MANAGED MONEY

Finding winners in a risk on/risk off world

BY **DANIEL** P. COLLINS

Once again managed futures found itself in a difficult environment and, although the Barclay CTA Index was negative for a record third consecutive year, there were many traders able to navigate the rough waters to find profitable trading opportunities.

Managed futures had another difficult year in 2013, and not only suffered a poor return environment spurred on by continued unprecedented government and central bank intervention but also by media attacks and costly regulations hitting at the worst time.

Profiting in a risk on/risk off world
Discretionary ag traders step up

Last year we reported how the Barclay CTA Index experienced back-to-back negative years for the first time in its 35-year history. Make it three in-a-row as the index dropped 1.46% in 2013.

There is a consensus of opinion that the risk on/risk off nature of markets in recent years is to blame for the difficult environment of the last few years. Normal fundamentals drivers have taken a back seat to speculation on how the Federal Reserve will react to news, causing sharp reversals of trends, the bane of all trend-followers.

"Yes the markets have fundamentally changed and yes it has been a bad cycle," says Thomas Rollinger principal at Red Rock Capital. "The forced zero interest rate policy and other government intervention in the markets created unique behavior that was troublesome for most."

Dunn Capital Management President Martin Bergin says, "There is pretty good evidence that the risk on/risk off nature of markets [creates a difficult environment] for trend-followers. The worst case scenario has you make gradual profits and then have sharp reversals."

Dunn, however, was one of the few more traditional trend-followers who performed well in 2013. Its benchmark WMA program earned 34.19%, its D'Best program earned 37.61% and its combined earned 57.74%.

The combined program gives equal exposure to WMA and Revolution Capital Management's short-term Mosaic program.

Revolution Principal Michael Mundt

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attributes their success to adding intraday trades to their already short-term approach.

As a short-term program Mosaic was the more likely strong performer, 41.44% in 2013, but the strategy had struggled in 2011 and 2102 as choppy markets damaged traders across the time spectrum.

BarclayHedge President Sol Waksman says, "A lot of it depends on your time-frame. If you are a shorter-term or [super long-term] trader you were ok, if you are in the middle somewhere you might have a problem."

Waksman says the first few months of the year were decent but in the middle of the year trends were choppy and volatile.

Bergin attributes Dunn's success to profitable trades in Asian financial markets early in the year and changes to its methodology that allowed them to keep more of those profits. Dunn does not alter

DeCook: Seasoned over four decades of trading

Steve DeCook has been a successful trader and money manager across several eras and market environments. In 2013 his low-risk Hawkeye Spread program earned 10.4% focusing on grain and livestock markets.

"A lot of [our success] was centered on bull spreads in the soybean complex," DeCook says. "We did a little bit of corn/wheat spreading but most of the profits were with bull spreads in the bean complex."

PHOTO BY FOUR SEASONS COMMODITIES CORP.

STEVE DECOOK

It is a little ironic that DeCook found success with bull spreads as he, along with partner Malinda Goldsmith, reentered the world of money management in 2005 with CTA Four Seasons Commodities Corp. specifically to bear spread grain markets.

DeCook, who grew up on a farm in Iowa, was one the most successful early commodity trading advisors in the 1980s and 90s with Fundamental Futures Inc. The fundamental discretionary ag program averaged more than 15% over a 20-year period and managed more than $100 million at its peak.

After a tough year he decided to pack it in and trade on his own. But DeCook was always a student of the markets and when he saw the opportunities being created by the massive money flows of long-only commodities indexes, the Goldman Sachs Commodity Index in particular, he decided to get back in the game.

"We did the bear spreads with the Goldman roll when I saw that it looked to be easy money and it worked for a couple of years but pretty soon everyone caught onto it and when everyone catches on then it doesn't work anymore," DeCook says.

But just because the "free money" bear spreading in front of the Goldman roll dried up didn't mean there weren't opportunities in the ag complex, especially for someone who spent a lifetime studying the fundamentals.

"Since the Goldman situation didn't present an opportunity anymore, it was a matter of looking for other ways to spread the markets," he says. "I look at where the fundamentals dictate where price should be and if it is a long way away from where it should be, I view that as an opportunity to put on a trade."

In 2013 he found opportunity with a tight domestic supply hangover from the 2012 drought along with stronger South American production.

"We had a tight domestic supply [and] we had a bumper crop in South America so the deferred options had no reason to rally because there were plenty of beans in the world, it was just a matter of logistics," DeCook says. "Last year they had ships that were waiting over 60 days to get loaded with beans. To get the beans to the port they don't have a great infrastructure. They don't have a rail, they don't have a Mississippi barge traffic, and in the meantime we were the supplier of beans and it kept getting tighter and tighter."

This is the type of analysis that allowed DeCook to outperform other traders. He is under no illusion that he has greater information than others, but he can apply decades of fundamental experience.

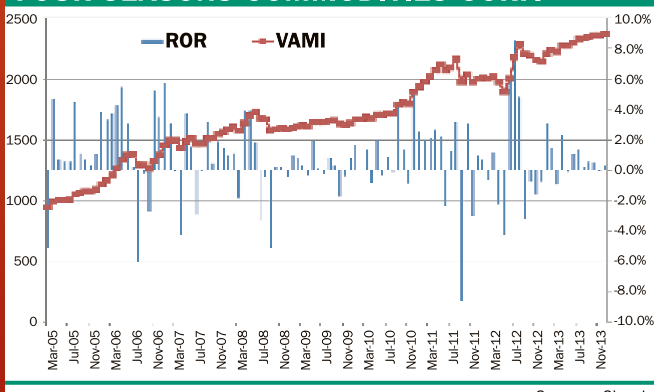
"Thirty years ago, growing up on a farm in Iowa, I thought I had grassroots knowledge that not everyone had a grip on but in today's information age, there are no longer any secrets. I don't know anything that other people don't know," DeCook says.

But he does know that not all that information is relevant. "You have to get through all the nonsense and down to the 5% or 10% of the news that is really pertinent and useful. [The ability to] figure out what is relevant and what isn't is the difference between a successful trade and one that isn't."

Perhaps the biggest change from his earlier program, for DeCook and the industry itself, is the focus on risk management. "Twenty or 30 years ago we traded one contract per $25,000 in equity but now we trade one contract per $100,000 and that is a spread rather than outright," DeCook says. "Back in those days we were making 40% or 50% but that is not going to happen again."

On a risk-adjusted basis his current strategy may be stronger.

FOUR SEASONS COMMODITIES CORP.



Source: eSignal

Hu: A diamond in the rough

When Diamond Capital Management was profiled as a “Hot New CTA” in *Futures* more than a decade ago it was a conservative option-writing program that would later have difficulty with the huge spikes in volatility six years ago. Diamond Principal Kelly Farrell relaunched the strategy with new head trader Albert Hu in October 2009 and since it has produced a compound annual return of 18.04% with a worst drawdown of 10.82%.


PHOTO BY FINGER PHOTOGRAPHY

ALBERT HU

Hu also operates Cauldron Investment, a program targeted at qualified eligible participants (QEPs) trading the same strategy with slightly different gearing.

Option-writing is still used but it is just one of three components trading the S&P 500 in a triangulated approach. The three sub-strategies include trend-following, countertrend and option-writing.

While the program targets absolute return by utilizing its countertrend and premium collection strategies, in 2013 most profits came from the trend program capitalizing on the bull market in equities.

“2011 was a better example of how it could outperform the S&P. The trend reversal worked. May 2012 [had one of the] largest down moves for the S&P and we were marginally lower,” Hu says.

For 2013 the Advanced S&P Program earned 28% with its trend-following approach, 8% in options and gave back 2% (all before fees) in its trend reversal system. Hu says their correlation to the S&P 500 was higher than normal, adding that its trend reversal program drove more profit in the volatile periods in 2011 and 2012.

Diamond made money with the option program throughout the year and managed to avoid losses during the Fed-inspired volatility in the spring. “Because of that we actually made more money the next month because we write options on the 21st so when volatility spiked for two days our options captured more premium,” Hu says.

Diamond’s positions did not get hurt by the spike in volatility and that spike allowed it to capture more premium through the summer months.

Hu says, “The option-writing does not have anything to do with the other two programs, it is totally independent. Every month we just write puts; unless the calls have a [high] premium we would not write any.”

The trend-following system can be very long-term and is usually long the market. “Last year we were sitting on a long position for 365 days,” Hu says. “Market conditions of the last year don’t happen very often.”

Before Hu would consider taking a short signal in the trend-following model, he would have to determine that the market had moved into a bear mode. “I would have to have market conditions meet my bear market criteria before I will take a short in the trend-following system.”

This doesn’t mean Diamond was long 365 days last year as the countertrend model took them out of the market at times. “If the [countertrend] signal is weak we [would] ignore it, we would just maintain our trend- following program,” Hu says. “If it is strong we would get out of our trend-following [position]. If we get a really strong signal in the trend reversal system, we would actually go short.”

This didn’t happen in 2013. “The best we ever did in the reversal program is to get neutral,” Hu says.

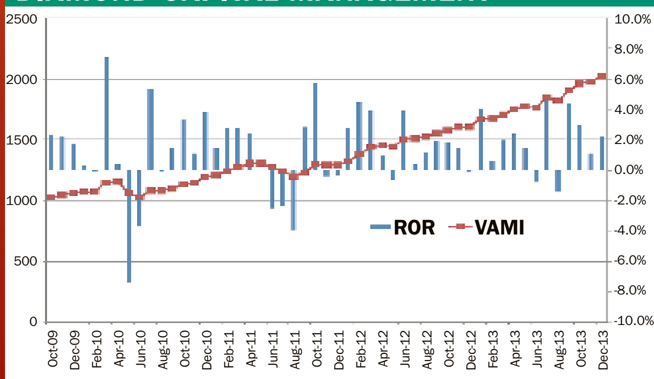
While he is nearly completely systematic across his trend-following and option programs, when it comes to the reversal there is a little more judgment.

“The reversal system is a little bit more of art and science,” Hu says. “Between weak, strong and stronger, it is more of a pattern recognition [strategy]. I haven’t been able to digitize it. It is a sell signal when we need it.”

It came in handy in May of 2012, helping it to offset the huge bear move. Hu has developed his approach over several decades of trading. No one knows what the market will look like this year so it is important to be able to profit from different market scenarios.

Diamond’s approach does just that.

DIAMOND CAPITAL MANAGEMENT



Source: eSignal

Tlaloc: A safe beachhead

If there is one theme that has permeated the managed futures world over the difficult period of the last three years, it is the importance of flexibility and solid risk management. Of course, a deep institutional-level knowledge of markets always helps.

Jean Beach, principal of Tlaloc Capital, epitomizes the knowledge and discipline it takes to perform in difficult market environments.

PHOTO BY SCOTT KOHN

JEAN BEACH

The Tlaloc program trades corn futures with a short-term fundamental approach. Beach was a proprietary trader at Enron and headed up risk management at Tyson Foods before launching her own commodity trading advisor in 2011.

Risk management has remained foremost in her approach as demonstrated by her solid risk-adjusted return numbers. While Tlaloc's 10.71% return for 2013 may not seem so impressive, it comes with a worst drawdown of 3.58% over the worst period in the history of managed futures.

Key to Beach's success is her knowledge of the fundamentals. "I trade off of a variety of different things; you have to have both the supply and demand side of the equation," Beach says. "Weather is certainly impactful but you have to have a good grasp of what is going on with margins not only for ethanol producers, but at the same time what is going on with protein processors, what is going on with potential feed substitution. You need to take a look at both sides of the balance sheet in a very detailed fashion."

Beach understands both sides of the equation and that her fundamental analysis could be off, or at least early, so she looks at different timeframes. "My trade philosophy is to have core positions but to also have intraday and intraweek trading to generate additional alpha," Beach says. "If you look at the total trades in a year — let's say 1,000 — about 60% of those trades are going to be intraday. The percentage of those intraday trades that are profitable is significant."

This is simply an acknowledgment of the dynamic nature of markets. "I like having a core position but based on the information flows that come in, to be able to hit some singles and doubles to generate additional alpha and stay very nimble."

In 2013 this meant understanding the choppy nature of the corn market and finding valuable short-term trades. "It was choppy downward and there was significant volatility, which helped because I have core positions but also like to do intraday and intraweek trading, and that helped me to maintain a program with relatively low margin-to-equity usage."

Beach also likes to read the market to see where traders are leaning going into a report. "One of the things I look at when taking a position is to ask if the trade is overcrowded. For example, in the [January 2014] USDA [stocks] report even though you could be bearish, the expectations were so high relative to production you [had to ask if] it looked a bit overcrowded [and] may be better off staying flat."

In 2013, Beach saw that there was greater risk to the downside based on a solid South American crop, feed substitution and the fact that prices remained elevated from the 2012 drought.

"These factors combined with the elevated price level as well as the macro environment, much had been priced in, [that] the higher potential for price risk for corn was to the downside," Beach says.

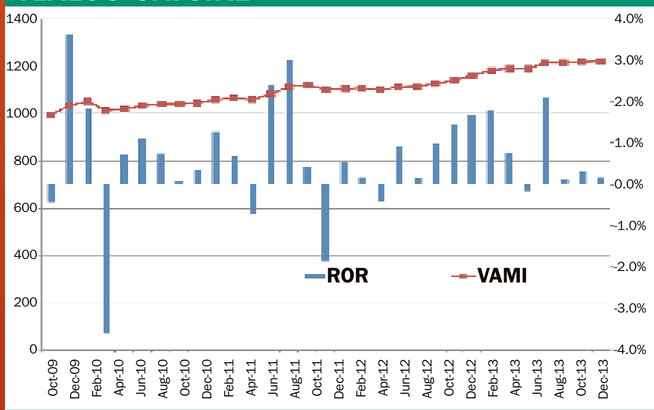
She maintained a core short position but was disciplined with it. "There were certainly opportunities to scale in and out," Beach adds.

It was this understanding of the fundamentals and nimbleness during the volatile growing seasons that allowed Tlaloc to pick up short-term profits while keeping risk low.

"Discretionary managers have the ability to price the relevant fundamentals that are driving the markets and also can adapt to changing trade environments," Beach says. She adds that keeping her margin at risk low allowed her to "react to market changes quickly."

By keep risk low, understanding the core fundamental drivers while also staying flexible enough to catch short-term moves, Tlaloc was able to deliver superior risk-adjusted returns in a difficult market environment.

TLALOC CAPITAL



Source: eSignal

TOP CTA PROGRAMS ABOVE/BELOW $10 MILLION

Below are the top CTAs managing more than $10 million at the end of 2013. Programs have a minimum track record of 30 months through December 2013. Statistics were calculated since program inception dates, unless otherwise indicated, from a universe of 526 programs.

CTA	Current YTD return	Worst draw-down of 2013	Compound annual return	Sharpe ratio	Worst drawdown	Upside/ downside STD	Best 12 months	Worst 12 months	Money under mgmt. ($ mil.)	Date started
DUNN Capital Mgmt. (Combined)	57.74%	9.49%	5.14%	0.09	69.60%	1.26	101.06%	-43.62%	21.0M	Nov-99
Opus Futures	50.45%	10.92%	17.14%	0.36	50.61%	1.34	91.50%	-41.91%	11.6M	Mar-11
e360 Power Fund LP	47.14%	5.56%	24.25%	0.96	28.71%	1.38	50.45%	-18.09%	25.1M	Feb-11
Mulvaney Capital Mgmt. (Gl. Markets)	43.10%	17.18%	13.14%	0.35	45.02%	1.49	115.15%	-35.29%	150.0M	May-99
Revolution Capital Mgmt (Mosaic)	41.43%	10.79%	10.98%	0.31	53.34%	1.12	104.46%	-38%	64.0M	Oct-06
CenturionFx Ltd (6X)	40.63%	6.50%	58.73%	2.14	21.60%	2.38	238.76%	7.34%	41.3M	Jan-06
DUNN Capital Mgmt. (D'Best Futures)	37.60%	10.63%	10.75%	0.21	52.06%	1.35	130.77%	-43.56%	47.0M	Jun-94
SMILe Global (Mgmt FX)	36.40%	5.03%	40.53%	2.05	8.09%	2.78	69.88%	9.54%	12.3M	Mar-11
DUNN Capital Mgmt. (WMA)	34.18%	16.97%	13.86%	0.29	60.05%	1.41	128.87%	-44.15%	335.0M	Nov-84
Two Sigma (Enhanced Compass)	29.68%	5.70%	28.75%	1.36	19.26%	1.96	78.42%	-14.90%	4436.0M	Jan-05
Gables Capital Mgmt (Global FX)	29.40%	6.29%	4.54%	0.43	18.81%	1.37	29.40%	-17.75%	46.0M	Feb-09
Abbey Global LP	27.67%	4.99%	10.88%	0.56	43.38%	1.27	58.51%	-39.16%	42.2M	May-02
H20 AM LLP (Force 10)	27.41%	1.83%	20.51%	2.18	7.23%	2.58	37.36%	10.41%	2144.1M	Mar-11
Pan Capital Mgmt (Energy)	27.11%	18.58%	53.01%	2.66	18.58%	2.11	145.03%	27.11%	19.0M	Jul-11
24FX Global Advisors	25.73%	10.00%	26.38%	1.4	19.28%	1.57	105.36%	-12.12%	55.1M	Jan-01

Below are the top CTAs managing less than $10 million at the end of 2013. Programs have a minimum track record of 30 months through December 2013. Statistics were calculated since program inception dates, unless otherwise indicated, from a universe of 325 programs.

CTA	Current YTD return	Worst draw-down of 2013	Compound annual return	Sharpe Ratio	Worst drawdown	Upside/ downside STD	Best 12 months	Worst 12 months	Money under mgmt. ($ mil.)	Date started
Investment Capital Adv (Managed Acts)	104.73%	9.48%	57.56%	1.44	29.64%	1.94	109.06%	-4.83	5.5M	Nov-10
QQFund.com (QSIIP)	91.24%	5.36%	27.18%	0.85	35.81%	1.4	103.21%	-26.26	0.5M	Sep-08
Clinamen Fin. Group (Volatility Arb)	40.91%	17.62%	-4.91%	-0.19	45.08%	0.85	40.91%	-37.11	0.5M	Jul-09
Option Capital	40.50%	7.18%	39.89%	3.11	13.19%	1.74	69.98%	7.18	2.8M	Jun-11
Bayou City Capital	39.95%	5.00%	19.59%	0.41	80.34%	0.98	160.52%	-67.63	8.1M	Jan-01
Redleaf Capital (Fallback <$50K)	38.12%	16.49%	41.44%	1.2	16.81%	2.68	70.75%	1.64	0.5M	Jan-11
LEH Advisor (Break out Point)	37.21%	2.11%	23.99%	1.41	15.35%	1.98	75.12%	-14.90%	3.7M	May-09
Four Capital (FX)	34.19%	7.03%	11.77%	0.83	11.30%	2.09	44.75%	-11.10%	0.8M	Jun-07
AgTech Trading Company	34.10%	5.58%	11.32%	0.22	65.09%	1.3	225.63%	-54.96%	0.8M	Apr-82
JarrattDavis (Managed FX)	29.85%	5.01%	48.81%	3.01	5.92%	6.04	130.37%	13.49%	7.6M	Mar-08
Boston & Zechiel (ACTS Aggressive)	29.33%	2.07%	2.04%	0.06	62.39%	0.81	50.23%	-50.69%	0.4M	May-08
Niederhoffer, R.G. (Optimal Alpha B)	26.56%	14.08%	3.87%	0.13	42.99%	1.12	36.10%	-27.07%	6.8M	Dec-04
Diamond Capital Mgmt. (Enhanced S&P)	26.41%	1.43%	18.04%	2	10.81%	1.87	27.46%	8.37%	4.8M	Oct-09
Serac (Reversal Program)	24.78%	8.48%	41.84%	1.2	16.36%	3.68	93.54%	-13.09%	0.7M	Apr-11
Goldman Mgmt (Stock Index-Prop)	24.66%	2.71%	13.91%	1.03	14.44%	1.65	53.86%	-3.84%	8.0M	Feb-02

Source: BarclayHedge

its approach often but at the beginning of the year initiated its Adaptive Risk Profile that dynamically changes its risk exposure based on proprietary analysis. “We made 16% in February and didn’t give it back,” says Bergin. The question for every manager is, ‘How do you reduce volatility without reducing performance’ and this does it.”

It also highlights the difficulty in making assumptions in the trend-following space because despite the recent difficult environment there are trend-followers who managed to find a way to produce outsized returns.

Yet, as a whole, risk on/risk off made it a difficult year for trend-followers and the manager who did well concentrated on niche markets, avoided the chop by trading shorter-term and having the flexibility of discretion to avoid the wild swings.

Rollinger says, “Much of the choppiness seen by globally diversified trend followers is indeed linked to the risk on/risk off phenomenon. That phenomenon, however, has not been problematic in the long/short commodity space.”

Physical commodities rule

Short-term, discretionary and agricultural market-centered managers did well. The Barclay Agricultural Traders Index earned 2.89% for 2013 and two of our top traders of the year are ag focused: Tlaloc Capital and Four Seasons Commodities Corp. Tlaloc combines all those elements with a disciplined approach to produce solid risk-adjusted-returns.

Albert Hu, head trader for Diamond Capital Management, says the difficult environment is not just about risk on/risk off due to government intervention but the fact that central banks are acting more in concert with each other. “With all this globalization the major central banks have adopted the same kind of strategies,” Hu says. “The world economy has become much more integrated. In order to make money in the currencies you have to have very different central bank policies; now all central banks have the same policy.”

He adds that the same holds true with global fixed income markets.

Four Seasons Founder Steve DeCook says politics is a growing fundamental factor. "The Chinese have been a huge buyer of beans and now the whole world is waiting to see if they are they going to continue to buy our beans and pay $1 per bushel more or are they going to switch their sales to South America."

The Chinese have been known to cancel large orders but the takeaway here is that this type of factor that could disrupt normal trends in the market and be extremely difficult for a systematic manager to react to.

This gives an edge to programs concentrating on physical commodities and using discretion. "Tangible commodities such as corn, wheat and sugar behave differently and in a more predictable manner than financial markets," says Rollinger who launched a commodity-focused long/short program this year. "Fundamentals appear to play out more normally in physical commodities markets. Supply, demand, weather, etc. oftentimes create short-term, directional volatility bursts that our strategy is designed to capture."

And people are voting with their wallets. Tlaloc launched in 2011 and is currently managing more than $58 million trading the corn market. Four Seasons reached the $90 million mark in 2013.

These are large allocations for ag-focused managers. DeCook's partner, Malinda Goldsmith says they are getting allocations from institutions, many offshore, looking specifically for commodity traders.

DeCook adds, "A certain number of people want a fundamental agricultural trader and there aren't a lot of choices if that is what you want."

Is the end in sight?

With the Federal Reserve beginning to taper its asset purchases many managers are hoping to see an end to the risk on/risk off merry-go-round of recent years and a return to more 'normal' market conditions.

"Our view is tapering should bring back more normal behavior," Mundt says. "Fed purchases are distortive on the markets."

While many traders are hopeful, Hu expects difficult environment to continue. "People doing trend following are not going to do well in the foreseeable futures," Hu says. "People need to do more research to adapt to the new environment. They will have to find a way to combine trend following with mean reversion."

Of course that is not the only headwind facing managed futures. Bloomberg news published a pretty distorted piece on the industry, equating managed futures in general to certain high fee retail products and failing to distinguish those retail structures from the core managed account CTA structure.

"They shouldn't worry about fees," Bergin says, "They should be concerned that the fees are adequately disclosed."

And fees are adequately disclosed, a point the National Futures Association's Dan Roth made in a response to the Bloomberg story.

The industry also is facing higher compliance cost due to greater regulation. "The problem isn't risk, it is unknown risk," says Bergin. Dunn had been moving towards the retail space with its European UCITS products but Bergin says they anticipate less of that in the current regulatory environment. "Expense are going to increase and we will do less [in the retail space] due to requirements and regulations."

Hu says trading will become much more complicated but the industry has always rewarded innovation. One of the best performers in 2013 was the e360 Power Fund that earned 47.15% trading domestic power markets from a fundamental discretionary perspective. E360 is a hybrid CTA that trades on volatility, direction and relative value but more from the voice broker over-the-counter world. Are they the future? Perhaps but one must remember that the death of trend-following has been announced many times over and even though the current bad stretch has persisted longer than other tough periods, systematic long-term trend-following is still the most consistently profitable strategy over many decades and will most likely remain so.

"People are cutting back their exposure to [managed futures] waiting for things to change," Waksman says, "and it will change but the question is when."

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