In New York City savvy street vendors sell both sunglasses and umbrellas. By carrying two items that sell in very different weather conditions, the vendors have a product to sell regardless of weather. Prudent investors do the same by diversifying their investment portfolios among different types of assets which may respond differently to various economic conditions. Then again, famed investor Warren Buffet is known to have said that “wide diversification is only required when investors do not understand what they are doing.”

So whose advice should we listen to? One thing is for certain—the last ten years have been treacherous even for investors who have maintained diversified traditional portfolios of stock and bonds. As a result, astute investors have looked to alternative investment strategies as a means to further diversify their portfolios. In this article we delve into the concept of constructing a core-satellite approach which blends traditional asset allocation ideas with active management strategies like managed futures.

Traditional Asset Allocation

Asset allocation is the strategic combination of securities from different asset classes—traditionally cash equivalents, stocks and bonds—to create a diversified investment portfolio. Asset class describes a group of securities that share similar risk and return characteristics, and since different asset classes are less than perfectly correlated there are benefits to be derived by combining them in a portfolio. A further source of diversification comes from investments representing different economic sectors, geographic regions, etc.

Additionally, there are several approaches to asset allocation which differ in their required levels of active management involving changes in economic outlook, and assumptions about investors’ risk tolerances. The following descriptions are some of the most popular strategies typically employed by investors:

Buy and hold. This is the most basic approach in which an investor determines an initial allocation—for example 60% stocks and 40% bonds—and then holds this portfolio throughout market fluctuations without making adjustments. In the buy-and-hold approach an investor will hold a greater percentage of stocks as stocks appreciate and a smaller percentage as stocks depreciate. Thus this strategy implicitly assumes that the investor’s risk tolerance changes with the level of wealth accumulated.

Insured. Another approach adjusts the portfolio’s allocation to stocks in relation to a predetermine floor value below which the portfolio should not fall. In other words, the investor sells stocks as they depreciate reducing the allocation to stocks to zero as the portfolio value approaches the floor value. Consequently, insured asset allocation explicitly assumes that the

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An investor has zero tolerance for risk below the floor value and increasing risk appetite at levels above the floor value.

**Strategic.** A third approach establishes target portfolio percentages for each asset class based on long-term market assumptions and the investor’s long-term attitude toward risk. The investor makes periodic adjustments to restore this targeted portfolio mix as the relative value of the asset classes change with respect to each other. Accordingly, the investor will sell assets that have grown at a faster rate and buy assets that have grown at a slower rate. This is often referred to as rebalancing. Implicitly strategic asset allocation assumes that the investor’s risk tolerance does not change with short-term fluctuations in the level of wealth—the investor will hold stocks in the targeted proportion regardless of market direction.

**Tactical.** This approach requires that the investor actively adjust the portfolio’s target asset allocation to reflect changes in his/her own shorter-term market expectations. Often such adjustments reflect views about expected market developments that are contrary to market sentiment. The investor reduces exposure to assets that have appreciated beyond his/her estimate of fair value and reinvests the proceeds in assets he/she estimates are undervalued. Like strategic asset allocation, tactical asset allocation assumes that an investor’s risk tolerance is stable over the investment horizon regardless of the level of wealth. However, unlike the strategic approach, a tactical approach anticipates changes in the relative value of different assets and seeks to benefit from adjusting the portfolio mix before these changes occur.

**Integrated.** An integrated approach to asset allocation incorporates both changes in market assumptions and investor risk tolerances, and revises the target allocation mix accordingly. This approach has the benefit of being the most comprehensive strategy; however, it is also the most complicated to implement. One way to implement this approach is by using a core-satellite portfolio construction. Simply put, core-satellite blends a core traditional allocation using buy-and-hold, strategic or insured approaches with an overlay of active management alternative investment strategies. An optimal blending of the core and satellite allocations is often driven by what is commonly referred to as an “active risk budget” which is determined by how much active risk the investor is willing to assume when attempting to implement their asset allocation plan.

**Establishing a Core Portfolio**

Establishing an asset allocation plan is the first step toward developing a disciplined investment strategy. The plan should reflect an investor’s unique investment profile based on personal circumstances including wealth, investment horizon, tolerance for risk and financial objectives. Attention to these circumstances help investors decide how the portfolio should be allocated among asset classes and investment strategies.

The graph below provides a simplified example of how asset allocation plans can vary from investor to investor. For instance, conservative investors who have short time horizons or very low tolerance levels for risk may allocate a much larger portion of their portfolios to fixed income. Not surprisingly their potential for reward (indicated by the triangle) will be less than that of aggressive investors.

Selecting the best asset allocation approach depends on an investor’s goals and preferences. For instance, does the investor wish to actively trade the portfolio and formulate assumptions about changes in capital market expectations? Or does the investor wish to take a more passive, long-term approach?

<table>
<thead>
<tr>
<th>Buy-and-Hold</th>
<th>Strategic</th>
<th>Tactical</th>
<th>Insured</th>
<th>Integrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rebalances to target allocation</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Assumes changes investor’s risk tolerance</td>
<td>Yes</td>
<td>No</td>
<td>N/A</td>
<td>Yes</td>
</tr>
<tr>
<td>Anticipates changes in market expectations</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Works best in:</td>
<td>Long term secular bull markets</td>
<td>Bull markets but adapts to oscillations</td>
<td>More reliant on investor skills than conditions</td>
<td>Reduces risk during bear markets</td>
</tr>
</tbody>
</table>

*Trading is speculative and not appropriate for all investors. Past performance is not necessarily indicative of future results.*
So far the discussion has been focused on traditional investments such as stocks and bonds that can be used to construct an investor’s core investments. The following sections describe satellite investments that have the potential to further diversify and even hedge the core traditional portfolio using alternative investments, specifically managed futures as a vehicle.

**Absolute versus Relative Returns**

Active risk differs from market risk. Market risk is associated with the risk and return of the broad market or subsector of the market. This structural source of systematic risk/return is often referred to as *beta* and is represented by an index. In recent years there has been a proliferation of indices which purportedly represent proxies for beta. Financial innovation, in turn, has converted many of these proxies into investment products such as ETFs. As a result, investors can now more than ever easily diversify their portfolios across multiple sectors in what has been termed as the “multiple beta” approach.

Active risk, on the other hand, is the risk of an active manager underperforming their benchmark. In other words, active money managers attempt to outperform their asset class/style benchmark on a relative basis, more positively on the upswing or less negatively on the downswing. Certain active managers attempt to produce positive returns regardless of underlying market conditions in an approach generally referred to as “absolute returns”. This skill-based return generated by active managers is called *alpha*.

An honest discussion of active management cannot be made without examining the ideas of *relative returns* and *absolute returns*. It should be simple, but knowing whether a portfolio manager is doing a good job can be a challenge. The reason why it is difficult is because it depends on how the rest of the market is performing. For example, in a bull market 2% is a horrible return. But in a bear market, when investors are down 20%, just preserving your capital would be considered a triumph. In that case 2% doesn’t look so bad.

Absolute return is the fixed percent an asset or portfolio returned over a certain period. Therefore, the 2% mentioned in the paragraph above is considered absolute return. If a trader returned 8% last year, then that 8% would be its absolute return. Relative return, on the other hand, is the difference between the absolute return and the performance of the market, which is usually gauged by a selected benchmark.

Relative return is the reason why a 2% return is bad in a bull market and good in a bear market. For example, if the absolute return of your portfolio is 10% and the performance of the S&P 500 during the same time period is 6%, then you have a relative return of 4% greater than the market. If, however, during this same time period the S&P 500 returns 15%, then you have a relative return of negative 5%.

Why is relative return so important? Because it is the generally accepted method for measuring the performance of actively managed portfolios, which should get a return greater than that of the market. After all, you can just buy an index fund with a low expense ratio which will proxy the market’s return. However, if you are paying a manager to perform better than the market, but the fund doesn’t have a positive relative return, it may be worth finding a new manager or buying an index fund.

But this is where things can get complicated. Who is to say what the “market” is? The S&P 500 index is often cited as the benchmark for the stock market but it actually represents mostly large-cap stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the U.S., while Barclays Aggregate Bond Index is comprised of fixed income securities to simulate the universe of bonds in the market. For commodity markets this question is infinitely more difficult one to answer.

For these reasons, we note that managed futures is vastly different from most other types of investments that an investor allocates to. Considerations specific to managed futures include the range of styles within managed futures, underlying assets upon which an advisor focuses, which benchmarks is most appropriate for comparing performance, and leverage and its impact on performance comparison. Each of these areas is a topic deserving further discussion in upcoming issues of *CT Focus*.

**What is Managed Futures?**

The increasing popularity of commodities is a reminder of the everlasting debate between investors as to the extent passive asset class exposure is the primary driver of return, versus to what extent does a tactical approach to investing play a positive, negative or neutral role in managing risk and return. In recent years, institutional investors have significantly increased their exposure to commodities, both in an effort enhance returns and as a means to provide protection against inflation.

Historically, the way investors gained exposure to commodities was either by investing in commodity-related stocks or engaging in active trading using the commodity futures markets. As a result of the CFTC Act of 1974, active futures trading evolved into a sector of the industry known as managed futures.

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Generally, managed futures refer to professionally managed assets in commodity as well as financial exchange traded futures and options. Management is directed by Commodity Trading Advisors (CTAs) and Commodity Pool Operators (CPOs) in a highly regulated environment overseen by the CFTC and the NFA, a self-regulatory body. Accounts are custodied with clearing firms called Futures Commission Merchants (FCMs) and Introducing Brokers (IBs) serve as correspondents. Nowadays, managed futures not only includes trading on commodity futures but also on financial contracts such as currencies, interest rates and stock indices.

Savvy investors have long been attracted to the transparent structure as well as the often non-correlated returns managed futures investments can provide beyond exposure to traditional asset classes. A key reason why is that trading advisors tend to trade on both the long and short side of the market, creating the potential to profit from rising and falling markets. Further, various studies have concluded that managed futures have low correlation to traditional asset classes, enabling them to enhance returns as well as lower overall volatility. Indeed, managed futures provide both exposure to alternative assets and an array of trading styles, and traders who operate in this specialized universe often offer a superior tradeoff between risk and return.

Accordingly, the potential benefits of managed futures within a well-balanced portfolio include:

- Potential to lower overall portfolio risk
- Opportunity to enhance overall portfolio returns
- Broad diversification opportunities
- Opportunity to profit in variety of economic environments
- Active risk management by trading advisor

The following illustrates that adding managed futures to a traditional portfolio improves investment return while also potentially reducing risk. This has been substantiated by academic research, beginning with the landmark study by Dr. John Lintner of Harvard University in which he wrote: “... the combined portfolios of stocks (or stocks and bonds) after including judicious investments ... in leveraged managed futures accounts show substantially less risk at every possible level of expected return than portfolios of stocks (or stocks and bonds) alone.”

Of course as with any investment there are risks associated with managed futures. When choosing a single trading advisor or when constructing a managed futures multi-advisor portfolio it is important to properly analyze performance history and determine if the style and strategy is appropriate. The next section discusses various considerations for establishing a satellite portfolio consisting of managed futures programs.

### Integrating Managed Futures

Investing in managed futures can be complex to the uninitiated, and the typical stock broker at a large wirehouse is not going to be a specialist in managed futures. Fortunately there are experts in the space such as Capital Trading Group that can help educate and guide investors in making investment decisions.

Trading advisors’ strategies generally fall into two major categories: a group known as trend following and a group referred to as mean reversion.

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Integrating Managed Futures and Traditional Investments

To as market-neutral traders. As the name implies, trend followers follow evolving trends in the market (we note that one man’s trend may be another’s counter-trend; hence time horizon is an important factor). Alternatively, market-neutral traders typically try to profit from non-directional trading strategies.

When executing their trading strategies advisors use either fundamental analysis, technical analysis or quantitative analysis in their decision-making process. In addition, trading can either be discretionary or systematic—meaning advisors either trade based on experience and a “gut” feel, or they automate their trading using computers. Finally, some trading advisors focus on a diversified basket of underlying assets, whereas others focus their trading on agriculturals, energies or metals.

Sometimes investors ask why not just invest in commodity ETFs? The truth is that commodity ETFs are actually securitized managed futures products—underlying each commodity ETF is a CPO typically employing simplistic passive “long-only” strategies. On the other hand, legacy managed futures programs use sophisticated active management strategies like hedge funds, and thus generate alpha-type returns.

Investing in general, particularly managed futures, is a combined craft of art and science best learned by experience. Accordingly, a practiced guiding hand can be very helpful in identifying appropriate managed futures programs to complement a traditional investment portfolio. Interestingly, a core-satellite approach can also be used when constructing a portfolio invested in multiple trading programs—this call a multi-advisor approach. In such an approach the core program is typically a trend-following program, and the satellite programs are trading advisors who are focused on niche strategies.

Investment in CTA programs is often facilitated through separately managed accounts whereby the investor provides the CTA authorization to trade their account. The big advantage to this structure is that it allows the investor to closely monitor all activity occurring in his or her futures account. To open a separately managed account there are two sets of account paperwork to complete: (a) the FCM’s documents which include new account forms and a trading authorization form; and (b) the CTA’s account agreements and questionnaire.

It is important to note that this is a tri-party relationship and the broker with whom you work can help monitor the trading of CTAs. Alternatively, investors interested in managed futures but who aren’t inclined to identify specific CTA programs in which to invest can utilize the services of a CPO which are funds specializing in constructing and monitoring CTAs. The disadvantage to this approach is that it doesn’t offer the same kind of transparency as separately managed accounts.

The above discussion about managed futures only touches upon a variety of considerations which we will be addressing in future issues of Capital Trading Focus. For more information about alternative investments in general or a specific CTA, contact a representative at Capital Trading Group to further discuss how managed futures can enhance your portfolio.

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