Index

Note: Page numbers followed by f refer to figures.

Accounts, 69–70
Accredited investors, defined, 70
Allocations, constraints on, 324–325
AlternativeEdge Teamwork Index, 281
AMLs (anti-money laundering regulations), 70
Anecdotes vs. analysis, 152
Approaches, comparison of, 291–296
Arbitrage, 22–23
Assets, 5–6, 17, 332–333
Assumptions, simplification of, 114–115
Autocorrelations
and compound returns, 161–163, 164f, 176f
and daily returns, 131–132, 132f
distribution of, 157–161, 159–160f
estimates of, 156–163, 158f, 161–162f
and returns, 179–180f
Backfill months, 48f
Barclay Hedge index, 2, 42, 154, 160f, 167
Benchmarks, use of, 101
Bias
in distributions, 258
in estimated Sharpe ratios, 328–331
reducing, 263
selection, 3
and skew, 142–143
survivorship, 44–45
Black boxes, use of, 6
Breakout period, shortening, 309–310
Buffers, 32–33, 77–78
Buys and sells, classification of, 240
Cash
buffers, 32–33
dormant, 225
management of, 18–19, 38–39
Cayman Islands, 60
CF 13, 154, 159f
CF, generic returns, 159f, 160f
CFTC (Commodity Futures Trading Commission), 68
Checks, fat-finger/no-finger, 137–138
Collateral, 18–19
Commodities, 94–97
Confidence, false sense of, 145–146
Contest, portfolio managers, 262–270
Contract rolls
problems of, 82
rule for, 109–110
schedule, 83f, 111f
timing of, 87
and transaction costs, 86–87
Contracts
E-mini S&P 500, 20–23, 109, 229f
S&P 500 specifications, 21–22, 22f
terms of, 21
weights of, 114
Convenience yield, 23
Correlation distributions, overlapping, 260f
Correlations
cluster results for, 125f
conditional, 263f
distributions of, 133f, 257f, 258f, 298f, 317f, 318f
estimates of, 256–262, 258–260
## Correlations (continued)
- Evidence on, 310–313
- And future results, 270
- Heat map, 290
- Historical and realized, 299
- Implied, 259, 259, 261, 306, 306
- Importance of, 316
- Between indexes, 104–105, 105
- Long-term, 313, 314
- And number of assets, 302
- With other investments, 307
- Pairwise, 305–306, 305
- Pairwise vs. implied, 301
- Past and future, 261, 282, 283
- Questions about, 104–107
- Regression summaries for, 262
- Shape of paired, 260–262
- Short-term strategies, 312
- Stability of, 262
- Between two assets, 257–258
- Vs. mean return, 275–277

### Costs
- Calculation of transaction, 81–82
- Of dropping assets, 294
- Interest income and cash management, 32
- Transaction, 86–87

### CPOs (commodity pool operators), 60–62
- Crable Capital Management, programs of, 49, 50
- CTA funds, 58–62, 67

### CTAs (Commodity Trading Advisors)
- Annual returns of, 57
- Assets under management, 43–44, 43
- Defined, 1–2
- Information on, 42
- Number to choose, 53, 55–58
- Reasons for leaving databases, 45–46
- Regulation of, 68
- Returns of, 4, 42, 202–203, 210–214, 211
- And revisions of daily data, 134–137

### Currency hedges, 31

### Correlations
- Daily, 139, 145–146
- Daily vs. monthly, 139, 324
- Fitting the curve to, 237–238
- Market-depth, 227
- Overlapping, 167–168, 170, 175
- Quality of, 130–138
- Reliability of, 129
- Revisions in, 134–137, 135–136, 137
- Short-term traders index, 132–137
- Updated, 175–176

### Databases, 44–46, 45, 46
- Data sets, 229–234, 248–249, 282–283, 287
- Deleveraging, and drawdowns, 193, 194
- Distributions, 184–185, 192–196, 274

### Diversification
- Advantages of, 7–8, 337–338
- And asset correlation, 261
- Benefits of, 315
- Costs of, 320–321
- In CTAs, 55–58
- Importance of, 297
- And risk, 256, 299
- Rules of thumb for, 54
- Diversification ratio, defined, 255

### Drawdowns
- Calculation of, 190
- Core function, 190–192
- Defined, 168, 182–183
- Distribution of, 148–150, 149–150, 173, 183–190, 184, 185, 192–196, 196
- Effects of returns and volatility on, 188
- Future, 198–199
- Inception analysis, 37
- Influences on, 186
- Length and depth of, 172–175
- And liquidity, 38
- Observed, 174, 193, 194
- Patterns of, 181–182
- Peak-to-trough, 181
- Probability of, 198
- Rule for firing managers, 218, 218
- Simulation of, 187
- Statistics, 36
- Variables for maximum, 189, 190

### Due diligence, 338–339
Index

Eigen analysis, 208–210
Eligible set, resilience in, 295–296
Equity options, 204
Estimates, imperfect, 319
Estimation vs. evaluation, 328
Eurostoxx, 31, 243
Expectations, 333–335
Expiration cycles, 82, 110
Fair value, 23–24, 24 f, 25 f
Fast-day/slow-day averages, 75–78
Fees, 49–50, 61–62, 89, 217–218
Finance, psychological, 6
FINRA (Financial Industry Regulatory Authority), 68
Fitting the curves, 237–238
FOMC announcements, effect of, 244–246
Foreign currency, 31–32
Foreign exchange, 11. See also global markets
Funding levels, 19, 37–38
Funds
handling of, 38–39
multi-CTA, 60–62, 67 f
subscription procedures for, 71
turnover in, 293–295
Futures
and data, 129
expiration of, 110
managed, 1
market impact of, 246 f, 247 f
mechanics of, 20–27
prices of, 82–86, 84 f, 85–86 f
relationship with cash, 22–25
typical portfolio of, 27–39
vs. conventional money management, 17
Gains and losses
consecutive, 170–172, 171 f, 178 f
daily, 33–36, 33 f, 34 f, 35 f, 36 f
settling up of, 18
and volatility, 156
Give backs, 98
Global markets, 206–208, 207 f, 215. See also foreign currency; foreign exchange
Hedge funds, 5, 199
Highest relative frequency approach, 287, 288
Holding costs, 23
Holding periods, 308–313
Humility, need for, 301
IFEMA (International Foreign Exchange Master Agreement), 69–70
Illmanen, Anti, 5–6
Indexes, 304–305, 314–315, 316
Information requests, 69–70
Inherent return, 89–91
Inside the Black Box (Narang), 6
Instantaneous, defined, 239, 240 f
Interest, foregone, 222
Interest income, 88–89
Investments, minimum/maximum, 71
ISDA (Institutional Standard Derivative Agreement), 69–70
ISDA (International Swap Dealers Association), 69
Knowledge, imperfect, 303
Kurtosis, 185–186
Lags, 156, 221–222, 225
Lead programs, 44
Leads and lags, 221–222
Leverage, and worst returns, 336–337
Limit order books, 236–237
Liquidation/reinvestment, 220–224, 221 f
Liquidity
calibrating for hidden, 243
and commodities, 94
and CTAs, 9–10, 11
data on, 229
estimates of hidden, 239–243
in funds, 60
hidden, 238–243, 242 f
phantom, 238–239
in short-term strategies, 314
during the trading day, 227–228
Lo, Andres, 325
Lockdown, and reported return, 135 f
Losers, throwing out, 331–338
Loss carry-forward, 217–220, 219 f
Index

Madoff, Bernie, 5
Managed accounts
advantages of, 54
maintenance of, 68
overview of, 62–66
structures of, 63–64 vs. funds, 60, 67 f
Management, costs of active, 224–225
Managers
choosing, 295 f
closed, 71
conditional predictions for, 284 f, 285 f
correlation coefficients for, 286 f
correlations between, 317
dropping and adding, 267 f, 270–275, 277
evaluation of, 332–333
experience of, 197, 197 f
firing of, 219–220, 220 f, 254
optimal weights for, 265 f
past and future correlations, 283–287
rating of, 290–291
risk profile of, 144–145
selection of, 264–265, 266 f
Sharpe ratios of, 253
team player vs. superstar performance, 254 f
volatility of, 143–144, 144 f
z-scores of, 273
Marcus, Alan, 272–273
Margins, 29–30
Margin-to-equity ratios, 32–33
Market makers, 234–237, 235 f
Market periods, overlapping, 131
Markets
capping, 114
environment of, 98
impact profiles of, 243–246
over-the-counter, 10
positive/negative carry, 82, 84
selection of, 80 f, 108–109
Master feeder structure, 60
Mean reversion, 151
Mean/variance approach, 293
Models
80/40 breakout, 309 f, 310–313
breakout, 309–313, 310 f
case study, 1994–2003, 89–94
market-depth, 249–250
moving average, 123 f, 126 f
Newedge CTA Trend Sub-Index
correlation, 115–117, 116 f
performance of, 115–124
sector weights in, 126
trend-following, 311–313
Moments, 323–324
Momentum trading. See trend following
Narang, Rishi, 6
Net asset values, 3 f, 182–183, 183 f, 203 f, 219 f
Net liquidating value, and futures, 18
Newedge AlternativeEdge Short-Term Traders Index (STTI). See STTI
Newedge CTA Index
correlation cluster results, 99–100, 100 f, 103 f
data for, 131–132
net asset values, 107, 107 f
source for data of, 42
usefulness of, 51, 53
use of, 55, 101–102, 130–131, 202–203, 203
Newedge CTA Trend Sub-Index
correlation cluster results, 99–100, 100 f, 102–104
correlation with models, 115–117, 116 f
net asset values, 107, 107 f
profitability of, 120
and volatility, 118, 119 f
Newedge Trend Indicator, 124
NFA (National Futures Association), 68
Notional funding level, 19, 38
Opportunity losses, 222–223, 225
Optimal weights, 322–323
Order imbalance, 231–232 f, 231–233, 233 f
Past returns, 151–152, 169 f, 177 f
### Index

Performance
- comparison of, 267–268
- evaluation of bad, 272–274, 273
- expected, 338
- individual vs. portfolio, 253
- prediction of future returns from past, 175, 269
- worst, defined, 271–272
- year-by-year comparison, 292

Periods, choice of, 307–308

Persistence, defined, 151–152

Platforms, 66, 67

P/L gains and losses, 1995–2004, 90

Portfolios
- computations required for, 264
- construction of, 81, 110–114, 279, 281–282
- correlation coefficients for, 286
- cost of diversified, 224
- distribution of simulated, 334
- evaluation of, 338–339
- formation of, 266
- inclusion in average rho, 289
- low-correlation, 255–256, 280, 288
- makeup of, 266
- mean/variance, 280–281
- optimal vs. equal-volatility, 328
- randomly formed, 288
- rebalancing of, 115
- returns on, 55, 96
- risk by year, 96
- sample, 28, 29, 112–114, 113
- Sharpe ratios for, 268–270
- structuring options, 53–54
- Superstar, 275, 280, 291, 293
- Superstar vs. Teamwork, 300, 330–331
- synthetic, 25–27
- Teamwork, 279, 280, 291
- weighting of, 5

Power of attorney, 62

Prices
- concatenation of series, 110
- histories of, 108–109
- mispricing, 5–6
- relationship between futures and spot, 22–23
- spot, 82, 84
- volatility of, 245
- volume-weighted average, 240–241
- of worst performers, 336
- Profits and losses, analysis of, 120–124
- protected Cell Companies, 64–65, 65
- Purchasers, qualified defined, 70

Randomness, effect of, 319–320

Rates of return, 33–37, 94

Registration status, 68

Resizing, 88

Results, generic vs. track records, 93–94

Return and leverage, rates of, 94

Return correlations, 8

Return distributions, 147–148

Return histories, 9

Return moments, value of estimation of, 276

Returns
- actual vs. simulated, 335–336, 335
- analysis of, 108–110
- backfilled, 48, 49
- in building a portfolio, 296
- calculation of, 194, 307–308, 307
- and commodities, 97
- compound, 161–163
- daily vs. monthly, 154–155
- and dropping out of databases, 47
- estimated parameters, 277
- forgone, 223
- and future results, 283
- historical, 263–264
- improving risk-adjusted, 321–331
- and past performance, 165, 167
- real vs. synthetic stock portfolios, 26
- reporting of, 41
- risk-adjusted, 56
- runs in, 165
- serial correlation of, 199
- test tally of, 155–156, 155
- volatility of, 19–20, 20
- of worst performers, 336

Returns net of fees, 49–50

Returns on investment with CTAs, 2–4, 17
Index

Rho average, defined, 289
lowest average approach, 287, 289–290, 295

Risk controlling, 124
currency, 31–32
and diversification, 256f
figuring, 235–236
foreign currency, 31–32
and futures, 26–27
in futures, 9–10
management of, 6–7, 8, 9–10, 18–19, 88
market maker’s, 234–236
measurement of, 181
Risk-aversion parameter, 243f
estimation of, 243
Ross, Stephen, 9, 338

Rules 5 percent rejection, 333
80/40 breakout, 309–310
drop/add, 271, 282
of execution, 115
maximum relative frequency, 294–295
roll, 109–110
of thumb, 54
Rumsfeld, Donald, 319

Runs calculation of, 163–165
in daily returns, 165
defined, 156
of gains and losses, 166f, 176f
measuring, 170
in monthly returns, 165
and serial dependence, 163–165

Sample size, significance of, 157
Sampling error, 325–326
Samuelson, Paul, 6
Seconds per half-tick, 239
Self-reporting, and databases, 44
Serial dependence, 155–156, 163–165
Serial independence, 152, 157–158
Sharpe ratios
annualized, 294f, 321f
for CTA portfolios, 56f, 59f
distance from optimal weights, 322f, 323f
distributions of, 268f, 301f, 328f, 330f
and drawdowns, 190, 192
and estimated returns, 144, 276
and future results, 270
historical and realized, 269f, 270f, 300f
improving, 321–331
and losses, 271–272
of managers, 253–254, 254f
negative, 272f
one standard deviation bands for, 302f, 320f, 326f, 327f
and optimal weights, 303f
past and future, 283
prediction of, 282
of STTI constituents, 315
use of, 291–293
variability of, 325–326, 331f
Shiller, Robert, 5
Shofterg, 6
Short-term trading programs, 93
Skewness, 185–187
S & P 500 historical volatility of, 204f
and market volatility, 206–210, 208f
returns and degree of volatility, 211–214, 213f, 214f
volatility of, 201, 202f, 203–206
SPAN margins, 29–30
SPVs (special-purpose vehicles), 63–64, 65f
Statistical significance, 157
Stock portfolios, creation of synthetic, 25–27
Stops, 88
Stoxx Index, percent changes in, 31f
Strategies always-in, 153
random, 310–313
short-term vs. long-term, 313
Structured notes, 69
STTI (Newedge AlternativeEdge Short-Term Traders Index), 130, 304f, 316, 318f
Index

Superstar approach, 295
Superstars, performance of, 269
Survivorship bias, 44–45
Sweeping the book, 230
Sweep-to-fill
  calculation of, 227–228
  cost of, 228
  market impacts of, 241–242, 242
  practice of, 230
  profiles, 245
  vs. order size, 237 f, 238
Systems
  breakout, 91 f, 95 f
  differences between, 91–93
  moving average, 95 f, 99
  moving average crossover, 75–78, 77 f,
  92 f, 108, 116–117, 117
  range breakout, 78–79, 79 f, 108, 116

Taxes, 11
Ticker symbols, 21
Time to next trade, 231–232, 231–232
Timing of investments, costs of, 152–153, 153
Total return swaps, 69
Track records
  analysis of, 46–48
  correlated, 326–329
  and drawdowns, 185–187
  and future returns, 151–152
  length of, 45, 48–49, 139, 141
  usefulness of, 338–339
  of volatility estimates, 141 f
  vs. generic results, 93–94
Trade price and order imbalance, 231–233
Traders
  short-term, 131, 132–137, 313–314
  short-term vs. long-term, 308
  systematic, 6
Trading level, defined, 19, 37
Trading programs, 48–49, 228
Trading velocity, effect of, 121–122, 122 f
Trading volume, differences in, 244 f
Transactions costs, 121 f, 223–224, 314
Transparency, 10–11, 62
Trend-following
  in Newedge CTA Index, 102 f
  results of, 58
  returns from, 93 f
  strategies for, 75–79
  use of, 6, 75, 99
  value of, 105, 106 f
True market price, 230–234, 234 f
Underperformance, risk of, 56
U.S. stock market, historical returns of, 202–203
Villeneuve, Pierre, 310
Volatility, 139, 141
  analysis of, 118–120
  confidence intervals, 141 f
  and drawdowns, 191 f
  effect of, 142
  eigenvalues for, 209 f
  eigenvectors for, 210 f
  estimated, 130 f, 139–145, 140 f
  estimation of, 112, 138–139
  expected, 37
  importance of, 190
  and managers, 195, 290–291
  measurement of, 129–130, 204–205
  and modeling, 124
  past and future, 7 f, 283
  and returns, 94, 146–148, 195, 203–206
  risks from, 8
  and stock prices, 201, 205 f, 206 f
  weights of, 112
Weights, 112, 266
Worst, analysis of, 332 f, 333 f, 336–337
Z-scores, 273–274