

## PUTTING 2004-2005 MANAGED FUTURES PERFORMANCE IN PERSPECTIVE

*Most managed futures programs have struggled over the past two years to produce returns consistent with their historical averages. The drawdown currently being experienced by the vast majority of Commodity Trading Advisors is one of the most severe in some time but, nevertheless, appears to be a normal part of the performance cycle. As is the case with virtually all drawdowns, the current period of equity retracement followed two strong years of performance – 2002 and 2003 – averaging an annualized 12.60% when measured in terms of one benchmark index, the CISDM TAQU.<sup>1</sup>*

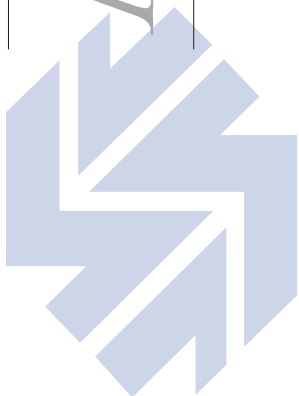
*What's behind this recent period of poor performance? A careful review of the past couple of years suggests that a number of market-specific fundamentals and certain global macroeconomic factors have combined to create a particularly difficult – and unusual – trading environment. More important, we believe that many of these same market conditions may now be at or near inflection points that will lead to significant opportunities going forward for managed futures strategies. In this report, we look at managed futures performance from three perspectives: 1) absolute returns, focusing on the correlation between annual changes in the prices of selected markets and the profitability of Commodity Trading Advisors; (2) relative returns, exploring the performance disparity among different CTA strategies during the current drawdown and over time; and (3) future returns, evaluating the likelihood of a near-term recovery for CTAs, based on the seasonality of price momentum and potential shifts in macroeconomic fundamentals.*

### **Absolute Returns: Why most managed futures programs have lost money in the 2004-2005 period**

In attempting to understand CTAs' recent 18-month period of underperformance, we chose to view this brief period as part of a longer performance cycle – one that began in 2002. The years 2002 and 2003 were among the best in a decade for managed futures, being largely characterized by strong uptrends in virtually all the major global markets (stocks, bonds and commodities), accompanied by a major decline in the U.S. dollar. These moves were largely driven by massive amounts of monetary and fiscal stimulus designed to pull the world out of recession and avert price deflation. As a result of this stimulus, money supply grew rapidly; interest rates fell to new lows; global equities reversed

<sup>1</sup>CISDM TAQU is the Center for International Securities and Derivatives Markets' Trading Advisor Qualified Universe, which is comprised of approximately 260 CTAs, representing total assets under management of over \$72B, as of January 2005.

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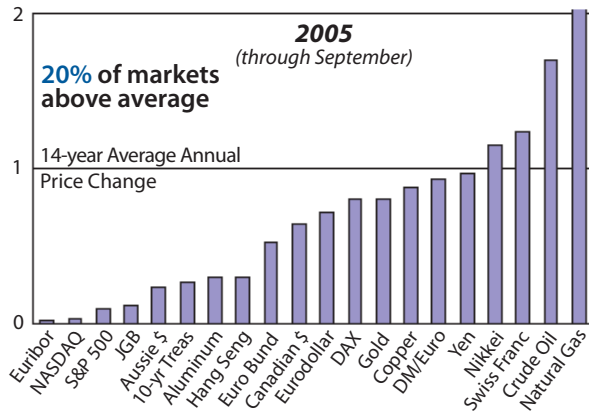
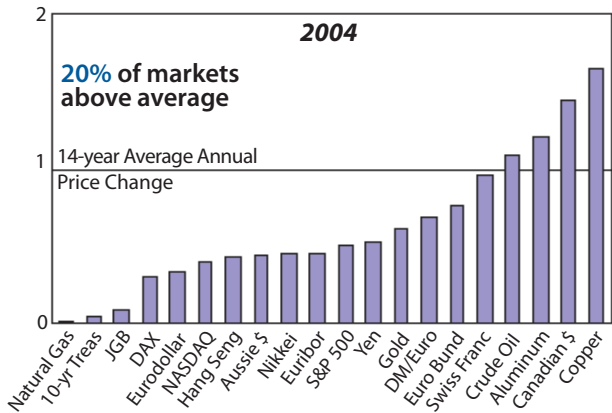
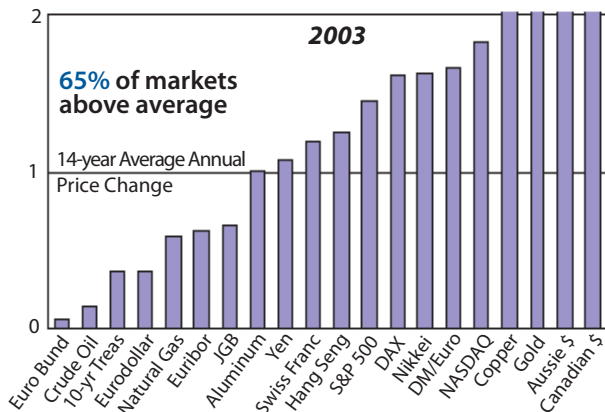
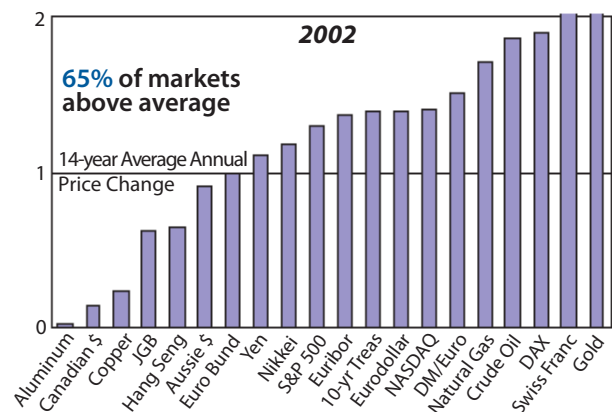


and retraced much of their bear market losses; the dollar weakened after a six-year positive run; and commodity markets moved steadily higher, buoyed by negative real interest rates and anticipation of a pickup in economic growth. The so-called “carry-trade” became increasingly popular due to the lowest real interest rates in decades, steadily declining risk, and a bull market in virtually all assets, financial and real alike.

However, the situation began to change in early-to-mid 2004 as the Fed and other central banks became increasingly concerned about excessive

stimulus and its impact on the global economy. This precipitated a change in monetary policy, the impact of which has been seen in a number of areas. The Fed has increased its benchmark Fed funds rate a total of 11 times since it started hiking rates in June 2004. Money supply growth has slowed significantly, but has yet to turn negative. The U.S. yield curve has flattened significantly, but remains positively sloped. Market-driven interest rates have risen, but remain at historically low levels, particularly in real terms. Inflation has begun to slowly pick up, but, even now, is evident in only a few areas.

*Chart 1*  
**Absolute Value of Annual Price Change by Market**  
 (in proportion to the 1991-2004 average absolute value price change)



*In response to this change in market conditions, most markets lost momentum and moved into sideways trading patterns, but did not reverse to the downside.* Over the course of 2004 and thus far in 2005, most markets have exhibited minimal net changes (up or down), resulting in few profitable directional trading opportunities and significant potential for trading losses. The fluctuating levels of profit opportunities present in the major futures markets during the 2002-2005 period are presented in the four-panel graph (*Chart 1*) at left, which shows the absolute net percentage change in price of a portfolio of 20 major markets as a percentage of each market's average absolute annual net change from 1991-2004. A value of 1 indicates that the market in that particular year exhibited an absolute (i.e., up or down) change equal to its average over the entire 14-year period. A value of 2 would be twice its average, and so forth.

The high degree of directional movement and profit opportunity present in 2002-2003 is evident in the fact that 65% of the markets in the portfolio exhibited above-average movement in each of those years. The lack of trading opportunity (and hence the potential for losses) is equally evident in 2004-2005, with only 20% of the markets in either year exhibiting above-average directional movement. It is clear that profit opportunities in 2004-2005 have been quite limited. However, there is significant potential for major trends in a number of markets should price changes revert to their historical means.

### **Relative Returns: Why some managed futures strategies have outperformed**

CTA performance in 2002-2003 was generally quite strong, as virtually all types of managed futures programs caught the broad-based

uptrends in the financial, currency, and commodity markets. The comparatively poor performance seen in 2004 and 2005, however, has exhibited much greater variability, with certain types of programs and strategies materially outperforming others on a relative basis.

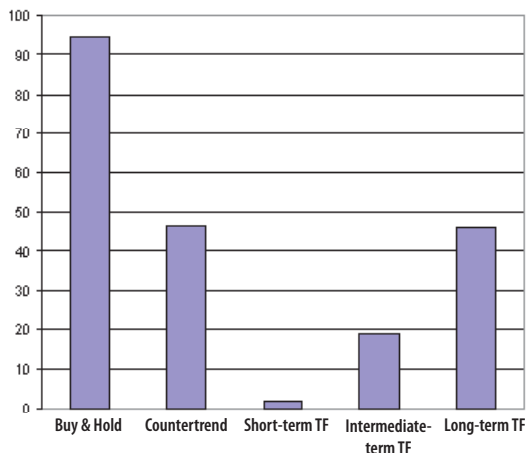
While many markets have exhibited a relatively choppy, sideways pattern since March 2004, certain sectors have proved more difficult to trade than others. Programs with a heavy allocation to foreign exchange have suffered due to the choppy, countertrend rally in the U.S. dollar that began late last year. Programs allocating to fixed income, particularly U.S. instruments, have also suffered, as bond yields refused to move higher (or significantly lower). The strongest price gains have been in European financial instruments and Japanese stocks. Programs focusing on non-U.S. markets, and particularly emerging markets, have benefited the most.

Portfolio composition, however, only partly explains the divergence in performance among various CTA programs during the 2004-2005 period. Differences in trading strategy have also contributed to the variability. While we are not privy to the proprietary trading strategies of other CTAs, we can derive a reasonable amount of information from some fairly simple, widely used trading rules and from our own proprietary models.

In order to generate the necessary data, we performed a historical simulation, comparing the returns of five different trading approaches – a buy-and-hold or passive strategy; short-, intermediate-, and long-term trend-following rules; and a very short-term countertrend model. The buy-and-hold model simply establishes a long position at the beginning of the period and holds that position throughout, rolling into new contract months as necessary. As a proxy for trend following, we selected a very simple breakout model, one that buys

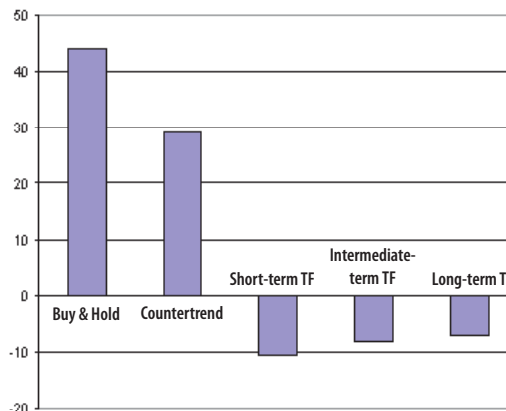
*Chart 2*

**2002-2005 Relative Returns of Five Different Trading Strategies**



*Chart 3*

**2004-2005 Relative Returns of Five Different Trading Strategies**



an x-day highest high and sells an x-day lowest low. The number of trading days used in the formula varied over three time frames or holding periods: short-term used a look-back of 8 days and resulted in an average holding period of less than one month; medium-term used look-backs of 13, 21, 34 and 55 days and resulted in trades averaging about 1.5 months in length; long-term used look-backs of 89 and 144 days and resulted in trades lasting about nine months. For the countertrend strategy, we used a short-term proprietary model that had an average holding period of less than three days. For this test, the four active strategies traded a portfolio of interest rate, stock index, commodity, and currency futures that are commonly traded by CTAs. The passive buy-and-hold strategy traded the same portfolio, except for currencies, which do not logically lend themselves to a buy-and-hold approach.

The simulated returns generated by these five strategies are shown in *Charts 2* and *3*, covering the full trading cycle, 2002-2005, and the recent

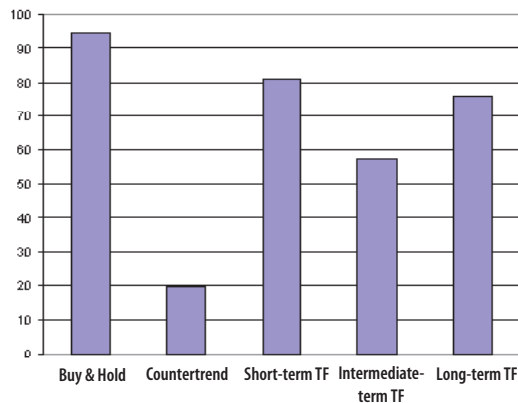
period of underperformance, 2004-2005. All five strategies were profitable over the almost four-year period presented in *Chart 2*, albeit with some variation in performance. The passive buy-and-hold approach generated the highest return, followed by the proprietary countertrend model and the long-term trend-following rule. Short-term trend following was barely profitable. Returns in the 2004-2005 period as seen in *Chart 3* show a similar relative orientation, although they are all shifted downward in response to the more difficult trading conditions. The buy-and-hold approach remains the most profitable, followed by the short-term countertrend model. However, all three trend-following time frames lost money, with the short-term, once again, performing the worst. It appears from these two charts that strategies emphasizing long positions and infrequent trading (i.e., those that were relatively passive and long-only) would have performed best during both of these periods.

*Charts 4 and 5*, further support this thesis, as we separately break out the returns from long and short positions during the four-year time period. *Chart 4* shows that all five trading approaches were profitable trading long positions only, with the passive buy-and-hold approach, once again, proving most profitable. Interestingly, this suggests that the optimal approach to managing long positions was not to manage them at all, and is likely a result of the strong, broad-based uptrends that have existed during this period. In this long-only test, it is the short-term countertrend model that provides the lowest returns – not surprising, since its objective is to exploit short periods of countertrend moves rather than long-lasting uptrends. Returns from the other four models are quite similar to one another. *Chart 5*, however, shows that this is not the case when generating returns from short positions only. The proprietary countertrend model is the only profitable approach, while all three

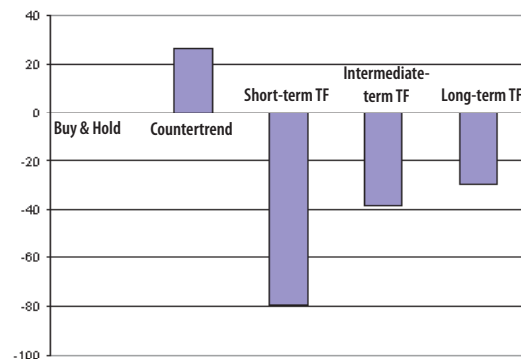
trend-following time frames lose money. The trend-following rules lose money in proportion to the frequency of their short positions. The short-term trend-following rule loses the most because it attempts to trade the short side more often than the others. These results are unsurprising, considering the markets' strong uptrends in 2002-2003 and then their sideways-to-higher drift since 2004. The passive approach, long-only by definition, appropriately generates no return, positive or negative.

The evidence presented to date suggests several things that may simply be artifacts of the relatively short 2002-2005 period being examined. Based upon this limited data, one might conclude that a passive approach to managed futures investing outperforms an active approach and that long-only positions outperform long and short. The next two charts provide additional insight into these tentative conclusions.

*Chart 4*  
2002-2005 Relative Returns from Long Positions Only

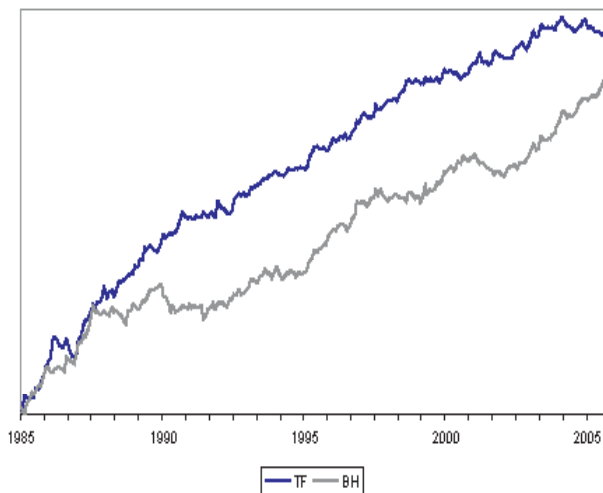


*Chart 5*  
2002-2005 Relative Returns from Short Positions Only



*Chart 6*

**Cumulative Returns of Trend-following and Buy & Hold Strategies: 1985-2005**

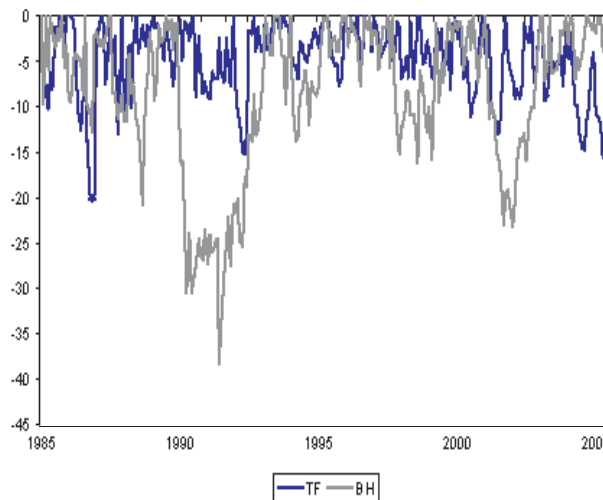


*Chart 6* presents the cumulative returns of the passive buy-and-hold strategy compared to that of the three trend-following time frames combined over a much longer 21-year period. It is clear that prior to 2002, the trend-following approach outperformed, sometimes decisively, the passive buy-and-hold approach.

*Chart 7* presents the drawdowns associated with the cumulative returns plotted in *Chart 6*, for the buy-and-hold and the trend-following strategies. This chart shows that, except for the most recent period, trend-following strategies generally manage drawdown risk much better than a passive approach. Drawdowns tend to occur at similar times for the two strategies, except for the most recent period. The two strategies begin to diverge significantly in early 2004, as the trend-following approach begins its worst drawdown of the 21-year period, while the passive buy-and hold continues to make new equity highs. The picture here is relatively clear – from 1985 through 2002, a trend-following approach, with its ability to go long and short and its

*Chart 7*

**Trend-following and Buy & Hold Strategy Drawdowns: 1985-2005**



implicit risk control, handily outperformed a passive long-only approach. More recently, however, the strong secular trends that have existed during this period (e.g., falling interest rates, disinflation, etc.) have created conditions particularly favorable to a passive buy-and-hold approach. Does this represent a permanent change in market conditions, or is it more of an aberration caused by the extreme monetary stimulus introduced by the world’s leading central banks in response to the recessionary and disinflationary conditions present in 2001-2002?

**Future Returns: Why current economic and market conditions suggest CTA performance will rebound in the near term as conditions for directional trading return to “normal”**

Despite the difficult trading conditions that have existed for CTAs over the past two years, there are a number of reasons to believe that better times, possibly much better, lie directly ahead. Three separate factors favor strong CTA performance in the near term. First, it is highly unlikely that the economic and market conditions that have characterized the

2004-2005 period will persist in their current state. Second, the directional trading approach employed by most CTAs typically thrives on increasing and higher levels of volatility. With volatility just now starting to rebound from multiyear lows, the expected increase in market volatility is likely to provide strong support to CTA performance. Finally, volatility and directional movement, as we will illustrate, has a seasonal tendency that favors the fourth quarter of the year.

Our view is that strong, profitable trends will re-emerge once the economic transitional phase completes and market prices turn broadly lower – something that may already be in the process of occurring. Market prices have been stalled for some time now, during what has been a fairly long transition phase between an environment which is nominally bullish for prices and one we believe is likely to turn bearish in the near term. In the past, after a period of strong uptrends (such as those seen in 2002-2003), we have seen strong downtrends typically develop in the markets most often traded by CTAs. Several market indicators already point in this direction. The Treasury yield curve has steepened, and credit spreads have widened, reflecting the bond market's sense that inflation and default risk are increasing. Meanwhile, implied equity option volatility has risen from 12-year lows and is approaching a level that historically indicates outperformance for CTAs.

While it is possible that trends will emerge to the upside, we believe that it is highly unlikely that we will see a repeat of the 2002-2003 bull markets. Strong moves to the upside would require significant monetary and fiscal stimulus that are no longer available nor likely to occur in the near future. In fact, the current situation is beginning to look much more like the

mirror opposite of the conditions that led to the bull markets of 2002-2003. The world economy then was weak, the Fed was throwing liquidity at the markets, inflation was tame, and investors' appetites for risk were growing. Today, the economy is much stronger, the Fed is raising rates, energy costs are nudging inflation expectations higher, and risk premiums are starting to rise from very low levels as investor complacency begins to diminish. Even if more favorable conditions, similar to those of 2001-2002, existed, it is highly doubtful that the markets have the same upside potential that they had in 2002-2003. The potential rewards on the upside in most major markets are clearly not what they were four years ago.

In terms of timing, seasonal tendencies suggest that the transition to a higher-volatility, more directional trading environment might very well occur in the fourth quarter of this year. Examining the same data used to evaluate the absolute change in various markets, we can evaluate the tendencies of markets as a group to exhibit directional movement in each of the four quarters of the year. Using the same portfolio of 20 different markets, we calculated the average absolute change for each quarter of the year compared to the average change of all quarters. *Chart 8* presents the results that show directional movement has historically been well-above average in the third and fourth quarters of the calendar year and below average in the first two quarters. The fourth quarter in particular has shown the largest price changes, with the second quarter exhibiting the smallest. The year to date has followed this pattern closely, which suggests that the fourth quarter of this year might offer significant profit opportunities.

*Chart 9* presents the same data in a slightly different way, showing the number of markets, out of the 20 in the portfolio, exhibiting their largest price change in a given quarter. Almost half (9 of 20)

Chart 8

**Quarter-by-Quarter Seasonal Deviations from Average Return**

(Jan 1992 through Sept 2005)

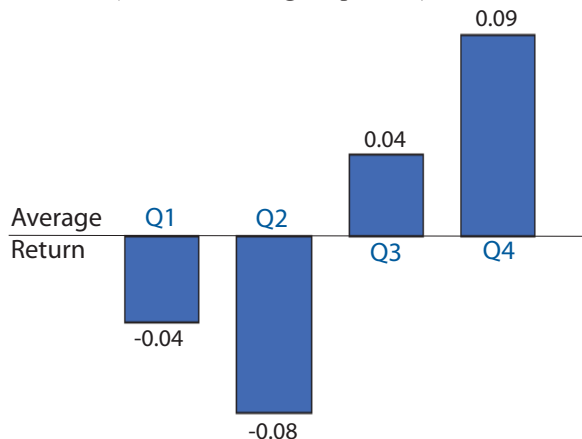
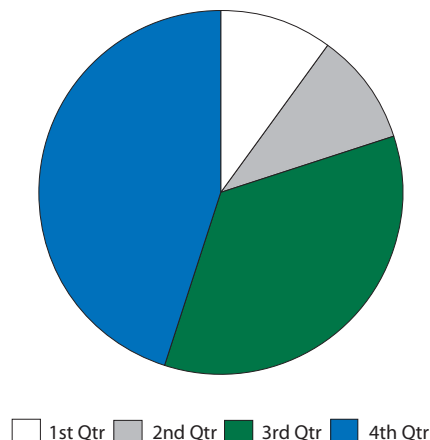


Chart 9

**Number of Contracts Having Greatest Relative Quarterly Price Change in Each Quarter**



of the markets historically have exhibited their largest price changes in the fourth quarter.

**Summary and Conclusion**

During the past 18 months, the directional trading strategies employed by most CTAs have underperformed their historical averages. Absolute return analysis supports the view that profit opportunities in 2004-2005 have been severely limited, but that there is significant potential for some major trends should a number of markets revert to their historical mean values. In reviewing the variations in performance across several different types of managed futures strategies, we saw that the most recent two year period favored a passive, long-only approach with virtually no risk control.

Although no one knows with certainty what future returns may be, we see a concurrence of

events indicating that upcoming market conditions are likely to prove particularly favorable for the very strategies that have struggled the most over the past two years – i.e., those with a directionally unbiased, multi-time-frame trading approach and tight risk control.

Given current market conditions and our view of their likely direction going forward, we believe that managed futures is the optimal strategy for allocating investment capital at this time. Managed futures never claimed to be an investment for all seasons, although there are many conditions in which the approach can generate positive returns. However, most managed futures trading strategies are ideally suited, particularly in comparison to the other investment alternatives, for periods of expanding volatility, increasing uncertainty, and bear markets – all of which, we believe, are distinct possibilities over the next 6 to 12 months.

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