Managed futures and systematic strategies

Maximising the potential for uncorrelated returns

April 2009
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Aref Karim  
Chief Executive Officer & CIO

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Introduction

The global financial crisis has posed a tremendous challenge to everybody in the financial sector these past two years. And it may be fair to say that even alternative investment strategies such as hedge funds, which are intended to deliver returns uncorrelated to the direction of markets, have struggled to cope – leaving many investors disappointed with the results.

However, there has been one major section of the alternative investment strategy universe – namely, the domain of quantitative trading, and of systematic managed futures in particular – which has clearly emerged as a shining exception. While hedge funds on average delivered significantly negative returns in 2008, the commodity trading advisers of the managed futures universe on average delivered significant double-digit gains. If ever proof were needed of their ability to deliver non-correlated gains in the toughest of market conditions, here it was – and in spades.

At a time when there is clearly a heightened interest in these types of strategies, we therefore feel it is highly timely for us to produce this report. In the following pages, we aim to give you a closer look at what this strategy area is all about – its history and evolution over the years, plus providing a feel for the range of what have always been a very colourful set of characters who ply their trade in these areas. We quote them extensively on how they see the markets, and how they go about what they do.

The resulting report is thus full of insightful comment, plus key statistics from the HedgeFund Intelligence database, and which we hope will be of interest to everybody in the alternative investment world.

Neil Wilson
Editorial director, HedgeFund Intelligence
David Winton Harding, founder of London-based Winton Capital Management, says that if you look hard enough you can find a literary quote to serve as a *mot juste* for virtually any event or circumstance. To prove the point, he rears one off from *Julius Caesar*: “There is a tide in the affairs of men which, taken at the flood, leads on to fortune…”

“How good a quote is that for a trend-follower?” Harding asks. “I’m not interpreting it in a geeky way, but it is so appropriate for trend-followers. It’s all a question of catching the tide. It’s not a question of being right about things. It’s all about riding the wave.”

Not all Commodity Trading Advisers (CTAs) are trend-followers. But most of those that are were able to ride the wave to spectacular effect in 2008. In a miserable year for many hedge fund strategies, the HedgeFund Intelligence Managed Futures index was up by 15.79% in 2008, compared with a decline of 13.87% for the mean version of the broader composite index.

That striking outperformance has led some commentators to refer to 2008 as the year in which CTAs re-emerged from years in the shadows. But veterans of the managed futures industry say that to focus on what CTAs delivered in 2008 is to misunderstand their history and to underestimate their importance.

“Yes, managed futures had a good year in 2008,” says Anthony Todd, chief executive officer and one of the four co-founders of Aspect Capital, a London-based systematic investment manager that was established in 1997 and had assets under management of just over $4 billion as of February 2009. “But managed futures have a track record going back 30 or 40 years and, over that period, they have consistently been able to deliver strong, uncorrelated returns, especially during difficult market conditions.”

Two of Aspect’s other co-founders – Martin Lueck and Michael Adam – are former colleagues of Harding, for whom the tide turned decisively in 1985. Three years after graduating from Cambridge University with a first class degree in natural sciences (specialising in theoretical physics), Harding joined Sabre Asset Management, the group that had been set up in 1982 by Robin Edwards and Peter Swete, and which is generally recognised as the UK’s first CTA.

Today, Sabre is still a well-regarded specialist quantitative hedge fund manager. But when Harding joined in 1985, he was struck by the primitive nature of the group’s approach to research. Years later, he would recall that the first half of each day was spent drawing hundreds of charts by hand. Nevertheless, it was a valuable training ground for Harding, who was one of a number of young scientists to pass through Sabre’s doors in the 1980s and put the experience to good use as architects of the European CTA movement.

Alongside Lueck and Adam, Harding himself became a founding partner in 1987 of AHL, which is now a part of the Man Group and manages assets of around $24 billion. In the genealogy of the European managed futures industry, AHL – now headed by Tim Wong – sits at the top of several family trees, with a number of today’s market leaders having been spun off from the firm over the past two decades.

Following a disagreement with his colleagues about the importance of research in 1997, Harding himself peeled off to set up Winton Capital, which with some $13 billion under management is now one of the largest CTAs in the world.

Other young managers who cut their teeth at Sabre in the 1980s and 1990s, albeit at different times, included the three founding partners of the Jersey-
based Altis Partners, which as of February 2009 had $1.245 billion under management in its Global Futures Portfolio.

“Many of the early CTAs in Europe emanated from Sabre in one way or another,” says one of the three, Stephen Hedgecock, who was Sabre’s chief dealer between 1991 and 1995. “Whether or not those managers were similar to Sabre in terms of their style and strategy, the establishment of Sabre was definitely responsible for a whole genre of quantitative-based CTA programmes,” he says.

The genre also included Beach Horizon, a specialist commodity manager that grew out of Beach Capital Management, which was originally set up in 1998 by another ex-Sabre manager, David Beach, as a discretionary programme.

By then, the managed futures sector in the US had grown to be an important pillar of the broader alternative investment management industry. Although some say that CTAs in the US can be traced back to as early as 1948, the market’s development was rubber-stamped in 1974 with the establishment of the Commodity Futures Trading Commission (CFTC).

Because all entities that trade on US futures exchanges (regardless of their domicile) are required to be registered with the CFTC, some managers refer to the term ‘commodity trading adviser’ as a regulatory category. This requirement also explains why the term has survived, although it has in many instances become a misnomer: today, the majority of the exposure of most CTAs is not to commodity markets at all, but to financials such as interest rate and stock index futures.

It was in 1983, however, that the CTA space in the US took an important leap forward following the Trading Places-style experiment undertaken by two renowned commodity traders, Richard Dennis and William Eckhardt, to determine whether trading ability was inherited or could be taught. Their conclusion was that individuals with no previous experience could be trained to become highly successful traders, and the by-product of their experiment was a new generation of players who were famously dubbed Turtle Traders by Dennis in 1989.

At the time of the Dennis/Eckhardt experiment, the US CTA universe was well-populated but rudimentary. Two investors who are especially well-qualified to remember how the US CTA landscape looked in the early 1980s are Marc Goodman and Kenneth Shewer, who in 1983 co-founded the Kenmar Group, an independent fund of funds specialist whose assets under management reached $4 billion in 2008.

“When we set up in 1983 there were about 2,000 registered CTAs, almost all of which were domiciled in the US,” recalls Goodman, Kenmar’s president, co-CEO and co-CIO. “Virtually all their trading was conducted on US markets and was concentrated almost entirely on commodities rather than financials. Of those 2,000, only about 50 were serious players and the balance were individuals who had sent registration forms into the CFTC because they happened to have traded futures.”

The investor base in the US was similarly under-developed in the early 1980s. “In 1984, there was no institutional investment in CTAs,” Goodman adds. “There were only retail investors, which was why it was a struggle to raise $1.5 million when we launched our first fund in 1984.”

It was in the mid-1980s, according to Goodman, that the Europeans first demonstrated that they meant business in the US market, with the acquisition by the then ED & F Man of a 50% stake in Mint Investment Management, a CTA headed by Peter Matthews and Larry Hite that went on to become the first to reach $1 billion of assets under management.

Nevertheless, although by the start of the 1990s a more research-intensive CTA sector was taking shape on either side of the Atlantic, the size of the market in Europe remained Lilliputian. By 1989, Sabre’s assets under management had still only reached $80 million, while AHL’s were a modest $50 million. In the same year, Futures magazine quoted one non-US manager as saying the number of CTAs outside the US could be counted “on the fingers of one hand”.

That started to change in the 1990s, however, with the foundation of a number of Europe’s largest and most colourful players. Continental Europe saw the establishment in 1991 of Transtrend in the Netherlands, which has since flowered into one of the largest CTAs in the world, with assets under management of $7.6 billion at the end of January 2009. In France, meanwhile, Capital Fund Management (CFM), which now manages about $2.4 billion (half of it in CTA strategies), was also set up in 1991.

The following year, former Bankers Trust market maker Lawrence Staden established GLC in London, knocking like so many of the early CTAs on Sabre’s doors in search of advice. Staden was unable to attract any backing from Sabre, but that did not stop GLC growing into a prominent multi-strategy player with over $1 billion of assets invested in four underlying programmes.

Measured by assets under management, growth in
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the CTA sector in absolute terms has gathered momentum since 2000. In part, this has been driven by the global expansion in the futures market, but it has also been a by-product of the relentless progress in technology and improvements in the efficiency of trading systems. The result was that assets under management in managed futures exploded from $38 billion in 2000 to an estimated $227 billion by late 2008.

In relative terms, however, the share of CTAs in the wider alternative investment management universe has fallen over the past 20 years. “Managed futures are now estimated to account for about 13% of total assets in the alternative investment market,” says Patrick Welton, CEO of Welton Investment Corporation, which was set up in Carmel, California, in 1998 and manages assets of just under $500 million. “But if you go back to 1990 they had a share in the low 20s. And if you combine managed futures and global macro, back in 1990 they represented about half of all hedge fund assets.”

The principal reason for that relative decline, says Welton, has been the emergence of a range of alternative strategies, many of which were able to boast much higher returns than managed futures.

Svante Bergström, managing director of Lynx Asset Management, a part of the Brummer & Partners group in Stockholm which now has about $1.6 billion under management, agrees that there are plenty of reasons managed futures have appeared to lose much of their relative appeal over the past two decades. “People have tended to look at the performance of CTAs on a stand-alone basis,” he says. “Because CTAs had high relative volatility and modest returns, Sharpe ratios were generally low and people assumed there were sexier alternatives elsewhere in the hedge fund world.”

That may explain why some of the titans of the US hedge fund universe, who began their careers as CTAs, have migrated to other strategies. Paul Tudor Jones’s mentor, for example, was Eli Tullis, a New Orleans cotton trader; Louis Bacon, meanwhile, began his Wall Street life as a clerk on the New York Coffee, Cocoa and Sugar Exchange.

Perhaps it was the withdrawal of iconic figures such as these from the CTA space in the 1990s that accounts for why the US appears to have surrendered its leadership in the market to European managers. Certainly, the consensus seems to be that it was the UK and Europe, rather than the US, that started to drive growth and innovation in the sector in the early 2000s.

According to a briefing on managed futures published by AHL in November 2007 and updated at the
start of this year, it was in 2004 that European managers most visibly began to reap the harvest of their investment into research and development. That, says the AHL report, was the year that separated the wheat from the chaff.

“While European managed futures houses massively increased their research teams from roughly 10 to 50-70 people on average and improved electronic trading, their US equivalents were left behind,” notes AHL. “Different from Europe, managed futures traders in the US were mainly global macro traders that ran a managed futures portfolio on the side. Hence their expertise lay more in trading financial markets and was less quantitatively driven. As a result, most of the top-class managed futures traders can now be found in Europe. This development is quite amazing, considering the fact that some of the first trading methodologies, such as moving averages, were invented in the US.”

That, however, tells only part of the story. It would, after all, be absurd to suggest that the importance of scientific research mysteriously passed the Americans by. A more plausible argument is that US CTAs have suffered because their roots lay in commodity markets, the performance of which is influenced by different forces from those that prevail in the market for financial assets. A consequence may have been that their research and their models failed to adapt quickly enough to the growing importance of financials.

“It is true that American managers have historically been more commodities-oriented, meaning that their strategies have tended to be more breakout-based,” says Rob Christian, directional trading sector head at fund of funds group Financial Risk Management. “The Europeans, many of which are descendents of the AHL family, have been more moving average-based because of their more intense focus on financials.”

Others agree that European CTAs’ relative adaptability has served them well, relative to their US competitors. “It’s not just a question of research,” says Paul Netherwood, a founding partner of Beach Horizon who began his career at AHL in 1983. “It is also a question of having the courage to make modifications to your systems and programmes, especially if they have worked successfully in the past. I think the European managers may have been more prepared to adapt to changing markets than some of the US players.”

At Altis Partners, Stephen Hedgecock elaborates on how managed futures specialists in Europe and the US have gone in different directions over the past decade or so. He says that, when it was set up in 2000, Altis introduced a relatively new concept which he describes as the “unconstrained portfolio”. Previously, he says, the norm among CTAs had been to build highly rules-based strategies.

“Historically, CTAs had tended to be quite conserv
strained in the parameters they used," he says. "They came from a school of rigid sector and instrument weightings. When we started out we suggested something new, which was to approach the portfolio as a whole, meaning that every single instrument we looked at was assessed relative to something else. That was a departure from the concept of trading with firm entry points, exit points and stop losses. It was heavy going at first, because at the time investors didn’t necessarily want something different; they wanted something safe.”

Heavy going, perhaps, but it was a strategy that has proved its worth over recent years. "Perhaps the reason why some of the earlier CTAs, especially in the US, became less influential is because they failed to adapt to the changing environment," says Hedgecock.

Some of the statistics tracking performance and assets under management (AUM) would certainly suggest that, for whatever reason, the fortunes of some of the pioneers of the CTA space in the US have deteriorated sharply relative to some of the newer arrivals in Europe. Witness, for example, the unflattering recent performance of a pioneer such as Campbell & Co, which was established in 1972. In the 12 months to the end of February 2009, Campbell Composite’s compounded annual returns were -0.13%. In the 24- and 36-month periods prior to the same date, they were -4.87% and -2.71%, compared with a positive return of 15.39% since inception.

Performance data from John W Henry & Co, which was set up in 1982, is more shocking. Assets under management at John W Henry have been in decline since May 2005, when they stood at about $3 billion. Glancing at the firm’s performance data, especially between 2005 and 2007, it is not difficult to see why. “I believe JWH has been reluctant to update or tweak its system,” says one European manager. “Its performance staged a recovery in 2008, but the few years before then were a catastrophe.” By sharp contrast, a number of Europe-based CTAs – including Winton, Lynx and Transtrend – can continue to boast that since the early 2000s their programmes have never posted calendar-year losses.

Generalisations are of course crude and, as Goodman at Kenmar points out, plenty of examples of US success stories have emerged in recent years. “If you look at a manager like Graham Capital,” he says, “it has spent a tremendous amount of money building a highly efficient trading system designed by a very knowledgeable team of people. Or look at the track record of managed futures players such as Tudor Tensor and Roy Niederhoffer.”

True enough. But if this were the Ryder Cup of the investment management industry, Europe would probably have built up a slender lead by now.

“IT IS TRUE THAT AMERICAN MANAGERS HAVE HISTORICALLY BEEN MORE COMMODITIES-ORIENTED, MEANING THAT THEIR STRATEGIES HAVE TENDED TO BE MORE BREAKOUT-BASED”

Rob Christian, Financial Risk Management
EXPANSION AND DIVERSIFICATION

The combination of an expanded futures market and improved technology has not only supported the growth of assets under management in the managed futures space worldwide, it has also underpinned the continued diversification of the CTA sector.

“It is important to stress that, five or 10 years ago, CTAs formed a very homogenous asset class,” says Mathieu Vaissié, of the fund of funds management group at Lyxor Asset Management in Paris, which now has 18 pure CTAs on its platform. “Then, they were more or less all long-term trend-followers. That is not the case at all today.”

The rapid expansion and diversification of the managed futures market has led to a blurring of definitions, with some commentators describing CTAs as hedge funds and others insisting that they are not. Emmanuel Balarie, for example, managing director of the Chicago-based Balarie Capital Management, notes on his website that the first popular misconception about the industry is that “managed futures are hedge funds.” Others, however, insist that CTAs do belong in the hedge fund pigeonhole. After all, they charge hedge fund-style, performance-related fees, can use leverage and take long as well as short positions.

This is not just a question of semantics. Perhaps it is because of its fuzzy nomenclature, or perhaps simply because of the stigmatisation of the hedge fund industry over the past year or so, but a number of CTAs believe that the market in which they operate remains egregiously misunderstood by too many investors, as well as by the general public.

In particular, say some, the media did the managed futures sector a notable disservice in the summer of 2007, tarring all quantitative funds with a similarly damning brush. “I was outspoken about the press, in August 2007, when some of the not-so-specialised newspapers published headlines saying that all the quant funds had been hit when liquidity dried up,” says Karsten Schroeder, CEO of Amplitude Capital, one of the newcomers to the European CTA landscape which was set up in 2005. “I found it very irritating because, while fundamentally oriented equity strategies were hit, since the start of the credit crunch managed futures have done exceptionally well.”

It is disinformation of this kind, say managers, that make it so important that CTAs are accurately defined, even if doing so within a single sentence is a challenge. “CTAs are often systematic quantitative traders who analyse price time series to produce signals for trading,” says Elena Ambrosiadou, co-founder of Cyprus-based IKOS.

“The group also includes discretionary global macro traders using predominantly futures contracts for trading. Hedge funds are discretionary or systematic or a mixture of both, but they can aim for market or factor/sector neutrality. As independent investment management practice has developed, the two styles have come closer together, with techniques used in one group increasingly being applied by the other, particularly in the systematic space.”

Those two styles have co-existed for a number of years at one manager, GLC. “When I set up in 1992, I called myself a CTA,” recalls GLC founder Lawrence Staden. “But, by 2000, everybody was calling us a hedge fund, because we also have a market-neutral statistical arbitrage programme...
which is definitely a hedge fund. One way of distinguishing between the two is to see hedge funds as the ones that buy real assets, while CTAs deal in futures, with everything done on margin. By that definition, we are something like 35% hedge fund and 65% CTA, although I’m not sure that people make much of a distinction between the two.”

Evidence for this is provided by a recent article that named New York-based currency specialist FX Concepts as one of the world’s five largest managed futures funds, with assets under management of about $11.6 billion. That came as news to its CEO, John Taylor, who headed Citibank’s foreign exchange marketing and advisory service before founding FX Concepts in 1988.

“We’re a structured currency manager, and the vast majority of our assets are traded in the interbank market,” he says. “We have very little in financial futures.”

Taylor manages the firm’s single CTA-like product, Global Financial Markets, which has assets under management of about $150 million, trades interest rates, commodities and stock indices as well as FX, and is the one product within the FX Concepts stable that does make active use of managed futures.

“We are overseen by the SEC and the CFTC, but we are not a CTA – although we’re often slotted into that group, which doesn’t bother us at all,” says Taylor. “We have a lot in common with CTAs and we handle risk in much the same way. We also compete with CTAs for the same people. For example, we have just recruited somebody who was also offered a position by Campbell & Co.”

The growing diversity of the CTA market has certainly been supported in recent years by the entry of a number of new entrants into a market that has been tough, but meritocratic, for newcomers. Some of those have been set up by former proprietary traders able to generate seed capital from their former employers.

Take the example of a manager such as Thayer Brook Partners in London. The firm was set up in October 2005 by Philip Stoltzfus and Scott Ganis, previously of Mizuho Corporate Bank, which provided $100 million of seed capital for the new fund.

At Mizuho, Stoltzfus had headed the multi-strategy proprietary trading business for more than 10 years, while Ganis had been responsible for risk management and performance measurement for eight years.

The Thayer Brook Fund, which was launched at the start of October 2005, is a non-discretionary strategy trading fixed income, short-term interest rate and foreign exchange futures markets. Stoltzfus explains that this strategy builds on the model that he and Ganis launched at Mizuho in April 2000. Since then, the Thayer Brook flagship strategy has delivered a compound annual return of 11.43%.

More recently, Thayer Brook has added the Global Diversified Fund to its product range, which uses the same model to trade foreign exchange, fixed income, short-term interest rate, equity index, commodity and energy futures contracts. On a pro forma basis, this delivered an average annual return of 22.12% between April 2000 and December 2008, with average annual volatility of 14.71% and a Sharpe ratio of 1.3.

Continental Europe, too, has continued to see the launch in recent years of new programmes offering alternative management styles. Quantica Capital, for example, was set up in 2005 by Bruno Gmuir and Jose Eduardo Homem de Montes, previously of Bank Julius Baer in Zurich. Today, Quantica has some $200 million in assets under management, $150 million of which is in its fully systematic quantitative programme, Quantica Allocation Overlay Managed Futures. This returned 27% in 2005, 12% in 2006, 6% in 2007 and almost 19% in 2008, with a low realised volatility level over the four-year period of close to 10%, according to Montes.

“I think we have been able to differentiate ourselves from other strategies because we started out with a fully systematic and purely price-driven equity market-neutral fund,” says Montes. “When we applied our model to a range of other asset classes, we found that it was able to generate very consistent, low volatility returns, which allowed us to construct a directional strategy based on a multi-dimensional relative approach.”

Investors such as funds of funds say that they are generally receptive to newcomers with refreshing ideas. “A few years ago, our focus was chiefly on the more established funds,” says Lyxor’s Vaissié. “But as we have gained more experience, we have progressively tried to look for new funds that may be less experienced, but have strong potential and good diversification properties.”

Examples of relative newcomers mentioned by Vaissié include Quantitative Investment Management (QIM), based in Charlottesville, Virginia; another is Karsten Schroeder’s Amplitude, which
has quickly established its credentials as a specialist focusing on capturing short-term trends.

Amplitude ended 2008 with assets under management of about $600 million and, since its inception in June 2005, its Dynamic Trading Fund has posted a compound return of 21.31% with an annualised volatility of 16.38%.

How much scope there will be for new players such as Quantica or Amplitude to bring added diversity to the global CTA market is open to question, because the sector is no longer an easy one for newcomers to penetrate, with barriers to entry high and rising.

“There is no doubt that the regulatory burden is increasing and that the standards of corporate governance that investors are demanding are rising,” says Anthony Todd, CEO of London-based Aspect Capital. “Gone are the days when it was possible to set up a CTA with a couple of people and a data feed. Institutional investors won’t tolerate that. They are insisting on robust and scalable operational processes that call for very significant investment.”

Altis Partners’ Hedgecock agrees. “Survivorship in the CTA world has always been bad, but it’s now getting worse,” he says. “For newcomers, the first three years are a killer because there are so many risks – investment management risk, regulatory risk, supplier risk, track record risk. There have been plenty of instances of CTAs with great ideas and models but which have not had the business acumen to survive.”

Over and above the costs associated with corporate governance and compliance, the investment that needs to be channelled into research and development is becoming prohibitive for all but the most deep-pocketed players. That is partly because the largest CTAs have, in effect, become huge research institutes. At Winton Capital, which has

### BIGGEST CTAs/SYSTEMATIC MANAGERS

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<td>Dec-08</td>
</tr>
<tr>
<td>R. G. Niederhofer Capital Management</td>
<td>New York, NY, USA</td>
<td>1.60</td>
<td>Jan-09</td>
</tr>
<tr>
<td>Brummer &amp; Partners Lynx</td>
<td>Stockholm, Sweden</td>
<td>1.56</td>
<td>Dec-08</td>
</tr>
</tbody>
</table>

1 Managed by Transtrend  2 moving in June to Jersey  * Estimate  †Fund only assets  Source: HedgeFund Intelligence Database
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SIZE also brings more opportunities for international expansion, with AHL having recently announced that it plans to open a second trading centre in Hong Kong. As Skaliotis says, that will not just give AHL access to experienced local traders in Asia; it will also mean that it has an additional disaster recovery centre outside the UK.

Size, however, can also bring problems. “When you get big, you get slow,” says GLC’s Staden. “You can’t swing around a $15 billion portfolio on a three-day strategy, so inevitably you would end up slowing down your models if you had that much money.” That may be. But most CTAs say they still have plenty of room to grow before they hit any capacity constraints.

SYSTEMATIC VERSUS DISCRETIONARY STRATEGIES

You seldom hear anybody in the investment management industry, or in the broader financial services sector, question the perfection of their own technology. On the surface, therefore, it is surprising that Anthony Daniell, director of sales and marketing at Winton Capital in London, should say...
that the systems that are used by the majority of CTAs (his own firm included) are very far from perfect. “The difficult thing to understand is that if our systems are right 51 times out of 100, and wrong the other 49 times, that is fine. If you trade enough markets often enough, and you’re right 51% of the time, you can make a lot of money,” says Daniell.

That, in a nutshell, describes how the systems that underpin the trading strategies of most CTAs work. “We collect lots of data, clean it, and then do hundreds of experiments to see whether something happening today can explain tomorrow’s risk and return,” says Daniell.

A colourful (and unusual) example he quotes is data on rainfall. “You take 100 days of rainfall data and 100 days of stock market data and see if there is any relationship between the two. There isn’t,” he explains. “So you refine it to see if it matters what time of day the rain falls. And so on. What you’re doing is taking one series of data and measuring whether it explains another series.”

The principal data used in this process is, of course, price – or, more specifically, the rate of change of price, rather than anything to do with the climate, or the football results, or any other arbitrary external circumstance. It is that rate of historical price change that forms the basis for the algorithms that create trading signals shaping directional strategies.

That, say CTAs, makes the majority of their systems considerably less complex than many outside observers may assume. It also means that, although it is often assumed that all systematic management programmes are the same as quantitative strategies, it is a mistake to see the two as being interchangeable.

“A lot of people lump systematic and quantitative programmes together,” says Paul Netherwood of Beach Horizon. “But obviously a systematic programme that works solely on price is going to be very different from a quant programme that looks to calculate the fair value of a share price based on a whole range of fundamental indicators, including factors such as accounting standards.”

One of the key attractions of systems-based strategies is that they strip away many of the human frailties, of which fear and greed are the

able concern to London, the reputation of which has already been seriously damaged by everything ranging from the short-selling ban to the fiasco over Sir Fred Goodwin’s pension, it ought to be. So, too, should the fact that, in a world dominated by systematic trading, there are few reasons why a manager sitting in London should enjoy a competitive edge over firms based virtually anywhere else. Indeed, a number of managers trading out of less obvious financial centres believe that their locations offer conspicuous advantages relative to London.

Svante Bergström, managing director at Lynx Asset Management, points to two related key benefits associated with being located in Stockholm.

First, he says that, as his staff of 12 researchers have never worked for any other CTA, Lynx’s models will genuinely be different from those of his competitors based in more crowded financial centres.

Second, because Stockholm is not known for the ferocious competition for talent in the alternative investment management industry, attracting and retaining top-quality individuals presents much less of a challenge than it might in, for example, London. “Our researchers are Swedes and Finns who tend to be very loyal,” says Bergström. “We have never had a leaver from our research department. I doubt whether many London-based firms can say the same.”

Other CTAs based away from the more traditional financial centres also say that there are tangible advantages to be derived from their locations. John Locke Investments, for example, has offices in Fontainebleau-Avon, near Paris, and in Geneva. That is Geneva, Illinois, which is 40 miles west of Chicago, rather than Geneva, Switzerland.

“I would much rather pay for researchers, systems and computers than for a Champs-Elysées location,” says Bonnin. “We pay three times less for our premises in Fontainebleau and Geneva than we would in Paris or Chicago.”

Nor does the location of managers seem to be a concern to investors. Newton says that Global Advisors discussed its planned move to Jersey with the 2,500 past, present and prospective clients on its database, all of whom were understanding and supportive of the manager’s decision to up sticks.

Don’t, however, write off London or its Square Mile completely. One CTA that has been happy to remain in the City is Beach Horizon. “Many of the old buildings in Mayfair are lovely,” says one of its founding partners, Paul Netherwood. “But many are also listed, which means you may need planning permission to drill a hole in a wall. For an IT-based company with substantial communications infrastructure requirements, that can be very inconvenient.”

Additionally, says Netherwood, the City continues to have outstanding transportation links, while costs are now looking very competitive in the Square Mile relative to the West End. “You hear of rentals reaching £120 per square foot in Mayfair,” he says. “In the City, you can be paying less than £50 per square foot for better quality offices.”

“A lot of people lump systematic and quantitative programmes together, but obviously a systematic programme that works solely on price is going to be very different to a quant programme that looks to calculate the fair value of a share price based on a whole range of fundamental indicators”

Paul Netherwood,
Beach Horizon

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most obvious, that can exert such a destructive influence on so many other strategies.

“The reason we apply a 100% systematic approach is that we are trying to divorce ourselves from emotional biases in the market,” says Aref Karim, CEO and CIO of the Weybridge-based Quality Capital Management (QCM).

Arrogance, prejudice and ambition are other human frailties that are peeled away from the trading process by emotionless systems. “We have a very humble view of our ability to look into the future,” says Winton’s Harding. “While many people in the City pontificate about what’s going to happen in the future, we take a very agnostic view. Because we don’t make any forecasts we don’t get any predictions wrong, and because we don’t get any predictions wrong we tend to do better than other people.”

Other human weaknesses addressed by computers are the temptation to move jobs, vulnerability to illness and mortality. At AHL, Skaliotis says that a key benefit of a systematic programme is that it makes procedures repeatable irrespective of personnel changes. “That is a very powerful advantage because it means the investor is investing in a process rather than in an individual,” he says.

However, although many managed futures strategies are referred to as being 100% systematic, that is a slightly misleading description for two reasons. First, because although a strategy may be run entirely systematically, how those systems are built in the first place, and the choice of inputs on which they depend, are discretionary. Second, because, for very obvious reasons, all managers reserve the right the overlay some discretion when circumstances demand.

“There are certain things a system can’t know,” says Winton’s Daniell. “It couldn’t know, for example, that at one point recently it looked as though the Korean market was going to close. For a while that led us to close all our positions in Korea, which was purely a discretionary decision.”

Unforeseen events, such as the closure of markets, make it essential that managers are continuously able and willing to adapt their models. So too do unprecedented influences on price movements. At Altis Partners, Hedgecock points out that the most important variable in securities markets in 2008 – liquidity – is one that traditional models are ill-equipped to capture. “A lot of the downgrades of CDO debt last year were liquidity rather than valuation plays,” he says. “So the first thing you needed to build into your models in 2008 was the dynamic nature of liquidity, which is almost impossible to model on a forward basis.”

No matter how much they can be adjusted or adapted, however, dependence on computers is something that analysts schooled in fundamentals inevitably find hard to come to terms with. “Many people in the City consider using science as the basis for trading markets to be for the birds,” says Winton’s Daniell.

Mistrusting technology, rather than the people who operate it, is a mistake, in the view of Karsten Schroeder, CEO of Amplitude Capital. He is a licensed private pilot, and he sees similarities between the application of technology in aerospace and in finance.

“If you look at the statistics in private aviation, the number one cause of fatalities is running out of fuel,” he says. “The second is flying into bad weather. Between 80% and 90% of fatalities are caused not by engine failure or poor technology, but by human error, which you could even call stupidity.”

Trusting the technology behind the models is one thing; agreeing with the conclusions those models reach is quite another. Emphasising the importance of risk management in times of extreme turmoil, such as 2008, Aspect Capital’s Todd says that one of the main challenges of last year was to resist the temptation to intervene in the systematic process. “In an environment like 2008, if you’ve done your research correctly and have your risk management systems in place, you should be able to trust your system to take advantage of the drivers of market performance,” he says.

Aspect Capital maintained its 100% systematic approach throughout 2008, although that was an approach that came under Aspect’s microscope almost on a daily basis. “Especially in September and October, our risk management committee was meeting several times a day, constantly questioning how our models were behaving, analysing the size of our positions and ensuring that our performance was completely consistent with our research,” says Todd. “Our conclusion every step of the way was that all our models and risk management procedures were performing exactly as they were designed to do, so we did not intervene at all. That is important, because I firmly believe that when you’re investing in a systematic strategy you expect your manager to retain that discipline, not to be
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systematic 95% of the time and discretionary the remaining 5%.” Aspect’s faith in its systems appears to have been well rewarded last year, as its Diversified fund was up 25.4% in 2008.

Although systematic strategies are now the norm among CTAs, that does not mean that all aim to be nominally 100% systems-based. GLC’s programme, for example, is a blend of systematic and discretionary management.

“The system gives us most of our alpha,” says Staden. “If we make 13%, probably 8% of that is from our models and 5% from good execution.”

Placing more emphasis on discretionary management has at least two beneficial side-effects for GLC, says Staden. First, it helps to differentiate GLC from its peer group. “To a certain extent, when you’ve bought one long-term trend-follower you’ve bought them all,” he says. “By having models that aren’t pure-trending, that have some counter-trending elements in them, and are managed with some discretion, we offer investors an opportunity to put something in their portfolios that is a little bit different.”

Second, GLC’s more discretionary approach is one reason why it is able to see execution costs as an opportunity rather than a threat, generating positive slippage, which Staden defines as the difference between GLC’s actual and its simulated results.

“Basically, positive slippage means we’re doing better than the models have told us we would,” says Staden. “The way we’ve achieved that is by giving our traders a lot of flexibility about when to trade. And they’ve done very well, adding about 5% per year over the last five years. It’s a competitive edge, and the reason we have that edge is that we’re all ex-market makers who are better at getting in and out of a market than computers.”

Perhaps. But a number of other managers are sceptical. Lynx warns in a recent presentation that “costs and fees can chew you up in a negative market,” and its managing director, Svante Bergström, says that slippage is always negative.

“The question is, what can you do to minimise it?” he asks. “We have put a lot of investment into improving our execution algorithms and leaving as small a footprint as possible whenever we enter or exit a trade. Of course, slippage increases as your assets under management rise but, in our case, that increase has been compensated for by our improved algorithms. So, on a net basis, our slippage costs are about the same as they were two years ago, even though our assets have increased.”

The choice between systematic and discretionary programmes may also vary, depending on the macro-economic outlook. Another investor, Dan McAlister, head of directional strategies at the Jersey-based fund of funds manager Ermitage, believes that today’s economy may favour discretionary management. “The result of all the volatility we’ve seen recently is that there have been some very big dislocations that discretionary macro managers may be able to take advantage of in the short term,” he says. “In commodities, fundamental supply and demand issues are starting to influence areas like grains, so there may also be some good opportunities there that the systems won’t always pick up.”

Others believe that the longer-term trend among CTAs is away from discretionary and towards systematic management styles.

Max Ferri, at Laven Partners in London, believes more managers will make the transition from discretionary to systematic management as technological efficiencies gather momentum.

“Artificial intelligence seems a long way off,” he says. “But it is more than likely that by the end of 2010, we will see some form of artificial intelligence in the market – by which I mean systems that are able to react to news – generating and executing trading ideas as a result. Could that mean that we move towards a world in which the majority of hedge fund allocations are based on systematic strategies? It could well happen.”

One example of a manager that has successfully made the transition from discretionary to systematic management is the commodities specialist, Global Advisors, which was founded in 1999 by Daniel Masters and Russell Newton. Prior to setting up Global Advisors, Masters and Newton had worked as commodity traders at Royal Dutch/Shell and at Phibro before joining JP Morgan, where they ran the energy desk.

Newton explains that in the early years of Global Advisors’ existence, the gradual discovery of commodities as an asset class played into the hands of a fundamentally oriented specialist that managed funds on a discretionary basis. Given that the market inevitably did not share the liquidity of financial securities, a complication emerged when the strength of the commodities story filtered through to the broader institutional investor community, aggravating the imbalance between supply and
Russell Newton, Global Advisors

“Culturally it was difficult because as discretionary traders with 20 years of experience, it was hard to stand back and let the models do what we had done before”

That increasingly compelling story was reflected in the explosive growth of products, such as the Pimco Commodity Real Return fund, where assets under management rose from $31 million in 2002 to more than $12 billion by the end of 2006.

“We figured out that, at the peak of demand, the proliferation of funds and indices was sucking something like $250 billion of capital into the commodities market,” says Newton.

“The weighting of copper, for instance, in the Goldman Sachs Commodity Index (GSCI) was the equivalent of institutions going out and buying the world’s entire commercial inventory of copper. That was inevitably going to have a tremendous impact on prices.”

It was against this backdrop – of capital flows becoming more decisive in influencing commodity price movements than fundamentals – that Global Advisors made the strategic decision to launch the Global Commodity Systematic (GCS) programme in the middle of 2005.

“We still strongly believed that commodities behave differently from financial assets, and that one way to address the issue of capital flows becoming so important was to launch a more quantitative-oriented programme,” says Newton. “With a much broader range of commodities available to us, we believed that we could add value by imposing a more consistent approach to risk management and sizing algorithms, and by introducing a set of more rigorously applied models on when to go long and when to go short.”

Newton says that he has been delighted by the results generated by the GCS programme, since its inception in July 2005, with some seed capital from Global’s discretionary fund. “The programme has done precisely what we hoped it would do, which is to grind out consistently positive returns with well-managed drawdowns and low volatility across many different macro environments,” says Newton. As of February 2009, GCS had assets under management of $290 million and had delivered an annualised return of 18.92% and an annualised volatility of 11.52%, with a high Sharpe ratio of 1.46.

The system certainly proved its worth in 2008, capturing the key reversal in the oil price trend with commendable precision.

“By midsummer, we were about as long in crude oil as we had ever been when one of our models started going short at $134 per barrel,” says Newton. “So we took no more than a small draw-down in July and August, and recovered quickly over the rest of the year.” For 2008 as a whole, the GCS posted a return of 20.38%.

Fair enough. But for experienced commodities traders with a nose for the idiosyncrasies that drive the pricing of everything from crude oil to cotton and lean hogs, was it not frustrating to sit back and let computers take over?

“Culturally it was difficult because as discretionary traders with 20 years of experience, it was hard to stand back and let the models do what we had done before,” explains Newton.

Newton adds, however, that the move into the systematic space was not entirely a leap in the dark, given that the use of constantly evolving models had always been an important part of Global’s overall strategy. “Those models had served us well and were the inspiration, or building blocks, for the systematic programme,” says Newton. “So although some people think of it as a complete departure, we prefer to see the move as the natural next stage in our evolution.”

While Global’s transition from discretionary to systematic management did not, therefore, represent a wholesale strategic volte-face, it did lead to some important changes in its day-to-day operations in, for example, its recruitment policy. An increased emphasis on systems and systems development inevitably called for a greater number of programmers. “We deliberated for a long time about the sort of staff we wanted,” says Newton. “And we eventually went for people who didn’t necessarily know much about commodities, but knew a tremendous amount about engineering, processing and IT. We took the view that it would be easier to teach scientists about the commodity markets than it would be to teach deeply detailed statistics to an expert in commodities.”

Another notable by-product of the move to systematic management was a surprising change in Global Advisors’ trading patterns. “What has been amazing is that, although we have roughly the same size of assets as we had in the discretionary programme four years ago, we are now generally seeing lower levels of turnover and much lower leverage,” says Newton.

That in turn, he says, is having an impact on trading costs arising from a lower level of slippage, which Newton says amounts to about 1% a year. Slippage is inevitably more of a problem in some of the less actively traded commodities, such as palladium and tin, than in the highly liquid crude oil market.
2008 Management Firm of the Year (WINNER)
2008 Best Managed Futures Fund - BlueTrend (WINNER)
2008 Best Mixed Arbitrage & Multi-Strategy Fund – BlueCrest Capital International (Nominee)
2008 Best Mixed Arbitrage & Multi-Strategy Fund – AllBlue (Nominee)
2008 Best Credit & Distressed Fund – BlueCrest Multi-Strategy Credit (Nominee)
2008 Best Equity Market Neutral & Quant Strategies Fund - BlueMatrix (Nominee)
2008 Fund of the Year – BlueTrend (Nominee)

2007 Best Managed Futures Fund – BlueTrend (WINNER)
2007 Best Mixed Arbitrage & Multi-Strategy Fund – BlueCrest Capital International (Nominee)
2006 Best Macro Fund – BlueCrest Strategic (Nominee)
2006 Best Managed Futures Fund – BlueTrend (Nominee)
2005 Best Macro Fund – BlueCrest Strategic (Nominee)
2005 Best Managed Futures Fund – BlueTrend (Nominee)
2005 Management Firm of the Year (Nominee)

2004 Management Firm of the Year (WINNER)
2004 Best Mixed Arbitrage & Multi-Strategy Fund – BlueCrest Capital International (Nominee)
2004 Best Macro Fund – BlueCrest Strategic (Nominee)
2004 New Fund of the Year – BlueTrend (Nominee)
2002 Best Mixed Arbitrage Fund – BlueCrest Capital International (Nominee)

2001 Best Mixed Arbitrage Fund – BlueCrest Capital International (WINNER)
2001 Fund of the Year – BlueCrest Capital International (Nominee)

2008 Best Operator in Discretionary Global Macro Single-Manager Hedge Funds (WINNER)
2008 Best Operator in Fixed Income Single-Manager Hedge Funds (WINNER)
2008 Best Operator in Managed Futures Single-Manager Hedge Funds (WINNER)
2007 Best Operator in Multi-Strategy Single-Manager Hedge Funds (WINNER)
2007 Best Operator in Discretionary Global Macro Single-Manager Hedge Funds (Nominee)

2008 Michael Platt, Co Founder of BlueCrest Capital Management for Contribution to the European Single Hedge Fund Management Industry (WINNER)
2008 Best Managed Futures Hedge Fund on a Risk Adjusted Basis – BlueTrend (Nominee)

2008 Credit Manager of the Year - BlueCrest Multi-Strategy Credit Fund (Nominee)

2006 Winner of Hedgestock’s “Star of NETFEST - Top Fund”
Superficially at least, the clearest indication of the vast diversity within the universe of CTAs has been the polarisation of performance in the market, especially in 2008, which is described by many managers as having been a bumper year for the strategy.

Many – especially some of the younger European players – posted record returns last year, although they had their work cut out to eclipse the coruscating performance of the London-based Mulvaney Capital Management’s Global Markets Fund. Originally launched in May 1999, this non-discretionary programme posted an astonishing return of close to 109% in 2008, gaining 45.5% in October alone.

But you didn’t have to be Mulvaney Capital Management to enjoy 2008. According to Credit Suisse/Tremont’s review of the hedge fund industry’s performance in 2008, 90% of CTAs posted positive returns last year, while 87% recorded gains of more than 10%.

To students of the long-term track record of managed futures, those superior returns came as no surprise, although to some other more generalist commentators they may have done.

“I remember an article that appeared on the front page of the Wall Street Journal in 2001 or 2002 that said CTAs were an invalid asset class,” says Stephen Hedgecock of Altis. “In hindsight, that makes me chuckle a bit, because they have turned out to be one of the few asset classes on the planet to have delivered decent alpha since then.”

Others emphasise the same point. “Was 2008 a one-off?” asks Harry Skaliotis, investment manager at AHL in London. “The answer is a resounding no. The AHL Diversified Fund was up by 33% in 2008, but to get a more complete picture you need to look at our medium-term rolling 12-month returns, which have been about 20% annualised since the strategy was launched in May 1996.”

Others emphatically agree that to look at 2008’s returns in isolation is to do an injustice to the sector. “Last year was a time when probably every trend-follower made money, so the 62% we delivered in 2008 probably does not mean very much,” says Theo Schmid, a founder of Switzerland-based Progressive Capital Partners (PCP).

PCP was set up in July 2001 and is the investment adviser to the Tulip Trend Fund, which has appointed Transtrend BV of the Netherlands as the fund’s trading advisor. Described by Schmid as a leveraged version of the Enhanced Risk profile of Transtrend’s Diversified Trend Program, the Tulip Trend Fund is a systematic trend-following strategy that has delivered a compound annual rate of return of 28.07% with an annualised standard deviation of 25.37% and a downside volatility of 10.63%.

“Investors are of course chasing returns at the moment, but we think it is essential that they try to understand a strategy from a longer-term perspective,” says Schmid. “As futures provide easy access to leverage, outright returns don’t tell you anything. That’s why the focus on risk-adjusted returns and measures is crucial in selecting trend followers.”

Schmid’s colleague at PCP, Daniel von Allmen, adds that, aside from analysing a track record over an extended period, investors should focus on CTAs’ research capability and business stability.

“Unfortunately, the whole industry is preoccu-
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“Unfortunately, the whole industry is preoccupied with Sharpe ratios, which are very bad indicators because they penalise managers for upside volatility,” he says. “We therefore believe that investors should be looking at the Sortino ratio instead, because by only taking into account downside volatility, that gives a much fairer view of risk-adjusted returns.”

Perhaps. But however much CTAs like to accentuate the resilience of their long-term returns, there is no question that it is in highly stressed markets that managed futures come into their own. That much is clear from the track record that they have established throughout all the most tumultuous recent global crises.

Greg Taylor, head of product development at fund of funds manager FRM, lists a few of them: during the stock market crash of 1987, he says, the Barclay CTA Index rose 9.6% while the S&P 500 declined by 31.9% and the Barclay High Yield Index dipped by 3.5%. During the crisis fuelled in 1998 by the Russian debt default and the collapse of LTCM, the CTA Index advanced by 5.9% in August alone while the S&P 500 retreated by 14.4% and the High Yield Index fell by 5.5%. Similar patterns were observed during the US banking crisis of 1990, the stock market decline of September-November 2000 and February-March 2001, in the immediate aftermath of the 9/11 attacks, in the wake of the WorldCom collapse in the summer of 2002, and at the time of the stock market falls in September of the same year.

None of those patterns, however, are as extreme as the divergent performances of the three indices between August 2007 and February 2009. During the present global crisis, according to the data assembled by FRM, while the S&P 500 and the Barclay High Yield indices nose-dived by 47.53% and 22.13%, respectively, the CTA Index has surged by 21.41%.

It is not difficult to grasp why managed futures strategies have flourished so conspicuously over the past 18 months. While most other crises since 1987 have been characterised by sudden shocks and quick downward lurches, the most recent downturn has manifested itself in a series of trends that were predictable, strong, and long. The result, as Thayer Brook’s Stoltzfus puts it, is that “2008 was definitely a year in the sun for trend-followers.”

Those trends were very strongly pronounced across all major asset classes, although commodities, in particular, trended like a dream for some of the more concentrated players, such as Beach Horizon. It posted a return just shy of 60% in 2008, and did so without increasing its leverage. “It was the exact opposite,” says Beach Horizon’s Paul Netherwood. “Our average margin to equity ratio prior to 2008 was about 15%, which is fairly modest and well below the average leverage of most CTAs. In 2008, we were able to bring that ratio down to 10% because our systems were continuously reducing risk in response to rising volatility.”

For outside observers, the obvious assumption to make is that successful managed futures strategies specialising in commodities owed the bulk of their success to capturing the very clear trend in the highly liquid crude oil market in 2008. The truth of the matter, however, is that commodities specialists benefited from firmly established trends in a number of smaller commodities markets as producers and consumers battened down the hatches in anticipation of a recession or a depression.

“One of the key things about our portfolio is that it avoids over-concentration of risk and, in 2008, that proved to be a highly successful approach,” Netherwood explains. “Oil is only a smallish part of our portfolio, and many other commodities saw very strong moves last year. Livestock markets, for example, are considered to be good recession indicators, as are base metals, where prices fell as the market priced in a decline in construction activity. So, for us, it was a story that was applicable across the board.”

Another commodities specialist, who did well by maintaining a diversified presence in markets other than oil last year, was Salem Abraham who has been trading commodities since 1987. He says that his best three trades in 2008 were being short orange juice, nickel and zinc. “Our biggest money maker last year was our short orange juice position, although that accounted for less than one tenth of our profits in 2008,” he explains. “Some people in the managed futures world focus on making very big concentrated bets, but as a diversified CTA our goal is to hit a lot of singles.” In the case of the Abraham Trading Company’s flagship fund, those singles contributed to a return in 2008 of just over 30%.

Although the Texas-based Abraham’s roots are in commodities, its diversified strategy also had...
exposure in 2008 to interest rates (16%), currencies (15%) and global stocks (12%), and it is clear that diversified trend-followers were also able to exploit last year’s extreme conditions highly effectively.

“Our Aspect Diversified fund trades long-term bonds, short-term interest rates, currency markets, stock indices, energy, metals and agriculturals,” says Todd at Aspect Capital. “We made positive returns in six out of those seven sectors, and those returns were reasonably well-balanced across all six. So although people may assume that managed futures programmes such as ours made all their money from being short equities last year, we had a broad spread of different sources of alpha and avoided concentration risk.”

Another manager that did considerably more than shorting equities last year is Quality Capital Management (QCM), a systematic macro manager set up in 1995 by Aref Karim, which had $800 million under management at the end of 2008. Its flagship QCM Global Diversified Programme has posted significant double-digit returns each year since a number of enhancements were made to the system in February 2005. In 2008, the flagship programme, which uses QCM’s proprietary Advanced Resource Allocator (ARA) to shift resources between assets and strategies, was up by just under 60%.

“A number of CTAs made money last year from the linear trend moves in equities and commodities,” says Karim. “We traded a little differently, looking to profit from linear opportunities in the first half of the year and some non-linear movements in the latter. For example, we picked up a lot of our returns in the last quarter from fixed income, which was a more opportunistic non-linear participation than many of our peers.”

In re-emphasising their ability to deliver strong returns, CTAs may also have enjoyed the opportunity to indulge in a little *schadenfreude* at the expense of some other alternative investment strategies. “Historically, the term trend-follower has been used in a somewhat derogatory way, often preceded by the words ‘only a,’” says Winton’s David Harding. “Some of my hedge fund manager friends consider trend-following to be intellectually trivial, and some even go further and

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**TOP 20 CTA PERFORMERS WITH AUM >$250M OVER 1 YEAR**

<table>
<thead>
<tr>
<th>Fund name</th>
<th>Last 12 months</th>
<th>Inception</th>
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<tr>
<td>1 Tulip Trend Fund - USD C</td>
<td>59.96%</td>
<td>Mar-03</td>
</tr>
<tr>
<td>2 QCM Global Diversified Programme</td>
<td>59.51%</td>
<td>Dec-95</td>
</tr>
<tr>
<td>3 SMN Diversified Futures Fund</td>
<td>58.53%</td>
<td>Nov-96</td>
</tr>
<tr>
<td>4 Altis Global Futures Portfolio $ Lead Series - Altis Master Fund ICC</td>
<td>56.91%</td>
<td>Jul-01</td>
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<tr>
<td>5 Roy G. Niederhoffer Negative Correlation Fund Ltd</td>
<td>54.62%</td>
<td>Nov-03</td>
</tr>
<tr>
<td>6 NuWave Combined Futures Portfolio Ltd</td>
<td>51.34%</td>
<td>Aug-04</td>
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<tr>
<td>7 Roy G. Niederhoffer Diversified Offshore Fund Class A</td>
<td>51.32%</td>
<td>Sep-95</td>
</tr>
<tr>
<td>8 Hyman Beck Global Portfolio</td>
<td>48.98%</td>
<td>Apr-91</td>
</tr>
<tr>
<td>9 Conquest Macro</td>
<td>45.03%</td>
<td>May-99</td>
</tr>
<tr>
<td>10 BlueTrend - USD</td>
<td>43.37%</td>
<td>Apr-04</td>
</tr>
<tr>
<td>11 Global Commodity Systematic Fund Class B2</td>
<td>42.06%</td>
<td>Jun-07</td>
</tr>
<tr>
<td>12 Brummer &amp; Partners Lynx (Bermuda) Ltd - USD</td>
<td>36.76%</td>
<td>Apr-04</td>
</tr>
<tr>
<td>13 Quantitative Global Fund (3X)</td>
<td>35.73%</td>
<td>Jun-05</td>
</tr>
<tr>
<td>14 Graham Global Investment Fund (BVI) Ltd - K4D-15</td>
<td>35.67%</td>
<td>Oct-01</td>
</tr>
<tr>
<td>15 Man AHL Diversified plc</td>
<td>33.22%</td>
<td>Mar-96</td>
</tr>
<tr>
<td>16 Transtrend Diversified Trend Program - Enhanced Risk - USD</td>
<td>29.38%</td>
<td>Jan-95</td>
</tr>
<tr>
<td>17 Abraham Trading Company - Diversified Program</td>
<td>28.77%</td>
<td>Jan-90</td>
</tr>
<tr>
<td>18 Graham Global Investment Fund (BVI) Ltd - Global Monetary Policy Portfolio</td>
<td>27.48%</td>
<td>Mar-06</td>
</tr>
<tr>
<td>19 Aspect Diversified Fund - USD</td>
<td>25.41%</td>
<td>Dec-98</td>
</tr>
<tr>
<td>20 Graham Global Investment Fund (BVI) Ltd - Proprietary Matrix Portfolio</td>
<td>25.14%</td>
<td>Jul-99</td>
</tr>
</tbody>
</table>

*Source: HedgeFund Intelligence Database*
regard it as charlatanry. That is because most people in the securities industry believe in the efficient market theory which makes trend-following impossible. What the so-called ‘respectable’ hedge funds do is find deviations from the efficient market theory and arbitrage them out. When we do well, people seem to think what we do is either lucky or fraudulent, whereas neither is the case.”

There was clearly nothing lucky or nefarious about the strategies or performance of most trend-following CTAs last year. When GLC’s Lawrence Staden explains how trend-following works by saying that “CTAs make money by front-running institutional orders,” he is not suggesting any impropriety. His point is that trend-followers can only make money by effectively riding on the coat tails of sizeable institutional trading, rather than by responding to movements caused by more speculative market participants. “The reason last year was so good for trend-followers is because the institutions were so busy, while prop desks and macro funds were less active,” he says.

Generating trading decisions from oil tanker-style trends created by institutions generally means passing up on some of the upside – or waiting for a confirmation before trading. It also means imposing a rigid discipline of never fighting the market. In other words, it means following the mantra that ‘the trend is your friend’ and responding to the emergence of those trends quickly.

“The lesson of 2008 was to be ready for things that are unlikely to happen,” says Jerry Parker, a former Turtle Trader who set up the Richmond, Virginia-based Chesapeake Capital Corporation in 1988. Chesapeake, which is exclusively a long-term trend-follower, now has about $1 billion under management and has been delivering roughly 15% per year on an annualised basis, according to Parker. “The essence of CTAs is following price trends without adding any overlays, opinions or fundamental analysis – you just go with the flow. Your absolute and relative performance will be a pure reflection of how strong the trends are and, in 2008, the trends were very powerful,” he says.

That makes the strategy sound beguilingly simple. But there are a number of clear reasons explaining why a handful of CTAs were such stellar

**TOP 20 CTA PERFORMERS WITH AUM >$250M OVER 3 YEARS**

<table>
<thead>
<tr>
<th>Fund name</th>
<th>Last 36 months</th>
<th>Inception</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Quantitative Global Fund (3X)</td>
<td>248.17%</td>
<td>Jun-05</td>
</tr>
<tr>
<td>2 Tulip Trend Fund - USD C</td>
<td>193.70%</td>
<td>Mar-03</td>
</tr>
<tr>
<td>3 QCM Global Diversified Programme</td>
<td>153.16%</td>
<td>Dec-95</td>
</tr>
<tr>
<td>4 Roy G. Niederhoffer Diversified Offshore Fund Class A</td>
<td>132.63%</td>
<td>Sep-95</td>
</tr>
<tr>
<td>5 Altis Global Futures Portfolio $ Lead Series - Altis Master Fund ICC</td>
<td>127.29%</td>
<td>Jul-01</td>
</tr>
<tr>
<td>6 BlueTrend - USD</td>
<td>103.88%</td>
<td>Apr-04</td>
</tr>
<tr>
<td>7 SMN Diversified Futures Fund</td>
<td>90.95%</td>
<td>Nov-96</td>
</tr>
<tr>
<td>8 Conquest Macro</td>
<td>89.41%</td>
<td>May-99</td>
</tr>
<tr>
<td>9 Amplitude Dynamic Trading Fund C Class - USD</td>
<td>80.48%</td>
<td>Jun-05</td>
</tr>
<tr>
<td>10 Roy G. Niederhoffer Negative Correlation Fund Ltd</td>
<td>79.33%</td>
<td>Nov-03</td>
</tr>
<tr>
<td>11 Transtrend Diversified Trend Program - Enhanced Risk - USD</td>
<td>77.38%</td>
<td>Jan-95</td>
</tr>
<tr>
<td>12 Hyman Beck Global Portfolio</td>
<td>76.25%</td>
<td>Apr-91</td>
</tr>
<tr>
<td>13 Brummer &amp; Partners Lynx (Bermuda) Ltd - USD</td>
<td>71.89%</td>
<td>Apr-04</td>
</tr>
<tr>
<td>14 NuWave Combined Futures Portfolio Ltd</td>
<td>71.66%</td>
<td>Aug-04</td>
</tr>
<tr>
<td>15 Global Commodity Systematic Fund Class A</td>
<td>69.96%</td>
<td>Jul-05</td>
</tr>
<tr>
<td>16 Man AHL Diversified plc</td>
<td>69.51%</td>
<td>Mar-96</td>
</tr>
<tr>
<td>17 Graham Global Investment Fund (BVI) Ltd - K4D-15</td>
<td>68.68%</td>
<td>Oct-01</td>
</tr>
<tr>
<td>18 Winton Futures Fund</td>
<td>68.22%</td>
<td>Oct-97</td>
</tr>
<tr>
<td>19 Abraham Trading Company - Diversified Program</td>
<td>67.20%</td>
<td>Jan-09</td>
</tr>
<tr>
<td>20 Cyril Systematic Fund - USD</td>
<td>63.82%</td>
<td>Jan-06</td>
</tr>
</tbody>
</table>

Source: HedgeFund Intelligence Database
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performers in 2008, while at the opposite end of the spectrum, several were notable underperformers.

“The average CTA was up by roughly 12% or 13% in 2008, which is a perfectly admirable performance,” says Pat Welton of Welton Investment Corporation. “But, as in previous years, the dispersion of performance was extremely high. It’s not uncommon for the difference between the top and bottom 10% of funds to be as high as 50%. If there weren’t substantive differences between CTAs, you wouldn’t see this huge dispersion in returns. If you look at large versus small-cap US equity funds, the top and bottom quartile are often separated by a couple of per cent, and in the fixed-income universe the gap can be as small as 50bp.”

Foremost among the reasons for this divergence of performance is that although long-term trend-followers account for the bulk of CTAs, there is a wide range of other strategies under the broader managed futures umbrella. “People tend to categorise CTAs as long-term trend-followers, but we believe that is not what the space is all about,” says Kenneth Shewer, chairman, co-CEO and co-CIO of the Kenmar Group. “It is also about multi-systems, varying time frames, idiosyncratic strategies and specialisations in different sectors. Trend-following has less of a representation in our portfolio than many of our peers, and we have found that by diversifying the management styles within our portfolio, we have been able to deliver a significantly lower standard deviation than the equity market and the hedge fund index.”

Others agree that the dispersion of returns among CTAs in 2008 was underpinned by the diversity of strategies available to investors in the managed futures universe. “All you needed last year was a very slight tilt in your frequency spectrum to deliver very different returns,” says Aspect Capital’s Todd.

The onshore Swedish krone-denominated Lynx Fund is one example of a strategy that believes its outperformance (it returned 42% in 2008) is a byproduct of its diversification. “We have consistently outperformed all CTA indices in recent years, and the main driver for that has been our more diversified portfolio models,” explains Bergström. “What makes us different from other CTAs is that we allocate roughly 60% to trend-fol-

### TOP 20 CTA PERFORMERS WITH AUM >$250M OVER 5 YEARS

<table>
<thead>
<tr>
<th>Fund name</th>
<th>Last 60 months</th>
<th>Inception</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Tulip Trend Fund - USD C</td>
<td>319.96%</td>
<td>Mar-03</td>
</tr>
<tr>
<td>2 Altis Global Futures Portfolio $ Lead Series - Altis Master Fund ICC</td>
<td>218.59%</td>
<td>Jul-01</td>
</tr>
<tr>
<td>3 QCM Global Diversified Programme</td>
<td>178.12%</td>
<td>Dec-95</td>
</tr>
<tr>
<td>4 Winton Futures Fund</td>
<td>126.35%</td>
<td>Oct-97</td>
</tr>
<tr>
<td>5 Quantitative Global Program</td>
<td>124.04%</td>
<td>Dec-01</td>
</tr>
<tr>
<td>6 Transend Diversified Trend Program - Enhanced Risk - USD</td>
<td>112.10%</td>
<td>Jan-95</td>
</tr>
<tr>
<td>7 Man-AHL Diversified plc</td>
<td>108.11%</td>
<td>Mar-96</td>
</tr>
<tr>
<td>8 Brummer &amp; Partners Lynx Fund (SEK)</td>
<td>106.11%</td>
<td>May-00</td>
</tr>
<tr>
<td>9 Roy G. Niederhoffer Diversified Offshore Fund Class A</td>
<td>93.35%</td>
<td>Sep-95</td>
</tr>
<tr>
<td>10 Eckhardt Standard HL Program</td>
<td>88.24%</td>
<td>Nov-97</td>
</tr>
<tr>
<td>11 Man-AHL Alpha plc</td>
<td>81.90%</td>
<td>Oct-95</td>
</tr>
<tr>
<td>12 Tewksbury Investment Fund</td>
<td>80.73%</td>
<td>Feb-91</td>
</tr>
<tr>
<td>13 Eckhardt Standard Program</td>
<td>77.26%</td>
<td>Aug-91</td>
</tr>
<tr>
<td>14 Conquest Macro</td>
<td>77.13%</td>
<td>May-99</td>
</tr>
<tr>
<td>15 Athena Guaranteed Futures Limited</td>
<td>74.08%</td>
<td>Dec-90</td>
</tr>
<tr>
<td>16 Abraham Trading Company - Diversified Program</td>
<td>71.76%</td>
<td>Jan-90</td>
</tr>
<tr>
<td>17 Roy G. Niederhoffer Negative Correlation Fund Ltd</td>
<td>71.11%</td>
<td>Nov-03</td>
</tr>
<tr>
<td>18 Transend Diversified Trend Program - Standard Risk - USD</td>
<td>68.94%</td>
<td>Jun-92</td>
</tr>
<tr>
<td>19 SMN Diversified Futures Fund</td>
<td>67.80%</td>
<td>Nov-96</td>
</tr>
<tr>
<td>20 Crabel Fund Ltd (Class A Multi-Product Program)</td>
<td>62.87%</td>
<td>Mar-98</td>
</tr>
</tbody>
</table>

Source: HedgeFund Intelligence Database
lowing strategies and the balance into others, including contrarian, intra-market and short-term models. In total, we trade 20 different models.”

Other managers corroborate the view that diversification away from pure long-term trend-following has a very palpable impact on returns and diversification. It also helped to erode the correlation coefficient between long-term trend-followers, which is generally high, at between 0.7 and 0.8.

Witness the example of Salem Abraham’s Trading Company, which until 2005 was exclusively a long-term trend-follower. “Since then, we have aimed to reduce our correlation with other traders by expanding from one strategy to five,” says Abraham. The result is that while long-term trend-following accounted for 35.6% of Abraham’s strategy in 2008, mean reversion accounted for 29.2%, short-term momentum for 14.9%, stock index momentum for 12.3% and short-term trend-following for 8%, “Going multi-strategy also reduced our volatility,” says Abraham, “which has come down from 30% on an annualised basis to 13%, roughly half of the volatility of stocks.”

Diversification within the trend-following discipline has also been an important cornerstone of the strategy for the French manager, John Locke Investments, which has some $700 million under management. Its flagship product, the Cyril Systematic USD, is a trend-following strategy capturing long (one to four month) and medium (one week to one month) trends as well as some high frequency movements. Since inception, Cyril Systematic USD has posted a net annualised return (to February 2009) of 16.12% with a Sharpe ratio of 0.89.

A more recently launched programme is the Cyril High Frequency, which was launched at the start of 2005 and has returned 30.99% to February 2009, with a Sharpe ratio of 1.47. John Locke launched a third fund in May 2008, based on the same high frequency programme, called the Global Systematic ST SPC, which has posted a net annualised return (to February 2009) of 20.96%, with a Sharpe ratio of 1.9 “The High Frequency programme aims to make money on short-term trends but also on noise, so as well as trend-following systems, it uses contrarian systems to buy and sell exaggerated upward and downward moves,” says François Bonnin, John Locke’s managing director and founding partner.

**HOW SUSTAINABLE ARE TREND-FOLLOWERS’ RETURNS?**

CTAs concede that the strong performance of 2008 begs an obvious question. “Is now the wrong time to invest in CTAs because they have just done exactly what they were supposed to do?” asks Russell Newton, co-founder and director at Global Advisors Ltd, a commodity specialist. “In other words, if we go back to a more well-behaved environment, are CTAs going to carry on performing?”

The general consensus, unsurprisingly, is that the performance of 2008 is unlikely to repeat itself in 2009 or 2010. But managers argue that to gauge CTAs by short-term performance fluctuations is inappropriate. “If you compare the volatility-adjusted performance of CTAs with the S&P 500 index between 1980 and 2000, which was a period of strong gains for equities, the returns are similar, although there is no correlation between the two,” says Bonnin of John Locke. “But, since 2000, CTAs have continued to perform well on a risk-adjusted basis, while the equity market has recorded a negative performance. Anyone investing in a CTA with a one-year horizon is making a mistake. But, if you invest over a three-year horizon, you’re much more likely to make money because trend-following moves occur in cycles.”

Peter Matthews, the former co-founder of Mint who is now back in the game with his new PJM Capital strategy, makes a similar point: “Systematic managed futures traders earn their risk premium by managing the unexpected risks of an unknowable future and capturing excess returns from the large surprise moves,” he says.

Barry Hines, a managing partner at Boomerang Capital, a leading hedge fund development firm that works with PJM, adds: “Clearly, there are those looking at CTAs now just because of their recent performance, but they’re missing the point. There is no good or bad time for managed futures, no point in ‘timing’ an allocation.”

Others agree that the longer-term performance of CTAs, combined with their proven capacity to offer protection against the impact of crises, means they should be regarded as a form of insurance policy. “Because we’ve been producing consistent double-digit returns each year, we can almost be seen as an insurance policy that even pays out when you’re not claiming,” says Beach Horizon’s Netherwood.

So much for the longer term. What of the short-
Jean-Pierre Aguilar, CFM

"Last year was a good year for CTAs because price patterns were exceptional"

Jean-Pierre Aguilar, CEO of the Paris-based multi-strategy quantitative manager, CFM

The principal concern, for long-term trend-followers, is that a fall in volatility will erode returns for CTAs across the board. Thayer Brook’s Stoltzfus says that, in broad terms, the performance of the Thayer Brook Fund has been related to the Merrill Lynch Option Volatility Estimate (MOVE) index, a yield-curve weighted average of the normalised implied volatility of one-month Treasury options expressed in basis points. “If you look at our flagship strategy, we have generally been flat to slightly positive during lower periods of volatility measured by the MOVE index, and consistently making double-digit returns during periods of higher volatility,” says Stoltzfus. “Equally, volatility in other asset classes is a performance driver of trend-following strategies as a whole.”

Stoltzfus is, however, relaxed about the threat of nose-diving volatility and its likely impact on Thayer Brook’s funds. “If we were to go back to the environment of ultra-low volatility that we saw in 2005 and 2006, that would tend to favour short-term strategies,” he says. “Will that happen? I think the probability is very low. If you look at the past 20 years, the period of ultra-low volatility was anomalous.”

That view appears to mirror a wider belief that the outlook for the macro-economy is such that the odds against the world slipping back into a calm, low volatility gear are long. A more realistic threat for long-term trend-followers is that the strong influence of institutional players recedes. That may well happen if last year’s exceptionally strong trends were chiefly a by-product of a once-in-a-generation phase in which institutional investors have made wholesale asset allocation shifts, which have now been completed. “If we have a year in which institutional investors just don’t trade, things could turn a bit ugly for managed futures,” says GLC’s Staden.

While a reversion to a more normal trend pattern would erode returns for long-term trend-followers, it need not have the same impact for those focused on capturing shorter-term trends. “Last year was a good year for CTAs because price patterns were exceptional,” says Jean-Pierre Aguilar, CEO of the Paris-based multi-strategy quantitative manager, CFM. “But the CTA part of our programme was not necessarily helped by those patterns because we’re high frequency traders, which means we take advantage of the very short-term price dislocations our systems identify. Those patterns take place regardless of whether or not we have long-term trends.”

Implicit in that explanation is the suggestion that the higher frequency model may be a more sustainable one in markets that don’t trend quite as conveniently as they did in 2008. “The likelihood of a repeat of 2008’s trends is remote,” says Aguilar. “That is because trends aren’t generally friendly. They usually start in a very active way, develop for a while and then end violently.”

Some investors certainly appear to be favouring shorter-term strategies in today’s macro-economic environment. “We’re not aggressively going after trend-following strategies at the moment,” says Dan McAlister of Ermitage. “We are going more for the non-trend, systematic, high frequency strategies. Of course, they may also have trend-following characteristics, but those tend to be coincidental as their strategies and ideas aren’t generated in the same way.”

Irrespective of the degree to which trends play out over the short to medium term, investors emphasise the importance of diversifying their exposure to CTAs. Lyxor Asset Management, for example, has increased its allocation to managed futures over the last 18 months.

“We have been overweight CTAs, with an allocation of between 20% and 30%,” says Mathieu Vaissié, of the fund of funds management group at Lyxor in Paris. “One of the main reasons for that is the diversification properties that CTAs can provide, which varies according to the strategy. For example, if you’re looking for downside risk management, then short-term high frequency CTAs are a very good fit. If it’s more about maximising the upside potential, longer-term CTAs can be very interesting.”

“When volatility is high but you don’t have strong trends, it is better to overweight short-term CTAs,” says Vaissié. “But when volatility declines and clear trends reappear, longer-term CTAs that are able to deliver strong returns become more interesting. That is very important because it means that whatever the market conditions are, there will always be an appealing sub-strategy for investors in the CTA market. So CTAs certainly shouldn’t be looked at as a homogenous asset class.”
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In the summer of 1991, the Virginia Retirement System (VRS) took what was regarded as a bold and unusual step for a US pension fund. It made a modest allocation of $100 million to a diversified selection of managed futures strategies, and it monitored its exposure with something approaching obsessive care.

That experiment came to a shuddering halt following a barrage of negative publicity and a political reshuffle in the state. “The Virginia investment in managed futures was big news at the time,” recalls Marc Goodman at Kenmar. “Although the Eastman Kodak pension plan had previously invested in managed futures, this was the first time that a public retirement system had done so. Unfortunately, when the governor was voted out, the new administration appointed a new investment board and, rather than learn about futures, they decided the smartest thing to do would be to exit the entire programme.”

Goodman adds that, although the San Diego County Retirement System has since made an allocation to managed futures, they have continued to suffer from what he describes as ‘benign neglect’ at the hands of US pension funds for the best part of 20 years.

Salem Abraham recalls how deeply engrained popular mistrust of futures markets were in the US in the late 1980s and early 1990s, and he says that attitudes have been very slow to change since then. “Twenty-two years ago, my grandfather asked me why I had picked the fastest possible way to lose money,” he recalls. “I’ve had a similar reaction ever since. People still think that dealing in futures is like handling rattlesnakes – sometimes with good reason because so many people have gone bust trading futures.”

Several years before the Virginia initiative, however, some European pension funds had started to explore the potential of managed futures for the first time. The external shock that galvanised a number of pension funds into looking at options, other than their natural habitat of long equity exposure, says Kenmar’s Goodman, was the global stock market crash of October 1987. “We and some others had called on a number of European institutions prior to then,” he says. “But none of us had persuaded them to make any meaningful allocations to CTAs.”

Many of those institutions, Goodman adds, were severely hammered by the 1987 crash. Some of the more enlightened investors were encouraged by their experience of 1987 to do some research into the investors and the investment strategies that had survived the October 1987 declines, and even prospered during the fourth quarter of the year. Their findings were that a handful of US investors had performed outstandingly during the crash.

Most notably, Paul Tudor Jones is famously reputed to have tripled his money in October 1987. “The result was that starting in early 1988, we started to sign up some small but interesting accounts from European institutions,” says Goodman.

It was not just European institutions that were alerted to the potential of managed futures by the upheavals of 1987. One investment manager with vivid memories of October 1987 is Aref Karim of Quality Capital Management (QCM).

Prior to then, Karim was a senior investment manager in the Alternative Investments department at the Abu Dhabi Investment Authority (ADIA), one of the world’s largest sovereign wealth funds. He says that, following the stock market crash of 1987, ADIA identified the degree to which the absence of correlation between equities and CTAs was magnified during tail...
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events such as the upheavals of October 1987. “We recognised at ADIA that CTAs needed to play a role in our long-term asset allocation, almost as an insurance policy, and, in January 1988, we started to invest in long volatility strategies,” Karim explains.

Institutions like ADIA have, however, remained firmly in the minority over the past 20 years, with one recent estimate suggesting that average institutional allocations to the managed futures space are no more than about 4%.

Managers say, however, that there are a range of indications that institutional investors are once again preparing to lift those modest allocations.

“A number of investors we have been speaking to have told us not just that they are looking to increase their total allocation to CTAs,” says Thayer Brook’s Philip Stoltzfus. “Investors who in the past tended to restrict themselves to one or two managers in the CTA space are also saying that they plan to increase that number very significantly because of the dispersion of returns among managed futures managers. That is a very positive development.”

There is more than anecdotal evidence to suggest that pension funds are looking more constructively at the role that CTAs can play as a source of decorrelation and diversification within a portfolio. Last September, it was reported that the $231 billion California Public Employees’ Retirement System (CalPERS), which is the largest pension fund in the US, would be committing $100 million to the BlueTrend Fund, a systematic programme managed by the London-based BlueCrest Capital Management.

The CalPERS move was not surprising, perhaps, given that the $7 billion BlueTrend strategy has been among the top-performing CTAs of recent years. Launched in 2004 and managed by a team headed by Leda Braga – who, like the BlueCrest founders Mike Platt and Bill Reeves, worked previously at JP Morgan – BlueTrend was the EuroHedge award winner for top risk-adjusted performance in Managed Futures for both 2007 and 2008, with gains of 27.77% and 43.34%, respectively.

Indeed, the performance of BlueTrend has been a major driver for BlueCrest overall in recent years. Braga has become the biggest manager by assets among female managers in the industry globally; and her performance and growth underpinned the firm’s EuroHedge award for Management Firm of the Year in 2008. It is not surprising, therefore, that she should be catching the attention of the world’s biggest investors.

CTAs believe that this process will gather momen-

turn over the coming five years. Pat Welton of Welton Investment Corporation points to recent surveys, such as the Morningstar/Barron’s poll of US institutions and financial advisors, published in November 2008, as evidence of changing attitudes towards alternative investments in general. Some 53% of respondents to that survey believe alternatives will be as important as, or more important than, traditional investments over the next five years. That compares with 32% who made the same prediction in 2007.

Of course, many of those respondents will have based their answer on a knee-jerk reaction to the dire performance of long-only investments over the past 12-18 months; and many of those who plan to increase their exposure to alternatives will not necessarily turn to CTAs. However, leading players in the managed futures arena, on either side the Atlantic, say that they are either seeing more demand from mainstream institutions, or that they are planning to step up their marketing to institutional investors.

In London, Aspect Capital’s Anthony Todd says that more than half his clients are now what he describes as “high level institutions”, such as pension funds, insurance companies and sovereign wealth funds. In California, meanwhile, Welton says that these institutions have been identified as a key client base for the future. “The pension fund and endowment space is not an area that we have targeted up until now, but, as we are now approaching our five-year milestone, this is an investor base that we will be focusing on more intensively in 2009,” he says.

What, then, would be an appropriate weighting to managed futures within an institutional portfolio? “That is a question that institutional investors everywhere are asking themselves,” says Welton. “We have had some very candid feedback from a number of institutions that are telling us they have a serious asset allocation problem right now. Many of them are saying that they are very disappointed by a lot of the strategies they chose last year that turned out not to be alternatives at all. So, without putting an exact number on it, if an endowment fund was allocating 5% of its assets to what it believed to be alternatives, only to find that 90% of those assets were effectively long equity beta, what is an appropriate allocation to a strategy like managed futures? It could be well over 50% of its allocation to alternatives as they begin to classify properly some of their hedge and private equity funds as active equity strategies.”

At IKOS, Elena Ambrosiadou agrees that institutional allocations to CTAs could increase dramatically
over the coming years, as recent performance has demonstrated conclusively that CTAs can produce returns that are negatively correlated with traditional equity managers. “The CTA group includes active currency management, which is under-represented as an asset class,” she says. “It is expected that the class will grow to 5% of the allocation of institutional portfolios, and it could be argued that this percentage should be higher. Inflows into the style, coupled with reallocation still to take place from other hedge fund styles, could see the percentage market share of currency funds double.”

Whatever weighting institutions allocate to managed futures going forward, the consensus suggests that rising demand will push CTAs’ total share of the market for alternative assets well above its current level of around 13%. (In Europe, CTAs represent a slightly higher proportion – with managed futures at just under 18% of the $400 billion on the EuroHedge database at the end of 2008.)

Still, say some managers, that represents little more than a pin-prick in the context of global investable assets, which suggests that there is immense scope for expansion of the industry. “There is about $220 billion allocated to managed futures on a global basis, compared with something like $45 trillion in equities and bonds,” says Welton. “So even a very small shift in asset allocation towards an alpha-producing strategy, like managed futures, would create a huge increase in the amount of tradable capital.”

“If you assume that the size of the global hedge fund industry remains relatively static at about $1.75 trillion, and that managed futures double to $400 billion or so, that takes us to a total market share of about 20%, which is where we were in the early 1990s,” Welton adds.

Donough McDonough, a managing partner of seeding platform Boomerang Capital, makes a similar sort of calculation: “In a global investment market that still has assets in the tens of trillions, a couple of hundred billion in managed futures doesn’t add up. I wouldn’t be at all surprised to see CTA assets grow five-fold in five years.”

Rich Brereton, managing director at Boomerang, adds: “To some, managed futures are just another asset class that will be in and out of favour from time to time. To us, though, a good CTA represents a superior way of navigating an inherently unpredictable world.”

THE FUND OF FUNDS ROUTE

Whether future investment flows go directly to single managers, or via the more conventional fund of funds route, seems to be open to question. “Historically, we very seldom talked to tier two or tier three institutions,” says Stephen Hedgecock at Altis Partners. “But I think the world has changed. People used to go to banks or funds of funds for the perceived security they offer. That whole premise has been turned upside down. Many two or three tier investors have lost faith in funds of funds and are approaching managers direct.”

A number of other single managers report that relative demand for CTAs from funds of funds has declined over the past year. That is hardly surprising, given the liquidity offered by CTAs in a year when outflows from hedge funds amounted to just over $580 billion, according to Credit Suisse/Tremont’s data. Industry assets overall dropped more than 32% during the year, from just under $2.7 trillion to just over $1.8 trillion, according to HedgeFund Intelligence research.

Nevertheless, plenty of funds of funds are thankful that they increased their allocation to directional strategies at the start of 2008. “Managed futures was one of our high conviction calls at the beginning of last year,” says Sean Molony, an investment manager at the London-based International Asset Management (IAM), an independent fund of hedge funds manager which was established in 1989 and had assets under management of $2.6 billion at the end of 2008.

Molony says that IAM’s internal asset allocation committee currently recommends a 15% allocation to the managed futures strategy. He adds that IAM’s commitment to the CTA space was underscored at the start of February when it announced the launch of the IAM Trading Fund, a dynamically managed portfolio initially spreading its assets across 10 to 15 holdings.

According to Molony, one of the principal reasons for launching the Trading Fund was to establish a diversified portfolio that would be able to minimise volatility going forward.

“Clearly, there will be months when we see a high level of co-drawdowns among managers with similar time frames,” he says. “So, by building a portfolio of managers using a range of investment techniques and time frames, we will be able to increase our allocation to this area within our multi-strategy portfolios and decrease the risk at the same time.” Molony adds that there is no leverage in the Trading Fund and that the underlying managers within the fund generally maintain low margin to equity levels.

Another fund of funds manager that stepped up its ex-
posure to the managed futures space in 2008 was Jersey-based Ermitage. “We came into 2008 with quite a bearish top-down slant from an economic perspective and an allocation of about 25% to directional managers,” says Dan McAlister, Ermitage’s head of directional strategies. “That wasn’t an over-aggressive position, but managed futures hadn’t been the best performers in 2006 and 2007 where it had been more efficient to have equity and credit exposure providing beta.

“Over the course of 2008, we became more aggressively supportive of the directional story and finished the year with an allocation of about 50% to directional strategies,” he adds. “But we don’t see directional as being a self-contained strategy, because there are so many differentiations within it. So we aim to create directional baskets within our multi-strategy programmes that can either act as hedges or make money on a standalone basis.”

Rising institutional inflows, be it from mainstream institutions or funds of funds, is seen as an overdue development because CTAs believe that institutions are not only very seriously underweight in managed futures. Some say that the strategy is still one that is widely misunderstood by funds of funds as well as by more mainstream pension funds and insurers.

“The quality of some of the analysts I have met has been shocking,” says one manager. “Many have no understanding of the whole systematic trading concept.” One result of that misunderstanding, the same manager suggests, has been a gravitation towards the larger and more established players on the basis of brand recognition rather than on a thorough analysis of management styles and strategies. “When you’re a fund of funds, you’re responsible for creating a well-diversified, stable portfolio and for doing thorough due diligence,” he says. “You can’t just rely on the well-known names.”

That is an observation that the longer-established funds of funds would endorse up to a point. After all, sloppy due diligence is the last accusation that can be levelled at a manager like IAM, which has screened 345 CTAs over the past 14 years. Molony says that the due diligence process is an intensive one that typically takes between one and three months. “Some of the characteristics we look for include a strong infrastructure, significant investment in research and development, model and asset diversification and managers’ preparedness to refine and improve their models on an ongoing basis,” says Molony.

Other things being equal, that would suggest that the size of a single manager will be a significant factor in the due diligence procedure. “While we don’t neces-
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It was Dr John Lintner of Harvard University who famously documented the diversification properties of managed futures in his landmark study, “The Potential Role of Managed Futures Accounts in Portfolios of Stocks and Bonds”, published in 1983. “The combined portfolios of stocks (or stocks and bonds) after including judicious investments […] in leveraged managed futures accounts show substantially less risk at every possible level of expected return than portfolios of stocks (or stocks and bonds) alone,” he wrote.

If that was something that most institutions thought they understood, last year’s turmoil came as a profoundly unsettling surprise. That is because the principal shock of 2008 was not, perhaps, how poorly some hedge fund strategies performed, but how closely correlated their returns were with other asset classes that their clients were aiming to diversify away from.

“If you look at the evolution of the alternative investment management sector over the past five years, a whole new range of exotic strategies has been created, a number of which were stress-tested for the first time in 2008 and came up woefully short,” notes Anthony Todd at Aspect Capital. “Quite rightly, investors have been focusing on building up diversified portfolios over that time. But, in an extreme period like last September or October, many found that the diversification they thought they had achieved was a complete illusion.”

Others agree. “I think that all investors are recognising that so many of the assets they were investing in, that were supposed to be orthogonal, turned out to be highly correlated,” says Russell Newton, co-founder and director of commodities specialist Global Advisors. “One of the lessons learned from 2008 is that investors will have to work harder to find orthogonal returns.”

One of the best places to look for those diversified returns, say CTAs, is the managed futures space. “If you look at the Credit Suisse/Tremont Hedge Fund Index’s correlation to the S&P 500 since October 2005, it is 77%,” says Thayer Brook’s Philip Stoltzfus. “In comparison, the correlation coefficient of managed futures to the S&P 500 over the same period is -0.09. That, before anything else, tells investors why they need to be in this space. This sector needs to be clear about its methods and objectives and the bottom line is that it is a genuine absolute-return strategy and a highly efficient diversifier.”

That view is shared by a number of other CTA managers. “It is probably fair to say that CTAs won’t deliver another 15% to 20% average performance this year, and that Lynx won’t be up by 40% again this year,” says Bergström. “But we need to impress on investors that a return of the kind we delivered last year shouldn’t be the driver of investment in managed futures. The driver should be managed futures’ ability to deliver low or negative correlation.”
LIQUIDITY AND TRANSPARENCY

Those who insist that it is a mistake to become too sidetracked by the headline absolute returns generated by CTAs in 2008 point to a number of other credentials that ought to make them increasingly attractive to institutional investors. High on the list of those credentials are liquidity and transparency, which go hand in hand. “What was so special about 2008 for managed futures was that they were able to prove that this is the only perfectly liquid strategy,” says Karsten Schroeder at Amplitude Capital.

A measure of the liquidity that CTAs enjoy is the efficiency with which, in extremis, they can turn over their entire portfolio. At Quantica Capital, for example, Montes recalls how in March 2008 his team became uneasy at the deteriorating fortunes of Bear Stearns, which had been the fund’s prime broker since its inception. “So we chose to close down our entire portfolio and to eliminate all counterparty risk by moving it away from Bear Stearns,” he recalls. “It took no more than about 45 minutes for us to turn around the entire $150 million portfolio, and we even ended up making money on the day.”

The liquidity of the futures contracts they trade is what allows CTAs to guarantee liquidity to their investors. This cuts both ways. On the credit side of the equation, it makes the CTA sector highly accessible to institutional investors. On the negative side, it makes managed futures the first port of call for institutions looking to raise liquidity in a hurry. And the bigger the programme, the more vulnerable it inevitably becomes to acting as an ATM for investors. Assets under management at Winton, for example, peaked at about $16 billion before redemptions in 2008 pegged the total back to $13 billion.

Winton was by no means alone in being used as a liquidity spigot in 2008. “You speak to some single managers who posted returns of 50% last year, but still lost 40% to 50% of their assets,” says Dan McAlister at Ermitage.

Fortunately, for the more accomplished single managers, the compelling appeal of managed futures in 2008 ensured that much – if not all – of that shortfall was replenished. At Aspect Capital, for example, Todd reports that total assets under management were more or less exactly the same (about $4.3 billion) at the end of 2008 as they were at the start of the year – although over the period as a whole he reckons that redemptions amounted to about 25% of that total, all of which were compensated for by performance. This stability, he says, has come about as a result of Aspect’s cultivation of a broader and more sustainable investor base. “There is no doubt that the biggest redemptions last year came from the fund of funds sector,” he says. “Our strategy has always been to reduce the volatility of those redemptions by building a more diversified base of investors.”

Others have made a point of pursuing a similar strategy. “Because managed futures are so liquid, it is important to be highly selective when it comes to your investor base,” advises Amplitude’s Schroeder. “There’s plenty of hot money out there which we don’t want to attract, and I have to give credit to our investor base which has been extremely stable.”

While being picky about its investor base is one solution to the liquidity conundrum, what is not an option for the CTA sector is to resort to the sort of restrictions that many hedge funds imposed on their investors in 2008.

“I keep reading about various credit and other hedge fund strategies announcing new side pockets or gates preventing investors from extracting their money,” says Stoltzfus at Thayer Brook. “That is anathema to the managed futures industry. It is the polar opposite to the way we operate.”

At John Locke Investments, François Bonnin says that maintaining daily liquidity is pivotal to his business model. “The daily liquidity we guarantee our clients is not a publicity stunt,” he says. “If a client wants to redeem, it costs us very little to offset that position, due to the liquidity of our strategies. We could unwind the entire $700 million of assets that we have under management in less than an hour without incurring any slippage. There would be no deterioration in pricing because we are dealing in such extremely liquid markets.”

With that liquidity, say CTAs, comes a level of transparency that was conspicuous by its absence in so many asset classes in 2008. “In the managed futures sector, what you see is what you get,” says Pat Welton. “Managed futures strategies are consistently valued on a mark to market basis, so it provides a totally transparent representation of returns.”

Transparency in the CTA space, a number of managers point out, is also enhanced through the use of managed accounts. “The majority of assets in the CTA world are in managed accounts, which provide the ultimate transparency because all the positions you’re trading are constantly visible,”
“In an ideal world, we would love to have access to the best strategies for minimal fees, but we need to be realistic. At the end of the day our returns are net, so I don’t mind paying fees if I know I’m getting a good return.”

Dan McAlister, Ermitage

says Paul Netherwood at Beach Horizon. “In the hedge fund world, products are generally offered in fund format where true value can often be disguised.”

Another key piece in the jigsaw for investors weighing up the pros and cons of investment alternatives is leverage. Aspect’s Todd believes that, as well as focusing on the liquidity and transparency associated with managed futures, the excesses of 2008 will encourage investors to look with a much more critical eye at leverage.

“Many of the strategies that came to grief in 2008 were those that depended on exploiting a tiny amount of alpha and leveraging it to the hilt to generate strong returns,” says Todd. “It may be that those strategies return to favour in years to come, but I don’t think that they will be the strategies that institutions are looking for over the next two or three years. Their focus will be on diversification, as well as on a high level of liquidity and on strategies that don’t depend on a high degree of external leverage.”

As Todd and others point out, that will play to the strengths of CTAs, which do not depend on external borrowings from lenders that may or may not be prepared to leave their commitments in place.

“Leverage is a very bad word these days, but we need to distinguish between the leverage used by a traditional hedge fund and that which is used by a CTA fund like the Tulip Trend Fund,” says Daniel von Allmen, a partner at Progressive Capital Management.

“Hedge funds’ leverage is generally provided by prime brokers that can leave them in the rain without warning. CTAs are quite different because they depend on the leverage provided by futures exchanges. In theory, the exchanges could pull the plug on that leverage, but none would do so because it is at the heart of their business model. And the proof of that is that, amid all the volatility of the past 18 months, nobody has questioned the strength of the futures clearing houses.”

BLACK BOXES OR OPEN SECRETS?

Ask a pension fund consultant, such as Watson Wyatt, why its clients still have no more than a modest allocation to managed futures and you will be given two main reasons.

One is the fee structure charged by CTAs. “One of the things we look at is whether a strategy makes sense from a fee perspective,” says Leon Beukes, who heads the multi-strategy hedge fund research team at Watson Wyatt in the UK. “Most charge the typical hedge fund fees of 1.5% or 2% and 20%, and we have to assess how that compares with other strategies a pension fund can access via traditional managers. Clearly, CTAs need big research teams and considerable IT resources, but their concept is fairly formulaic and it’s not always obvious to us that paying 2% and 20% for those strategies represents good value for money for clients.”

To date, there seems to have been little downward pressure on fees in the managed futures market, which most managers would — unsurprisingly — fiercely resist in any case. “If you lower your fees, the danger is that you will cut corners on research and suffer extended drawdowns as a result,” says Bonnin.

Investors, for their part, appear to be unconcerned about fees — as long as their managers perform. “In an ideal world, we would love to have access to the best strategies for minimal fees, but we need to be realistic,” says Ermitage’s McAlister. “At the end of the day, our returns are net, so I don’t mind paying fees if I know I’m getting a good return.”

The principal reservation of Pension fund consultants about the suitability of managed futures, however, is based on what they see as the opacity of CTAs’ systems. “The amount CTAs are willing to tell us about their trading algorithms and risk modelling has, to date, been fairly limited, which makes it difficult for consultants to be sufficiently comfortable about what their clients are buying and what the risks are behind their systems,” says Beukes.

That, he adds, is changing. “We’ve had several meetings with CTAs, recently, and it is notable that post-Madoff and after some of the other scandals involving hedge funds, they are recognising that they need to be more open if they want to attract more long-term institutional money,” he says.

Unsurprisingly, managers comprehensively repudiate the allegations that their strategies are based on impenetrable black boxes on a number of counts.

At Beach Horizon, Netherwood says that it is not as though the basic data that is fed into most CTAs’ systems equate to anything approaching state secrets. “It’s not a black box to us,” he says. “A black box is a system where given an input, you don’t know what the output is going to be. In a
systematic programme you know exactly what the output will be, while for most European CTAs the only input is market data, which is price, volume and open interest. Some managers may use some additional data feeds, but I doubt whether they would have an issue with telling their investors what they are. Where the intellectual property comes in is simply how that data is weighted, what they are. Where the intellectual property would have an issue with telling their investors additional data feeds, but I doubt whether they can look incredibly obvious when they have been discovered. The wheel wasn’t obvious to cavemen, and stirrups weren’t invented until 700 AD, so they would have looked very clever to the Romans.

That is an argument that many investors appear prepared to buy. “We accept that managers are unwilling to disclose the formulas they use,” says Jean-Christophe Wicker, senior research analyst and member of the portfolio management team at IAM in London. “But what we do need to understand is the time frames they are trading across, how diversified they are and the allocations they make between the different models.”

QCM’s Aref Karim has participated in the black box debate from both sides of the fence, having previously been on the buy-side at Abu Dhabi Investment Authority (ADIA). There, he had a similar view on managers’ models to Wicker’s. “One of the things I used to look for at ADIA was some degree of clarity in terms of the manager’s philosophy and investment process,” he says. “We weren’t looking to be told about all the individual components of the model because we believed that managers with long track records had the necessary technical know-how, and respected the fact that such information was usually proprietary.”

“As an investor, we also wanted to know how parametric the modelling process was,” Karim adds. “In other words, we wanted to know what the model’s main drivers were with some knowledge of the inputs and variables. The danger when you have 100 PhDs or quants sitting together in a room is that there is a tendency to try to address every tiny market characteristic for each asset. The risk then is that model decay sets in very quickly, which in turn calls for a lot of maintenance and recalibration. As long-term players, we were reticent about investing in those kinds of strategies because our concern was: could those strategies survive for the next five years without constantly being rejigged?”

It is perhaps because he has seen either side of the market that Karim has made a point, he says, of being more open about his models than some of his peers. “Without giving too much away, we try to explain what the main drivers of our system are,” he says. “And we also try to keep our inputs as non-parametric as possible.”

“We accept that managers are unwilling to disclose the formulas they use. But what we do need to understand is the time frames they are trading across, how diversified they are and the allocations they make between the different models”

Jean-Christophe Wicker, International Asset Management
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Lynx Asset Management AB is a leading CTA based in Stockholm, Sweden. The firm was founded in 1999 by Jonas Bengtsson, Svante Bergström and Martin Sandquist. Today the management team consists of 25 investment professionals with a strong research focus. The Lynx programme is purely systematic and the portfolio consists of 20 models with different approaches applied to some 65 markets globally. The broad portfolio of models is one of the explanations why Lynx consistently have outperformed CTA peers over the years. The average annual return has been over 18 per cent since inception with a standard deviation of 14. Total AUM is USD 1.5 billion and the firm offers two offshore funds with different risk targets. Lynx has had multiple nominations in EuroHedge Awards as best European managed futures fund.

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Estlander & Partners, formerly Estlander & Rönnlund, is a CTA operating out of Helsinki and Vaasa in Finland. While we have changed our name to better reflect the strong partnership within our close-knit team, we continue concentrating on our core business and constantly strive to improve our strategies.

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IKOS is a highly successful quantitative hedge fund specialising in the electronic trading of the global financial markets. It was founded by Elena Ambrosiadou and Martin Coward in 1992. IKOS manages $1.5bn in a number of funds, several of which are ISE listed vehicles, as well as via managed accounts. IKOS is distinguished by its commitment to objective, scientifically based trading strategies, which it implements via a totally automated, globally distributed electronic trading platform. IKOS adheres to the highest regulatory standards in the industry.

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Lyxor Asset Management, a wholly-owned subsidiary of Société Générale Group, thrives since 1998 to provide the best of financial investment solutions. Lyxor has established itself as a leading niche player by offering its expertise in three major investment universes: Alternative Investments, Structured & Quantitative Management and Index Tracking (ETF).

Lyxor gained its prominence with its unique Hedge Fund Platform which provides independent valuation, risk monitoring and weekly liquidity. Lyxor offers a broad range of hedge funds, funds of hedge funds and absolute return funds, adhering to high risk-management standards and rigorous hedge fund manager selection guidelines.

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Founded in 2003 Quantica Capital AG is a leading Swiss investment manager with an exclusive focus on development and management of quantitative strategies.

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Please visit www.lynxhedge.se to learn more about the Lynx Programme and the Brummer & Partners group.