



CTA ConfidentialSM

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into managed futures trading programs"

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Vaca Capital Management, LLC.

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Global Diversified Program

PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS. INVESTING IN FUTURES AND OPTIONS INVOLVES RISK AND MAY NOT BE SUITABLE FOR ALL INVESTORS. THEREFORE, INVESTORS SHOULD CAREFULLY CONSIDER THESE RISKS AND DETERMINE WHETHER THEY ARE SUITABLE FOR INVESTING IN LIGHT OF THEIR FINANCIAL CONDITION AND INVESTMENT OBJECTIVES.

Vaca Capital Management, LLC (Vaca) is a commodity trading advisor (CTA) established in 2000 by Dr. Francisco Vaca, chairman, CEO and principal trader for the company, and Paul Rabar of Rabar Market Research, Inc. Dr. Vaca began his career in the futures industry in 1996 as an executive researcher for C&D Commodities co-founded by Richard Dennis of "Turtles" fame. His responsibilities included the research and implementation of systematic trading strategies for the futures and equities markets. In 2000 he formed Vaca after gaining valuable insight into the workings of the commodity markets and trading system development from his tenure at C&D. Dr. Vaca holds a Ph.D. in physics from the University of Illinois at Chicago in addition to his undergraduate degrees in both physics and mathematics. Mr. Rabar does not participate in trading decisions, but does provide operation and trading support to the CTA.

As a physicist Dr. Francisco Vaca likes to understand the nuts and bolts of trading systems. "Why does it work? What's driving it? Can I come up with a hypothesis? Can such hypothesis be tested? Why should we make money in the futures market? Is it the futures market or is it the timing of when I get in or out?" These questions go to the heart of the 'source of return' question that astute investors ask traders.

The answer according to Dr. Vaca follows in the tradition of Keynes' (1930) theory that there is a risk premium built into the futures market, and the key is to capture/harvest this premium. In other words, the edge is built into the market, and "all this getting in and out of the market is just a vehicle to extract risk premium." Therefore, if a trader is going to get paid for taking risk, the key is figuring out how much one can get paid per unit of risk taken. Hence, the focus should be on managing risk and returns will follow.

Armed with a doctorate in physics and undergraduate work in math, Dr. Vaca gained real world experience in the trading of futures and forward markets under the employment of two managed futures legends, Richard Dennis and Bill Eckhardt of C&D Commodities. Originally on track to develop a career in experimental particle physics, Dr. Vaca came to a crossroads in his life involving his other passion—trading. That opportunity came as research analyst for C&D Commodities where he performed programming, market and strategy research, strategy implementation and studying risk-reward metrics of strategies.



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After working at C&D Commodities for five years Dr. Vaca founded Vaca Capital Management and was joined by fellow C&D alumni Paul Rabar. In June 2001 he launched a high frequency equities program, and then started trading the Global Diversified managed futures program in June 2004. One of the things that Dr. Vaca did early on while putting together his managed futures system was to ask himself how an allocator puts together a portfolio of CTAs. Typically this involves finding as much divergence between different styles and trading timeframes. This became the impetus for developing a multi-style approach.

The Global Diversified program is actually a combination of 16 different systems involving four main styles of trading: pattern recognition, momentum, trend-following and counter-trend. Each of these styles are equally weighted 25% each. Additional diversification is achieved by implementing each style using both a short term 5-10 day holding period, and a medium term 30-60 holding period. Last, and probably most importantly, there is a “probabilistic overlay” which determines bet size.

“In any system that has an edge, the betting scheme is a great part of what you do because it can amplify your profits,” says Dr. Vaca. “The overlay will determine whether to make larger or smaller bet size based on the strength of the trade signal.” Essentially what the system does is look at current volatility, current market momentum and current price relative to historical pricing, and compares those values against 25 years of data to identify market profiles that reflect a similar situation, and then determine the probability. This “outside observance” is used to adjust the order size. “If the odds do not look good, then the original bet size is decreased. If the probability is so low, the system may adjust bet size to zero.”

What is really interesting is that the probabilistic overlay doesn’t occur just at the initiation of the trade, but over every single day of the life of the trade. The result is a dynamic and adaptive system. For example, the longer the persistence of a trend, the greater the likelihood such persistence will come to an end. As explained by Dr. Vaca, “It becomes harder to find similar profiles of such market conditions, and at some point the overlay will signal to reduce or even eliminate the position entirely.”

Dr. Vaca believes that the combination of the multi-styles coupled with the multi-timeframe, coupled with the probabilistic overlay is what gives the system a risk-reward advantage. “Others may use probability, but not in the same way. This is the only way that makes any sense to me—it’s like a blackjack game. Now that I have an edge, how many chips am I going to buy given the cards I’m dealt.” One way Dr. Vaca has tested his hypothesis is by turning off the probability filter, and then turning it back on or recalibrating it to see if there is an improvement in returns.

With respect to money management, the Global Diversified program has various methods of managing risk and liquidating positions. One is based on market action; another is volatility; third is liquidations based on the probabilistic overlay; and if everything fails, the program maintains a “hard” trailing stop. As Dr. Vaca explains, “At some point you have to draw a line and say this is a model. Models are only as good as their programming, and you need to make sure that you keep models boxed-up. You never want to give a model an unlimited amount of potential risk trading the markets.”



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When it comes to systems trading, winning trades by construction tend to persist longer and result in bigger dollar winnings. Losing trades, on the other hand, tend to be short-lived with smaller dollar losses. The way Dr. Vaca calibrates overall risk limits is by determining risk on a daily basis on a per trade basis, per market basis, per sector and finally at the portfolio level. As he explains, “We want to know our odds. What is potentially going to be our worst day.”

Yet, Dr. Vaca also admits that there are limitations to systems and models. “Once you approach semi-scientific endeavors such as medicine or trading, it’s not arithmetic anymore. Nobody can say that one plus one equals two. We don’t know. Risk management is about giving investors a best estimate of what they’re getting themselves into. It’s one thing to calculate the risk on any one trade, but the truth is that you live and die by the sum of multiple risk factors, which is why we also calculate portfolio risk.”

As to opinions about the current macro-economic situation, it has been Dr. Vaca’s long-lasting policy to not comment on any future market expectations. “I’m not an economist; that’s not what I do.” Given twenty-five years of data in his database, the system theoretically works in many different kinds of markets and economic environments. However, as to what may actually happen in the future... “nobody knows”.

In the final analysis, what is important is having a robust multi-style approach that adapts to underlying market conditions. “Systems should be designed to understand how to navigate volatility, including rapid increases in volatility and rapid decreases in volatility. This can be achieved by varying bet sizes, but if a system is adjusting on volatility and ignoring the probability of the move to continue, then the system may suffer a reversal.” Dr. Vaca’s point here is the turnkey idea which differentiates his approach.

“We want markets to move, but not in the sense that there is panic,” says Dr. Vaca. “In other words, we don’t want parabolic moves because when we get to that extreme high volatility, basically you can’t make any money. Markets become so erratic that they move from one extreme to another and it becomes very hard to predict direction. What we want is mild to high volatility. Why? Because then the pullbacks and deviations are not exaggerated so you can get your arms around it and actually trade it.”

According to Dr. Vaca, because markets cycle through various conditions investors need to approach managed futures with a more realistic timeframe. “I always tell people that if you are not able to park your money for at least three years, don’t do it. This strategy is not something for those who want to get rich quick. This is for investors who are seeking to get long-term appreciation of their capital with reasonable risk-reward objectives. It’s possible to make money from sheer luck, but it always catches up.”

In a working paper titled, “The Winners and Losers of the Zero-Sum Game,” the author divides traders into skilled and unskilled, lucky and unlucky.[1] Having had an opportunity to discuss Dr. Vaca’s background and ideas on the market, we believe that his approach falls into the skilled camp. For more information about Vaca Capita’s Global Diversified program, feel free to contact one of our representatives.

For more information about the trading program described in this article or about managed futures in general, visit our website at www.ma-research.com. You may also contact us at (800)308-1495 or via email at data@ma-research.com.

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Footnote:

[1] Harris, Lawrence. "The Winners and Losers of the Zero-Sum Game: The Origins of Trading Profits, Price Efficiency and Market Liquidity" School of Business Administration, University of Southern California, Draft 0.911, May 7, 1993. Document available at: <http://www.scribd.com/doc/29617036/Winners-and-Losers-of-the-Zero-Sum-Game-Harris>

This article was written by John P. Gilbert, Principal and Michael "Mack" Frankfurter, Chief Investment Strategist of Managed Account Research, Inc. (MARI). The analysis and opinions expressed in this commentary have been reviewed and is approved by the principal of Managed Account Research, Inc. as of the date of this issue. Every effort has been made to ensure that the contents have been compiled or derived from sources believed reliable and contain information and opinions, which are accurate and complete. There is no guarantee that the forecasts made, if any, will come to pass. This material is for informational purposes only. It does not constitute investment advice and is not intended as an endorsement of any specific investment. Further, this material does not constitute a solicitation to invest in any program offered by Managed Account Research, Inc. including any program of Vaca Capital Management, LLC which may only be made upon receipt of its Disclosure Document. Past performance is not necessarily indicative of future results. Investment involves risk. Investing in foreign markets involves currency, regulatory and other significant risks. The risk of loss in trading commodities can be substantial.

About the authors: P. Gilbert is the Principal of Managed Account Research, Inc. an independent Introducing Broker focused on advising its clients in managed futures investments. MARI maintains a proprietary CTA research database of over 250 CTAs, and is always searching for new trading talent. Mr. Gilbert has been involved with the futures industry since 1985. He has traversed all aspects of the industry, from governmental regulation and filing, investment program evaluation, screening and selection to daily operations and risk management of investment programs and strategies. Michael "Mack" Frankfurter is the Chief Investment Strategist of Managed Account Research, Inc., and also a co-founder and Managing Director of Operations for Cervino Capital Management LLC, a commodity trading advisor and registered investment adviser. He is author of many articles on futures trading.