

A Primer on CTAs

“The elements of good trading are: (1) cutting losses, (2) cutting losses, and (3) cutting losses. If you can follow these three rules you may have a chance.” Ed Seykota

For this issue of the Tapestry **SPOTLIGHT** we focus on the strategies employed by Commodity Trading Advisors (CTAs), key points to consider when reviewing them and how to incorporate them as part of a well diversified investment program.

Futures trading originated in the commodity markets as a means of dealing with the risk of deferred delivery. In 1730, the Dojima Rice Market based in Osaka, Japan was thought to have instituted the first organized exchange to trade futures contracts. For the delivery of rice they were said to have in place standardized definitions of product quality, delivery time, and delivery location. In 1848, the Chicago Board of Trade (CBOT) was founded to facilitate what were termed “to-arrive” or forward contracts and by 1865 the exchange had added standardized futures contracts.¹ During the last thirty years, the futures market has expanded exponentially both in terms of types of contracts and total volume traded. In the last ten years, trading execution has largely moved in the financials futures market from mostly “open outcry” on the exchange floors to electronic trading platforms owned by the exchanges.

Initially, CTAs were limited to trading commodity futures but with the introduction of futures on currencies, interest rates, bonds and stock indices in the 1980s the trading spectrum widened considerably. This proliferation of non-traditional commodity futures was further catalyzed by the regulatory separation between the brokerage and investment management functions of the futures business and provided the impetus necessary for the modern CTA industry. This is when CTAs were first defined as a legal category and the strict regulatory regime which covers this category of investment advisors was established.

Early notable CTAs include Richard Donchian who is widely regarded as one of the 'grandfathers' of the CTA industry. From the time he started the industry's first managed fund in 1949, Donchian's work, which he shared until his death, on break-out and moving averages marked the foundation research for many of today's long-term trend followers. He was followed in the late 1970's and early 1980's by Millburn, Campbell and AO Management who were some of the first managers to be used in public commodity funds. This group of technicians were followed by the likes of Bill Dunn, JW Henry and Richard Dennis who came to be commonly known as the 'father of the turtles.' More recently, modern day CTAs were defined in the 1990's with the rise of AHL, GFTA and Sunrise. Discretionary traders, which tend to be categorized as Global Macro and for making money and leveraging bets on very specific and highly publicized trades, include the likes of George Soros, Julian Robertson, and Paul Tudor Jones.

Managed futures funds have been available for investment since 1948 when the first public futures fund started trading but it was not until the late 1970's that the industry started to flourish. Commodity Pool Operators (CPOs) are those organizations that advise a pool of assets contributed by a number of persons. In the United States, the futures industry is regulated by the Commodity Futures Trading Commission (CFTC).

Types of investment strategies employed by CTAs are typically categorized into global macro/discretionary, systematic, or a combination thereof. In many ways, these strategies are similar to most other investment styles. That is, managers are trying to capture either directional or relative value price movements based on fundamental concepts of value and risk. But in their detail, these strategies do differ in some important respects. For example, often the time horizon of these strategies is shorter than that of a value oriented equity Long/Short manager or a distressed player. Also, a broader use of diversified global financial instruments is more frequently applied. Further, portfolio turnover, in keeping with strict management regimes, may be higher than some other investment styles.

For systematic strategies, it is important to understand the theoretical basis of the models, the history of their development, and the manager's background and experience in developing and evaluating complex quantitative models. In particular, what market “behaviour” or inefficiency is the model attempting to capture?

Systematic and Discretionary strategies are similar only in that they may trade in the principle asset classes of global equities, bonds, currencies and commodities. For Systematic CTAs, the instruments traded are almost always futures, spot, or forward FX and options, though some of the larger CTAs are starting to use swaps on commodities and within a growing segment of the CTA community cash equities have been incorporated into their portfolios.

The main difference between Discretionary and Systematic is that most Systematic CTAs predominately rely on historical market data to make their investment decisions. In the large majority of funds, the entry and exit points are decided systematically by mathematical models utilized by the Portfolio Manager. While managers may exercise some judgment in determining the parameters of their system, in many cases it is the model that tells them when to enter and exit positions in the various markets. By far the largest percentage of Systematic CTAs fall into the category known as “long-term trend followers,” but the short-term (high frequency) managers are increasing in number.

Discretionary strategies on the other hand tend to make leveraged, discretionary, opportunistic investments in global currency, equity, bond, and commodity markets. They typically will invest across both cash and derivative instruments and to this effect are sometimes the hardest to pin down in terms of overall investment parameters (their effective “sand box”). They usually rely on a top-down global approach and base their trading views on fundamental, economic, political, and market factors. It is not uncommon however for a manager to utilize quantitative models to assist in their decision making. Global macro managers are by no means homogenous in the specific strategies they employ, but tend to depict a more liberal attitude towards risk and overall position sizing.

Often times it is difficult to know what to cover when interviewing either a Discretionary or Systematic CTA. Listed below are a few questions to consider for each:

Discretionary Strategies - What to consider:

- Is the investment approach discretionary, quantitative, or some combination of the two? If it is a combination of the two then what decisions are model based or discretionary?
- Are investment decisions based on fundamental or technical analysis? Often a particular manager will have a macro framework which is used as a type of base case scenario but will manage the portfolio day-to-day in an opportunistic manner with an eye toward shorter term technical opportunities trading around core positions.
- Is the typical investment horizon for a trade long term or shorter term in nature and is active intraday trading a meaningful source for returns?
- What constitutes the investable universe for the fund across regions, asset classes, and instrument types (exchange vs. OTC) and what systems are in place to monitor the portfolios exposures especially when dealing with a wide array of instrument types?
- Is the fund more directional in nature or relative value? Relative value oriented strategies will typically have higher nominal or gross exposure levels and lower net exposures. With these trades it is important to understand the relationship between the long and short side of a particular trade and the financing arrangements between the fund and its counterparties.
- Does the research process rely mostly on in-house analysis or outside sources such as consultants and what is the structure of the research team and how consistent has this been through the history of the fund, has the turnover within the group been high or relatively steady?
- What is the process for identifying potential positions separating core long term themes from tactical trading opportunities that arise and how are these trades translated into instrument selection?
- What is the sizing methodology and what tools are used and do they more so inform the discretion of the manager or are they the determinant factor?
- After an initial position is taken does the manager require confirming price action before adding to the position, and if not, what is the philosophy toward adding to losing positions?

- What determines the exit of a trade? Are stops enforced for losing trades and for winning trades does the manager let profits run and look for some reversion in price before exiting or exit based on valuation?
- What is the philosophy towards risk management from the individual trade to the portfolio level? How are the risk reduction methodologies differentiated? Are stop-losses used for liquidating a position vs. hedging or offsetting risk by incorporating inversely correlated positions into the portfolio?

Systematic Strategies - What to consider:

- What constitutes the investable universe for the strategy?
- Is the investment style trend following or mean reverting in nature and what are the types of systems used statistical, moving averages, breakout, pattern recognition, neural networks, artificial intelligence, oscillators, cyclical analysis, multifactor analysis, counter-trend, or fundamental analysis?
- Who was the developer of the system?
- How has the system evolved over time, have the return and risk objectives changed, have models and/or markets been added or taken away and for what reasons?
- What is the fund's average margin to equity, what has been the max and min since inception and what factors lead to those extremes?
- What is the process for development and testing of new models and how are they implemented into the portfolio?
- What has been the attribution of each asset class to the fund's performance since inception and in the event of consistent outperformance or underperformance in a particular sector what rationales can be assigned to this?
- Where a fund only trades a single instrument or asset class is it because the system is only profitable in that market and what can explain this? In other words, does the system have breadth across markets?
- Since inception of the fund has the Portfolio Manager ever overridden the models and was the impetus a pre-emptive reaction to major exogenous event (government intervention or natural disaster) or was it the result of model performance?
- Is there a process for shutting a model down and if so how is it re-engaged and how many times has this happened since inception?
- Are models run overnight and orders generated on a daily basis or are they run intraday at different points throughout the trading session? This will vary based on the holding period of the strategy and the size of the fund.
- How are orders executed? Over the past decade electronic execution and computer based order management systems have become much more prevalent but in many markets human involvement is still necessary.
- How are the model and sector weightings determined for the portfolio and are they static or is some type of optimizer used and how often are weightings adjusted (if weightings are being adjusted on a regular basis compare how actual achieved results compare to those had the portfolio been static)?

Incorporating into Portfolio:

In our view, CTAs represent an important component of a diversified investment program and if selected properly can be quite beneficial to enhance the overall return profile by incorporating distinctly different strategies that trade globally. Trading in futures remains one of the most liquid and cost effective methods to access markets long and short, providing access to a multitude of financial and non-financial (commodity) sectors. Market participants, either systematic or discretionary, can quickly reposition long, short or flat which makes them much more tactical and dynamic in nature.

Taking a top down view, CTAs can also be considered as a tool within a portfolio to manage through and mitigate losses in a "regime" change or shift, given their adaptability when compared to equity and fixed income oriented strategies. Historically, this pattern is reinforced by the high CTA returns during the 1998/LTCM/Russian default crisis, in the

aftermath of September 11, and more recently during the credit and market crisis of 2008. The ability to shift and adapt to changing market environments, increase market breadth and add performance in volatile periods makes a compelling case for this asset class.

ⁱ Understanding Futures Markets, Robert Kolb and James Overdahl, 2006

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