Sanctity Capital Management
SafeMoneyMetrics™

"Your Direct Risk Management Solution for Managed Futures"

49. Indexes: High Risk of Current Applications and Low Risk Solutions

This article reveals the original intention and benefits of indexes, relative to applications currently used in equities and managed futures. The relevance of current applications to prudent risk management, consequences of erroneous applications and finally a few low risk solutions are offered. This article is about managed futures. Indexes originated with equities, so equities are briefly discussed.

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Current Application vs. Original Intent

***The idea of using indexes as benchmarks for managed futures investments evolved from the stock market. While searching the internet for suitable research, the Russell Educational Center appeared. The article "Using Indexes as Benchmarks - Measure Performance by Comparing Apples to Apples" is located at: http://www.russell.com/us/Education_Center/learn/Indexes_as_Benchmarks.asp.
The article stresses the importance of using the right index. "Comparing your results against the correct benchmark gives you a more accurate statement of how your fund is performing. And comparing different indexes is a good indication of how different market segments are performing," says Hansen. The article teaches investors to use indexes directly comprised of stock prices as benchmarks for evaluating their professionally managed investment accounts.

The very first index, created by Charles Dow was developed to gauge performance trends of the entire stock market, NOT as a benchmark for evaluating managed account. "**History of the Dow, Charles Dow, Revolutionary** By Randy Befumo and Alex Schay is located at: http://www.fool.com/DDow/HistoryOfTheDow3.htm.
One paragraph is: "Charles Dow had one goal in mind when he created the Dow Jones Averages: to measure the market as a whole rather than simply focus on individual stocks. He wanted to make these Averages the foundation of a comprehensive theory that could be used to explain and predict general market movements. Dow was originally credited with creating the first general market average in July of 1884, although he later modified this and began to publish separate Industrial and Railroad Averages on May 26, 1896. These Averages are the foundation of Dow Theory."

Read the entire article to gain fundamentally valuable information on prudent use of indexes. The article elaborates on detecting market trends (not advisor performance trends) by applying two moving averages to the index data. When the averages cross, trends change. The article brings a reader into the

current time and environment. Notice that the intention of the DOW has not changed since inception.

Who Decided that Indexes Should Measure Trading Talent?

Go back to the first paragraph. Notice that indexes calculated on stock values, originally intended to "measure the market as a whole" are now used to "measure the ability of a money manager." Ask yourself a few questions:

1. What is the direct relationship between "stock price movement" and "money manager talent"?
2. What factors determine "investment performance" and what factors determine "price performance"?
3. What added costs and risks should be considered when evaluating investment performance?

Managed Futures Offer a Constructive Alternative

The decision to use stock market indexes to "benchmark" trading talent in stocks probably needs to be re-evaluated. Our industry (managed futures) adopted the "idea," however we use advisor performance indexes to evaluate advisor performance. Managed Account Reports, Barclay Group and DB Stark & Co. are the oldest data bases in the industry. The oldest CTA Index I can locate was originated by Managed Account Reports in 1979. Barclay was next, then Stark. (There is a decade in age difference between Barclay and Stark and there was over a decade between Barclay and the founders of Managed Account Reports).

Before we move forward it's important to note that there is no central resource to accurately determine capital flowing into managed futures. Data bases have knowledge relative to what is reported. As of June 30, 2005 the National Futures Association listed the following.

Commodity Pool Operators	511
Commodity Trading Advisors	737
Commodity Trading Advisors/Commodity Pool Operators	910

Exemptions are not included in the NFA data. Managed Futures are a growing global marketplace. Exemptions for Non-US and US based advisors require NFA exemption letters. A few exemptions are NON-US advisors managing only QEP Accounts, offshore funds and CTA's managing under15 accounts. POINT: Be aware of the number of advisors data bases track relative to NFA data and the global possibilities. Experience has taught me that many superior advisors never report to a data base; however what we do have in data bases, is an exceptional starting place. http://www.nfa.futures.org/registration/nfa_membership.asp

It might be wise for the managed equity industry to consider wisdom offered by the managed futures industry.

Managed Futures Indexes as Benchmarks -

The managed futures industry is young, officially less than 30 years old. We have unlimited upside if the quality of managed investments continues to improve. In my humble opinion, indexes should remain as Mr. Dow intended, to gauge performance of an industry, and that includes managed futures.

Using indexes as benchmarks has a tendency to perpetuate mediocrity, something we all need less of. HOW? Indexes calculate performance data and create an average return for the time frame used. People then believe that if their investment is equal to or is above the average, they are doing great! In a way averages teach people to settle for less. Also there is currently little relevance to an index and its direct value to investors. Probably most important, benchmarks external to an investment, work against universal laws. Anything that works against universal law always raises the risk of loss. The latter statement has no opposition.

Considering a fact that indexes are here to stay, I asked myself a question: How can indexes be constructed, so they offer more value to the marketplace?

Traditional rate of return calculations and sometimes assets under management are currently used to create indexes. The underlying data is common to all companies, even though they have different standards for calculating their indexes. Superficially, the process makes total sense. Once we delve into how performance is traditionally calculated and its relevance to prudent investment evaluation, one can begin to question the validity of using indexes as benchmarks. Without wasting space in this article, you can download "Standards for Advisor Evaluation" and a Guide to SafeMoneyMetrics™ at http://www.safemoneymetrics.com.

What if Indexes Revealed Risk/Return Properties and More Closely Mirrored Actual Accounts?

Using two more calculations, indexes can reveal not only performance trends, but the risk/return properties of these trends. With that foundation, each sector can then be grouped by account size. Think about it, what value does an index comprised of $5,000,000 minimum account values have to a $1,000,000 investor? What can we do to give more value? With the help of a few good friends and Microsoft Access we can "almost" build meticulous indexes.

"Almost" is defined as awareness of inherent limitations and how indexes are calculated. With awareness we can compensate for weakness rather than be trapped into a few more erroneous beliefs, such as indexes or any analytical process is a holy grail evaluation tool.

Two New Calculations

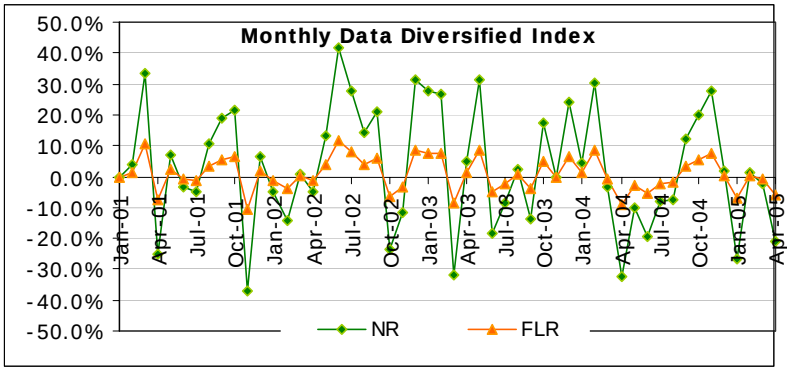
Using a minimum account size, margin to equity and minimum funding level relative to a monthly rate of return provides an ample foundation for creating useful indexes. Most important the result reveals risk/return trends. When remembering the limitations of indexes as benchmarks, equity weighted or simple does not matter. The explanations below are facilitated by the data samples beneath it. You can also link to the entire excel worksheet here.

As an example, we calculated a Diversified Traders Index from January 2001. The average monthly rate of return for each trader * total assets = $PL. Each trader's maximum margin to equity **(M/E**) * BNAV is used as capital at risk when calculating the Net Ratio **(NR).** The Minimum Funding Level **(MFL)*** BNAV is capital at risk when calculating the Funding Level Return (FLR). The $PL / M/E = Net Ratio **(NR)** and the $PL/MFL Assets = FLR. Each trader is individually calculated then added to the index. Both the Net and Funding Level Ratios can be applied to $1000 VAMI's if desired. POINT - Investors can evaluate their account relative to Average, maximum, mninimum or last Net and Funding Level Ratios. The index can be then be created by account sizes.

The NR and FLR numbers are also returns, but the equity base differs. They can be applied to $1000 VAMI's. The Net Ratio is always above the Funding Level, when it drops below, risk increases. Detailed explanations are at http://www.safemoneymetrics.com/asmarticles.htm

Date	1. BNAV	2. $PL	3. M/E	4. MFL
Jan-01	$1,811,435,439	-$4,322,046	$362,287,088	$1,358,576,579
Feb-01	$1,805,964,729	$68,038,301	$361,192,946	$1,354,473,546
Mar-01	$1,862,601,314	$624,978,265	$372,520,263	$1,396,950,985

5. NR	6. $1,000	7. FLR	8. $1,000
-0.2%	$690,254	-0.1%	$44,596
3.8%	$716,259	1.2%	$45,117
33.6%	$956,593	10.4%	$49,797



Annual Summary		Avg	Max	Min	Return
2001	NR	2.6%	33.6%	-36.8%	31.5%
	FLR	0.8%	10.4%	-10.8%	9.5%
2002	NR	7.5%	41.7%	-23.7%	90.6%
	FLR	2.1%	11.8%	-6.7%	25.6%
2003	NR	5.1%	31.5%	-32.0%	61.2%
	FLR	1.4%	8.5%	-8.8%	16.8%
2004	NR	1.3%	30.3%	-32.2%	15.3%
	FLR	0.4%	8.4%	-8.9%	4.5%
2005	NR	-12.2%	1.1%	-26.7%	-49.0%
	FLR	-3.4%	0.3%	-3.4%	-13.8%

Currently many advisors do not report the minimum funding level and it's not a priority to data bases. We carry it. When advisors cannot or will not report, a default value of 75% is used (it was 100%). The default value for maximum margin to equity is 25% and Round Turn Per Million is 1200. When traders report, the default values are removed. Our data base identifies traders using default values and it when they are replaced.

Summary and Value to Investors

Any investor can calculate their Net and Funding Level Ratios and compare their investment to an industry average. More important, investors can easily identify high quality investments because they can now evaluate, cost, capital at risk and return.

Data is Courtesy of D.B. Stark & Co.

End 1630 words

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Always Room for Improvement***

We appreciate your time sending constructive suggestions for change.
1. What do you want more of?
2. What you want less of (except God and philosophy)?
3. What needs more clarification?
Use the email link
mailto:mj@safemoneymetrics.com?subject=ASMSuggestions

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