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The Small Managed Futures Account Conundrum

I recently scanned a Commodity Trading Advisor data base to look at minimum account sizes for managed futures accounts. I found minimum account sizes ranging from $25,000 to $5,000,000. I also found the typical Commodity Trading Advisor (CTA) trading a small minimum account size has concentrated portfolios, high-margin requirements, little money under management, a short track record, high volatility, just traded options or was offering a pooled investment. Diversified trend followers offering individually managed futures accounts seemed to have minimums that were usually at least $1 Million.

Small managed futures accounts (less than $250,000) face considerable challenges not experienced by large managed futures accounts. Considering that most commodity futures contracts have face values in the tens or hundreds of thousands of dollars, it is easy to surmise that these contracts are for large accounts. But, low-margin requirements have long attracted smaller speculators and are the proverbial "rope to hang oneself with".

Let's analyze why large managed futures accounts may have it easier than small managed futures accounts. First, large managed futures accounts can afford to trade almost any opportunity at any time. There are over 100 tradable commodity markets worldwide, and should buy or sell opportunities simultaneously exist in any or all of them, a large managed futures account can easily afford the margin and exposure. It is said that when it comes to investing that "diversification is the only free lunch" and large managed futures accounts can afford to diversify with impunity. This is in stark contrast to the small managed futures account where prudence dictates only having risk and exposure in a few markets simultaneously.

A large managed futures account is not restricted from trading contracts whose volatility is fairly high. For example, a London copper trade with a stop loss $14,000 away represents a risk of 1.4% in a million dollar managed futures account, but in a $100,000 managed futures account, this same trade would represent a risk of a whopping 14%! Any sensible Commodity Trading Advisor would avoid that trade in such a small account; however, having to skip these opportunities is yet another penalty paid by the small managed futures account.

What's more, the large managed futures account can use one of the easiest forms of risk control available, contract scaling. For example, let's assume a large account is long 50 gold contracts during a large bull market run and wishes to cut his open trade profit exposure. He can simply scale off as many contracts as he needs to lock in profit, while maintaining his profitable position, but what can the small managed futures account do for scaling out if he only has on one contract in the first place!? Once again, the small managed futures account does not enjoy the flexibility to control risk in the same fashion as the large managed futures account.

Now, for all the negativity I've just outlined above I believe the smaller account has advantages over large ones. Small accounts are able to trade markets that would be far too illiquid for large accounts. Most institutional size funds are nearly confined to the trading of financial and energy instruments. They end up missing out on trading opportunities in the traditional physical commodity markets. Specifically commodities like Grains, Foods, and Fibers and the like. This creates a lack of diversification and an over reliance on those few sectors. The ironic thing is that many small accounts end up with the same problem because they have chosen to deal with their small account problem by only trading a few (or one) market! They end up missing out on the sharpest edge they have on the "big boys".

It is for those smaller traders who want the advantages of true global diversification, with an individually managed (not pooled) account, that we formed Hoffman Asset Management Inc. HAMI is carving out a unique niche by offering a managed futures account program that monitors and trades over 70 diversified commodity markets, while trading accounts as small as $30,000. The program's design tries keeping draw downs and volatility in line with what might be available in a large widely diversified account. This combination of trading many markets within a small account while keeping volatility in check is truly unique. It fills what we feel is a tremendous void in traditional managed futures account offerings.

What we do is proprietary; however, the basic premise uses a form of relativity. HAMI monitors a large universe of tradable commodities for opportunities, yet, is highly selective in those trades that it will take. For roughly every 10 trading opportunities identified by HAMI's combination of trading systems, it takes only 1. HAMI's algorithms are not only considering the market's direction and movement potential, but also how that potential ranks on a risk-adjusted basis. The idea is that an opportunity can only be evaluated relative to what else is available. For example, how do traders know if a 5% return is acceptable or not? The answer should be "it depends on what else is available". In other words, the 5% return is only acceptable or not relative to other options. HAMI's strategy is continuously identifying a small percentile of all the markets it tracks as being the best candidates. Then, it considers only those markets should one of its many trading systems generate a signal.

The portfolio selection process is dynamic and rebalanced every day. From day to day the basket of markets that we will consider trading changes. We feel this keeps HAMI's trades limited to only those markets with the best risk adjusted potential. This allows us to evaluate a large portfolio while still keeping trades and margin requirements low.

Monitoring a large portfolio is crucial because if traders limit themselves to a predetermined small portfolio, how do they know that those markets will be the best markets? (Hindsight bias portfolio selection is a form of curve fitting and is a leading downfall of many traders). If an exceptional opportunity develops in a market outside a predetermined portfolio, a trader should want to take advantage of it. By trading with Hoffman Asset Management's trading systems, traders do not arbitrarily rule out any market that may perform well, and they have reduced the likelihood that a portfolio is merely the product of past performance (curve fit) considerations. The key is researched logic that can do this automatically, and that is what Hoffman Asset Management's trading strategy uses.

Please feel free to contact us for additional information.

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