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Managed futures strategies

For more than 30 years, managed futures have shown their ability to generate returns from investing in futures and options contracts, going both long and short on the full range of commodity, currency and financial markets. They can generate positive returns regardless of whether the financial markets are rising or falling. Consequently, they have great appeal to investors wishing to diversify their equity market exposure. The low correlation between managed futures and other types of hedge funds also adds to their strength as a source of diversification. For example, over the period from 1 January 1990 to 31 December 2008, the Stark index (benchmark of the managed futures) has a correlation of -0.01 with the HFRI Equity Hedge Index, -0.09 with the HFRI Event Driven Index and -0.12 with the HFRI Relative Value Index. The correlation close to zero means that the change of stark index and the HFRI index are almost uncorrelated.

The managed futures industry has grown substantially in recent years. Figures from the Barclay Group show assets management by the industry rose from USD310 million in 1980 to USD206 billion at 31 December 2008. The compound annual growth rate is 26.1%.

The managed futures universe can be broadly divided into discretionary and systematic strategies. Discretionary managed futures managers apply opportunistic strategies drawing on both fundamental and technical analysis. Discretionary traders rely on fundamental analysis by studying factors that affect demand and supply of a particular commodity to predict future prices. They rely less on computer generated signals and more on their experience and trading skills. These may cover issues as diverse as economic strength, government policies, domestic and foreign political events or the weather. Fundamental analysts believe that markets have a fair value to which they must converge over the medium term and seek to identify and profit from periods of over or under valuation. As discretionary traders rely on human input, the number of trading opportunities is smaller compared to systematic trading strategies.

Conversely, the systematic strategies make use of historical price data and historical relationship that can be tested to anticipate future price movements and rely heavily on computer generated, technical trading signals. They include:

- 1) Trend following (seek to capitalize on medium to long-term trends in a variety of markets);
- 2) Trend reversal (seek to capitalize on key turning points in liquid futures markets);
- 3) Contrarian or counter-trend (seek to sell near market tops and buy at market bottoms)

Systematic trading is based on computerized quantitative models that use moving average prices, break-outs of price ranges or other technical rules to generate buy and sell signals for a set of markets.

Systematic managed futures traders run programs that are quantitative and primarily directional in nature. Their investment rules are executed within a systematic framework. Trading takes place around-the-clock and real time price information is used to respond to price moves on over different markets and exchanges. These markets include, without limitation, stock indices, bonds, currencies, short-term interest rates and selected commodities, including energy and metal contracts.

The managed futures style is characterized by large return distributions. For the period January 1994 to November 2008 the monthly distribution of returns for Stark index ranged from -6.39% to 8.16%. Compared with other hedge fund styles, managed futures have the highest return potential but also high volatility and downside deviation. They also have lower Sharpe ratio than other hedge fund, reflecting their greater volatility.

However, many managed futures funds recorded a fall in NAV per share in the first 4 months this year. The majority of the losses came from the currency and bond sectors where a multitude of factors saw sustained periods of whipsawing movements in asset prices and significant trend reversals.

Managed futures funds prefer stable price trends and do not benefit from this type of environment. In order to minimize the losses from whipsawing, they use order filtering and volatility controls within the trading systems. As volatility increases, positions are duly scaled back.

Managed futures funds had an excellent year in 2008, profiting from a wide range of trends. Although they are underperformed in the first few months this year, we believe that they are still one of the essential tools for portfolio diversification and they are not expected to switch frequently.

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