

Access **Alternative thinking** to stay buoyant
in rising and *falling* markets



Please note: The name of Select Futures Fund was changed to the Aspect Futures Fund on 7 May 2009



This paper addresses some of the key benefits and features of investing in Managed Futures. We hope that it will assist advisers and investors in better understanding Managed Futures, and more importantly, how to incorporate them into a portfolio. The following topics are addressed:

1. Managed Futures – Introduction
2. Futures Markets - Defined
3. Managed Futures - History
4. Managed Futures Investment - Defined
5. Commodity Trading Advisor (CTA) Styles
6. Why consider Managed Futures?
7. What Risks are involved with Managed Futures?
8. Performance: Risk and Returns
9. Is there an Optimal Allocation to Managed Futures?
10. Conclusions



1. Managed Futures – Introduction

The term Managed Futures refers to the active trading of a portfolio of global futures, forwards and options contracts on commodities and financial assets in order to generate an investment return. Investment strategies are typically 'rules based' and have a strong directional bias (long or short), and incorporate leverage.

Organised futures markets began in the 1840s, established by American farmers and grain merchants to establish a future value for their goods. The futures markets came to the attention of investors during the 1970s and 1980s and such market participants / traders were originally known as Commodity Trading Advisors (CTAs), as commodities made up the majority of their Managed Futures portfolios during that early period.

CTAs and Managed Futures investment managers (these terms are generally used interchangeably) believe that futures market behaviour is not random and that there are statistically predictable movements which can be identified and captured. The key to successfully identifying these movements is rigorous and continuous research. The Managed Futures investment process is research intensive and designed to capitalise on market imperfections to generate returns for investors.

Used in combination with a traditional investment portfolio, Managed Futures can enhance the overall risk adjusted performance and provide access to investment markets previously inaccessible to traditional investors.

2. Futures Markets - Defined

Futures contracts represent obligations to purchase or sell a standardised quantity and grade of commodity or financial asset at a specific time and place in the future. In the period between the trade and expiration date of the contract, the price of the underlying investment fluctuates as does the price of the futures contract itself (the two prices converge at expiry). Futures contracts are derivative instruments, whose value is dependant upon the value of the underlying investment. Futures markets are highly regulated, incorporate the use of clearing houses (removing counterparty risk), are highly liquid, and typically have low transaction costs.

There are currently over 150 futures markets worldwide. Futures can be grouped into two broad categories:

1. Commodity: Available on various sectors of the physical commodities markets and include:
 - a. Energy: (Crude Oil, Natural Gas, Heating Oil, Unleaded Gasoline);
 - b. Metals: (Gold, Silver, Platinum, Copper, Aluminum);
 - c. Agricultural: (Wheat, Corn, Soybeans, Live Cattle, Lean Hogs); and
 - d. Soft: (Coffee, Cocoa, Sugar, Cotton, Orange Juice).
2. Financial: Available on several underlying financial instruments and includes:
 - a. Foreign Exchange: (Euro, Yen, British Pound, US Dollar Index);
 - b. Interest Rates: (US Tsy. 10 yr. Note, 5 yr. Note, Eurodollar, LIBOR); and
 - c. Equities: (S&P 500, FTSE 100, Euro Stoxx 50, French CAC 40, Japanese Nikkei).

According to statistics collated by the Futures Industry Association (FIA), the total number of futures and options traded on exchanges around the world reached approximately 11 billion contracts for the year ended 2006, an increase of approximately 19% from the previous year. Looking back through time, the pace of growth appears to be accelerating. While trading in commodity contracts grew faster than other markets over this period, this is still a market dominated by financials. More than 90% of all trading in exchange traded derivatives is tied to interest rates or equity prices.



3. Managed Futures – History

Trading in commodities themselves dates back to classical times but it was not until more recently, with the development of the futures markets, that commodity trading came to be viewed as a potential tool for investment managers. The nature of commodities – particularly agricultural ones – is such that the buyer and seller need to make judgments about the likely supply and demand (and hence price) at some point in the future. This uncertainty results in there being an element of risk involved which opened the door to market players who were prepared to take on these risks, in the expectation of financial gain (i.e. the risk premium). Commodity traders performed two useful tasks: they provided liquidity to the markets; and they allowed ‘conventional’ traders – those who actually produced the commodities and those who had an end use for them – to offset risk. It was a short step from there to realizing that commodity trading could form the basis of an investment vehicle, with the first managed fund of this type starting trading in the late 1940s.

Up until the mid 1970s the industry was referred to as ‘commodity trading’ and was dominated by the agricultural markets (grains, metals and meats). The market changed in 1975 with the introduction of the first financial futures contract (Government National Mortgage Association) and again in 1977 with the introduction of the second financial futures contract (US Treasury Bond). These were the beginnings of the introduction of contracts which were not linked to traditional commodities and, because these markets establish the price in the future, the term ‘futures market’ came into being.

As with commodity trading (grains, metals and meats) the objective of financial futures contracts were much the same, to establish a price at some time in the future. But this time the commodity was money rather than commodities. Not long thereafter, the volume of trading in financial futures contracts started to overtake commodity futures contracts.

The introduction of a futures contract that could be used to hedge financial risk rather than commodity price risk opened up a whole new opportunity set for traders and investment managers alike. It is now more common for financial futures to be used by traders to hedge their investment portfolios rather than commodity futures being used to hedge commodity price risk. The advent of financial futures contracts assisted in the expansion of the number and types of trading strategies for Managed Futures investment managers.

In the last 20 years, participation in the world’s stock and bond markets has increased markedly, due in a large part to the growth in managed funds. In addition, this growth has cascaded to the futures, forwards and options markets through increased investor interest. Investors’ desire for new investment opportunities has contributed to the growth of Managed Futures as a distinct alternative asset investment strategy.

4. Managed Futures Investment - Defined

Managed Futures investment managers typically buy long or sell short futures contracts to profit from upward or downward price trends respectively. Some managers also use spread trades between comparable contracts to take advantage of perceived pricing discrepancies between the two. The aim of the Managed Futures investment manager is to add value via the active portfolio management of futures contracts.

Managed Futures investment managers generally invest using a proprietary ‘rules based’ trading system that speculates on the direction of the market prices of stocks, bonds, currencies, fixed interest, and commodities (both individual contracts and indices). Strategies involve long and short investing across both financial and commodity contracts using the global futures, options and forwards markets.



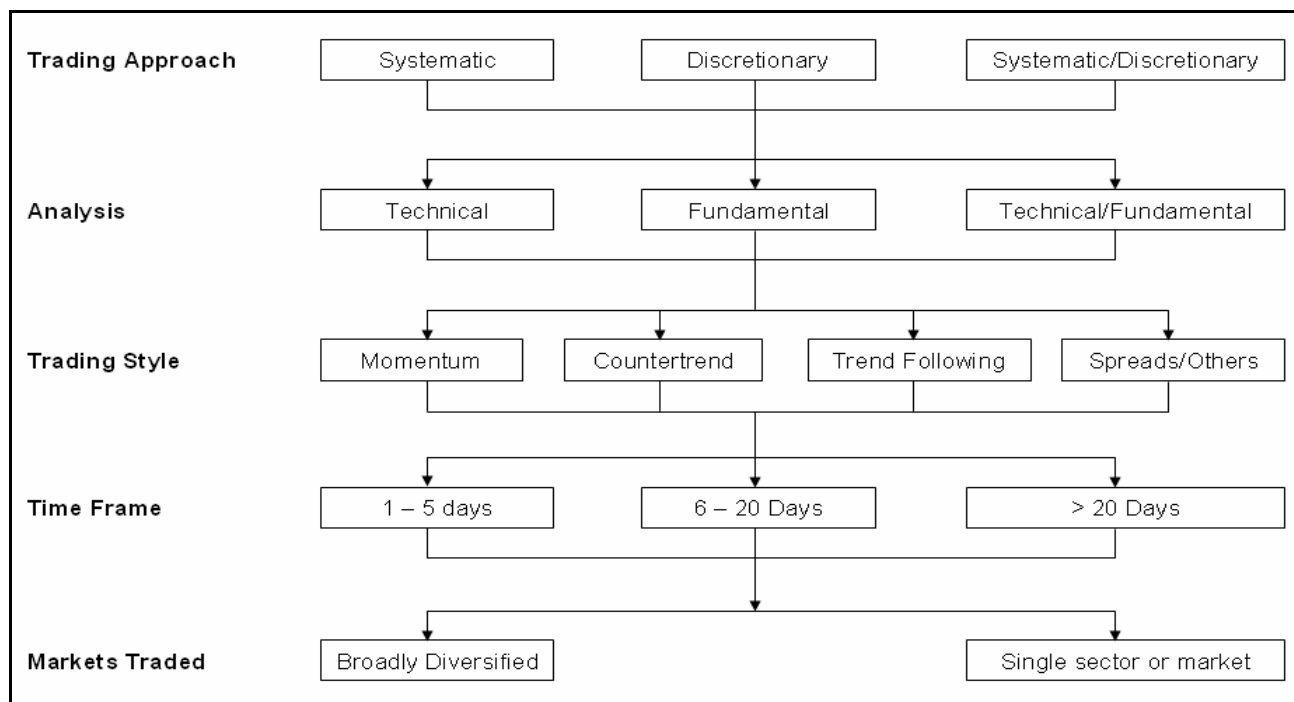
In the past and sometimes even today, there has been a general lack of understanding of the underlying investment strategies used by Managed Futures investment managers and, as a consequence, many people have described the approach as ‘black box’ investing. Even though investors may not be familiar with the details of the underlying strategies, the decision making systems are generally programmed in computer algorithms and have been developed after extensive research and development, and constantly refined over time.

Managed Futures investment strategies have developed extensively since their emergence in the 1970s. Early Managed Futures strategies utilised ‘technical’ trading patterns that were relatively simple in nature with names such as ‘head and shoulders’ and ‘support and resistance’. Some of these are still in use today. In the 1980s many of these early investment strategies were supplemented by newer strategies such as ‘simple moving averages’ and ‘breakouts’ which were more systematic in nature. This period was characterised by the introduction of computers to assist in the analysis of historical market prices and trends. The 1990s saw the increased use of computers accompanied by a boost in the level of research and development undertaken by traders. Nowadays the number and types of strategies available to the Managed Futures investment manager are vast and the amount invested in research and development continues to grow due to the need to try to stay ahead of the competition.

5. Commodity Trading Advisor (CTA) Styles

CTAs can follow a diverse range of trading styles. These styles can incorporate different trading approaches, analytical approaches, trading rules, time horizons and markets traded.

The diagram below outlines the various investment approaches of CTAs:



Source: Select Asset Management



CTAs can be generally grouped into one of two investment approaches: systematic or discretionary:

- Systematic traders are primarily 'trend followers' and use computer models to identify trends. Trading programs are 'rules based', designed to be unemotional in their behaviour. Systematic managers may concentrate on short-term, mid-term or long-term trends, or a combination thereof. Investment opportunities may be as short as intraday or as long as a several months.
- Discretionary traders usually take a less quantitative approach and rely more on fundamental analysis of the macro economic situation. They trade financial, currency, and commodity futures/options based on a wide variety of trading models including those based on fundamental economic data and/or the individual trader's beliefs.

6. Why consider Managed Futures?

One of the most important developments in portfolio management worldwide over the past two decades has been the growing acceptance of, and focus on, alternative investments such as Managed Futures. However, while it is fairly common and routine for individuals to invest in the stock and bond markets, it is less common for individuals to invest directly the futures, options and forwards markets. These markets require specialist knowledge, can be volatile and often involve leverage, meaning small price movements can have large impacts on overall trading results. As a result they have remained mainly in the domain of the professional portfolio manager.

Managed Futures have the ability to generate positive returns during times of market crisis and are generally lowly correlated with other investment types. This can enable them to enhance the level of diversification when combined with a more traditional portfolio and provide a level of downside protection. This in turn can improve the risk and return profile of that portfolio, for example reducing the overall volatility.

- **Low correlation to traditional assets.** Managed Futures, in general, exhibit a low correlation with more traditional asset classes such as stock and bonds. Diversification is improved by building investment portfolios comprising lowly correlated assets. A portfolio of lowly correlated assets can provide improved risk-adjusted returns. A study undertaken in the early 1980s concluded "that Managed Futures exhibited low correlations to stock and bond portfolios and that adding Managed Futures to these traditional portfolios resulted in superior return distributions and improved risk return tradeoffs"¹. It is hard (though some might try) to imagine a link between the behaviour of, say, pork bellies and the stock market. And as most equity and bond funds take only long positions, it is clear that the use of short positions (i.e. the ability to profit from both upward and downward price moves) immediately affects the correlations to other investments within a portfolio. Portfolio theory had, for some time, convinced the investment world of the risk reduction benefits of constructing a portfolio that consisted of non correlated assets. This concept held to be true even for traditional portfolios which consist of equities, bonds and cash which tend to be slightly positively correlated. As the theory developed over the years, and the measure of correlation became one of the key yardsticks by which an asset class could demonstrate its usefulness, so the use of Managed Futures in institutional portfolios grew.

¹ 1983, Dr John Linter, Harvard University, *The Potential Role of Managed Commodity Futures Accounts in Portfolios of Stocks and Bonds*



The diagram below highlights the correlation of Managed Futures relative to the more traditional asset classes of stocks, property, bonds and cash for the period June 1992 to October 2008.

Correlations: Managed Futures and traditional asset classes
Period: June 1992 to October 2008

	Barclays CTA Index (A\$)	Australian Shares	Global Shares (A\$)	Listed Property	Australian Bonds	Global Bonds	Cash
Australian Shares	-0.06	1.00					
Global Shares (A\$)	-0.16	0.51	1.00				
Listed Property	0.02	0.59	0.37	1.00			
Australian Bonds	0.22	0.17	0.04	0.28	1.00		
Global Bonds	0.31	-0.03	-0.10	0.16	0.65	1.00	
Cash	0.12	-0.07	0.00	-0.14	0.35	0.25	1.00

Source: Bloomberg, Morningstar.



Correlations: Managed Futures and individual hedge fund strategies
Period: January 1998 to September 2008

	Barclays CTA Index (A\$)	Equally Weighted Hedge Fund Index	Convertible Arbitrage Index	Equity Market Neutral Index	Event Driven Multi-Strategy Index	Fixed Income Arbitrage Index	Global Macro Index	Merger Arbitrage Index
Equally Weighted Hedge Fund Index	-0.03	1.00						
Convertible Arbitrage Index	0.01	0.56	1.00					
Equity Market Neutral Index	-0.05	0.68	0.54	1.00				
Event Driven Multi-Strategy Index	-0.09	0.88	0.67	0.65	1.00			
Fixed Income Arbitrage Index	-0.16	0.50	0.71	0.50	0.62	1.00		
Global Macro Index	-0.03	0.65	0.34	0.60	0.58	0.34	1.00	
Merger Arbitrage Index	-0.11	0.74	0.55	0.57	0.87	0.54	0.51	1.00

Source: Bloomberg, CISDM

The chart above illustrates the correlations of Managed Futures relative to individual hedge fund strategies. It must be remembered that correlations can and do change over time. In a bull market, Managed Futures investment managers will initiate long positions in their investments in a similar fashion to long only managers. This can mean that the correlation of Managed Futures investments and traditional investments may potentially increase; whilst in a bear market Managed Futures investment managers will be able to initiate short positions relative to long only managers and the correlation can subsequently fall.

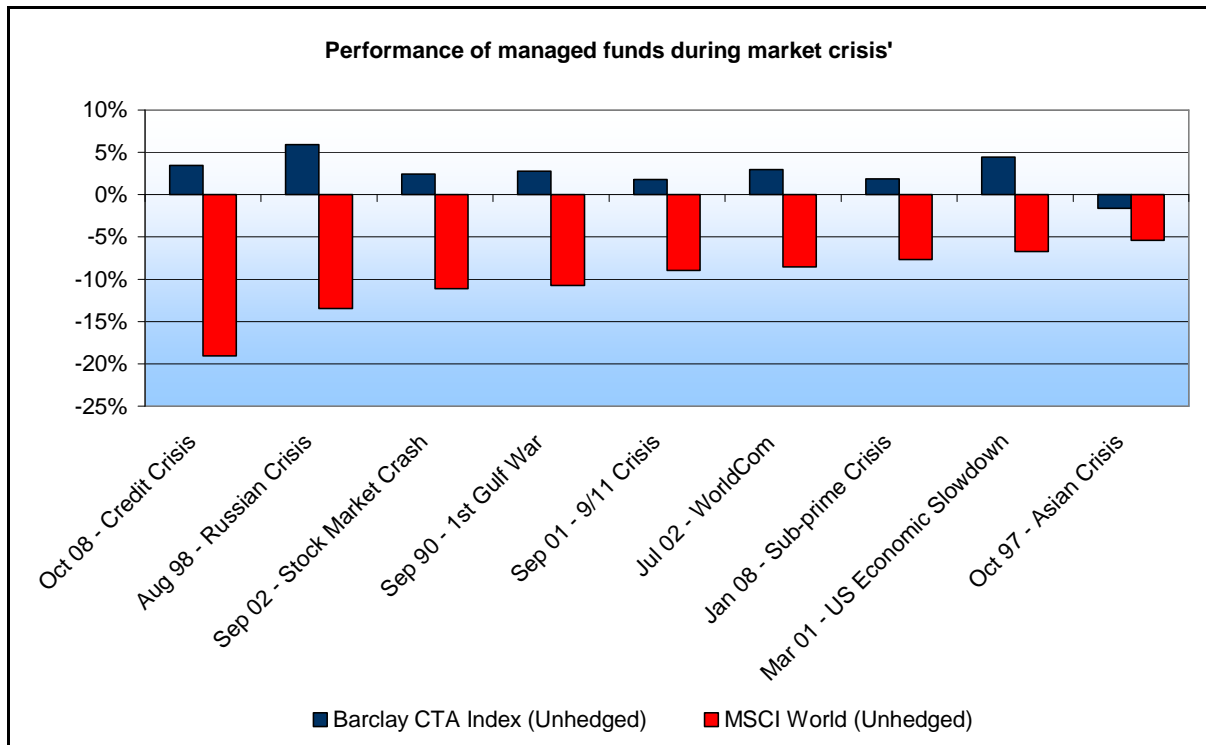
- **Reduced portfolio volatility.** One of the benefits of including an allocation to Managed Futures within an investment portfolio is the potential to reduce overall portfolio volatility (a common measure of risk). Managed Futures, being derivatives, have been thought of by some as being riskier than equities. However, a study undertaken in 2002² concluded that Managed Futures were no more risky than traditional stock portfolios, and that being lowly correlated then risk reduction benefits should be able to be obtained in combination.
- **Enhanced portfolio diversification.** Managed Futures have been used increasingly as a source of diversification. Most Managed Futures investment managers run globally diversified portfolios and trade in excess of 100 or more markets. This means they can provide exposure to a diversified and broad range of global markets. In the last two decades, the futures markets have grown dramatically and now there are over 150 global futures markets comprising many different sectors.

² Thomas Schneeweis, 'Benefits of Managed Futures'



- Ability to generate positive returns during times of market stress/crisis.** Managed Futures investment managers aim to benefit from the identification of price trends. Their investment philosophy aims to take advantages of rising market conditions where they may hold long positions, as well as falling market conditions where they have the ability to short the market. Additionally they have the ability to invest in gold and precious metals as well as other commodities which often perform well during times of global market stress or upheaval.

The chart below highlights the performance of Managed Futures during times of market stress / crisis **including the recent credit crisis**. The downside protection this generates is very important and can reduce the overall level of drawdowns in a portfolio.





7. What Risks are associated with Managed Futures?

Generally speaking there are risks associated with any investment. Some of the main risks associated with an investment in Managed Futures include transparency, leverage, foreign currency exposure, and market risks.

- **Transparency** - One of the challenges with Managed Futures investment managers is that most of the trading approaches are quantitative in nature and are often viewed, especially from the investors' perspective, as particularly complex. Generally, Managed Futures investment managers are not willing to reveal detailed information on the exact nature and mechanics of their proprietary trading systems. This is in part because they feel that their investment programs are superior to that of their peers and they are subsequently protective of their intellectual property. However, increasingly they will detail the futures contracts they are holding from time to time, particularly through the use of managed accounts where they essentially act as a Trading Advisor.
- **Leverage** – Leverage is a key characteristic of investing with Managed Futures investment managers. Leverage is considered the double-edged sword of investing. The technique that can bring so much excess gain can also be the cause of catastrophic distress, as the demise of Long Term Capital Management demonstrated so graphically. In the futures markets, investors are only required to put down a relatively small fraction of money (the 'margin') against the full value of the futures contract invested in. This means that small movements in the underlying price, especially negative moves, can represent large dollar moves in the value of the contract. Leverage is monitored closely by Managed Futures investment managers against acceptable limits.
- **Foreign Currency Exposure** – The underlying futures contracts can be domiciled in a large number of global markets and may be exposed to foreign currency exchange risk fluctuations. The use of foreign exchange hedging techniques can help manage this risk.
- **Market Risks** – Managed Futures investments generally require trending markets in order to make money. Subsequently, Managed Futures investment managers tend to perform well in both rising and falling markets. However, many Managed Futures investment managers experience difficulties in choppy, directionless markets. During such markets, the aim of the Managed Futures investment manager is to preserve capital / limit their losses. The performance of Managed Futures investment managers can suffer when markets undergo sharp reversals.



8. Performance – Risk and Return

The table below shows the returns that historically been delivered by Managed Futures (using the Barclay CTA Index, Hedged), as measured by annualised returns and volatility (annualised standard deviations), compared to traditional assets over the period from June 1992 to October 2008:

Investment Area	Benchmark/Index	Ann. Return %	Ann. Vol. %
Alternative Strategies			
Managed Futures	Barclay CTA Index (Hedged)	8.0#	8.0#
Traditional Assets			
Australian Shares	S&P/ASX 200 Accumulation	8.7	12.8
Global Shares	MSCI World Index (A\$)	4.7	12.6
Listed Property	S&P/ASX 200 Listed Prop Accumulation	8.0	13.7
Australian Bonds	UBSW Comp All Mats Bond Index	7.6	4.0
Global Bonds	JP Morgan Government Bond (Hedged)	8.3	3.2
Cash	UBSW Bank Bill Index	5.9	0.3
Mainstream Portfolio*		8.4	7.4

* Mainstream Portfolio: 35% Australian Shares, 20% Global Shares, 10% LPT's (prior to April 2000 the ASX Accumulation Property Trust Index was used), 20% Australian Bonds, 10% Global Bonds and 5% Cash.

Calculated using an estimated price for the Barclay CTA Index for the end of October as at 18/11/2008.

While this table provides some idea of the risks and returns of Managed Futures and traditional investments, the limitations of historical analysis must be emphasised, particularly over relatively short time periods. That is, history can be a poor guide to the future



9. Is there an Optimal allocation to Managed Futures

It is widely accepted that diversification across lowly correlated investments can meaningfully reduce portfolio volatility without significantly impacting the expected return, thereby improving the risk/return profile of a portfolio. Generally speaking it is the low correlation of alternative investment returns like Managed Futures to those of more traditional assets which provides an opportunity to exploit this characteristic. By combining Managed Futures with a traditional portfolio an investor can create a smoother pattern of returns over time.

There are a number of limitations with this approach:

- History is often a poor guide to the future and historical returns, volatilities and correlation may be very different from historical experience going forward.
- Modern Portfolio Theory assumes that markets are generally efficient and that asset returns are normally distributed. However, alternative investments such as Managed Futures tend to exhibit return distributions that are often not normally distributed (this can be a positive characteristic in that Managed Futures investments are often positively skewed).
- Investors consider more than average returns, correlations and standard deviation when constructing a portfolio.

Notwithstanding these limitations, a fairly crude analysis can illustrate the benefits of combining Managed Futures with a traditional portfolio.

The following table shows the composition of a typical traditional portfolio.

Traditional Portfolio	Allocation
Australian Shares	35%
Global Shares	20%
Listed Property	10%
Australian Bonds	20%
Global Bonds	10%
Cash	5%



In the table below are the results of analysis, using historic data for the traditional portfolio shown on the previous page and Managed Futures (as represented by the Barclay CTA Index (Hedged) between June 1992 and October 2008, which illustrates the potential risk reduction benefits of including an allocation to Managed Futures within a traditional portfolio. The information is intended purely for illustrative purposes.

Effects of adding Managed Futures to a Traditional Portfolio

	Traditional Portfolio	Traditional Portfolio combined with a 10% allocation to Managed Futures
Annualised Return	8.0	8.1
Annualised Standard Deviation	7.4	6.7
Annualised Sharpe Ratio	0.38	0.43

Note:

- The calculation of the Sharpe Ratio utilises a constant risk free rate of 5.25% per annum as at 05/11/2008.
- The Barclay CTA Index is calculated to the end of October 2008 using an estimated price as at 18/11/2008.

However the data in the table on page 10 and above does not demonstrate the full potential to earn attractive returns from active investment management in this sector since we are using an index to represent Managed Futures. Investing with the right (upper quartile) CTA(s) can dramatically improve the overall risk and return characteristics of the total investment portfolio, as demonstrated below.

The table below contains the results of including an allocation to an actively managed program (the Select Futures Fund) within a portfolio of traditional assets. The analysis is undertaken from December 1998 (due to data availability) through to the end of October 2008.

Effects of adding Managed Futures (Actively managed) to a Traditional Portfolio

	Traditional Portfolio	Traditional Portfolio combined with a 10% allocation to Managed Futures
Annualised Return	5.3	6.3
Annualised Standard Deviation	6.9	6.0
Annualised Sharpe Ratio	0.01	0.18

Note:

- The calculation of the Sharpe Ratio utilises a constant risk free rate of 5.25% per annum as at 05/11/2008.

Generally speaking there can be a wide variation in investment returns between top and bottom quartile CTA's, and this variation creates enormous opportunities to generate superior returns through careful and experienced manager selection.

The illustration above highlights the importance of investing well in Managed Futures as investing with a top quality manager can improve the performance of a Traditional Portfolio and dramatically improve the overall risk return profile, as measured for example by the Sharpe Ratio.



10. Conclusions

Managed Futures are considered a subset of the alternative investment field. 'Alternative' can be used in two senses: firstly, referring to the markets traded in and secondly, to the methods used to trade those markets. Managed Futures, trading as they do in currencies and commodities as well as stocks and bond instruments, and which use non-traditional methods such as short selling and leverage, fulfil both criteria.

The benefits of investing in Managed Futures include:

- The potential to reduce the overall volatility of an investment portfolio;
- The potential to enhance the overall diversification of the investment portfolio by providing exposure to a lowly correlated investment and to markets which have been traditionally difficult to access, thereby providing a smoother pattern of returns over time; and
- The ability to provide positive returns and downside protection during times of general market stress / crisis.

Managed Futures have been trading for over forty years and provide access to highly diversified, liquid and transparent underlying markets. They offer unique risk and return characteristics through their ability to trade both long and short positions across global stock, bond and commodity markets. Some of the markets traded are considered the most liquid markets in the world.

Managed Futures are considered complex and challenging to understand and it has been difficult for small investors to participate. However, as the methodologies employed become more familiar, and as the long term track records build up, more investor friendly vehicles will be developed. Managed Futures are starting to emerge from the shadow of its older, more traditional cousins, and are increasingly seen by experienced investors to be as important an investment class as stocks and bonds.

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