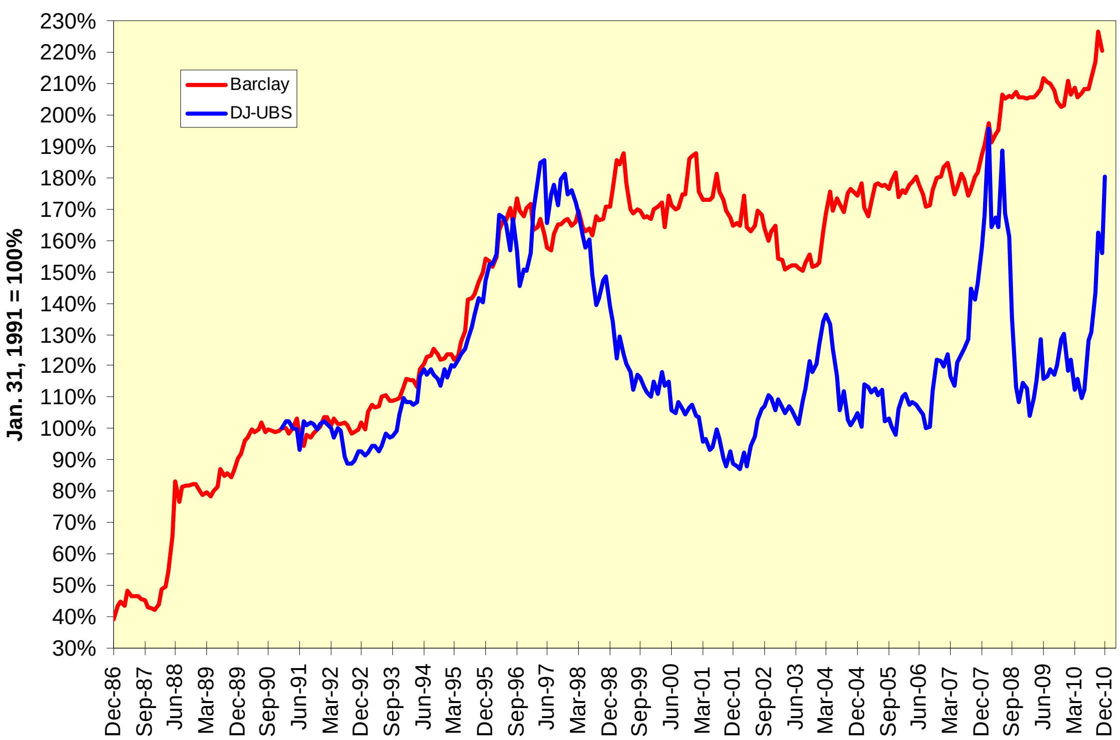
Agricultural CTAs Can Add Value

As a bona fide "commodity guy," I have been suspicious of long-only index funds since I first became aware of the concept in 1986. In the interest of time and space I will glance over the argument investors can harvest a roll yield from selling one month's futures positions and buying the succeeding month's; not only have I done this with a somewhat esoteric argument about implied insurance costs, instruments such as the U.S. Oil Fund and U.S. Natural Gas Fund have done a better job of massacring their holders in practice than I ever could in theory. These are the orange tree frogs of the financial world: Touch them and die.

Other arguments include these long-only products are a perversion of the actual uses for futures markets; these include risk transfer, price discovery and commerce facilitation. Nowhere in this list is anything arguing for a group of buyers to hold contracts independently of their price expectations and do it in size sufficient to exhaust short-side liquidity.

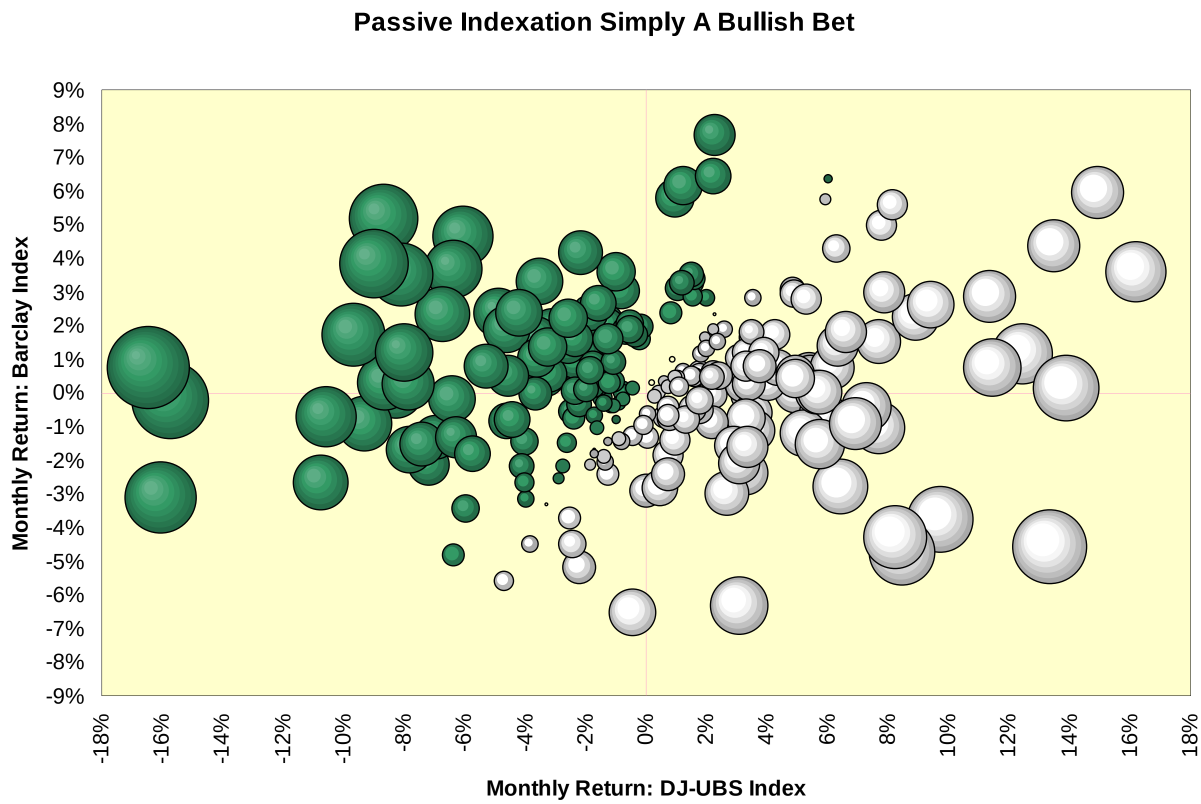
Stripped of their marketing glitz, the long-only funds depend on price appreciation far more than they allow. This implies they will lose and lose heavily whenever their underlying commodities enter a bear market. Such has been the case in the world of agricultural futures. Let's compare the long-only and passive Dow Jones-UBS Agriculture index to the Barclay Hedge index of Agricultural commodity trading advisors (CTAs), with both indices reindexed to January 1991.

Active Vs. Passive In Agricultural Markets



It really is a one-side contest; not only has the Barclay index outperformed the passive DJ-UBS index, it has done so with lower volatility. The source of variance is simple to find; note what happened to the performance of the long-only index between 1998 and 2002 and again in late 2008 and early 2009. The CTAs, bless them, had the good sense to come in out of the rain, an act prohibited by long-only index funds' charters. They must have copied this brainless lack of self-preservation from stock index funds, but I digress.

If we map the monthly relative performance of the Barclay index versus the DJ-UBS index against each index' monthly returns, we see as neat of a data divide as you ever will see again in this business. The Barclay index outperforms and by an increasing margin (green bubbles, with the diameter representing the extent of the outperformance) when the DJ-UBS index turns lower, and vice-versa. Restated, the long-only index is nothing more than a bullish bet on agricultural commodities.



While we are in a bull market right now, such is not always the case. Incredibly, the average annual constant-dollar returns for corn, wheat and soybeans all are negative since 1947, a period in which the world's population has come close to tripling. Riding the price pony here is just not a good idea.

If you must play the agricultural markets, do it in the way our Creator and the Chicago Board of Trade intended: Long and short. It is the only sensible course of action.