



TraderSource

MANAGED FUTURES AND TRADERSOURCE

Introduction to Modern Portfolio Theory

One strategy on which almost every investment advisor will agree is that diversity is key to a successful portfolio. Historically investors have “diversified” by investing in various stocks, bonds and mutual funds. According to Modern Portfolio Theory (MPT), however, portfolios consisting only of stocks, bonds and mutual funds are actually not adequately diversified. In his article *Portfolio Selection*, Professor Harry Markowitz illustrated that holding stocks, bonds and mutual funds do not adequately lower an investor’s risk because each of those types of investments move in concert with one another. He concluded that diversification “reduces risk only when assets are combined whose prices move inversely, or at different times, in relation to each other.” (1)

In other words, investors can properly diversify their portfolios only when investing in *different asset classes* having no correlation with each other. Since stocks, bonds and mutual funds are all of the same asset class and generally move in line with one another, an alternative investment solution is needed to properly diversify a portfolio. One solution is managed futures.

Managed Futures

A futures contract is a standardized, transferable agreement between two parties to make or take delivery of a specified quantity of a commodity, currency or index, at a specified time at a specified place. The term “managed futures” describes participation in the futures market whereby professional money managers called commodity trading advisors (“CTAs”), trade futures and forward contracts on behalf of investors pursuant to a limited power-of-attorney.

The term “CTA”, however, is a misnomer—while futures and forward contracts may represent agricultural products, energies, cattle, hogs, metals, and other commodities, many CTAs also trade currencies, financial instruments, stock indexes and single stock futures.

When investing in managed futures, the goal is to profit from moves in the contract prices of commodities, stocks, bonds and currencies-- not an appreciation in value of the underlying asset. Each CTA employs his or her own strategy for profit maximization. There are thousands of CTAs and hedge fund managers--some of them are experts and some are not. It can take years to understand their strategies and distinguish the skilled from the unskilled traders. That is where TraderSource can help.

TraderSource, Inc.

Unlike many investment advisors who focus on many investment strategies, TraderSource, Inc. is exclusively dedicated to managed futures and foreign exchanges (“forex”), which means TraderSource offers a unique expertise to investors. TraderSource specializes in finding, evaluating and monitoring trading talent within the universe of managed futures and forex.

TraderSource also assists clients in structuring portfolios of CTAs and monitors each CTA’s strategy on a daily basis for style drift, performance and risk. TraderSource has a systematic review process, both a qualitative and statistical risk management process and an experienced team. TraderSource has developed a number of sophisticated algorithms that provide the ability to combine and analyze the historic quantitative results of hundreds of CTAs, allowing the TraderSource team to assist their clients in selecting the ideal blend of managers to complement and diversify each of their client’s overall portfolios.

In a market with thousands of managers, it is easy to get lost. TraderSource can guide investors through the fog of CTAs to select suitable managers for their portfolios.

A brief history of the US futures market

The futures market in the United States developed in response to widely fluctuating agricultural prices. During harvest time, large supplies severely depressed prices. Grain merchants bought and stored as much grain as they could at the lower prices, but as their supplies ran low, the merchants would have to purchase more grain. Because the farmers' supplies were dwindling, the price of grain would skyrocket. To help make the prices more predictable, forward contracts were born—the farmer and the grain merchant would sign a contract that stated the price, quality, quantity, delivery date and location of each delivery. The farmer and the grain merchant thus obtained price certainty—no matter how much the supply varied over the course of the year.

The forward contract obligated each party to perform in accordance with its terms, but it did not eliminate all risk. If the farmer was unable to produce enough grain to satisfy the amount specified in the forward contract, he would have to purchase that grain in the open market—presumably at a much higher price than he would receive from the grain merchant. If the price of grain fell unexpectedly, the grain merchant would still have to pay the higher price stated in the contract, despite that the open market price was significantly lower.

Eventually, speculators began buying and selling those forward contracts—hoping to make a profit by rebuying (or reselling) the forward contract at a lower (or higher) price. The speculator never intends to accept delivery—he or she is merely using the volatility of the market to make a profit. These contracts became standardized and laid the foundation for the United States' current futures contracts. The number and type of futures contracts have increased dramatically over the last 150 years. In fact, as of September 30, 2002, there were approximately 900 futures and options contracts authorized for trading by the Commodity Futures Trading Commission ("CFTC"). (2)

Suitability

Although managed futures can provide badly needed portfolio diversification to many portfolios, only investors with risk capital who understand and appreciate the risks and rewards involved in trading futures should invest in managed futures. Investors should not treat managed futures as a short term trading opportunity. Because futures markets tend to be cyclical, investors should plan to hold an individually managed account, commodity pool or fund investment for at least two to three years.

IRAs and other self directed plans can invest in managed accounts, commodity pools and funds as long as the plan permits such investments. If the plan's custodian does not accept alternative investments, the investor will have to open an account with another custodian that does.

Money Under Management

Growing numbers of corporate, institutional and individual investors have been allocating a portion of their portfolio's assets to managed futures accounts. Assets in managed futures as of the **2nd quarter 2004** increased to **\$117.7 billion**, an increase of **\$13.1 billion** from the previous quarter. This represents a **36.07%** increase in assets since the beginning of 2004.(3)

Money under management in managed futures 1980 – 2003 (3)

	\$ billions on Dec. 31	\$ billions on Dec. 31	\$ billions on Dec. 31
1980	0.31	1988	5.51
1981	0.38	1989	7.00
1982	0.56	1990	10.54
1983	0.63	1991	14.50
1984	0.77	1992	18.50
1985	1.49	1993	26.00
1986	1.96	1994	24.90
1987	3.90	1995	22.80
		1996	23.98
		1997	33.10
		1998	36.00
		1999	41.30
		2000	37.90
		2001	41.30
		2002	50.94
		2003	86.50

Benefits of managed futures

Some of the reasons for the increased interest in managed futures include:

Opportunity to reduce risk and enhance returns.

Over the long term managed futures have been negatively correlated to traditional stock and bond portfolios when they have experienced prolonged losses, and positively correlated when they have experienced prolonged gains. That means that investors who add managed futures to their portfolios may benefit by reducing overall volatility and enhancing overall returns. For an illustration of how managed futures can enhance returns and reduce volatility, see the hypothetical portfolio on page 5.

Ability to profit in any economic environment.

CTAs can take advantage of price trends. During periods of inflation, they can buy futures contracts in anticipation of a rising market. Conversely, they can sell futures contracts if they anticipate a falling market. As shown from the data above, the potential for profit exists regardless of the overall direction of traditional markets.

Expanding markets and global diversification.

During the last decade, the futures markets have expanded to include single stock futures, stock indexes, debt instruments, currencies and options, in addition to conventional commodities. These new categories created global markets, expanding the scope of investment opportunities even more. In fact, as of September 30, 2002, there were approximately 900 futures and options contracts authorized for trading by the CFTC. (2)

The following data illustrates the benefits of managed futures over the S&P 500 and NASDAQ for 2000-2003:

The data shows that the average rate of returns for managed futures was negatively correlated with the NASDAQ and the S&P 500 during the down years of 2000, 2001 and 2002 and positively correlated with the NASDAQ and the S&P 500 during the recovery in 2003. This data supports the conclusion that there is little or no correlation between managed futures and traditional equity markets.

Both the S&P 500 and NASDAQ experienced significant losses from 2000 through 2002. As of December 2003, neither the S&P 500 nor NASDAQ had recouped those losses. Managed futures, on the other hand, only experienced a relatively small loss which was recouped in only 3 months.

AVERAGE ANNUAL RATE OF RETURN(4)				
	2000	2001	2002	2003
S&P 500	-10.1%	-13.0%	-23.4%	26.4%
Nasdaq	-39.3%	-21.0%	-31.5%	50.0%
CTAs (5)	10.63%	5.39%	15.22%	15.99%

DRAWDOWN ANALYSIS(4)					
	VAMI Change	Term Mths	Peak Date	Valley Date	Recovery Months
S&P 500	-46.28%	25	Aug. '00	Sep. '02	N/A
NASDAQ	-75.04%	31	Feb. '00	Sep. '02	N/A
CTAs (5)	-11.97%	6	Oct. '01	April '02	3

Hypothetical portfolios.

Contrary to popular belief, research shows that portfolios including managed futures generate higher returns and have less volatility than portfolios that do not include managed futures. The following chart shows the returns, volatility and Quick Sharpe Ratio for stocks, bonds, and managed futures from January 1990 through December 2003. The data clearly shows that managed futures generated a higher return than stocks and bonds and had lower volatility than stocks during that 14 year period.

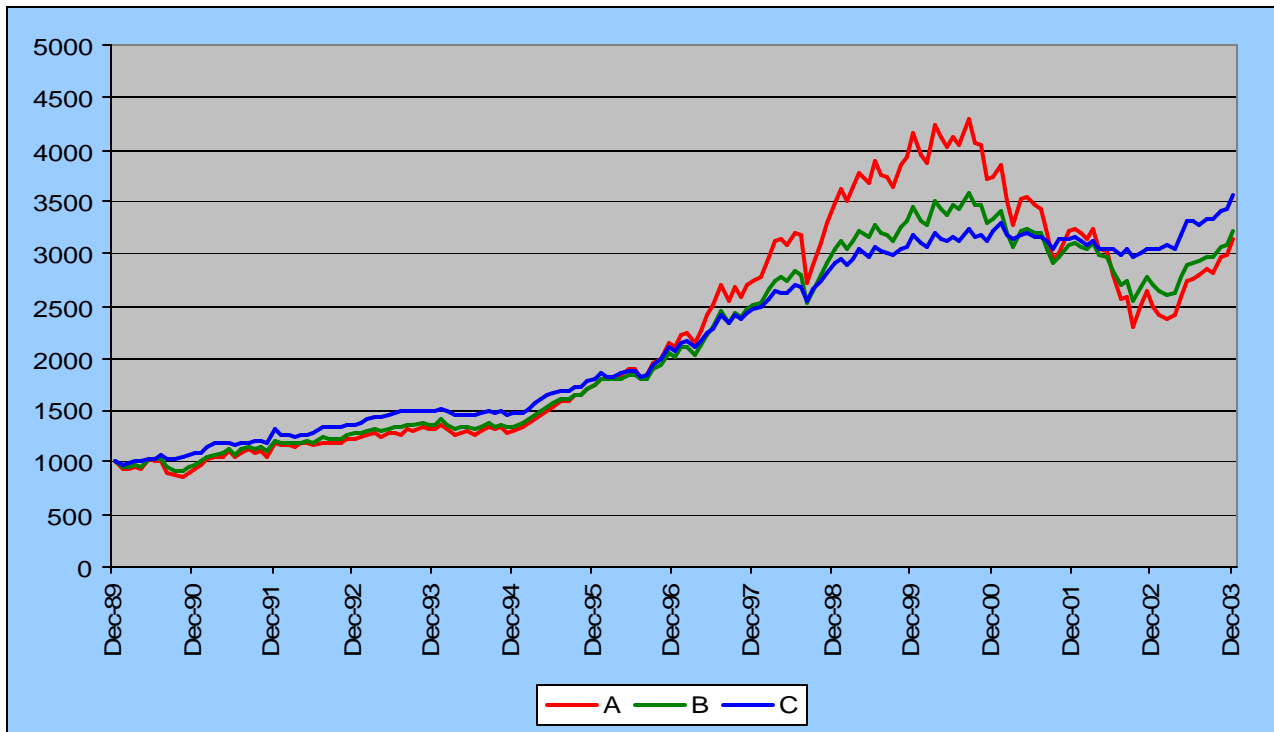
	S&P 500	Bonds	CTAs
Annual Return	8.53%	7.94%	11.21%
Standard Deviation	15.00%	3.91%	12.99%
Quick Sharpe Ratio(6)	.57	2.03	.86

Based on the data above, we can calculate returns in hypothetical portfolios allocating various amounts to stocks, bonds and managed futures, enabling investors to compare the performance of portfolios including managed futures to those that do not. Consider the following three hypothetical portfolio allocations:

	Stocks	Bonds	CTAs
A	100%	0%	0%
B	70%	30%	0%
C	45%	30%	25%

Note on hypothetical portfolios:

This composite performance record is hypothetical. Hypothetical performance results have many inherent limitations, some of which are described below. No representation is being made that any multi-advisor managed account or pool will or is likely to achieve a composite performance record similar to that shown. In fact, there are frequently sharp differences between a hypothetical composite performance record and the actual record subsequently achieved. One of the limitations of a hypothetical composite performance record is that decisions relating to the selection of trading advisors and the allocation of assets among those trading advisors were made with the benefit of hindsight based upon the historical rates of return of the selected trading advisors. Therefore, composite performance records invariably show positive rates of return. Another inherent limitation on these results is that the allocation decisions reflected in the performance record were not made under actual market conditions and, therefore, cannot completely account for the impact of financial risk in actual trading. Furthermore, the composite performance record may be distorted because the allocation of assets changes from time to time and these adjustments are not reflected in the composite. Because there are no actual allocations to compare to the performance results from the hypothetical allocation, investors should be particularly wary of placing undue reliance on these results.



Based on the returns from January 1990 through December 2003, it is clear that hypothetical Portfolio C, the only portfolio including managed futures, generated the highest reward and the lowest risk.

	ARR	VOL	QS
A	8.53%	15.00%	0.57
B	8.71%	10.64%	0.82
C	9.60%	7.24%	1.31

Managed Futures vs. Other Alternative Investments

Similarities

There are many similarities between managed futures, hedge funds and fund of funds. All of these investments provide:

- * Diversification to a typical portfolio of stocks and bonds
- * Professional investment management
- * Access to different investment strategies, styles, and markets
- * Returns that are highly dependent on the talent and skill of specific managers instead of general market appreciation.

Differences

In addition to these shared characteristics, managed futures offer greater accessibility, transparency, liquidity and security than most alternative investments.

Managed futures trading is more accessible to investors because managed futures accounts have lower commitment requirements than many other alternative investments and managed futures accounts may accept daily subscriptions and redemptions.

Most alternative investments require a bigger capital commitment and offer far less liquidity than managed futures. Investors opening individually managed accounts can add additional capital to or redeem capital from that account anytime the investor chooses. Most hedge funds and fund of funds, on the other hand, accept subscriptions from new investors and additional capital contributions from existing investors' capital only on a monthly basis. Further, many hedge funds and fund of funds are closed to new investment and the open funds only accept new capital contributions monthly or quarterly after they begin trading. Typically, hedge funds and fund of funds only allow for monthly or quarterly redemption.

Managed futures provide greater transparency than other alternative investments.

Full transparency means that investors can see each individual trade made by a manager. The brokerage firm

holding individually managed accounts will send investors confirmations on each trade—ensuring 100% transparency. Depending on the brokerage firm the investor selects, investors in individually managed accounts will likely also have online access to their accounts.

Hedge funds and funds of funds often trade exotic over-the-counter (“OTC”) instruments that can not be easily priced because they are traded in unregulated, non-public markets and many do not report trading activity to investors on a daily or monthly basis. Thus, investors in hedge funds and fund of funds generally do not have transparency into the fund’s underlying holdings.

Managed futures may have greater liquidity than hedge funds and funds of funds.

Futures contracts are highly liquid and can usually be bought or sold in a matter of seconds. The only exception to this rule is when prices are very volatile and a contract trades through its daily price limit or stock prices trigger a “circuit breaker” between the equities markets and futures markets. Since the interbank currency market is one of the biggest markets in the world and is open twenty four hours, seven days a week, it is also highly liquid. Therefore, it is usually easy to open, roll or offset a futures contract or currency position. OTC derivative contracts, on the other hand, may be complicated and costly to close out early if a hedge fund manager needs to liquidate a position before it is due to expire.

Managed futures may provide investors greater security than hedge funds and funds of funds.

Capital invested in managed futures accounts is held in customer segregated funds accounts (“Seg Accounts”). CFTC Regulations prohibit Futures Commission Merchants (“FCMs”) from using Seg Account funds in the conduct of their business or commingling those funds with the FCM’s own funds. Therefore, Seg Accounts may provide greater security for customer assets than many bank or securities brokerage accounts used by hedge funds and fund of funds. Further, investors control assets in a managed account, whereas the general partner controls assets in a fund.

Considerations in Structuring Your Portfolio

Notional Funding

Notional funding is the term used for funding an account below its nominal value. For example, assume a CTA requires a minimum investment of \$1,000,000 (the “Nominal Value”) and the margin requirement is \$50,000. The investor can either deposit \$1,000,000 to “fully fund” that minimum investment requirement or she can invest only a portion of the \$1,000,000, as long as she meets the \$50,000 margin requirement.

Now assume that the investor decides to fund the \$1,000,000 account with \$100,000 (the “Funding Level”). This means that the investor is using leverage of 10X—ten times \$100,000 equals the \$1,000,000 minimum investment. The difference between the Nominal Value (\$1,000,000) and the Funding Level (\$100,000) is \$900,000. The \$900,000 is referred to as “Notional Funding”.

Investors are interested in using notional funding because notional funding capitalizes on the free cost of leverage. The leverage is free because the notionally funded amount (in this case, the \$900,000) is not borrowed or deposited—the Funding Level (\$100,000) is a good faith deposit for the full value of the account. In other words, the \$100,000 trades as if it were \$1,000,000, even though the investor only deposited \$100,000 and is not paying interest or has not otherwise borrowed the remaining \$900,000. If the account is doing well, the investor earns money on the full \$1,000,000—even though she only funded the account with \$100,000. If the account is not doing well, however, the investor is responsible for the amount lost, regardless as to the original Funding Level, up to the Nominal Value.

For example, assume that the account has a profitable year and the CTA reports profits of 20% (\$200,000) for the fully funded account. The account that was only funded with \$100,000 also had \$200,000 in gains—but the investor’s profit percentage was 200%, because the investor earned \$200,000 on a \$100,000 investment. Investors must be aware, however, that this is a double edged sword. If the account has a drawdown, the investor will suffer a significantly larger percentage decline than the fully funded account. If the example above suffered a 20% drawdown for the fully funded account,

the notionally funded account would have a 200% drawdown. In such a situation, the investor would not only have lost her initial \$100,000 investment, but also an additional \$100,000. Furthermore, to keep the account open, the investor would have to deposit at least enough cash to cover the margin requirement.

In this regard, notional funding significantly increases the volatility of an account. Investors must ensure that they understand how much leverage the CTA is using—and the consequences such leverage might entail.

Multi versus Single Manager

Since alternative strategies are, by definition, not buy-and-hold strategies, the fact that there may be numerous stocks or other instruments in an account at any given time does not constitute diversification. Because the manager will trade in and out of those positions frequently, the return depends on the manager’s trading skill rather than the longer-term performance of the underlying instruments. Therefore, even if a single manager directs the assets into many different positions (stocks, bonds, futures, etc.) in an individually managed account, the account is not truly diversified because all of the positions are controlled by the same manager. Investors should thus consider allocating a portion of their investments among several managers. They may also want to consider whether a fund structure might be more beneficial than individually managed accounts.

Individually Managed Accounts vs. Commodity Pools vs. Fund of Funds

Individually managed accounts (“Managed Accounts”) are an arrangement by which the holder of an account gives written power of attorney to a CTA to buy and sell futures contracts and options without prior approval of the holder.

Commodity pools (“Pools”) are an investment trust, syndicate, or similar form of enterprise whereby multiple participants invest collectively (or “pool” their funds) in trading commodity futures or options and share ratably in profits and losses. The Pool may be managed by a single CTA or several CTAs.

Fund of funds (“FoFs”) are collective investment vehicles typically organized as limited partnerships or limited liability companies in which a fund invests in other funds or commodity pools rather than directly in futures and options contracts. Investors in a FoF enjoy instant diversification among numerous funds and CTAs, typically across numerous industries and via numerous strategies. Some FoFs are extremely diversified and allocate their assets to 100 or more managers while others concentrate their investments among only a few managers. As with other investments, generally speaking a more diversified FoF will provide smoother (less volatile) performance than one that is concentrated. Certain FoFs focus on a particular sector within the alternative investments industry (i.e. futures or fixed income) while others allocate across the broad industry.

Investors should consider the following when choosing between investing in a Managed Account, Pool, or FoF:

Expertise

Because of the large number of futures markets, it is impossible for an individual investor to be an expert in each sector. Investors can hire consultants, however, to assist them in building Managed Accounts or selecting an appropriate Pool or FoF. Consultants, such as TraderSource, and FoF managers typically employ one or more analysts to interview and monitor CTAs and have a thorough initial and ongoing due diligence process. Therefore, consultants and Pool and FoF managers are usually better equipped to build and monitor alternative investment portfolios than a part-time investor with other time commitments or less experience.

Economies of Scale

Like most large investors, Pools and FoFs may be able to negotiate better fee arrangements with individual managers than an individual investor could obtain on his or her own. Further, as industry insiders, Pools and FoFs may enjoy access to information about managers that is too expensive or difficult for smaller investors to obtain on their own. Because consultants have industry experience and relationships with many CTAs, they may be able to assist individual investors in negotiating fees and obtaining information on behalf of the investor.

Limited Liability

Because Pools and FoFs are often structured as limited liability companies (“LLCs”), investors can enjoy the benefits of limited liability. Limited liability can be a major benefit if an account is notionally funded because the investor is only liable for the amount of cash actually deposited in the Pool or FoF. Investors with individually managed accounts can limit their liability by forming an LLC to make the investment, though FCMs may require a personal guarantee, thereby negating the limited liability protection.

Access to Assets

With a Managed Account, only the investor and the brokerage firm have access to the cash. The CTA has limited power of attorney to initiate trades, but he or she cannot withdraw funds for any purpose. With Pools and FoFs, however, the investor can not access the cash--only the manager can do so. Due to the potential for misuse of funds, investors in Pools and FoFs should be sure to review internal controls and audited results before selecting a FoF.

Transparency

With a Managed Account, investors can see each individual trade made by the CTA. The brokerage firm holding the account will send investors confirmations on each trade—ensuring 100% transparency. Depending on the brokerage firm selected, investors will likely also have online access to their accounts. Investors in Pools and FoFs generally do not have transparency into the fund’s underlying holdings. Further, investors in Pools and FoFs typically only see the aggregate gains and losses of the Pool or FoF as a whole--not the performance of each individual CTA.

Liquidity/Cash Management

Managed Accounts provide investors with daily liquidity. Pools and FoFs, on the other hand, typically only allow investors to withdraw their assets at the end of a calendar month or quarter. Pools and FoFs typically include lock ups, triggering redemption fees upon withdrawal within a certain period of time. If a FoF has in-

vested only in other funds, the investing fund will have to pay the redemption fee upon withdrawing cash from the Pool or fund. If, on the other hand, in addition to investing in a Pool or another fund, the FoF has invested in Managed Accounts, upon a request for redemption the investing FoF can withdraw the redemption from the Managed Account, thereby avoiding the redemption fees imposed by the Pool or fund. In this regard, a FoF investing in a Pool or another fund can use the Managed Account to help manage its cash flow.

Similarly, if an investor would like to make an investment, the cash can be deposited into a Managed Account immediately, whereas the investor would have to wait until the month/quarter-end to subscribe to a Pool or fund.

Fees

Due to the significant legal, accounting, auditing and other expenses incurred in the organization and operation of Pools and FoFs that are not applicable to Managed Accounts, Pools and FoFs generally have higher operating expenses than Managed Accounts. Further, CTAs charge both FoFs and Managed Accounts management and incentive fees. However, there is an additional layer of fees with Pools and FoFs because the Pool or FoF manager also charges management and incentive fees. Therefore, Pools and FoFs must strive to earn a return high enough to cover the CTA fees and the management fees.

Endnotes:

- (1) Professor Harry Markowitz, *Portfolio Selection*, Journal of Commerce, March 1952.
- (2) http://www.cftc.gov/files/anr/anr2002dea_contracts.pdf, July 7, 2004
- (3) http://www.barclaygrp.com/indices/cta/Money_Under_Management.html
- (4) Past performance is not necessarily indicative of future results
- (5) Based on the ITR P40 Index
- (6) Quick Sharpe Ratio is calculated by dividing the average rate of return by the standard deviation

Contact Information

TraderSource, Inc.

Portland

522 SW 5th Avenue, Suite 800
Portland, OR 97204

Tel: 503 445 2405

Fax: 503 445 2406

David Welch,
Maggie Finnerty,
Andrew Gibson

New York

224 East 52nd Street
New York, NY 10022

Tel: 646 536 3445

Fax: 212 658 9472

Zahid Ullah

www.tradersource.net