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ALTERNATIVE INVESTMENTS FOR EVERYMAN

By Ira G. Kawaller

A key principle of modern portfolio theory is that both risk and aggregate returns can be improved by diversification. With this consideration in mind, a still-small segment of the institutional investment community has embraced the idea of including *alternative assets* in their portfolios. The idea is that by allocating a small portion of non-traditional assets to a broader portfolio, the whole portfolio will generally generate higher risk-adjusted returns -- lower volatility for the same expected returns, or higher returns for the same level of volatility -- an unambiguous improvement relative to the performance under the original portfolio composition. In academic circles, this claim is non-controversial, but its validity is contingent upon two critical assumptions being satisfied: (1) the performance of the newly introduced asset class must have positive expected returns, and (2) those returns are uncorrelated with those of the rest of the portfolio.

Managed futures accounts represent one investment design that is used to satisfy this same objective. A managed futures account pairs an investor with a trading manager who is typically designated as a *commodity trading advisor* or CTA. Whether or not these qualify as *true* asset classes is somewhat of a semantic minefield. What's important is that managed futures represent trading activities that deliver -- or strive to -- the same benefits that are sought from allocation to alternative assets.

Under the typical arrangement, the CTA trades futures contracts (or options on futures contracts), which are federally regulated contracts that offer exposure to a broad range of markets, including financial markets like stocks, interest rates and currencies, as well as agricultural markets, metals, energy and other commodities. Besides the federal regulatory controls, futures also have the attributes of offering highly liquid markets with excellent price transparency, low transactions costs, and virtually no credit risk.

In the typical arrangement, the CTA earns an *administration fee* and a participation fee, normally 2% of funds under management 20% of profits, respectively. As futures trading involves the posting a margin deposit in lieu of fully funding positions, the administration fee is ordinarily based on an agreed upon a notional value. Only a portion of this notional value is required to open the brokerage account with the firm that provides the trade execution services.

Traditional CTA strategies

While variants to the rule abound, CTAs generally follow one of the following approaches:
1. Trend-following
2. Mean-reverting
3. Discretionary

Most trend followers tend to trade in a number of markets. Basically, using objective criteria (e.g., moving averages), they buy when they discern a rising trend and sell when they discern a falling trend. The risk in this strategy is that, rather than trending, prices vary within a relatively narrow range. If the perceived trend fails to evolve after the trade is initiated, the CTA would end up generating whipsaw losses -- buying "high" and selling "low," (or selling "low" and buying "high"). Although whipsaw losses are, to some extent, unavoidable, if the CTA can participate in a *strongly* trending market for only a small percentage of the markets traded, the hope is that this gain would dwarf the whipsaw losses on the non-trending markets. Clearly, if the trending markets are few and/or the magnitudes of their associated price moves are limited, the promise of profits might not be realized. This outcome certainly has to be expected to occur for some time periods.

A mean-reverting strategy is just the opposite approach to that of trend-following. Whereas the trend follower observes a price increase and hopes for a continuation, the mean-reverting orientation looks at sufficiently large price changes as aberrations that will likely be shortly reversed. Like the trend followers, mean-reversion types will generally apply the concept to a host of markets. They're hoping that most of the markets will be relatively stable, and they'll be able to sell "high" and buy "low" (or buy "low and sell "high.") These players are looking to make small gains with high frequency. It should be understood that they're positioning for a reversal which may not occur. That is, they bear the risk that they could get caught in a trend.

Both trend-following and mean-reverting trading programs rely on mechanical trading rules that are devised on the basis of trying to optimize earnings over some past period. The resulting rules are thus dependent on the period analyzed. Choose a different time frame and you get a different trading algorithm. There's something less than satisfying about that result, and simply updating and revising the trading rules periodically doesn't necessarily improve the rules. Future success is likely contingent on the character of the market going forward to be consistent with its character in the prior time that was used for determining the trading rules. Maybe that consistency will hold, but maybe it won't. For the most part, the promoters of either of these approaches point to the fact that they worked in the past for the justification for

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expecting them to work in the future.

"Discretionary" has become somewhat of a catch-all term that means that the manager can do whatever he or she wants. Sometimes, the underlying trading philosophy is presented transparently, and sometime not. That is, some managers elect to present their ideas openly and answer any questions prospective investors might have. Others seem to take an approach that rests on the "trust me" principle. Both extremes and every gradation in the middle are out there.

Arguably, the big disadvantage of managed futures is that they're structured in a way that makes them largely inaccessible for all but the very wealthy. A good portion of CTAs (if not a majority) only offer their services to institutional customers. Qualified eligible persons (QEPs -- i.e. market professionals) or accredited investors -- individuals having portfolios valued at over $2 million and incomes in excess of $200,000 per year also are eligible. Regulations restrict those who serve to this restricted audience from virtually *any* communication with non-QEP individuals. As a consequence there's a huge void in readily accessible information about available CTA services to the less-than-high-net-worth investors.

Besides the managed futures account, an alternative vehicle for non-qualifying investors is a commodity pool. A *commodity pool* is structured as a limited partnership that functions much like a mutual fund. The commodity pool operator (CPO) offers the services of one or more CTAs to a set of limited partners, where the required amount to participate tends to be smaller than that required for a managed account. Pool requirements vary widely, but a minimum investment of, say, $25,000 seemingly opens the opportunity for improved diversification to a huge population of serial savers -- not just rich folks.

Unfortunately, because limited partnerships are deemed to be securities, these programs fall under the jurisdiction of the SEC, and the SEC tightly controls communication from CPOs. For instance, broad-based advertising and promotion of commodity pools is prohibited; and pool operators can only post information about their pools on password-restricted Web sites. Prospective investors can reach out to CPOs if the managers are known to them, but CPOs are constrained in the way they can approach new prospects.

This informational blackout is clearly intended as a consumer protection, but the cost has been considerable. The lack of readily available information about CTAs and CPOs has certainly contributed to their limited use by all but a select stratum of sophisticated investors. But why should the less-well heeled be denied the opportunity to do something smart? Small improvements in investment returns translate to large dollar amounts over an extended investment horizon; and that's precisely what managed accounts or commodity pools are expected to deliver. Denying these benefits to smaller investors clearly puts them at a disadvantage.

Choosing A Manager

So how should a prospective investor proceed? Most likely, you'll want to rely on the recommendations of friends or financial professionals to help select a prospective CTA or CPO. Making it hard, however, is that many perfectly competent financial professionals in their own realm are totally ignorant about the world of CTAs and CPOs. In all likelihood the credential that most likely reflects some degree of competency in this realm would be registration with the National Futures Association (NFA). In any case, one way or other, you have to identify and make contact with prospective managers and request their *disclosure documents*. Answers to the key questions that you should be asking can be found in these offerings.

The dirty little secret is that it's virtually impossible to distinguish skill from luck in this area. Even access to large databases of CTAs or CPOs and a capacity to run a seemingly sophisticated analysis of past returns and volatility may not be sufficient to guaranty a successful choice. Historical data will have little or no value if trading styles are adapted to changing market conditions over time; and, let's face it, that's what happens. Moreover, many if not most programs have limited histories; and as a consequence, the validity of statistical results relating to expected returns, volatilities and correlations should be viewed skeptically.

The starting point should be conceptual: What's the underlying approach described in the disclosure document, does it have intellectual appeal? What markets are covered? Is there appropriate consideration of the tradeoff between risk and reward? Assuming the approach and coverage is compatible with your own interests and sensibilities, it's critical to go beyond the track record. In particular, three key issues that deserve attention:
(1) Who is the manager?
(2) How much has the manager personally invested in the fund?
(3) Are the interests of the manager and the investor appropriately aligned?

Bernie Madoff proved that even seemingly sterling biographies aren't necessarily indicative of honesty or integrity, but relevant experience should count for *something*. Assuming the biography passes muster, it speaks volumes when a manager's own money is at risk. With that condition satisfied, you should make an effort to assess whether your interests and those of the manager are aligned.

With respect to the alignment of interests, two areas provide useful information. The first deals with the way expenses are treated. You should expect to bear commission charges as part of return calculations, but that's about it. Maybe it's just me, but when someone charges me for an "administration fee," I think it ought to cover such things as overhead, marketing costs, research and data services. In fact, if disclosed, these expenses can legally be shifted to the investors; but that doesn't make it right.

The second consideration relates to the concept of a *lockup period* for a managed account or commodity pool. A lock up period commits the investor to a minimum term. It also seems to me to be a red flag. Lockup periods are fairly typical for hedge funds -- particularly those that invest in illiquid assets, such as private equity or real estate. In these cases, a precipitous termination by the investor could come at an inopportune moment, and managers might legitimately feel that they would be able to better serve their investors by having a window of opportunity to exit from their holdings. The length of the lock up period, however, should relate to the degree of liquidity (or *illiquidity*) of the assets held by the fund. With positions held by CTAs and CPOs being

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futures contracts and options on futures, managers can easily trade in and out of contracts on virtually any business day. Applying an extended lockup requirement in these situations seems unjustifiable. It is the investors' money, after all.

Conclusion

The inclusion of a professionally managed futures trading program in an otherwise more traditional investment portfolio promises higher risk-adjusted returns; but is this promise truly reliable? In fact, we live in an uncertain world, and there are no guarantees. The desired outcome is predicated upon the returns on the alternative investment being positive and uncorrelated with the returns of the other investment categories. Although these expectations could fail to be realized, appropriate due diligence in connection with manager selection, should lessen the probability of this perverse result.

The CTA or CPO allocation you make in your investment portfolio should apply a strategy or approach that you understand and embrace -- which means being fully cognizant of the character of the performance that is likely to arise over time, warts and all. In this context, past returns clearly aren't necessarily indicative of future returns, and it's useful to point out that records -- both good ones and bad ones -- were made to be broken. A short history of high returns may reasonably attract attention, but it certainly shouldn't be a sufficient selection criterion.

Prospective investors should investigate a prospective manager's background, validate that he or she has have funds at risk in his/her program, and check to make sure that the treatment of expenses and lockup requirements aren't set up to unfairly burden the passive investor(s). There are still no guaranties, but the prospect of a successful experience with alternative assets will be enhanced if you follow this advice.

I*ra Kawaller is founder of Kawaller & Co., which assists businesses in their use of derivative instruments to manage financial risk. Previously, he was a vice president-director of the New York Office of the Chicago Mercantile Exchange, where he was responsible for promoting financial futures and options to the professional financial community.*

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