

As difficult as it is to create a trading program that can consistently produce positive risk-adjusted returns in multiple market conditions, emerging commodity trading advisors are just as likely to be tripped up by operational issues as trading losses.

Back office: The backbone of a successful CTA

BY DANIEL P. COLLINS

One of the most consistently repeated points at managed futures industry conferences and seminars is that to be a successful money manager, commodity trading advisors (CTA) and commodity pool operators (CPO) must realize that they are running a business. A robust and profitable trading strategy or years of fundamental trading expertise is not enough to ensure success. If a manager's regulatory and back office ducks are not in a row, he will have a hard time surviving regardless of trading prowess.

At the heart of the back office operation is the reconciliation of trades. A CTA holds no funds, but generates trade signals and places

orders with numerous executing brokers, who in turn may report the trade back to the CTA and the multiple clearing future commission merchants that hold the trading accounts of the different customers of the CTA. The CTA's back office must ensure that that flow of trade documentation moves smoothly and correct any errors along the way (see "The integrated CTA," right). A

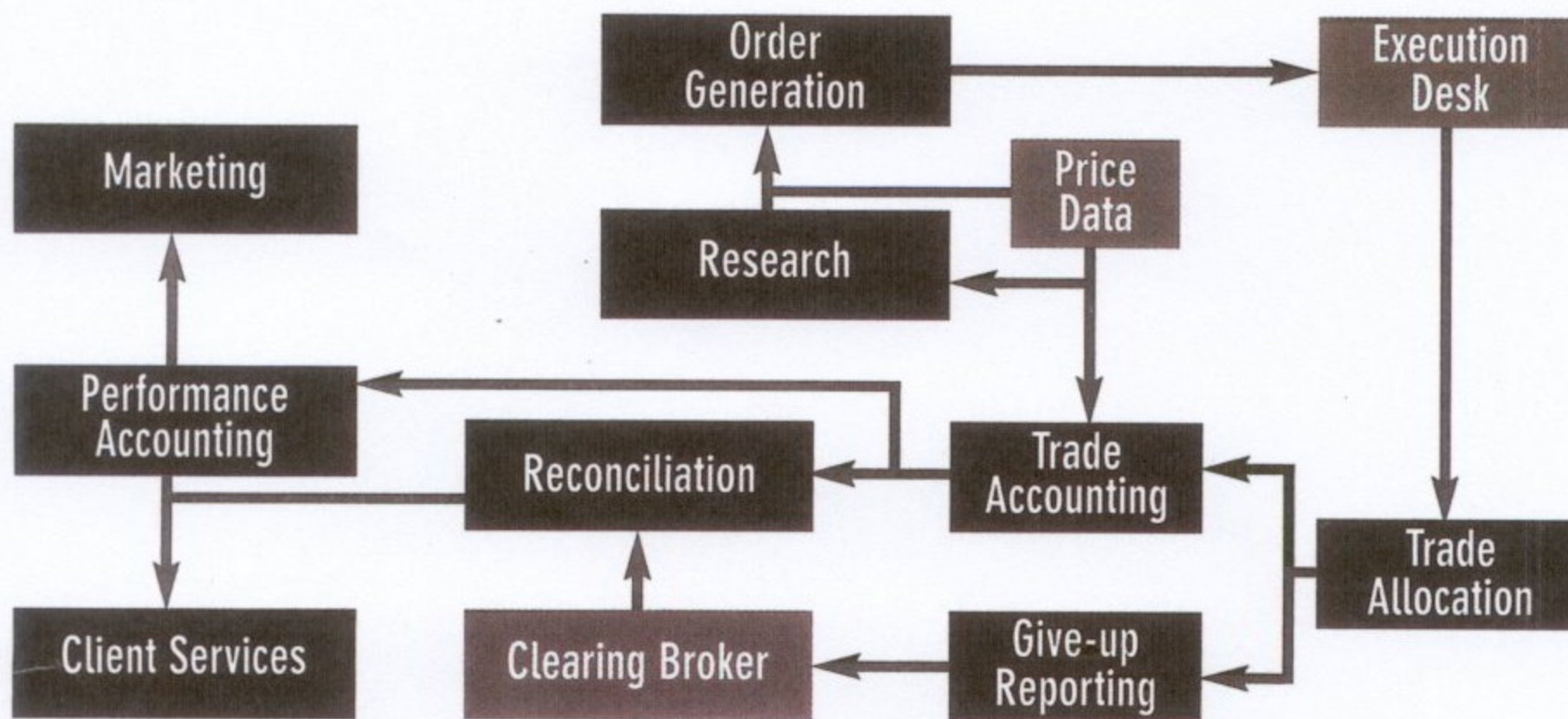
CTA offering managed accounts most likely has at least one executing broker for each sector — if not each market — it trades and multiple clearing FCMs. Throw in the mix partially funded accounts, offshore markets, split and partial fills and systems to allocate them and things get confusing in a hurry.

"No matter what you think — you being the trader — the truth at the end of the month is the broker statement even if it is wrong and the nature of the business is it is not always right. The key to not getting screwed is to make sure the trades you believe you did are accurately reflected on your



THE INTEGRATED CTA

A solid back office software application can automate many of the processes involved in managing a CTA back office.



Source: DMAXX

brokerage statement,” says Dan Comolli, president of back office software firm DMAXX.

Back office issues can be particularly vexing for emerging managers who often are one or two person shops. The manager does all the research, enters all the trades, performs the due diligence and operates the back office. While this may be manageable with just a couple of accounts, especially with a longer-term program that doesn't trade as rapidly, as the CTA grows and adds more managed accounts, operational issues take more time.

Each customer may have his own FCM and introducing broker that needs to be involved and while it would be simpler for the CTA to require all accounts be introduced through one broker and clear one FCM, an emerging CTA is not in a

position to make those kind of demands. Also, because most newer CTAs tend to have lower minimums, being unable to target institutional allocators without a track record, they are in a position of having to handle many accounts to trade a relative small total. A manager with a minimum investment of \$100,000 could conceivably have 20 managed accounts to trade \$2 million, an amount that rarely draws institutional monies and most likely won't produce enough profits to start hiring more staff.

The ability for exchanges to offer average pricing services and electronic markets has relieved some of the hassles, according to CTA Mark J. Walsh, who notes that front-end system providers are doing a better job incorporating software that improves the give-up process.

“If they are going to have a solid front-end system, they are going to have to have a solid give-up facility where they can make it easy for CTAs and money managers,” Walsh says.

While technology has eased some burdens, the rapid proliferation of non-U.S. markets has complicated the job.

“We have to break down the order and confirm with all of our clients throughout the course of the day. If Man is a clearing broker and Bell commodities did a trade for Man, Bell is going to be giving it to Man. Man needs us to confirm that,” Walsh says.

“We also are sending them a trade sheet as well. Trader X should be expecting 10 Australian 10-year bonds at such a time and such a price. If the price that I tell you is dif-

ferent from the price that they give you, obviously we have an outrade. That is when the work for the back office starts. They have to track it down and make sure that everything was done properly," Walsh says.

Rob Friedl, principal of Wisconsin-based Fall River Capital, which uses "The Books" software to manage its in-house back office, says that a report to three or more entities routinely must be sent for every managed account.

Walsh has someone monitor his trades in non-U.S. markets overnight and has increased his minimum investment over 20 years from \$250,000 to \$1 million.

"When we first started, there weren't foreign markets there were only domestic markets, so our minimum was \$250,000. As you start adding markets, you need to have a higher minimum. Just take a look at the guys who have increased in assets dramatically over the course of five or 10 years. Their minimums have all gone up," Walsh says.

"The stress points on back offices just become how many markets you are trading and how you trade. If you are short-term, it will be a lot more taxing on your back office," he adds.

ONE BIG MANAGED ACCOUNT

Some managers have gone the route of the CPO, structuring their program in a fund format to avoid the hassle of operating multiple managed accounts. Joe Santaularia, president of Parrot Trading Partners, went that route after successfully operating a CTA for a short period.

"It was a matter of, I cannot physically manage multiple accounts in this format — it is too much work — but the methodology is successful so why not manage \$2 million instead of a bunch of \$100,000 managed accounts," he says.

Santaularia moved to the CPO format specifically to avoid the back office issues of managing multiple accounts.

"It is significantly more time consuming trading individual accounts and the trade confirmations involved. Sometimes with the trading that I do you cannot assign everything out on a pro rata basis. Individual accounts do not work unless the account is sizable," he says.

Santaularia operates a hedged option writing program and says there are scale benefits operating a fund as well as a reduced workload.

"We get better fills because of size. We get better commission rates because of size. You get a lot of economies of scale in a bigger account than you would in smaller accounts," he says.

Operating a fund also can help established managers retain accounts once growth mandates higher minimums. John Bondurant has operated CTA Mississippi River Investments since 1986 but has stopped soliciting new investments and is trying to convert existing managed accounts to its fund. Mississippi manages approximately \$60 million split roughly evenly between its fund and managed accounts.

"We are just a three-man operation and we are handling about \$60 million. When we get really active and you start trying to allocate a couple of thousand contracts around it is a lot of trouble. If I buy 1,000 contracts of corn, I have to spread it over 80 accounts. It is a time consuming project," Bondurant says.

Mississippi, while diversified to numerous markets, only holds positions in a couple of markets at any time. Its low minimum investment, \$25,000, has created a nearly unworkable amount of managed accounts. It manually has to place one contract in the smallest accounts, five in another and 30 in another.

"[A fund] is just a whole lot less complicated and more efficient use of money because you try and allocate your trades in relation to account size. Some accounts are big and some accounts are small and you try and

tailor the amounts to the risk and it is just complicated," Bondurant says. "I'd rather have it in one big pot then it is real easy."

MANAGING ACCOUNTS

Comolli acknowledges that by pooling all customers into a fund, you can remove some back office headaches but he points out that there are disadvantages as well and with the proper software a manager need not give up the ability to offer managed accounts.

Reconciliation, tracking positions and counterparty notification are all potential back office headaches that become more difficult when dealing with multiple accounts instead of one.

While a fund offers many solutions to those headaches, most institutional allocators demand the daily transparency and leverage autonomy offered by managed accounts. A solid back office operation can be developed through outsourcing or through software products that can greatly reduce a firm's in-house workload.

"An effective back office can manage more accounts with less effort. Advisors, especially start-up advisors, tend to avoid managed accounts because multiple clearing and execution relationships almost inevitably results in additional staff. An automated back office system can result in significant less staff even for a moderately sized firm," Comolli says.

An example is Fall River Capital, which manages \$260 million with 35 managed accounts, six clearing brokers and 14 execution relationships. It operates a one-person back office.

"Having a solid operating product means you don't have to trust multiple counterparties to make sure they got everything right. It catches their errors quicker, so their errors don't become your errors," Comolli says. "An efficient back office means you are able to publish your numbers quicker so that you can get paid quicker."

Friedl says managers must decide

on whether to outsource their back office, create their own software package to manage it or purchase a back office software management package. Outsourcing may be the easiest solution and offers the benefit of providing independent performance reports automatically. Many argue that it is not a complete solution because some procedures, such as trade position management, need to have some in-house oversight and if you want daily information to go out, it can get quite expensive.

Creating your own back office management is cost-prohibitive and may only be feasible for large firms with several billion under management. Comolli claims his software allows one customer, a \$2 billion CTA/CPO, to operate a one-man back office.

"For those people who want to grow, you can grow without adding people or you can spend your time researching your strategies," Comolli says.

Managers can outsource their accounting obligations such as monthly performance reporting, tax reporting and incentive fee compilations or purchase a more complete solution that includes trade reconciliation. CPA firm Michael J. Liccar & Co. performs these accounting functions for many CTAs.

"The reason people come to us is they like outside groups reporting their [numbers]," says Michael J. Liccar, president of the CPA firm. Liccar, while noting that there are advantages for a CTA to have a third party report its performance numbers, says it may not be prudent for a CTA to outsource the reconciliation process. "It is a little dangerous," he says.

NAV Consulting is a full-service back office solution for CTAs. President Nav Gupta says there is a trend in the industry of allocators looking for managers who outsource their back office. "They have more comfort knowing a third party is handling the back office," Gupta says.

Gupta says they can create all of the needed reports as well as manage the reconciliation process. Another advantage, notes Gupta, is that once an allocator has done due diligence on a manager that outsources to NAV, that allocator won't need to examine the back office of another one of his clients. He will have a report in hand.

Keeping your back office in house allows a manager to keep all of his data in house.

"It is a control issue. You have a lot more control over your business if you have all of your information in house," Friedl says.

CTAs typically use their trading data to create reports on slippage, how their multiple trading models performed independently, which sectors performed better, all of which requires the manager to be able to access trading data.

"A back office can provide a basis for analytical risk management. If you have a full history of your trades and the resulting positions, what-if scenarios can be tested, actual vs. theoretical returns can be analyzed, historical margin utilization can be calculated as can more sophisticated measure like value at risk," Comolli says.

Finally, a solid back office can be a strong marketing tool particularly for managers targeting institutional allocations and their monies.

"The back office can provide non-traditional benefits such as marketing and risk management. It is probably not the reason you become a CTA, but an effective back office is a key asset that will allow to grow your business," Comolli says. Providing accurate daily numbers with no surprises at the end of the month builds confidence in a manager. Comolli points out that he has been contacted by CTAs who were referred by institutional allocators who wanted the manager to put in place a back office management package in lieu of making a sizable allocation. **FM**

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