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Investor Sentiments

People understandably became risk averse in the crisis of 2008. That seemed to change in 2009 as equities attracted money and recovered, but this year you get the impression investors are generally wary. Credit Suisse capital flow data suggests that money is slow in trickling back to hedge funds, though global macro was an exception—see Index Tracker.

Our lineup contains insights for those pondering investment decisions. Almanac Founder George Zivic gives an in-depth discussion of opportunities and risks in commodity markets. Futures Lab presents a lesson, courtesy of Altegris chief executive John Sundt, from the experience of three years ago.

Inside Talk by Brazil-based Gabriel Pellegrini offers a glimpse of a non-US commodity trading advisor.

Two of the contributors to this issue specialize in selling options. This is not a strategy for the faint of heart, but Craig Kendall in Practitioner View and Alex Khalil in Manager Profile provide excellent discussions of how it works.

Mr. Kendall has long-term experience with option selling. While this includes a rough patch in 2008, overall he has compiled an attractive track record. The two option selling programs he manages are both on our Top Ten list.

We hope you'll find these discussions useful.

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In This Issue

Investing in Commodity Niches

George Zivic, chief investment officer of Almanac Capital Management, discusses the finer points of commodity investing. Mr. Zivic started his commodity trading career in 1999 at Enron, where he participated in the development of weather derivatives. He has contributed to a book on the subject—*Weather Risk Management: Markets, Products and Applications.*

After Enron, he worked for commodity hedge fund Takara, reinsurance company XL Capital and Dutch bank Rabobank. Before founding Almanac Capital in 2007, he was a director and the head of commodity allocations at Credit Suisse, where he selected commodity hedge funds.

Almanac Commodity Fund made 15.4% in 2009

George Zivic

"While our universe is much smaller than long/short equity, there are interesting managers in niches. But first you have to establish which niche you should participate in. ."

Opalesque Futures Intelligence: How did you get into commodities?
George Zivic: It was at Enron, where I helped start the weather derivatives business. We looked at interrelations between the weather and certain commodities and set up a commodity correlation trading book. I learnt how dynamic and interrelated commodity markets are. A group of us left Enron to start a similar business at XL Capital. Later at Rabobank I worked more directly on agricultural commodities, which was a very useful addition to my experience. Then at Credit Suisse I helped build a commodity fund of funds.

OFI: Is Almanac a fund of funds?
GZ: We are not a traditional fund of funds allocator. I think of Almanac as a multi-strategy commodity fund that predominately uses outside managers. With our background in the trading and risk side of the business, we take a trader's approach to building the portfolio. The commodity space is extraordinarily complex. Information flow is far more important in these markets than in just about any other market. This is our expertise. We have a view of what's going on in specific commodities and where the opportunities are.

OFI: How do you identify the opportunities?
GZ: We develop a macro outlook and also look to get a sense of market psychology—meaning what the market believes is going to happen. The key question is how the macro outlook will drive movements in specific markets. That creates opportunities in areas like volatility. We pick managers to extract value in specific trades that are promising.

OFI: Do you trade yourself?
GZ: Up to 10% of the portfolio we trade ourselves, like an in-house hedge fund. We pick shorter term trades based on the best ideas that are in line with our macro view.

OFI: Given you trade yourself, why do you allocate to outside traders?
GZ: The goal is to make sure the portfolio is diversified across commodities. This is different from the typical fund of funds approach, which starts with a statistical analysis of manager returns and picks managers on that basis. To determine the right strategy for the environment, we analyze the implications of market psychology and our macro view for every market. For instance, if I expect a market to be exceptionally volatile, then I'll hire a volatility trader. If we expect a market to be

very upward trending, we may hire a long-biased manger for that market.

OFI: Do you get outside managers that focus on specific sectors?
GZ: I invest in pure commodity funds and 80% of my exposure is in funds that trade a single commodity. Currently our portfolio has an agricultural trader, a base metals trader, two natural gas traders, a power trader and a weather derivatives specialist. In effect, together we constitute a multi-strategy commodity portfolio. While our universe is much smaller than long/short equity, there are interesting managers in niches. But first you have to establish which niche you should participate in.

OFI: How do you know what the outside managers are trading?
GZ: I spend much of my time studying commodity markets from a trading perspective. It makes me a much better allocator in this space, in contrast to someone who knows almost nothing about commodities. Because we trade capital in-house, we're very connected with the markets our managers are in. I compare what the managers and performance and risk measures are telling me with what I see in the market Our job is to align markets with managers, not just to pick managers. Having an outlook and an understanding of the markets, we make better decisions when we deploy capital. Our expertise and direct market participation also allows us to communicate better with managers.

OFI: Why would investors go with an active manager when they can just buy commodity exchange-traded funds?
GZ: Pensions and endowments want to buy commodities because they expect commodity prices to go up when inflation goes up. But commodity markets have much less liquidity than the traditional markets institutions invest in and have physical characteristics like no other market. Because of liquidity constraints and other specific characteristics, the downside deviation and volatility is very high in commodities. Historically, commodities traded at 30% to 40% volatility; natural gas has traded as much as 120% volatility. Long-only commodity investments lost heavily in 2008—those losses compounded investors' pain as equity and credit markets went down.

OFI: Are all commodity investments subject to high volatility?
GZ: There is another way of trading commodities that is not price dependent. Commodities have life cycles—think of corn all the way from the seed being planted to when it becomes ethanol or food and is delivered to end users. This life cycle is generally very inefficient and specialists trade different stages of the life cycle to take advantage of inefficiencies. Our focus is on the inefficiencies rather than price dependency. We look to where the inefficiencies are and how they will be affected by macro trends. That way we can capture much of the upside but protect ourselves against downside price movements. Many investors don't understand the inefficiencies that drive commodity trading opportunities, such as physical and curve constraints, so instead they go for index investments.

OFI: Are there many inefficiencies at any one time?
GZ: The beauty of commodities is that there are many related but distinct markets. Oil in the US is different from oil in Europe. High-protein wheat is not the same market as low-protein wheat. There may be not enough of one but too much of the other. An expert will arbitrage that inefficiency by buying the first one and selling the other. These strategies can be executed in futures or options.

"In gold and oil there is a great deal of noise masking the supply and demand fundamentals. "

OFI: Is Almanac different from a traditional commodity trading advisor?
GZ: We are not a systematic CTA but a discretionary commodity trading firm that does in-house trading and allocates to outside managers who may specialize in a single commodity. Most CTAs have only a 20% allocation to commodities proper and the ones in commodities are typically biased to gold and oil because those are the more liquid markets. We try to limit our exposure to gold and oil, which tend to be dominated by large macro hedge funds, CTAs and index investments. In gold and oil there is a great deal of noise masking the supply and demand fundamentals—prices move for reasons other than the life-cycle inefficiencies we look for.

OFI: So you don't like gold and oil?
GZ: We have very little exposure, but I might look for a volatility-based oil trader. While prospects for oil are bullish in the long run, in the current environment there are contrary macro views that we expect will lead to high levels of volatility in a non-trending market, which is more conducive to volatility trading. Eventually demand side changes will turn that market around and trending strategies may become more appropriate.

OFI: Which commodities do you like?
GZ: Agriculture has many characteristics I like, but it is a small market. During the growing season there is weather-based volatility in agricultural prices. A manager who can take advantage of short-term volatility using an options-based

strategy is promising. From a long- term view there are a couple of strongly bullish markets in the agricultural space because of demand trends in emerging markets over the next five to 10 years. So I do have a manager with significant agricultural exposure and a long bias.

OFI: Why do you have two managers trading agricultural commodities?
GZ: These managers have two different strategies, one using options and focused on short-term volatility, the other using outright futures and focused on long–term trends. They capture alpha from markets in different ways. Correlation between these two funds is very low.

OFI: Are weather derivatives an attractive investment?
GZ: Weather derivatives have evolved a lot in the 10 years I've been in the market. There are more participants, like utilities hedging their snowfall and rainfall risk. We have a manager that trades only weather derivatives.

OFI: What's your outlook?
GZ: In many commodities we do not think demand will grow as much as expected, which is what we thought in 2009 as well. We expect volatility to continue through 2010 and probably 2011, or at least until a consensus view is established on the demand picture for commodities. People with long-only investments will be very frustrated, not only by price behavior but also by a bearish (contango) curve structure. There may be a reallocation of commodity exposure from passive to active strategies. Long term, I see greater opportunities for us in markets like carbon trading, shipping and weather derivatives. These markets are not huge right now but will grow in time. There are interesting trades already, such as a shipping arbitrage that makes US soybeans more attractive to Chinese importers, compared to South American soybeans.

OFI: Will Almanac be affected by regulatory changes?
GZ: Those will have much more of an influence on the dealer network and possibly on multi-billion-dollar funds with large positions in the market. Our exposure is to smaller managers who trade very narrow markets with high turnover but not high volume. I don't expect a significant impact from regulatory changes.

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Understanding Quants' Hazard

As investors consider riskier assets, it may be useful to recall a lesson from three years ago. The following parable is from an August 2007 newsletter sent to clients by Jon Sundt, president and chief executive of Altegris Investments, an allocator to hedge funds and commodity trading advisors.

The example was inspired by the steep losses suffered by quantitative traders in August 2007. It is from real experience, but Mr. Sundt used fictional names for the two funds he compared, PhD Fund and Plain Vanilla Fund.

Both funds are market neutral and go long and short US equities. Both have stellar track records, low correlation to the S&P 500 and reasonable performance in up and down markets.

By 2007, low volatility had lulled many quant shops into a false sense of security. The lack of any recent blowups or spikes in volatility made them feel immune to market jolts. At the same time, quantitative models were picking up nickels where they formerly picked up quarters. Because the models would need to pick up more nickels to make the same amount of money, many turned to leverage for help.

The PhD Fund had run its models over the past five years and made a killing. Its managers were rich. They had found that because of the low volatility in the market and the low correlation within their market-neutral system, they could leverage their fund.
So they decided to lever eight to one. For every $1 million the Fund put forward, it borrowed enough to have $4 million for its long book and $4 million for its short book, staying with the "market neutral" label.

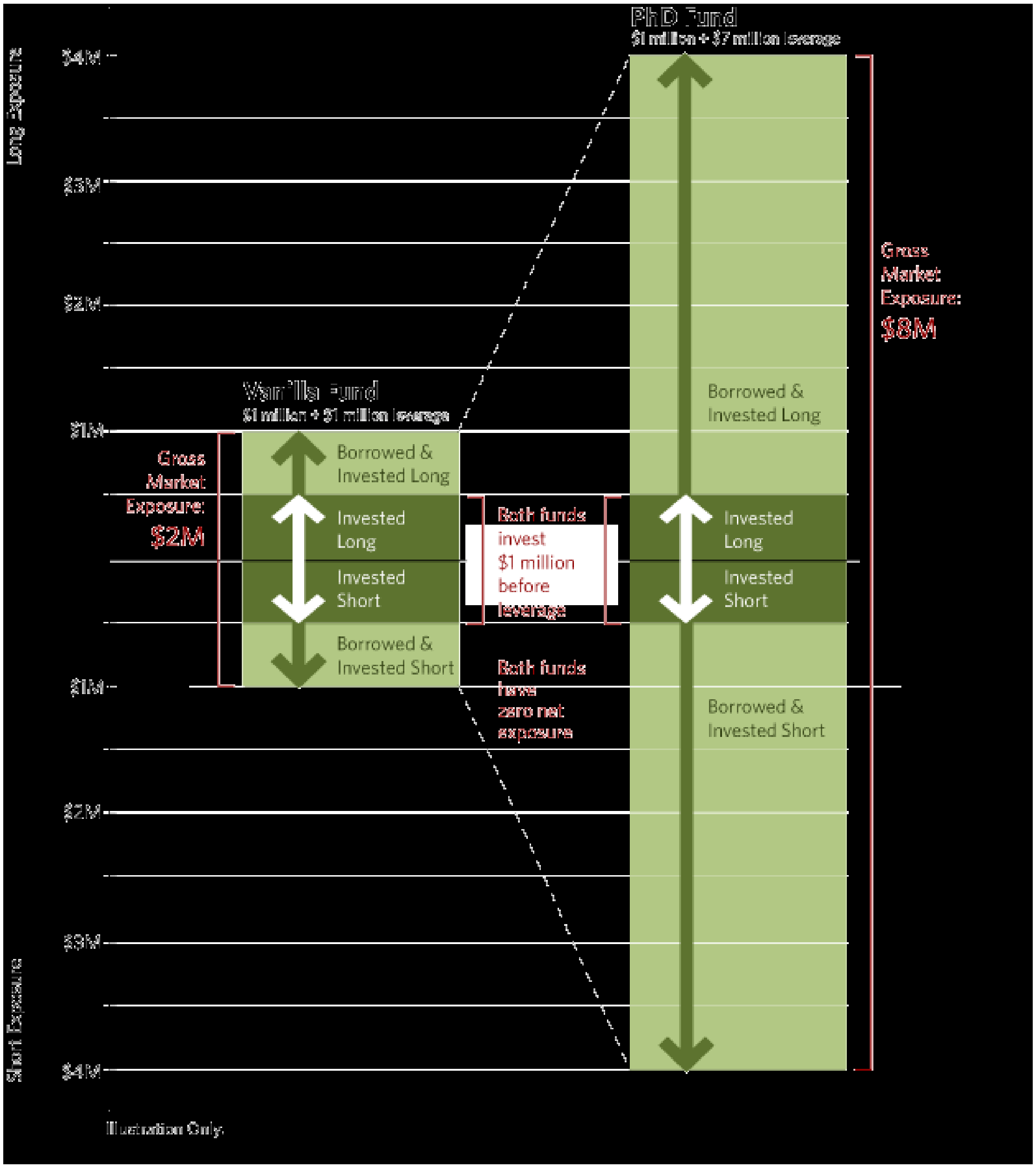
This was genius! The PhD Fund amplified returns, all the while keeping its market neutral hat on. It had $1 billion under management before leverage. With leverage, its assets were $8 billion. Its net exposure was zero ($4 million long plus $4 million short), but its gross exposure was 8x.

For comparison, consider the Plain Vanilla Long Short Fund, with around $400 million under management. It has an experienced research team that evaluates fundamental measures of a company's stock (bottom-up research) as well as overall industry trends (top-down research). The team buys what they believe are undervalued stocks and sells what they believe are overvalued stocks.

The Vanilla Fund's team trade 50 positions long and 50 positions short. They keep their book market neutral, so their net exposure is zero. They do this by using the regular margin available for many brokerage accounts. The Vanilla Fund borrows $1 million for every $1 million dollar invested, meaning it uses $1 million to go long and $1 million to go short, for a gross leverage of 2x. With leverage, the Vanilla Fund has $800 million under management.

The Vanilla Fund and the PhD Fund both have zero net exposures for every dollar long they have a dollar short. Combine this with their performance, and they look pretty similar. But that is a wrong perception.

The difference is seen by looking at the funds' gross exposure. Here the differential is huge: 200% for the Vanilla Fund compared to 800% for the PhD Fund (chart). Gross exposure shows just how leveraged these funds are: 2x versus 8x.



During a few days in August 2007, there was an extreme event in the stock market. In particular, the stocks bought vs. short sold by quant funds went through a sharp reversal. Because many funds had similar positions, they drove the market down as they tried to liquidate holdings.

The PhD Fund suffered a 4% loss on the longs and a 4% loss on the shorts. But that was before the leverage. Because of the leverage, you have to multiply it by eight, for a 32% loss! The Vanilla Fund also lost money that month, but less.

The moral: Net exposure can be misleading. One has to pay attention to gross exposure.

Global View from Brazil

Commodity trading advising attracts people from many parts of the world. Gabriel Pellegrini hails from São Paulo, Brazil. He began his career in financial markets in 2003, working in the agricultural sector of the Bolsa de Mercadorias & Futuros. He began to trade his own capital in 2004 and tested systems he developed for futures markets, before starting his own firm, Global Edge Capital Management.

Registered with National Futures Association as a commodity trading advisor and commodity pool operator, Global Edge has both Brazilian and American clients

The program returned 8.6% last year, doing better than many systematic CTAs. It made 23.3% in 2008.

Gabriel Pellegrini

"There are some very good quantitative traders now in Brazil, but mostly they're in equities. "

Opalesque Futures Intelligence: How did you get into futures trading?
Gabriel Pellegrini: My first job was at the Brazil futures exchange and I traded in only Brazilian markets for about four years. Then I started to trade in international markets. By 2003 I had learnt about systematic futures trading and looked for a firm that did this, but I could not find one in Brazil at that time. I traded Brazilian futures for myself and in 2008 opened Global Edge Management.

OFI: Why did you move to international markets?
GP: For quantitative trading, you need a lot of liquidity. We don't have many liquid markets in Brazil. At the time, there was only one agricultural market in Brazil where I could do quantitative trading and that was coffee. But I traded the financials, including FX – the US dollar vs. the Brazilian real – and interest rates. Those are highly liquid.

OFI: What is your investment strategy?
GP: Long-term trend following is part of our strategy, but long-term trend following does not make money when markets move sideways. Markets stay sideways much of the time, perhaps more than 60% of the time. So long-term trend followers have a problem. When there are trends, trend followers make good money. But there are lengthy periods when they don't. There are other ways to make money. I developed a short-term trading model to take advantage of other types of market moves, using mean reversion and countertrend strategies. This program trades over-bought and over-sold markets. It tends to make money when trend-following does not. In addition we have a medium-term strategy, with 15-day average holding periods. These diverse models allow us to find opportunities in different markets.

OFI: How significant is trend following for your program?
GP: Trend following is still about 40% of our portfolio, but the blend is much better than any single strategy. We have 12 distinct models.

OFI: Are Brazilian markets good for trend following?
GP: To do long-term trend following properly, you have to trade many, uncorrelated markets. Brazilian markets are highly correlated. I think the strategy works better in the international markets that I trade.

OFI: What's the key characteristic of your models?
GP: The most important thing I've learnt in trading is that it is essential to trade on the side of the long-term trend, say as measured by a 200-day moving average. With our countertrend strategy we go with the long-term trend— buy the dips on the uptrend and sell the peaks on the downtrend. My other principle is not to have any preconceptions about markets and to test every idea.

OFI: Which markets do you trade?
GP: The approach is to trade as many markets as possible because you never know where the next opportunity will be. I trade more than 100 futures markets, though not all at the same time. All our models look at all the markets every day and signal attractive trades. We put on only those that meet our risk control rules. Global Edge has 35 to 45 positions on average at any time.

OFI: Where do you see growth opportunity?
GP: We'd like to add more Asian markets to the portfolio. I've been looking at China. I've traded only the Hong Kong futures market, but I expect to add other Chinese markets.

OFI: Is systematic futures trading common in Brazil?
GP: There are 200 to 300 multi-market hedge funds in Brazil. Most of them trade stocks and very few are quantitative. There are some very good quantitative traders now in Brazil, but mostly they're in equities and some trade futures alongside equities. Systematic futures trading is very new here, I don't know of any managed futures funds other than Global Edge.

OFI: What's the outlook for managed futures?
GP: The past 18 months have been difficult for many CTAs but the turning point is probably near. Managed futures outperformed most asset classes in the past 30 years. People talk about CTAs becoming mainstream, but it has not happened yet. I look forward to CTAs becoming mainstream in the next five years.

Global Macro Proves Mettle in H1

With the dust settled on the first half of the year, global macro has emerged as the second best performing hedge fund strategy after fixed income arbitrage, according to Credit Suisse data. Managed futures made back the losses from earlier in the year but did not sustain the gains, ending up about flat for the first six months.

Global macro outperformed relative to the broad index, which tends to occur when there is a big rise in volatility, says Boris Arabadjiev, chief investment officer at Credit Suisse's fund of hedge funds group. The strategy has desirable characteristics for the current environment and is one of the strategies usually better able to exploit volatile markets, he said.

Stock, bond and commodity markets posted losses in H1. Both global macro and managed futures, as well as hedge funds as a whole, beat the markets (table).

January through June 2010 Performance

Selected Credit Suisse Hedge Fund Indexes

	Cumulative Return	Best Performer	Worst Performer
Global Macro	4.2%	14.9%	-18%
Managed Futures	0.3%	16.5%	-18.7%
Broad Index	0.6%	30.8%	-59%
Market Indexes			
MSCI World	-10.9%		
DJ UBS Commodity	-9.6%		
Barclays Global Bond	-0.3%		

INDEX TRACKER

Investors apparently agree that global macro is a good strategy for this environment, judging from asset flows. Global macro received close to $10 billion new capital in the first half of the year. This was the largest inflow among hedge fund sectors, half of which had net outflows during the period.

Money moved also to fixed income arbitrage and event-driven strategies, but in smaller amounts. By contrast, managed futures assets were flat.

Credit Suisse reported that hedge funds as a whole had a slight outflow in the second quarter. Total industry assets are at $1.5 trillion, well below their peak before the massive wave of redemptions in 2008 and early 2009.

Macro funds had low correlation to global equities in the first half of the year. This is a most desirable characteristic, Mr. Arabadjiev says, but the strategy's relation to markets, or beta, is nonsystematic—meaning it is sometimes high and sometimes low. However, he sees global macro returns compounding nicely because the downside is limited while nimble managers keep more of the upside.

Returns and asset numbers vary across databases because of differences in constituents and the methodology used.

Option Selling for the Long Haul

Many investors regard option selling as a very risky strategy. Here Craig Kendall, founder and president of Financial Investments Inc., argues that the risk is manageable and the strategy has long-term potential.

Financial Investments' Option Selling Strategy returned 38.9% in 2009 and 21% for the first six months of this year. However, it had a drawdown in 2008, with a 23% loss. By contrast, the more recently launched Credit Premium Program made money in 2008 as well as in 2009. Both programs are among this issue's Top Ten.

Mr. Kendall also manages a hedge fund that applies the same strategy to equities and equity indexes.

"For investors who think outside the box, there are opportunities to generate absolute returns in these uncommon markets."

I searched for an alternative investment strategy after certain experiences in the stock and real estate markets. During the dotcom heyday I helped some companies go public. It was an exciting time but I noticed the disconnect between valuations and future cash flows. You could see there was a bubble and it was going to burst. In the early 2000s I helped with real estate deals, but there too values were increasingly not supported by cash flows.

Meanwhile, I learnt about option selling. This sounded like a viable long-term strategy. True, it is not for the faint of heart. But having implemented the strategy for almost six years, we understand the risks very well.

The basic investment idea is to write options with the expectation that we will retain the premiums as the options expire worthless. We make money as the options' value decays over time, rather than from market direction. That's what I love about selling options. I'm not a betting man—I'm a businessman .We can be 100% wrong about equity and commodity markets and still generate a commendable rate of return.

It happened in 2009. Our team looks at a lot of research, but we never anticipated that equity markets would rebound as strongly as they did in 2009. Our forecast for equity markets was totally wrong. But our results were fine and it worked out perfectly well for the clients.

Insurance Analogy

Selling options on futures contracts and collecting premiums is similar to selling insurance. Like insurance companies, the option seller has probability on his side. With the amount of capital a client has allocated to us, we execute trades based on predefined risk parameters for that amount of capital. We manage the risks every day and have never had a margin call for any of our clients.

This is not a black box strategy, though we do use proprietary programs for signals as to the next opportunity. But that's just the starting point. Based on volatility signals, we find which market offers opportunity, then do the research to decide what is the derivative option for getting the best rate of return. In other words, we do a systematic search to find opportunity but use a discretionary approach to finalize the best trades.

We trade liquid commodity markets, including crude oil, natural gas, wheat, corn, and currencies. Often we manage to sell at high and buy at low. When gold was very expensive about two-and-a-half months ago, we sold gold calls. Since then gold dropped and is now at support level, so we look to sell gold puts. When crude oil runs up, we sell crude calls; when crude oil runs down, we sell crude puts. The same thing happened with the euro/dollar and bond markets. We just have to be careful not to be whipsawed.

Right now wheat is a good opportunity. It's hitting six year high prices, with lots of volatility.

Hedging

Our Option Selling Strategy (OSS), which has a track record of five and a half years, sells far-out-of-the-money contracts. About three years we started the Credit Premium Program, which executes closer-to-the-money contracts with higher yields and larger capital requirements. For CPP, we hedge every contract we enter into and we know not only our predefined gain but also our predefined loss for every trade. Going closer to the money enhances returns; the downside is a little more volatility. Everything is hedged to control losses.

In 2009, volatility stayed within a good range for us. By contrast, in October of 2008 volatility exploded. In that situation, the CPP program did much better than the OSS because we rolled out of contracts much quicker. The 2008 black swan put quite a few of our competitors out of business.

We worked to improve risk management to address future black swan events and are very conscious of the potential impact of a big equity market drop on our positions. We're not doing S&P 500 contracts.

This year so far has been great for us, even as commodity and equity markets went down for most of the year. A lot of up and down movements and uneasiness create a perfect environment for our strategy. I credit our team for managing so well.

We do not target outstanding returns. Our object is to manage the risk and generate commendable returns for clients. And our business model is set up for the long haul.

Looking forward I think there will continue to be uneasiness in equity and commodity markets, certain sectors will continue to deflate and economic recovery will be difficult. But for investors who think outside the box, there are opportunities to generate absolute returns in these uncommon markets.

How Option Selling Works

Alex Khalil

The previous article is by the head of a business that specializes in option selling. Here, we have another perspective on option selling, from Alex Khalil of Vantage Capital Management.

Mr. Khalil started his financial career at Oppenheimer & Co. He picked up technical skills during a stint at AT&T's database development and migration business and was an assistant trader at the hedge fund Millennium Partners. He has worked as a securities trader at ETG LLC and Assent LLC.

He founded Vantage in December 2008 and started to manage client money the next November. His return from proprietary trading was 54% in 2009.

Mr. Khalil's commentary reveals the mindset underlying the strategy.

"Many short sellers and option traders got hurt in 2008 by relying on their systems."

I traded for myself for about a decade, primarily equities with some options. That taught me true risk management; when you trade your own money, protecting your capital base becomes the priority. After all, that's what enables you to trade and supports your earnings. So you look very carefully at the impact of leverage and other risks. This experience made me a defensive trader. I worry a lot about losing money.

Over the years I became a proficient short trader. Traders tend to develop a bias to going long, but I developed a bias to go short and would make most of my money on the short side. In 2001, when the dotcom bubble burst, short selling was relatively easy. But even after that I did well on the short side.

Short selling stocks laid the foundation for my current strategy of selling put and call options on the S&P 500 index.

After I'd been trading for a while, I went to the NYU Stern School of Business to get an MBA. While finishing the MBA I developed a new trading strategy. At that time, I did not have a futures account, so I used the SPY, an exchange-traded fund, as the surrogate for the S&P 500 to test my theory. I traded options on the SPY.

This went on through 2008, which was a very turbulent year and not ideal for selling options, especially puts. I knew in 2008 that the strategy would work if I could implement it well. It is easier to execute in a less volatile environment, but the strategy did well in 2008. By the end of the year I was convinced it would work and established a futures account.

Tail Events

Being short a stock is similar to selling naked calls. But with the option, you have more breathing room. When you sell a naked call, you're in essence going short the stock, but selling OEM calls is easier than shorting the stock because you're further out of the money.

With calls I have an edge because I can be selling it out of the money but remain just as defensive as with the underlying stock. By contrast, when you short an equity you could be immediately under water if the price ticks one penny higher than your entry price.

In the past I wrote trading algorithms that were fully automated. This strategy is not, but it relies on rules and parameters that determine the trades mechanically about 70% of the time. I allow myself 30% discretion to look at what's going on. I worry about tail events. Many short sellers and option traders got hurt in 2008 by relying on their systems or models. The model told them that the market was coming back up after losing heavily by the middle of the year, but those models did not factor in the credit crisis!

If you put on blinders, the model can fail you when something unusual happens. Yes, you need to stick to the methodology, but there are conditions you can monitor and intervene as necessary. You do need to look at the global picture and its implications for markets. There were warning signs the market was unraveling while the credit crisis was in the making.

My biggest fear is another September 11, when the market closes and then reopens 20% lower without any opportunity to adjust your position. I was trading at the time. It is a day I'll never forget. By contrast, in 2008 the market dropped sharply but it was orderly in the second half of the year. You had an opportunity every day to adjust your position.

Time Decay

When you sell a naked put, the risk and return are not different from selling a covered call option, where you are long the stock and meanwhile collect a little premium.

A lot of the premium revenue from selling calls and puts is driven by Theta, the "time decay" feature of options. An option has an intrinsic value if it is in the money. But if is out of the money, the price depends on time value.

Time decay is the mechanism by which the price of options depreciates. The longer it takes before the option expires, the more time value is built into the premium of the option. As the days tick by, the option becomes worth less as the chance that it will go into the money declines.

I look to collect time decay. If you sell options you want the time value to depreciate as you want the price to be lower when you buy the option than when you sold it. Time decay is how I generate revenue.

This strategy is scalable, at least up to $200 million. The S&P 500 is a very deep and liquid market. I could also implement the same strategy for other indexes, like the FTSE. It can be used for any index with a liquid market that is actively traded.

I think these kinds of strategies have a promising future. Investors may have thought that equity mutual funds carry less risk than CTAs or hedge funds, but the fact is mutual funds lost around 50% annually twice in the past decade, in 2001 and then again in 2008. Many hedge fund managers who are also CTAs do much better than mutual funds.

Twelve-Month Winners

These are the top advisors for the past 12 months, from Managed Account Research Inc. The list is limited to advisors with at least 10 million under management. They've been ranked by compounded annual return for the period June 2009 through May 2010.

Two option selling programs from Financial Commodity Investments, managed by Craig Kendall, were among the top ten—in second and sixth place. For Mr. Kendall's commentary and information about the option selling and credit premium strategies, see Practitioner View in this issue.

Some of these programs are only available to investors who meet the financial requirements for Qualified Eligible Persons as describe in CFTC regulation 4.7.

Rank	Investment	12-Month Compounded Return
1	Ace Inv. Strategists (SIP)	48.45%
2	Financial Commodity Inv. (Option Selling)	45.32%
3	LJM Partners, Ltd. (Option Writing)	28.34%
4	Emil van Essen (Spread Trading-High Min.)	26.27%
5	Liberty Funds Group (Diversified Option)	26.16%
6	Financial Commodity Inv. (Credit Premium)	20.78%
7	Global Ag LLC (Capsule A)	20.37%
8	Valu-Trac Investment Mgmt Ltd (VTS)	19.87%
9	Newport Private Capital, LLC (Optimum Income Program)	18.86%
10	HB Capital Mgmt. (Multi-Strategy-Diversified)	17.50%

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