Managed Futures Frequently Asked Questions

Investor Questions

Q) What are managed futures and why should I use them?

A) The term managed futures usually refers to the industry of professional money managers known as Commodity Trading Advisors (CTA) but may also be associated with commodity funds or futures funds (commodity pools). These advisors manage client assets using global futures and options markets as trading vehicles for their clients. They have the ability to take both long and short positions to provide investment opportunity to clients throughout market cycles. Managed futures offer investors direct exposure to international financial and non-financial asset sectors that include grains, meats, softs, currencies, financials, energies, and metals. While traditional money managers implement long-only techniques to drive client return, CTAs have a broader toolkit of investment options at their disposal.

Although managed futures have been a part of the financial services industry for several decades, their popularity has recently increased as more investors realized their benefits. The impressive transparency and liquidity of managed futures has been viewed as an increasingly important benefit. Other benefits of managed futures are: opportunity for enhanced returns, increased diversification compared to traditional investments, lower total portfolio risk (including volatility), and potential to profit throughout market cycles (a product of low correlation and exposure to multiple markets).

Q) Who should use managed futures?

A) Managed futures may be appropriate for investors seeking the addition of greater diversification to their traditional portfolios with a long-term investment horizon. Managed futures allow investors the potential to gain exposure to markets and strategies uncorrelated with traditional asset types and can also provide insight into the trading of a professionally managed account. In addition, institutional investors are increasingly allocating capital to managed futures. These investors may include pension funds, endowments, and family offices. However, managed futures may not be right for everyone, and it is important for an investor to understand all the risks involved before investing in managed futures.

Q) Are managed futures appropriate for short-term investment?

A) Managed futures are not a short-term investment. It is important to note that managed futures should be considered a long-term investment and one that should be added to a traditional portfolio for greater diversification. This is primarily due to the cyclical nature of markets, which affects all investments. Even managed futures programs that are very successful have periods of losses or “draw-downs.” This is why it is recommended that managed accounts be maintained for at least one year and ideally for at least a three-year commitment. They should not be viewed as short-term investments or something that should be traded in and out of quickly.

Q) Who regulates CTAs?

A) CTAs are regulated by both the federal Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA), which is a congressionally authorized, self-regulatory organization within the futures industry. All CTAs must be registered with the CFTC, and those managing customer accounts must be members of the NFA. The NFA and CFTC do not verify trading performance, and registration in no way means that the CTA’s documents have been “approved.” For more information, please visit www.cftc.gov and www.nfa.futures.org.

Q) What is a Disclosure Document?

A) A Disclosure Document is required by the NFA and CFTC for specific types of CTAs. The document describes the CTA’s trading program, risks, fees, past performance, manager profiles, rules, and other relevant details. CTAs are required to update their Disclosure Documents at a minimum of every nine months. Updates may be more frequent if significant changes are made to their trading programs. Each CTA Disclosure Document is different and should be read before investing. Certain types of CTAs are exempt from the requirement of producing a formal Disclosure Document. Exemptions are usually based on the type of investor the CTA intends as his clientele.

Q) Where is the money deposited when a managed futures account is opened?

A) (1) If the investor is placing money with an individual CTA in a managed account, funds are deposited with the brokerage firm and are maintained in a futures customer segregated account (or, if applicable, a foreign futures secured account). (2) If money is being placed with a fund, or a fund of funds, then the money is given to the fund (or the fund of funds).

Q) How much are management and incentive (performance) fees in this type of investment?

A) Generally speaking, most CTAs charge a 2% annual management fee and a 20% annual, performance-based incentive fee. These fees can vary among managers depending on trading strategy and CTA philosophy. For example, some CTAs may not charge a management fee but will increase their incentive fee to gain greater participation in upside performance. Depending on the investment size, fees may be negotiable. CTAs may have a fee scale that is dependent upon the net liquidity of the client account or the percentage that the program is profitable. Lastly, in rare instances, CTAs may charge an accounting fee in addition to the management and incentive fees. All fees charged by a CTA are described in the CTA's Disclosure Document and should be scrutinized carefully by both the broker and client before opening an account. Special approval processes apply to the broker's participation.

Q) How are management and incentive fees deducted?

A) Management and incentive fees are typically deducted on a monthly basis from the client's account based on the CTA's gross performance. The incentive fee is applied to the month-over-month-end profits that are in excess of the previous "high-water mark." The incentive fee is calculated net of all fees and commissions. Realized and unrealized (open equity) profits and losses are normally included in this calculation.

Q) What does high-water mark mean? How does the CTA make money?

A) A high-water mark is the performance level that the CTA must exceed in order to charge incentive fees and typically is calculated net of brokerage commissions, exchange fees, and the CTA's management fee and incentive fee payments. For example, an account with a beginning value of $1,000 earns trading profits of $100 and pays a 20% incentive fee during the first billing cycle. The actual ending account value for that billing period is $1,080 ($1,000 + $100 - $20) and the CTA would report these gains as +8% (80/1,000). $1,080 would then be used as the high-water mark for the following billing period. If the CTA made another $100 during the second billing period, the fees would again be $20 ($100 x 20%), leaving an account value of $1,160 ($1,080 + $100 - $20); $1,160 is now the new high-water mark. The performance would be reported as +7.4% ($80/$1080.) Suppose that the CTA lost money during the third billing period. The high-water mark remains $1,160 and an incentive fee would not be charged again until the account value exceeded that amount. Management fees are charged regardless of performance or high-water mark, and are based on account value. It is essential that an investor understand the fees inherent of managed accounts and the methodology used for their calculation. Fees are addressed in the CTA's disclosure document and advisory agreements.

Q) What is the minimum investment with a CTA?

A) Minimum investments via managed accounts can range from $10,000 to $50,000,000. In most cases, the longer and more prolific a CTA's track record, the more likely it is that he or she will dictate a higher account minimum. The CTA's target investment audience also influences required minimums. CTAs who predominantly work with high net worth individuals (HNWI) and institutional investors are likely to require higher account minimums. Additionally, many trading strategies require large investment amounts to work effectively.

Q) What is notional funding?

A) Notional funding enables qualified investors to invest in a CTA program at a lower minimum by using increased leverage. For example, for an account with a minimum of $100,000, an investor may want to fund the account with $50,000 of actual funds and $50,000 of notional funds. In that instance, the notional value of the account is $50,000 and the nominal value is $100,000 (nominal – notional = actual). This means that the account has $50,000 of actual client assets but will be leveraged to trade like a fully funded, $100,000 account. The same volume and number of trades placed in a fully funded account ($100,000) will be employed in the notionally funded account ($50,000), thus increasing the margin/equity ratio. It is important to note that the degree of risk increases proportionately when leverage is used. In the case mentioned above, the profits and losses of the notionally funded investor would be magnified by two. If an account fully funded at $100,000 experienced a 2% profit or loss, then an account notionally funded at $50,000 would experience a 4% profit or loss. Notional accounts are normally reserved for those clients who qualify and meet certain investor requirements. The Notional Account Agreement can usually be found in the Disclosure Document or will be provided upon request to the CTA. It is essential that the client read and be made aware of the risks and increased leverage involved in notionally funded accounts. Keep in mind

that with notionally funded accounts, the advisor will earn fees off the nominal amount (nominal = actual + notional; in this case, $100,000).

Q) How is performance reported on managed futures accounts?

A) CTAs report performance net of all commissions and fees. Performance figures are commonly found in the CTA's Disclosure Document and marketing materials. Customers will also receive confirmation and monthly statements from MF Global showing all activity in their accounts.

Q) Are there any lock-ups?

A) Managed accounts normally do not entail lock-ups. Lock-ups are more likely to be found in fund products. If there is a lock-up, it will be referenced in the Disclosure Document.

Q) What are "give-up" charges?

A) A CTA doing business with MF Global may have a designated broker other than MF Global. In this case, a client opens a managed futures account with an MF Global Account Executive (AE). The trades of the selected CTA are executed by the designated broker, and those trades are then "given-up" to MF Global for clearing. The designated broker charges the MF Global client for these give-ups. The client or the CTA (if authorized by the client) will enter into a give-up agreement prior to opening the account. The client should be made aware of the additional costs. Where MF Global is executing the order, both clearing and execution fees will be negotiated between MF Global and the CTA.

Q) Will I be able to see the trades and know what the CTA is doing?

A) Depending upon their investment structure, managed accounts may provide a great deal of transparency. The broker and the investor will be able to access both day-end and month-end statements of all trade activity and in some cases, intra-day activity.

Q) Can I invest funds from my Individual Retirement Account ("IRA") in a managed futures account?

A) Yes, but they must be invested through a "self-directed" IRA. You must first open a self-directed IRA that accepts futures accounts through a third-party trust custodian and then open a futures account under the custodian's name. IRA funds that are placed directly into a futures, options, or foreign exchange account could cause unintended tax consequences for investors. A self-directed IRA allows the investor to roll his or her assets forward and continue to let them grow, tax-deferred.

Q) What are the tax benefits of managed futures accounts?

A) Clients should consult with their tax advisors.

Futures trading involves risk of loss and is not suitable for everyone.