

# Futures

Magazine for technical trading  
June 2008



## Managed Futures: solving the mystery

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**Do Managed Futures constitute an asset class? Or are we merely talking about a non uniform group of individual managers who cannot be lumped together? The answer is not only of theoretical interest if there is the possibility of including Managed Futures as part of an investment portfolio.**

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Everything was very simple in the early days of portfolio management. Essentially there were only three different classes of assets: stocks, bonds and the rest, which concerned only very few investors - alternative investments, encompassing real estate, private investments in companies not listed on the stock exchange, art, commodities or hedge funds. Even the pure academics, who were busy developing modern portfolio theory during the 1960s and 70s, either made do with the time-honored classes or didn't bother with them at all. In his paper „Portfolio Selection“, Markowitz derives a solution which allows the best mix ratio of two or more individual stock. Tobin, creator of the Capital Market Line, and William Sharpe, whose Capital Asset Pricing Model (CAPM) was soon to become a widely accepted market portfolio-based risk model, initially wasted no time on market segmentation. They simply proposed allocating a variable proportion of the market portfolio to a

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### Impressum

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FTC Capital GmbH

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riskless asset so that risk propensity and earnings expectation are in harmony with one another. Sharpe suggested just what this market portfolio might comprise: the sum of all available - not riskless - assets, weighted according to their respective capitalization.

So, for example, an investor would have to own a significant amount of stock in Google, Shell or Toyota, because these instruments are very highly capitalized, but only a negligible amount of Tanzania Tea Packers Ltd stock, because the latter's capital stock of around 5 million euro is, to say the least, peanuts. Vietnamese government bonds are not at all included in the market portfolio, because they are not available.

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### Oil tankers and silver spoons

The CAPM with its market portfolio had far-reaching consequences for what are now popular forms of portfolio construction and for the choice of individual instrument in the context of asset management. One of which is particularly interesting for the purposes of this article: if the market portfolio genuinely comprises ALL available assets (weighted according to capitalization), then it would obviously include not only stocks and bonds, but also currencies, commodities, real estate, silver spoons, stamps, Van Gogh paintings and latterly - given that they are available in the form of appropriate investment products - container ships, oil tankers and aircraft.

Because no investor is capable of putting together such a portfolio, much less sustain one, Sharpe may also be regarded as the incubator of a booming sector of industry: the index branch. Indices are seen as a practical approximation of the overall market they are attempting to reflect. Whereby the rule of thumb is that the broader the index (i.e. the bigger the proportion of the market reflected by the index), the more precise the approximation. And the narrower the index, the easier it is to emulate. Over the years, day-to-day asset management has given rise to several blue-chip indices which are now used by asset and

portfolio managers as market portfolio benchmarks. For the stock markets, these would be the S&P 500 (USA), Nikkei 225 (Japan), Stoxx 50 (Europe) or MSCI World (global). As far as bonds are concerned, the JP Morgan Total Return Indices play a similar role. For commodities, the Standard & Poor's GSCI Index is a favorite, and even the beloved arts have failed to escape the clutches of the index industry. However, silver spoons are still waiting for a suitable benchmark.

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### The case of the chaotic DIY store

Why are we so obsessed with categorizing every last outpost of the investment universe? Put simply: imagine you're at a DIY store trying to put together a set of essential tools with which to successfully complete your DIY projects. The way things tend to be sectioned throughout the store, it's already sheer torture. And now imagine there is no system of categorization at all...

If you have a vivid imagination, you're probably already in a state of panic and can sympathize how it would be for any asset manager worth his salt trying to manage without indices and asset classes. Apart from the fact that he is unable to substantiate his success owing to the lack of a benchmark, he would come up against a brick wall in the form of the sheer mass of opportunities on a globalized financial market.

The selection of assets for an overall portfolio nowadays is usually a top-down process: first, asset classes are selected and weighted (represented by their indices), and then the most promising individual positions of the respective classes are selected. Because everyone from the buyers to the sellers of all types of investment product is aware of this, there has been discussion for a fairly long time as to what makes a group of assets a separate class and which of them unquestionably belong in a portfolio.

Whilst it is in the interests of sellers of participations in ships to position and market their products as a separate investment class, asset managers aspire to keep their universe as transparent as

possible. They therefore often tend to include all equity holdings apart from exchange-traded stocks in the private equity class.

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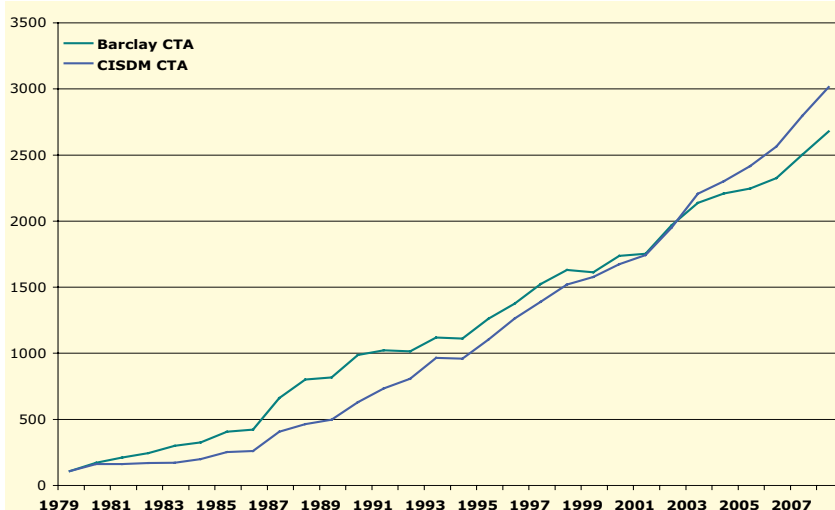
### The Managed Futures conundrum

Opinion is similarly divided when it comes to defining the role of Managed Futures (also known as Commodity Trading Advisors or simply: „CTAs“) within the investment universe. Is it an investment style, a strategy or even an asset class? Actually, Managed Futures are a riddle in some ways:

1.) Managed Futures contain virtually all liquid asset classes. CTA portfolios consist of commodities - from aluminum, cotton, crude oil, orange juice and pork bellies through to tin - currency rates, money market and bond interest rates as well as a wide range of stock indices from Japan to Europe and the USA. The entirety of these managed futures market accounts comes extends the market portfolio since managed futures can also sell short all submarkets something which is not provided for in Sharpe's market portfolio.

2.) The futures markets on which Managed Futures are traded seem to be zero-sum games. Whenever one contractual partner wins, it follows that the other has to lose. Consequently, the expected value of the earnings of a futures market would be zero (even less than zero once transaction costs have been deducted). Assuming that futures markets are efficient, it would be impossible for a single participant to continue making a profit for any length of time. Such a consideration would tend to rule out Managed Futures as an asset class which an investor would absolutely have to have in his portfolio.

3.) But Managed Futures nevertheless return consistently positive earnings. They have been around for exactly 60 years (Robert Donchian launched the first systematic fund with Futures Inc. in 1948) and have enjoyed sustained growth since the 1980s. Some of today's most successful products have been returning consistent earnings for



The two oldest Managed Futures benchmarks, Barclay Group and CISDM: performance based on the annual returns from 1980 to 2008 (2008 = January-March, 31.12.1979=100). Zero-sum games tell a different story.

over 20 years. The oldest two index families for Managed Futures, the Barclay CTA and CISDM-CTA Index, have shown overall performances since 1980 of 2,500 and 5,000 % respectively – a zero-sum game tells a different story.

4.) Managed Futures are uncorrelated to the stock market in the long term. There is plenty of academic literature about the phenomenon that is Managed Futures and, despite the different data samples used, the various studies carried out over the last 20 years repeatedly point to this notable characteristic of CTA products.

### A paradoxical asset class?

The four aforementioned points paint an almost paradoxical picture: let us first assume that we accept a practical definition of an asset class. Something like: „an asset class is a group of assets with common and individual beta characteristics“. The key class properties would therefore be the two variables used in the beta formula, namely correlation (or covariance) and standard deviation (or variance) of the earnings. We would expect the following criteria to apply to an asset class in the context of this definition:

1.) The individual elements of a class may differ in terms of risk and earnings, but should offer a generally positive

earnings expectation as well as a correlated (i.e. positive) beta in relation to this class.

2.) An asset class and its individual elements should be independent insofar as they deliver broadly uncorrelated (beta-neutral) earnings in relation to virtually every other asset class and their elements.

If this definition applies, then previous studies suggest that Managed Futures are a separate asset class. Based on widely varied data samples the aforementioned properties of Managed Futures have already been proven several times over.

But how does this fit with the fact that Managed Futures consist of a number of likewise independent asset classes? And how do their market-neutral, consistently positive earnings correspond with the fact that overall, futures markets have an earnings expectation of zero?

Are CTA managers secretly collaborating? Can some kind of swarm intelligence lead them to the same conclusion about the direction of the markets which is generally better than any that the other participants in the futures markets might come to?

Or are previous studies as well as all CTA indices simply subject to a strong survivorship bias - are we left with just the one half, the surviving random

### The significance of Sharpe's beta

Beta is an indicator introduced by William Sharpe. In William Sharpe's CAPM risk model, beta represents the systematic risk (in short, the market risk) of an investment. Beta ( $\beta$ ) is calculated for a specific fractional value of a market (W) in relation to the entire market or the benchmark (M) based on the relative value fluctuations (e.g. monthly or daily performances in percent). The formula:

$$\beta = \text{Covar}(W:M) / \text{Var}(M)$$

or alternatively:

$$\beta = \text{Correl}(W:M) * \text{StDev}(W) / \text{StDev}(M)$$

where Covar stands for covariance, Var for variance, Correl for correlation coefficient and StDev for standard deviation.

**Variance and standard deviation** indicate the extent to which the individual markets fluctuate around the average of all market changes. The higher the (always positive) value of variance or standard deviation, the higher the risk.

**Covariance and correlation** indicates the strength and direction of a linear relationship between two random variables. The correlation coefficient has a value between +1 (W and M produce profits and losses in 100% of all cases in the same periods) and -1 (W and M move in entirely opposite directions in all periods).

**The beta sign** is the result of covariance or correlation.

**The absolute value of beta** (the number which follows the sign) indicates the strength of the value fluctuations of the individual value (in relation to a 1% move of the market). A beta of 1.5 would lead us to expect the individual value to rise by 1.5% if the market portfolio rises by 1%. If, by contrast, beta is between -1 and 1, then the volatility of the individual value is probably lower. In the case of zero correlation, however, the absolute value of beta is of no significance. In such cases we refer to uncorrelated beta and we can assume that apples have been compared with oranges.



winners, whilst the other half, the random losers, has disappeared from the database?

To solve the conundrum, we obviously have to shift from theoretical speculation to the empirical data. For this purpose, let us initially take a closer look at the capital-weighted CISDM CTA index family.

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## The CTA universe

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As of the end of March 2008, the broad, capital-weighted CISDM CTA Index encompassed 505 Managed Futures funds, which can be divided into two main segments:

- 1.) Systematic CTAs, which use technical trading programs. In this case, computers use predefined sets of rules to decide when, what and how much should be bought or sold. The vast majority of this group trades widely diversified portfolios of commodities and financial assets.
- 2.) Discretionary CTAs, where managers make investments based on key parameters. Many funds in this group specialize in individual markets (commodities and currencies are significant subgroups). With the discretionaries, widely diversified funds in a form which is typical for the systematic segment are barely represented at all.

The group of systematic products accounts for over three quarters of the funds and around 90 % of the total capital, where the majority trade a widely diversified portfolio of financial assets and commodities. The capital-weighted overall index therefore reflects the trends shown by these products. This is substantiated by the figures: over the last 10 years, the correlation between the CISDM CTA Systematic Subindex and the overall index has been 0.96, i.e. just shy of the threshold value of 1. By contrast, the CISDM CTA Discretionary Subindex shows a correlation coefficient of around 0.5 with the overall index and with the Systematic Subindex.

CISDM rival Barclays, the second index provider specializing in Managed Futures, has a database of 571 funds and here, too, systematic funds account

for more than three quarters of the total (434). In the (equally and non-capital-weighted) Barclay CTA Index, the systematic CTAs therefore have a 76 % weighting.

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## The asset class test

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When we talk about Managed Futures nowadays, we are primarily referring to technical/systematic CTAs as well as CTAs that are broadly diversified across all futures classes. All known products in Austria (with the exception of FTC Commodity Fund Alpha) also fall under this umbrella. Let us focus on this category and try to establish whether, in the context of systematic, diversified CTAs, we are talking about an asset class that corresponds with our previous definition. If this is the case, then we would expect, when comparing individual values, groups and overall indices as well as in relation to other asset classes, to discover similar common characteristics as for traditional asset classes (e.g. stocks).

The problem is that there is no specialized index for measuring our CTA class. Both popular CTA index families have a subindex for systematic managers. But these also include pure commodity or financial futures products. What is more, they are not without sources of error, a frequent criticism in the literature. There are alleged data distortions that would render an analysis highly vulnerable based on only one of the two indices: the „survivorship bias“ we have already referred to (the successful products outlive those that gradually drop out of the index), a „self-selection bias“ (unsuccessful managers stop reports to the index provider) or simple assignment errors, which can easily occur owing to the incorrect self-classification of fund providers.

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## The test group

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To filter out this kind of background noise and data distortion as best as possible, let us take a reliable sample of products from the world's biggest providers as our primary data source. We'll call our theoretical peer group

„SCTA25“, comprising 25 of the biggest, systematic and diversified futures funds, which comply with the following criteria:

- 1.) Seamless track record between the end of 1997 and 2007
- 2.) Diversified portfolio of commodities and financial futures
- 3.) Active management based on technical/systematic approach
- 4.) One fund per provider only

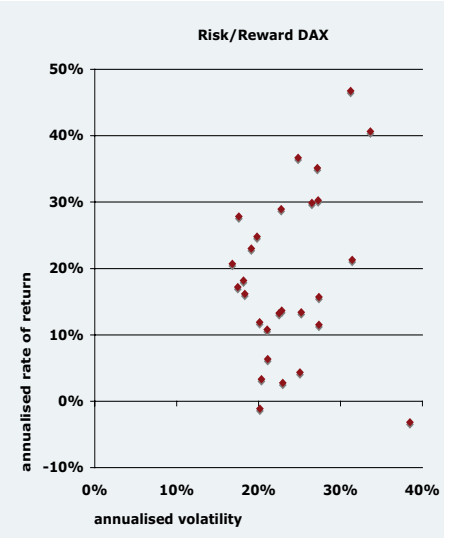
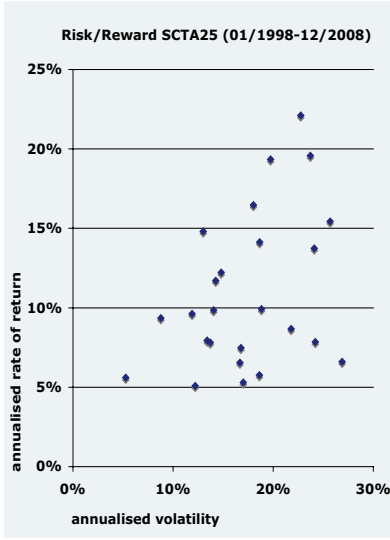
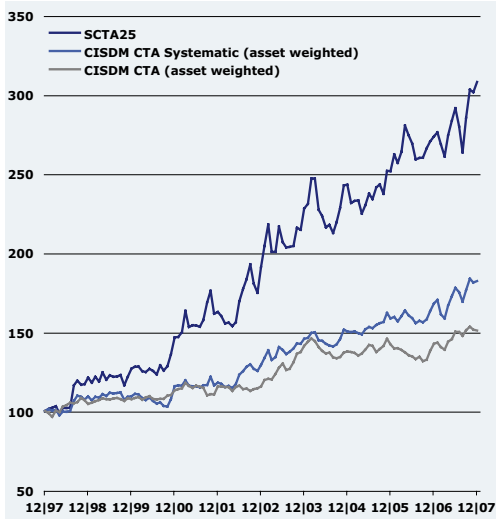
The 25 funds have a total capitalization of around 25 billion dollars (from 87 million for the smallest to 4.6 billion for the biggest fund) - depending on the estimate, this corresponds to 10-15 % of the total volume of the Managed Futures industry. Figures are based on monthly performances between January 1998 and December 2007, where all funds are weighted equally.

We will use the individual stocks of the DAX as our reference (the statistical series covers just 5 years, from May 2003 to April 2008), otherwise too many individual values would be missing because of the frequent restructuring of the index. Of today's 30 DAX values, there are only 28 values with a price as of April 30, 2003 (even stock indices can be hit by the survivorship bias). Which for our purposes is not important. We are, after all, not interested in a performance comparison. The reference is merely used to check whether there are similar class properties among the CTA products.

We have also taken the CISDM Systematic Index as the superordinate benchmark (something like a global stock index in relation to a regional index). This allows us to rule out the eventuality of a random hit from our sample which is not representative. One indicator would be significant differences between our sample and the overall market.

A glance at the key indicators in this context already tells us that this is not the case: both the correlation values between the sample and index (significant: 0.86) as well as those independent of the MSCI global stock index (-0.19 / -0.08 respectively) point to a very similar trend between the sample and overall market and to common characteristics, at least in relation to the stock market.

There is one significant difference between SCTA25 and the benchmark



Risk/return ratios of the SCTA25 individual funds and the corresponding values of the 28 DAX stocks: the bandwidths are considerable in both cases.

	SCTA25	CISDM CTA Systematic
<b>Earnings indicators</b>		
Earnings over 10 years	207,85 %	82,08 %
Annualized earnings	11,90 %	6,18 %
Positive months	63,33 %	56,67 %
Best month	13,92 %	7,53 %
Worst month	-8,28 %	-5,42 %
Ø Monthly earnings	1,02 %	0,53 %
<b>Risk indicators</b>		
Volatility (ann.)	13,86 %	8,02 %
Downside volatility	12,48 %	6,80 %
Standard deviation in monthly earnings	4,00 %	2,32 %
Max. decrease in value	-13,93 %	-7,94 %
Longest drawdown (months)	19	14
<b>Risk- and earnings indicators</b>		
Sharpe-Ratio (modified)	0,86	0,77
Sortino-Ratio (modified)	0,95	0,91
MAR-Ratio (modified)	0,85	0,78
<b>Correlations</b>		
to CISDM Systematic Index	0,86	1
to MSCI World Index (USD)	-0,19	-0,08
<b>Beta</b>		
to CISDM Systematic	1,48	1
to MSCI World Index	-0,18	-0,05

Chart: The performance of the SCTA25 group, the CISDM CTA Systematic Index and the broad CISDM CTA benchmark, which encompasses all CTA styles.

Table: A comparison of our peer group and the industry benchmark CISDM CTA Systematic Index.

in terms of performance and risk - our sample is much more volatile but returns earnings that are more than twice as high. One simple reason for this could be that successful funds attract more capital than less successful ones and therefore our selection by size and age outweighs the most successful (in performance terms) programs. This cannot be denied.

But there is a significant spread within the sample: the highest individual performance is 638 %, compared with the lowest at 64 % - which corresponds to a tenth. Annualized returns are also widely varied (maximum: 22.12 %, minimum: 5.9 %). Which means we have a broad cross section. The values for annualized volatility are between 12 and 27 %.

### Test 1: correlations

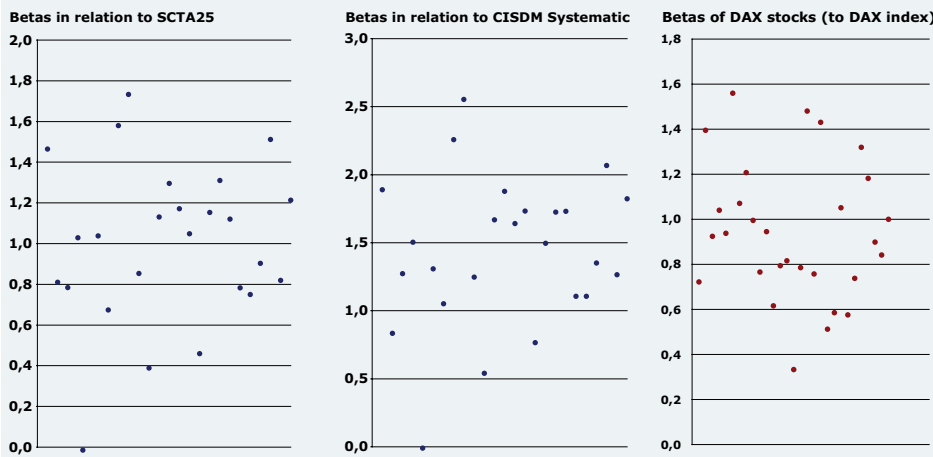
First, let us see how similar the products in our SCTA25 are in terms of their trend. We would expect the majority of the funds to move predominantly in the same direction in the same periods. However, the value bandwidth should also reflect the diversity in portfolio weighting and systematic approaches to trading (e.g. trend-following, counter-trend, multi-system approach) - just as there are individual values in a stock index which swim against the tide (e.g. cyclical vs. anti-cyclical instruments). So the first test

is a matrix which represents the correlation coefficients of all 25 programs. There are 300 possible combinations. The matrix average for our SCTA25 is 0.52, the median 0.58. 24 of the funds show a correlation which is generally positive (minimum: 0.12, maximum: 0.83). The only exception is the Crabel Diversified Futures Program, which shows virtually zero (to slightly negative) correlation with all other funds. This fund is in fact a rogue: its correlation coefficient in relation to the SCTA25 average is -0.02 - which inevitably has to yield a negative beta. On paper, it resembles a data error (which we can rule out) or an element which does not belong to the same asset class. The lower threshold value so far reached in empirical measurements for betas of stocks is a positive 0.3. We will return to this later.

Overall, the matrix paints a similar picture (see diagram this page) as we might expect for the individual stocks of a stock index. In the concentrated, highly positive value range, our SCTA25 appears to be more homogenous than the individual stocks of the DAX, whose average correlation coefficient is lower (0.34).

### Test 2: group betas

Next, we will calculate the beta factors of the individual funds of the SCTA25 group and the superordinate CISDM CTA Systematic Index.



Betas of the individual funds for the SCTA25 (left) and the superordinate CISDM Systematic Index (center): for both groups the funds show identical beta characteristics and a higher beta for the broad index than for the smaller selection. By comparison: betas of the 28 DAX stocks with a price history of at least five years in respect of the DAX (right).

The high beta of 1.48 of the SCTA25 in relation to the index is reflected in each individual instrument. Compared with the index, the positively correlated 24 out of 25 funds show a beta that is 1.3 to 1.6 times higher than compared with the SCTA25 sample. We can conclude that the performance trend of our sample fund is better than the broad average, but because of the similar beta ratio vis-à-vis the comparison group and index, the sample fund is nevertheless representative in relation to the distribution of beta characteristics.

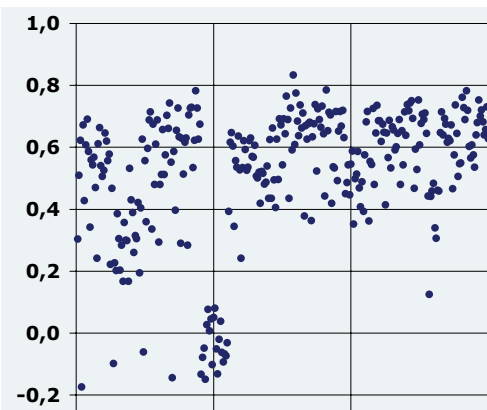
### Test 3: CTAs and other asset classes

If systematic, diversified Managed Futures are actually a separate asset class, then according to our class definition, the beta characteristics of the individual values should also show clearly recognizable similarities with another asset class. The uncorrelated group beta of virtually zero (also the CTA index beta) in relation to the stock market alone, which an analysis of the figures has already shown us, is not sufficient proof of this. This could be due to a purely random average of all of the individual values (e.g. 50 % positively correlated individual values on the one hand, and 50 % negatively correlated on the other). Let us first look at the individual betas of the funds (and the beta components) in relation to the MSCI World stock index.

A quick glance at the chart shows that the funds not only have comparable beta characteristics in relation to the stock market, but also very homogeneous characteristics. The very low beta factors (between -0.47 and 0.17 and an average of -0.18) are not the result of the funds' lower volatility compared with the stock index, but of the weak or even zero correlation (between -0.43 and 0.07 and an average of 0.2). In many cases the beta and correlation coefficient coincide.

The result is another strong indication of the independent risk/return characteristics of Managed Futures.

As a final point, let us also look at the correlations and beta factors of the sample and the CISDM Systematic benchmark in



Top: Visualization of the „SCTA25“ correlation matrix. There is a concentration of highly positive correlation coefficients above 0.6. Bottom: By comparison a correlation matrix of DAX individual stocks for the month-on-month changes of the last 5 years (26 stocks with a long enough price history). We see a similar picture with a lower concentration in the highly positive range.

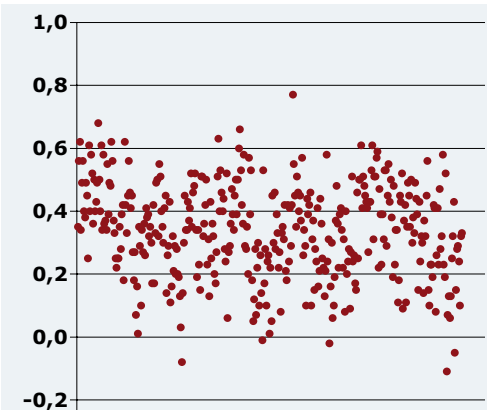
We would also expect to find similar distributions here as for stocks and their respective stock indices. Here, the betas are consistently above +0.3. In the case of our CTAs, we should also see a significant concentration in the positive value range and, at the same time, a wide spread - comparable to a mixture of value and growth stocks.

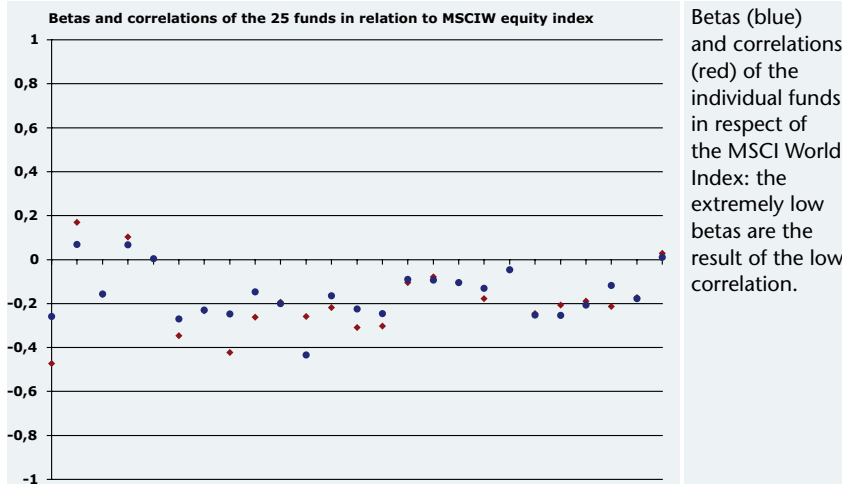
What is more, we hope to find further clues based on a comparison of the betas for the SCTA25 and those of the CISDM Systematic Index as to how our selection behaves in relation to the „universe“ of systematic CTAs.

The results: the 24 positive betas for the SCTA25 are - as expected - widely spread. In 10 cases, they are between 0.39 (minimum) and below 1 and in 14 cases between 1 and 2.55 (maximum). The aforementioned „runaway“ shows an uncorrelated beta of -0.01.

If we then compare this result with the DAX reference values, the only distinction of any real significance is the single uncorrelated fund - the minimum for the DAX at 0.33 is close to the threshold value (it is the healthcare stock Fresenius).

A further comparison of the 25 individual funds with the superordinate CISDM Systematic Index confirms what the figures have shown us: that each of the individual instruments has a directly proportional relationship to the index.





relation to other instruments:

The correlation factors both of our sample and the superordinate benchmark indicate a weak correlation at most with other typical instruments which play an important part in today's asset allocations.

CORRELATION	SCTA25	CISDM Systematic
Commodities (GSCI)	0,27	0,23
Bonds (JPM GGBI)	0,29	0,26
Hedge funds (CS/T)	0,12	0,10

There is a near-zero correlation between systematic Managed Futures and hedge funds, of all things, i.e. the group of investments in which they are frequently included: the correlation factor for the CISDM Systematic and the Credit Suisse/Tremont Hedge Index is a mere 0.1 (SCTA25: 0.12) for the 10 year period in question.

For commodities (Goldman Sachs Commodity Index) and bonds (JP Morgan Global Gov. Bond Index), the correlation coefficient also lies within the insignificant, slightly positive range.

Because they are broadly uncorrelated, the betas have no real explanatory value. We have included them merely to complete the picture.

BETA:	SCTA25	CISDM Systematic
Commodities	0,16	0,08
Bonds	0,57	0,32
Hedge funds	0,24	0,13

## Conclusion

An analysis of the data confirms what earlier studies suggest: Managed Futures, in particular the large group of systematic products from the CTA universe, do not correlate with any other asset class in the significant range. Their contribution to the diversification of an overall portfolio is therefore crucial.

We have been able to prove that the individual elements of the selected sample (from the perspective of the exception we have mentioned repeatedly) have beta characteristics similar to those of the „traditional“ asset classes. We have also shown that industry benchmarks, in particular the CISDM CTA Index, are ideal as a proxy for the overall market. The effect of data distortions such as survivorship or self-selection biases appears to be less pronounced than is frequently assumed.

There is no question that the group of systematic and diversified Managed Futures products (by far the biggest segment of the CTA industry) behaves like a separate asset class and as such represents a beta source that is independent of other classes in a long term time-frame. Given the diversity of the system designs represented, some of which can even deliver uncorrelated earnings, Managed Futures offer sufficient scope for diversification. Whether Managed Futures can be deemed an asset class in the strictly academic sense or just an investment strategy is, as far as portfolio management is

concerned, a question that has little practical relevance.

Incidentally, our data analysis does not take into account whether other CTA styles such as discretionary managers or products specialized in individual market segments (e.g. pure currency programs) possess any other characteristics.

## Solving the puzzle

Finally, we offer the most probable solution to the Managed Futures conundrum: how is it possible for systematic and diversified Managed Futures products, as actors in the futures trading zero-sum game, to deliver unusually highly correlated and, more importantly, sustained (verifiable over extended periods) earnings?

First let us address the question of high correlation: most futures trading systems are based on medium to long-term trend-following models. These approaches to trading may offer plenty of scope for variation - for example as far as entry and exit strategies are concerned, the precise windows in which trends are identified, the logic according to which the individual assets of the portfolio are weighted or in terms of leverage. But generally speaking, during a sustained upward market (e.g. the energy sector at the moment) we can expect virtually every trend-follower to be net long and, in a pronounced downward market, to be net short. The result, in our opinion, is that the majority of products in the majority of measuring periods move in the same direction.

Besides the trend-followers typical for the Managed Futures industry, there is another smaller group which uses other trading models. These include very short-term trend-following models as well as intraday, mean reversion or even counter-trend systems. Multi-style systems, which are based on a number of different models, are also becoming increasingly popular. All of these approaches can often be positioned against the „long“ market trends. Which is why they repeatedly deliver earnings which are largely uncorrelated with their trend-



following neighbors. But because they are a much smaller group within the systematic CTA circle, their influence on the broad indices is too small to change their essentially trend-following nature. Incidentally, the rogue of our sample (Crabel Diversified Futures) also belongs to this group – the important factor here is an ultra-short-term trading system based on momentum and mean-reversion.

Based on these considerations, we can be confident in our explanation of the strong directional correlation between the CTAs. And strictly speaking, our results should be narrowed even further: in truth, trend-following, sys-

tematic and diversified CTAs behave like an asset class. Individual runaways can also deliver market-neutral (beta-neutral) earnings in this class.

Oh yes, earnings - we have established that the industry benchmark as well as our sample of time-honored products both deliver very attractive earnings. Because it is very unlikely that this can be explained by data errors in the indices, there must be something along the lines of a predominant „swarm intelligence“ among futures trading systems, mustn't there? We are inclined to believe that the trading systems simply work better, more quickly and

securely than the bulk of human traders. They are free from fear and greed, they never tire or become sick and are not plagued by the multitude of other human weaknesses. They are also unrivalled in terms of the discipline with which errors of judgment are quickly corrected and successful trades, as long as they remain profitable, are continued as opposed to being prematurely terminated. Let's put it this way: Managed Futures, and especially the systematic traders among them, are the materialization of the findings of behavioral finance researchers over the last 30 years and an affront to classical financial market theory.



## Market & Opinion by Eduard Pomeranz, CEO

Monday, June 9, 2008: Vienna has ground to a halt since the start of Euro 2008, Austria's football fans are licking their wounds after the previous day's defeat at the hands of Croatia and the headlines are devoted to very little else but football. The record rise in oil prices does make the news, however. On Friday, the price of a barrel of US light crude for delivery to New York in July rose by a huge 8.4% to an all-time high of 138.54 dollars. The increase was even more pronounced than that of September 14, 2001, when the price of crude oil rose by 6.88% in the wake of 9/11 following three days of no stock exchange trading. The main difference is that this time there was, thank heavens, no incident of comparable proportions. And this time a rapid return to considerably lower levels does not seem to be imminent (back in September 2001 prices quickly slumped to a year-low after the initial shock). On the contrary: most analysts are forecasting further records during the summer.

### Financial crisis trumped by inflation

Anyone who reads the financial pages closely these days will soon see that the financial crisis is losing its status as *causa prima* - rapid inflation is now

very much under the spotlight, driven as it is by the increase in energy prices. And it's the consumers who are suffering - and at the end of the day, we are all consumers. By contrast, only a very small minority are actually benefiting from this trend: petroleum companies, „the finance minister“ as representative of the fiscal system, which is generating unexpected additional revenue thanks to the petroleum tax, and of course those „speculators“ who are making a fat profit from rising oil prices. And if you profit from something that is damaging to the majority, then you tend to be suspected as being the cause of the damage.

### So who is to blame?

No wonder that FTC has been inundated with media questions in the last few weeks and months about „who is to blame for high commodity prices“. The sometimes explicitly vocalized, sometimes only implicitly resonant criticism: „You are probably just as guilty.“ The temptation to point the finger elsewhere is considerable, of course. I could say: „Why not ask the finance minister?“ But instead I say: „I don't know.“ And I genuinely do not know. How big is the influence of the billions which private investors have pumped

into the commodities markets by purchasing certificates, guaranteed bonds or ETFs since the start of the boom in 2002? How much of the current price is accounted for by speculative positions? How much of an influence does demand pressure from China really have? In response to all of these questions, I can only give you my opinion, not the truth.

### Trading in expectations

I'll let you into a secret: the other participants on the commodities markets are just as clueless. If they knew all the answers, then there would be no ups and downs on the markets, simply a straight line reflecting the one, true price. None of us are trading in oil, grain or gold, but rather in expectations about their future prices. The only reason we have liquid trading is that these expectations are constantly recalibrated by each individual participant with every headline, every subordinate clause in an ECB statement and every price fluctuation and yet there is never any unity.

Anyone who thinks that making a profit from this ought no longer to be allowed should be consistent and ban futures trading altogether, as India has done recently with certain agricultural commodities. Admittedly, the consequences of such a ban would be tantamount to taking us back to the 19th Century. Let us not forget: it is thanks to the „speculators“ that we have the liquidity on the market which is so crucial to all hedging transactions. And hedging transactions in turn prevent price fluctuations from having an immediate impact on consumer prices. So anyone who wants to close the stock exchanges should be clear about what that would mean: new prices for virtually everything, every day.

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