RCM Alternatives: MF Overview

Managed Futures: Overview

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What if you could make an investment that was in no way tied to what the stock market will do in the next 10 years? Such an investment could do well in the face of extended declines in the stock market, and do well if there is a market recovery. The investment could also perform poorly in all three cases, but such an investment is, by definition, lowly correlated with the stock market. This ability to achieve returns independent of stock market performance is the defining characteristic of managed futures.

Futures refer to a type of alternative investment which relies on professional investment managers known as a Commodity Trading Advisor (CTA), who specializes in commodity futures and options trading. Managed Futures investments are also referred to as CTA programs or Managed Futures Accounts, as the commodity trader (CTA) actually manages each client's individual account, placing trades in the client's accounts directly on their behalf, like their own personal futures trader.

Absolute Returns

The strength of many Managed Futures investments lies in their low correlation to the stock and bond markets, meaning you can make (or lose) money whether stocks go up or down. This ability to post "absolute returns," paired with low correlation, makes investing in managed futures a great option for portfolio diversification.

Commodity Trading Advisors can produce absolute returns by playing both sides of any market. They can buy futures positions in anticipation of a rising market or sell futures positions if they anticipate a falling market. Trading advisors can even use strategies employing options on futures contracts that allow for profit potential in flat or neutral markets.

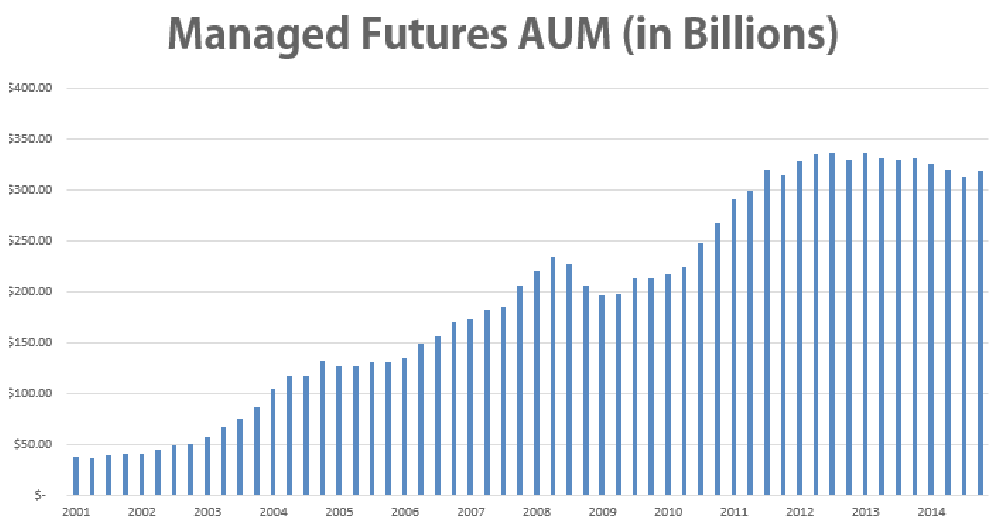
This ability of managed futures to provide absolute returns and provide true diversification to a portfolio come from their exposure to commodity markets, which rely on supply and demand factors instead of factors such as a strong economy, credit conditions, or corporate profits as their price drivers.

And unlike long only commodity indices and commodity ETFs which rely on the price of commodities rising, managed futures programs actively trade both sides of commodity price movements, allowing them to perform whether commodity markets go up or down.

> **"Absolute returns, paired with low correlation, makes investing in managed futures a great option for portfolio diversification"**

Growth of Managed Futures

Managed Futures have enjoyed tremendous growth in popularity since the financial crisis of 2008 when managed futures were one of the only asset classes to post positive returns. See our performance profile alternatives file for more on the performance profile of managed futures.



Source: BarclayHedge CTA Database. [(Although we think this number might not be as accurate as it could be.)]

Long and Short

The ability of managed futures to profit from crisis periods in other asset classes comes mainly from their flexibility to go both long (buying in hopes of prices going higher) and short (selling in hopes of prices going lower) depending on market momentum and/or current price trends. While nearly all other investment types rely only on the price of the asset appreciating, managed futures ability to go short enables it to also make money when prices fall.

Trend Following

Even though managed futures growth over the past two decades has seen the dawn of other strategy types within the asset class, trend following is still the bread and butter of the world of managed futures. In fact, in our recent breakdown of the CTA industry, trend following was far and away the dominant strategy. What is trend following?

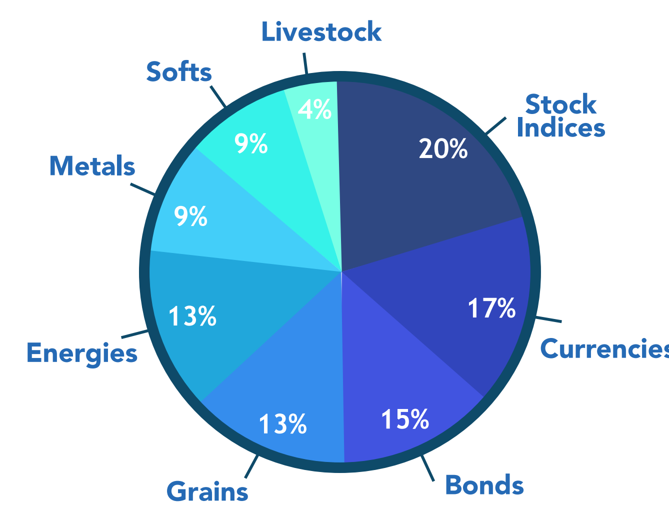
While trend following, by definition, is the process of recognizing and trading along with an up or down trend, there are multiple mechanisms for identifying both when a trend starts and when it ends, with technical indicators such as Bollinger Bands, Donchian Channels, and Moving Average Cross Overs. The different types of trend following methods are essentially broken up into two types: those that believe a new trend is triggered by a breakout of prices above/below a certain level, and strategies which use the relative movement of prices to determine whether a new trend has started.

One of the hallmarks of trend following is its ability to capture big outlier price moves, like the down moves in 2008; and their ability to do that isn't magic. Trend followers capture those outliers by also being involved in a lot of failed trends. A typical trend follower brackets the market and gets into each breakout above the current range. Most of those breakouts (we're talking 2-3 per year in a single market) won't amount to much, but one out of 5 or so can be the outlier which provides asymmetrical returns to the risk taken. Multiply that pattern by dozens of markets and you have your modern day trend follower.

Commodities Exposure

We mentioned above that trend followers usually operate on dozens of markets, and one of the strengths of managed futures is the broad market exposure they provide. We have seen managers trading markets as normal as S&P 500 stock index futures, as strange as Palm Oil futures, and markets like Gold, Crude Oil, Wheat, Bonds, and everything else in between. The following breakdown of market diversification is a good example of the breadth of market sectors a managed futures program will access.

But what we like best about managed futures is the tactical exposure to commodity markets they provide. While many so called alternative investments (like hedge funds) are really no more than alternate



strategies within an existing asset class, managed futures provide diversification into a true alternative asset class through exposure to commodity markets. Venture capital, private equity, and many hedge funds are actually an extension of the equity class (stocks), not an alternate asset class altogether. In contrast, managed futures can bring exposure to a truly different asset class in commodities, which provide economic value through being consumed or transformed - not on the basis of future cash flows like stocks and bonds.

Individually Managed Accounts

Managed Futures and their individually managed account structure are an easy solution to avoiding frauds such as Bernie Madoff. Individually managed accounts are really no more complicated than what their name implies. They are accounts in the client's name which are managed by someone else. A manager who accepts individually managed accounts will actually place trades directly into a client's account, review the specific balances and positions in that account daily, increase and decrease position sizing for that specific account, and so on.

Contrast this with a manager who operates through a fund structure. In that case, the trades are placed in single fund account, versus the individual accounts of hundreds of investors. And the manager reviews the positions and balances for the overall fund only, not worrying about how much money a specific investor in the fund has.

When you invest in a fund — you are handing over your money to that fund, and putting your money in the name of the fund. Your money becomes part of the assets of the fund, with you owning a part of those overall assets. With an individually managed account, you don't hand over your money to a fund, you keep your money in your name, and your money does not become part of the assets of the manager you invest in.

With everything in the name of the manager, the risk of fraud exists due to the manager basically having check writing ability for the assets of the fund. He or she could decide to buy a new car or cash the whole fund out and head to the Caribbean if so inclined (or do a Ponzi scheme as Madoff). In contrast, the risk of that type of fraud is eliminated in an individually managed structure, where only the client has check writing privileges out of their account.

Management & Incentive Fees

Most Managed Futures programs have terms similar to a hedge fund, with a 0% to 3% annual management fee, and 15% to 30% incentive fee, which means they take around 20% of the profits they make you. While some investors scoff at having to pay a portion of profits to the manager, we like the alignment of interests that presents - as the commodity trading advisor doesn't make the bulk of their money unless the client makes money.

Disclosure Documents

Investors interested in a managed futures program which is not exempt from providing such, must review and sign off on the commodity trading advisor's Disclosure Document. The disclosure document (or D-Doc) includes an agreement whereby the client authorizes the CTA to direct trading in the client's commodity account, and outlines certain risk factors general to managed futures and specific to the advisors program. The disclosure document also discloses any and all management and incentive fees as described above to be charged to your account by the CTA.

Notional Funding

A characteristic unique to managed futures accounts is the ability to use notional funding to trade. Because a futures trade requires only posting a performance bond with the exchange equal to roughly the amount of money that position could lose in a day, there is often a large difference between a CTA's required minimum investment amount and the amount which technically needs to be in the account to cover the performance bonds, or margin. For example, this opens up the possibility of being able to utilize just $50,000 to be traded as if it were $100,000. One caveat to this, however, is that you will still be charged fees on the notional balance ($100K in our example), and those will be a much higher percentage of your actual balance ($50K in our example).

Read our newsletter on notional funding

Transparency & Liquidity

Two big advantages a managed futures investment has over alternative investments in vehicles such as hedge funds or real estate is full transparency and nearly instant liquidity. Investors can see all of their positions marked to the market at all times, and should an investor need cash for any reason, wires can typically be processed the same day if received by 11AM.

Tax Benefits

Managed futures accounts are taxed based on their value at the end of the year. This is good news for investors, as futures gains or losses are treated as 60% long term capital gains and 40% short term capital gains, NO MATTER the holding period. For example, an investor who holds a futures position for just a few minutes, or hours, can book 60% of the profits on that trade as long term gains - even though the trade was anything but long term. What a deal!
There is also no trade by trade accounting in futures, no wash sale rules, and losses can be carried back three years on futures based investments.

Read our newsletter on futures tax accounting

Or, read the next article in the series
The Alternative Files: Performance Profile

Disclaimer

The information contained in this report is intended for informational purposes only. While the information and statistics given are believed to be complete and accurate, we cannot guarantee their completeness or accuracy. RCM Alternatives has not verified the completeness or accuracy of any of the information and statistics provided by third parties.

As past performance does not guarantee future results, these results may have no bearing on, and may not be indicative of, any individual returns realized through participation in this or any other investment. The risk of loss in trading commodity futures, whether on one's own or through a managed account, can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. You may sustain a total loss of the initial margin funds and any additional funds that you deposit with your broker to establish or maintain a position in the commodity futures market. Any specific investment or investment service contained or referred to in this report may not be suitable for all investors. You should not rely on any of the information as a substitute for the exercise of your own skill and judgment in making such a decision on the appropriateness of such investments. Finally, the ability to withstand losses and to adhere to a particular trading program in spite of trading losses are material points which can adversely affect investor performance.

We recommend investors visit the Commodity Futures Trading Commission ("CFTC") website at the following address before trading: http://www.cftc.gov/cftc/cftcbeforetrade.htm

Managed futures accounts can subject to substantial charges for management and advisory fees. The numbers within this website include all such fees, but it may be necessary for those accounts that are subject to these charges to make substantial trading profits in the future to avoid depletion or exhaustion of their assets.

Investors interested in investing with a managed futures program (excepting those programs which are offered exclusively to qualified eligible persons as that term is defined by CFTC regulation 4.7) will be required to receive and sign off on a disclosure document in compliance with certain CFTC rules The disclosure document contains a complete description of the principal risk factors and each fee to be charged to your account by the CTA, as well as the composite performance of accounts under the CTA's management over at least the most recent five years. Investors interested in investing in any of the programs on this website are urged to carefully read these disclosure documents, including, but not limited to the performance information, before investing in any such programs.

Those investors who are qualified eligible persons, as that term is defined by CFTC regulation 4.7, and interested in investing in a program exempt from having to provide a disclosure document, are considered by the regulations to be sophisticated enough to understand the risks and be able to interpret the accuracy and completeness of any performance information on their own.

RCM Alternatives ("RCM") receives a portion of the commodity brokerage commissions you pay in connection with your futures trading and/or a portion of the interest income (if any) earned on an account's assets. CTAs may also pay RCM a portion of the fees they receive from accounts introduced to them by RCM.

RCM Alternatives is a registered 'DBA' of Reliance Capital Markets II LLC.

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