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Blackthorne Capital, Inc

Building on the past

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Building on the past

An abstract mathematician reaps returns

By Marsha Zapson

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Vital Statistics

Assets under mgt	\$10.5 million
Combined Index Program	\$7.0 million
Financial Futures Program	\$3.5 million

Minimum investment

Combined Index Program	\$50,000
Financial Futures Program	\$100,000

Registration CFTC

Fee structure

Management fee	2%
Incentive fee	20%
Commissions	\$20

Ratios

Avg margin-to-equity	10%
Ann comm-to-equity	4%
Roundturns/\$M/year	2,500

Auditor N/A

A dichotomy emerges in conversations with Timothy Morge, founder of Blackthorne Capital, Inc. He's an abstract mathematician and former economist—a theorist who sees beauty in the charts of various commodities. Yet, he's eminently practical: His goal is to make money for his 95 investors.

And if his index program's performance to date is any indication of alpha, Morge is meeting his objective and then some.

During his 25-year career, Morge has been a floor trader on the CME, a cash forex trader, an institutional arbitrageur, an offshore fund manager, a private speculator and a bibliophile. He opened Blackthorne in July 1991, and launched his Lucida Combined Index Program in September 1999. But his attraction to commodities dates back to his teens when he accessed an extensive trading library, replete with manuscripts of technical analysis circa 1930 through 1950, belonging to a family friend.

Later, while attending the University of Chicago, a roommate's father, who was a floor trader, presented the students with a trading problem to be solved using a computer. Because computers were then in their infancy, the time and programming the task consumed are almost inconceivable today, he says: three or four days in the mid-1970s versus five or 10 seconds today.

Blackthorne's current program, though not directly descended from his student work, can trace its origins from that period. Morge was—and continues to be—influenced by Dr. Alan Andrews, Roger Babson and George Marechal, all doyens of technical analysis' golden age.

Isolating a pattern

Once Morge began working, he was able to purchase old trading manuscripts and books, amassing, he estimates, a library that today includes some 10,000 items. During one estate sale, he acquired 150

boxes containing hand-drawn charts and correspondence between, among others, Andrews and Marechal. The debate between those two, as manifest in the letters, sent Morge on a mathematical investigation that ultimately shaped his current trading model.

He sought a specific pattern, which was neither intuitive nor visually present in charts. "It was maddening at first," says Morge. "But we did isolate it, and now describe it as a zero state, which means the market is in equilibrium. It's the market's next move out of that state that propels the model's next move."

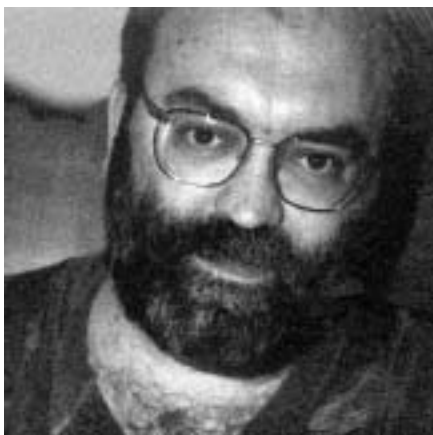
From that zero state, says Morge, the market will regain its energy. And at that point, he will go either long or short. The model generates entry levels for the upside and downside, as well as stop-losses and profit targets.

This model, which is the basis of the index program, is constantly reexamined by Morge and his partner, Gary Fritz, because markets change, he says. "The markets today are much different than they were in 2000, for example. The difficult part is creating money management and risk reward rules that exploit the non-changing zero state pattern in an ever-changing market."

Blackthorne, with some \$10.5 million under management, currently runs two programs. The first, the Lucida Combined Index Program, has some \$7 million under management and is open to all investors. It trades only Nasdaq 100 and S&P 500 futures.

The Financial Futures Program, with some \$3.5 million under management, trades bonds and currencies (euro, Swiss franc, Japanese yen). Because it is still being tested, it is open only to qualified investors; however, Blackthorne plans to officially launch it for all investors in the near future.

Blackthorne's trading model is applied to both programs, although each has slightly different trading characteristics. The index program is short term ori-



Timothy Morge

ented, completing about 66% of its trades the same day.

"The Nasdaq is a vehicle in which the signals, when they're good, happen immediately," says Morge. "In 2000, our average winning Nasdaq trade was about six hours; now a 3% move takes a full day. Nasdaq trades are still around one day, while S&P trades average three-and-a-half days."

The Lucida program has a robust compound annualized return of 39.3%, compared with 3.4% for the Zurich stock subindex median. However, the program is down 7.9% through May, whereas the median is up 4.1%.

During this first quarter, the program suffered three consecutive monthly losses—the first time such a thing had happened. Morge says the program ran into two problems: gaps in the market and quiet periods.

"In the first, we'd put on a position and a gap would open on the other side—it would knock us out. Then the position would move back the other way, and we didn't have a way to reenter at a good risk/reward level—we would miss the move."

In the latter, he says, the market was "so quiet for protracted periods, that it was difficult to distinguish between the quiet periods we sought and general market quietness."

For those reasons, "we spent a lot of time upgrading the model and adjusting

Blackthorne Capital, Inc

PERFORMANCE HISTORY

September 1999– May 2002

	Lucida Combined Index Program	Median of Zurich Stock Subindex	S&P
Return (%)			
Annual comp rate	39.32	3.38	(6.27)
1999 (4 mths)	31.67	3.40	11.73
2000	52.04	7.92	(9.09)
2001	35.08	(2.40)	(11.88)
2002 (5 mths)	(7.94)	4.11	(6.50)
June estimate	0.00		
Risk (%)			
Annual std dev	29.77	8.31	17.15
Semideviation	6.87	6.03	12.55
Maximum decline	(11.17)	(11.66)	(30.49)
Return/Risk			
Sharpe Ratio	1.15	(0.50)	(1.00)
Comparison with Zurich Stock Index			
R-Squared	0.01		
Alpha	2.86		
Beta	0.31		

the math," he says. "We made a major change, not in how we apply the patterns, but in the models' ability to measure the pattern more precisely."

Since then, there has been a significant change in the signals. April and May were positive, and June is estimated to be flat.

The tolerance test

Blackthorne never risks more than 3.2% of capital on any one position, says

Morge. "We know the initial stop before we take the position, and we put both in the market simultaneously. Stops are never moved for the worse, always for the better; and as soon as possible we move to break even."

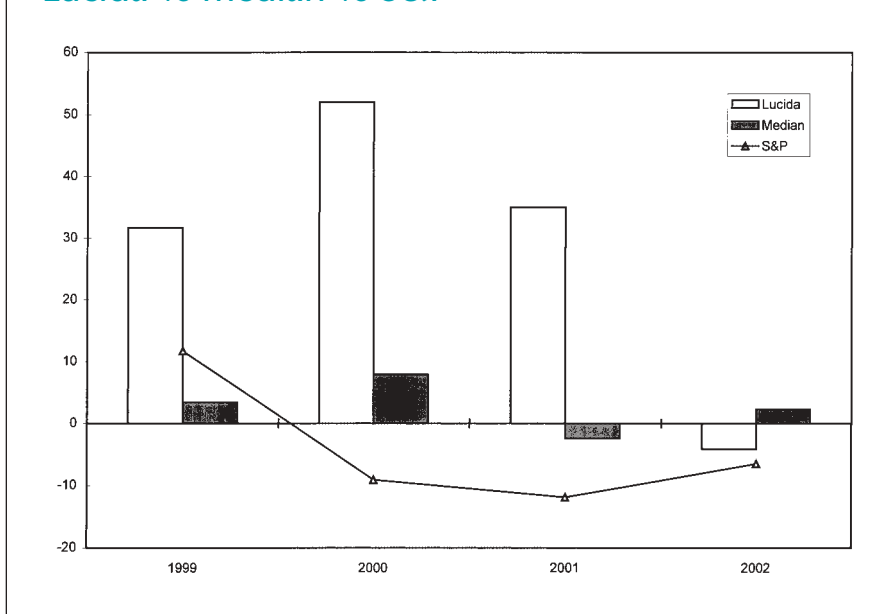
In general, Morge says, he tries not to go beyond an 11.0% decline, peak to trough. So far, his maximum decline is 11.2%, which compares favorably with the median's 11.7%; he is, however, more than three times as volatile as the median.

"Investors say they're in for the long haul and that a 15% drawdown is not a problem, but when you approach 9% or 10%, that's when the investor's real tolerance emerges. If we're going to make 35% per year, we're going to have drawdowns greater than 11% occasionally. But the fewer and the smaller they are, the less we'll have to find out an investor's risk tolerance."

And for that reason, Morge says, he prefers a wide investor base. "I have some large investors now, and I'm in some big pools. I've lost 15 or 20 investors along the way, but I still have my first 10."

Because of his performance, he says, many have suggested that he bump up his minimum to \$250,000 or \$500,000 and lose the smaller accounts. He resists. He sees no reason to close them, but he also believes "all traders are created equal in the eyes of the market." ■

Lucida vs median vs S&P





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