



CAPITAL TRADING GROUP

The Art of Diversification:
Liquid Alternatives



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Liquid Alternatives



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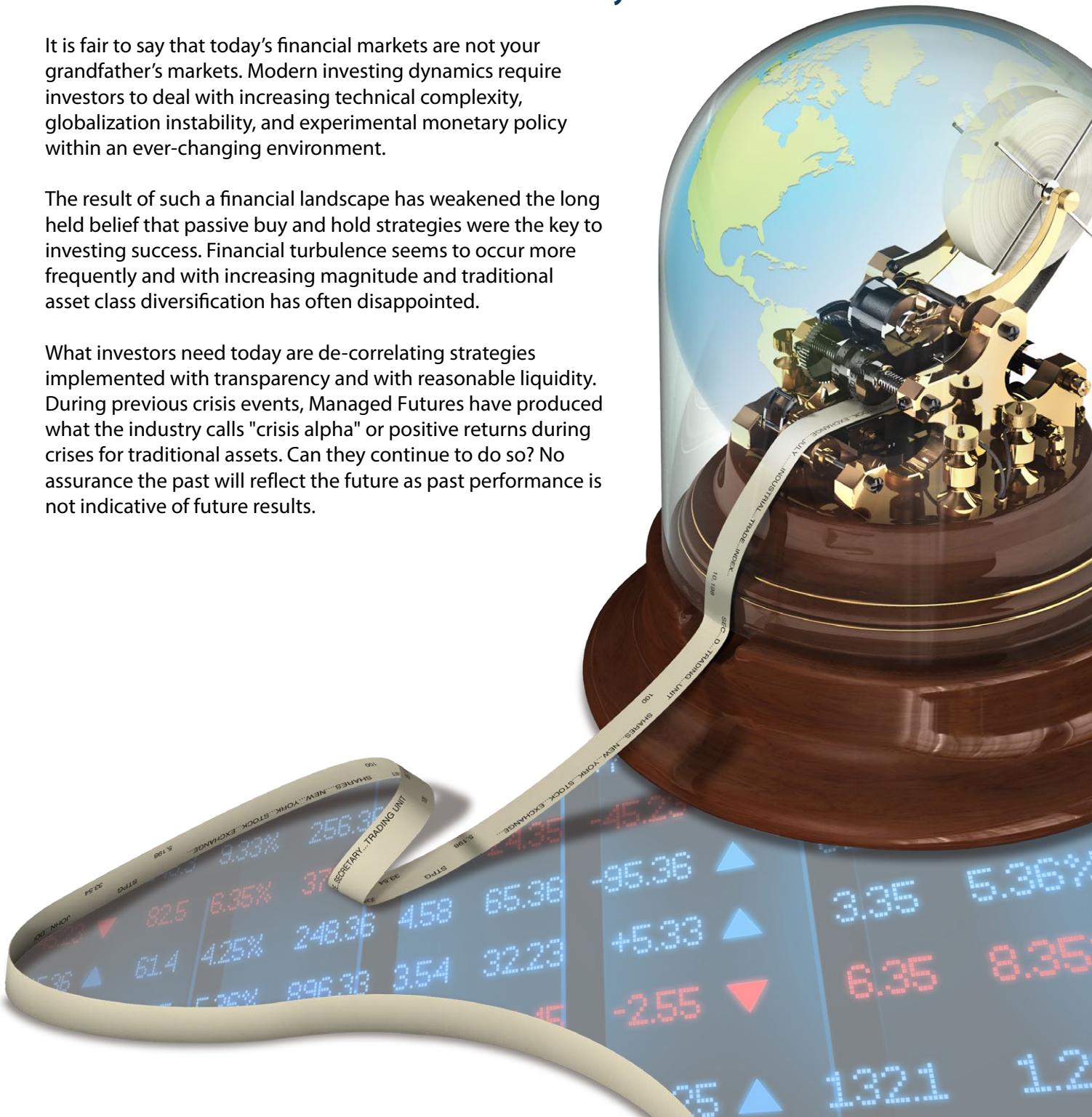
Managed Futures 101

It is Not Your Grandfather's Financial Market Anymore

It is fair to say that today's financial markets are not your grandfather's markets. Modern investing dynamics require investors to deal with increasing technical complexity, globalization instability, and experimental monetary policy within an ever-changing environment.

The result of such a financial landscape has weakened the long held belief that passive buy and hold strategies were the key to investing success. Financial turbulence seems to occur more frequently and with increasing magnitude and traditional asset class diversification has often disappointed.

What investors need today are de-correlating strategies implemented with transparency and with reasonable liquidity. During previous crisis events, Managed Futures have produced what the industry calls "crisis alpha" or positive returns during crises for traditional assets. Can they continue to do so? No assurance the past will reflect the future as past performance is not indicative of future results.



How Do Managed Futures Work?

Managed Futures were first introduced as investing options in the mid-1970s. At that time, commodity traders began to offer their strategies to individual investors in the form of individually managed accounts or pools. They were attempting to take advantage of the increase in volatility in the traditional commodity markets and the newly blossoming ones in interest rates and equity indexes. Forty years later, Managed Futures have evolved in an eclectic and diverse universe with a multitude of investing strategies built on the idea of capturing that often elusive alpha or skill based superior performance.

In Managed Futures, professional traders and investment managers are usually structured as Commodity Trading Advisors (CTA) for the purpose of managing many individual accounts based on the same strategy in which they specialize. Some advisors can also organize as Commodity Pool Operators (CPO) to execute similar strategies but in the form of a fund.

CTAs and CPOs utilize futures and options (and occasionally forward agreements) to implement systematic or discretionary strategies. Systematic managers probably represent the majority of CTAs and structure their strategies following a quantitative approach based on pre-set algorithms.

SYSTEM VS. DISCRETIONARY

A system approach, trend-following or mean-reverting, has the advantage of removing the emotions from the trading equation, an effect that can occasionally cloud the trader's judgment.

The other trading approach is called discretionary and as the name implies, it is based on the manager's feel for the markets; such "feel" is often derived from an extensive fundamental knowledge of the supply and demand dynamic or a significant experience on daily trading patterns. A discretionary trader will have the advantage of flexibility and will retain the ability to respond more quickly to changes in the fundamentals or structure of the underlying markets.

A recent trend is developing in the multi-strategy category, where CPOs mix, inside one vehicle, different and hopefully uncorrelated strategies to achieve minimum volatility returns.

Why Managed Futures?

Managed Futures offer three characteristics that today's markets have made essential:

1> Liquidity

2> Transparency

3> Generally uncorrelated returns

As opposed to the traditional alternative investment vehicles such as Hedge Funds and Private Equity, Managed Futures have the distinctive advantage to operate in mostly very liquid markets. For example, futures for US Treasuries, S&P500 Index or Crude Oil trade thousands of contracts every day, 24 hours a day and often on multiple exchanges around the world.

CTAs also typically offer daily (or close to it) liquidity on the investment as opposed to many alternative vehicles that are structured with lengthy lock-up periods.

The CTA format also provides full transparency to the investor. An account is opened with a broker of choice (in the futures arena, brokers are called Futures Commission Merchants or FCMs) in the name of the client. The client then signs a limited trading authorization designating the CTA as the trader on the account; this will enable the CTA to implement the strategy and place trades but he/she will not have any authority to move funds out of the account other than for the negotiated management and/or incentive fees. In this structure, the client is informed by a third party (the broker) of all movements in the account, therefore, the strategy can be monitored closely and deviations from style or agreed upon leverage can be spotted immediately.

A quick look at the major Managed Futures Indexes also shows the uncorrelated nature of the returns when compared to the traditional asset classes. As a practical example, when most traditional investments were being obliterated during the 2008 crisis, Managed Futures produced a 14% return (Barclay CTA Index). Please note that the Barclay CTA Index is not investable and may not reflect the performance of your investment portfolio in managed futures.



Who's the Sheriff?

Managed Futures are regulated by two main regulatory bodies: the Commodity Futures Trade Commission (CFTC) and the National Futures Association (NFA). The CFTC was created by Congress in 1974 with the task to protect investors from fraud and market manipulation. The NFA is a not-for-profit membership entity vested with the task to audit its members and enforce customer protection regulations.



Where is the Industry Today?

The Managed Futures industry has grown dramatically in the last few years with approximately \$330 billion in assets under management as of the fourth quarter of 2012. This success is undoubtedly good recognition of Managed Futures' de-correlating advantage. Individual investors, institutional players and progressive Registered Independent Advisors have increasingly embraced this asset class to gain a strategic edge in their portfolio allocations.

Changes in the financial industry, resulted from the chaos of 2008, are influencing the Managed Futures industry as well. The CFTC has already approved new rules on position size limits (although the rule is in appeal with a Federal District court) and the NFA has improved its auditing procedure by moving certain functions to an electronic procedure.

What Now?

Modern Portfolio Theory postulates that a highly and smartly diversified portfolio should result in the most efficient risk adjusted investment pool. Until recently, such diversification meant stocks, bonds and some cash. The most progressive investors (and the ones with the deepest pockets) ventured into Private Equity and Hedge Fund investments trying to capture illiquidity premium and diversification as well. However, the 2008 crisis and the global systemic response to such turmoil permanently changed the financial markets. New sources of risk adjusted returns are being sought after by investors and new risk premia are being placed on liquid and highly transparent investments. Managed Futures can be the right answer.

Defining Crisis Alpha

Managed Futures have shown, over the last thirty years, the kind of uncorrelated returns that investors would want to incorporate in their allocations to improve their Efficient Frontier. No assurance can be made that they will continue to provide this uncorrelated return aspect and there is a risk of loss associated with managed futures. Many studies have analyzed such dynamic asset allocation, from the seminal Lintner study in 1983 to the Peters work in 1992.

However, one has to understand crises to fully comprehend why Managed Futures, above other Alternative Investments solutions, can provide such an edge during "edgy" times.

During a significant market crisis, there are objective limitations to those elements that usually keep markets orderly. There are limits to arbitrage actions, forced liquidations push large and leveraged players into unwanted and inefficient de-leveraging and of course major technical glitches mar trading action. Many crises often center on credit issues, which can very quickly engulf many other generally healthy parts of a financial ecosystem. Lastly, significant market breakdowns will be accentuated by behavioral inefficiencies. The end result is a disappearance of liquidity resulting in massive increases in volatility.

But I have Hedge Funds to Protect Me from These Crises...

Most Alternative vehicles such as Hedge Funds, Funds of Funds or even Private Equity

Funds cannot easily escape the vicious circle of liquidity drying up, de-leveraging and increasing fear due to the nature of most of their strategies and their implementations. Most Alternative vehicles are usually highly leveraged and dependent on easy access to funds; additionally, they tend to make money by exploiting illiquid anomalies. These parameters create a toxic combination during major financial dislocations. Please note that increasing leverage increases risk.

In 2008, for example, the Barclay Hedge Fund Index was down 21.63% for the year while Managed Futures, as mentioned earlier, were actually up.

The ability of Managed Futures to provide positive returns during major dislocations was termed "crisis alpha" by Kaminsky and Mende in their 2011 work on the subject. But why would Managed Futures work when everything else fails? In order to answer this question we need to understand the nature of most futures based strategies and how they are implemented.

Most CTAs will be highly leveraged, but thanks to the structure of futures and options - usually their tools of choice for strategy implementation - they will not be held hostage to credit crises as much as Hedge Funds and P.E. firms.

Futures trading only require a small down payment as collateral for the trade as opposed to most other asset classes, such as stocks and bonds, that require full funding (even in the case of margin transactions in equities, the investor would have to borrow the additional funds to purchase the extra shares). In the case of Private Equity investments, we can also point out that besides financing and liquidity factors, the drivers of performance are very similar to traditional equities. After all, a business will be successful thanks to accelerating sales and productivity whether its legal structure were public or private.

CTAs also operate in very liquid markets; if a manager wants to express a particular view on interest rates, he/she will act in the bond futures arena, which is one of the most liquid markets in the world. The same can be said for equity bets as index futures are very liquid. Although liquidity has been evident through-out the history of commodity trading, there can be no assurance it will remain so.

This relative independence from sources of funding that can quickly disappear in a crisis and the ability of quickly finding a counterparty for their trades can give CTAs an advantage over many other alternative managers.



Managed Futures and Real Crises

The Managed Futures advantage during serious financial dislocations is not only confined to its liquidity, but also its potential diversification across multiple markets and multiple time frames.

In the table below, compiled by Abrams, Badhuri and Flores for the CME Group, we can see the Managed Futures' response (measured by the BTOP 50 Index) to the major crises of the last 25 years.

Figure 2: Performance of Managed Futures during Some of the Worst Crises

Time Period	Crisis	S&P 500 Index (%)	BTOP 50 Index (%)	Difference (%)
4th Quarter 1987	Stock Market Crash	-23.23	16.88	40.11
3rd Quarter 2002	WorldCom Bankruptcy	-17.63	9.41	27.05
3rd Quarter 2001	9 /11 Terrorist Attack	-14.99	4.12	19.10
3rd Quarter 1990	Iraqi Invasion of Kuwait	-14.52	11.22	25.74
2nd Quarter 2002	Aftermath of Technology Bubble Burst	-13.73	8.52	22.26
1st Quarter 2001	Bear Market in U.S. Equities	-12.11	5.97	18.01
3rd Quarter 1998	Russia Default, Long-term Capital Management Failure	-10.30	10.54	20.84
1st Quarter 2008	Credit Crisis	-9.92	5.92	15.84
3rd Quarter 2008	Credit Crisis	-8.88	-3.40	5.48
4th Quarter 2000	Dot-com Bubble	-8.09	19.78	27.87
3rd Quarter 1999	Y2K Worries	-6.56	-0.67	5.89
1st Quarter 1994	Increase in Interest Rates	-4.43	-2.10	2.33
4th Quarter 2007	Subprime Crisis	-3.82	3.02	6.84
1st Quarter 1990	U.S. Recession, Oil Spike	-3.81	1.76	5.57
1st Quarter 2003	Second Gulf War	-3.60	4.68	8.28

This exhibit shows discrepancies in performance between managed futures and the S&P 500 Index as well as the BTOP 50 Index during the worst crises of the previous 25 years¹. Please note that due to low and often negative correlation of Managed Futures to traditional assets, they may underperform equities during positive periods for traditional assets. The Barclay CTA Index does not represent the entire universe of all CTA's, and actual ROR may be significantly different and more volatile than those of the index. Individuals can not invest in the index itself.

¹ Source: Abrams et al. (2010) in "Alternative Investments," Chapter 21 by Davide Accomazzo, 2013, Hoboken, Wiley

Furthermore, a recent study ² of different asset class correlations for the past ten years revealed that 15 of the 24 most common asset classes in institutional portfolios (including 10 alternative strategies) had a correlation to the S&P 500 of 0.65 on average. The study also found that Managed Futures correlation to stocks was a negative 0.16 (measured by the Newedge CTA Index). Please note that while managed futures can help enhance returns and reduce risk, they can also do just the opposite and result in losses in a portfolio.

The key to healthy long term portfolio returns is in the ability of the investor to insulate as much as possible the assets from extreme volatility. Portfolios that are especially vulnerable to shocks will inevitably underperform as the compounding advantage will lose effectiveness. The table below shows the difference in returns between two portfolios. The table merely shows how volatility eats up returns; it is a textbook example of the difference between arithmetic and geometrical averages whose arithmetic average annualized rate of return is the same, 10%, but the return of portfolio B – the most volatile is almost 20% lower. Please note, The 20% difference refers to the difference between 33% and 24.8%. 24.8% is over 20% lower than 33%: $(33-24.8)/33 = 24.85\%$ delta.

Portfolio A	Portfolio B
Return Year 1: +10%	Return Year 1: +20%
Return Year 2: +10%	Return Year 2: -20%
Return Year 3: +10%	Return Year 3: +30%
Arithmetic Yearly Average = 10%	Arithmetic Yearly Average = 10%
Actual Realized Return = 33%	Actual Realized Return = 24.8%

² Source: Kris Devasabai, "Managed Futures on the Rise as Investors Chase Diversification," Risk.net, April 2011



It Can't be All Good... Where is the Catch?

One important element to understand is that all the studies relating Managed Futures to portfolio construction are based on indexes and unfortunately, such Alternative Investment Indexes are generally not investable (this is true of Hedge Funds indexes as well). Such indexes usually include hundreds if not thousands of funds or CTAs, making it rather difficult to build a portfolio closely resembling the tracked benchmark. This problem can be tackled by utilizing a framework that allows the investor to pick an efficient blend of superior managers.

This process starts by identifying the predominant strategies implemented in Managed Futures. The universe has changed over the years and thanks to the advent of improved technology and more sophisticated managers, the spectrum of strategies available to investors has increased significantly. This growth carries many benefits but also some potential problems, which require additional layers of analysis.

The classic strategy remains trend following; a manager would identify, usually by ways of quantitative analysis, a trend in one or more markets (up or down) and would ride it until its reversion. Improvements in technology, an increase in daily liquidity provided by high frequency shops and a migration of many pit traders to "upstairs" electronic trading has also fostered a surge in short-term mean reverting strategies. These models have different pay-offs than trend following and they should show a high win/loss ratio with small wins and small losses.

The third major set of strategies is built on utilizing options, sometimes as a stand-alone, sometimes in conjunction with futures. In this segment, volatility selling option strategies are very popular with high Sharpe ratios, consistent profits and usually uncorrelated results until... a major crash. These strategies can be great performance providers but do correlate highly with crises as opposed to Managed Futures in aggregate. There are many other option strategies available, such as covered calls and tail risk hedging, which sport different risk profiles and pay-offs.

In conclusion, a winning approach to Managed Futures requires analytical homework to identify the needed strategy, to pick the right managers and discipline to fully unlock the investment advantage. Indeed, a sufficient investing horizon should be allowed to maximize asset class exposure. A study by Abrams in 2010 revealed that holding periods of three to five years meaningfully increase the probability of a successful investment.



How to Choose a CTA

A Needle in a Haystack

Once an investor makes the decision to break free from stale asset allocation models and takes the plunge into alternative investments, the real work begins. Managed Futures as an asset class has become very fragmented over the years. More strategies have been developed and improved technology and reduced costs have made existing trading models viable for additional classes of investors.

The increasing variety of programs is a positive to investors who can really target different nuances in their portfolios, but it comes with a price: much deeper analysis is required. As explained earlier, most studies on portfolio construction and asset allocation conclude that adding Managed Futures to a traditional portfolio reduces the volatility and improves the returns of the entire allocation. However, most studies are built on calculations that use non-investable alternative indexes; the trick is translating theory into practice and as Yogi Berra used to say: "In theory there is no difference between theory and practice, in practice there is."

There are probably over 1000 registered CTAs and a few additional exempted outfits, so to the inexpert investor, it may feel a little like looking for a needle in a haystack. Still it is a much smaller haystack than looking for a mutual fund or hedge fund manager, which are two investment vehicles that list thousands and thousands of choices.

Looking for the right CTA is a complex process but once a framework is developed, the procedure becomes efficient and results will follow. A right approach consists of three major areas of analysis: qualitative, quantitative and operational.



It's All About Quality

A screening process is often built strictly on a quantitative approach in an attempt to achieve analysis efficiency and economies of scale. However, a true edge is discovered when a detailed qualitative analysis is accompanied to the process of number crunching. The first step required relates to what general strategy – or mix of strategies – an investor should investigate. Sub-categories in Managed Futures are moved by different dynamics and risk profiles can be vastly diverse. As discussed in the previous section, trend-following is one of the predominant strategies, which essentially has a long volatility profile and tends to do well at times of extreme market conviction and during significant dislocations. On the other hand, mean reversion, or a contrarian approach, should work better during times of uncertain direction and tend to have shorter time frames.

Another popular strategy consists of option writing or volatility selling. This approach can be very successful but it has a diametrically opposed risk profile than trend following. Ultimately, the key is to truly understand the characteristics of the strategy chosen and the inherent advantage of the specific program. An investor should always ask herself/himself why this strategy worked in the past and why it should continue to work, what the drivers of price formation are and whether this edge can be arbitrated away.

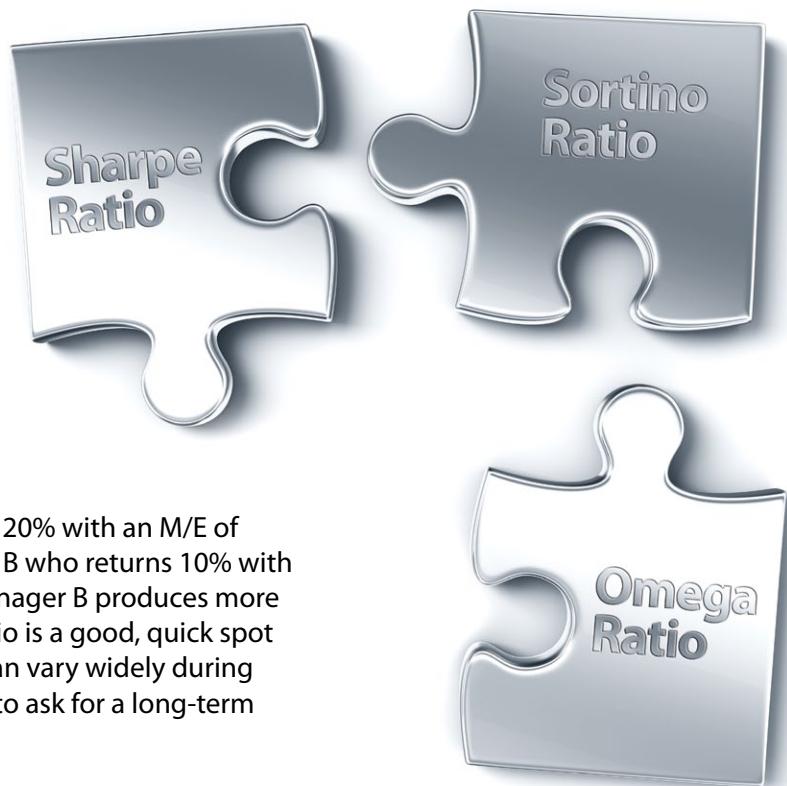
Another qualitative element that should be taken into consideration is whether the money manager is emerging or established. There are many different definitions of an Emerging Manager but they usually refer to a program with less than three years of track record and less than \$10 million AUM. Emerging Managers usually produce higher rates of return because of a greater level of “hunger” and more flexibility due to their smaller positions. However, they also carry a superior risk level because of their unproven ability to escalate their business operations and potential inability to continue to produce higher returns as the assets under management significantly grow.

Established managers will most likely produce, on average, lower annualized returns but they will have a much reduced operational risk and much less potential for unexpected “blow-ups.” Their longer track record will also allow for different “scenario dependent” analyses or the ability to see how a program performed under different macro-economic contingencies.



Quants Rule!

The qualitative variables discussed earlier should help the investor create a short list of interesting CTAs, which will then be analyzed via different quant formulas. The first and most immediate risk check should be the Margin/Equity ratio. This number indicates how much minimum collateral is required for trading a specific program. This level is an immediate spot check on the leverage of the manager and a good indication of its risk level. For instance, if manager A returns 20% with an M/E of 50%, he will actually be inferior to manager B who returns 10% with an M/E of 20%. On a risk-adjusted basis, manager B produces more return for dollar risked. Margin to Equity ratio is a good, quick spot check but it is limited in its analysis and it can vary widely during different market conditions. A good idea is to ask for a long-term chart of M/E compared to the benchmark.



As the analysis gets deeper, one should look at the following three risk formulas:

Sharpe ratio, Sortino ratio and Omega ratio.

$$\Omega(r) = \frac{\int_r^{\infty} (1 - F(x)) dx}{\int_{-\infty}^r F(x) dx}$$

$\Omega(r)$ = Ratio of Probability of having a Gain by the Probability of having a Loss

F = Cumulative Distribution Function

r = Threshold Defining the Gain versus the Loss

The Sharpe ratio was developed by Nobel Prize Bill Sharpe in an attempt to adjust returns for systematic and unsystematic risk. The ratio subtracts the risk free rate (usually the 10 year US Treasury) from the program return and divides it by the standard deviation of the program's returns. This is a relative ratio and allows an investor to compare and rank different programs; the higher the ratio the better. Over the years, this ratio has become the "über alles" of all risk ratios, but it does have a flaw because it may penalize for good and bad volatility. In other words, as an investor, you may be upset if losses end up being higher than expected but you may be rather happy if the gains are higher than expected. The Sharpe ratio would penalize for both deviations.

$$S = \frac{R - T}{DR}$$

R = Portfolio Average Return Realized

T = Target or Required Rate of Return for the Investment Strategy

DR = Target Semi-deviation and is termed Downside Risk

In order to mitigate this issue, a new ratio was developed: Sortino ratio. In this case, one subtracts a minimum acceptable return from the program return and divides it by downside volatility (or the downside deviation of actual returns falling below the minimum target). This formula also allows investors to set different minimum acceptable targets; for example, an investor could run the ratio with a target of 10%, 5% and 0 and see the strength of the program under different scenarios. The Sortino ratio is also a ranking ratio and not an absolute number and usually one would look for a Sortino ratio higher than the Sharpe.

$$= \frac{\bar{r}_p - r_f}{\sigma_p}$$

\bar{r}_p = Expected Portfolio Return

r_f = Risk Free Rate

σ_p = Portfolio Standard Deviation

A supplementary look at risk-adjusted returns is accomplished by running the Omega ratio. This formula provides one additional layer of analysis to the Sharpe and Sortino ratios; the Omega ratio is the weighted gain/loss ratio relative to any given targeted return level. Value at Risk and Rank correlation analysis can also be beneficial within the context of a quantitative framework.

A serious investor should also study monthly returns to get a better sense of the volatility of the program and check performance against specific market moves. During this analysis, one should check the maximum drawdown or the loss in the program from the peak to the next trough and how quickly such decline was recovered. When analyzing returns, one should also remember that arithmetic averages will most likely overstate performance, while a geometric calculation will be closer to reality. To this point, an investor should look at the Value Added Monthly Index (VAMI) or the equity curve, a representation of compounded returns.

One important element to consider when analyzing returns is to avoid so called "performance chasing." A classic tendency is to be drawn to the hottest and most recent returns and practically act on momentum. Many studies have shown that serial correlation in CTA returns is quite random; in simpler words, past performance is not necessarily an indication of future results. This factor highlights once more the need to analyze performance quantitatively and qualitatively.

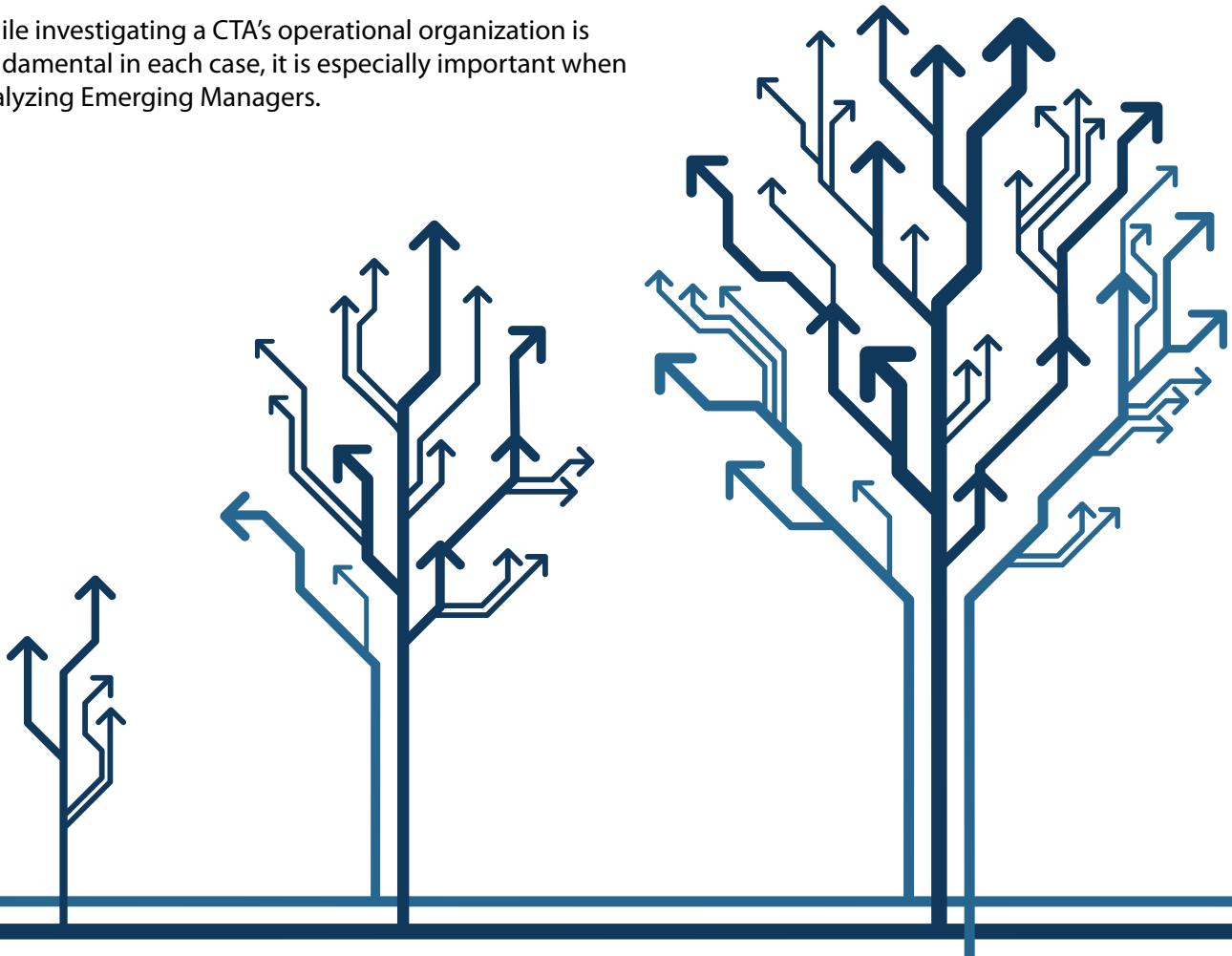
The Operational Edge

Analysis of the operational backbone of a CTA is another often overlooked element, yet it can be extremely beneficial in avoiding unnecessary problems. Some of the factors that require an investor's attention include the experience of key people and their role within the outfit. Special attention should be given to a CTA's succession and replacement plan; one should make sure that the success of a strategy is not dependent exclusively on one individual with no real back up plan should something unexpected occur.

Investors should review a CTA operational structure also within the context of future growth of the program. For instance, does the CTA have a plan in place to allow for significant increases in AUM and the following increase in back-office work?

The ability of a CTA to plan for growth is not only restricted to its capacity to handle paperwork, but it is also important from a trading perspective. Many strategies have a capacity limitation, or that level of AUM beyond which a manager finds it increasingly difficult to arbitrage market anomalies due to liquidity issues or execution complexity.

While investigating a CTA's operational organization is fundamental in each case, it is especially important when analyzing Emerging Managers.



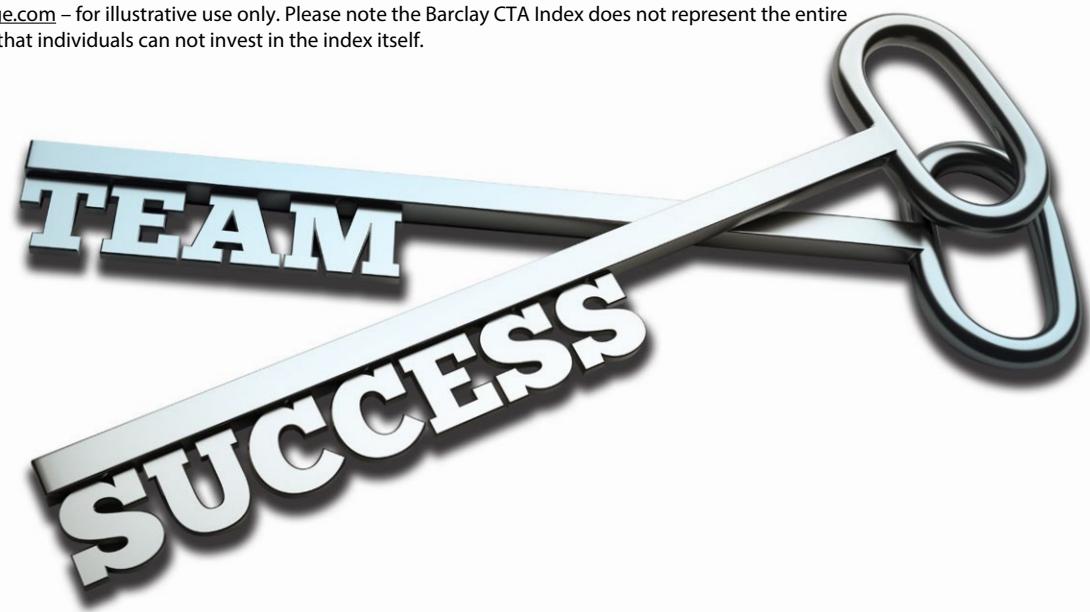
We are on the Same Boat

One last consideration relates to the alignment of incentives. The best way to insure that the manager and client are aligned is to invest with a CTA who has also invested a significant portion of his/her assets in the strategy.

Barclay CTA Index Performance Table

1980	63.69%	1992	-0.91%	2004	3.30%
1981	23.90%	1993	10.37%	2005	1.71%
1982	16.68%	1994	-0.65%	2006	3.54%
1983	23.75%	1995	13.64%	2007	7.64%
1984	8.74%	1996	9.12%	2008	14.09%
1985	25.50%	1997	10.89%	2009	-0.10%
1986	3.82%	1998	7.01%	2010	7.05%
1987	57.27%	1999	-1.19%	2011	-3.09%
1988	21.76%	2000	7.86%	2012	-1.70%
1989	1.80%	2001	0.84%	2013	-1.37% [†]
1990	21.02%	2002	12.36%		
1991	3.73%	2003	8.69%		

[†] Estimated YTD performance for 2013 calculated with reported data as of Jan-27-2014 13:27 US CST – source: www.barclayhedge.com – for illustrative use only. Please note the Barclay CTA Index does not represent the entire universe of all CTA's, and that individuals can not invest in the index itself.



Different Investment Options

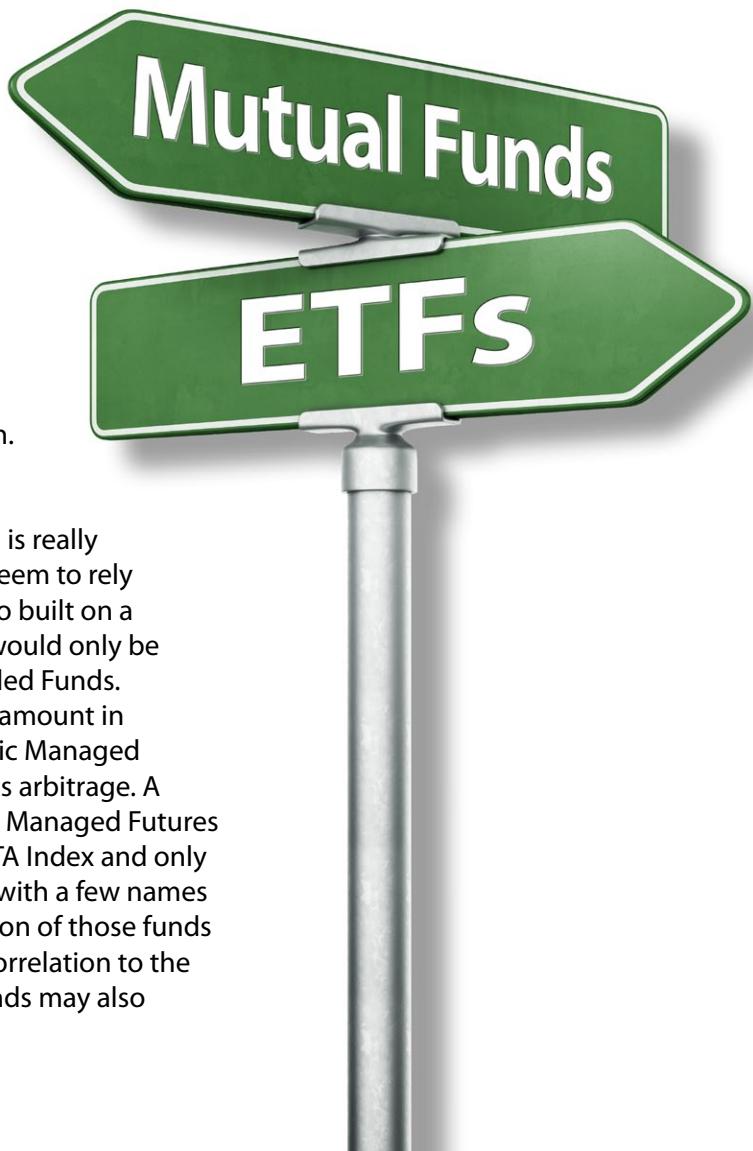
To the astute investor that wants to modernize his portfolio allocation and expand into alternative vehicles specialized in futures, options and commodity driven strategies, there are different options.

The most efficient and most flexible solution is by far a direct investment in Managed Futures by means of building a diversified portfolio of CTAs tailored to the specific needs of the investor. A close alternative is an investment in a multi-strategy fund (usually in the form of a Commodity Pool Operator), which, very efficiently, will provide instant diversified exposure to the space.

The nascent market for liquid alternatives is providing new additional solutions. These new products have the advantage of providing easy access for the retail investor to a space that traditionally has come with higher barriers of entry; however, it must be noted that such vehicles, at present, do not seem to deliver the same performance produced by CTAs.

The two main products in the emerging liquid alternative arena are 40 Act Funds (mutual funds) and exotic Exchange Traded Funds (ETFs). The mutual fund subsector dedicated to funds specialized in Managed Futures strategies has been growing at exponential speed in recent years. Only in 2007 could an investor count such funds in single digits, while now Morningstar reports about 150 mutual funds in its Managed Futures subcategory. The rise in assets under management since the first mutual fund was launched in 2007 until September 2012 (the latest data point we have from ForwardInvesting) has been a significant \$9.2 billion.

The propagation of such funds requires a detailed level of analysis to figure out how closely each fund is really linked to Managed Futures exposure. Some funds seem to rely on one single manager while others have a portfolio built on a multi-strategy platform. Occasionally, some funds would only be invested in Managed Futures related Exchange Traded Funds. Understanding the construction of each fund is paramount in forecasting how closely one investor will track classic Managed Futures strategies such as trend following or options arbitrage. A study by another brokerage house found that most Managed Futures mutual funds have low correlation to the Barclay CTA Index and only a handful have significant correlations above 50% (with a few names up in the 80% and 90%). This is most likely a reflection of those funds relying on a single manager whom may have low correlation to the overall index. A different fee structure in mutual funds may also contribute to distort net performance numbers.



Overall, most mutual funds seem to produce lower returns than the Barclay CTA Index. This is not a fair comparison as the Barclay CTA Index is not investable after all, but any underperformance may be a tell for possible misconstruction of the specific fund being analyzed.

For instance, one year, three year and five year annualized returns in the Morningstar Mutual Fund Managed Futures Index (expressed as simple averages) are negative respectively at -2.72%, -4.68% and -5.92%. The performance numbers for mutual funds do seem to be partly skewed by a sample that is rapidly changing and growing. This problem requires an investor to dedicate some time to a significant qualitative approach when selecting a fund rather than just relying on quant screens.



Another available option is represented by alternative ETFs. ETFs, in general, have become the darling of investors thanks to their flexibility, low cost structure and easy access. The ETF boom started with passive replication of broad and narrow indexes and it is now moving into low cost replication of active strategies. In a way, this may seem like an oxymoron: a passive replication product utilized to commoditize alpha. Without getting into a very complex discussion on beta and alpha, an investor will get what he/she pays for: if an alternative strategy is the result of some structural source of return (beta), the ETF should cheaply capture such risk premium; but in the case of a strategy being successful strictly due to a manager's set of skills, the ETF will fail.

One of the original Alternative ETFs was Ishares sponsored ALT. Launched in 2009, this ETF aimed at maximizing absolute returns from an array of futures based strategies with low correlation among each other. Strategies such as yield and futures curve arbitrage, technical momentum and reversal trading and fundamental relative value were all mixed in the same platform; strangely pure commodity exposure was not included. The performance was fairly correlated to the Barclay CTA Index but again lower in spite of an expense ratio relatively cheap at 95 basis points.

The point on the level of the expense ratio is important because mutual funds usually have a fee structure different than direct managed futures investments. Mutual funds are often sold via different classes of shares: A shares, for instance, are often designed for the long-term investor since they usually carry a large one time upfront fee. Other classes of shares may have lower but yearly recurrent fees. Additionally, when a mutual fund acts practically as a fund of funds, the layers of fees may significantly lower the attractiveness of the investment.

Capital Trading Group (CTG) and Registered Investment Advisors

A thorough analysis of Managed Futures highlights two pivotal elements:

1. Including Managed Futures in a traditional portfolio can potentially help significantly reduce total volatility and improve performance.
2. Building a solid exposure to Managed Futures can be complicated.

Capital Trading Group can be a powerful ally in navigating the enticing yet sometimes uncomfortable space of alternative investments. The combined four decades of experience in the futures industry that the two principals, Patrick Lafferty and Nell Sloane, bring to the table is an invaluable asset for the pro-active Registered Investment Advisor.

CTG can professionally help an RIA in the following areas:

- Alternative Investments Education and Research
- Managed Futures Portfolio Building
- A pre-existing multi-strategy fund for immediate cost effective allocation
- Administration and support services for the establishment of new investment vehicles tailored to an advisor needs and branded originally by the advisor.

CTG offers a vast array of educational material and alternative research. The firm produces a recurrent newsletter, articles on hot investment issues and deeper research work in the form of white papers on specific subjects of interest to the investment community.

However, where CTG can really turbo charge an RIA capability to distinguish his or her business, is by offering access to the Managed Futures Portfolio Builder. The Portfolio Builder is a powerful database that allows to sort quantitatively through the CTA universe and to efficiently start the process of investment implementation. Patrick and Nell can then help an RIA refine the quantitative results of the screen in order to arrive at an optimized portfolio.

Subsequently, when it comes to actually putting real dollars to work, CTG can offer different enhanced solutions.

Over the years, CTG has cultivated relationships with the industry's top FCMs and top clearing members, which grant CTG access to worldwide exchanges and investment products.

Ultimately, progressive RIAs will want the flexibility of creating independent products tailored to their specific needs and originally branded. CTG has developed the expertise to replicate this process successfully for those advisors that really want to distinguish themselves from the other 10,511 U.S. registered advisors (reported number by the SEC as of November 2012).

Principal - Patrick Lafferty

Patrick Lafferty is a principal and co-owner of Capital Trading Group (CTG). Patrick has a degree in Economics from DePauw University and has worked in the futures and options industry for over 25 years. Patrick is the author of the books *Single Stock Futures*, *The Option Strategy Guide*, and *Breaking Through to Success: The Commodity Investor's Guidebook*. He also edits the weekly TradeView commodity newsletter and the Easy Options Advantage newsletter. Patrick has spoken at investment and trading conferences around the country and in the U.K.

Principal - Nell Sloane

Nell Sloane began her career over 29 years ago at the Chicago Futures Exchanges. She initiated her introductory to the industry by working for a grain trader at the CBOT. As she continued to handle the trade execution, reconciliation and Capital Raising she moved on to becoming a featured contributor to Daily Metals Commentaries for 321 Gold, Kitco, Silver-Investor.com, FreeMarketNews.com and periodically for the Moore Research Center. Nell eventually launched her own commodity newsletter providing fundamental and technical analysis entitled *The Opening Belle*. Later in her career she was listed by a variety of financial publications as a broker to use. These publications included, *Hume Super Investors Files*, *Opportunities in Options* by David Caplan, *McMaster On Line* by R.E. McMaster and featured in *The Art of the Trade* published by McGraw Hill. She spoke at numerous financial seminars and financial radio shows.

In efforts to provide further diversification amongst various FCM's (Futures Commission Merchants), Nell formed Capital Trading Group LP (www.ctgtrading.com) with Patrick Lafferty to put forth effort to mitigate counterparty risks as well as to reduce vulnerability within the margin controls that the firms impose. In addition to being principal and an associated person of CTG, Nell is a managing member of a commodity fund. Her registrations include both her securities series 7 as well as the commodity series 3. CTG provides investors alternatives within the asset class of managed futures products. The firm matches high net worth clients with those seeking alternatives in managed futures.

Ms. Sloane presently is a member of the Vistage International, which is the world's leading chief executive organization. Vistage is located in 15 countries and have over 14,500 members helping business owners make better decisions and becoming better leaders in their communities. She is an active participant in raising money for charities such as American Cancer Society, Mercy Home for Boys and Girls, Diabetes foundation and Make a Wish. Nell previously volunteered with the international au pair agency matching host families with childcare and was previously an Executive Member of Chicago Finance Committee. She's a proud mother of a marine and a son that just entered College to major in finance. During her spare time she loves to golf, horseback ride and travel.

Danielle Bourbeau

Danielle Bourbeau began her career in the Commodities futures industry in 1987. She has worked in all aspects of the business including compliance, trading, research and educational webinars. She has been fortunate to build long lasting relationships with many of the Financial Industry's top Analysts, Educators and Traders. You can review our Educators section of the website for more information. It is the ability to explain and assist her Clients with these strategies that have helped her solidify strong relationships with her clients.

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Glossary

Futures Commission Merchant (FCM): broker involved in solicitation and acceptance of futures and options on futures contracts

Introducing Broker (IB): futures broker holding the relationship with the client but who delegates the work of the floor operation and execution to an FCM

Initial Margin: minimum amount of funds required to initiate a certain position in the futures market

Maintenance Margin (also known as Variation Margin): the amount of funds required in the account to continue to hold a position in futures (this margin is lower than the Initial Margin)

Mean Reversion: strategies based on fading short-term moves away from longer term averages

Trend Following: rule based strategies aimed at capturing significant market trends

Volatility Arbitrage: strategies based not on market direction but on discrepancies between historical volatility and implied volatility (or the future volatility expected by market participants)

Portfolio Diversification: the process of adding multiple assets with different risk drivers in a portfolio with the intent of improving the risk adjusted returns of such portfolio

Statistical Arbitrage: strategies based on mathematical models, which attempt to exploit price inefficiencies between securities

Sharpe Ratio: a measure of relative risk adjusted returns; portfolio returns minus risk free rate divided by the portfolio standard deviation

Sortino Ratio: an improved measure of relative risk adjusted returns, which does not penalize for good volatility; portfolio return minus minimum accepted target divided by semi-variance

DISCLAIMER

TRADING IN THE COMMODITY FUTURES AND OPTIONS ON FUTURES MARKETS INVOLVES SUBSTANTIAL RISK. THE AUTHORS OF THIS EBOOK DO NOT INTEND IN ANY WAY, SHAPE OR FORM TO IMPLY THAT FUTURES TRADING AND OPTIONS ON FUTURES TRADING DOES NOT INVOLVE RISK OR THAT PROFITS CAN EASILY BE MADE. THERE IS A SUBSTANTIAL AMOUNT OF LEVERAGE INVOLVED IN TRADING FUTURES AND OPTIONS ON FUTURES SO ALTHOUGH PROFITS CAN BE MADE WITH CAREFUL RISK MANAGEMENT POLICIES, THERE IS AN EQUAL AMOUNT OF POSSIBILITY THAT SUBSTANTIAL LOSSES CAN OCCUR, AMOUNTS WHICH CAN SURPASS THE AMOUNT OF FUNDS ON DEPOSIT, WHICH WILL REQUIRE YOU TO DEPOSIT MORE FUNDS INTO THE ACCOUNT. TRADING MANAGED FUTURES DOES NOT MEAN THERE IS NO RISK. WHILE YOUR ACCOUNT WILL BE MANAGED BY A FUTURES PROFESSIONAL, THE RISK OF INCURRING SUBSTANTIAL LOSSES IS ALWAYS PRESENT. FURTHERMORE, YOU WILL NEED TO OVERCOME SUBSTANTIAL FEES CHARGED IN A MANAGED ACCOUNT PROGRAM. YOU SHOULD CAREFULLY REVIEW YOUR FINANCIAL CONDITION BEFORE INVESTING IN THE FUTURES MARKETS. YOU SHOULD ALWAYS INVEST RISK CAPITAL AND ONLY RISK CAPITAL. SHOULD YOU LOSE YOUR ENTIRE INVESTMENT, SUCH LOSSES SHOULD NOT HAVE ANY IMPACT ON YOUR LIFESTYLE OR YOUR LIVING HABITS. SHOULD YOU INVEST MONEY IN THE FUTURE MARKETS WITH THE INTENTIONS OF EARNING A MONTHLY LIVING TO SUSTAIN YOUR LIFESTYLE, YOU SHOULD NOT BE INVESTING IN THE FUTURES MARKETS.