Contents

Acknowledgments xiii

Introduction: Why Invest in CTAs? 1
  What Kind of Hedge Fund Is a CTA? 1
  Why Do CTAs Make Money? 2
  How Much Should You Invest? 7
  What About the Risks? 9
  They’re a Good Fit for Institutional Investors 10
  How the Book Is Structured 11

PART I: A PRACTICAL GUIDE TO THE INDUSTRY

CHAPTER 1
Understanding Returns 17
  Risk and Cash Management 18
  Trading, Funding, and Notional Levels 19
  The Stability of Return Volatilities 19
  Basic Futures Mechanics 20
  A Typical Futures Portfolio 27

CHAPTER 2
Where Are the Data? 41
  The CTA Universe and Your Range of Choices 42
  The Fluid Composition of a Database 44
  How Backfilled Data Can Mislead 46
  Trading Programs and Lengths of Track Records 48
  Returns Net of Fees and Share Classes 49
  Sources of Data for Indexes of CTA Performance 50

CHAPTER 3
Structuring Your Investment: Frequently Asked Questions 53
  How Many Managers Should You Choose? 55
  What Are CTA Funds? 58
  What Are Multi-CTA Funds? 60
Contents

What Are Managed Accounts? 62
What Are Platforms? 66
How Do You Compare and Contrast These Offerings? 66
Who Regulates CTAs? 68
How Are Structured Notes and Total Return Swaps Used by CTA Investors? 69
What Are the Account Opening Procedures for a Managed Account? 69
What Is the Minimum Investment in a CTA? 71
What Does It Mean When a Manager Is Closed? 71
What Are the Subscription Procedures for a Fund? 71
Conclusion 72

PART II: BUILDING BLOCKS

CHAPTER 4
How Trend Following Works 75
The Two Basic Strategies 76
Making the Systems Work in Practice 79
Transactions Costs 87
Other Considerations 87
Case Study: Two Models from 1994–2003 89
Rates of Return and Leverage 94
Commodities and Capacity Constraints 94
Market Environment and Give-Backs 97

CHAPTER 5
Two Benchmarks for Momentum Trading 99
Data and the Trend-Following Sub-Index 101
Trend-Following Models 108
Laying the Groundwork for Analyzing Returns to Trend Following 108
Constructing a Portfolio 110
Simplifying Assumptions 114
How Did the Models Do? 115
The Newedge Trend Indicator 124
Next Steps 124

CHAPTER 6
The Value of Daily Return Data 129
How Good Are Daily Data? 130
Estimating Return Volatility 138
Distributions of Estimated Volatility 139
Beware a False Sense of Confidence 145
What If Underlying Returns Are Highly Skewed? 146
Effect on Drawdown Distributions 148
CHAPTER 7
Every Drought Ends in a Rainstorm: Mean Reversion, Momentum, or Serial Independence? 151
A Focus on Conditional Returns 152
The Costs of Being Wrong about Timing Investments Can Be Substantial 152
The Data 153
The Test Tally 155
Test for Serial Dependence: Autocorrelation 156
Test for Serial Dependence: Runs 163
Conditional Return Distributions 165
Conclusion 175

CHAPTER 8
Understanding Drawdowns 181
Drawdown Defined 182
What Should They Look Like? 183
What Forces Shape the Distributions? 184
The Distribution of All Drawdowns 185
The Distribution of Maximum Drawdowns 187
The Core Drawdown Function 190
Empirical Drawdown Distributions 192
Reconciling Theoretical and Empirical Distributions 192
Putting a Manager’s Experience in Perspective 197
What about Future Drawdowns? 198
Further Questions 199

CHAPTER 9
How Stock Price Volatility Affects Returns 201
A Look at Historical Returns 202
Stock Price Volatility and Returns on the S&P 500 203
S&P 500 Volatility Dominates Market Volatility 206
CTA Returns, Correlations, and Volatility 210
Conclusion 215

CHAPTER 10
The Costs of Active Management 217
Forgone Loss Carry-Forward 217
Liquidation and Reinvestment 220
Other Costs 224
Conclusion 225

CHAPTER 11
Measuring Market Impact and Liquidity 227
A Very Fat Data Set 229
PART III: PORTFOLIO CONSTRUCTION

CHAPTER 12
Superstars versus Teamwork
The Contribution of Low Correlation to Portfolio Performance
How Reliable Are Correlation Estimates?
The Contest
Dropping and Adding Managers
The Value of Incremental Knowledge about Return Distributions
The Costs of Dropping and Adding Managers

CHAPTER 13
A New Look at Constructing Teamwork Portfolios
Why Look Back?
A Fresh Look at the Original Research
Two New Approaches
Comparing the Four Approaches
Reviewing the Results

CHAPTER 14
Correlations and Holding Periods: The Research Basis for the Newedge AlternativeEdge Short-Term Traders Index
Review of Previous Research
Index Methodology and Construction
How Low Are the Correlations?
Why Are the Correlations Low?
Holding Period and Return Correlation
Why Are There Not More Short-Term Traders?
Replicating the Index
Cautions and Managing the Index
Conclusion
Appendix
CHAPTER 15
“There Are Known Unknowns”: The Drag of Imperfect Estimates

Improving Risk-Adjusted Returns 321
Throwing Out the Losers 331
Due Diligence and Evaluation 338

Bibliography 341
About the Authors 343
Index 345