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How Investors Lose 89 Percent of Gains from Futures Funds

By David Evans - Oct 7, 2013
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The pitch was enticing. At a time when the Standard & Poor's 500 Index had suffered a decline of 41 percent in the previous three years, Morgan Stanley was offering its clients the possibility of some relief.

In a prospectus, the New York securities firm invited its customers to put their money into a little-known area of alternative investing called managed futures.

"If you've never diversified your portfolio beyond stocks and bonds, you should know about the powerful argument for managed futures," the bank wrote. "Managed futures may potentially profit at times when traditional markets are experiencing losses."

Morgan Stanley presented a chart telling investors that over 23 years, people who put 10 percent of their assets in managed futures outperformed those whose investments were limited to a combination of stocks and bonds, Bloomberg Markets magazine will report in its November issue.

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Clients jumped in. During the decade ended in 2012, more than 30,000 investors entrusted Morgan Stanley (MS) with $797 million in a managed-futures fund called Morgan Stanley Smith Barney Spectrum Technical LP. The fund already had $341.6 million invested during the previous eight years.

Top fund managers speculated with that cash in a wide range of asset classes. In that period, the fund made $490.3 million in trading gains and money-market interest income.

No Gain

Investors who kept their money in Spectrum Technical for that decade, however, reaped none of those returns -- not one penny. Every bit of those profits -- and more -- was consumed by $498.7 million in commissions, expenses and fees paid to fund managers and Morgan Stanley.

After all of that was deducted, investors ended up losing $8.3 million over 10 years. Had those Morgan Stanley investors placed their money instead in a low-fee index mutual fund, such as Vanguard Group Inc.'s 500 Index Fund, they would have reaped a net cumulative return of 96 percent in the same period.

The "powerful argument" for managed futures turned out to be good for brokers and fund managers but not so good for investors.

In the $337 billion managed-futures market, return-robbing fees like those are common. According to data filed with the U.S. Securities and Exchange Commission and compiled by Bloomberg, 89 percent of the $11.51 billion of gains in 63 managed-futures funds went to fees, commissions and expenses during the decade from Jan. 1, 2003, to Dec. 31, 2012.

Fees: $1.5 Billion

The funds held $13.65 billion of investor money at the end of last year, according to SEC filings. Twenty-nine of those funds left investors with losses.

The $8.3 million loss in Morgan Stanley's Spectrum Technical fund over a decade pales in comparison to an aggregate deficit of $1 billion in 29 Morgan Stanley and Citigroup Inc. (C) managed-futures funds in the four years ended on Dec. 31, the filings show. Those funds charged investors a total of $1.5 billion in fees.

Morgan Stanley and Citigroup merged their funds' management in 2009; Morgan Stanley bought out Citi's share in June.

"The big news here is, the fees are so outlandish, they can actually wipe out all the profits," says Bart Chilton, one of five members of the Commodity Futures Trading Commission. Even though the CFTC oversees managed futures, Chilton says he hadn't been aware of the effects of the high costs for investors.

"We absolutely need to do a better job of letting consumers know in plain English what's going on," he says. "Those numbers tell a story. It's astounding."

Little Noticed

The impact of high fees on investors has escaped the notice not only of regulators, but also some industry executives.

The Morgan Stanley Spectrum Technical fund was opened in 1994 under the leadership of then-Chief Executive Officer Philip Purcell.

He was succeeded in 2005 by John Mack, who had spent most of his career at Morgan Stanley. James Gorman, who replaced Mack in 2009, joined Morgan Stanley from Merrill Lynch & Co. in 2006.

The prospectus pitching the Spectrum fund, issued in March 2003, said the firm would accept investments as low as $2,000 for individual retirement accounts.

Morgan Stanley's chief investment strategist, David Darst, who has written a book on managed futures,

declined to comment on his firm's fees. Bank spokeswoman Christine Jockle also declined to comment on the funds referred to in this story.

'Historically High'

"Fees associated with managed-futures funds across the industry have been historically high," Jockle says.

Brokers have an incentive to keep clients in managed-futures funds because they receive commissions annually of up to 4 percent of assets invested, prospectuses show. Investors pay as much as 9 percent in total fees each year, including charges by general partners and fund managers.

People put money into managed futures because their brokers recommend them, says Thomas Schneeweis, a finance professor at the University of Massachusetts Amherst who was a futures-fund manager from 2004 to 2010.

"Everything is marketing," he says. "Getting out there and pushing it. These things are sold, not bought."

Broker pitches that don't clearly tell investors about the drastic effect of fees should be considered fraudulent, says James Cox, a securities law professor at Duke University in Durham, North Carolina.

'License to Steal'

"Otherwise, the pitch is a half-truth," he says. The government is to blame for allowing these products to be offered with inadequate disclosure, Cox says. "I would call it a license to steal," he says.

Because the managed-futures market is opaque and poorly understood, otherwise sophisticated investors often don't realize how pervasive the profit-eating fees are. The firms marketing the funds are at times also left in the dark. The industry refers to the computers programmed with trading algorithms as black boxes.

Some banks say they can't see into the boxes of the traders they hired.

"Particularly given the black box character of many managed-futures strategies, it is virtually impossible for the manager to detect strategy changes," Bank of America Corp. (BAC)'s Merrill Lynch says in an August 2010 SEC registration for its Systematic Momentum FuturesAccess LLC.

The 7,752 investors in that fund faced losses of $135.3 million, after fees, from 2009 to 2012, according to data from Merrill's SEC filings. Merrill spokesman Bill Haldin declined to comment.

Side Bets

High fees and black boxes are just part of the story. Some funds also allow their managers to make undisclosed side bets by trading ahead of or opposite to the fund's trades.

Chicago-based Grant Park Futures Fund LP, which is marketed by Zurich-based UBS AG (UBSN), says on

page 90 of a 180-page, April 2013 prospectus that David Kavanagh, president of the $660.9 million fund's general partner, may place such personal trades.

"Mr. Kavanagh may even be the other party to a trade entered into by Grant Park," it says.

The Grant Park Futures Fund reported a net investor loss of $68.6 million during the decade ended on Dec. 31, after fees and commissions of $427.7 million. Kavanagh, president of Dearborn Capital Management LLC, which manages Grant Park, didn't respond to requests for comment.

Misleading Numbers

When financial advisers promote managed-futures funds, they often rely on charts produced by a small company in Fairfield, Iowa, called BarclayHedge Ltd. The firm, which has no connection to London-based Barclays Plc (BARC), reports a 29-fold gain through 2012 for managed futures overall since 1980. Those numbers can mislead investors.

BarclayHedge doesn't deduct billions of dollars of fees charged by funds. It uses only information volunteered by managed-futures traders. Traders can stop providing data if their system starts to lose money or collapses, says BarclayHedge President Sol Waksman.

The BarclayHedge data, even with its flaws, Waksman says, is the industry benchmark. Investors need to look at more than just his index, he says.

"They've got to accept some of the blame for going into something without any knowledge," he says.

Managed-futures funds are a subset of hedge funds. They're run by so-called commodity-trading advisers, or CTAs, who these days invest largely in financial futures. While hedge funds typically charge a 2 percent management fee and 20 percent of investor profits each year, a managed-futures fund often duns clients 7 to 9 percent of assets invested annually and 20 percent of any profits.

'Ask Questions'

The National Futures Association, a self-regulatory group, doesn't require managers to disclose the effects of fees on investor profits over time, says Mary McHenry, an associate director in the NFA's compliance department.

"We can't just give investors all the answers," she says. "It's important that they ask questions before they invest."

While brokers commonly promote managed futures as protection against stock market declines, the language in prospectuses belies that notion. Managed futures are noncorrelated; that means their performance doesn't track that of any other investments, either positively or negatively.

"As a risk transfer activity, trading in commodity interests has no inherent correlation with any other investment," Grant Park wrote in its February 2013 prospectus. In other words, managed futures behave like a knuckle ball in baseball.

'Don't Know'

Players know a knuckle ball isn't a fastball or a curveball, but beyond that, they don't know what it will do. A managed-futures fund isn't a stock or a bond; it may sometimes behave like one -- and sometimes not.

McHenry says she knows that brokers pitch managed futures as protection from stock market declines -- and that fund risk disclosures say there's no correlation. Asked how those contradictory statements add up, she says, "I don't know how to answer that question."

Like hedge funds, managed-futures funds haven't been required to file with the SEC as a matter of course. However, an SEC rule has mandated that any partnership with more than 500 investors and $10 million in assets -- even a hedge fund -- must file quarterly and annual reports.

The SEC has no category listing managed-futures funds, as it does for mutual funds or corporate filings. Bloomberg Markets culled through thousands of filings in several categories, including one called "SIC 6221 Unknown," to identify 63 managed-futures funds that reported to the SEC.

T-Bills

While each trading adviser has a different black box, there are similarities in how fund managers approach their jobs. Some of their investments are plain vanilla. They place money from investors into U.S. Treasury bills or other short-term debt. They then use about 15 percent of the funds to buy or sell futures contracts.

They can bet that prices will rise or fall on more than 150 different futures contracts, including those covering stock indexes, government bonds, currencies, interest rates, agricultural commodities, oil and metals.

Treasury bills turn out to be critical. Interest income from T-bills and other debt investments has effectively masked the high fees funds charge their investors. The 63 funds that reported to the SEC collected interest totaling $2.34 billion in the decade from 2003 to 2012.

Without those gains, the combined 10-year earnings of $1.3 billion after fees in the 63 funds would have been converted to a loss of more than $900 million. As interest rates have fallen to historic lows since 2008, managed-futures funds have suffered their largest declines ever.

More Risk

Fund managers amp up the risk in their investments by using leverage. They can buy futures contracts on

margin, with down payments as low as 10 percent. A $100 investment in Morgan Stanley's Spectrum Technical fund, for example, bought $1,000 worth of futures contracts, according to its 2003 prospectus.

By comparison, the New York Stock Exchange requires investors to maintain a minimum margin of 25 percent of the market value of a purchased security.

Even the managed-futures funds that file with the SEC don't have any obligation to disclose how fees in recent years ate up all trading gains.

The Grant Park Futures Fund filed a prospectus in April to raise $927 million from investors. Although it included the boilerplate language saying substantial fees could offset trading profits, the document doesn't say that the $25.6 million the fund had gained since 2009 was obliterated by fees. Investors suffered a $223.6 million loss over that period.

Advisers Confused

Ken Steben, who runs a fund, says managed futures can be confusing to both investors and advisers. His Futures Portfolio Fund, started in 1990, gathered $2 billion from more than 17,000 investors during the decade ended on Dec. 31. The fund has been marketed by 140 firms, including San Francisco-based Wells Fargo & Co. (WFC) and Minneapolis-based Ameriprise Financial Inc. (AMP)

It had gross returns of $619.5 million in that decade. Investors paid 86 percent of that amount in fees and commissions, leaving $84.3 million, for a 3.6 percent compounded annual growth rate.

"Most individual investors don't understand what we're doing," says Steben, 58, sitting in the boardroom of his no-frills suburban Steben & Co. office in Rockville, Maryland, in April before the firm moved to Gaithersburg. "In many cases, the financial advisers don't completely understand it."

Individuals Pay

While pension funds, college endowments and other institutions invest in managed futures, individuals bear the brunt of the fees.

Institutions that invested at least $1 million with London-based Winton Capital Management Ltd., one of the world's biggest CTA firms, received a net total of 11.9 percent from 2009 through 2012, the company reports. Winton charges those investors a 1 percent management fee and 20 percent of profits.

Individuals who invested in the Altegris Winton Futures Fund were less fortunate. Altegris Investments Inc., an alternative investment firm in La Jolla, California, allows clients to come in with as little as $10,000. Altegris collects additional annual fees totaling up to 4 percent, according to SEC filings.

Because of that, some of Altegris's Winton investors lost 10.1 percent in the same period institutional investors had gains, SEC filings show.

Altegris Executive Vice President Richard Pfister asks, “Are any of these managed-futures funds worth it anymore at these fee levels? Do they make sense?”

1990s Success

One of the biggest and oldest futures managers, Baltimore-based Campbell & Co., did well for investors in the 1990s and early 2000s. Its flagship Strategic Allocation Fund provided a 10.5 percent compounded annual rate of return to investors in its first decade of trading through Dec. 31, 2003.

What followed wasn’t as good. From 2003 to 2012, more than 15,000 investors put a total of $4.5 billion into the fund. Clients were recruited by Merrill Lynch, UBS and other firms. The Strategic Allocation Fund earned $2.43 billion, according to SEC filings.

Those returns shrank to $158.8 million after investors paid fees and expenses of $2.27 billion, equaling 93 percent of the gains. The result was a 0.6 percent compounded annual rate of return for the decade. That compares with 7.1 percent, including dividends, for the S&P 500 during the same period. Campbell closed the fund to new investors in 2008.

‘Outdated, Inaccurate’

Like most managed-futures funds, Campbell develops algorithms for its black box. Those systems are flawed, Campbell tells investors in annual reports.

“A previously highly successful model often becomes outdated and inaccurate, sometimes without Campbell & Co. recognizing that fact before substantial losses are incurred,” the firm wrote. Keith Campbell, founder and chairman of the firm, declined to comment.

The knuckle ball nature of managed futures can flummox even the professionals. Gerald Corcoran, CEO of Chicago-based R.J. O’Brien & Associates LLC, the largest independent futures broker in the U.S., says he recently lost money investing in managed futures. Corcoran, 58, is a director of the Futures Industry Association.

His $25 million RJO Global Trust managed-futures partnership, pitched to retail investors with as little as $5,000 to invest, fell 35 percent during the four years ended on Dec. 31 after gaining 41 percent in 2008. It charges up to 7.25 percent in annual fees.

‘No Question’

“You’re going to lose money in managed futures over the course of a period of time. There’s no question,” Corcoran says. “I mean, I’ve just experienced it myself.”

“I actually would not even encourage most retail investors to be in managed futures,” Corcoran continues. “It’s on the riskier end of the investment spectrum.” He says managed futures serve wealthy investors.

"They're an important part of a diversification of a sophisticated portfolio," he says.

Keith Stafford, an accountant who specializes in auditing hedge-fund and managed-futures data, says he and his colleagues are constantly amazed by the poor performance of managed futures for individual investors.

"We look at each other all the time and say, 'Why would anyone invest in this?'" says Stafford, the member in charge of performance analysis at Arthur Bell, Certified Public Accountants, based in Hunt Valley, Maryland. "It's a racket."

The CFTC

While managed-futures funds are relatively new, official trading of futures in the U.S. dates back to 1848 at the Chicago Board of Trade -- which became regulated by the U.S. Department of Agriculture in 1922. The CFTC, formed by an act of Congress in 1974, took on oversight in 1975.

Morgan Stanley was the first firm to allow individual investors to buy into managed-futures partnerships, starting in 1979. Although commodity-trading advisers initially focused on futures tied to physical commodities, such as wheat, corn, oil and gold, most futures trades now cover stock indexes, interest rates or currencies.

Today, CTAs can be based anywhere. Their main assets are computers -- and the people who program them. Bill Dunn, a CTA pioneer, runs Dunn Capital Management LLC from the top floor of a three-story building in Stuart, Florida, alongside the St. Lucie River.

Dunn, 79, who earned a doctorate in theoretical physics from Northwestern University in Evanston, Illinois, in 1966, began trading managed futures for clients in 1974 after a brief career as a consultant to the federal government.

Mainframe Computer

He raised $137,000 from friends and family and used punch cards to build a program to detect profitable market trends and control risk. He purchased processing time on a mainframe computer to run the cards.

High on one wall of Dunn's windowless trading-room floor, hundreds of red and green numbers blink with currency and commodity prices.

The three traders on duty one March afternoon watch the numbers but don't make decisions based on them. They leave that to their black box, which makes trading choices on contracts for 53 investments, including the Australian dollar, U.S. Treasury bonds, interest rates, stock indexes, cocoa, copper, live cattle and crude oil.

The so-called box is actually lodged in six computer servers linked by blue and yellow cables. It

automatically collects tick-by-tick trading data on all 53 possible trading choices and runs it through hundreds of different models, asking each whether to buy or sell. Then it makes a decision, which it relays to the human traders.

‘Your Orders’

“In minutes, you have your orders for the day,” Dunn says.

Dunn doesn’t cater to most retail investors; he requires a commitment of at least $100,000. He boasts a 13.2 percent compounded annual rate of return over the past 29 years, after a 25 percent fee taken from profits. He charges no management fee.

“I think investors are very comfortable knowing that if they’re having bad times, we’re having them as well,” says Dunn, who sports a shaved head and neatly trimmed salt-and-pepper goatee. “We’re in the same boat.”

In a practice more typical of the industry, Morgan Stanley’s profits aren’t dependent on investors’ making money.

The firm’s 220,000 clients that purchased the 13 funds started by Morgan Stanley and are included in SEC filings paid a total of $2 billion in fees, commissions and expenses during the decade ended on Dec. 31. (The bank opened four of those funds after 2003.)

13 Funds

Investors lost money in seven of the 13 funds, SEC filings show. Spectrum Technical performed well during its first eight years, starting in November 1994. Its investors received a compounded annual return of 7.9 percent in that period. In the decade ended on Dec. 31, 2012, the fund had no gain. Morgan Stanley closed the fund to new investors in 2008.

The worst of the 13 funds was the Managed Futures Premier BHM Fund, which was started in November 2010. It had a compounded annual return of negative 11.7 percent over two years and two months. Five of the six gainers had compounded annual returns below 1 percent.

The best performer, the Morgan Stanley Smith Barney Spectrum Strategic Fund, had a compounded annual return of 2.1 percent during the decade ended on Dec. 31. By comparison, the Fidelity Money Market Fund gained a compounded annual return of 2.9 percent in the same period.

Morgan Stanley runs its managed-futures funds through a subsidiary, Ceres Managed Futures LLC. That was previously a joint venture with New York-based Citigroup. The two top-performing Citi funds, now managed by Morgan Stanley, were energy-focused investments that returned 14.2 percent and 14.8 percent compounded annually in the decade ended on Dec. 31.

Cautions Investors

Citigroup spokeswoman Shannon Bell declined to comment.

Darst, Morgan Stanley's chief investment strategist, cautions investors about the cost of managed futures in his 2013 book, "Portfolio Investment Opportunities in Managed Futures" (John Wiley & Sons).

Darst, interviewed in April, says investors shouldn't pay more than 2 to 3 percent in annual fees for managed-futures funds. He says even that's steep compared with other investments.

"It's higher," he says. "That's something you've got to be upfront with people about. This is not a bargain-basement kind of thing."

He says investors should ask questions about fees before buying managed futures.

Double, Triple

Most Morgan Stanley funds impose annual fees that are double -- some are triple -- Darst's suggested level. Morgan Stanley funds generally charge 6 to 9 percent of assets in annual fees. Darst declined to answer follow-up questions about his firm's fees.

Even if an investor understands the effect of fees on returns, it's impossible to avoid a potential conflict of interest between investors and fund managers. Such risks are explained deep in prospectuses or SEC filings.

Morgan Stanley cautions that employees of the general partner and trading advisers may buy futures for their own accounts, in competition with investors. Clients will never know, the 2008 Morgan Stanley Spectrum Technical fund prospectus says. That's because those trading records are kept secret from investors.

"As a result, you will not be able to compare the performance of their trading to the performance of the partnership," the prospectus says.

Lowering Fees

Morgan Stanley spokeswomanJockle says the firm's managed-futures funds performed well during the stock market plunges that began in 2000 and late 2007. The funds overall gained 22.5 percent after fees in 2008. The bank sells only to investors it deems qualified, and it clearly defines risks and fees, she says.

Morgan Stanley is lowering fees for its new funds, she says. She declined to comment about conflicts of interest.

So incomplete are the disclosures for managed-futures funds that investors, referred to as limited partners, sometimes can't even find out the names of the people managing them. BlackRock Inc. (BLK),

the world's biggest money manager, refused to name the CTAs it hired for the BlackRock Global Horizons I partnership, even after the SEC requested that information in 2009.

"We do not believe that disclosure of the trading adviser identities would be material to limited partners," New York-based BlackRock wrote to the agency on Oct. 27, 2009.

The SEC persisted.

"Because your trading advisers manage your assets, it appears that the identity of these persons is material," the SEC wrote back.

Investor Losses

Five weeks later, BlackRock began making the disclosures. The fund lost $10.2 million for investors in the decade ended on Dec. 31, after paying fees, commissions and expenses of $170.3 million.

"We maintain an open disclosure with the fund's accredited investors and regularly provide them with insight into who we are investing with," says BlackRock spokeswoman Jessica Greaney.

The world's largest futures exchange by trading volume entices individual investors to put money into managed futures by painting a glowing picture.

"Over the past few decades, managed futures have consistently outperformed asset classes such as stocks," CME Group Inc., which owns the Chicago Mercantile Exchange, wrote in a brochure.

CME Group, which says the managed-futures market holds $337 billion in assets, points to 2008 as a banner year for managed futures, saying these funds do well during stock market declines.

'Short Selling'

"They employ short-selling and options strategies that allow them to profit in such markets," the CME brochure says.

When the S&P 500 plunged 37 percent in 2008 because of the global financial crisis, BarclayHedge reported a gain of 14 percent in managed futures.

CME, which also owns the Chicago Board of Trade and the New York Mercantile Exchange, omits two key facts from its promotional material. By using BarclayHedge data, CME masks vast extra fees paid by fund investors.

And CME says managed futures outperformed stocks. But from 2003 through 2012, the S&P 500 delivered more than twice the gains of the BarclayHedge CTA Index -- 98.6 percent compared with 47.9 percent.

In a written response to questions from Bloomberg Markets, CME says that although the S&P 500's return was higher, managed futures performed better because they were less volatile. "Outperformance is more than raw returns," it says.

CME Income

Since most such funds don't file results publicly because they have less than 500 investors and CME cites the BarclayHedge index in its brochure, there's no way to independently verify whether managed futures are more or less volatile than stocks.

CME Group makes money from managed-futures trades. CTAs are important to CME's bottom line, says Kelly Brown, a managing director of the exchange operator, who declined to provide exact figures.

"CTAs are kind of the backbone of the exchange," he says.

No matter how good a CTA's track record is, even some of the best can fall from grace quickly. John Henry, 64, the principal owner of the Boston Red Sox and the Liverpool Football Club, opened John W. Henry & Co. in 1980. Henry's Financial and Metals Portfolio earned 19.8 percent compounded annually for the 27 years ended in 2011, when it closed.

Citigroup hired Henry to manage at least four funds. Citi shut down three of those in 2007 after they each plunged more than 44 percent in three years. The fourth, Westport Futures Fund, gained $40.7 million in the decade ended on Dec. 31.

Those earnings were more than erased by $73.8 million of fees. Henry declined to comment.

Investor Misimpressions

In the secretive world of managed futures, managers often keep millions of dollars of investment gains even as their clients suffer losses. And hype by brokers routinely gives investors misimpressions.

One improvement for investors would be a mandate that managers clearly explain in writing how severely fees have consumed returns over time.

"We don't have a requirement where they have to present that information," says the National Futures Association's McHenry. "That would be valuable."

It would also create a quandary for the managed-futures industry. If fund managers and brokers told investors the whole truth, they might lose the very people who make their business so profitable.

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