



## **The Benefits of Managed Futures in the Post-Lehman, Post-Madoff Era**

**By E. Bruce Mumford, Partner and Head of Client Relations at 2100 Xenon Group  
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An investor considering an allocation to managed futures recently asked me if the Lehman Brothers' bankruptcy and the collapse of Bernard Madoff's fraudulent investment firm had been good or bad for the futures industry. There is no single or easy answer to that question.

In 2008, these events shocked the global markets in different ways. Lehman and Madoff were "bad" in terms of the damage they inflicted on people's portfolios and how they eroded investor confidence. The fallout from these losses will likely be felt for years to come.

The important lesson learned—namely the need for a well-diversified, transparent, reasonably liquid portfolio—is the "good" thing that sprang from these events and the market turmoil of recent years.

In different ways, Lehman and Madoff illustrated the need for the very best of what the managed futures industry has to offer, specifically transparency, liquidity, and uncorrelated returns. Throughout the recent financial crisis, the global futures markets continued to perform well and most investors with exposure to futures directly realized the benefits of diversification into these markets.

Two years later, Lehman and Madoff are history, but other events continue to roil the markets and further erode public trust. As many investors search for ways to recoup the losses sustained in 2007 and 2008, there is still much uncertainty with respect to the direction of the economy and the markets. The legislative environment remains murky. There is talk of position limits and tax law changes. Implementation of the Dodd-Frank financial reform legislation will have far-reaching and as yet unknown consequences. The resolution of these issues could have dramatic effects on the markets, including offering new opportunities.

### **Managed Futures Investment Options**

First introduced in 1975, managed futures use futures, forwards, and options to gain access to the commodity, currency, interest rate, and equity markets. A futures contract is an agreement to buy or sell an asset at a specific price at a later date. When establishing a contract position, a trader must post a performance bond, also referred to as margin, to cover potential losses on the position. As prices change throughout the life of a futures contract, the trading accounts where performance bonds are held are debited and credited accordingly. Profits are made when the market or "spot" price of a commodity exceeds the futures' purchase price. Additional returns can be made when traders renew or "roll" contracts and the sale price of the old contract exceeds the cost of purchasing the new contract. Interest earned on margin posted in the trading account also contributes to returns.

In 2008, when US and international equities dropped 38% and 45%, respectively, managed futures were up 14%.<sup>1</sup> Managed futures provided strong, uncorrelated returns to traditional asset classes that suffered during this period. Institutions and high net worth individuals took note, boosting total investment in managed futures to its current level of over \$200 billion in assets under management.

## **Commodity Trading Advisors**

Investment managers that implement and trade managed futures strategies are commonly referred to as commodity trading advisors (CTAs). These trading advisors may participate in any of the more than 150 global markets in products that range from soy beans to natural gas and from currencies to interest rates.

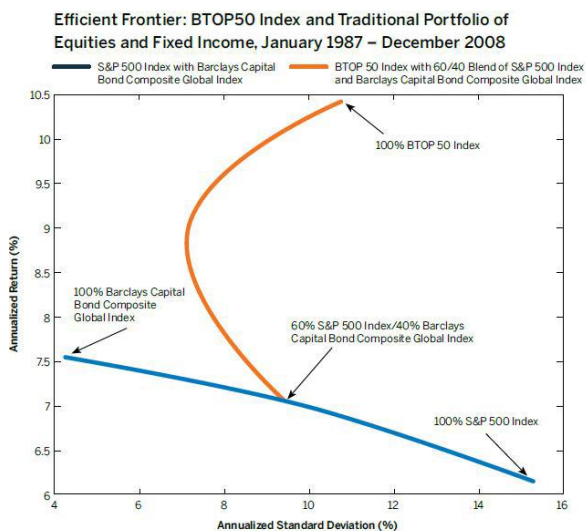
CTAs can generate profit in increasing and in decreasing markets through their ability to go long (buy) futures positions in anticipation of rising markets or go short (sell) futures positions in anticipation of falling markets. Trading styles of CTAs tend to fall into two primary categories: systematic and discretionary. Systematic trading uses computer models that are based on the technical analysis of market data or fundamentals. The models usually have been validated through backtesting of quantifiable market data. Trade entry and exit signals are generated by the models and the CTA that is 100% systematic will follow the signals precisely. By comparison, the discretionary trader relies on subjective entry and exit criteria and therefore will not always interpret a market indicator in the same way that a model might, or apply it in a similarly consistent manner. The discretionary trader uses experience to determine the value of market indicators at a given point in time, and may or may not use computer models in trading strategies.

CTAs that offer managed accounts and funds are required to be registered with the National Futures Association (NFA) and the Commodities Futures Trading Commission (CFTC), which are the regulatory bodies overseeing these investment pools. CTAs are compensated with a combination of management and performance fees, which is a clear incentive for managers to perform to the best of their abilities and in the best interest of their clients.

## **Non-Correlated Returns**

Managed futures offer a source of liquid return typically not correlated to other investment classes. This was clearly seen in 2008, when many investors thought they had achieved sufficient diversification with their investments in long/short equity and event-driven hedge fund strategies, or other alternatives such as high-yield debt and real estate. It turned out of these investments were highly correlated to Standard & Poor's 500® stock index, and investors found their alternative investments falling in lockstep with their traditional investments. One of the most important lessons learned during 2008 was that portfolio diversification doesn't come from the number of managers or positions in a portfolio. Diversification comes from building a portfolio of fundamentally different return streams and managed futures offer diverse drivers of positive and negative returns.

Managed futures are one of the few investments that have zero or negative correlation to the equity markets. Since their inception in the 1970s, managed futures have repeatedly produced non-correlated returns during periods of stock market dislocation. Dr. John Lintner of Harvard University, one of the co-creators of the Capital Asset Pricing Model, first published his seminal work on managed futures in 1983. He concluded that portfolios consisting of equity and fixed income investments “exhibit substantially less variance at every possible level of expected return when combined with managed futures.”<sup>ii</sup>



As illustrated in the chart above, Linter's work remains as current today as it was in 1983. Adding even a small amount of managed futures, as represented by the BTOP 50 Index, to a traditional portfolio of stocks and bonds has offered better returns at lower risk over a 20-year period—one that has included Black Monday (1987), the First Gulf War (1990), Long Term Capital Management/Russian debt default (1998), terrorist attacks on the World Trade Center and Pentagon (2001), and the recent credit crisis (beginning in 2007).

## Liquidity

Knowing who is managing your money and how it is being managed was the moral of the Madoff story. Of all the potential alternative investments, including hedge funds, private equity, and commercial real estate, managed futures rank among the highest in terms transparency and liquidity. The vast majority of the instruments are highly liquid; markets are deep and exchange-traded. Intra-day and closing prices are readily available and many products are traded around the clock.

The investment structure of CTAs contributes to their security and liquidity. CTAs may offer their investors two structures: traditional commingled funds or managed accounts. Of the two structures, managed accounts offer the greatest liquidity. In a managed account, the investor authorizes the CTA to trade an account maintained at the investor's chosen broker/dealer, or clearing firm. The CTA is authorized to trade the managed account on behalf of the investor, but never takes possession of the funds.

From an investor's standpoint, the issue of liquidity also includes the ability to withdraw money at any time. Many CTAs offer daily liquidity to their managed account investors with none of the gates or lock-up periods often associated with other less-liquid alternative strategies. Additionally, investors who use the managed account structure have access to daily statements produced by their own broker/dealer, thus substantially reducing the risk of fraud.

It should be noted that managed accounts do require a higher degree of operational attention from investors, or at minimum a greater reliance on brokers to manage the daily fluctuation of cash balances used in margin accounts. The fund structure is the preferred vehicle for investors wishing to minimize administrative oversight.

Protection from counter-party risk is also provided to the investor through the regulatory requirements imposed upon the clearing firms. US Commodity Futures Trading Commission (CFTC) requires clearing firms to maintain segregated accounts for funds posted by their customers as margin for futures trading. The segregated

accounts are titled for benefit of the clearing firms' customers. The customer funds in segregation also have a bankruptcy preference in the event of a clearing firm's insolvency, which permits an orderly transfer of the funds to alternate clearing firms or back to the customers. Segregated funds protection is extremely important in a situation like Lehman, as it provides customers in the regulated markets with a better outcome than customers in the non-regulated markets.

## **Transparency**

The exchange traded futures market offers an enormous amount of transparency. During the Great Depression, President Franklin D. Roosevelt signed legislation regulating futures and securities markets to ensure that they were transparent, fair, and orderly. The futures market should not be confused with the opaque over-the-counter derivatives market that was the trading ground of a limited number of financial institutions and contributed to the fall of Lehman Brothers and the near collapse of the broad markets in 2008.

In a speech delivered on June 3, 2010, CFTC Chairman Gary Gensler criticized the over-the-counter derivatives market for its lack of transparency: "The buyer and seller never meet in a centralized market. The lack of transparency enables Wall Street to profit from wider spreads between bids and offers. This is in stark contrast to the regulated futures and securities markets, where the public can see the price of the last transaction traded on a regulated exchange as well as the latest bids and offers." In arguing for a need to reform, Chairman Gensler went on the comment that, "We now must bring a similar level of transparency—and benefit to the public—that exists in the futures and securities markets to the over-the-counter derivatives markets. The more transparent a marketplace, the more liquid it is and the more competitive it is and the lower the costs for hedgers, borrowers and, ultimately, their customers."<sup>iii</sup>

The centralized clearing model supported by Chairman Gensler has been the mainstay contributing to the transparency and integrity of the managed futures space since inception. Each global futures exchange settles the account of each member clearing firm on a daily basis and sets and adjusts clearing firm margins for changing market conditions. Before the beginning of each trading day, all of the previous day's results have been reported by the clearing firm to each trading account, losses have been collected and all gains credited or paid.

## **The Benefits of Portfolio Diversification**

It is the fervent hope of all market participants that regulatory change and enhanced oversight of investment managers can prevent a recurrence of events of the magnitude of a Lehman Brothers bankruptcy or Madoff's fraud. However, we continue to live in a world where market volatility can spike as a result of political and social events, natural catastrophic events, or market glitches that precipitated the flash crash of May 6, 2010.

The primary benefit of adding the uncorrelated return stream of managed futures to an investment portfolio is the potential to dampen portfolio variance or volatility. CTAs generate positive returns and uncorrelated variance through the exploitation of trends and other price behaviors that accompany large macro dislocations and event-driven spikes in volatility. As stocks and bonds often perform poorly during such periods, managed futures are able to provide downside protection.

During the last 30 years, managed futures have had a maximum drawdown of 15.66%. In contrast, the S&P fell 50.95% during its maximum peak to trough.<sup>iv</sup> Managed futures' superior risk-adjusted returns can save a portfolio during bad times and help investors accumulate more in the long run.

## Summary

The Lehman Brother and Madoff events, along with the ensuing market mêlée reinforced the need for investors to construct portfolios that contain a diversified array of investment strategies with highly liquid and transparent elements. In 2008, many investors learned, with unfortunate consequences, that they did not fully understand the correlations of their various investments or the drivers of positive and negative performance in each asset class.

The recent crisis permanently changed the financial markets. Money managers have placed a renewed emphasis on investing in well-regulated, highly liquid, and fully transparent products with diverse sources of return. During the shocks of 2008, those who invested in managed futures were well-rewarded; managed futures was one of the few asset classes that as a whole performed strongly, and generated true alpha for its investors. Managed futures may well be an essential component of the well-balanced, long-term investment portfolio capable of withstanding the financial shocks of the future.

### About the author:

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<sup>i</sup> Figures cited reflect returns of the S&P 500 Total Return Index, MSCI EAFE Developed Markets Index, and Barclay CTA Index. Source: S&P, MSCI, and Barclays.

<sup>ii</sup> Lintner, John. "The Potential Role of Managed Commodity-Financial Futures Accounts (and/or Funds) in Portfolios of Stocks and Bonds," delivered at the Annual Conference of Financial Analysts Federation in Toronto, Canada in May 1983 and published in the The Handbook of Managed Futures: Performance, Evaluation & Analysis. Editors Carl C. Peters and Ben Warwick, McGraw-Hill Professional, 1996, pp. 99-137.

<sup>iii</sup> Remarks of Chairman Gary Gensler at Sandler O'Neill Global Exchange and Brokerage Conference, New York, NY, June 3, 2010. Available online at: <http://www.cftc.gov/PressRoom/SpeechesTestimony/ChairmanGaryGensler/opagensler-46.html>.

<sup>iv</sup> Figures cited reflect returns of Barclay CTA Index and the S&P 500 Total Return Index. Source: Barclays and Zephyr StyleADVISOR.