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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

# Investing in Managed Futures

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**SECTOR – GENERAL INVESTING**

**TWST: What are managed futures?**

**Mr. Snyder:** Let me try to set the stage with some background just a tad. Futures contracts are legally binding agreements to buy or sell a commodity or a financial instrument at a later date. And they've been around a long time. I believe the first bit of reported trading was in 1865. The breadth of markets covered is incredible — physical stuff, like grain, meats, oil and precious metals, and then intangibles, like stock, and interest rate indices and currencies. There are formal exchanges with clearing houses as well as over-the-counter markets. Reputedly, over 500 million contracts change hands a year, with total dollar volumes beating everything else, including stocks.

There are commodity pool operators, CPOs, combining investor funds into a pool, which is what we do at Shinnecock Partners, and commodity trading advisers, CTAs, managing individual investor accounts. The Commodity Futures Trading Commission, CFTC, is the federal regulator, big brother for these activities. The National Futures Association, affectionately known as the NFA, is the self-regulator, which keeps tabs on all practitioners like us.

**TWST: Why did you choose to focus on futures?**

**Mr. Snyder:** I picked managed futures because I had gotten brainwashed. When I was a student at Harvard Business School, I had the opportunity to study under several professors who had done some of the seminal work showing how adding a futures component to any diversified portfolio will lower the volatility, and therefore the risk, yet increase the return over time. Harvard adopted that approach in their famously successful endowment. They attribute a significant amount of their success to adding futures to their portfolio. It allowed them to accomplish their objective of lowering volatility and increasing return, and they have said this publicly. This had an impact on me — guess I was young and impressionable.

When I went to Wall Street, no doubt as a young punk, I had occasion to analyze the futures business further and did a fair amount of work in futures, and found out that what I had learned in school was true. Eureka! When I left Dean Witter, I was managing most of the product areas. So I said, "Gee, I need to put something together for myself because I think Wall Street is frequently casual about risk, and they also have been known to build high fees into products." I figured that the tailor had to make his own coat. Therefore, I created these funds of funds about 20 years ago. From the beginning, I felt strongly about adding a futures component to what I was doing. It turned out to be a very good thing, and it's been extremely productive. We are not alone. Some others have discovered this holy grail as well, and the futures business has grown like a weed as a result.

**TWST: What are the reasons futures have grown so much?**

**Mr. Snyder:** I think there are several. It's a highly regulated market. We have a strong regulator in the Commodity Futures Trading Commission, CFTC, and the National Futures Association. Also we have pretty intensely regulated futures exchanges. Commodity pool operators, like Shinnecock, are regulated by them and are periodically audited. I think that gives investors comfort that it's not only a liquid but fair market. No money manager gates are put up to freeze withdrawals because of this liquidity, and there is plenty of depth for trading.

Second, and this is not so intrinsically obvious, I believe regulated futures contracts have a very delicious tax advantage, even though I am not a tax accountant or a lawyer. Under section 1256 of the Internal Revenue Code, regulated futures contracts are taxed 60% long-term capital gains or losses, and 40% short-term, regardless of the holding period. As you can imagine, that gives you all sorts of flexibility in building a portfolio. Whether you hold a position for one day or 18 months, you can have a favorable tax outcome. That is not a widely appreciated benefit.

A third growth stimulator is that you've had intense academic research done on the power of adding managed futures to a highly diversified portfolio. You've had the academic underpinning from Lintner and Ibbotson to explain that it works. Craig Israelsen, who is a professor at Brigham Young, has done some basic research into it as well, showing the power of futures and the real diversification it offers to a portfolio. That academic research has given others the comfort of adding it to their portfolios in a carefully executed way.

Fourth, you've had the proof of the pudding from the successful use by the major endowments. Futures are being used by Harvard, Yale and Stanford, to name a few unknowns. The bottom line is whether it's the research that proved it or the actual results, you can get attractive returns with managed futures that are not correlated with equities or bonds. It is true diversification and, as a result, lowers the overall portfolio volatility. That's something I don't think is really obvious to most investors.

We spoke a moment ago about the challenge of timing one's investments. Sometimes it's hard to figure out when you want money out of something, and lord knows you want to be able to get it when you want it. Also you can't always know when you will have additional cash to invest. By investing in a fund of funds and getting a blend of individual manager returns, you can achieve a more consistent return pattern with less risk, as long as you do it carefully and well. That's good because it allows you to simply put money in when you want to put it in without being forced to time a top or bottom — usually impossible for mere mortals to do anyway. Equally so, if you need money for an emergency on the way out, you're not going to have somebody say, "Now is not a good time to take your money out because you're losing a lot of money." You don't want to be in that position.

*"The key in structuring any portfolio or selecting any single manager is working hard to select the best, and that takes a lot of energy. I believe, moreover, a fund of futures managers offers tremendous investor benefits and lowers the risk. A portfolio of futures managers gives you instant diversification."*

Think back to 2008, when the markets got crushed. How often do people say, "Wow, I lost 50% of my money, ouch. But gosh, the next year I made a 100%, so I'm really doing great." Of course, the truth is they're not doing great. They just spent two years on a roller coaster ride and are now back where they started. Maybe the concept that consistent returns are really the way to compound money has come to the fore. That's a good thing because I believe it is correct.

Maybe implied in what I've said but worth going through in a top-line way is this: Futures, because they add true diversification, can generate attractive returns in any market environment, and they frequently will do well when the stock market is getting hammered. There's lots of data to back this up. I'd be happy to go through it if you'd like, for the indexes or us as one practitioner. In a nutshell, lowered volatility is why futures have been added to traditional portfolios, which normally consist of stocks and bonds.

**TWST: Why are some traditional investors so leery of futures?**

**Mr. Snyder:** The folklore when I was in the securities business was that most futures participants lose money, and this would be equally true of most people who dabble in the options market. Many investors in these sectors frequently dart in and out, and use high leverage, whether it is buying options, buying calls or puts or futures. They aren't doing it as part of a cohesive professional investment program. I think that's part of it because this type of investing frequently ends up being more speculation than a disciplined approach to the market.

Another reason is the enormous variation between managers. Let's say you want to diversify through a multistrategy execution just in the futures component. If you look at individual futures managers — holy smokes, the spread between winners and losers in any particular period of time is enormous. Data from Barclays (BCS) shows that you have had one manager making 300% in a year and another losing 50% in the same year. I think people look at that and go, "That's too hair-raising for me."

**TWST: Is there a way to get the benefits without some of the risks?**

**Mr. Snyder:** "You betcha," to steal a line. The key in structuring any portfolio or selecting any single manager is working hard to select the best, and that takes a lot of energy. I believe, moreover, a fund of futures managers offers tremendous investor benefits and lowers the risk. A portfolio of futures managers gives you instant diversification. It helps meet the minimum investment requirement for all of the individual managers. Also it can give you diversification across a broader array of futures markets. By participating in 60-plus different markets — from gold to oil to orange juice futures, grains, all the way to futures on interest rates and various stock indices — you get this powerful diversification. And you want to get diversification, not just across markets but across management styles. This approach has worked well for us and our investors.

Another thing that's compelling about using a fund of funds is that it simplifies all the record keeping with one tax return, one account statement and one performance report, versus one of each from every single manager.

You asked earlier why people are afraid of futures. Implied in your question is the skepticism investors have in general, and I would say understandably so. After learning about some of the challenges that have occurred post-Madoff, Enron, a corporate challenge, etc., it has made people very cynical. I think the critical thing is to have a high-quality professional support team that protects whatever you are investing in.

You want to have a first-class, peer-recognized auditor. In our case, we use Deloitte & Touche, one of the Big Four. They perform an independent, third-party audit on each of our funds. That's important. You don't want some name that you don't know run out of the back office of somebody's house, which has happened.

You also want, I believe, an administrator that does all the investor accounting independently of the money manager. Now what does that mean? An administrator gives you real peace of mind because they are an independent third party that gets the results directly from the underlying investment, prime broker or manager. If they're big, that's good, because they'll have all the controls in place. We use ALPS Price Meadows, which was recently ranked by *Institutional Investor*'s Alpha as the number one administrator in the country for funds under $1 billion in assets.

The third thing is having a cash custodian. This role, I think, is frequently misunderstood because there are all different descriptions as to what a cash custodian can do. In my early days, I did national banking on Wall Street and learned that there are all different flavors of banks and the controls they offer. With our funds, I wanted to be able to give our investors confidence that neither I, nor anybody working at Shinnecock, could sneak the money out and run off to Buenos Aires. Most banks will say, "We have all these controls, we won't move any money unless the right people say it's okay." The problem is, most banks do that only by putting a "flag" on the account, and a flag just means somebody has to review it before they go do something. Guess what, they often forget to look or get busy. We looked for a bank that could put a complete computer block on an account, such that nobody could walk into a branch and say, "Oh, just give me a counter check," and that way, go around any so-called flag on the account.

JPMorgan Chase (JPM), pretty interestingly, set up a special unit and a special bank account with a computer block on the account, meaning that for anybody using this, the only way money can move is to do a "mother, may I." We have to say to our administrator, "Hi, we would like to move the money here, there or invest it over here," and they say, "Well, can you explain why?" And you go through all of that. If the administrator agrees, they put in their electronic key — its password changes every 60 seconds — and we put in our password key, and then the money goes electronically to wherever it's supposed to go. All of those controls give investors more peace of mind than they've had in other situations. They can have fully independent accounting and total audit autonomy. No longer can you cook the books, if you were so inclined, and you can't run off to Buenos Aires with anyone's money. These are the kinds of things that, I believe, any investor should look for in these types of investments to make sure that safeguards are in place.

*"To protect against any distractions or other risks, we diversify managers among asset class and strategy, whether it's technical, quantitative, fundamental or trend-following, including all of the in-between blends. The more diversified you can be, the better."*

The other layer of comfort is to use a third-party investigatory firm to verify information on money managers and discover things not always disclosed. The firm we primarily use is actually run by an ex-FBI investigator. They are expensive but worth it. We have them do a deep dive on money managers, where they examine backgrounds of the principals and the firm, check for any civil or criminal litigation, verify attendance in schools, employment, verify all the regulatory stuff, and come back and say, "Hey, we found this," or "We found that," or "Everything looks okay."

In our case, by the way, even after we've done a lot of due diligence ourselves on managers, we have had situations where the investigator has come back with some of the most astonishing information. These have been things that would have been very difficult to find on our own. Fortunately, the information turned up by the investigators has kept us from investing in places that we probably would have regretted.

In conclusion, I think it's these kinds of security measures that create peace of mind and help give people comfort to invest in places like managed futures and funds of funds.

**TWST: What would you say is your core investment philosophy?**

**Mr. Snyder:** Here is what we believe and some of the precepts that we try to follow. First, creating after-tax investment capital ain't easy, therefore don't lose it. Second, do your utmost to avoid large losses, to avoid over-reaching for performance that requires some outlandish results just to get even. Third, compounding works two ways: Steady gains is our prejudice, wins the race and avoids the requirement of trying to time your investment on the way in or on the way out. As we talked about before, a 50% loss requires not just a 100% gain to get even but a lot more, given that you want to earn a rate of return.

Next item, avoid maximally leveraged "guaranteed safe strategies" to increase returns. Leveraging something that seems safe may work well for years, but don't be fooled about risk. You can look at Bear Stearns' levered CMO fund — it worked very nicely for years — or Long Term Capital, same thing even years before Bear. Where the difficulty lies is if you have a discontinuous market, as Mr. Taleb would say, and the black swan floats by, things go haywire and existing historical relationships break down. In this situation, if you're highly levered, you can lose all your money very quickly. You want to hit singles and doubles and have the chance to always get up to bat in the future.

Years ago, when AT&T (T) was broken up, I was working on Wall Street and our trading desk came and said, "This is a guaranteed lock. We can make 40% on our money within six months if we arbitrage this, that and the other thing, and there is no risk." I remember, as a very young guy at the time, being asked about it when I was running the options area. I timidly said, "I don't think it's guaranteed." Amazingly, some listened. The amount of money they put at risk was dramatically truncated, but most of it was lost in the next six months. The guaranteed hedge didn't work. Once burned, twice shy, we are very cynical about high leverage and guaranteed hedges.

In a positive sense, what do we believe? We believe in super diversification. For us, that means diversifying by asset class, by manager and more. Let me share a quick digression about diversifying by manager and how numbers don't tell all. Years ago, I had lunch with a manager who was doing exceptionally well. We were having a delightful lunch, and he pulled out a picture of this beautiful young lady, a dancer, whom he had just married, his second try. He described how they were having enormous amounts of fun, and she had given him an entirely new perspective on investing. He was following it, he had been extraordinarily successful and at the end of the lunch, asked what I thought. I told him that I wished him well, but that we were going to withdraw our investment with him. I said I was happy that he was having so much fun, but I was concerned that his new bride did not have his investment acumen. In the next two or three years, his performance deteriorated sharply because he had strayed from what he was so good at. Eventually he did right himself, which was great, and went on to make even more money. But due to his humanity, he was, at least for those years, distracted in a most delightful way.

To protect against any distractions or other risks, we diversify managers among asset class and strategy, whether it's technical, quantitative, fundamental or trend-following, including all of the in-between blends. The more diversified you can be, the better. Other dimensions are by holding period of the investment, which can be as short as a day or as long as 18 months or more, and by trading instrument. Different trading instruments will have different attributes associated with them, whether it's futures, an option on top of the future, swaps or things like that, etc. Then clearly the most widely known dimension is by position. You don't want everything put on "red 23." You want sub-managers to have diversified positions. In sum, we believe super diversification will create a more consistent return pattern.

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In addition to super diversification, there are risks to protect against as best as one can. Covariance is something you really must pay attention to. Covariance means you want to be sure that the managers don't all end up acting in the same way at the same time because then you're concentrating your bets, which is something we try to avoid.

Another thing is never rush for the bus, there is always another bus. Don't shortcut your due diligence process because somebody says, "Oh! You've got to give us your money now because this, that or the other thing." Be very watchful of such demands.

Another caveat would be avoid undue concentration or other extremes, i.e., there is a lemming effect. Be incredibly careful about avoiding it. Often these days, proprietary trading strategies are built around the concept that things will return to the historic equilibrium. The Black–Scholes model is a good example of an equilibrium-based approach and is often used by trading operations in options. The buzzword is "mean reversion." That's great, except occasionally there is a secular shift. You want to be sure that if such a shift occurs, you are not killed and thus, you can't have total reliance on mean reversion and historical relationships. Certainly this risk is the explanation for some of the well-known blowups that have occurred.

We believe that intellectual horsepower counts. We are not believers in the random walk theory. We do think intense intellectual energy applied will make a difference, i.e., alpha is real to us and we try to find it to the best of our abilities.

Then he or she is unable to hop, like the proverbial frog, to the next lily pad for the next idea, as the first idea is gradually discovered by the rest of the world. We think that's why, at least in some of these trading strategies, there is a higher turnover or burnout of a particular manager. It's hard to write the next novel, if you will. That's why we feel this constant monitoring is very important, particularly in the futures category or with any other proprietary kind of trading strategy. We use things like efficient frontier and all that stuff, but it's a blend of our prejudices, the toolkits and mostly perspiration that is key.

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The other thing we see is that leadership is concentrated. Years ago, I was on the receiving end of an examination from that famous Peter Lynch of Magellan (FMAGX) fame. While he was grilling me, I realized he was terrifyingly brilliant and head-and-shoulders above most, including the others in the room. Filling his shoes at that fund after he left was quite a challenge, kind of proving the point. Again, we believe leadership and intellectual horsepower is concentrated. We want to talk whenever we can to leaders of whatever manager we're investing in and/or read what they write.

Lastly on this point, here is one thing that's kind of scary: There is no perfect protection against fraud. Hard as you may try, you can never do enough due diligence; it's impossible. After the fact, of course, any shortcomings are obvious. However, if there is extreme collusion among all of the parties, it can be hard to find, which is why we believe again in this concept of super diversification as the ultimate bulwark.

**TWST: If you do everything you said and pick the best managers, is that it?**

**Mr. Snyder:** No, while a high proportion of what we do is being a giant talent scout to find the best and the brightest, and hopefully the most honest managers, there is another piece. People sometimes say, "Well, if you select the 'best' managers, game over, you win." We would say "No, no, no!" The other part is constructing the portfolio itself. There we would say another mouthful: multidimensional dynamic portfolio balancing. Simply put, what we mean by that is think of a giant teeter-totter or a seesaw, where you have all those things that I outlined which we look for — asset class, sector, strategy, etc. — all that on one side of the teeter-totter. On the other side are the quantitative measures of returns, volatility, beta, etc. You're trying to do this three-dimensionally, trying to do it with each of the underlying managers and in different blends of the different managers. The goal is to try to optimize the result as to risk and return.

Computer analysis of historical data is a start because that's the only data you have, but it won't predict the future nor will it totally measure risk. In addition, you're trying to stress test the portfolio against various other possibilities. You must create some tools that give you early warning of problems. We use standard regression analytics plus some "secret sauce" to look at any manager's returns against themselves and their peer group. If they start to have a return that is more than one standard deviation from their historical behavior, whether it's on the upside or the downside, we want to increase our monitoring to see if we can ascertain if there is a bad trend developing and/or strategy drift. Of course, the manager should periodically exceed one standard deviation, but it is a good trigger for increased monitoring. Thus, you can see we believe that the portfolio part of this effort is very real and important.

Let me give you another example. The futures area is frequently much more trading oriented than fundamental approaches used by many equity managers, using quantitative toolkits or a unique insight as of a particular moment. As a result, we find that the average manager duration we have had in the portfolio is about four and a half years. Of course, we have had some that are much longer and some that are shorter. For example, a manager might get a powerful insight into something about a particular market and make money for a considerable period of time.

**TWST: What are the differences between your funds?**

**Mr. Snyder:** We are a manager of privately placed funds, so we can't advertise nor can we promote. We have to make sure somebody meets all of the investor criteria before we even talk about these things. We have a multistrategy fund of funds and a futures fund of funds, plus an insurance-dedicated futures fund of funds offered as an investment option for either privately placed variable annuity or variable universal life insurance policies. In one way, these funds are similar in the sense that they are multistrategy, multimanager and encompass all of the other super-diversification criteria we spoke about earlier.

**TWST: Is there such a thing as the right number of managers?**

**Mr. Snyder:** There are two divergent schools of thought in answering that question. Some friends of mine would say you should have as many as 50 managers in a diversified fund of funds, that way your individual positions are about 2% on average. We don't believe in that. We think it's quite a Herculean challenge to discover 50 managers, period. You're trying to find the best, not simply settling. To find so many managers, you exponentiate the amount of examination you must do to uncover 50 needles in the proverbial haystack from every possible piece of straw. We think such an attack is challenging and leads to diminishing returns. If you're not careful, you'll end up with an index but, oops, the goal is to do considerably better than any index. So we're not believers in that approach.

We think an optimal mix is somewhere on the low side of 10 and on the high side of 20. If you think about it, having 10 managers in a portfolio with all of those other diversification criteria means that you have 10% exposure on average to a single money management organization. Fifty manager proponents argue that it's similar to having an individual stock position. That's their analogy, which seems spurious to us. The managers we pick are widely diversified in their positions, have sometimes multiple strategies embedded in their organization, etc. So you're already building in that kind of diversification.

The reason to have more than one manager is you're diversifying by all of the different criteria that I described earlier. The risk is, "Okay, I have maybe somewhere between a 5% and 15% exposure to any single organization." Such a risk seems to be outweighed by the benefits of having the best and concentrating your ongoing monitoring efforts.

**TWST: Thank you. (LMR)**

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