CTA Cycles – Surges follow the declines

Editor's Comment:

Investors tend to look at money managers, in all categories, based on recent returns. More often than not, investors like to buy a manager that has had "good performance". This leads them to buy after a profitable period or surge, and sell when disappointed during a down period or drawdown. This research provides investors the logic behind doing just the opposite: buy the declines and enjoy the surges.

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Investors tend to look at money managers in all categories based on recent returns. More often than not, they like to buy a manager whose performance they consider good. This leads them to buy after a profitable period or surge, and sell when disappointed, during a down period or decline.

But some recent research, focused on managed futures, provides investors with the logic of doing just the opposite: buying the declines and enjoying the surges.

Background on the study:

In late 1999, the managed futures industry was in a funk. Several firms had announced that they were closing their doors and the performance of the MAR Trader Advisor Qualified Index (TAQI) was looking like it might be negative for the year.

Discussions with potential clients outside the futures industry about using the rough year as an opportunity to buy various trading advisor programs typically elicited responses such as, "CTAs have lousy performance" and "They've lost money this year."

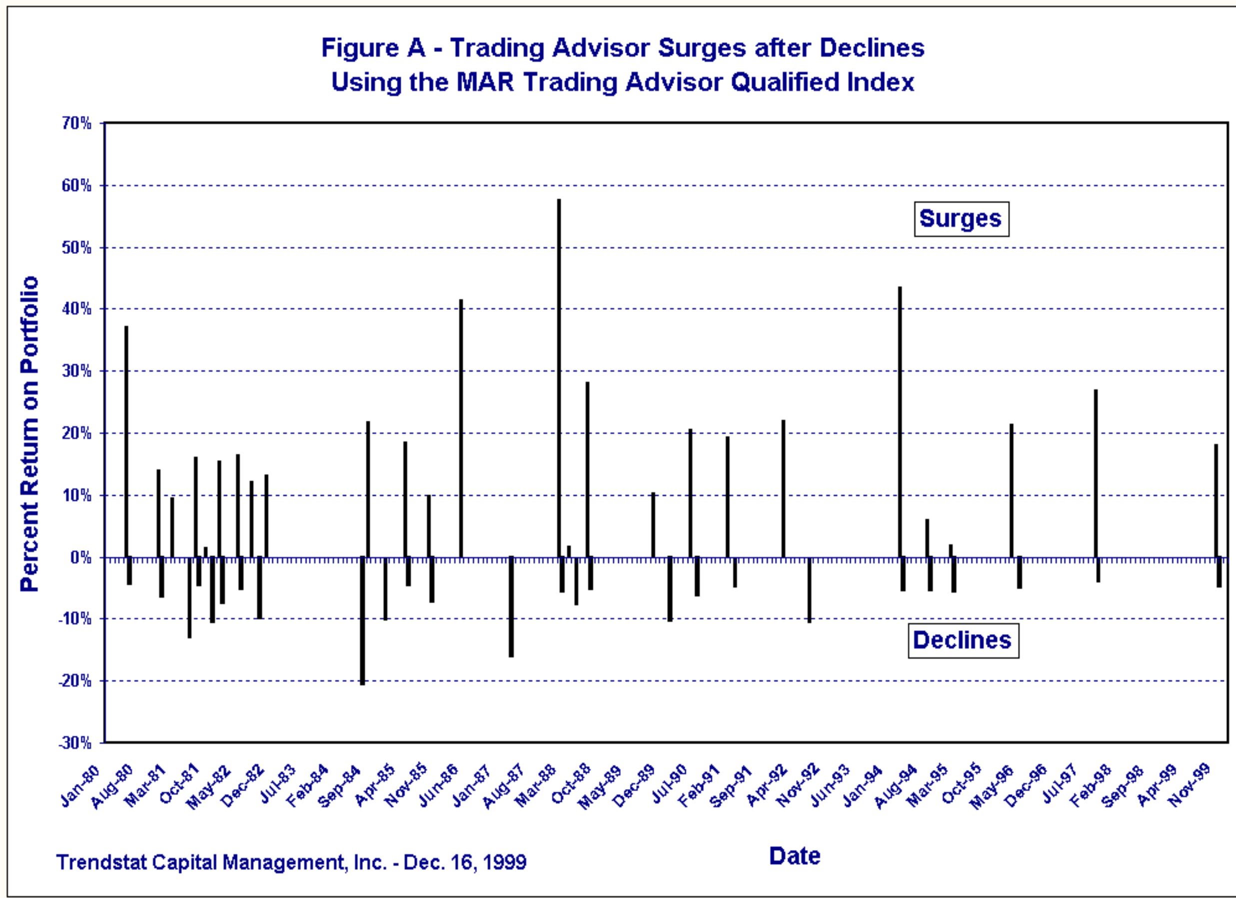
But, long-term experience in the industry has shown me that performance has cycled in the past and is likely to do so in the future. So I decided to take a look at the trading advisor cycles and examine the surges following the declines.

The Study:

I first obtained data on the MAR Trading Advisor Qualified Index, which I will call TAQI Index, back to January 1980. I then created a computer program to search for every instance where the CTA Index declined more than 4% from recent highs. In my experience, anything less than a 4% drawdown usually doesn't bother most clients.

I used the program to calculate the subsequent run up in profits (surge) following a decline until such time as the CTA Index went into its next drawdown of at least 4%. The results are plotted in Figure A below.

Figure A



I looked into the performance of the index over the almost 19 year period, calculating the averages, standard deviations, maximums and minimums for drawdowns and surges. The results are listed in Figure B below:

Figure B – Statistics on CTA Drawdown and Surges

Percent threshold to initiate a drawdown = 4%
Number of drawdowns since Jan-80 = 25
Average number of drawdowns per year = 1.27

	Average	St. Dev.	Maximum	Minimum
Drawdowns over threshold	- 7.72%	4.08%	-20.39%	- 4.08%
Surges following a drawdown	19.46%	13.48%	57.78%	1.62%

Buy the drawdowns:

The managed futures industry has had drawdowns and it has had some hugely profitable years. This is not likely to change. On average, the industry has had drawdowns of -7.7% followed by average surges of +19.5%. The surges have typically happened during periods of price volatility that has negatively affected other forms of investing, for example, in October 1987 and August 1998.

Many studies have shown that CTAs have great potential to diversify traditional stock and bond portfolios, as well as traditional hedge fund investments. Given the above information on surges following declines, the logical way to invest in CTAs is to get excited about investing during times when recent performance has suffered. The end of 1999 is one of those periods. It'll be interesting to see what the new millennium brings.