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Your Q&A: How Are UMAs, SMAs Investing in Commodities?

Q:

How should advisors and managers of UMA or SMA platforms structure an investment in commodity trading advisors (CTAs) on behalf of their high-net-worth clients?

- RIA, U.S. West

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A:

Advisors and managers of separately managed accounts (SMAs) and unified managed accounts (UMAs) are turning to commodity trading advisors (CTAs) as part of a broader diversification trend.

CTAs have become an increasingly popular option for institutional and high-net-worth investors over the past several years. They manage approximately 15% of the $2 trillion in hedge fund assets under management.

CTAs can provide important portfolio diversification benefits as a result of low and sometimes negative correlations to traditional asset classes and macro indicators. Typical risk-return profiles

for a pool of CTAs have had negative correlations to equities in several crisis periods and are relatively insensitive to the broader economic climate. They also have their own attractive risk-return characteristics, making them truly all-weather investment opportunities, in our view.

Once investors buy into the concept of CTAs, SMA and UMA platforms need to consider how to structure the investment. The primary considerations are whether to use a single-manager CTA or a pooled vehicle, and whether larger or smaller emerging CTAs will work best.

Though single-manager CTAs can post solid returns, their volatility is higher due to the potential for sizable drawdowns occurring at different points of an economic or market cycle. Risks can also come from an overreliance on a manager's unique trading program and style. Indexes can mask single-manager volatility and drawdown profiles of their underlying constituents.

For example, the Newedge CTA Index reflects 20 of the largest CTA funds. Over the trailing five-year period ending Dec. 31, 2011, the Newedge CTA Index had a maximum drawdown of just 7.1%. However, looking at the underlying constituent programs, no fewer than 13 programs – or 65% of the constituent index sub-funds – experienced drawdowns of at least 15% over that same period. These are worrying numbers for the financial professionals designing a plan for their platform offerings.

Our experience suggests that investments in smaller emerging CTAs can be very effective. To demonstrate this, we compared the performance statistics of two recognized CTA indexes (BarclayHedge and Newedge) with 10 of the largest CTAs by size and an actively selected pool of 25 smaller emerging CTAs, which were diversified by style, trading timeframe and asset class. An "emerging manager pool" of 25 CTAs was selected on the basis of qualitative and quantitative due diligence by a group of experienced investment professionals.

The results were clear: We observed that while a broad exposure to CTAs has attractive characteristics, the emerging manager pool demonstrates alpha over diversified indexes, showing higher returns, fewer drawdowns and lower volatility compared with the top 10 CTA pool.

Some shy away from less-established managers because of their shorter track records. However, we believe emerging managers' flexible investing styles and trading time horizons provide benefits not seen from the larger CTAs, which tend to move in tandem due to their size, market liquidity constraints and their focus on similar trading strategies.

Key factors for successful CTA investing

Overall, it's our experience that putting together an actively managed pool of smaller emerging CTA managers and integrating them into an SMA or UMA structure requires the following:

• Deep experience and a rigorous investment process in manager selection based on exhaustive due diligence, both on the operational and investment side;

• Access and ability to effectively screen a large global universe of CTAs that have differentiated models, signals and styles;

• Quantitative tools that enable value-added strategic and tactical asset allocation processes; and

• Advanced risk management tools that use trade-level transparency to aggregate exposure and profit-and-loss statement contributions on a daily basis to monitor risk at various levels and conduct various risk analyses.

We believe the evidence supports the theory that an emerging manager CTA strategy is a strong addition to institutional and high-net-worth investor portfolios. As an asset class, CTAs have strong risk/reward characteristics and offer investors transparency and liquidity. They can exhibit low correlations to other major asset classes and generate alpha in their own right. SMA and UMA platforms can take an actively managed pool of smaller emerging CTAs and combine them to form a “multi-strategy” exposure through a single fund offering. This can be an effective way to open this investment class to high-net-worth clients.