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Going Up Against the Hedgers

By Michael S. Fischer, Senior Financial Correspondent | Friday, June 13, 2008

Long-time trader David Druz tells how he turned an insight about futures markets into a competitive advantage.

For someone who has always been reluctant to speak with the press, Dr. David Druz is remarkably forthcoming when he finally does agree to an interview. But then he is unusual in a number of respects. He has been a successful player in the managed futures arena since 1981, around the time the likes of Campbell, John W. Henry and Tudor were rising to prominence, yet he has never become a brand name. Nor does he have billions of dollars in assets under management. He's unusual in another respect. For the first dozen years of his career as a commodities trader, he pursued a dual career as a board-certified emergency physician.

Mr. Druz recently spoke by telephone from his office on the North Shore of Oahu, Hawaii, where the day-to-day activities of his Tactical Investment Management take place. He described how he got into futures trading, the strategy he developed 28 years ago and still uses today (with a few tweaks along the way) and why he isn't better known in the managed futures space despite producing a strong track record. He also spoke about the evolution of the industry since he entered it, and how this has affected his trading.

Dr. David Druz, Tactical Investment Management
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After receiving his medical doctor degree from Johns Hopkins School of Medicine, Baltimore, in 1979, Mr. Druz set up and ran Tactical Investment Management while concurrently doing an emergency medicine residency and then practicing emergency medicine fulltime. He stopped practicing medicine in 1991.

Mr. Druz says his interest in commodities markets was piqued while he was still an undergraduate pursuing a premed track at the University of Illinois, Urbana-Champaign, Ill., when a fraternity brother turned a $2,000 bet into $500,000 in one year trading the big bean movement in the 1970s. "Basically, I kept on with the medical track, but I always felt that at some point I would discontinue it because my real fascination has been with markets. I enjoyed practicing medicine for the time I did, but I moved on."

Elusive Market Share

By his own admission, Mr. Druz has never been much of a marketer, which helps explain why Tactical's assets under management are relatively low, at $50 million, after 27 years in business. "I love trading, I love research, I hate marketing, just hate it. You can hardly get me to talk to people. It just hasn't been my interest."

In the 1980s and 1990s, when other CTAs were building market share by forming relationships with third-party marketers or brokerage firms, Tactical also was approached by these firms. "But it never seemed right to me to rip off a client like that, so we never played the game," says Mr. Druz. But neither did the firm get market share, and over the years this has made potential investors wonder why its asset base is so low.

"It's a big problem. It has been my experience that it is not the case if you have a good product, you will automatically get money. In this business, marketing is largely responsible for the amount of assets under management. Someone spectacular doesn't need a marketer. But there are very, very few spectacular traders; there's a significant number of decent traders, and those that have really good marketing arms have a lot of money under management," he says.

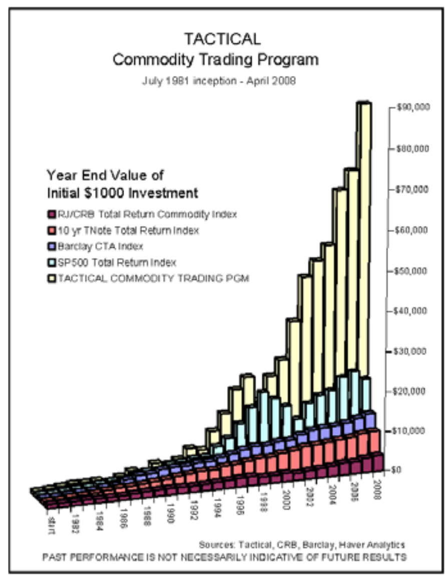
Recently, Mr. Druz brought Rob Lingle, an experienced marketing professional, on board as vice president of investor relations with the goal of raising the firm's profile in the investment community.

Tactical's current investor base comprises institutions and those Mr. Druz characterizes as "just regular people:" professionals and people who have their own businesses and run pension funds for their employees or themselves. "Most of our investment from regular people is in the form of pension money; even if they've started out with regular money, they've switched over to pension money because they don't want to pay tax."

Tactical offers two products. The Tactical Commodity Trading Program has been running since 1981, and the current offering of this product, Tactical's Institutional Commodity Program, has been trading since April 1993. The second product, Tactical Multistrategy Commodity Fund LP, is designed for investors who want a lower volatility version of Tactical's strategy.

Zero-Sum Game

Tactical trades futures on commodities and financial markets as well as foreign exchange. Mr. Druz says he observed early on that these markets are zero-sum games. "If someone wins in that marketplace, somebody has to lose. It's very straightforward. This is how we approached it way back when, thinking: Who loses money over time?"



Only two groups of people lose money over time, he says. One group is unsophisticated small speculators, who represent a minuscule amount of the money that goes into the pool of money that is taken by the people who win. The big group is the hedgers.

Over time, commercial hedgers lose money in the markets, Mr. Druz says. "This has been demonstrated many times. At least in the old days, it was easy to figure out from the Commitment of Traders reports that the hedgers were net losers, but the hedgers are pretty sophisticated now, and it's not so easy to see from the Commitment of Traders reports anymore. But over the long run, commercial hedgers lose money."

His idea, which drives his strategy, is that if this is the case, Tactical should try to stay opposite commercial hedgers as much as possible, using money management techniques to be intelligent about risk profiles, and diversify as much as possible. This will give it an edge in the market.

Hedgers buy when prices are low and sell when prices are strong, Mr. Druz says. By doing the opposite, Tactical actually loses money on the majority of its trades, but makes money when prices strengthen or weaken well beyond hedgers' expectations.

A case in point is the Minneapolis Wheat market last year. "When we were getting signals to buy Minneapolis Wheat in May 2007, it was at multi-year highs and looked too high to buy. But it surprised everyone by continuing to go up much farther. We took profits in the fall, but soon thereafter got another buy signal right near all-time highs. To everyone's complete astonishment, the price more than doubled after that. Surprises of this magnitude don't come along that often, but this is a perfect example of how we try to make money by trading opposite hedgers. Hedgers were selling around the levels we were buying and wound up paying us handsomely."

Mr. Druz says he is amazed people don't understand where the money comes from for the profits for those who win. "Somebody has to lose in this business, and the plankton in the food chain is the hedgers. The little guys don't count, even though they do lose. We just try to stay opposite the hedgers as much as possible."

In developing his program, Mr. Druz found various types of market patterns that correlate with when hedgers flip from long to short and from short to long. "We identified those years ago, and we identified them with a very simple elegant mathematical algorithm, and we still use that to this day."

The algorithm is applicable over multiple time frames because hedging exists over multiple time frames. "We use the idea that the markets are fractal to be able to apply this on more than one time frame, but they aren't fractal forever. If you get too short, things break down; if you get too long, things break down. But there's a big area in the middle where the concept works."

The Tactical program is fully systematic, using this mathematical algorithm. Discretion came in only in the design of the original algorithm, and deciding money management and markets to be traded, says Mr. Druz. "After that we just let the thing go."

The program trades any market in which the hedging concept makes sense. These include exotic foreign exchange markets if there is liquidity and a real market exists. "There's real hedging in those markets with international businesses and banks, and a lot of times we've found that in those markets, you don't have so much professional money in there yet and we like that. The fewer professionals you're competing against, the more of the hedgers' risk premium to go around."

For example, one of Tactical's best markets in recent years has been the Brazilian real. "The real is a currency not every CTA trades, even the big guys, since you have to know how to trade non-deliverable forwards in the FX market. We were long the real from July 2004 to December 2005, and except for a brief hiatus in August 2007, we've been long again since August 2006 to date. Of course, since I mentioned it, odds are the party is now over."

The program also trades grains, metals and softs. However, Tactical stopped trading meats as its time frame became longer, Mr. Druz says. "When we were shorter term in the early days, we traded the meats; it made sense. But as we moved farther out, we said we can't trade these anymore; it doesn't make sense to our model because the animal would be dead, you can't store it; it just doesn't work."

The program doesn't trade stock indexes either because stock indexes don't have hedgers on the opposite side. "People who are ‘hedging' in stock indexes are really arbitraging to the underlying core stocks. It's not the same thing; they are not laying off risk in order to benefit their business in the same way. So, we have never had stock indexes as part of the portfolio because it didn't fit our market model."

Tactical's Institutional Commodity Program has enjoyed a long, successful run. Since 1993, it has generated a compound annualized return of 19.7%. But sandwiched in the middle of the track record is the year 1999, when the program lost 20.2%. Which raises the question, under what conditions will the program not run well?

Tactical thrives on surprises, when markets do not behave in ways hedgers expect and they lose more money than they make. But when markets act normally and things are quiet and stagnant, Tactical doesn't do well because hedgers are winning during these periods.

"In 1999, we had a long period when things were just not doing anything whatsoever," Mr. Druz says. "That went on a long time. We just lost and lost and lost. That year, we closed our very aggressively leveraged offering of our Commodity Trading Program, which we'd been running since the beginning and just continued with the current institutional leverage because the volatility was too much for our investors to take."

Tactical regained traction the next year, producing a return of 32.7%, and has not suffered a losing year since then.

Tactical's second product, the Multistrategy Commodity Fund, began trading in November 2000. This essentially is the firm's fund of funds, with half its assets allocated in-house to the Institutional Commodity Program and the other half to Jaycor Capital Management's Diversified Futures Managed Account Program. According to Mr. Druz, Jaycor's principal, Harvey Silberstein, trades only for himself and his family and for Tactical. Like Mr. Druz, he is a former emergency physician, and he has been a futures trader for 26 years.

The Jaycor program provides a nice complement to Tactical's program in that it is discretionary versus Tactical's systematic approach and has a much shorter time frame. It trades futures and forwards in more than 60 commodity and financial markets, relying on the adviser's judgment and intuition to select the portfolio of markets to trade. Jaycor's decision making is facilitated by a number of proprietary pattern recognition techniques, and relies on the advisoe's insight into which markets have higher probability opportunities for profits using its trading methods.

Jaycor monitors daily and weekly charts to determine market trends, selecting markets showing strong trends or the potential to develop strong ones. The adviser uses a proprietary systematic trend-following approach to enter the markets selected and to manage trades. The trading time frame is medium term. Profitable trades tend to be held open from several weeks to months, while losing ones are held from one day to several weeks. Positions are rolled from one delivery month to another in order to avoid delivery.

Since inception, the Tactical Multistrategy Commodity Fund has produced a compound annualized return of 18.2%.

Increasing Market Noise

Mr. Druz emphasizes that Tactical's basic concept has not changed at all in the 27 years since the system was developed. What has changed is the universe of markets available to trade, and therefore the markets in its portfolio. "The way markets are traded, how we have to execute things—those things have changed; and our time frame has changed. And that's where a lot of our research has come in—in areas of diversification and time frame."

He says that in the late 1970s and early 1980s, markets did not have as many professional participants as they do today. In the earlier period, there was not a lot of market "noise;" there were many fewer false signals when things moved one way or another, no matter what the nature of the trader's methodology. With less noise, it was much easier for Tactical to trade on a shorter time frame. A shorter time frame is beneficial because a trader can compound his money more quickly and get out of drawdowns faster.

However, as the market has gotten more sophisticated and professional participation has increased, more and more players have joined the fray at the shorter and intermediate time frames. From the standpoint of an investor or a trader, Mr. Druz says, this means there's an increasing amount of noise in the markets because the professionals trade on all different time frames and for the most part, they are trend followers.

"So, when a market starts to move a little bit, a bunch of guys jump in and push a little bit, then the next level of guys jump in and push farther and so on. You get these moves, which may or may not have any fundamental basis, but it amounts to mathematical noise."

This used to be balanced by a certain amount of hedging activity, he says. If a price went far enough in one direction or another, the hedgers would jump on it and that would dampen the activity. But over time, so much professional money has entered the markets that it has swamped this normal dampening that should occur.

He says this is prevalent in markets across the board, particularly in ones of medium depth, such as the softs and the commodity markets, which too much professional money can inundate. "You see it as well in the financials, and you see it in the currencies now. It's just everywhere. There are too many sharks and not enough plankton. So, you've got more and more volatility, more and more noise. That's the main thing we've seen happen over time."

The ramifications of this are that it should be harder to make money in the markets with the same type of performance characteristics as a person has achieved in the past. "You should still be able to design methods to get an edge out of the markets, but in order to obtain that edge, you need to realize you will have to accept more volatility in your equity curve in order to do it as long as more and more professional money keeps coming in and adding more and more noise.

"So, the edge has decreased in those areas, and our research has shown that in order for us to maintain the edge, we have to move [our time frame] farther and farther out, or we have to come up with something different. I would rather not come up with something different because in my mind this is the simplest, most elegant robust concept I can think of. It should work 200 years from now. So, I would rather move out and try to avoid the shorter-term noise."

Mr. Druz points to the huge washout in commodities earlier this year as typical of what he's talking about. "When people start to go, they all head for the door at the same time. It's a type of thing we're going to continue to see forever. I don't foresee that the professional money is going to decrease; it's even going to increase. I see the professional money growing faster than the hedging money, which is opposite it. Markets are going to continue to get noisier, and what we've seen now is just an example of that."

Electronic Trading Arrives

Another major change Mr. Druz has witnessed, and does not like, is the advent of electronic trading. "The reason we don't like it is that you never know when the markets are open, you never know when a tick is real during the off hours."

He says that the futures markets, with the exception of interest rates and currencies, still tend to be thin, which presents a problem in off hours. Take commodities. "If something happens overnight, you don't know if it's real, and even if it is real, how do you execute it if you don't have somebody on the other side? Until such time as the markets become deep and liquid 24/7, it's really frustrating to have these markets open all the time. Not that I have any difficulty with the electronic aspect of it; it's the hours of the electronic aspect, which make it very difficult."

Mr. Druz says the bigger a CTA, the bigger a headache this is for him. He cites coffee and sugar as examples. "Say you get some kind of move overnight. Now if you have a big position you want to move and the market's at the price you want to take a signal at, you just can't do it. By the time the market gets deep enough, it could be far away from your level, and you're in a tough position. You just don't know whether the market was there or wasn't there. It's frustrating.

"So, the bigger the CTA, the worse I feel for him. But fortunately for the bigger guys, they don't trade much in commodities anyway; they're mostly financial."

Emphasis on Efficiency

Tactical Investment Management's office of record is located in Nevada, but most of its activity takes place in Hawaii. The operation is very small. Two full-time staff members—a trader and a professional who runs programs and does all back office—have worked with Mr. Druz since 1984. He contracts out work to a compliance attorney, an information technology professional and other service providers as needed. Mr. Lingle, the client services member of the team, is based in southern California.