



A Primer on Alternative Investments and Managed Futures in Particular

By James J. Eccleston, Esq.

“**A**lternative investments” is a term used to describe numerous investment alternatives to stocks, bonds and real estate investment trusts (REITs). Let's explore the characteristics of these new menu items, especially one in particular, managed futures.

According to the Financial Planning Association (FPA), the alternative investments are: hedge funds, commodities (that is, futures and options), direct ownership of real estate, limited partnerships, private-equity funds (that is, investing in privately-held companies), venture capital or angel investing (that is, investing in local start-up companies or small growth companies), and managed futures. The general characteristics of each of these alternative investments, according to the FPA, are: higher fees, higher investment minimums, minimum net worth and income requirements for investors, and illiquidity (3 to 5 year commitments are not uncommon). The FPA also notes that it can be difficult to find appropriate benchmarks to measure performance and risk, unlike, for example, using the Dow Jones Industrial Average or the S&P 500 to measure stocks. Finally, the FPA observes that most advisers recommend no more than 10% to 15% of one's investment assets be placed in alternative investments.

Let's examine managed futures. One commentator, Cynthia Harrington, CFA, described them this way in 2002:

Less well-known than their hedge fund brethren, managed futures offer investors good returns, better transparency and a higher level of regulatory oversight.

More recently, in an August, 2005 article, entitled, "Searching for Absolute Returns with Managed Futures", Brad Zigler writes that "managed futures long preceded hedge funds as the [alternative investment] of choice for most high-net worth investors." Mr. Zigler formerly headed marketing, research and education at the Pacific Exchange's option market.

In his article, Mr. Zigler reports that managed futures have offered low performance correlation to the stock market and have experienced "double-digit returns", including a 10.3% return since 2000. That is impressive, but what are the risks of managed futures? Ms. Harrington observed in 2002 that, "A client with a low tolerance for risk may not be willing to stick with a manager who suffered a 20%-plus drop in one month, for instance." She noted that managed futures may be leveraged 2x, 3x, even up to 6x, through the use of high risk margin, resulting in the ever-present "risk of losing significantly more than the cash invested."

While Mr. Zigler does not discuss the risks of managed futures in his article, he does discuss costs: "Now comes the bad news: the admission ticket to the world of managed futures costs a pretty penny." Indeed, managed futures make hedge funds look like a bargain! Like hedge fund managers, commodity trading advisors (CTAs) who manage futures impose maintenance fees. However, the fees that CTAs charge are higher, averaging 2% to 3% per annum according to Mr. Zigler. Then there are the "incentive fees", which hedge funds also charge, typically in the 20% range. Finally, there are the brokerage commissions charged by the futures commission merchant (FCM) or the introducing broker (IB).



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(Page 2 of 2)

Accounting for these high costs, Mr. Zigler concludes that, "[F]or managed futures investors to earn attractive returns, the gross profits (i.e., before fees and expenses) must typically exceed 30% per annum." That is extremely difficult to do on a consistent basis, nearly all would agree. Nonetheless, Mr. Zigler reports that typically, advisers now recommend that high net worth investors commit 5% to 20% of their investment assets to either managed futures or hedge funds.

That commitment may be excessive. Clearly, managed futures appear to be suitable only for aggressive investors who can afford to lose a significant portion of their investment assets.

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