

Common portfolio construction and fees in the CTA and managed futures industry

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Abstract

During the summer 2014, we conducted a survey to establish "*The Common Denominators in the CTA and Managed Futures Industry*". The survey was sent to over 3,500 financial industry practitioners globally and we received 51 (1.5%) responses. The survey was conducted from 17th June 2014 until 11th July 2014 by the Nanyang Technological University in Singapore and supported by J8 Capital Management LLP in London.

This article is the second in a series of three articles. The first article presented the most popular markets traded by the CTA industry. This article presents the survey results on the most popular return engines, portfolio management methods and fee structures in the CTA industry. The final article will present an investible index based on these survey findings.

The full survey report will be published in the Journal of Index Investing with the Institutional Investor Journals.

Introduction

While the choice of markets is one distinguishing factor between CTAs and managed futures programmes, the choice of return engines, risk allocation, money management, and fee structure are the next main distinguishing factors. The "Return engine" tell us how managers generate returns from the underlying markets. "Risk allocation" tells us how managers weigh the different underlying markets or in signals, and "money management" how they and allocate and mange money. Finally, we discover which fee structures are most common in the CTA and managed futures industry.

RETURN ENGINES

A fund's return engine is potentially the most important distinguishing feature between itself and other managers. The most common family of return engines is "momentum or trend following" which received 56% of survey ticks (Exhibit 1). The overwhelming majority opted for "medium" as the most common trading frequency (59% (Exhibit 2).

61% of the respondents voted 100% systematic as their management style. Hence, making fully systematic systems the most preferred management style. Only 4% preferred purely discretionary as their management style leaving 35% taking a hybrid approach between systematic and discretionary (Exhibit 3).

It is interesting to note that the likelihood of a CTA/managed futures programme being 100% systematic AND using momentum or trend following AND trading at low-to-medium frequency is about 20%.

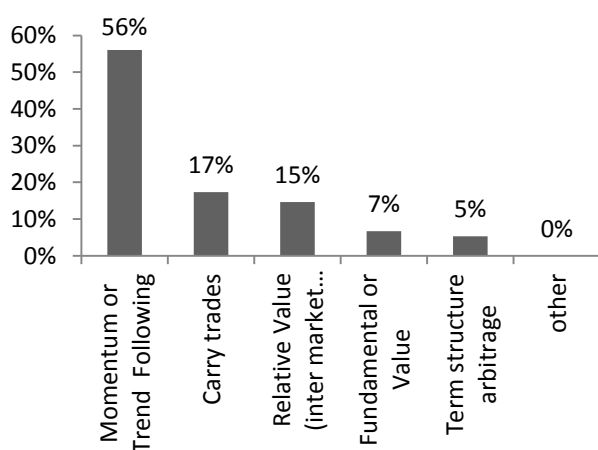


Exhibit 1: The frequency result of most popular return engines.

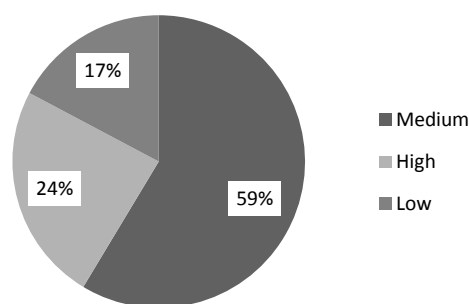


Exhibit 2: Common trading frequency of CTAs

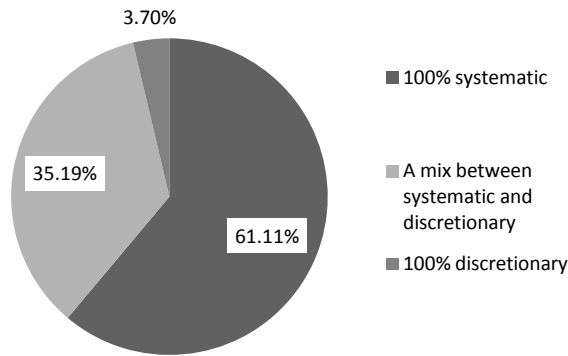


Exhibit 3: Management style

RISK AND ASSET ALLOCATION

Risk and asset allocation play an important part in portfolio construction. Exhibit 4 shows risk parity or equal volatility weighted, as popularised by Bridgewater Associates in 1997, as the most common mechanism (57%). Daily portfolio rebalancing was the most popular rebalancing frequency (Exhibit 5).

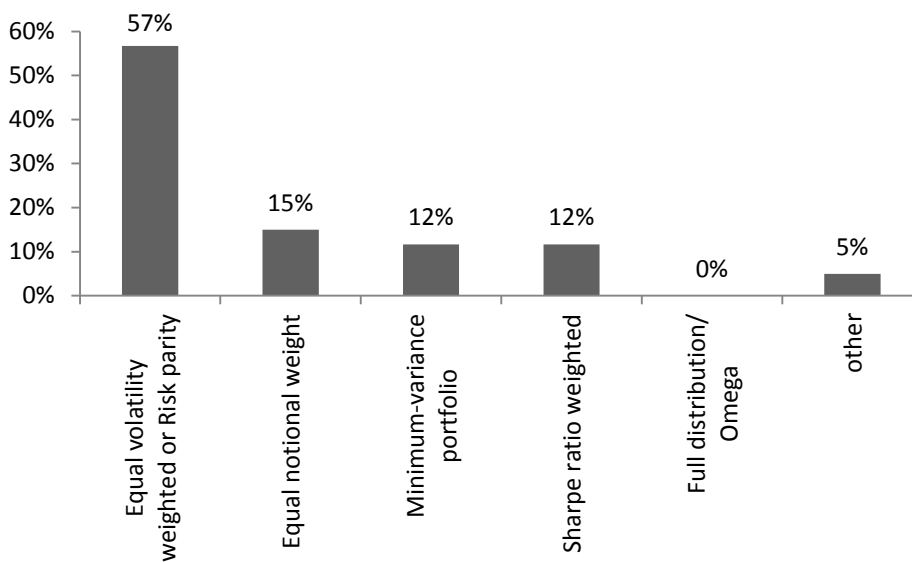


Exhibit 4: Most common risk and asset allocation method.

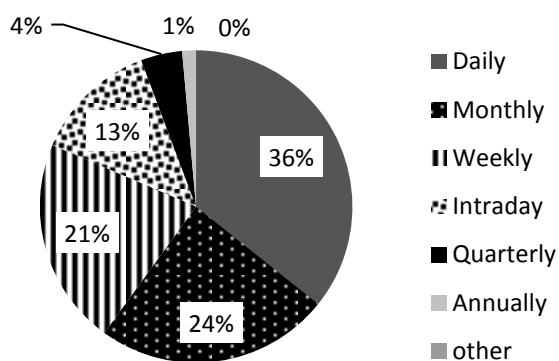


Exhibit 5: Portfolio rebalancing frequency used in the managed futures industry

MONEY MANAGEMENT

In money management, use of a target volatility mechanism is the most popular method (39%) and setting drawdown limits (32%) or value at risk (27%) follow closely behind (Exhibit 6). Two respondents commented they believed stop-loss mechanisms were of importance.

Money management is most commonly performed daily (Exhibit 7).

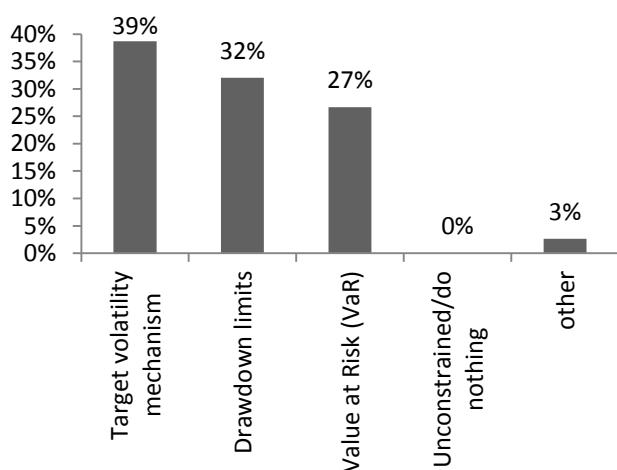


Exhibit 6: Most common money management systems

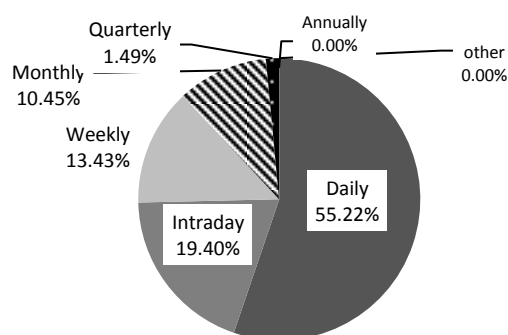


Exhibit 7: Money management frequency used in the managed futures industry

Fees structure

Managers typically charge a management fee and a performance fee. The management fee is often perceived as a base fee to ensure the operation does not run out of money, whereas the performance fee is to align the manager's interest with the investor's and both share in the success. Sometimes, hurdle rates need to be reached before the manager enjoys any share in the performance success.

As shown in Exhibit 8, respondents believe management fees of between 1.5 and 2% per annum to be most widespread with 45% of all responses. A 15-20% high water mark was the most popular performance fee structure (55%) (See Exhibit 9).

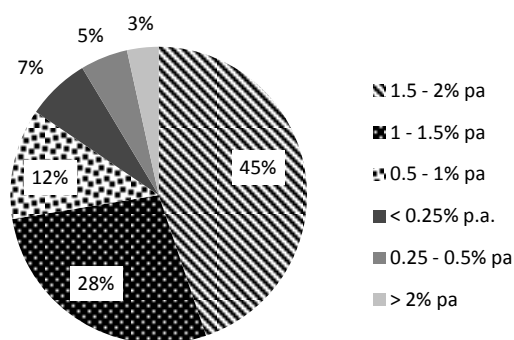


Exhibit 8: Management fee distribution

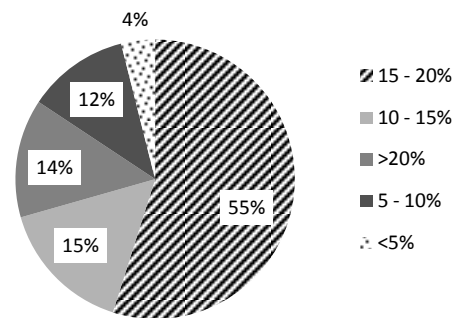


Exhibit 9: High water mark performance fees.

A number of comments also suggested that no hurdle rate was a regular occurrence. However, if they do exist, the choice of hurdle rate is dominated by US LIBOR, with 44% choosing this. A negotiated rate is not uncommon, either (Exhibit 10)

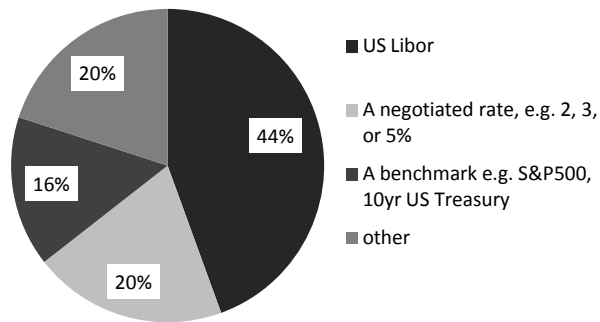


Exhibit 10: Popular hurdle rates in the CTA industry

Conclusion

The headline findings of the survey suggest that the CTA and managed futures industry could be characterized as trading a portfolio of diversified popular global markets in a momentum or trend following driven risk-weighted portfolio managed to a target volatility and applying a 2/20 fee structure.