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An Infinite Learning Curve

Scientists are said to have an infinite learning curve. No matter how highly educated and distinguished a scientist is, he or she continues to learn, as an editorial in NatureJobs.com pointed out some time ago. Scientists tend to remain curious about their subject. Good investors and traders are like that, too. They're always curious about what makes markets and people tick.

Peter Matthews, a pioneer trend follower and system builder, certainly fits that description. He got very excited telling us what he's learnt in the past several years and how it has changed his trading. Read his story in Founding Fathers.

Mack Frankfurter was just as excited explaining what he sees as a basic error in the calculation of the roll return on commodities. That may sound like a somewhat technical point, but it is potentially of great significance to investors. Mack worked hard to distill his lengthy and complicated study into a few pages for this issue's Futures Lab.

We were lucky, too, that Victor Sperandeo of Trader Vic fame took the time to explain the advantages and disadvantages of investable managed futures indexes. This is very useful Insider Talk about a growing niche. The Royal Bank of Scotland, by the way, is preparing to offer a new index product.

We heard from Aquila Capital about their distinctive new fund, which provides daily liquidity—see News Briefs. And reflecting on the dramatic lessons of 2008, Mike Covel has come up with a new version of his trend followers book—excerpts are in Practitioner Viewpoint. It's exciting to move along the learning curve.

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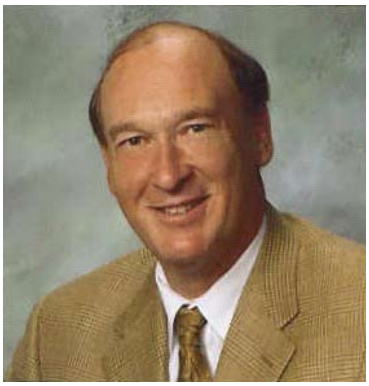
In This Issue

Building a Better Mousetrap



Peter Matthews

Peter Matthews developed the trading system of Mint Investment Management, which was the basis of Man Group's products until AHL took its place. In 2000, Dr. Matthews retired from trading other people's money. But he kept his interest in markets, continued doing research and chaired the Foundation for Managed Derivatives Research.

In 2004 he came back with a new model and in 2005 started to trade for Caxton Associates. Subsequently he founded PJM Capital and got seed money from a large fund of funds and a bank. Below he explains how markets work, why he built the new system and how it differs from other trend following models. He made 28% last year.

Opalesque Futures Intelligence: How did you get into futures trading?

Peter Matthews: I heard about futures in the late 1970s, when I was doing graduate work in statistics. Someone said you can put in only 5% and if you get it right, you can make 10 times on your money. I thought, Why didn't they tell me about this sooner? So I tested different ideas and found that trend following might work. Back then it was so much harder to do research. You had to find data and get time on a mainframe computer to do the programming. I was so obsessed with finding a way to make money trading futures that I would replicate the computer simulations by hand. I could not trust the computer.

OFI: How did you end up in a partnership with Man Group?

PM: Back then Man had a small brokerage and we did our trades through them. They noticed that our trades tended to work out while many of their other clients blew up. That was bad for the brokerage because it meant they always needed new clients. So the brokers branched out and started to market our system. They took a 50% partnership in 1984.

OFI: What helped Mint grow?

PM: Futures products were a hard sell in those days—and still are to some extent. They were thought of as too risky. We were the first to come up with a guaranteed fund. That was the key to making the product acceptable to the mainstream. Our first guaranteed fund was sold in Australia. The product has been much copied since then. Mint started with $2 million, grew to $1.1 billion by 1991. We were by far the largest in our field. I stayed in the partnership till 2000. I felt I had done all that I wanted to do, so I retired.

OFI: Why did you return to money management?

PM: In retirement, aside from the usual golf, I pursued the same intense interest I've had for decades in what makes markets tick. I was curious whether one could look at markets from a fresh perspective and develop a better mousetrap. With the Mint, we used a statistical

approach, that is, we looked at the data to design models and back tested them using historical data. Empirically, it worked. But I've always wanted to know why it worked. Once I understood that, I built a trading system based on a grounds-up understanding of markets.

OFI: How does this system differ from the previous statistics-based models?
PM: There is a science behind investment markets, which are complex adaptive systems. Many processes, from earthquakes to evolution, work this way. Complex adaptive systems may go into equilibrium from time to time but there are tremendous underlying forces that disturb the equilibrium. So a positive feedback occurs and a trend develops. That's the way these systems work. By late 2004, I had designed a trading model based on first principles compatible with the workings of complex adaptive systems.

OFI: Which markets does this model apply to?
PM: I still trade in the same markets and follow trends, but the tactics I use differ from other traders'. All liquid futures markets that you can trade electronically – commodities, currencies, bond futures – are examples of complex adaptive systems with the same potential paths and risks/rewards.

OFI: Is your new model better?
PM: Since I built the original Mint systems, I have an apples-to-apples direct comparison with the way I used to do things with the Mint models. The science led me to a better solution. Once you realize how dangerous complex adaptive systems are, you know it's all about risk and survival. You have to focus on risk because anything can happen. Focusing too much on identifying trends is a mistake. The issue is always risk.

OFI: What do you do about risk?
PM: If markets go against you, you need to get out. As an industry, we do that. What I do is a more scientific version. I make sure that the model adapts. Many people in the investment business do not cut their losses until it's too late. They say their value at risk is such and such, but they don't take action when the risk numbers are hit. When I talked to an endowment over a year ago, I explained how they could lose out in every one of their asset classes. They thought that explanation did not apply to them, but in fact they had a terrible time in 2008.

OFI: Did your system adapt last year?
PM: What happened in 2008 was not surprising if you think in terms of complex adaptive systems. Markets going down 40%, big shifts in trends—none of it is surprising. People were surprised because they think in terms of normal distributions. We've been using the model since 2004. The past year was the best possible test for it. All kinds of unprecedented things happened, like Lehman Brothers going under. Yet when you look at our daily returns, they're smooth as silk, because our model adapted to the changes. In 2005 and 2006 we did all right, but getting through 2008 was the real test. It showed that our system adapts.

OFI: What's going to happen this year?
PM: I do not make predictions. Complex adaptive systems have so many potential paths, you can't predict which one will happen. Most risk is not contained in value-at-risk bounds. I can say that managed futures are not just an alternative investment, we're the solution to the problem investors have. We're the real hedge funds. Strategies like long/short equity just track the market.

OFI: Will there still be trends to trade on?
PM: There will be trends because the nature of complex adaptive systems is that equilibrium is not sustainable. Equilibrium is the best time for us to invest, because it looks like everything is quiet but underneath the surface the plates are shifting and there's potential for an earthquake.

OFI: What could go wrong with your model?
PM: It's not about the model but the whole game would change if the government takes control, nationalizes banks, takes over commodity exchanges. Then there will no longer be a self-organizing market, so it won't be a complex adaptive system. If someone imposed control over the many people that make a market, the market would no longer work through adaptive processes. That would be a sign to me to simply stop trading. That's the advantage of knowing what makes markets behave the way they do.

"There is a science behind investment markets, which are complex adaptive systems."

Is "Roll Yield" a Fictional Return?

This article is an extract from *"Term Structure and Roll Yield: Not Your Father's Backwardation,"* a paper by Michael "Mack" Frankfurter, managing director and co-founder of Cervino Capital Management and chief investment strategist of Managed Account Research Inc. Mr. Frankfurter will continue this discussion in future articles.

Term Structure and Roll Yield

Question: if something is stated repeatedly as fact, does that make it necessarily true? We no longer believe the sun circles the earth, but that idea was once conventional wisdom.

A similar issue faces investors who use passive commodity indexes. In a recent Financial Times story, "Steep 'contango' forces traders to adapt commodities plans", we are told that investors in commodity index products "obtain a separate return, known as the roll yield, as they shift their positions each month from the expiring futures contract into the following month." This idea is so commonly asserted that it is accepted as fact—but is it?

The problem is that empirical tests using a variety of models have produced inconsistent conclusions as to whether there is in fact positive expected returns from speculating in the futures market. This is vexing to financial institutions who sell products structured around commodity benchmarks such as the S&P GSCI or DJ-AIG, and who need to "market" a structural source of return in what is essentially a zero-sum game.

Notably, ten years ago mainstream thinking about commodities was largely negative. Thomas Schneeweis and Richard Spurgin in their 1996 paper, "Multi-Factor Models in Managed Futures", stated that the low level of investment in managed futures was due to the fact that investors required both a theoretical basis and supporting empirical results.[1] In other words, prevailing wisdom at the time was against speculation in commodities.

The industry's marketing solution came in the form of a series of studies over the past decade of which the most cited is "Facts and Fantasies about Commodity Futures" written by Gary B. Gorton and K. Geert Rouwenhorst, two Yale University academics.[2] After their paper was referenced by Jim Rogers in his book Hot Commodities, the concept and theory of the roll yield became well established in the investor mindset.

Our working paper "Is Managed Futures an Asset Class; The Search for the Beta of Commodity Futures" nonetheless takes issue with Gorton and Rouwenhorst's conclusions.[3]

To begin with, the roll yield is derived from a simplified definition of backwardation and contango based on what Hilary Till, co-editor of Intelligent Commodity Investing, describes as the "term structure of the futures price curve." Nowadays, backwardation is commonly defined as conditions when "the futures price is below the current spot price" and contango as conditions when "the futures price is above the current spot price."

However, this paradigm is not in line with the original definition of normal backwardation as described by John Maynard Keynes (1923, 1930), and related phenomena identified by Nicholas Kaldor (1939) and Holbrook Working (1948, 1949).[4] Classically, backwardation and contango correlate the futures price to the "expected future spot price," which is an unknown, to be discovered in the future, at the time the futures converges with the spot.

This difference in assumptions is not insignificant. The conundrum is that for every buyer of a commodity futures contract there is a seller—sine qua non, there is no intrinsic value in forward contracts. They are simply agreements which commit delivery of an asset at some place/point in time. So how does rolling contracts yield positive expected returns?

Rolling the Futures Contract Backward

Futures and forward contracts, unlike securities, are instruments with a finite life and terminate on pre-

specified dates when the futures contract converges with the spot price. At that point the spot price is discovered and delivery of the underlying cash commodity is made between commercial participants.

A wheat futures contract, for example, has delivery contracts for March, May, July, September and December. For this reason, and as a matter of practice, most speculators do not allow their positions to enter the delivery period, and a perpetual long futures position requires a trader to "roll the contract" from one contract month to the next.

A close look at the studies written by proponents of the roll yield reveals use of a model or algorithm that results in a fictional trade. Rather than rolling the futures contract forward, they in effect roll the futures contract backward to provide "proof" for their thesis. This is facilitated with the assumption that the "expected future spot price" is a pre-determined static constant, which it is not.

As a real world example, let's assume that a trader goes long a March futures contract at $100. The trader subsequently rolls that contract in sixty days by selling it at $120, and simultaneously reenters the long position via a July futures contract at $121. Another sixty days later the trader exits the position altogether by liquidating the July contract at $111.

The long March futures contract trade results in a $20 realized gain and the long July futures contract trade results in a $10 realized loss. Using a simple method for calculating rate-of-return of an investment, the net gain of $10 is divided into the original $100 March futures contract price, resulting in a 10% return. This is straightforward and logical.

By contrast, the model for calculating the roll yield is complicated and arguably illogical. The following example is based on formulas conventionally used by researchers to calculate roll yield as documented by Till.[5]

Let's assume a trader goes long a March futures contract at $100, and then sixty days later sells the March contract at $120. The net gain of $20 is then divided into the original investment of $100 resulting in a 20% return. This is referred to as the "spot return."

Now at the time the trader purchased the March futures contract, assume that the July futures contract was trading at $90. The algorithm for calculating the roll yield then subtracts this $90 July futures contract price in the past from the current $120 March contract liquidation price. This is called "excess return" and the net gain of $30 is then divided into the $90 July contract price for a 33% return.[6]

COMMODITY RETURN SOURCES

SPOT RETURN

Gain or loss from changes in the underlying spot prices. When the spot price of the commodity rises, the value of the futures contract tends to rise.

COLLATERAL RETURN

Interest on the deposit required to trade derivatives.

STRATEGY RETURN

Some analysts refer to a return derived from how one weights and rebalances the components of a commodity index.

ROLL RETURN

Generated by owning a futures contract for a time, and subsequently selling that contract and buying a longer dated contract on the same commodity.

The "arithmetic roll yield" is calculated by subtracting the spot return of 20% from the excess return of 33%, which results in a supposed 13% return to the investor. Obviously, this mathematical trick mixes up past and present prices, and creates roll yield out of an imaginary transaction that is impossible to duplicate in the real world.

Admittedly, models are an abstraction from reality. Expecting such models to be exactly right is unreasonable, and it is generally understood that neoclassical economic models have inherent limitations. Ergo, we must be careful not to follow models over a cliff.

As noted by Robert Greer in his paper "What is an Asset Class, Anyway?", the inherent problem with investing in commodities as an "asset class" is that they are not capital assets but instead consumable, transformable [and perishable] assets with unique attributes.[7]

By definition, any commodity trading facilitated for financial rather than commercial reasons is speculation. Further, derivatives are risk management tools, fundamentally different from the "rising tide raises all ships" concept of the capital formation markets.

Investors should recognize that commodity markets are more complex than what many proponents would have you believe. In truth, the "zero-sum conundrum" makes it impossible to isolate a persistent source of return without that source eventually slipping away.

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Trader Vic's Case for Long/Short Indexing

Victor Sperandeo

"If inflation starts up in a year or so, the indexes will be extremely profitable."

Victor Sperandeo, a veteran trader, founder of Alpha Financial Technologies and the author of the "Trader Vic" series of books on trading, has created several successful investable trend-following indexes. A new product, named the Trader Vic Index, is being launched by the Royal Bank of Scotland.

What are the pros and cons of index investing in managed futures? We asked Mr. Sperandeo. He, Laurence Black, who heads Thematic Research and Indexes at the RBS, and Fred Magnanimi of Alpha Financial argue that this type of investment has significant advantages.

Alpha Financial manages S&P DTI, a long/short commodity and FX Index used in the Rydex Managed Futures Fund, a US Mutual fund, as well as two sub-indexes, one in commodities and the other in FX and US Treasuries. The sub-indexes are the basis of the Direxion Commodity Trends and Direxion Financial Trends mutual funds.

Opalesque Futures Intelligence: What does an investable index mean in the managed futures context?

Fred Magnanimi: An index is a basket of futures contracts. The new Trader Vic Index has 24 components spread across physical commodities, global currency and US Treasuries. These are all highly liquid, US traded futures contracts. The idea is go long and short to reflect cyclical trends across these markets. The dislocation in the hedge fund industry benefits this type of product, because investors want the liquidity and transparency indexes provide.

OFI: How do current conditions affect index performance?

Victor Sperandeo: The equity rally was the big event in March. Commodities and equities are correlated—when equities improve, commodities also tend to improve. Although our index does a great job in providing robust returns over the course of a year, the fact is that passively driven investments do not do as well at turning points. The index adjusts with a lag, so you don't get the big returns we like to see.

OFI: So, this was a situation where the index is a disadvantage?

VS: Where I had discretion to change positions before the index did, I did anticipate the equity market shift. Our discretionary trading did far better in this rally than passive investments. Stocks had gone down too much. Governments are doing everything they can, throwing the kitchen sink to turn economies around. That caused short sellers to back off a bit and cover the shorts. For those reasons, we bought at the market lows.

OFI: Do you change the index components when markets change?

VS: We make a point not to change the algorithm. You just get into trouble trying to fiddle with it. If you fiddle with the index because it is not working in the current environment, then it does not work once the environment changes. We developed these concepts in 1999. The first index we created has been in use since 2001 and performed better than the back testing indicated. These indexes are created to be very robust over 12 month periods.

OFI: You don't make any adjustments at all?

VS: We like to keep things the same for the sake of consistency. But there are events that force us to change the index, as for instance when a gas contract was delisted and we had to substitute another contract for it. If the British pound were to merge with the euro, we'd have to account for that. That's not likely to happen but if it did, we'd have to change the allocation. We have a committee for such emergency changes.

FM: What we like about having the same algorithm is that clients can go back in time and model what our strategy does for their portfolio. Because it's the same basket, you can rely on the track record and lack of correlation to major markets. If the trading allocations were a moving target, then the track record would become a less effective way to assess the strategy. So continuing with the same basket adds value.

OFI: But what about these periods when investable indexes can't catch up with the market?

FM: With the new index, we're going to have two versions. The base index will be fixed but there will be another version where the investment committee will be able to make discretionary changes. The reason for the second version is that in transition periods the index can lag the market, as Victor said. Adding an element of discretion helps when markets change fast.

OFI: Who's likely to invest in the new product?

Laurence Black: We expect it will appeal widely to three categories of clients, namely sophisticated retail investors who understand the benefits, private banks and their high net worth clients who want to reduce the volatility in their portfolios, and institutions. We have the technology to deliver this strategy in a wide variety of formats.

OFI: Does the rest of this year look favorable for futures indexes?

VS: Indexing is a lagging process. While very robust over 12-month periods, it is not necessarily robust in any one month. I suspect the upswing will continue and that will benefit passive investments. If inflation starts up in a year or so, the indexes will be extremely profitable.

NEWS BRIEFS

Aquila Launches UCITS CTA

Aquila Capital Group has made its Pharos managed futures program available as a European mutual fund product with daily liquidity within the UCITS III legal structure.

Pharos Evolution Fund, launched March 6th, is subject to Luxemburg regulators' requirements such as having a custodian and independent administrator.

Lauren Damask, an executive at Aquila, said daily liquidity is possible because the fund does only intra-day trades and does not carry positions overnight. Positions are closed at end of each trading session if not earlier. She says this is the first UCITS commodity trading advisor fund.

The investment strategy has been in operation since 2001 in other investment vehicles and made 24.7% in 2008. According to Aquila, the Pharos program was ranked in the top 20% of more than 2,000 hedge funds tested by Harry Kat, an academic researcher and specialist in replicating hedge fund returns.

Professor Kat found that Pharos generates 41 basis points of returns per month that cannot be replicated.

Aquila Capital has about $2.4 billion of assets under management and is not a newcomer to UCITS regulation. It manages SVMN Multi-Asset Fund, another UCITS III pool. SVMN returned 11.3% in 2008.

Ms. Damask says alternative strategies are being increasingly offered in the UCITS framework but there aren't too many such funds and Aquila is a pioneer in this area.

Price Group Expands

Chicago-headquartered Uhlmann Price Securities LLC and its affiliate Price Group opened a new office in Lake Oswego, Oregon, that will be managed by Dick Ebel. Mr. Ebel joined Uhlmann and Price Group after 35 years with UBS Securities. He has experience in both securities and commodities

"This is an opportune time to be expanding our market reach when many firms are downsizing," said Tom Price, president of Price Futures Group. "Dick will be instrumental in recruiting new brokers for our companies in this location as well as other areas we have strategically selected."

Uhlmann Price Securities, founded by Fred Uhlmann, former chairman of the Chicago Board of Trade, is a securities broker and investment advisory firm that offers traditional and alternative investments including managed futures products and commodity index funds.

Price Group is an independent introducing broker with MF Global and has branch offices in Arizona, Florida, Georgia Nebraska and Texas.

Stark Offers New Data Service

Managed futures consulting and research firm Daniel B. Stark & Co. started a web-based version of its commodity trading advisor database, available by subscription.

"Not only will users of the database have expanded access to both qualitative and quantitative CTA information, but the development of the new system will allow us greater flexibility to continuously add new functionality and improved research and analysis tools," Mr. Stark said in a statement.

The firm, which goes back to1987, tracks the performance of nearly 600 CTA programs and futures funds. It publishes 12 proprietary CTA and fund indices. The new STAR CTA database includes CTA rankings, corporate profiles and individual program profiles covering a variety of quantitative information and analytics.

Wine Futures Weaken

According to *The New York Times*: The crowd of merchants, consumers and investors that flock to Bordeaux every year for tastings has thinned out. The tastings are done to sell wines still in the barrel and are known as the futures campaign. Financial industry bonuses in the go-go years may have created a wine bubble that is now deflating as buyers turn to sellers. An index of fine wines, the London International Vintners Exchange's 100 Index, nearly tripled in dollar terms from February 2005 to August 2008. Then it plunged 48%. But a specialist quoted in the NYT story says people have not reduced their overall consumption of wine, rather they've traded down in price.

MANAGER PROFILES

There is a growing number of fund of funds devoted to commodity trading advisors. The following managers specialize in this type of investing. Here they describe their approaches, demonstrating the diversity among multi-advisor products. Their comments have been edited.

We will feature other multi-advisor managers in future issues.

Kim Avery

Autumn Gold Portfolio Management, Scottsdale, Arizona.

Kim is the manager of Autumn Gold Multi-Advisor Fund LP, a newly launched CTA investment vehicle. She will select advisors for the fund using a proprietary system that she developed during her thirty-year career in the futures industry.

In her book, Building Wealth with Managed Futures, she explains the statistical methods for evaluating a CTA and how to select traders for a diversified portfolio. These methods of evaluating risk, limiting leverage, and diversifying across trading styles and markets traded are some of the fundamental strategies that she employs. Ms. Avery is also the founder of AutumnGold.com, a database and statistical analysis service that has tracked CTAs and hedge funds since 1997.

She worked for a number of firms including E.F. Hutton, Merrill Lynch, Balfour Maclaine Futures, Price Group and Futures Asset Management. From July 1992 through March 1998 she was a European representative for Renaissance Technologies, the manager of Medallion Fund, a hedge fund with more than $5 Billion in assets.

Autumn Gold Multi-Advisor Fund is new and does not yet have a track record. The following return is for a CTA index from the Autumn Gold database.

Autumn Gold CTA Index 2008 return: 21.42%

Comments: "In the current economic environment there is a driving need for investment products that provide both transparency and liquidity. This futures fund is designed to address those requirements. It targets returns not correlated to traditional stock/bond portfolios and provides daily valuations and weekly liquidity.

With the volatility in the financial markets since September 2008, investors have been looking for calmer waters to ride out the storm. Many people are looking to move capital from stocks and hedge funds into other investment classes that are non-correlated to equities. Transparency and long-term lockups are a concern for all investors

The majority of futures funds report their trading performance after month-end. Investors wishing to redeem often are limited to monthly or quarterly withdrawals with 15 days or more notice

We will provide investors with a daily valuation for Autumn Gold Multi-Advisor Fund. In addition, investors will be able to see the fund's aggregate daily positions, including the number of long and short contracts. Investors will have the ability to make subscriptions and redemptions on a weekly basis."

James Edwards

London-based chief investment officer of Eurogestion & Partners SA, Geneva, Switzerland.

James was previously at UBS, as executive director of UBS Wealth Management Hedge Fund Advisory business and member of the UK Investment Committee. Before that he was CIO at Mizuho Investment Management in London and CIO of BAREP Asset Management, the alternative investment subsidiary of SG Asset Management in Paris. At BAREP he launched and managed credit and emerging market hedge funds.

Solaris Global Commodities Fund 2008 Return: 17.9

Comments: : "The fund is designed to harness the profit potential and volatility of global commodities markets in both rising and falling markets. SGCF invests with a diversified pool of eight to 15 best-in-class commodities specialists, selected to generate risk-adjusted performance and to offer full diversification in terms of markets (energy, industrial and precious metals, agriculture, meats and softs) and strategy (systematic and discretionary, trend-following and non-trend-following, technical and fundamental, directional and relative value).

The underlying managers trade highly liquid futures contracts on a managed accounts platform that provides optimal risk management capabilities through full transparency. SGCF offers monthly liquidity.

SGCF is managed with a dynamic bi-monthly allocation and rebalancing process, which enables the fund to quickly adapt to changing market conditions and to focus on the most attractive opportunities in order to be able to generate returns and adjust its risk parameters, whatever the direction of commodity markets. SGCF targets an annualized return of 12%-15% with a downside volatility target of less than 12%."

Below is an extract from Mr. Edwards' 2009 outlook, previously published in the Eurogestion monthly review.

"The hedge fund world has seen a number of spectacular blow-ups in 2008 and the industry has, on average, lost about 20% in performance. In addition managers, almost without exception, have seen a further 20% to 30% of their assets under management disappear as investors put in redemption requests to reduce their exposure. In other words, the hedge fund industry is likely to begin 2009 with at least 40% less assets than it had in 2008, a dramatic cleansing!

The dinner party talk of everyone setting up a hedge fund is, like the dot.com dinner party talk of the turn of the century, well and truly over. The once rosy outlook for hedge funds is thankfully subject to new scrutiny and we expect that the number of hedge fund closures will increase in 2009 as investors pull their cash and there is a re-allocation towards either proven alpha generators or back to long only.

This represents a historic opportunity for investors who understand the nature and dynamic of alternative investing to increase their exposures or make their first initial forays. The key skill set for investors is to identify the managers that will survive and, more importantly, that have the necessary investment skills to profit in the new liquidity starved, low leverage environment.

Certain broad strategies are expected to benefit from the continued volatility and uncertainty. Managers who are good disciplined traders in the broad macro space, including currencies, rates, commodities, anything liquid, should have plenty of opportunity. Equally there is still more juice in the CTA community and we see little reason for the short term CTA's to stop generating performance.

We are living through a long and painful, but ultimately healthy rebalancing. Change is progress and evolution. And in evolution, those who cannot adapt to changes in the environment eventually wither and die. We expect the pickings for those that survive to be huge."

Following the Winners

The first edition of Michael Covel's Trend Following: Learn to Make Millions in Up or Down Markets came out in 2004. It offered useful insights as to how successful futures traders make money. Mr. Covel has written an updated edition that contains even more useful information and insight. Below are excerpts from the new edition, published February 2009 and available from FT Press.

The world changed in October 2008. Stock markets crashed.. Millions of people lost trillions of dollars when their long-held buy and hold strategies imploded. The Dow, Nasdaq and S&P fell like stones, with the carnage carrying over to November 2008. Most everyone has felt the ramifications: jobs lost, firms going under and fear all around. No one made money during this time. Everyone lost. Hold on, is that really true? It is not true.

Wall Street is famous for corporate collapses or mutual fund and hedge fund blow-ups that transfer capital from winners to losers and back again. However, interestingly, the winners always seem to be missing from the after-the-fact analysis of the mainstream media. The press is fascinated with losers. Taking their lead from the press, the public also gets caught up in the drama and narrative of the losers, oblivious to the real story: Who are the winners and why?

The performance histories of trend followers during the 2008 market crash, 2000-2002 stock market bubble collapse, the 1998 Long-Term Capital Management crisis, the Asian contagion, the Barings Bank bust in 1995, and the German firm Metallgesellschaft's collapse in 1993, answer that all important question: "Who Won?"

There were winners during October 2008 and they made fortunes ranging from 5% to 40% in that single month. Who were the winners? Trend followers. How did they do it?

First, let me state how they did not do it:

1. Trend followers did not know stock markets would crash in October 2008.
2. Trend followers did not make all of their money from shorting stocks in October 2008.

What did they do? Trend followers made money from many different markets from oil to bonds to currencies to stocks to commodities. Trend followers always seem to do particularly well in times of wild and extended price swings, in part because their trend following trading systems programmed into computers can make calculated, emotionless buys and sells that human traders might be slower to accept.

The market crash of 2008 offered fantastic data to see how trend following is so different from most of the investing world's mindset.

Logically, it is difficult to keep saying trend following is risky, especially in the face of "leveraged buy and hold" approaches that cratered in 2008, but then again who said most of Wall Street (what's left of it) is logical. I have these same conversations with many top trend followers. I sometimes think they scratch their heads that so many people don't take advantage of what they offer. …

Maybe 2008 will be the tipping point for acceptance, but I would not bet on it!

Batting Average

The period from 2000-2002 was littered with volatile up-and-down markets. Although the prime story for that three-year period was the Nasdaq meltdown, several subplots also existed ranging from September 11 to Enron to trend following drawdowns and subsequent recoveries to new heights.

(For most of 2000) trend followers were in a nasty drawdown. They were down significantly heading into the last few months of the year. The press and skeptics were calling the strategy finished. … (But) the tide was turning.

People place too much emphasis on the short-term performance of trend followers. They draw conclusions about one month's performance and forget to look at the long-term. Just like a batting average, which can have short-term streaks over the course of a season, trend followers have streaks. Trend following performance does deviate from averages, but over time there is remarkable consistency. …

One of the main reasons that trend following trading does well is because it has no quarterly performance constraints. It is opportunistic. What do I mean? Both Wall Street and Main Street measure success on the artificial constraints of the calendar. For example, looking back at the end of 2000, you see that without November and December offering such huge home runs, trend followers would have had a terrible year. For those people who judge trading success by "quarters," trend followers were dead the better part of 2000.

The whole idea of quarterly performance reporting implies you can predict the market or successfully shoot for profit targets. Quarters as a measurement might not be real, but they provide a comfortable structure for investors who mistakenly believe they can demand nice, consistent profits. …

Imagine playing football where there are four quarters and you have to score in each quarter to win. … If a trend follower scores 28 points in the first quarter and no points in the next three quarters and wins, who cares when he scored? Wall Street's misguided emphasis on quarterly performance puts more importance on scoring each quarter than it does on winning the game.

The alternative is to become a home run hitter and take what the market gives no matter when it arrives.

Critical Thinking

Trend followers, like physicists, approach their world with an open mind. They examine and experiment. Like physicists, they think critically and ask smart questions. The skill of asking objective and focused questions (and then finding the answers) is a key reason why trend followers excel. To be successful as a trader, to be successful in life, you need to develop an ability to ask those right questions, those smart questions. …

Unfortunately most people do not ask critical questions when it comes to money and markets. Bernard Madoff is the great example…. The questions they do ask tend to be superficial and ill-informed because they have not taken ownership of the issue. Instead they ask dead-end questions (along the lines of) "Is this going to be on the test?" …

I hope investors who have asked few questions so far and, as a result, been beaten down by their rote memorization of the mantra "buy-and-hold is good for you" will finally ask critical questions and scientifically examine data for themselves.

Act as a devil's advocate. Question assumptions. Check your inferences. Consider the improbable or the unpopular.

FINRA Bids to Oversee Investment Advisers

Richard Ketchum, chairman and chief executive of the Financial Industry Regulatory Authority, testified before the US Senate Committee on Banking, Housing, and Urban Affairs on March 26th. As part of the testimony he talked about regulatory differences between broker-dealers and investment advisers and what needs to be done to make the rules more consistent. He says FINRA is "uniquely positioned" to build an oversight program for investment advisers. In addition, he raised the issue of the fiduciary responsibility of broker-dealers to their clients. Here are his comments on these points:

> There are differences in the current rules and standards that apply to broker-dealers and investment advisers, reflective of some of the differences that exist in the services provided by each class of professionals. And while the two channels have converged over the years, there remain some differences that need to be taken into account when enhancing oversight and exams to make that oversight fit the activity and services in each.
>
> Broker-dealers are subject to a very detailed set of rules established and enforced by FINRA that pertain to safety of customer cash and assets, advertising, sales practices, limitations on compensation, financial responsibility, and trading practices. FINRA ensures firms are following the rules with a comprehensive examination and enforcement regime.
>
> Investment advisers are subject to provisions of the Investment Advisers Act of 1940 that pertain to registration, disclosure, record-keeping, custody and compensation. Importantly, investment advisers are also subject to a fiduciary standard with regard to their clients. In designing a more regular oversight and examination program for investment advisers, these rules and standards should be taken into account.
>
> Simply put, FINRA believes that the kind of additional protections provided to investors through its model are essential. Does that mean FINRA should be given that role for investment advisers? That question ultimately must be answered by Congress and the SEC, but FINRA is uniquely positioned from a regulatory standpoint to build an oversight program for investment advisers quickly and efficiently. We have a strong track record in our examination and enforcement oversight, as well as in our other core programs. Certainly in the registration area, with regard to investment advisers and mortgage brokers, we have two success stories of adapting our infrastructure to meet needs in areas beyond the realm of broker-dealers. …
>
> We believe that regular and frequent exams are a vital component of effective oversight of financial professionals, and that the absence of FINRA-type oversight of the investment adviser industry leaves investors without that critical component of protection. In our view, it simply makes no sense to deprive investment adviser customers of the same level of oversight that broker-dealer customers receive. And quite simply, as we learned from the Madoff scandal, it would not make sense for two, separate independent regulatory bodies to oversee investment advisers and broker-dealers, especially when they exist in the same legal entity. Again, there would be no single regulator with a complete picture of the business.
>
> One of the primary issues raised about investor protection differences between the broker-dealer and investment adviser channels is the difference between the fiduciary standard for investment advisers and the rule requirements, including suitability, for broker-dealers. As this the process moves forward, this is the kind of issue that should and will be on the table as we all look at how best to reform our regulatory system and strengthen investor protections. In keeping with our view there should be increased consistency in investor protections across financial services, we believe it makes sense to look at the protections provided in various channels and choose the best of each.
>
> We stand ready to work with Congress and the SEC in exploring whether a properly designed fiduciary standard could be applied to broker-dealers' selling activities, and if there are problems raised, make a strong effort to resolve those problems.

We will feature top managers from a different database every month.

This issue's ranking is from Barclay Hedge. The Barclay managed futures database has been in operation for over 20 years. It is updated twice-monthly and covers 910 managed futures programs. Below are the top CTAs managing more than $10 million. Barclay has separate rankings for CTAs with less than $10 million assets and for sub-strategies including agricultural, currency, discretionary, systematic and stock index traders.

For an interview with Barclay Hedge founder Sol Waksman, see the February 10th issue of Opalesque Futures Intelligence.

Barclay Hedge Top Ten CTA Programs Managing $10 Million and Above

Manager and Program	Feb Return	2009 YTD Return
Oxeye Capital Mgmt. FTSE 100 Futures/Options	7.6%	19%
Fort Orange Capital Mgmt. Global Strategic	7.1%	4.8%
Clarke Capital Mgmt. FX-Plus	6.5%	-2.1
Linn, Hare, Huckabay & Associates Apex	5.6%	6.6%
Aisling Analytics Pte Ltd. Merchant Commodity Fund	5.3%	5%
Friedberg Commodity Mgmt. Currency	5.2%	-13.8
Quicksilver Trading Inc.	5.1%	8.2%
Capital Alternative Inv Mgmt. GmbH	5%	15%
Ansbacher Investment Mgmt. Elizaville Partners	5%	7.6%
James River Capital Corp. Navigator Futures Fund	4.9%	5.8%

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