Michael Rulle, MSR founder and CEO

Matthew Brown, MSR president and COO

SPOTLIGHT: MSR INVESTMENTS

The New Jersey CTA is seeking to monetise the trend towards index investing with a new platform

What should a trend-following manager do to diversify their business when the increasingly commoditised strategy has struggled to perform and investors are shunning alpha rates?

The question is one many managed futures shops have wrestled with in the current drawdown as investors head to the exit door and look for lower cost alternatives.

For New Jersey-based MSR Investments, founded by former Graham Capital president Michael Rulle, the answer has been to enter the index investing world.

"We concluded we didn't want to be a one-product shop any more that was going to live or die on one product," says MSR president and COO Matthew Brown.

But instead of carving out a lower fee offering, or adding extra factors to its flagship to enhance its standalone performance, the firm has taken another path. It has launched an investable index platform through which it can offer investors an endless number of products – pitched at the average price of a mutual fund.

MSR is not the first to make the move into index investing in the managed futures world. Mount Lucas launched its MLM index in 1988 as a benchmark for managed futures investing and as a passive, investable index – the first attempt to capture hedge fund beta.

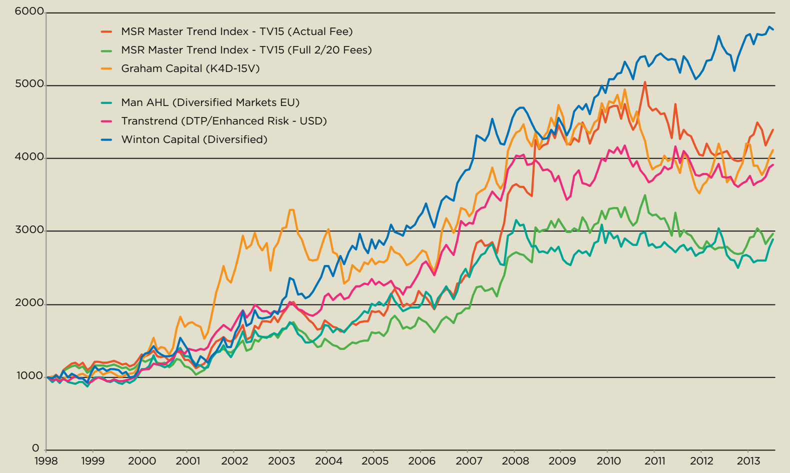
It is based on a simple 12-month moving average to detect trends over a diversified portfolio of 22 liquid futures contracts traded on US and foreign exchanges across commodities, currencies and global fixed income.

Since its launch, a number of others have followed a similar path, most notably Conquest Capital and Quest Partners. All argue that the CTA industry today can be replicated with high correlation using a very simple model.

"The truth of the matter is that pulling this off is really easy," Mount Lucas co-founder, president and CIO Timothy Rudderow said in a recent interview. "Our experience replicating the MLM index has been extremely good. There is lots of liquidity out there. We can execute our trades around the closing price because that's how the benchmark is built. And for us, at a pretty decent size, it's quite easy to do, and very efficient. We can track our index very effectively in the current (futures) exchange environment."

MSR says its differentiator from MLM, or the other more recent offerings, is that it has gone a step further – in both the breadth of the platform, the customisation and pricing.

MSR TREND INDICES VS TREND-FOLLOWERS



The product of six years of investment in technology and research, and up to $5m in development costs, the platform offers 1,200 indices. The indices were developed on "trading style" factors that hedge funds actually use, not mathematically derived factors. These style factors include target, or constant, volatility; trend-following; going long and staying long; and, to a lesser extent, reversal or counter trend.

MSR claims they are only indices which adjust for serial correlation. Other indices in the marketplace understate the actual measured annual standard deviation by as much as 40%, by ignoring serial correlation, MSR says.

The pitch to investors is straight-forward: they can replicate or benchmark CTA and hedge fund strategies at low cost by using one or any combination of the indices.

MSR's move to index investing started last year when the firm's management team began discussing their strategic plans for the future.

The company had launched its flagship Quantitative Directional Program (QDP) in September 2009. But a difficult asset-raising period and challenging investment climate stunted its growth – peaking at $25m in 2012.

"Our timing wasn't great, and like the rest of the industry we muddled along with positive, but fairly mediocre results, compared to the historical record of managed futures," admits Brown.

Seeing the marketplace move towards liquid alternatives, MSR decided it wanted to be one of the most committed players to take advantage of the trend.

"What we really wanted to do was get out in front of that," says Brown.

Replicating hedge fund beta

One of the core beliefs at the firm, and among many in the industry, is that a lot of the strategies that used to be alpha strategies have evolved into beta strategies. "Eighty-five per cent of all investments in hedge funds have occurred since January 2003," says Rulle. "Common sense dictates that trading styles have become increasingly commoditised. Just think of all the hedge fund 'spin-offs' as one cause of this. We believe it obvious that the incentive fee structure is no longer justifiable given how simply these trading styles can be replicated."

"When trend-following started 30-40 years ago it was truly a new thing, and people had a big knowledge advantage, and ultimately a return advantage," adds Brown. "It deserved 2/20 fees in the 80s and 90s.

"Now the formulas that everybody uses can be found on Wikipedia. Trend-following is no longer a mystery. It no longer requires a genius to do it. In our estimation, it has become a beta strategy and people who do it should be receiving more traditional money management-type fees, rather than high, hedge fund type fees."

MSR wanted to create indices that are designed to show the minimum return that a manager should be able to generate within a given strategy. For example, the firm took a simple trend-following model – the Moving Average Convergence Divergence (MACD) indicator with a simple moving average cross over – and applied it to 32 different markets to become its core trend strategy.

"What we're saying is here's an index: this is trend-following. And if a manager who says he's doing trend-following can get a return beyond this, then that's truly what alpha is," says Brown.

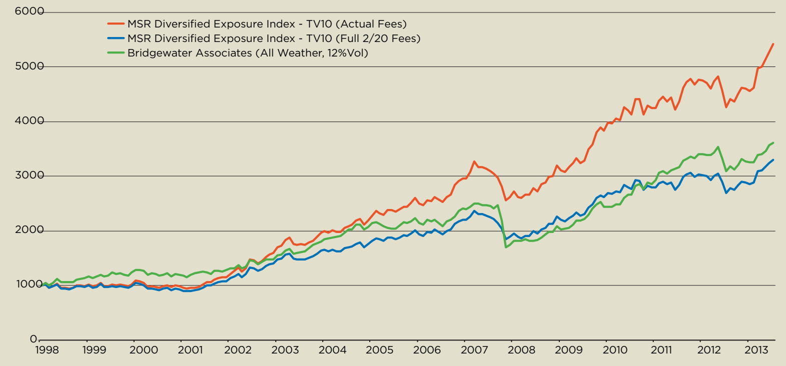
He adds when building the platform, the MSR team was surprised at how few trend-following managers actually beat the MACD model.

"We just made what we thought was the most basic trend-following model available with volatility weighting for markets," he says.

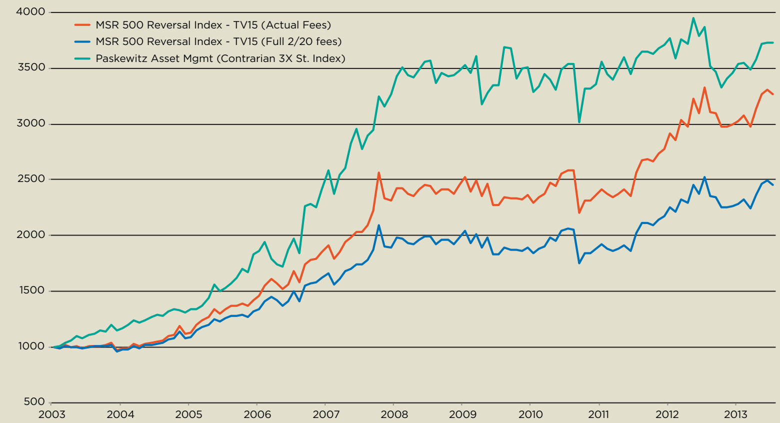
"That's not saying that no trend-followers beat it. But if a manager beats it then you know he's doing a good job. If your manager is not beating it, then you can invest in an index based at a very low rate, just like you can invest in an S&P 500 index fund."

MSR believes the high fees charged by CTAs and hedge funds also gives it a competitive advantage in the marketplace by offering a lower, flat fee structure on its platform. "Equity hedge funds charge 2 and 20 for targeting constant volatility," says Rulle, "that explains virtually all outperformance by hedge funds versus the stock market. Yet due to

MSR LONG ONLY INDEX VS BRIDGEWATER



MSR REVERSAL INDEX VS PASKEWITZ AM VAMI



fees, they underperform a long only MSR Index."

For example, Rulle says the BarclayHedge equity indices (Long /Short and Long Bias) have had a correlation to MSR's benchmark Long Only US Equity Index, at a target volatility of 7 (TV7), of between 0.75 and 0.80 since 2003. But over the same period, the Barclay indices have had an average Sharpe of 0.61, adjusted for serial correlation, compared to 0.73 for the MSR index. The main reason for the outperformance, Rulle says, is fees.

Likewise, MSR's benchmark Diversified Trend Index (TV5) has had a 0.76 correlation to the Barclay CTA Index – but the former outperforms by more than 60%. "This is almost entirely due to the 2 and 20 fee structure in hedge funds," says Rulle.

The MSR fee structure, at an annualised target volatility of 10%, ranges from 25bps for a long-only index to 75bps for trend-following index, and 100bps for a custom multi-strategy index, according to its marketing documents. MSR charges no incentive fee. Since May, MSR's flagship QDP program has also been migrated to the index platform to be priced more competitively, also following the flat fee scheme.

"Research still tells us that QDP is the best way to deploy our own capital, but it is now a custom index," says Brown, who is responsible for portfolio management, risk management, trade execution software and systems development at MSR.

QDP does retain some ingredients not offered as standard on the index platform, such as a VaR (value at risk) limits. But MSR says this can be added to any custom index.

QDP also uses a proprietary intraday breakout that is designed to trade out of a losing position in a dramatic down day.

Prospective clients can select from eight benchmark indices that MSR has created for immediate investment, or build their own custom index from the three core strategy components – long-only, trend and reversal – and apply them to up to 32 markets, while selecting a target volatility for either the overall portfolio, each strategy, or each market.

MSR has built the algorithms that calculate the index values in real-time and execute the trades to replicate the index.

"If they decide they want trend-following commodities, but trade reversal in equities, they have the ability to put that together," Brown says.

"When you have over 1,000 indices, the number of permutations is infinite. There is no limit to the number of indices you can combine."

Benchmarking top managers

One additional application that MSR has developed for its platform is a tool for investors to find MSR benchmark indices that will either outperform or match any specific program or index, based on an analysis of historical returns, using a ratio of correlation and volatility.

"The intent of the tool is to be agnostic to quality. It's to quantify the net output of what's going on," says Brown. "The idea is to provide a research tool for investors to check for style drift and also provide them with an alternative," adds marketing director Elizabeth Karamitis Kim. "Maybe they are desiring a particular style and haven't been able to find a manager that provides it. Then we're a very cost effective solution for them."

MSR expects the platform to appeal to the institutional investing world – from pension funds to multi-manager funds in the liquid alternative space. Even ETF providers.

It could also be attractive to traditional money managers, who could use the indices to see the marginal return that could be achieved from a strategic overlay such as a trend or reversal strategy.

The platform is structured to take investments via managed accounts, with investors able to choose their own FCM and have third-party verification.

"We will learn as we go in what the market place is most interested in," says Brown. "But our expectation is that when investors get into this they will end up building their own custom index anyway.

"Are we concerned about getting traction? I think we're out ahead of most people on this. Being one of the first there will hopefully give us a head start." CTA

HISTORY OF MSR INVESTMENTS

MSR Investments was founded in 2008 by Michael Rulle, a former president of Graham Capital Management from 2002 to 2007.

At Graham, Rulle chaired the investment and risk committee and was directly responsible for the firm's discretionary portfolio managers, which it had started to develop in 1999. As part of Graham's senior management team, Rulle also worked closely with the firm's quantitative research group.

He left Graham with the intention of creating his own firm, founded on the philosophy of statistical testing and the scientific method.

Rulle teamed up with former colleague Matthew Brown, whom he had first hired in 1999 to manage a fixed income arbitrage team while president and CIO at hedge fund Hamilton Partners. Brown later worked with Rulle at Graham, developing trading systems for fixed income arbitrage.

The pair spent more than a year in research and development before launching MSR's debut offering, the Quantitative Directional Program, in September 2009. Brown became COO and president of MSR.

Rulle was previously CEO of CIBC World Markets Inc, and ran the equity derivatives business at Lehman Brothers. He was one of the original representatives to the International Swaps Dealer Association (Isda).