INSIGHTS

CTA Trading Styles

Managed futures is an alternative asset class in which Commodity Trading Advisors ("CTAs") seek to generate returns by trading futures contracts on financial instruments and physical commodities.

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The potential return opportunities offered by CTAs reflect the wider universe of markets and securities that they trade, as well as the trading strategies they employ. Particularly noteworthy is their ability to take not just long positions that seek to profit from upward trends, but also to take short positions in an effort to take advantage of falling prices.

Another general characteristic of most CTAs is their trading approach of using stop-loss orders in an attempt to limit their losses in the event that a trend reverses soon after a position is established. For some CTAs, as many as 60% of all trades may result in relatively small losses. The remaining trades, where the CTA maintains a trading position and seeks to exploit a trend that gets established, may result in profits that more than offset these losses. CTA programs are also characterized by a target volatility, which is a function of how much risk the CTA chooses to take and how that risk budget is allocated across markets and sectors.

Many investors tend to associate managed futures with intermediate to long-term trend-following. While it is true that this trading style makes up the vast majority of the space, both in terms of number of CTAs and AUM, managed futures are not a homogenous asset class, and CTAs may follow several different trading styles. CTAs with varying styles may complement each other, because their programs tend to make or lose money in different ways and, consequently, at different points in time. Let us examine the dimensions along which CTAs may differ from one another.

1. FUNDAMENTAL TRADING APPROACH: SYSTEMATIC VS. DISCRETIONARY

Systematic traders use quantitative models to analyze trends and generate buy and sell signals. Discretionary traders analyze fundamentals and underlying economic factors, and they often specialize in particular sectors or markets. For example, a discretionary trader may take a position in wheat based on acreage planted, rainfall, supply vs. demand, etc.

2. SECTORS TRADED: FINANCIALS AND/OR PHYSICALS

Equity indices, interest rates, and currencies comprise the Financials sector, while energy, metals, and agricultural commodities form the Physicals sector. The risk budget allocated to these sectors varies across CTAs. Some commodity traders may focus primarily on Physicals, while diversified trading programs may trade both. Within these sectors, CTAs may also choose to trade different individual markets (anywhere from 25 to 150), such as wheat, gold, natural gas, Euro, Nikkei Index, and U.S. 30-Year Treasury.

3. TIME HORIZON: SHORT-TERM TO LONG-TERM

Systematic CTA programs use different time horizons to determine the existence of trends and to generate buy and sell signals. Time frames used can vary widely, from as short as intra-day to as long as six months or a year. Individual CTAs may choose to focus on one part of this spectrum, or may use multiple time frames.

4. TRADING STYLES: VARIOUS

Traders also vary by style. In a basic sense, all trading strategies seek to profit from trends in prices. Still, most CTA trading styles can be classified as one of the following, although some CTAs may combine some of these into multi-strategy programs.

- Trend-Following: *A strategy that seeks to profit from buying when models indicate that prices are trending up, and by selling when prices are indicated to be trending down. In general, pure trend-following models focus almost exclusively on the current price relative to some specified measure of historical prices, such as a moving average. This trading style is mainly reactive, as no effort is made to forecast future prices or trends.*
- Pattern-Based Trading: *A strategy that analyzes variables and attributes in addition to prices in seeking to identify the establishment of trends in markets. This is in contrast to a pure trend-following strategy, which looks only at price patterns. It can also incorporate some degree of prediction, as it may seek to anticipate the start of a new trend, or the end of an existing trend.*

- Contrarian Trading: *Also called counter-trend trading, this strategy tries to identify when a current trading trend will reverse, and seeks to profit from such reversals. Mean reversion trading models are also an example of this style.*
- Spread Trading: *Spread trading combines both long and short positions to mitigate the risks of holding only a long or a short position. Strategies may be calendar spreads (for example, long March soybeans and short June soybeans) or inter-commodity spreads. such as the crack spread (long crude oil and short petroleum products) or the crush spread (long soybeans and short soybean oil or soybean meal). Spread trading is an example of a relative value strategy, as it seeks to profit from relative price changes rather than a directional trend.*
- Option Trading: *A strategy that trades exchange-listed and/or over-the-counter options, mainly on futures contracts, seeking to exploit volatility in underlying markets.*

The wide range of differences exhibited by CTAs along the dimensions discussed above may result in potential benefits from investing in a diversified portfolio of CTAs rather than in an individual CTA program or a random selection of programs. CTA programs may evolve and change over time, underscoring the need for active management of such a portfolio. Active management includes risk monitoring, periodic portfolio rebalancing, and continuing due diligence of current and new CTAs with a view to future allocations and/or deallocations.

Regardless of trading style, investors should note that the profitability of any CTA program depends primarily on the ability of the CTA program to anticipate price movements in the relevant markets. Such price movements may be influenced by, among other things: (i) changes in interest rates; (ii) governmental, agricultural, trade, fiscal, monetary and exchange control programs and policies; (iii) weather and climate conditions; (iv) natural disasters, such as hurricanes; (v) changing supply and demand relationships; (vi) changes in balances of payments and trade; (vii) U.S. and international rates of inflation and deflation; (viii) currency devaluations and revaluations; (ix) U.S. and international political and economic events; and (x) changes in philosophies and emotions of various market participants. A CTA's trading methods may not take all of these factors into account. A CTA's determination about the attractiveness, value and potential appreciation or depreciation of a particular instrument in which it invests or sells short may prove to be inaccurate and may not produce the desired results.

STYLIZED REPRESENTATION OF CTA TRADING STYLES AND TARGET VOLATILITIES

For Illustrative Purposes Only.

CTA style is represented by distance from an axis. Target volatility is represented by the distance from the origin.

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PRINCIPAL COMPONENT ANALYSIS

A statistical tool that seeks to identify CTA style differences is Principal Component Analysis ("PCA"), which can be viewed heuristically as a type of multi-dimensional correlation analysis. The output of PCA is difficult to portray in a simple two-dimensional figure, but a stylized representation is shown at left. A random sample of CTAs is selected in order to illustrate a wide range of trading styles and target volatilities.

Trading styles are represented by four axes, with some caveats. First, there are more than four trading styles; with the exception of trend-following and spread trading, which are depicted by the two horizontal axes, other trading styles have been combined as shown. Along the lower vertical axis, we show some actual discretionary traders, as well as some other CTAs who appear to resemble this trading style. Along the upper vertical axis, we depict CTAs who span a range of styles, from pattern recognition to short-term trading.

The distance of each point from the origin (the point of intersection of the axes) represents the CTA program's target volatility. For example, among spread traders, Emil van Essen has a higher target volatility than does JE Moody.

As discussed earlier, a well-diversified CTA portfolio would seek to blend together several CTAs with different trading styles. For example: four or five trend-followers, combined with one or two discretionary traders, one or two spread traders, and three or four "other" CTAs might constitute such a portfolio. A portfolio manager's skill and value added would be in terms of the actual CTA programs selected and the allocations made to them.

APPENDIX

DEFINITIONS:

Long Position refers to the buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value.

Short Position refers to the sale of a borrowed security, commodity or currency with the expectation that the asset will fall in value.

Stop-Loss refers to an order placed with a broker that combines the features of a stop order with those of a limit order. A stop-limit order will be executed at a specified price (or better) after a given stop price has been reached. Once the stop is reached, the stop-limit order becomes a limit order to buy (or sell) at the limit price or better.

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EFM658
0015-NLD-01/04/2013