

Historically, managed futures funds have enjoyed low or negative correlation to virtually all other asset classes, including hedge funds. Thus even a modest allocation results in dramatically improved portfolio risk-return characteristics, a thesis first demonstrated by John Lintner of Harvard University in 1983 and one that has held true ever since.

Furthermore, few hedge fund participants seem to realise how many of the trading and risk management disciplines they now take for granted were first developed in the CTA sector - such as the now-ubiquitous stop-loss discipline.

Of course, in retrospect, it's easy to see why investors lost interest in CTAs, as returns in the broad CSFB-Tremont Managed Futures Index were little better than even from late 1998 to mid-2002.

During this period, growth in the sector flat-lined at roughly \$40bn, even as interest in absolute return strategies was soaring around the globe. More recently, those returns have improved, as managers turned around mid-year CSFB index deficit in 2002, ending the year up over 18 per cent and finishing 2003 with a solid 14 per cent gain.

This was followed by a predictable flood of money, with estimated growth of 70 per cent in 2003 and an additional 18 per cent in the first quarter of 2004, bringing total assets to over \$100bn.

Unfortunately, that winning streak seems to have hit a speed bump in April, with the benchmark Barclays BTOP 50 Index more than 4 per cent lower and many industry leaders facing double-digit draw-downs. Early indications are that May was not quite as bad but most probably negative.

While it may be tempting to side with the naysayers and proclaim CTAs down for the count, the return drivers in the 1998-2002 period are substantially different from the past two months. Whereas the late 1990s were marked by a period in which few underlying assets trended - a punishing environment for trend-following managers - April and May represented instead a technical inflection point in many of the underlying markets, a period which could be expected to pinch trend-followers temporarily.

Even more to the point, investors who turn their backs on CTAs may miss out on a longer-term opportunity. While proclamations that we are living in the decade of hard assets may be overdone, there are strong cases for production commodities and oil, gold and even currencies. In fact, legendary investor and Quantum Fund founder Jim Rogers is so convinced these trends will persist that he announced this spring he is re-entering the asset management game to capitalise on them. He's been right before.

## Hedge Row: CTA sector may be worth another look

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For many in the hedge fund industry, the past two months have validated their dim view of the managed futures and commodity trading adviser (CTA) industry as performance across the board has skidded. But despite its chequered past, some say the controversial sector is due a closer look.

There is no question that CTAs have had a tough run. Following their heyday in the 1970s and 1980s, CTAs hit a rough patch, dragged down by volatility and relative underperformance.

In addition to performance issues, CTAs have a number of characteristics that are, on the surface, unpalatable to some investors, including high volatility, a reliance on technical analysis and the fact that commodity markets are classic zero-sum games.

But while these issues may cause some investors dismiss the sector out of hand, that could be a mistake. There's no question the industry is volatile, but as Thomas Schneeweis of the University of Massachusetts has noted, it is actually less volatile than the average stock in the Dow Jones 30 index.

Even more to the point, much of that volatility is upside deviation, a function of the CTAs' focus on riding up-trends and quickly stopping out losing trades.

The zero sum market arguments also may be misleading. If the market were comprised solely of CTAs trading against each other, no money would be made across the CTA universe.

But the futures markets include myriad participants, many of whom are using the markets for purposes other than speculation and may, as a result, improperly price that risk transference. It is this diverse composition that allows CTAs to extract net returns over time.

Of course that leaves the most controversial element of the CTA strategy: technical analysis. To old-school fundamental analysts and strong-form efficient market hypothesisists, technical analysis is little better than voodoo. But insofar as technical analysis properly viewed simply quantifies the behaviour of market participants, the ascendancy of behavioural science in academia bodes well for broader acceptance of the technique.

Meanwhile, the prolonged period of poor returns has caused many alternative asset investors to lose sight of one the greatest benefits of CTA investing: portfolio diversification.