



Why institutional investors should allocate to CTAs

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CTAs and Managed Futures are one of the few alternative investment strategies that look back on a very successful year, having returned double digits in a very challenging environment. Total assets for the sector are now estimated to be USD225.5b, which represents a 22% increase over the previous year. Yet, average institutional allocations to the sector are estimated to be a mere 4%. This, in our view and decade-long experience, is insufficient. This article will examine the significant benefits of incorporating CTAs from the perspective of an institutional investor.

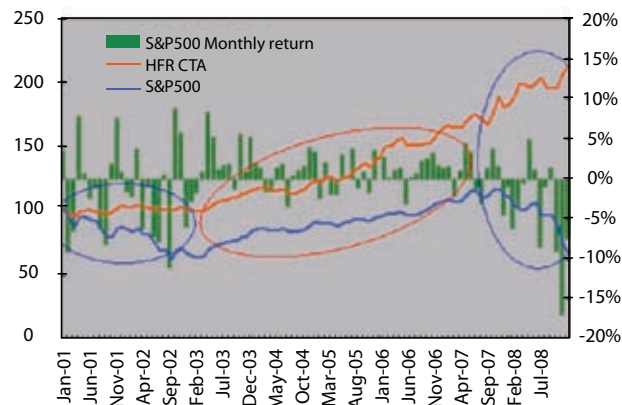
Competitive hedging tool in crisis: Let's look at recent history to examine the performance of CTAs in varying market environments.

First, CTAs work very well in times of down-trending markets. As can be seen in Graph 1 using the HFR CTA index, the sharp decline in the S&P500 since the summer of 2007 has provided a good opportunity for CTAs, which have been performing well by going short equity indices and long bond indices. From the beginning of 2001 to the first quarter of 2002, the S&P500 was in downward trend from a long-term perspective, yet equities jumped once every quarter. This created a whipsawed market, which is mostly an unfavorable market environment for CTAs. Depending on the trading time framework of each individual CTA, performance dispersion between them increased, but the CTA index overall remained basically flat. The constant upward trend in the S&P500 during

the remaining period (from the second quarter of 2003 to the summer of 2007) also provided a good opportunity for CTAs by going long equity indices.

As a consequence, CTAs are both a competitive hedging investment tool during stressed periods, as well as a performance generator in normal and bullish markets. This is because CTAs can benefit from both downward and upward trends by flexibly taking short or long positions.

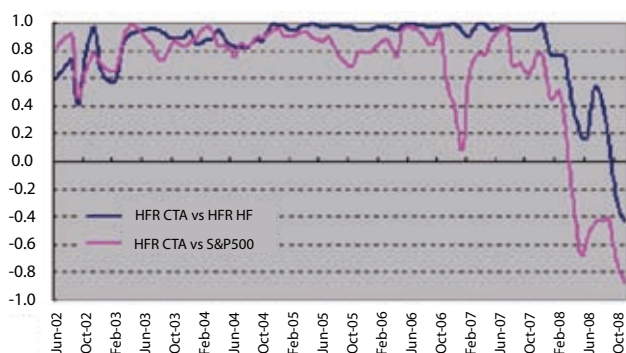
Graph 1 | HFR CTA Index vs S&P500 Index movement



Source: Bloomberg

CTAs have become an attractive component also for alternative investment portfolios because of aforementioned benefits, but also due to the negative or low correlation between them and *other hedge fund strategies*. Graph 2 shows the pronounced negative correlation with other hedge fund strategies, using six month rolling correlation between HFR CTA and HFR index.

So, why do CTAs perform well in market disruptions? The best answer to this question is that a majority of CTAs are systematic trend followers. During a crisis, risky assets such as equities and credits are heavily sold; flight-to-quality assets such as

Graph 2 | Six month rolling correlation

Source: Bloomberg

government bonds are voraciously bought. As a consequence, volatilities and correlations amongst asset classes diverge greatly from historical averages, and clear trends are generated. Under a flight to quality market environment, trend followers capture these clear trends because of their systematic decision making process.

Less concern about market liquidity dry up: CTAs are synonymous with managed futures. Their main trading instruments are futures, exchangeable options and currencies with large trading volume, all of which have deeper liquidity than cash securities and physical commodities. Needless to say, market liquidity has been a critical issue for market participants in 2008. Many illiquid asset classes have sustained significant mark to market losses. Some hedge funds and funds of funds have been forced to gate, suspend redemptions, or liquidate due to the deleveraging process. The highly liquid nature of CTAs is, especially in the current environment, a compelling feature.

Significant flexibility improvement for portfolio management: Pending sufficient investment size, a majority of CTAs accept so-called managed accounts. Managed accounts are attractive as they offer maximum (position level) transparency, favorable redemption terms, and leverage without any funding cost. A managed account awards the investor full discretion to change allocation amounts at any time with a few days advance notice. This privilege, the «short notice right», significantly enhances the mobility of the investors rebalancing. The high transparency allows an investor to significantly enhance risk management.

The ability to obtain leverage without any funding cost is also compelling. This is based on the rule of thumb that many CTAs usually use 5 to 20% of NAV as their margin. For instance, if one assumes 50% as maximum margin requirement in case of emergency, then the investor can gear up to 2X leverage

with no funding cost. In case of estimating 33% as a maximum margin rate, this free option could reach to 3X.

Drawbacks of CTA

As described above, there are several valuable benefits of allocating to CTA at both single strategy level and overall portfolio level. It is, however, worth noting that CTAs have their disadvantages as well. Whatever trading styles they take, directional markets provide the best environment. Trendless or choppy markets are the worst environments especially for systematic trend followers. Generally speaking, they cannot help marking drawdowns under such conditions.

Furthermore, operational due diligence is extremely important for both boutique houses as well as institutionalized firms. A large number of CTAs are boutique houses, so their platforms tend to be vulnerable to business risk, operation risk, key person risk and so on. Checking IT platforms, back office and business operations is fundamental. To large institutionalized firms, especially firms with rapidly growing AUM, due diligence should of course be carefully conducted as well. For instance, of concern should be how the fund handles market liquidity irrespective of AUM growth; keeps execution costs low when trading relatively illiquid instruments; and maintains the theoretical exposure to these less liquid asset classes. In addition, needless to say, other operational issues in terms of brokers, auditors and so forth are getting much more critical than they were before.

Conclusion

To summarize the key points for increasing allocation weight to CTA, we would like to highlight as follows: > It is a competitive hedging strategy for both traditional investors and FoFs during crisis and a performance generator in normal bull market. > CTAs are highly liquid, which especially in the current environment is attractive. > Managed accounts offer strong benefits from the perspective of portfolio management: Favorable redemption terms, high transparency, ability to obtain leverage without any funding cost. > It is possible to create highly diversified portfolios through trading styles (systematic or discretionary), asset classes, and trading time frameworks.

ORIX Investment Corporation is an asset management company which manages a part of the assets of ORIX Group through alternative investments in the form of FoHFs, CTAs and Managed Futures. In these spaces it has a history with its origin of ORIX COMMODITIES Corporation, a joint venture established in 1990 of ORIX Corporation in Japan and Commodity Corporation in U.S. (presently Goldman Sachs, Princeton).