

FUTURES INTELLIGENCE

Why Did People Shun Managed Futures?

A veteran investor I know used to talk about how he controlled the risk in the fund of hedge funds he managed. He invested in as many as 100 hedge funds at a time, across a wide range of strategies and styles. Managed futures was not among those. It was possibly the only hedge fund sector he avoided on principle.

We're talking about a seasoned pro. After several decades of experience, he had developed his own diversification tactics and analytical devices. The latter gave advance warning of rising correlation among strategies so that the allocations could be changed to keep the portfolio diversified and losses at a minimum—or so his robust track record suggested.

The credit crisis was not kind to my friend. While fund of funds generally lost less than 20% in 2008, the loss in one of his pools was more than double that. Part of the reason was that the portfolio was levered, which magnified the losses made by the underlying funds. Another reason emerged last month. He had a long-standing allocation to Bernard Madoff. It was not a big part of his fund, but still large enough to add a significant amount of red ink.

Here's a knowledgeable person who gave money to Madoff, about whom there were doubts for many years, but avoided managed futures as too risky. What is it about managed futures that turns off investors? Does it carry special risks not found in other strategies? How do long-time managers control the risks? This issue explores those questions.

AHL, part of Man Group, is one of the largest and longest-running futures trading programs. Tim Wong, chief executive of AHL, tells us how they keep improving the system. Jon Knudsen of Tapestry Asset Management presents the investor's point of view, explaining what's attractive about managed futures, what's not and what to watch for when investing.

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What Do Investors Look For?



We have a seasoned investor to tell us what characteristics of managed future attract/ deter investors. **Jon Knudsen** has been allocating money to hedge funds for around 20 years and has in-depth experience with futures. Among the positions he held at Goldman Sachs was portfolio manager of the Goldman Sachs Tactical Trading Fund, a multi-advisor macro and futures fund.

He started his career in futures as a runner for a Chicago commodity house, muscling his way into the trading pit. Currently he is co-chief investment officer of Tapestry Asset Management LP, where he helps design and manage portfolios for institutional investors.

Opalesque Futures Intelligence: What's the advantage of investing in futures markets?

Jon Knudsen: The three huge advantages to futures are the liquidity, the ease of marking positions and minimizing your credit risk by using clearing houses.

OFI: What's the biggest risk?

JK: Probably the most immediate danger to an investor is a manager violating agreed-upon limits on positions and losses because he is unable or unwilling to get out of a position. The risk is not catching this soon enough to mitigate most of the loss.

OFI: How do you get around that?

JK: You minimize the chance of something like that by staying in touch with the clearing houses and knowing the manager well. We track our managers' positions and compare their returns to what we expect them to be on the basis of market movements. If there's a discrepancy between what we expect and

what's being produced, that's a cause for investigation. Also, you diversify the portfolio so as to get away from single manager risk.

OFI: What's the basics for allocating to managed futures?

JK: Broadly, you make the most returns with trend followers but you have to decide how much volatility you want to take. There are enough managers with different return streams that you can construct a diversified portfolio.

OFI: How would you diversify among CTAs?

JK: CTAs are becoming more specialized. You might get one that specializes in financials, another that primarily trades agricultural commodities. There are very long term trend followers and others who have a short time horizon. Some put on trades lasting only hours or even minutes. These have different returns from most trend followers. Others put on relative value trades, taking advantage of seasonal

changes or other variations in markets. Much like you blend stocks in an equity portfolio, here you have long-term, short-term and relative value traders.

OFI: Is there anything specific about doing due diligence on CTAs versus other hedge funds?

JK: With a systematic CTA, you need to look at how the system was constructed and the idea behind it. Equity managers tend to tell you exactly what they do and the metrics they use, but may not want to show their positions. It's the opposite with CTAs—they'll give you the details of their positions but might talk only vaguely about how the signals are generated!

OFI: How do you get a handle on those signals?

JK: It helps to have both some technical analysis-statistical background and trading experience in order to understand whether a CTA really has insight into how markets function. Some people can construct models but do not really understand markets. You have to see whether they have market knowledge to match their modeling skills.

OFI: Don't investors complain that CTAs rely on unfathomable black boxes?

JK: Investors fail to understand the systematic managers, largely because the CTAs themselves make the process too opaque. Many managed futures strategies are simple, though applied in a very precise way.

OFI: Why do some funds of funds not invest in managed futures?

JK: If you look at the past few years, until relatively recently managed futures returns were by and large not as attractive as returns from other hedge fund strategies like long/short equity. A second barrier is that CTA and macro returns tend to be lumpy—you can have a period of substantial returns followed by a period of flat or negative returns. By comparison arbitrage strategies were yielding consistent returns. If people just followed the numbers and did not look ahead, they saw no reason to invest in managed futures. A third factor is some CTA returns are very volatile—but not all of them are, and recently we saw how volatile other strategies can be.

OFI: What would you advise a would-be investor?

JK: While it's a good idea to analyze the numbers using quantitative methods, you need a lot of qualitative work to see where the returns came from and what one can expect in different market conditions.