Managed Futures:
Myths, Misconceptions…and Enlightenment!

Managed futures are eminently suitable for any qualified investor who understands that a major difference exists between amateurs who 'dabble' and professionals who trade futures for a living. Isn't it logical to conclude that an unskilled person attempting to practice law or medicine would probably perform quite poorly, in the same manner as would an unqualified amateur trading futures? So it should come as no surprise that, in the highly complex and challenging world of futures trading, the vast majority of amateur futures traders just plain lose! On the other hand, experienced professionals, referred to as Commodity Trading Advisors (CTAs), have been shown to achieve consistent returns through prudent money management. Additionally studies have also shown that managed futures are no riskier than stocks. However the risks associated with trading commodities are significantly different than those of stock investing. Bear in mind that the risk of loss exists no matter who is managing your money, and that the potential exists in futures trading to lose more than your initial investment.

Modern Portfolio Theory and its Implications

Pension funds and sophisticated investors have long relied on Modern Portfolio Theory (MPT) in attempting to obtain the highest returns with the lowest level of risk. The premise underlying MPT tells us that the risk of *any* investment can be reduced and performance increased by holding a number of non-correlated investments in a variety of differing asset classes. Noncorrelated investments, by design, do *not* move in lockstep with one another. The father of MPT, Dr. Harry Markowitz, cautioned investors 50 years ago "holding securities that tend to move in concert with each other does not lower risk."
Dr. Markowitz concluded that a diversified portfolio comprised of investments noncorrelated with securities could provide the highest returns with the least amount of risk.

Offering almost a zero correlation versus stocks, professionally managed futures fit this description quite nicely.

Findings on Managed Futures Brought to Light

In what is considered a landmark study, Dr. John Lintner of Harvard University, in 1983, presented his paper "The Potential Role of Managed Futures Accounts in Portfolios of Stocks and Bonds." Lintner concluded that **"The combined portfolios of stocks after including judicious investments in managed futures accounts show substantially less risk, at every possible level of expected return, than portfolios of stocks (or stocks and bonds) alone."**

In further support of the conclusions reached by Mssrs. Markowitz and Lintner, the Chicago Mercantile Exchange (CME) published a study which stated that portfolios with as much as 20% in managed futures can yield up to 50% more than stock and bond portfolios, while offering comparable risk.

The Chicago Board of Trade (CBOT), in their highly informative brochure, “Portfolio Diversification Opportunities,” incorporated a graph entitled “Potential Impact of Managed Futures on the Traditional Portfolio, January 1980 - December 2001.” **The graph illustrates how a portfolio without managed futures under performs, and is riskier than, a portfolio that includes managed futures. The portfolio that exhibited the highest returns and least amount of volatility comprised 41% stocks, 41% bonds and 18% managed futures.**

Actual performance of stocks and managed futures, as illustrated in the CBOT publication, demonstrate how managed futures have remained positive even during some of the stock market’s worst periods of decline!

Past performance is not indicative of future results. The risk of loss in futures trading can be substantial. An investor could potentially lose more than the initial investment.

Managed Futures and Portfolios: A Provocative Statement

Managed futures have long been employed in connection with diversifying institutional portfolios. One such example is Harvard University. Jack Meyer, the chief executive of that school’s endowment fund regularly includes commodity, and financial futures related instruments in the portfolio. In fact, this proponent of Modern Portfolio Theory has placed himself on record by stating, **"Holding commodities offers protection against the ups and downs of stocks and bonds; they're the most diversifying asset in the portfolio. The benefits of diversification are indisputable; diversification rules. It's powerful and our portfolio is a good deal less risky [with commodities] than with only the S&P 500."**

Are Managed Futures Riskier than Stocks?

Thomas Schneeweis, Professor of Finance at the University of Massachusetts, in his 2002 academic study “Benefits of Managed Futures,” destroys the myth of managed futures as investments that are riskier than stocks. According to Schneeweis **“Managed futures are not any more riskier than traditional equity investments. Investment in a single commodity trading advisor is shown to have risks and returns, which are similar to investment in a single equity. Moreover, a portfolio of commodity trading advisors is also shown to have risks, and returns, which are similar to traditional investments.” The risk of loss in futures trading is substantial. Such trading is not suitable for all investors.**

Professor Schneeweis’s studies conclusion has strong support from a recent academic study by professors, Gary Gorton, and K. Geert Rouwenhorst. The name of the study is “Facts and Fantasies about Commodity Trading”. Both professors are from some of the top universities in the U.S. Gorton is from The Wharton School, University of Pennsylvania, and National Bureau of Economic Research. Rouwenhorst is from Yale University’s School of Management. The conclusion of the professor’s study, “Facts and Fantasies about Commodity Trading” states:

“During the past 45 years, commodity futures have had roughly the same return as stocks with less risk, have way outperformed bonds and are a better hedge against inflation than either stocks or bonds”. Both papers were prepared for educational purposes and do not

address the significant risks inherent in futures trading. Futures' trading is not suitable for all investors. An investor could potentially lose more than the initial investment."

Commodities Are the Place to Be!

While the party in stocks is over, the party in commodities is only beginning. With stocks mired in a secular bear market the likes of which will probably last at least 10 years, the commodity markets are finally awakening to the unstable geo-political and economic events of our time! Many believe the secular bear market in stocks will cause equities to under-perform for the next decade while commodities will offer significant opportunities. The risk of loss in trading futures can be substantial. An investor could potentially lose more than the initial investment.

This, of course, begs the question: Isn't it prudent to shift one's investment focus to those areas that can potentially provide the greatest investment opportunities with the least volatility? Some experts liken commodities to stocks and bonds in the early 1980s. Both embarked on one of the great bull markets after a long period of sluggishness. Many, in fact, believe we are at the "sweet spot" of the economic cycle for commodities, representing a classic opportunity for investors, who ought to be thinking long term.

If you're a qualified investor looking to maximize returns and minimize volatility in your portfolio, give us a call at (703) 893-8808 so we can tell you more about the most exciting investments of our time—professionally managed futures.