A Question & Answer Report

Managed Futures Accounts

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For the individual or the institutional investor who is simultaenously performance-oreinted and risk-conscious, the key question is how best to acheive a higher overall rate of return with acceptable risk.

The answer may be a diversified investment portfolio with some portion of the total assets invested in managed futures account. That is, an account that utilizes the abilities of a professional Commodity Trading Advisor who is able to bring experience, discipline, and a history of past success to the trading of futures contracts.

By providing plain language answers to plain language questions, the pages that follow can be helpful in deciding whether a managed futures account can help achieve specific investment goals, particularly in today's volatile and increasingly challenging investment markets.

1. What exactly is a managed futures account?

It is like any other brokerage account established to trade in futures except that responsibility for determing what trades to make and at what time, including discretionary authority to direct trading for the account, is delegated to a professional trading advisor. in this sense, the advisor is the account "manager". As will be discussed later, the advisor's compensation is normally a management fee based on the size of the account plus an incentive fee contigent on profitability.

2. What types of investors utilize managed futures accounts?

It's traditionally been individual investors seeking the profit opportunities of futures trading but without the responsibility and demands of day-to-day account management. Recently, however, growing numbers of corporate and institutional investors have been allocating some portion of their total portfolio assets to specially designed and professionally managed futures trading programs. The total amount of capital in managed futures programs is estimated to exceed $40 billion.

3. What's been responsible for growth in managed futures trading?

A variety of things. as traditional investment markets have become increasingly volatile - and vulnerable to often-unexpected events --- institutional money management and other sophisticated investors have sought to more effectively manage overall portfolio risk through diversification. Indeed, risk and diversification are major concerns in today's market environment --- along with, of course, yield.

A number of studies indicate that a portfolio that includes managed futures can yield appreciably higher and more stable return over time than a portfolio that includes only stocks and bonds. the same evidence indicatestthis can be achieved without added risk. (See next question.)

Still another factor in the growth of managed futures has been the tremendous broadening of futures markets to encompass stock indexes, debt instruments, currencies, and options as well as conventional commodities. This has created whole new categories of profit opportunities. The increasingly global nature of today's futures markets also has expanded the scope of investment opportunities.

Finally, from the standpoint of an indvidiual investor, managed futures accounts have proven to be considerably more profitable on the average than accounts that individuals trade on their own (See Question 10.)

4. How are profitability, volatility and risk affected when managed futures are included in an investment portfolio?

Harvard Business School Professor John E. Lintner found that including managed futures in a portfolio "reduces volatility while enhancing return." And that such portfolios "have substantially less risk at every possible level of return than portfolios of stocks, or stocks and bonds."

For the period of January 1, 1980, to December 31,1998, data show that managed futures investments (as measured by the Barclay CTA Index) had a compound annual return of about 15.8%. That compares very favorably with the 17.7% return that common stocks had durin gthe same period, one of the strongest stock markets in U.S. history. Further, it exceeded the 11.8% return on bonds.

Moreover, during a simliar period (Jan. 1, 1980, to December 31,1997), analysis showed that a portfolio that comprised some managed futures had similar profitability with far less risk.

Portfolio	Return During Period	Risk (Std. Deviation)
55% Stocks/45% Bonds/ 0% managed futures	14.5%	9.55
50% Stocks/40% Bonds/ 10% managed futures	14.9%	8.9
45% Stocks/35% bonds/ 20% managed futures	15.1%	8.7
37% Stocks/27% bonds/ 36% managed futures	15.6%	9.25

5. All things considered, why can investment portfolio performance be improved by including managed futures?

There's no single reason, but high on the list is that managed futures may perform best when other invesments are pferomring relatively poorly. On the occassions of the S&P 500® 's worst two declines during hte past decade, managed futures recorded net profits of 9.7% and 18.6%. A study by the University Of Massachussets Finance Professor Thomas Schneeweis compared the S&P's worst twelve months and best twelve months and found that managed futures posted gains during both periods.

An important advantage of futures is the opportunity they provide to respond swiftly on a highly leveraged basis whenver and wherever in the financial and commodity markets major price movements occur --- either upward or downward -- and to do so without liquidating other investment holdings or adding to overall portfolio risk.

6. Is a managed futures account appropriate as a short-term investment?

No. Futures markets, like most markets, tend to be cyclical. Moreover, even an advisor who is highly successful over the course of a year may --- and probably *will* --- experience some months in which losses are incurred. Thus, while you are free to close an account at any time (see Question 29), it's probably not a prudent investment strategy to establish an account that you don't plan to maintain for at least a year.

7. Does having a managed futures account lessen the risk of futures trading?

There is no method of futures trading that doesn't involve risk. The same leverage and price movements that can produce trading profits can produce trading losses. Indeed, any loss that can occur when an individual directs his own account also can occur in a professionally managed futures account.

Having said this, however, one of the things that should obviously be looked for in a trading advisor is a long-term demonstrated ability to manage risk. More about this later. (Also see discussion of loss limiting provisions of managed accounts, Question 22).

8. Is a managed futures account appropriate as a short-term investment?

If you are already familiar with the arithmetic of futures, this will be nothing new to you. Still, an example illustrates the reason for having some part of a total investment portfolio positioned to participate in profit opporutnities as and when there are significant price movements virtually anywhere in the economy. Example: Assume there are indications that the U.S. dollar will increase in value. Consequently, the value of a Swiss franc is expected to drop from 65.00 cents to perhaps only 60.00 cents. With a performance bond deposit of about $ 10,000, you could establish a short position in 6 Swiss franc futures. (Each Swiss france futures contract equals 125,000 Swiss francs). If the price declines by the expected five cents, the profit on the $10,000 performance bond deposit will be 37,500 (.05 x 125,000 x 6). That's leverage.

Now take the example one step further and assume the $10,000 peformance bond deposit was part of a $50,000 managed futures account and that you also have $150,000 in stock and bond investments with an average annual return of 12%. Even if the Swiss france year, a $37,500 gain would double the overall portfolio return for the year. Yet only 5% of the total $200,000 portfolio was invested in the futures positions. In the context of portfolio management, that's the significance of leverage.

9. But couldn't the trade have resulted in a loss?

Obviously, yes, if the Swiss franc price had risen rather than declined. For each one cent of price increase prior to the liquidation of each futures contract, there would have been a $1,250 loss per contract. Hopefully, a disciplined trading advisor would have liquidated the positions to limit the loss once it became apparent that prices were not moving in the expected direction.

10. How does the performance of managed futures accounts compare with those of self-directed accounts?

Some individual investors --- those who have they know-how, time, access to information, and necessary temperament -- are highly successful in directing their own futures trading. Unfortunately, the record suggests that only a small percentage of "do-it-yourself" futures traders possess these requisites for success. Studies indicate that somewhere between two out of three and nine out of ten lose money.

However, of the 119 funds and pools in the Managed Account Reports Fund/Pool Qualified Universe Index that traded from January 1990 through October 1996, 81% were profitable over the full time period.

11. Has the advantage of managed futures trading been increasing in recent years? And, if so, why?

Most industry experts agree this has been the case, due in large measure to the increasing complexity of financial markets in general and futures markets in particular.

With the complexities have come additional strategies for fine-tuning risk-reward relationships, and for using futures in conjunction with a wide array of other financial products. Recently created worldwide market linkages have likewise placed a premium on the ability to quickly analyze an act on vast amounts of information. These are capabilities that professional management is best able to provide.

12. Are there other reasons why managed accounts are generally more profitable?

The growing complexity of the markets is one factor but by no means the *only* factor. As in most areas of investment, trading experience and trading skills are ultimately major determinants of trading success. Profitable futures trading requires the discipline and temperament to respond to market realities if and when

they conflict with market expectations. It rquires a keen knowledge of when and how to liquidate them. It requires the development and implementation of carefully considered trading strategies --- a trading plan and a trading system.

And the list goes on. Effective account diversification demands an insightful understanding of how various markets react with and to one another. Otherwise, attempts to diversify could prove illusory. Even institutional and corporate portfolio managers who may have experience in futures --- such as for hedging applications --- generally choose to use professional advisors to manage their futures trading investments. For most individual investors, the advantages can be even greater.

13. Don't trading advisors differ from one another in their investment results?

Definitely. In any given year, some will realize impressive profits and others will incur losses. Still others will occupy the full range of everywhere in between. The success of your managed account will depend on the success of the advisor you select.

14. That brings up the obvious next question: How do you choose an advisor to invest with?

There are a variety of things to consider but in the final analysis it will come down to a judgement call --- yours! It will be a matter of gathering information, asking questions, and choosing on the basis of your confidence in the advisor's experience and ability.

Begin by visiting with futures specialists at the brokerage firm where you are considering establishing an account. Firms that offer managed account programs generally screen the qualifications of dozens of different trading advisors to narrow the list to the a few that they feel most confident in recommending at a particular time.

Persons registered with the Commodity Futures Trading Commission as Commodity Trading Advisors are required to provide detailed "Disclosure Documents" to prospective clients. These are simliar to a prospectus and contain a wealth of information about the advisor, his experience, approach to futures trading and trading results. Take the time to read them.

15. How important is the advisor's past trading performance -- the "track record?"

As of the ads and prospectuses are required to state, past performance is no guarantee of future results. An advisor who has performed well in the past may perform poorly in the future. And it is possible that someone who has performed poorly may begin to perform well. this not withstanding, in any endeavor some individuals are obviously better at what they do than others and a track record is at least an indication of past performance.

In addition, a track record can provide other valueable information about an advisor's experience approach to trading, and amount of money under management. You'll also want to note whether performance data included in the disclosure document refers to actual trading results or to "hypothetical" or "simulated" results. Make your own decision about whether to invest in a untested trading system that may be be based solely on market hindsight.

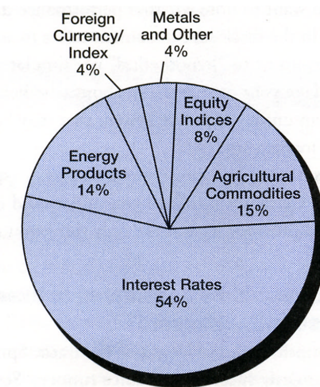
16. What should be considered in examining an advisor's track record?

Start by considering the length of the track. Sprinters aren't necessarily successful distance runners. Sensational performance in a short time span, bluntly put, may reflect little more than extraordinarily good luck. Or, of more concern, it may reflect someone who takes greater risks than you may be comfortable with over the long haul. Or it could reflect specialization in markets that, in a given period, were especially active.

Track records can be much more meaningful when you examine a longer track. This provides more information about how an advisor has performed over the landscape of continuosly changing market scenarios. And,very important, performance in less-than-spectacular years may be indicative of the advisor's risk management skills. That's crucial, particularly in markets that tend to be cyclical.

17. Which futures markets would I be trading in with a managed account?

This will be determined by your trading advisor and in all likelihood it will be different markets at different times. the pie chart below illustrates the scope and diversity of today's futures markets as well as the recent volume of trading in various categories.



Percentage of Total Futures & Options Trading Volume, 1999

Source: Futures Industry Association
Data for January-September 1999

18. How do trading advisors differ in their investment approaches?

One way is in how aggressively or conservatively they aprticipate in the markets. There also could be differences in which markets they trade. Some specialize in particular areas -- such as financial instruments, metals or agricultural products --- while other pursue profit opportunities wherever they appear to exist. If you have a preference for a particular approach, this should be taken into account.

Another difference is whether the advisor employs a “fundamental” of “technical” trading system --- fundamental meaning that trading decisions are based principally on supply and demand, and technical meaning that the marekts themselves are continously analyzed for signals to future price direction.

Even then, different advisors have developed and employ different systems and may read the markets differently. Moreover, the fundamental-technical distinction has broken down somewhat as fundamental advisors frequently employ computerized tools to pinpoint the timing of their trading decisions.

19. With a managed account, will I have market positions at all, or nearly all, times?

There is another way advisors can differ in their investment approach. Some believe the more profitable way to catch the price movements in herent in volative marekts is to maintain continous but changing market positions. And their trading systems are designed accordingly. Others commit capital to the markets only when there is a reasonable confirmation of significant longer-term price trends. In the absence of such trends, or under certain other market conditions, the advisor may temporarily elect to remain “market neutral”.
This is not to suggest that either approach is necessarily better, only that they are different. Which to choose may depend on your own investment temperament and the capabilities of a particular advisor.

20. Where will money be when I establish a managed account?

It will be with the brokerage firm where you have your account. While the trading advisor will direct trading for the account, all other account functions are performed by your brokerage firm, including custody of funds in a segregated customer account.

21. Is a manged futures account subject to performance bond calls?

A performance bond call is a request from the broker to deposit additional funds to the account, generally to cover losses on open positions; any futures account, managed or otherwise, is subject to them. However, a major objective of professional trading advisors is to manage and diversify their clients' investments in a way that will avoid the necessity for performance bond calls. You may want to inquire about whether all of your funds will be committed to the market at any one point

22. Do managed accounts have any automatic provision to limit losses?

If so, this will be described in the disclosure document. A loss of more than some given percentage, or losses that reduce the account value below a specified dollar amount, may trigger the liquidation of all currently open positions and a subsequent closing of the account. This "safety valve" feature is clearly one of the things to inquire about when you are considering establishing an account. Keep in mind, however, that no one can guarantee an absolute limit to the extent of losses any more than they can guarantee a given level of profit. Performance, it bears repeating, hinges on the success of your trading advisor.

23. Who regulates commodity trading advisors?

They are regulated by the federal Commodity Futures Trading Commission (CFTC) and by the National Futures Association (NFA), the congressionally authorized self-regulatory organization of the futures industry. All trading advisors must be registered with the CFTC and those who manage customer accounts must be members of the NFA.*
Advisors disclosure documents are required to be submitted to the CFTC for review in advance of distribution to prospective investors. On an ongoing basis, NFA audits disclosure documents (particularly performance information), promotional materials, and trading activities. Violations of CFTC or NFA rules can result in a loss of trading privileges and other penalties.

24. On an ongoing basis, how will I know the status of my account?

Your brokerage firm will provide the same timely reports you'd receive if you were directing your own account. This includes immediate mailed reports of all purchases and sales, a marked-to-the-market valuation of open positions, and a month-end summary of transactions, gains, losses, open positions, and current account value. Your broker, of course, will have the same information, updated at least daily.

* You can verify an advisor's registration and NFA membership by phoning NFA toll-free at 1-800-621-3570. NFA also offers, without charge, a number of informative publications regarding its regulatory activities and futures trading.

25. With the trading directed by an advisor, is the choice of a brokerage firm still important?

It's no less important than in any other investment relationship. On a day-to-day basis, the brokerage firm may be monitoring and evaluating the advisor's performance even more closely than you will. In addition, although the advisor directs trading for your account, it is generally your brokerage firm that will execute the trades, and manage all "back office operations" regarding your account.

Thus, it's important to know you are doing business with a firm that has the resources and skills to compete effectively in today's markets. Some do, better than others. And intangibly, but by no means least, it's important to have a high comfort level with the broker you'll be working with.

26. What mistakes do investors sometimes make regarding managed futures accounts?

Three probably top the list. First, the fact that a managed account approach may be more attractive than a do-it-yourself trading approach doesn't mean futures trading in any form is necessarily appropriate for a given person. Because risk is the constant shadow of the pursuit of profit, it's definitely not appropriate for everyone. Unless you're confident it's appropriate for you, don't invest at all.

Second, as already mentioned, choosing an advisor for the wrong reasons can be a costly mistake. Selecting solely on the basis of "who's hot and who's not" usually leads to flawed decisions.

Third, investors prone to "account jumping" frequently jump the wrong way. This doesn't mean the advisor your start with should forever be the advisor you stay with, but it does mean-and the records document it- that accounts maintained over a longer

period of time tend to perform appreciably better than accounts that are in short-term parking. That's all the more reason for your initial decision to be carefully considered.

27. How do trading advisors get paid?

Normally through a periodic management fee that's some percentage of the amount of money that's under management, plus an incentive fee that's a given percentage of net profits earned for the account during a given period. This will be described in the disclosure document. Some may charge only one type of fee or the other. And if the fee is a combination of the two, different advisors weight it in different ways. Naturally, management expenses as well as brokerage commissions are topics to discuss.

28. Is there a minimum investment that's needed to establish an account?

Yes, but different managed account programs have different minimums. At the least, it will be an amount the advisor and the brokerage firm-given the trading approach utilized-consider adequate to achieve account diversification.

Minimum account size also may be affected by whether the managed account program is designed principally to serve individual investors or institutional/ corporate clients.

29. Are there any restrictions in withdrawing funds from my account?

In a private managed account program-as distinct from a commodity pool or fund-the only restriction is usually that you do not make withdrawals below the minimum required investment. You will, however, be

free to withdraw all funds after liquidation of any open positions. This can be done at any time of your choosing unless the account agreement stipulates otherwise. Similarly, if there are profits in the account, you are free to withdraw them or leave the money available for reinvestment.

30. Any final words of advice?

Only that if you decide futures trading is an appropriate investment, you give careful thought to the advantages of a managed account approach. And that you choose your trading advisor with considerable care. For the right investors, teamed with the right advisors, today's futures markets are providing increasingly attractive and diverse investment opportunities. Perhaps you should consider them.

The original version of this booklet was prepared for the Chicago Mercantile Exchange by financial writer Fred Bailey. Over the past two decades, he has written extensively about futures and options and their uses in connection with portfolio management.

For more information about managed futures, see "Exchange-Traded Derivatives in a Professionally Managed Portfolio," also published by the CME.

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CHICAGO MERCANTILE EXCHANGE®

Chicago
Chicago Mercantile Exchange
30 South Wacker Drive
Chicago, Illinois 60606-7499
1 312 930-1000
FAX: 1 312 466-4410
E-mail: info@cme.com

London
Chicago Mercantile Exchange
Pinnacle House
23-26 St. Dunstan's Hill
London EC3R 8HN England
44 171 623-2550
FAX: 44 171 623-2565
Effective 4/22/00
PHONE: 44 20 7623 2550
FAX: 44 20 7623 2565

Tokyo
Chicago Mercantile Exchange
Level 16, Shiroyama JT Mori Building
4-3-1 Toranomon, Minato-Ku
Tokyo 105-6016 Japan
813 5403-4828
FAX: 813 5403-4646

Internet
www.cme.com