

Five Ideas of CTA Due Diligence

By Mark Shore, Founder www.shorecapmgmt.com

Over the years I've found people perform varying degrees of due diligence of a Commodity Trading Advisor (CTA). Some may only crunch the returns of the manager. Others will only ask the CTA to fill out a due diligence questionnaire and some will do a full due diligence process on the manager including research and operational due diligence. The first two points listed are good places to start, but is not the ending point as your goal is to get as close to a full due diligence process as possible.

Regarding the research/strategy component of due diligence, below are five major ideas to keep in mind when performing due diligence on a manager:

1) You want to know and understand as much as possible about the manager's strategy. In my article from a few years ago "[Decoding the Myths of Managed Futures](#)" I mentioned that some have stated they were intimidated by the so called "black box" and the managers would not tell them very much. There was a time in the past when managers were cautious of explaining the details of their system due to replication risk, but not today. Only having the manager fill out a questionnaire tells a small part of their entire profile. You should be doing onsite visits of their office.

2) Some of the questions to ask a manager include:

- Are markets ever added or deleted from the portfolio? If so, why?
- What are the duration of winning trades and losing trades?
- What is their risk management? Do they use stops or profit targets? Do they leg into positions or enter the entire position at once? Do they keep the stops close or far away from the market? Do they spread or utilize options for risk management?
- What triggers a signal into a position and why?
- Is risk management used often or infrequently?
- Will the position size vary from trade to trade or will it remain static?
- How often is the system reviewed and modified?
- What type of market environment will the system work well and work poorly?
- Is there an overlay system within the portfolio? As I noted in "[Overlaying Strategies in Managed Futures: Does it Help an Investor](#)" This idea does not often get much discussion. If there is an overlay, how much allocation does it get?

These may seem basic questions, but sometimes the most basic is missed. Each of these questions opens up the door to more complex conversations. Ideally you are trying to understand the concepts allowing more realistic expectation of the manager.

3) The research process, a component that is often missed as people talk about understanding the strategy, but less frequently does someone say they took time to understand the research process. Understanding how the manager develops and tests their research ideas and strategies may be the gateway to understanding the mindset of the manager. How much data was tested ; one year or 30 years of data?

4) You should do an onsite visit to meet the research team. What are their functions and who leads the team and makes the research decisions? Is there anyone outside the team involved in research decisions? What is their disaster recovery plan for their research team?

5) For these listed ideas to occur properly, you have to hire staff that understands the products and the research process. Due diligence is an extremely important process of the managed futures industry. It should not be taken lightly. If the person or team doing the due diligence is well-versed on the research, then the due diligence can be very enlightening.

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Mark Shore is also an Adjunct Professor and Board Member of the Arditti Center for Risk Management at DePaul University's Kellstadt Graduate School of Business in Chicago where he teaches a managed futures / global macro course.