

Investing for the Long Haul? Part 3

Manager Selection and Monitoring Accounts

By Maggie Finnerty, JD



However, if an investor does his homework, he may (just as an example) discover that this manager used to trade under a different name. The investor may then discover, for example, that when trading under the other name, the manager had great success for three years and then “blew up.” Thus, it’s easy to see that choosing managers should not be based on raw performance data alone, but also on non-financial information. Examples of what to look for under a two-pronged analysis follow.

Quantitative Analysis

In performing quantitative analysis, investors should look at financial and statistical information. Quantitative analysis allows investors to quickly compare performance of managers to their peers and to benchmarks such as the S&P 500. Some, but not all, things to consider are:

- *Rate of Return* – How has the manager performed since inception, on a monthly basis and on a daily basis? Has the performance been consistent, or did the manager have a strong few months, and then relatively flat months? While past performance is never indicative of future returns, investors should know what the past return patterns are.
- *Correlation* – Does the manager’s performance mirror the performance of the overall market or the performance of other managers? As discussed in the first two parts of this three-part article, diversification is key to successful investing. The term “correlation” describes the relationship between securities. The less correlation among managers, the more diversified the portfolio.
- *Performance* – How does the manager perform during bull and bear markets relative to his or her peers and relative to various indexes?
- *Average winning month* – What is the average return during positive months?
- *Average losing month* – What is the average return during negative months?
- *Worst drawdown* – What is the greatest peak to valley decline, and how long did it take to recover? Investors should know what their cut-off level is before they invest. Knowing the worst drawdown indicates a sort of comfort level with respect to drawdowns and allows investors to create a cut-off point if the manager experiences a drawdown that is greater than prior drawdowns. For example, consider a manager whose worst drawdown is seven percent; investors might not break a sweat if the manager has a drawdown of four percent, but may consider pulling out if the manager has a drawdown of ten percent.
- *Number of winning and losing months* – How many months did the manager have positive returns? Negative returns? Typically, investors should seek managers with more winning than losing months, even if the managers with more losing months than winning months have higher returns.
- *Standard deviation* – Standard deviation measures an investment’s volatility or risk. The higher the standard deviation, the more volatile the investment. Some investors are risk intolerant and are not willing to invest in managers with high volatility – even with high

This is the third in a three-part series about managed futures. In Part I (December *SFO*), we introduced the concept of managed futures and foreign exchange traders—what they are and how adding managed futures or foreign exchange trading to a portfolio can lower volatility and increase returns. In Part II (January *SFO*), we explained the concept of notional funding and introduced readers to several considerations in structuring an account—including whether to allocate to a single manager or to multiple managers and the differences between individually managed accounts, commodity pools and funds of funds.

This article takes readers to the next logical step by offering tips on manager selection and how to monitor the managed futures portfolio. It can serve as a very handy point-by-point aid in the process.

Manager Selection

Before adding managers to a managed account portfolio, it is important to analyze each manager from both a quantitative and qualitative standpoint. Quantitative analysis involves using financial and statistical information to evaluate a manager, whereas qualitative analysis involves subjective judgment based on non-financial information. Such a two-pronged approach is necessary to give a better understanding of the manager as a whole. Suppose, for example, that a manager has an impressive three-year track record and the ratios (discussed below) all indicate a sound investment. Most investors would be tempted to jump right in.

returns. Other investors are risk takers and are more comfortable with high volatility, provided that the returns are high enough.

- **VAMI** (“value-added monthly index”) – A VAMI tracks the monthly performance of a hypothetical \$1,000 investment. That is, an investor can see the value of a hypothetical \$1,000 investment over time, based on a manager’s actual performance.
- **Trend** – Is the manager’s performance improving or declining over time?
- **Average commission rate** – A manager’s average commission rate affects the overall performance, so investors should compare the manager’s average commission rate with the rate they expect to receive. Assuming consistent returns, a manager with an average commission rate lower than the rate an investor anticipates receiving will have artificially higher overall returns than a manager with higher commission rates.
- **Interest** – Does performance include interest?
- **Ratios** – Analysts use various ratios to analyze a manager’s performance. While analysts disagree on which ratios an investor should rely, some of the more commonly used ones are:
 - **Sharpe Ratio**. Provides investors with a measure to compare returns from different strategies/traders, using a non-directionally biased measurement of volatility to adjust for risk. Investors look for the highest Sharpe Ratio.

$$\frac{\text{Annual Return} - (\text{Risk-Free Rate})}{\text{Annual Standard Deviation}}$$

- **Sterling Ratio**.

$$\frac{\text{Compounded Annual Return}}{\text{Average Maximum Drawdown} - 10\%}$$

- **Sortino Ratio**. Measurement of return per unit of risk on the downside.

$$\frac{\text{Annual Return} - (\text{Risk Free Rate})}{\text{Annual Standard Deviation performance compared to a benchmark.}}$$

Qualitative Analysis

As discussed above, qualitative analysis is the non-financial prong of the two-pronged analytical approach. In performing qualitative analysis, investors should consider a number of questions, including:

- How long has the manager been trading?
- Is the manager trading his or her own money? If so, how much? If not, why not?
- How many assets are under management? Has there been a sudden influx or redemption of cash? Just as a sudden redemption from an account can have a negative impact on the manager’s strategy, so can a sudden influx of cash.
- Who are the manager’s clients, and how many clients does the manager have?
- Have any key employees left the manager’s employ? Investors should find out what the employee’s exact role was to discern whether his or her departure might affect the manager’s future results.
- With whom does the manager execute, and how many futures commission merchants are used for clearing and for execution?

This is important from an operations standpoint: the more executing brokers and the more FCMs, the longer it takes to clear and execute a trade.

In performing qualitative analysis, investors should be sure to personally meet with a manager and consider conducting a criminal and financial background check before allocating funds. Background checks can be done quickly and for a reasonable price over the internet. Often the best way to obtain information about managers, however, is to obtain references from the managers and talk with professionals within the industry. This is another area where engaging a consultant with expertise in the alternative investment space can assist investors in evaluating managers.

Portfolio Monitoring

Performance Monitoring. Monitoring accounts in large part depends on whether an investor opts to invest in a fund or set up a managed account. Investors in funds can only monitor the fund’s monthly performance and compare that performance to other funds or indexes.

However, when investing in a managed account, investors can see every trade made by all of the managers to whom the investors have allocated funds. Keeping a careful eye on the trades allows investors to see the daily, weekly and monthly returns for each manager – allowing them to spot trouble early on.

Investors should not just watch the manager’s returns, but also should keep an eye out for style drift, such as trading different markets or varied contract sizes.

Rebalancing. Investors should consider rebalancing their allocations to managers as certain managers within the portfolio over- (or under-) perform. For example, assume an investor opens an account with a total nominal amount of \$3,000,000 allocated equally among three managers - \$1,000,000 to each manager. Now assume that Manager A earns a 50-percent return for the year, but Managers B and C earn annual returns of only five percent each. At the end of the year, Manager A’s account will now be worth approximately \$1,500,000, and Managers B and C’s accounts will each be worth approximately \$1,050,000. The portfolio’s total value would be approximately \$3,600,000.

Clearly the account values are no longer proportionate to the original allocation. While some investors may be happy that Manager A is over-performing, a savvy investor will consider what will happen if Manager A has a drawdown. Because the amount in Manager A’s account is so high, if Manager A has a drawdown, the drawdown will have a significantly greater negative effect on the portfolio as a whole than if Manager A’s profits were reallocated (or rebalanced) among the other managers to correspond with the original allocation.

In our example, let’s assume that Manager A had a 20-percent drawdown in the first month of the next year. This would decrease the portfolio’s value by \$300,000. However, if the portfolio was rebalanced (each manager managing \$1,200,000), the portfolio would still suffer, but only by \$240,000. Consequently, rebalancing could have saved the account \$60,000.

Unfortunately, there is no magic formula to determine when it is time to rebalance. Investors should simply keep an eye on the account values in their portfolios and consider whether it makes sense to rebalance at least occasionally.

Industry Monitoring. As with any asset class, investors should continue to watch the industry indexes for legal and regulatory changes and remain generally aware of industry news.

And Finally...

Managed futures and forex managers offer alternative investment strategies that can provide more diversity, lower volatility and higher returns than traditional investments. However, to be successful in these areas, investors first must evaluate and select appropriate managers, then select the structure that is best for them. Once the portfolio is built, investors should continue to monitor their accounts.

There is no question that building and monitoring futures and foreign exchange portfolios require a great deal of knowledge and expertise. While it certainly is possible for investors to build and monitor these portfolios on their own, many of them engage consultants specializing in the area to assist them. **SFO**

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