CAPITAL TRADING GROUP

Capital Trading Group
One Financial Place
440 S LaSalle Street, Suite 2301
Chicago, IL 60605
Ph: 800.238.2610
www.CTGtrading.com

It is Not Your Grandfather's Financial Market Anymore

It is fair to say that today's financial markets are not your grandfather's markets. Modern investing dynamics require investors to deal with increasing technical complexity, globalization instability, and experimental monetary policy within an ever-changing environment.

The result of such a financial landscape has weakened the long held belief that passive buy and hold strategies were the key to investing success. Financial turbulence seems to occur more frequently and with increasing magnitude and traditional asset class diversification has often disappointed.

What investors need today are de-correlating strategies implemented with transparency and with reasonable liquidity. During previous crisis events, Managed Futures have produced what the industry calls "crisis alpha" or positive returns during crises for traditional assets. Can they continue to do so? No assurance the past will reflect the future as past performance is not indicative of future results.

How Do Managed Futures Work?

Managed Futures were first introduced as investing options in the mid- 1970s. At that time, commodity traders began to offer their strategies to individual investors in the form of individually managed accounts or pools. They were attempting to take advantage of the increase in volatility in the traditional commodity markets and the newly blossoming ones in interest rates and equity indexes. Forty years later, Managed Futures have evolved in an eclectic and diverse universe with a multitude of investing strategies built on the idea of capturing that often elusive alpha or skill based superior performance.

In Managed Futures, professional traders and investment managers are usually structured as Commodity Trading Advisors (CTA) for the purpose of managing many individual accounts based on the same strategy in which they specialize. Some advisors can also organize as Commodity Pool Operators (CPO) to execute similar strategies but in the form of a fund.

CTAs and CPOs utilize futures and options (and occasionally forward agreements) to implement systematic or discretionary strategies. Systematic managers probably represent the majority of CTAs and structure their strategies following a quantitative approach based on pre-set algorithms.

A system approach, trend-following or mean-reverting, has the advantage of removing the emotions from the trading equation, an effect that can occasionally cloud the trader's judgment.

The other trading approach is called discretionary and as the name implies, it is based on the manager's feel for the markets; such "feel" is often derived from an extensive fundamental knowledge of the supply and demand dynamic or a significant experience on daily trading patterns. A discretionary trader will have the advantage of flexibility and will retain the ability to respond more quickly to changes in the fundamentals or structure of the underlying markets.

A recent trend is developing in the multi-strategy category, where CPOs mix, inside one vehicle, different and hopefully uncorrelated strategies to achieve minimum volatility returns.

Why Managed Futures?

Managed Futures offer three characteristics that today's markets have made essential:

- Liquidity
- Transparency
- Generally uncorrelated returns

As opposed to the traditional alternative investment vehicles such as Hedge Funds and Private Equity, Managed Futures have the distinctive advantage to operate in mostly very liquid markets. For example, futures for US Treasuries, S&P500 Index or Crude Oil trade thousands of contracts every day, 24 hours a day and often on multiple exchanges around the world.

CTAs also typically offer daily (or close to it) liquidity on the investment as opposed to many alternative vehicles that are structured with lengthy lock-up periods.

The CTA format also provides full transparency to the investor. An account is opened with a broker of choice (in the futures arena, brokers are called Futures Commission Merchants or FCMs) in the name of the client. The client then signs a limited trading authorization designating the CTA as the trader on the account; this will enable the CTA to implement the strategy and place trades but he/she will not have any authority to move funds out of the account other than for the negotiated management and/or incentive fees. In this structure, the client is informed by a third party (the broker) of all movements in the account, therefore, the strategy can be monitored closely and deviations from style or agreed upon leverage can be spotted immediately.

A quick look at the major Managed Futures Indexes (Barclay CTA Index) also shows the uncorrelated nature of the returns when compared to the traditional asset classes. As a practical example, when most traditional investments were being obliterated during the 2008 crisis, Managed Futures produced a 14% return (Barclay CTA Index). According to the CME Managed Futures: Portfolio Diversification Opportunities, "During periods of hyperinflation, hard commodities such as gold, silver, oil, grains and livestock tend to do well, as do the major world currencies. Conversely, during deflationary times, futures provide an opportunity to profit by selling into a declining market with the expectation of buying, or closing out the position, at a lower price. Trading advisors can even use strategies employing options on futures contracts that allow for profit potential in flat or neutral markets." Please note that the Barclay CTA Index is not investable and may not reflect the performance of your investment portfolio in managed futures.

Who's the Sheriff?

Managed Futures are regulated by two main regulatory bodies: the Commodity Futures Trade Commission (CFTC) and National Futures Association (NFA). The CFTC was created by Congress in 1974 with the task to protect investors from fraud and market manipulation. NFA is a not-for-profit membership entity vested with the task to audit its members and enforce customer protection regulations.

Where is the Industry Today?

The Managed Futures industry has grown dramatically in the last few years with approximately $330 billion in assets under management as of the fourth quarter of 2012 (www.barclayhedge.com). This success is undoubtedly good recognition of Managed Futures' de-correlating advantage. Individual investors, institutional players and progressive Registered Independent Advisors have increasingly embraced this asset class to gain a strategic edge in their portfolio allocations.

Changes in the financial industry, resulted from the chaos of 2008, are influencing the Managed Futures industry as well. The CFTC has already approved new rules on position size limits (although the rule is in appeal with a Federal District court) and the NFA has improved its auditing procedure by moving certain functions to an electronic procedure.

What Now?

Modern Portfolio Theory postulates that a highly and smartly diversified portfolio should result in the most efficient risk adjusted investment pool. Until recently, such diversification meant stocks, bonds and some cash. The most progressive investors (and the ones with the deepest pockets) ventured into Private Equity and Hedge Fund investments trying to capture illiquidity premium and diversification as well. However, the 2008 crisis and the global systemic response to such turmoil permanently changed the financial markets. New sources of risk adjusted returns are being sought after by investors and new risk premium are being placed on liquid and highly transparent investments. Managed Futures **can** be the right answer.