FEES OBLITERATE MANAGED FUTURES FUND PROFITS

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Looking for a profitable fund to invest in? You may find one if you look to a managed futures fund. You might be surprised, however, to later find that despite your chosen fund showing significant gains, you've reaped little to no profit.

Recently, a widespread, decade-long practice of managed futures funds managers charging exorbitant fees to investors has come to light. These fees have been shown to wipe out most—and in some cases, all—investors' profits. So are managed futures funds profitable? The answer is yes and no. These funds are often very profitable for the managers of these increasingly popular alternate investments, but just as often not at all profitable for the investors whose gains are largely obliterated by unconscionably steep fees.

The Commodity Futures Trading Commission (CFTC) is now investigating the sky-high fees charged to investors in the managed futures fund market. The scrutiny comes after the U.S. Senate's Special Committee on Aging on December 19, 2013 sent a letter to the CFTC, appealing to that agency to work with the Securities and Exchange Commission (SEC) to investigate means for disclosing the exorbitant fees charged to retirement accounts.

A managed futures fund (also known as a managed futures account) is a variety of alternative investment (an investment other than cash, stocks or bonds) that is ordinarily monitored by commodity trading advisors or commodity pool advisors and overseen by the CFTC. These types of funds are typically sold to investors through brokers. Fund managers then invest in futures, which are financial contracts in which the buyer promises to buy an asset at a predetermined date in the future. Such futures obligations typically obligate the buyer to purchase assets like global commodities (goods and services), and foreign currencies, among other speculative financial instruments.

As of the second quarter of 2013, the assets under management held by managed futures funds totaled $331.6 billion, according to data compiled by BarclayHedge, a firm that measures the performance of hedge funds and managed futures funds.

Managed futures funds are not, in general, required to file quarterly and annual reports with the SEC. These funds, like hedge funds, are, however, subject to the SEC's "500 Investor Rule," which requires any company with over 500 individual investors and more than $10 million in assets to file financial reports within 120 days of their fiscal year's end. There are currently 63 managed futures funds that fit into this category. The vast majority of these funds, however, have no reporting requirement, as they are not subject to the 500 Investor Rule.

A review of SEC filings of the 63 managed futures funds that are large enough to be required to file regular reports with that agency, for the period from Jan. 1, 2003, to Dec. 31, 2012, showed that a stunning 89 percent of the $11.51 billion of gains in these managed futures funds went to fees, commissions and expenses collected by the fund managers—and not to investors, according to an investigation by Bloomberg Markets Magazine. Managed futures funds routinely charge clients 7 percent to 9 percent annually of assets invested annually and 20 percent of the funds' profits. Compare this to hedge funds, in which a management fee of 2 percent plus 20 percent of investor profits has been the typical structure, but that too is presently under attack for being unacceptably high. As The Economist describes hedge fund fees, it is "easy to think of people who have become billionaires by managing hedge funds; it is far harder to think of any of their clients who have got as rich." And managed futures funds fees are as much as 7 percent higher.

The managed futures funds investigation uncovered a number of glaring examples of managed futures funds in which every cent of investor profit was consumed by fees and commissions. For example, over the past four years, 29 of these funds run by Morgan Stanley and Citigroup lost an aggregate $1 billion, but charged investors fees of $1.5 billion. In the ten years ending in 2012, over 30,000 investors invested $797 million in a Morgan Stanley Smith Barney fund that, from 2003, saw profits of $490.3 million in gains and income. Over 100 percent of those profits were wiped out by $498.7 million in commissions, expenses, and fees paid to Morgan Stanley and individual fund managers, resulting in a loss of $8.3 million over the 10-year period for investors. Similarly, investors in a Merrill Lynch managed futures fund lost $135.3 million, after fees, in the four-year period from 2009 to 2012, according to that fund's SEC filings.

Moreover, the profit-consuming fees in the managed futures market are not adequately disclosed to investors. The National Futures Association (NFA), a self-regulating watchdog organization that oversees the trading of commodities and futures, does not require managers of managed futures funds to disclose how their fees impact investor profits over time. This lack of a disclosure requirement applies equally to the 63 managed futures funds subject to SEC financial reporting, as well as to the many others that are not required to make any SEC filings at all.

Bart Chilton, one of four CFTC Commissioners, told the investigative journalist he had been unaware of how the high fees have affected investors. "The big news here is, the fees are so outlandish, they can actually wipe out all the profits." "We absolutely need to do a better job of letting consumers know in plain English what's going on," Chilton continued. "Those numbers tell a story. It's astounding."

Chilton went on to say that, "In no way is 89 percent of the profit acceptable. The problem is that I don't think people know this. I don't think investors, consumers, understand this. I think regulators need to require that they communicate it right up front. It needs to be very clear to investors what the fees are." Similarly, Christopher Van Slyke, founder of Worthpointe Wealth Management, noted that it's "very difficult" for him to find all the fees in a fund. "The idea and expectation that folks who aren't professionals can find these fees and assess their impact on their performance is really absurd," he said.

Clients traditionally invest in these types of alternative investments on their brokers' recommendations, according to Thomas Schneeweis, University of Massachusetts Amherst finance professor and former futures-fund manager from 2004 to 2010. "Everything is marketing," he said. "Getting out there and pushing it. These things are sold, not bought." In addition to individuals, brokers may target family offices, which are private companies set up to manage finances, investments and trusts of single families. Web sites for certain management firms that invest in managed futures funds like Chicago's Walsh Asset Management and Horizon Cash Management, also based in Chicago, and San Diego-based Granite Asset Management, for example, indicate that they specialize in investing for such single family offices.

Given that managed futures are often marketed by brokers through a pitch then, investors who buy into a managed futures funds are highly unlikely to know that most—or all—of their trading gains would likely be obliterated by fees, unless this fact was specifically disclosed to the investor by his or her broker. It's hard to imagine that such information would be included in every broker's pitch.

Brokers will likely counter that these fees are disclosed in the funds' prospectuses. But, as the SEC has made clear, investors should be able to rely on their brokers' oral representations. As the SEC held in a 1994 Administrative Proceeding, an investor's reliance on oral misrepresentations of a broker is not necessarily unjustified, even where the investor had access to a prospectus providing full disclosure.

The Financial Industry Regulatory Authority (Finra) provides similar guidance. Finra's Regulatory Notice 94-16 states: "Members are also advised that, although the prospectus and sales material of a fund include disclosures on many matters, oral representations by sales personnel that contradict the disclosures in the prospectus or sales literature may nullify the effect of the written disclosures and may make the member liable for rule violations and civil damages to the customers that result from such oral representations." Finra's Regulatory Notice 03-71, regarding non-conventional investments, states that: "Members should provide investors with any prospectus and other disclosure material provided by the issuer or the sponsor. NASD reminds members, however, that simply providing a prospectus or offering memoranda does not cure unfair or unbalanced sales or promotional materials, whether prepared by the member, sponsor, or issuer."

"Broker pitches that don't clearly tell investors about the drastic effect of fees should be considered fraudulent," according to Duke University law professor James Cox, "[b]ecause the managed-futures market is opaque and poorly understood, otherwise sophisticated investors often don't realize how pervasive the profit-eating fees are. The firms marketing the funds are at times also left in the dark," he explained.

In the December 19 Senate Committee letter that has prompted the CFTC probe, Senators Bill Nelson and Elizabeth Warren wrote: "Clearly, individual investors, especially senior investors looking to find a suitable place to place their retirement savings, should be made aware of these managed-future funds' fees and commissions and the draining effect upon their investments. Although these funds are purported to be for sophisticated investors, some of these firms have a very low minimum investment that can be made from an Individual Retirement Account (IRA). We are very concerned about the potential impact these fees could have on the retirement security of the Americans who invest in these funds."

For a decade, managed futures funds have reaped significant fees for fund managers at the expense of profits due to their investors. Investors who own or have owned shares of managed futures funds, sold to them through a broker, may well were subjected to misleading pitches. Even where a broker provided to a prospective investor a fund's prospectus or offering materials, a pitch that touted managed futures profits—but failed to disclosure that those profits are often wiped out by fund management fees—should be considered fraudulent.

Managed futures funds are not a well-known category of alternative investment vehicles. Because most of these funds are not required to disclose the effects of high fees on profits, all levels of investors are vulnerable to pitches by brokers that fail to likewise disclose this risks inherent—if not endemic—of investing in these funds.

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