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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

THEORY TOPICS:

1 **Focal Point Concepts:** Issues to Consider When Firing a CTA

2 **Focal Point Concepts:** (continued)

3 **Statistical Insight:** Peak-to-Valley Drawdown

4 **Contract Spotlight:** CBOT 10-Year Treasury (Symbol: TY)

FOCAL POINT CONCEPTS:
Issues to Consider When Firing an Advisor

By Mack Frankfurter, Chief Investment Strategist

What distinguishes many successful investors and traders from the rest of the pack is discipline. That is why the best time to think about firing a commodity trading advisor (CTA) is before you hire the CTA in the first place. It's about having a game plan.

During the past two decades, managed futures has enjoyed significant growth along with the popularly of alternative investments. The professional advisors who represent this space offer investors exposure to unconventional investment strategies which provide both diversification advantages and return profiles different from traditional investments. However, assessing active managers is difficult without context.

The first step is to map out how a CTA can potentially help achieve your investment objectives. For some investors, exposure to a CTA is purely speculative and provides access to leveraged returns not typically available vis-à-vis traditional investments. For other investors, managed futures is a means to help diversify a traditional stock-bond portfolio through exposure to uncorrelated returns and assets.

A key difference from traditional investments is the active management approach used by CTAs. The returns from traditional investments mainly come from passive long-only exposure to stock and bond asset classes. Nowadays, with commodity-linked ETFs, investors can also obtain long-only exposure to commodities, but this wasn't always the case. Prior to the turn of the decade, for an investor to be exposed to commodities one needed to trade futures or hire a CTA focused on commodities.

This is where managed futures can become confusing to the average investor. Futures and options on futures exist on a whole range of different underlying assets. These assets can generally be divided into the following categories:

- financials which include stock indices, fixed income and currencies
- agriculturals encompassing the following subsectors:
  - grains such as corn, soybeans and wheat
  - "softs" like cocoa, sugar, coffee and orange juice and
  - meats such as live cattle and pork bellies

Focal Point Concepts continued on page 2

- energies including crude oil, natural gas and electricity
- industrial metals such as aluminum, copper, palladium and zinc
- precious metals including gold and silver

CTA trading programs vary in amount of exposure to the various assets listed above. Some focus solely on one sector or even a specific contract, whereas other CTAs trade diversified portfolios encompassing the whole range of listed asset classes.

"These strategies and time horizons can be combined into a distinct approach which makes up the CTA style."

Let's say, for example, an investor is seeking return diversification to his/her traditional stock portfolio and selects a CTA focused on stock indices. In this case return diversification needs to be generated from the trading strategies employed. If such trading program turns out to be highly correlated to the returns of the stock market, then perhaps the investor should consider discontinuing the trading program.

This brings up the subject of trading strategies and having a general understanding of the different types of strategies that exist. Trading approaches can usually be paired into contrary strategies, such as trend-following versus counter-trend, technical versus fundamental, or systematic versus discretionary. Then there are various time horizons to consider: intra-day, short term, medium term and long term. These strategies and time horizons can be combined into a distinct approach which makes up the CTA style.

Before investing in a trading program it is important to understand as best possible the combination of strategies employed by the CTA. This understanding is key to a very important tenet when deciding to fire a CTA—is the trader maintaining the trading strategy which was represented to the investor, or has the trading program been altered in a way that no longer represents why the investment was made in the first place?

For example, if one invests in a livestock trading program and then the trader begins trading currencies, some serious questions need to be asked why. As another example, if a CTA is hired because it was presented as a long-term trend following system diversified across a variety of assets, and then it turns out that the CTA actively trades intra-week, the question of discipline becomes an issue.

On the other hand, if a trading program is consistent with its stated style mandate but is going through a drawdown, then it may be appropriate to stick with the CTA taking into consideration that the program was hired for its style mandate to begin with.

"…it may be appropriate to stick with the CTA taking into consideration that the program was hired for its style..."

Regardless, before investing in a CTA's trading program, it is a wise idea for an investor to first determine his/her own investment parameters.

One technique is to establish a money management stop (e.g., 10% drawdown from initial investment) at which the program should be discontinued. The appropriate stop-loss needs to consider both the investor's risk appetite as well as the amount of return fluctuation which is required by a specific trading program. For some programs a 10% stop is sufficient room to reasonably manage trading, whereas other CTAs may require as much as a 50% swings in equity volatility in order to function.

When employing money management, it is important to be disciplined with stops.

Focal Point Concepts continued on page 3

Focal Point Concepts from page 2

This brings up the opposite situation—'good problems to have' as they say. What does one do if the program is successful in delivering strong returns. There are various schools of thoughts, but prudent investors regularly rebalance by reallocating profits to other investments.

If the CTA delivers an unexpected windfall—a time many neophyte investors like to double-up—it may even be a wise idea to reduce the allocation, or at least take profits off the table. Indeed, sometimes a reason to fire a CTA is because of such windfall profits—did the trader take undue risk in order to achieve such profits?

In Issue 6 of Intelligent Trading we discussed due diligence. Due diligence is key both in making a decision to invest in a trading program, and preparation for making decisions as to when to fire a CTA.

After making an investment, the due diligence process doesn't stop. Wise investors constantly revisit their investment choices and perform follow-up due diligence to ensure that what they initially learned is still consistent with the current operations of the CTA. If this is not the case, then it may be time to fire the advisor.

Old hands in the managed futures industry also have other reasons for firing a CTA. One consideration is capacity. While many naively think that the more assets under management the better, sophisticated managed futures investors recognize that trading programs can have capacity constraints which diminish returns. The question to ask early on is what the expected capacity constraint is for a trading program. If the CTA accepts assets beyond this constraint, it may be time for review.

Other reasons for firing CTAs have to do with personnel issues. Long-time managed futures investors know that it is never wise to put money with a trader who is going through divorce. Likewise, if a trader gets cocky and shows a lack of respect to investors, it may be a good time to get out. This often reveals itself in how the CTA manages communications with investors. Last thing an investor wants is a trader "hiding under the table" during a drawdown.

Final thought: don't be afraid to fire a CTA if you feel uncomfortable with the investment. Investing in CTAs is like trading—it needs to be disciplined.

STATISTICAL INSIGHT: Peak-to-Valley Drawdown

Last month's issue of Intelligent Trading described an industry standard method for calculating a commodity trading advisors' (CTA) compounded rate of return. This method is called a Value Added Monetary Index or VAMI. Using the VAMI, one can calculate drawdowns or losses experienced by a trading program over a specified period.

A CTA's worst monthly drawdown is simply the trading program's worst monthly percentage rate of return (ROR). The worst peak-to-valley (or peak-to-trough) drawdown is the greatest cumulative percentage decline in month-end net asset value (NAV) due to losses sustained by the program during any period in which the initial month-end NAV is not equaled or exceed by a subsequent month-end NAV (note: the VAMI can substitute for NAV).

In order to calculate this amount, one needs to refer to the trading program's continuous VAMI. Next, determine the first month in which the VAMI is not followed by a VAMI (or NAV) which is greater than or equal to that month's VAMI. This month is the peak. The lowest VAMI after this peak is the valley or trough.

The worst peak-to-valley drawdown will be the largest negative percentage change from a peak to a valley. Long track records may have multiple peak-to-valley drawdowns extending over various periods of time.

One important statistic to note is the length of time it takes for a trading program to get to new highs (i.e., a new peak VAMI). Most investors like to see short recovery periods. But beware: a CTA who is in a drawdown and makes a fast recovery might have taken undue risk to get back to breakeven. Prudent CTAs tend to "pull in their horns" and trade conservatively during drawdowns in order to mitigate the risk of an even greater drawdown.

CONTRACT SPOTLIGHT:
CBOT 10 Year Treasury Note (Symbol: TY)

For almost 130 years, the Chicago Board of Trade (CBOT) was strictly a commodity exchange, listing futures on agricultural products and precious metals. Then in 1975 the exchange introduced GNMA futures to track mortgage interest rates, the first futures contract designed to manage interest rate risk associated with a debt instrument. The CBOT expanded its product offerings in 1977 with the 30-year U.S. Treasury bond futures contract, later adding futures on 10-year Treasury notes (1982), 5-year Treasury notes (1988), and 2-year Treasury notes (1990). Currently, CBOT financial futures and options represent the majority of trading activity at the exchange. Treasury futures play an important role in the risk management strategies of a number of participants, including: bankers, cash managers, governments, insurance companies, bond dealers, pension funds, corporate treasurers, and portfolio managers.

The underlying instrument for the CBOT 10-year T-note is a $100,000 face value U.S. Treasury security. The Treasury futures market follows the conventions of the underlying cash market in quoting futures prices in points and increments of a point. A point equals 1% of the total face value of a security. Since futures on Treasury notes is $100,000 face value, the value of a full point is $1,000 for each contract. The 10-year T-note futures trade in minimum price increments of one-half of one thirty-second with a tick value, equal to $15.625. The T-note futures contract is a proxy for a specified range of maturities. To allow the futures price to reflect the full range of issues eligible for delivery, the CBOT developed a conversion factor system. This system was created to facilitate the T-note delivery mechanism and adjust for the coupons eligible for delivery into the futures contract.

Contract Specifications

Trading Unit	One U.S. Treasury note having a face value at maturity of $100,000	**Price Quotation**	Points ($1,000) and one-half of 1/32 of a point; i.e., 80-16 equals 80-16/32, 80-165 equals 80-16.5/32
Trading Hours (US Eastern Time)	Open auction: 7:20 a.m.-2:00 p.m. central time, Monday – Friday Electronic:M5:30 p.m. – 4:00 p.m. central time, Sunday - Friday	**Trading Months**	Quarterly Cycle: Mar, Jun, Sep, Dec.
Last Trading Day	Seventh business day preceding the last busines day of th edelivery month. Trading in expiring contracts closes at noon, Chicago time, on the last trading day. Last delivery day is last busness day of th edelivery month.	**Deliverable Grades**	U.S. Treasury notes maturing at least 6-1/2 years, but not more than 10 years, from the first day of the delivery month. The invoice price equals the futures settlement price times a conversion factor plus accrued interest. The conversion factor is the price of the delivered note ($1 par value) to yield 6 percent.
Settlement Type	Federal Reserve book-entry wire-transfer	**More Information**	http://www.cbot.com/cbot/pub/cont_detail/0,3206,931+53450,00.html

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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