

CHAPTER 1

Understand It

The Truth about Risk and Misunderstood Investments

There is an asset class that has been generally ignored by Wall Street—despite outperforming the stock market over 27 years, according to one of the most recent studies on the topic from the Chicago Mercantile Exchange (CME). (See Figure 1.1.)

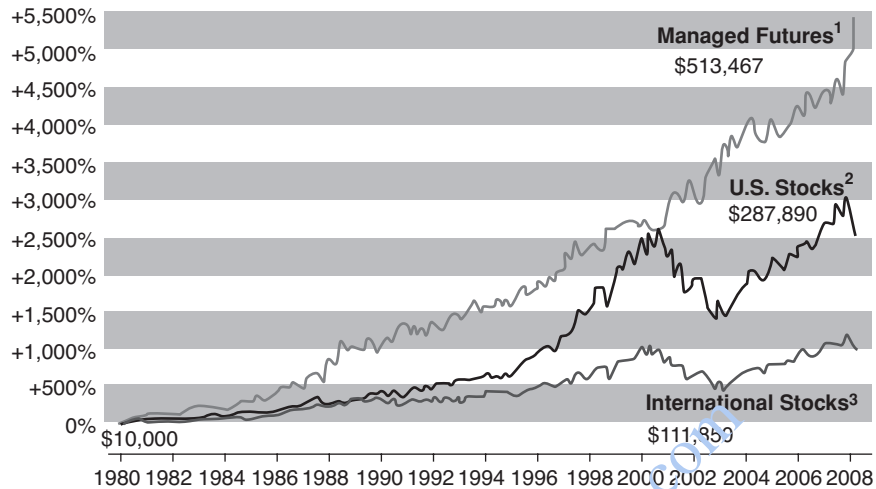
While many Wall Street institutions benefit through their portfolio investments in this asset class, the investment has been misunderstood by many financial advisors, as well as generally and perhaps deliberately obscured from qualified investors.¹ This is despite the asset class performing positively in nine of the last ten stock market declines with such low draw-down numbers it would even make the most talented hedge fund manager blush.²

The asset class is managed futures, a relatively unknown and misunderstood investment. Managed futures has provided investors several benefits, including diversification, tax benefits, the potential for high returns, lowered portfolio volatility, and lack of correlation to the stock market.

In fact it could be argued that managed futures is the most uncorrelated major asset class in history, the most diversified from stocks.³ Here is why:

Success in managed futures investing is not necessarily dependent on the positive or negative price movement of any market. This is relatively unique in the history of investing.

To illustrate this point, some market-neutral managed futures investments are designed to be profitable regardless of core price movements in the underlying markets in which they invest. Further, it is common in popular trend trading, and discretionary programs, for strategies to be designed



1) Managed futures: CASAM CISM CTA Equal Weighted; 2) U.S. stocks: S&P 500 Total Return; 3) International stocks: MSCI World.

FIGURE 1.1 Comparison of Performance, 1/1980–2/2008
Source: Courtesy CMEGroup.

so as not to be tied to the positive price movement in any market in which they trade.

This bold statement is based on empirical correlation statistics outlined in this chapter and throughout the book. But it also comes from a conceptual knowledge of the unique and very different option and spread strategies that are based on futures and option contract structures: different delivery time frames for spread trading, option premium collection strategies, and other opportunities only available in the *regulated* derivatives markets. This book isn't about technical details of futures and option contracts, but it is about how to use these unique structures to create truly powerful investments using what is an interesting asset class.

WHAT IS THIS "MANAGED FUTURES" I'VE NEVER HEARD ABOUT?

Managed futures is similar in some ways to a mutual fund for the commodities industry in that talented money managers with audited past track records invest client assets in worldwide futures and options markets.⁴ The core structure of the futures contract allows for very unique investment

strategies; sometimes long, sometimes short, and at times market neutral, indifferent to the up or down price movement of any market or economic factor at large. Managed futures is defined further over the next three chapters, and throughout the book, as is the idea that managed futures could be the world's most uncorrelated asset class.

Stock investors should understand managed futures and consider it as a component in their portfolio. However, this investment method is not for everyone. It involves risk and managing risk, as does all investing, to varying degrees. The key is to understand true risk and then appropriately manage it. The word *true* is used because investing risk is at times unclear, obscured behind a veil of mistaken perception. This is true in the stock market when one considers real drawdown and volatility as it is in hedge funds and managed futures when different hidden risks are exposed. In this book the investor will discover the truth—for better or worse.

And it's about time.

This chapter lays the foundation for the book, calling into question commonly held investing beliefs—societal norms, really. This book in part echoes the voices of Lintner and countless ignored academic studies since that have compared stock market risk to more diversified risk that includes managed futures, and the book does so in what the author believes to be a balanced and fair approach. Chapter 1 highlights risk statistics that those beholden to stocks might not want you to see:

- Stocks are not as “conservative” as you might think—just ask several Nobel Prize winners.⁵
- The truth about risk: The new “conservative” is asset diversified with risk.
 - Conservative should be defined by the level of diversification, not based only on the risky assets inside a portfolio.
- Intelligent investing, and this book, are about using diversification and reducing correlation to stocks and the economy; performing under a variety of economic circumstances—the good, the bad, and the ugly of economic times.

STOCK MARKET “SAFETY” AND OTHER MYTHS

Prior to September 2008, investors might have considered stock portfolios reasonably diversified, conservative, and maybe even the unthinkable: “safe,” to a degree. Investors might have believed that buy and hold was the

best long-term strategy and that stocks were the only traditional investment that met their needs. These images, call them core societal beliefs, were generally marketed by the same firms that were kind enough to give birth to the credit-default swap and mortgage-backed securities that were so beneficial to the economy. Yes, these societal beliefs are wrong. Dead wrong.

For some, the consequences of these incorrect beliefs have been dramatic—a nightmare of life-altering proportions. For others, stock market stagnation represents just a number change on paper, nothing altering daily life. But in either case, the impact, the scare, the failure, and the realization of investor vulnerability can lead to emotions that foster bad dreams. The problem is that nightmares don't end until you wake up.

It is time to wake up.

Waking up is a process, and investors may have problems, particularly if they support the societal value that says the source of investing power—its heart, its liver, all its vital organs—is only centered on the stock market and a little island of thought. It is time to challenge tired traditions and usher in new choice, the option for real asset diversification.

As stock investors look upon a decade without financial reward, commonly called the “lost decade,” they shake their heads with a disgust that comes from a man hoodwinked by a trusted friend. Ten years without capital gain or any appreciation in their stock investments; not even a thank you. How could the “safe” stock market fall off a cliff . . . again?

But here's the unwanted punch line: The coming 10 years could bring more uncertainty, kind of like raising a child. Stock investing could exhibit patterns of moody, unpredictable behavior with volatile price swings driven by economic forces beyond the control of mere politicians and governments, not to mention investors. At times everything might smell like roses; the stock market will experience bull runs to profitable ground; a new day will appear to be born. The market will rise in price along with investor hopes and dreams. Investors' emotions will drive them to think happy days are here again, the stock market is “normal,” back on track. However, normal in most contexts is relative. Investors entirely dependent on their equity savior will also realize that hope is a four-letter word, because the stock market will likely have difficulty navigating what can only be described as a unique and uncertain economic environment. It is said that a stock market crash is an anomaly, like a 100-year flood. If so, investors will do well to prepare a sturdy boat, because stock market 100-year floods might occur on a more regular basis.

And this leads to one point of this book:

Wouldn't it be nice if investing wasn't entirely dependent on the stock market or the economy at large?

INVEST WITH STOCK MARKET NEUTRAL PROGRAMS

To be clear, this book does not seek to replace stock investments. Stocks are too engrained as a cultural norm. The goal is to create a balanced portfolio that includes stocks, but uses uncorrelated assets so that the portfolio is balanced and more neutral to wild stock fluctuations.

True asset diversification and uncorrelated returns performance is something to which all investors should aspire. In fact, those who regulate the investing industry advocate diversification. In *Ten Tips for 2010* the Financial Industry Regulatory Authority (FINRA), one of two regulators of U.S. securities investments, advocates spreading investments among different asset classes and within each asset class, a sentiment echoed by the National Futures Association (NFA), which is one of two organizations that regulates the managed futures industry and audits its performance.⁶ “Although the concept may sound simple, the National Survey found that one-quarter of those who rated their financial knowledge as ‘very high’ could not correctly answer a question about risk and diversification,” the FINRA report noted. Separate studies have found that only a small but growing number of financial professionals understand how to properly diversify a portfolio from stocks and the economy using managed futures.

FINRA is not just a singular pillar in the stock-centric world that recognizes the value of diversification.

“In 2008 investors discovered what financial advisors touted as a ‘diversified portfolio’ was not,” noted Nadia Papagiannis, the Alternative Investment Strategist at Morningstar, a highly respected equity research firm. “Investors didn’t realize the true volatility in the stock market—nor understand their individual risk tolerance—until in 2008 when they experienced firsthand the true risk and volatility in the stock market.”

Papagiannis views managed futures from a unique vantage point as one who provides alternative investing insight for Morningstar, but more pointedly her previous experience as a commodity trading advisor (CTA) auditor at the NFA has allowed a firsthand knowledge of the strong performance reporting requirements demanded of the managed futures industry.

“Most investors had no idea managed futures and their uncorrelated strategies existed and that they are not as volatile as people think,” she observed. “What’s more, investors didn’t really understand they can manage volatility (dialing it up and dialing it down).”

There is indeed valuable information on managed futures and related diversification opportunities of which both professional and individual investors should be aware. The way to achieve enlightenment on the world of true asset diversification using managed futures involves an interesting

formula of Nobel Prize–winning lineage, a graphical risk measurement technique developed over 60 years ago. This concept was later advanced by a legendary Harvard University professor: a man who showed the world how to create portfolios diversified from stock market risk and volatility. It is a formula that in fact uses a volatile and risky investment, managed futures, with the goal to reduce overall portfolio volatility. In short, uncorrelated volatility will be used to reduce overall portfolio volatility, an interpolation of the work of Harvard’s Dr. John Lintner.

To understand this formula and recognizing the reality in risk and reward is important, particularly when an opinion is drawn about stock market safety.

THE STOCK MARKET IS NOT “SAFE” OR “CONSERVATIVE” AND DOES NOT OFFER TRUE DIVERSIFICATION

Considering potential outside activities, driving to the local store for a gallon of milk in the morning is generally considered a safe activity; alternatively, flying as a plane passenger could be considered risky. But did you know, on a statistical basis, flying as a plane passenger is much safer than driving down the street? It is all a matter of perception.

Managed futures and hedge funds are risky investments. So is the stock market, when considered on a cold, statistical basis. It is all about understanding the degree of risk versus the degree of reward. Author Emanuel Balarie points out in his book *Commodities for Every Portfolio* that “concluding commodities are more volatile than stocks is purely a myth.” Balarie cites several studies, including a 2004 Yale University study, a tilting academic opinion that showed over a 45-year period of time a portfolio would have been more volatile invested in stocks than commodities.⁷

This isn’t something investors are being told. But that’s not all.

Always Understand, Then Balance Risk and Reward

When considering managed futures risk and reward it is difficult to avoid the work of two legendary minds: Harvard’s Dr. John Lintner and Nobel Prize winner Harry Markowitz. For those unfamiliar, details are revealed in Appendix F of the amazing work of these bright minds, work that has been generally overlooked by those blinded by a stock-centered world. Here is the point of their work for this chapter:

Understand, then balance, risk along with reward and only take risks for which the investor is compensated.

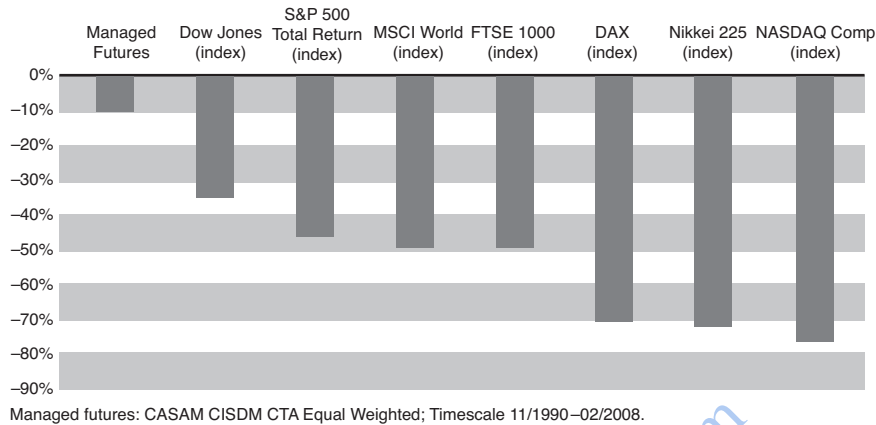


FIGURE 1.2 Comparison of Worst Drawdowns, 11/1990–2/2008
 Source: Courtesy CMEGroup.

That sounds so simple and logical. But if it is so logical, why have investors not been largely exposed to the following information?

One measure of past risk is an index's inevitable drawdown, or negative return. Consider Figure 1.2. This is interesting because drawdown is such a blatant measure of risk in any investment: bottom line risk in many respects. It shows the worst sustained losses of the major stock indexes and a managed futures index. For most investors, Figure 1.2 may come as a surprise. The NASDAQ had a worst drawdown of 70 percent, an amazing dilution of investor wealth. Based on index drawdown alone, any investment that loses close to three-quarters of its value in the blink of an eye can only be described as a very risky investment, indeed. By contrast, the managed futures index in the CME study had a worst drawdown of 9.3 percent. This is not to claim that managed futures is not risky; managed futures is risky. The point is to take an honest look at stock market risk. If managed futures is even a twinkle of a thought on investors' investment horizon, they might consider the asset class as risky. It is risky, but in some very different ways than that of the stock market. Judging the asset class through the lens of the index's worst drawdown, risk becomes a relative concept, and 70 percent is a massive drawdown number in any investment—the sign of a very risky investment, indeed.

To provide balance, this interesting managed futures index drawdown might not tell the whole story. There is currently no single investment that allows access to invest in the CASAM CISDM managed futures index, unlike stocks. While the CASAM CISDM index was used by the CME for their study and *Barron's* magazine utilizes data from the index for publication,

there are a wide variety of credible managed futures indexes to consider that vary in performance. Further, when investing in a single manager, as opposed to a diversified basket of managed futures programs, the investor may experience different performance from that of the broad index. Much like investing in a single stock, performance might differ from that of the index.

Drawdown Recovery Time: An Underutilized but Significant Risk Measure

If investors think the stock market is safe, consider the time to recover from negative returns performance. The length of time it takes to recover from sustained investment loss is a very interesting statistical measure of risk, particularly as it relates to managed futures. In Chapter 10, readers will discover a unique managed futures portfolio building method that features drawdown recovery time, volatility management and true diversification across five key points of correlation as a key risk management features. As the different drawdown recovery times are considered, understand that drawdown recovery is an underutilized yet potentially powerful risk statistic.

Figure 1.3 from the CME is illuminating. Managed futures in the CME study are represented by the CASH/CISDM managed futures index, and stocks by the S&P 500 Total Return index. The study shows the worst stock market meltdown took two years to recover, essentially working in the red from September 2000 to September 2002 with a 44.7 percent loss at its worst point, as measured by the S&P 500 Total Return index. By comparison, the managed futures index in the study had a relatively quick drawdown recovery period, lasting just two months. Its worst period of

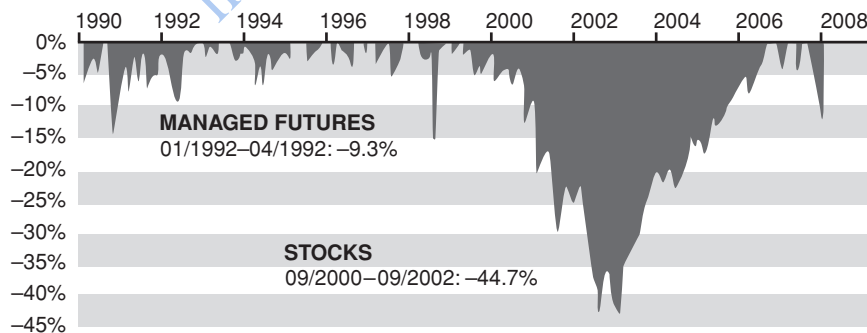


FIGURE 1.3 Comparison of Drawdown Duration, 1990–2008
Source: Courtesy CMEGroup.

investments to the left the least volatile, based on standard deviation; investments nearest the top have the highest expected or past returns and investments near the bottom have the lowest returns. Thus investments in the rarified upper left are most desirable: the lowest risk, highest return.

The stock market's statistical risk is evident when one views a Modern Portfolio Theory graphic on a cold, numeric basis. Investors should take an objective look at where the stock market falls on a risk-adjusted basis. For most traditional investors the fact that their beloved equity market falls in the same risky, unsafe neighborhood as truly risky managed futures can be quite a shock—as when the wrong turn off a city expressway lands the unknowing minivan in a very unsavory and foreboding urban neighborhood.

This is not a comment on the risk in hedge funds or managed futures. They are risky investments and no implication is being made otherwise. The point is to lay the stock market bare with its real risk. While the traditions of society might view the stock market as safe when compared to hedge funds and managed futures, it can look downright risky when viewed on a cold, hard statistical basis.

Investors may have been sold the approach that diversification using only stocks and bonds is appropriate, avoiding managed futures due to its risk. But this stock diversification is fallacy, according to a Nobel Prize winner who proved real diversification cannot be achieved with stocks alone.

The Nobel Prize Winner Who Questioned Stock "Diversification"

For years investors have been indoctrinated with a tonic that leads them to believe they can enjoy the protection of diversification with stocks and other traditional assets tied to the economy at large. However, this popular myth flies in the face of Nobel Prize-winning academic thought and common sense, which shows diversification among equities is not true diversification because of the *systematic* risk, or beta, associated with the stock market. Nobel Prize winner William Sharpe made the call, noting that investors cannot be diversified with stocks due to this problem:

Sharpe concluded that systematic (market) risk cannot be eliminated through stock diversification because stocks move more or less in tandem, causing wide fluctuations in price that even well-diversified stock portfolios cannot protect against.¹⁰

Sharpe noted the two primary drivers of a stock's price: factors associated with the company itself, such as management decisions, strikes, earnings, and so on, known as *unsystematic* risk, or alpha; and factors

associated with the general stock market or economy at large, known as *systematic* risk, or beta. About one-third of the variability of stock prices is due to systematic risk, or the general market factors that affect all stocks. It is this systematic risk Sharpe identified, which again points to the fact that stock diversification is a relative misnomer. This is confirmed by a Brinson study that notes that 92 percent of a portfolio's return is due to asset class selection as opposed to the selection of particular underlying securities.¹¹

In other words, all that time spent picking stocks would have been better spent diversifying among uncorrelated asset classes.

Even though stock investors may be diversified among different sectors and geographic regions, they are not really diversified due to the systematic market risk. Said another way, negative economic conditions generally impact all stocks across a variety of market sectors; just ask diversified stock investors in 2008. This leads to a conclusion:

True asset diversification is conservative, not the stock market.

Diversified Portfolio versus Same Old Same Old Take the concept one step further by comparing portfolio results with and without managed futures since 1986 (Table 1.1). The CME expanded on Lintner's academic work in 2008, updating his study of true asset diversification and volatility for modern times. Table 1.1 shows updated results of the same portfolio study the CME conducted. While this is not a complete view of risk, these portfolio statistics tell a very different story than what is being fed most investors.

Table 1.1 is a fascinating study. The "risky investment" with managed futures (B) reduced past overall portfolio risk statistics, which is the message of several academic studies. Consider that when returns go up when managed futures are included, past portfolio risk statistics actually decline. Look at volatility, measured by standard deviation, sink by over 20 percent when a volatile managed futures investment was added. Worst drawdown, for instance, is more than cut in half when the managed futures index is added to the stock and bond portfolio. While the returns when adding managed futures are higher, the significant benefit comes with lowered portfolio volatility in the form of reduced standard deviation, a significantly smaller worst drawdown, and quicker drawdown recovery time. This study's conclusion mirrors several academic findings and does not diminish the risk in managed futures investing, but rather shines light on the real risk in overexposure to stock investing. It is difficult to understand how this information can be so ignored by traditional Wall Street. The indexes utilized in the CME

TABLE 1.1 Advancing the CME Study: Hypothetical Portfolio Results with and without Managed Futures in the Portfolio

	Stocks & Bonds (A)	Managed Futures, Stocks & Bonds (B)
Correlation to Economy	High	Medium
Monthly Standard Deviation	2.7	2.2
Win Percentage	62.59%	64.43%
Worst Drawdown	27.39%	12.94%
Drawdown Recovery Time	3.30 months	2.76 months
Sharpe Ratio	0.40	0.63
Compounded Annual Returns	8.08%	9.15%

(A) Stocks and bonds portfolio included 50 percent stocks (MSCI World Index) and 50 percent bonds (JP Morgan Government Bond Index).

(B) This is compared to similar portfolio components with the addition of 20 percent managed futures as represented by the CASAM/CISDM Equal Weighted Index, 40 percent stocks (MSCI World Index), and 40 percent bonds (JP Morgan Government Bond Index). Past performance is not indicative of future results. Index performance may be different from that of individual investments in single stocks or CTAs.

Source: Barclay MAP.

study were high-performing indexes designed to be a relative reflection of the market in general and individual performance may vary from that of the indexes in both stocks and managed futures. Past performance is not indicative of future results.

This study of past portfolio performance using general indexes is interesting, but the portfolio allocation above is not our ideal managed futures portfolio because, in part, most managed futures indexes are unbalanced and might be difficult to replicate. There is no easily investible managed futures index that accurately replicates the diversity of the strategy. The current managed futures indexes are not the ideal, but a balanced approach that will be revealed through the book as a unique method to manage volatile investments. The simple point of this demonstration is to show a little-known diversification opportunity: Managed futures is an investment that should be considered in risk-appropriate investment portfolios, particularly by those who wish to design their overall portfolio to reduce their debilitating stock market exposure and its related volatility, as measured by standard deviation.

This overview chapter won't waste much more time documenting the obvious risk in the stock market. Throughout the book interesting studies are revealed regarding various markets and how to mitigate stock market

risk exposure, providing additional meat on this bone. The only reason any time at all is spent on the topic is because investors have been so effectively brainwashed into thinking traditional buy and hold equity investing was safe, it takes the hard reality of a little intervention to bring reality back.

Academic Reports Consider Managed Futures Risk

A variety of academic reports on managed futures question stock market risk by comparing it to managed futures risk, and this academic discovery should be explored further. In summer of 1998 Thomas Schneeweis, a leading alternative investment academic, penned an article in the *Journal of Alternative Investments* titled “Dealing with Myths of Managed Futures.”¹² The article noted that during the period 1990–1997 a single CTA on average had a monthly standard deviation of 6.26 percent, while the average S&P 500 listed stock had a higher standard deviation at 8.08 percent.

Further, in summer of 2004 academics Greg Gregoriou and Fabrice Rouah conducted a study of large CTAs in the *Journal of Wealth Management* noting the positive performance of CTAs during extreme market events and concluded: “. . . the trend by pension fund managers as well as wealthy individuals toward increasing their exposure to CTAs . . . makes sense.”¹³ This general line of thought is echoed by academic Richard Spurgin in his summer 1998 article “Managed Futures, Hedge Fund and Mutual Fund Performance.”¹⁴ Another interesting report was written by B. Wade Brorsen and John Townsend in the spring 2002 issue of the *Journal of Alternative Investments*. In “Performance Persistence for Managed Futures” the authors concluded “there could be some advantage to picking CTAs based on past headline performance when a long time series of data is available and precise methods are used.”¹⁵ These studies can be categorized as eye opening, but voices exist on both sides of the topic.

Providing Balance: Dissenting Views of Managed Futures Performance

Differences in performance exist between major managed futures indexes, such as the Barclay CTA index and the CASAM CISDM index, similar to differences between the S&P 500, the Dow Jones Industrial Average, and the NASDAQ stock indexes. Further, academic studies have questioned certain aspects of how the managed futures indexes collect and calculate managed futures index performance. Many of these critical managed futures studies fail to recognize the pivotal role that auditing by independent regulatory bodies plays in performance reporting accuracy. These studies fail to make appropriate distinction between different account structures and their impact

on governmental regulation, performance auditing, marketing regulations, and transparency. Further, when considering survivorship bias academic studies must not treat stock and equity markets with undue favor. All major managed futures index performance is listed on the *High-Performance Managed Futures* web site, as are all credible and publicly available managed futures studies, both positive and negative, along with a frank review of each study. Sol Waksman of BarclayHedge, one of the industry-leading managed futures performance reporting services notes four primary issues with all managed futures databases that essentially point to the core structural differences between managed futures and stock investments:

1. Managed futures categorization and inclusion is not standard.
2. The index performance is not standard in terms of weighting based on capitalization or equal weighting.
3. Differing methodologies exist for calculating returns and managing administrative methods, such as how they add and subtract CTAs from the index and deal with survivorship bias.
4. All managed futures databases are proprietary.

Further, it is appropriate to wonder why a certification method has not been introduced nor a more consistent and timely profit/loss reporting system for CTAs developed. These industry issues and many more are discussed in detail on the *High-Performance Managed Futures* web site, along with CTA performance reporting and analysis.

The point of mentioning this is to provide balance. There is no perfect investment. This book shows both the pros and cons of what is considered a misunderstood investment, because the belief is all will benefit when the investment, its risk, and its reward are properly understood.

To this point, considerable academic theory has been discussed, but does it have practical application?

IT WORKS IN PRACTICE BUT DOES IT WORK IN THEORY?

Two economists were discussing the successful implementation of a municipal tax levy that was not theoretically analyzed by academia before it was implemented.

“Sure, it works in practice,” one academic said to the other, “but will it work in theory?”

This book is more than academic theory. It is practical application that has been working for investors, proving itself day in and day out. And that's the beauty of what is discussed.

Consider Tom O'Donnell.¹⁶ In the early 1990s, as the managed futures industry was poised for significant growth, as Markowitz and Sharpe won the Nobel Prize, and after Lintner released his landmark report, O'Donnell was a portfolio manager at the Virginia Retirement System, a major institutional investor. The chief investment officer of the pension fund asked O'Donnell and one of his colleagues to embark on a task that would change the course of his life in an unexpected way.

"Investigate managed futures and see if it is an asset class we should consider," was the request handed down.

Managed futures? "Are you kidding?" O'Donnell said to his colleague, likely with the condescending tone stock investors typically use when discussing the asset class they don't understand. "That's pork bellies, leverage, and shorting!" At the time of the request, O'Donnell might have thought he had all the data he needed to determine that he shouldn't invest; perhaps thinking the fund would have better luck venturing off to Las Vegas and "investing" there.

O'Donnell then conspired with his colleague to write a research paper about managed futures that he thought might be so negative that the chief investment officer would have little choice but to scuttle this foolish idea forever. While the researchers clearly possessed a bias, they also approached the task with the intellectual honesty of a fiduciary. They looked at both the negative and positive claims and then dug deep to get a significant grasp of the issues. All the issues were thoroughly investigated.

And then came the day for the report: judgment day.

The report was honest. It detailed the risks of managed futures investing, which clearly must be understood by all investors. It pointed out the negative aspects of the investment. It considered the strategies and how this very different asset class operated. It pointed to negative stereotypes upon which many unfortunately base their investing decisions, and then it uncovered the naked truth.

Its recommendation?

The Virginia Retirement System, one of the largest pension funds in the country, began diversifying its portfolio with alternative assets and included managed futures in 1991. They followed the path that Markowitz and Lintner had so eloquently outlined, conducted their own research, and made their decisions without undue political interference.

Fast forward to 2009. In a speech about institutional investing, O'Donnell, now firmly engrained and working in the alternative asset investing arena, recalled their interesting experience: Once they got their feet

wet in managed futures, they started to feed the data into their computerized asset allocation models. And here is where they ran into problems. The numbers looked so good that the computer program recommended that they place the vast majority of the fund's assets into managed futures, ignoring the stock market and other alternatives, an interesting comment about the nonemotional and bias-free computer-based decision logic.

In fact, O'Donnell said people might have to put artificial constraints in their computer models so that they wouldn't always recommend managed futures.

At first it was also difficult understanding the unique CTA strategies. They worked with Nobel Prize winner William Sharpe, who built a computer model to understand all the equity strategies that their various fund investments employed. With a 93 percent accuracy rate, the computer could decipher the strategies many of the mutual funds were using just by feeding in the stock holdings. However, when the managed futures investment positions were fed into the computer it had no idea how to interpret these rather odd positions, underscoring the complication of the strategies underneath the surface of this asset class.

But here is a truism that you will discover in coming chapters: It is these very complicated strategies and the unique futures and options contract structures that make uncorrelated diversification work. Readers of this book might just be witness to the world's most uncorrelated major asset classes, and perhaps one of the world's fastest growing. (Go to the *High-Performance Managed Futures* web site or www.cme.com to listen to a recent speech given by O'Donnell discussing his experiences in managed futures while at a pension fund.)

WALL STREET'S MOTIVATION FOR KEEPING MANAGED FUTURES A SECRET

The growing attention paid to managed futures is done for obvious reasons. It is rare for an index to perform positively in nine of the last ten stock market declines, have worst drawdown statistics much lower than that of stocks, and to have much quicker index drawdown recovery times. These are key statistics. Past performance is never indicative of future results, but from the perspective of history the past lack of correlation in managed futures performance stands out in all of investing.

The fact that some investors try to diversify with stock investments alone is as ridiculous as the fact that managed futures is misunderstood by all but the most knowledgeable; but this, too, is starting to change. Bright

professionals are recognizing investing is about balancing risk and return through true asset diversification. Financial professionals have a duty to understand the latest products and methods of investing; at minimum, they have an obligation to understand an asset class that performed positively in nine of the last ten stock market declines and offers such uncorrelated diversification opportunities. So the question exists:

Why does traditional Wall Street thinking ignore managed futures?

In the recent past, broker-dealers (BDs) who restrict in-house financial advisors generally don't receive compensation on direct managed futures accounts unless they are registered as an Introducing Broker (IB), an effort requiring a new layer of regulatory supervision which few have been willing to undertake. Some Wall Street firms do offer limited selection of managed futures funds (as opposed to direct accounts), but the whisper is these nontransparent investments might be placed on the broker's platform only after the fund manager has agreed to pay a fee to the broker-dealer—a pay-for-play system that might not always be disclosed to the investor. Fund of fund investments in particular can charge an extra layer of fees and net investor performance can be lower. A study of the Barclay MAP database indicated that all fund investments, including funds of funds, reported compounded annual returns 27.26 percent lower than the same study group that included direct managed futures accounts.¹⁷ (This is not to say that fund investments are all bad; there are definitely pros and cons of different direct and fund account structures that are discussed throughout this book and on the book's web site.)

But there is more motivation for a financial advisor not to offer managed futures to investors: It takes extra time and effort.

For a financial advisor, there is significantly more work involved in offering and supervising managed futures, all for what can be the same fee they receive for managing stock investments, where it is comparatively easy for a financial advisor to manage a simple "buy and hold" approach. Managed futures, on the other hand, can require active supervision of many unfamiliar components, including complicated strategies, sophisticated margin-to-equity ratio management techniques and the understanding of market exposure that in some cases is only evident when the strategy risk is understood. Further, with certain account types the advisor can encounter financial risks not associated with traditional stock investments, particularly with aggressive investments. In the past, advisors might have had honest concerns regarding the complexity and volatility of the investment. Managed futures can be a volatile investment and unsophisticated investors who cannot

stomach volatility should not enter these waters. But it is also appropriate to raise the same issues regarding stock market volatility.

Even if Wall Street did have the motivation, learning about this investment is difficult. Futures and options are not a part of the normal educational curriculum, even at some of the more advanced institutions of higher learning. What's more, even in their in-house training, financial advisors don't appear to gain futures and options knowledge outside basic risk talking points.

There is more to this story, and investors should not be hypnotized by simple risk definitions or strong returns alone. This book is about balancing risk with reward. Managed futures can be a risky investment, particularly if it is not properly structured and managed. And here is one secret behind managing risk as well as an explanation for a significant degree of the amazing managed futures index performance statistics: diversification.

In Managed Futures Diversification, Not Cash, Is King

The next two points are not widely disclosed in the cloistered managed futures world, but they should be.

1. *Diversification is a primary reason behind the amazing managed futures index performance numbers and winning risk statistics.*
2. *Investing in an individual managed futures program, or even a single strategy, can expose the investor to more risk than the managed futures index performance indicates, more so than when investing in a truly diversified portfolio of solid managed futures programs.*

The book has strong opinions in this regard, because proper diversification is one key to success in managed futures investing. As you will see from studies throughout this book, proper diversification among solid programs can be vastly superior to investing in a single manager and a key to reducing an important component of risk in managed futures. In part, this book shows investors how to design programs with this goal.

Diversification is important in all investing. Proper diversification could be more important in managed futures than stock investing due to enhanced individual manager risk, or nonsystematic risk. A significant degree of volatility, or risk, in managed futures is on the individual manager level; the often complicated strategies they use, the markets in which they invest, and how they manage leverage, margin, and risk in their trades. All of these will be revealed as methods used to manage risk. But perhaps the most successful method found to mitigate this risk is through diversification among solid investment managers. A deep industry insight, however, is to question

the core validity of the diversification within the managed futures indexes, which can be understood in part by considering 2009 index performance.

Managed Futures Waterloo: 2009 Performance Fourth Worst in History

In 2009 managed futures, as represented by the Barclay CTA index, exhibited its fourth worst year in returns performance, down 0.10 percent. The worst year in the history of the Barclay CTA index was 1999, down 1.09 percent. In 2009 major stock indexes crowded gains of 26.46 percent, as highlighted by the S&P 500.¹⁸

There are financial professionals who proclaimed 2009 “managed futures Waterloo” because “managed futures failed in 2009 while stocks ended with stout gains.” These statements are illuminating for several reasons. First, and most obviously, it shows that some, but not all, in financial services are resistant to change and closed to new paradigms for diversification. Second, and most interesting, it potentially points to a future where two camps exist. The first camp of financial professionals and investors is open to new concepts for uncorrelated asset diversification. The second camp will resist change at all costs, finding fault with everything, regardless of the facts or situation. Third, and perhaps most significant, the period from 2008 to 2009 provides perhaps one of the best laboratories to understand a misunderstood asset class. Current times are more relevant to study managed futures for several reasons. Assets under management are much more significant in 2009 than 1999, for instance. The CTAs are much more sophisticated with more diverse strategies, the sheer number within the ranks of CTAs makes study of the current period statistically significant, and current CTA performance auditing and industry regulation provide significant benefits to the investor. While there are many insights that can be garnered from recent times, there is one insight from 2009 that illuminates the investment more than any other—and it is not the obvious insight.

Many consider 2009’s illuminating insight that as stocks go up, managed futures go down, thus the negative correlation. But that is wrong. The point isn’t negative correlation; it is neutral correlation. In the past as stocks rose, managed futures did its own thing; as stocks fell, managed futures operated independently, apparently to the beat of its own drummer. This lack of correlation shines a light on the real insight from the managed futures negative 2009 performance:

Diversification in managed futures is most important because each of the major managed futures strategies performs differently depending on the market environment.

In 2008, CTA trend-following strategies exhibited some of the best performance in its history, up 17.74 percent among the 443 trend followers reporting to the Barclay MAP database this book follows. While trend followers enjoyed the strong 2008 market environment, volatility strategies posted -14.14 YTD performance as represented by the 119 volatility strategies this book follows. As expected, when overall market volatility dropped significantly from the fall of 2008 to 2009, the primarily short volatility strategies this book follows were enjoying significant 14.30 percent gains in 2009 while trend followers scratched by with YTD performance near -3.33 percent.¹⁹

Appendix A of this book benchmarks the performance of each primary strategy. Each strategy has very different performance characteristics from one another and that of the stock market, which makes for interesting portfolio correlation considerations. The point is this: One given managed futures strategy can work well when other managed futures strategies may underperform, all based on the market environment. The real insight from 2009 is considering how managed futures strategies correlate to one another, and then designing investment portfolios appropriate to this insight. There are specific reasons for these correlations that provide clarity into the asset class and strategy points. For instance, a trend-following strategy generally has performed best when during a market environment of price persistence and volatility breakouts. The price direction doesn't matter so long as the movement is directionally consistent. This strong trending environment is not always ideal for short volatility strategies, for instance. It is in the understanding of how fairly complex strategies relate to market environments that a degree of success can be found in managed futures. This will be a topic for more detailed analysis in the advanced section of the book, but for this overview chapter consider the impact this performance has on the overall performance of the managed futures indexes and a more interesting fact emerges.

Managed Futures Indexes Are Strategy Unbalanced While the major managed futures indexes are diversified from individual manager risk and markets traded, they are not diversified in terms of strategy. The managed futures indexes significantly favor the most popular strategy, trend following. While the managed futures indices have displayed impressive lack of correlation to the stock market, it might not be as good as it could be because most managed futures indexes are not strategy diversified.

In any given year trend-following strategies can make up roughly 50 to 70 percent of a given managed futures index.²⁰ In 2009 trend followers exhibited one of their worst performances of all time, hence the major CTA indexes exhibited anemic performance as well. In other words, when trend-followers sneeze, the entire CTA index catches a cold. But the question

remains, is this the best representation of the managed futures industry as a whole? It is not uncommon for people to say managed futures had a terrible 2009. But that isn't true. Trend-following strategies had a terrible 2009, but it was a tremendous year for other strategies, including volatility strategies, which might only represent 5 to 10 percent of a managed futures index at any given moment in time.

This points to the fact that while the managed futures indexes are diversified, they may not be diversified enough.

Because the managed futures indexes are so primarily weighted toward trend following, all major reporting services ended the year with relatively negative performance of up or down a small percentage depending on the index. This is a deep industry topic that is explained in the advanced section of the book. The concepts of diversification, risk management, and volatility are the subject of several chapters; a brief overview of this critical component is mentioned here.

Watching Investment History Unfold This chapter has illuminated a limited number of common misconceptions. We live in a free will society where people hold different convictions and beliefs, and different tolerances for change and risk. In an ideal society, as in investing decision making, there should be transparency and proper disclosure so intelligent risk/reward decisions can be made without undue pressure. Thoughts should be freely explored and ideas investigated. All this points to a new investing paradigm unfolding before our eyes.

Note the date Monday, August 3, 2009. That was the day a little-noticed article in the *Wall Street Journal* perhaps identified a milestone, the start of a paradigm shift in investing.

The article noted the rise of investments with the potential for individual investors to make money regardless of stock market performance. Investing uncorrelated to the returns performance of stocks and unhinged from the economy is a powerful concept. The article noted that these alternative investments and their benefits of uncorrelated performance were once an exclusive country club; a gated community for institutional and high-net worth individual investors. But this exclusive club is now being democratized for professional investors and qualified individual investors who understand risk and reward. From major institutional hedge funds launching managed futures mutual funds to futures commission merchants (FCMs) and broker-dealers integrating efforts to offer more seamless service to hedge funds recognizing the value of managed futures, the industry is changing. But this change is not sustained by the industry alone; rather, lasting trends in this industry are sustained by investors.

“These are strategies that should have been offered to retail investors a long time ago,” said Morningstar’s Papagiannis. Morningstar is a firm the *Wall Street Journal* noted is “typically skeptical of new or seemingly faddish funds.”

Papagiannis has observed the motivations for the meteoric rise of managed futures at this moment in history.

From the supply side, after 2008 hedge funds and other institutional money managers realized they needed to diversify their investor base,” she said. “This is because institutional investors needed liquidity and pulled their money out. Retail investors’ money tends to be stickier, and retail investors represent a large untapped market for alternative investments.

From the demand side, both retail and institutional investors saw the need for uncorrelated and liquid strategies. They realized managed futures is the most liquid investment in which they could invest and the past diversification opportunity was hard to deny, especially in 2008, when these strategies were the only investments besides government bonds that made money.²¹

This all highlights a societal shift: A new risk paradigm is on the horizon, forced upon investors by the power of cyclical bear markets, massive government debt, and always-unpredictable economic circumstances. The new risk paradigm understands significant risk exists when real diversification is not in place; it recognizes that investments highly correlated to systematic stock market risk are in fact extremely risky.

On the Book’s Web Site

Available to the general public:

- Access to the FINRA document on diversification.
- Download: CME study on managed futures.

Available to registered book readers:

- Updated performance of all major indexes and studies mentioned in this chapter.
- Download: Speech given by Tom O’Donnell.

- Video conversations with the author regarding industry issues mentioned in the chapter.
- Comparisons of managed futures fund performance versus direct account performance.
- Interactive application that assists investors in choosing the appropriate account structure and managed futures investments.
- Weekly commentary on market news as it relates to managed futures.
- Study methodology, software screen shots, and data from all studies in this chapter.

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