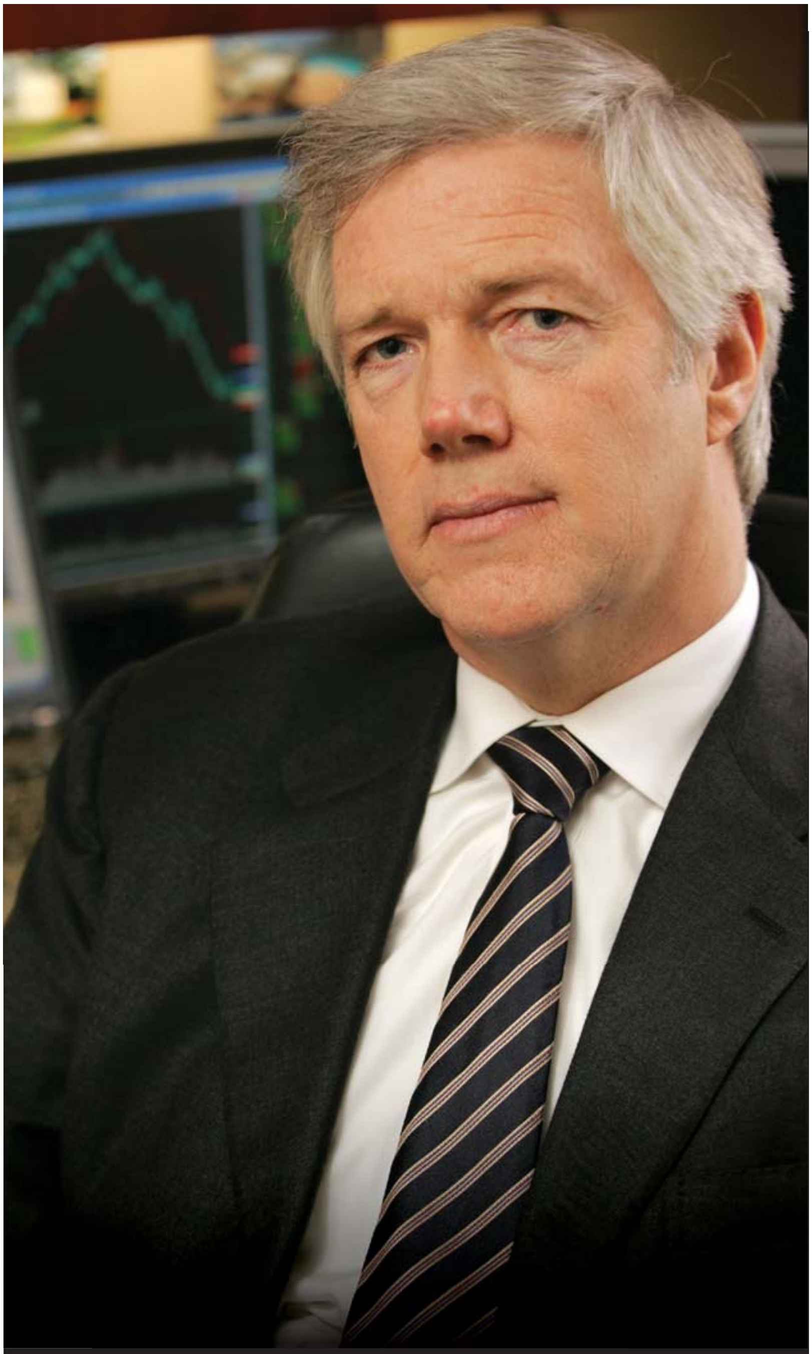


Spotlight: Drury Capital Incorporated

Former grain trader turned systematic manager Bernard Drury on his commitment to commodities and why Berkshire Hathaway investors should consider diversifying into managed futures

BY MATT SMITH

Amidst the 50th anniversary celebrations of Berkshire Hathaway, managed futures adviser Drury Capital floated an updated paper to explore how the legendary investment returns of Warren Buffett's portfolio could potentially be improved with the addition of other assets.

An ideal candidate for investment alongside Berkshire would be an asset with both positive returns on a standalone basis, and low correlation to Buffett's firm.

While Drury's systematic trend-following investment program does not boast the same longevity as Berkshire, it has nonetheless been in continuous operation for almost 19 years, a period encompassing many economic cycles and market conditions.

A comparative study by Drury shows that taken individually, the two performance records during this period are broadly similar (*see Table 1*).

But the correlation between the two return streams is a low 0.01.

And despite the overall similarity of returns, the paths of producing these returns share almost nothing in common.

As modern portfolio theory would predict, the performance of a portfolio holding Berkshire is potentially improved by being coupled with a non-correlated asset, such as Drury, and vice versa.

A look at the efficient frontier for the two-asset portfolio suggests that a roughly 50/50 blend would have produced the highest ratio of rate of return versus standard deviation of returns (*see chart, Efficient Frontier*).

Consistent with the theory, the combined portfolio raised the risk-adjusted return to a level higher than either asset could achieve individually.

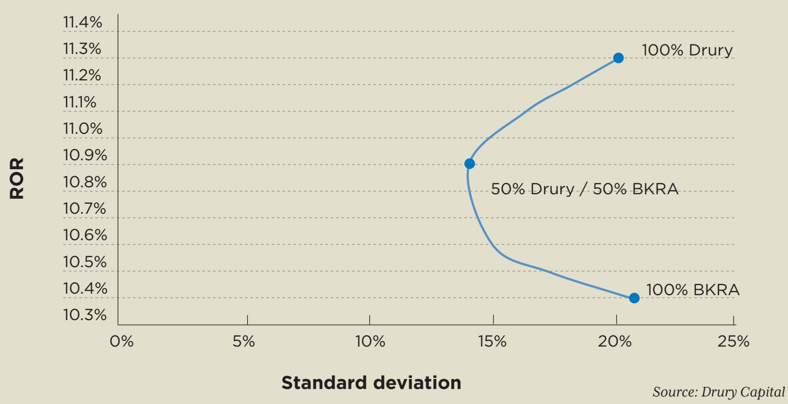
For the Berkshire investor, the diversification reduced the portfolio volatility by almost one-third and reduced the depth of the peak-to-trough drawdown by almost half. It also cut the length of the drawdown associated with holding Berkshire alone by 43 months (*see Table 2*).

TABLE 1: PERFORMANCE IMPROVEMENT (May 1997 to Feb 2015)

	Drury	Berkshire	50/50 blend
Rate of return (RoR)	11.3%	10.4%	10.9%
Standard Deviation (vol)	20.0%	20.6%	14.4%
Drawdown (DD)	32.5%	44.5%	23.9%
RoR/DD	0.35	0.23	0.5
RoR/Vol	0.57	0.5	0.83

Source: BRKA stock price. Percentage change in stock price month-over-month as of each month-end across the period covered

EFFICIENT FRONTIER



Source: Drury Capital

The takeaway from the article was that a pure equity investment can be profitable, but that the combination of equity investment with other strategies, such as managed futures, may be return-enhancing as well as volatility-reducing.

The motivation for the Berkshire experiment was a *Financial Times* article in October 2013, published at a time when many CTAs were facing a third consecutive year of losses.

It suggested that chasing trends was a "dangerous game", that momentum was a losing strategy for long-term investors, and that even a moderately successful attempt at using fundamental value for stock selection wins out in the medium and long term.

Drury Capital founder and CEO Bernard Drury begged to differ with this unfavourable comparison, and sought to demonstrate why, citing the example of one of the world's most famous value investors as a representative of that strategy.

Unlike many of his peers, Drury did not start out as a systematic trend-follower. He began his career as a fundamental trader in the grain markets and undertook research in momentum trading seeking a means to potentially improve his returns as a discretionary trader.

Drury Capital was registered as a CTA in 1992, and got early funding from a Chicago-based futures fund of funds, managing a discretionary grain trading program.

The current systematic program has a track record dating back to 1997, and Drury Capital, which today manages around $250m, is considered a long-term systematic trend-following shop.

Unlike many larger peers, it maintains a relatively heavy exposure to commodities, perhaps not surprising in view of its founder's background.

Getting into grains

In contrast to many in the hedge fund industry, Drury worked for years as a cash commodities trader. It was an academic background in Russian studies that drew him toward his career choice.

During the 1970s, entries by the Soviet Union and China as buyers in the world grain markets had caused major disruptions in the marketplace, recalls Drury.

"There was a certain glamour to the grain markets back then," he says. "Price moves were often dramatic in the 1970s, sometimes led by foreign buying, sometimes by crop concerns in the US."

As a student, Drury was one of the few Americans who during the Cold War went to the Soviet Union to study – once during high school and twice during university.

An opportunity to join the commodities giant Louis Dreyfus in 1978, straight out of Dartmouth College, dovetailed well with his Russian studies background and interest in international business.

Drury accepted a trading position and started out at the Minneapolis Grain Exchange, a transportation hub for the grain trade at the head of the Mississippi River.

For almost two decades Drury worked as a trader or analyst in the grain markets.

His evolution to systematic manager began while he was working at the Chicago Board of Trade in 1995.

He had arrived in the Windy City with ambitions to become a successful grain trader. However, while earning an MBA from the University of Chicago, Drury was impressed by two areas of study – decision-making and investments.

The study of decision-making in an uncertain environment explored the means by which model-based approaches could substitute for discretionary approaches.

The study of modern portfolio theory emphasized the value of diversification into uncorrelated assets in the creation of a portfolio.

TABLE 2: DRAWDOWN ANALYSIS (May 1997 to Feb 2015)

	Drury	Berkshire	50/50 blend
Drawdown	32.5%	44.5%	23.9%
Peak to trough (months)	32	14	10
Trough to peak (months)	23	47	8
Total (months)	55	61	18

Source: BRKA stock price. Percentage change in stock price month-over-month as of each month-end across the period covered

Together they encouraged him to seek a rigorous systematic approach to trading a portfolio with greater diversification than just grains. Drury decided that the most accessible means of trading greatly dissimilar markets was to trade them with technical, not fundamental analysis.

Putting all this together, and drawn to the consistency, rigour, and embedded diversification of systematic approaches, he began to develop and refine his own trend-following system.

In 1994, he joined the legendary hedge fund trader breeding ground of Commodities Corporation (now Goldman Sachs Hedge Fund Strategies) in Princeton, New Jersey, whose alumni include Paul Tudor Jones, Louis Bacon, Mike Marcus, Ed Seykota and Bruce Kovner.

Commodities Corporation was acquired by Goldman Sachs in 1997. At the time of its acquisition, the firm, which was originally renamed Goldman Sachs Princeton, had approximately $2bn in assets under management.

'Spinning out' of Commodities Corp

Like a number of Commodities Corporation traders, Drury went on to set up his own operation, enabling him to reach a broader investor base.

He focused on building Drury Capital into a money management company in its own right, in separate offices in Princeton.

Drury launched the Drury Diversified Trend-Following Program in May 1997. In its first 12 months, the program, then trading around 30 markets, predominantly commodities, with one system, advanced 59%, performance data shows.

Its first full calendar year of trading, 1998, saw the program return 47%.

"We were fortunate and hit the ground running," recalls Drury. "There were pronounced bullish trends in interest rate markets and bearish trends in commodities."

The Drury program has since evolved with the diversification of sub-systems and the addition of new markets – it currently trades around 60.

These enhancements have reduced its expected annualised volatility from 25% to 18%.

However, Drury notes that there remains "great similarity between the way we do things now and the way we did things at the start".

The long-term timeframe is the same, it's still a trend-orientated program, and commodity futures account for roughly half of the portfolio's exposure. The greater commodity exposure than many peers is something Drury is keen to retain.

"We try to get the best risk-adjusted rates of return that we can," he says. "The strong representation of commodities in the portfolio is not a sentimental attachment to my earlier years – it's what research tells us to do.

"I think that you get better returns with a robust mix of instruments over the long term," he explains. "50/50 is not a magic number, but in principle, our techniques seem to work best when applied to both financials and commodities.

"Some of the larger firms may have liquidity issues and they can't trade meaningful positions in corn, let alone nickel or orange juice."

Drury Capital's longer holding periods appear to have given the firm some protection against the choppy, 'risk-on/risk off' markets of recent years, which have 'whipsawed' some short-term managers.

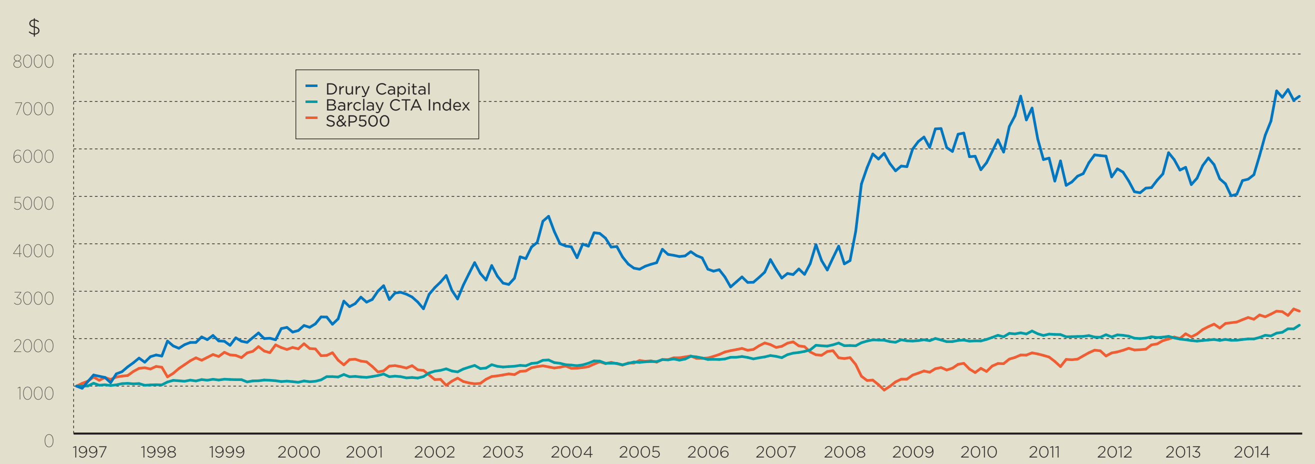
Drury Capital's average trade holding period is around four months. Winning trades tend to last about eight months, while losing bets are typically cut after around two months.

The firm's trading frequency is around half that of a typical medium-term trend-follower, according to statistics seen by *CTA Intelligence*.

"We trade small enough so that we can withstand the random ups and downs in the marketplace day-to-day and therefore remain in trades for a long period of time," says Drury.

The inspiration for his models came not from having worked at any other trend-following CTA, but rather observations from grain trading and from recognition of the importance of management of open equity.

GROWTH OF $1000 IN DRURY DIVERSIFIED TREND-FOLLOWING PROGRAM



Drury Capital's risk management system, which seeks to distinguish between trending and random conditions, results in different entry and exit points from other trend-followers, the firm's return profile shows.

"We don't have to be in the market at all times," Drury notes. "A range-bound market, for example, could be a bad candidate for a trend trader. "

For Drury Capital, the research process is ongoing and forward thinking.

"I think that there are certain classic ways in which markets behave over time and so rather than trying to adapt systems to supposed changes in the market environment, with the risk of over fitting to the recent past, the effort has been more orientated towards taking fresh ideas and researching them," explains Drury.

Compared to 1997 when the program was just starting, the firm now boasts an experienced team of people and a mature technology structure that has been almost 20 years in development.

Drury Capital's core belief has been that there are certain behaviours associated with markets and that there will be a mix of more favourable and less favourable periods for its strategy. Deviation around the mean performance is expected.

The firm didn't rush to make any particular changes following 2011 and 2012, which were losing years. It then returned 9.6% in 2013, when many other CTAs struggled, and delivered a strong 20.8% return last year.

The decoupling of markets, a return of volatility, and the exit of long-only money and bank trading units from commodities markets has been helpful to Drury Capital.

The resumption of fundamentals and the resulting price moves, which have taken some investors with short memories by surprise, have re-energised the potential of the firm's strategy to profit.

"As traders say, the best cure for high prices is high prices, because high prices discourage demand and encourage substitution while increasing and bringing to market new supply," notes Drury. "So, for example, in response to record high grain and soybean prices of recent years, we now see record acreage in the United States and globally.

"Likewise, high energy prices have led to ever greater efficiency on the part of the energy user, as well as to the boom of shale oil production in the US and to record global production and inventories of oil."

Drury adds: "We saw this in energies in the last year as the weight of expanded supplies, combined with a slowing of global demand and the strong US dollar, led to a major downward move in energies. Sometimes – and this is a strength of trend-following – a technical signal generates a profitable trade that even the sector specialists may not foresee."

Well-oiled machine

Today, Drury Capital employs a team of nearly 10 in its offices in Princeton.

Equinox Funds, the mutual fund specialist, and Eagle Trading, a systematic macro manager, are located in the same building. Asset management giant BlackRock is a neighbour.

The senior management at Drury Capital have worked together for more than a decade.

Stephen Graf, the firm's CTO, worked at Goldman Sachs Princeton (Commodities Corporation) from 1991 to 2002, latterly responsible for the technical design and implementation of systems for risk management, trading, and research.

Rafael Juan, a former executing broker for futures, foreign exchange, metals, swaps, options, equities and other asset classes on a multitude of global exchanges, as well as over-the-counter, heads trading operations. Graf and Juan both joined in 2002.

Ron Levinson, a former financial services consultant and JP Morgan technology pro, came onboard in 2004 as chief compliance officer.

On the marketing side, former head of European sales for Winton Capital, Bill Miller, joined the current leadership team in 2012 as Drury Capital's head of sales and marketing.

"We've got a very professional staff. We've got operations down to a tee. We run like a well-oiled machine," says Drury. "Everybody plays well in the sandbox, is serious, smart, well-educated and tech-savvy. It's a collegial, highly qualified team."

After the resumption of strong returns for the industry and renewed investor interest in managed futures, the focus for Drury Capital, as with many CTA firms, is on re-growing assets.

50/50 is not a magic number, but in principle, our techniques seem to work best when applied to both financials and commodities

Despite growing investors' money by 76% in 2008, Drury Capital was left with the same AuM at the end of the year as it had at the beginning.

The "cash machine" effect of investors redeeming from CTAs due to losses in other investments hit many managed futures firms. The industry's underperformance of recent years has hurt Drury Capital's ability to raise money, despite its more favourable performance, according to its founder.

"The industry has been undergoing a contraction phase," says Drury, who adds he is optimistic about the future. "We'd be happy to have greater AuM. We believe in the strategy and see that it serves as a diversifier to other asset holdings. Operationally, our business is very scalable."

Just how big could the firm grow? Several billion dollars in AuM would be manageable with the current program, reckons Drury.

As the investment world congratulates Buffett and moots his potential successor(s), Drury offers an encouraging thought for Berkshire Hathaway investors: diversify into managed futures. CTA