month; b) 450 contracts long or short in the expiring contract month as of the close of business on the first business day following the first Friday of the contract month
Last Trading Day	Trading shall terminate on the last business day of the contract month.	**Deliverable Grades**	Each futures contract shall be for 55% choice, 45% Select, Yield Grade 3 live steers, as defined by the United States Department of Agriculture (USDA) "Official United States Standards for Grades of Slaughter Cattle."
Settlement Type	Physically Delivered	**More Information**	http://rulebook.cme.com/Rulebook/Chapters/pdffiles/101.pdf

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