

## **The Driving Force Behind Profits in the Managed Futures Industry**

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## Where do managed futures returns come from?

I've been asked by clients numerous times why does Trendstat, or any other CTA for that matter, believe they can produce a positive economic return over time? Recently, I had the time, data and idea to research the issue. What I found shouldn't be surprising to most of us that trade the markets, but may give some confidence to those who hire or are considering hiring CTA's to manage some assets.

### Large changes in prices yield profits; small changes yield losses

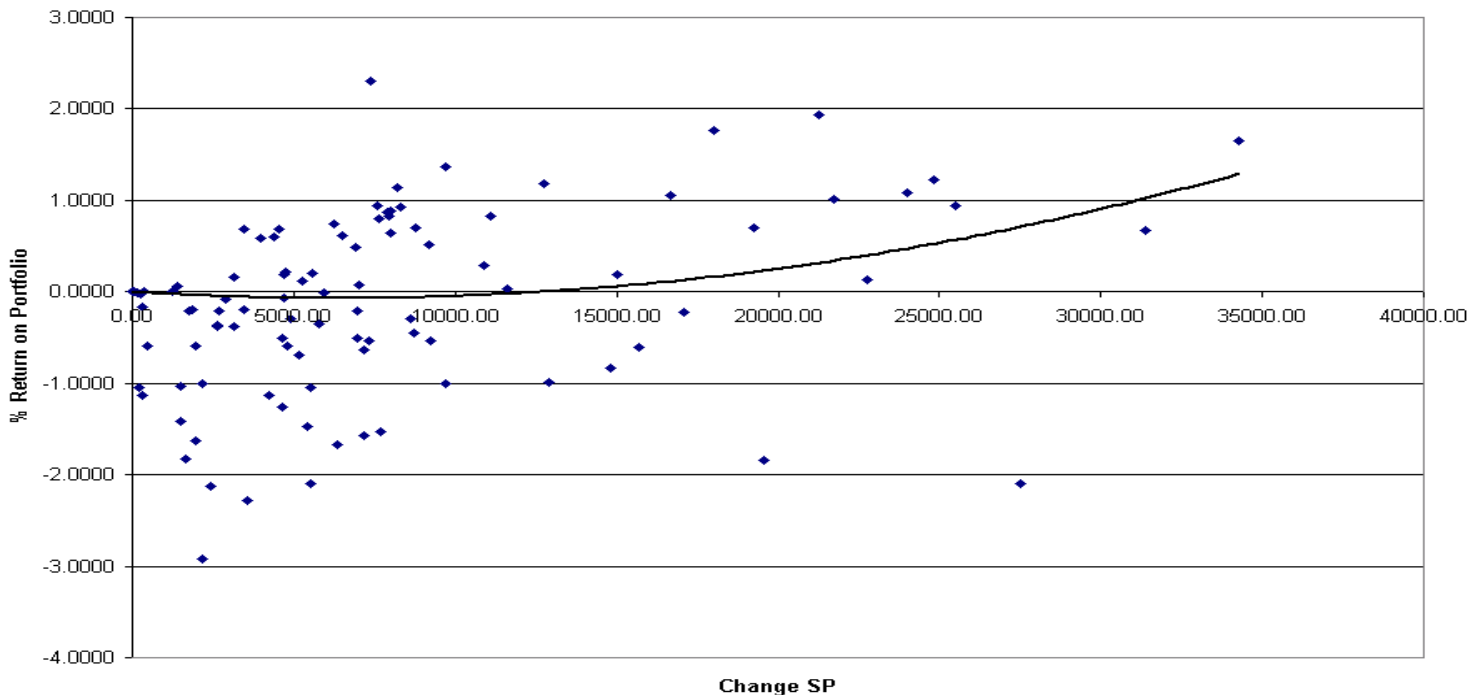
Many times during drawdowns, CTA's are asked why have you lost money? A common answer is: "The markets have been choppy lately." If this premise is correct, then the inverse should be true. When markets move significantly, CTA's, in general, should produce more profits.

I went into Trendstat's databases and used 24 diversified commodity and futures markets. The first step was to look at the profits that a trend-following strategy generated on each of the 24 markets. To do this, I first calculated the profit contribution to the portfolio, in percent, that each market had produced using our intermediate-term model that we call T-Trend. The model is a breakout, reversal system and should correlate well with most intermediate trend-following, diversified, systematic futures traders.

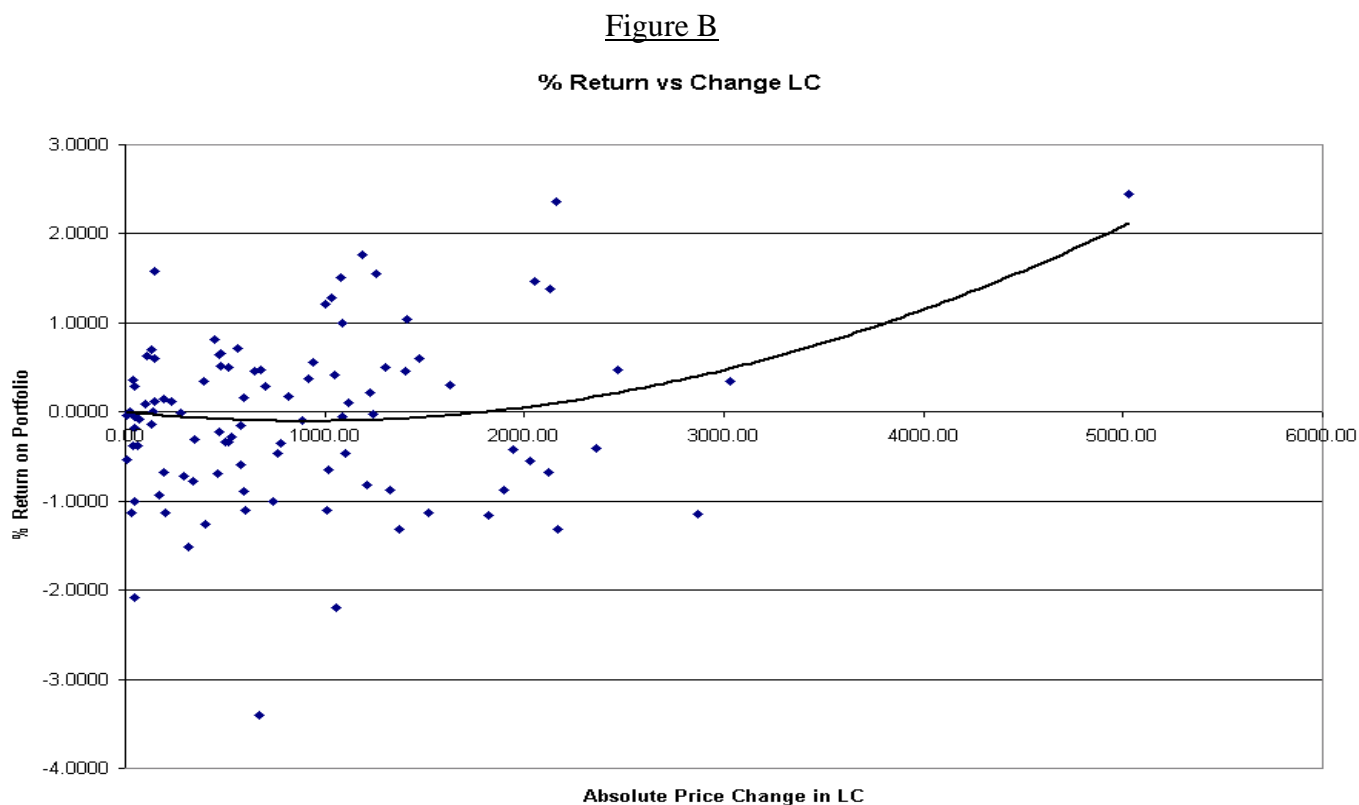
I then calculated the movement each month of each of the 24 markets and converted those movements into US Dollars per contract traded. An example of the S&P 500 Index futures contract (Figure A) shows the correlation between the absolute value of price change and profits. All but one of the 24 markets had the same upward sloping trendline. The only one that failed to exhibit the correlation was a short-term British debt instrument that few people trade.

Figure A

**% Return vs Change SP**



Another example is shown in Figure B. Here the absolute price change month for Live Cattle contracts are plotted against the profits from that market.



The indication looking at these graphs was very clear; the more change a market has during a month, the more profits the portfolio will enjoy from that market. Conversely, at some lower level of net change for the month for each market, you should expect losses. The breakeven point is different for each market. For the Japanese Yen, the break-even was \$1371/contract for a one-month movement. The S&P contracts required a much larger \$10,418 price change per contract for the month to get the profits into positive territory.

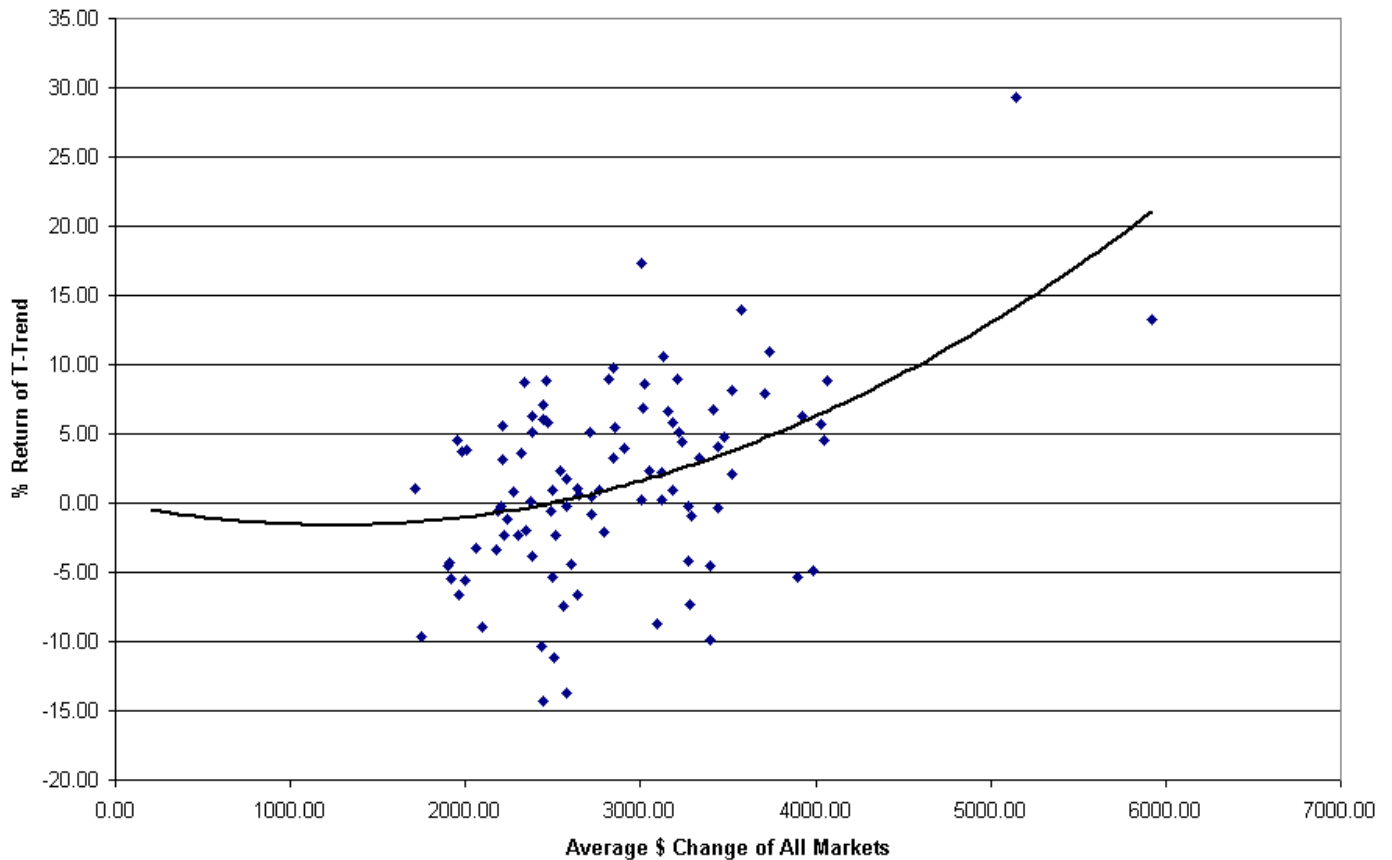
As I indicated above, none of this is any news to those of us who trade for a living. When markets move in a big way, there are great opportunities to make a profit and if there's little movement, it's often a struggle to stay even.

### Same results with a CTA portfolio:

The next step in the research was to take it up one level to the CTA level and see if the correlation between price change and CTA profits held up. To do this, I took Trendstat's T-Trend model and looked at the monthly profits versus the average change of all the markets in the portfolio. Trendstat's T-Trend model is a simple breakout reversal strategy and should logically correlate well with most of the industry's trendfollowing CTAs. The results are shown in Figure C.

Figure C

**% Return of T-Trend vs Average Change all Markets**



The same tendency to produce more profits in large change periods was apparent at the CTA or portfolio level. More than an average change of \$2525 per contract per month was necessary to produce an expectation of profits. Any smaller change months than that showed an expectation of losses that month.

### How about the entire industry?

The next step was to make the leap in the research to the entire industry of CTA trend-following programs. From Managed Accounts Report, I obtained the database on the Trader Advisor Qualified Index and the sub-indices going back in time. I assumed that many in the industry are trend-followers of some sort. Since the MAR indexes are dollar weighted, the larger CTA's cause more movement in the index. In addition, since those same larger CTA's need to trade more liquid markets to find the capacity to handle larger assets, the liquid markets that Trendstat trades should roughly reflect where much of the diversified, trend-following capacity in the industry is also investing.

Figure D represents the MAR Trend-follower Subindex plotted against the average change of all markets in dollars for the month. The same upward sloping trendline indicates once more that the more price change there is in the markets, the more profits the industry can expect.

Figure D

**% Return MAR Trendfollower Subindex vs Average Change all Markets**

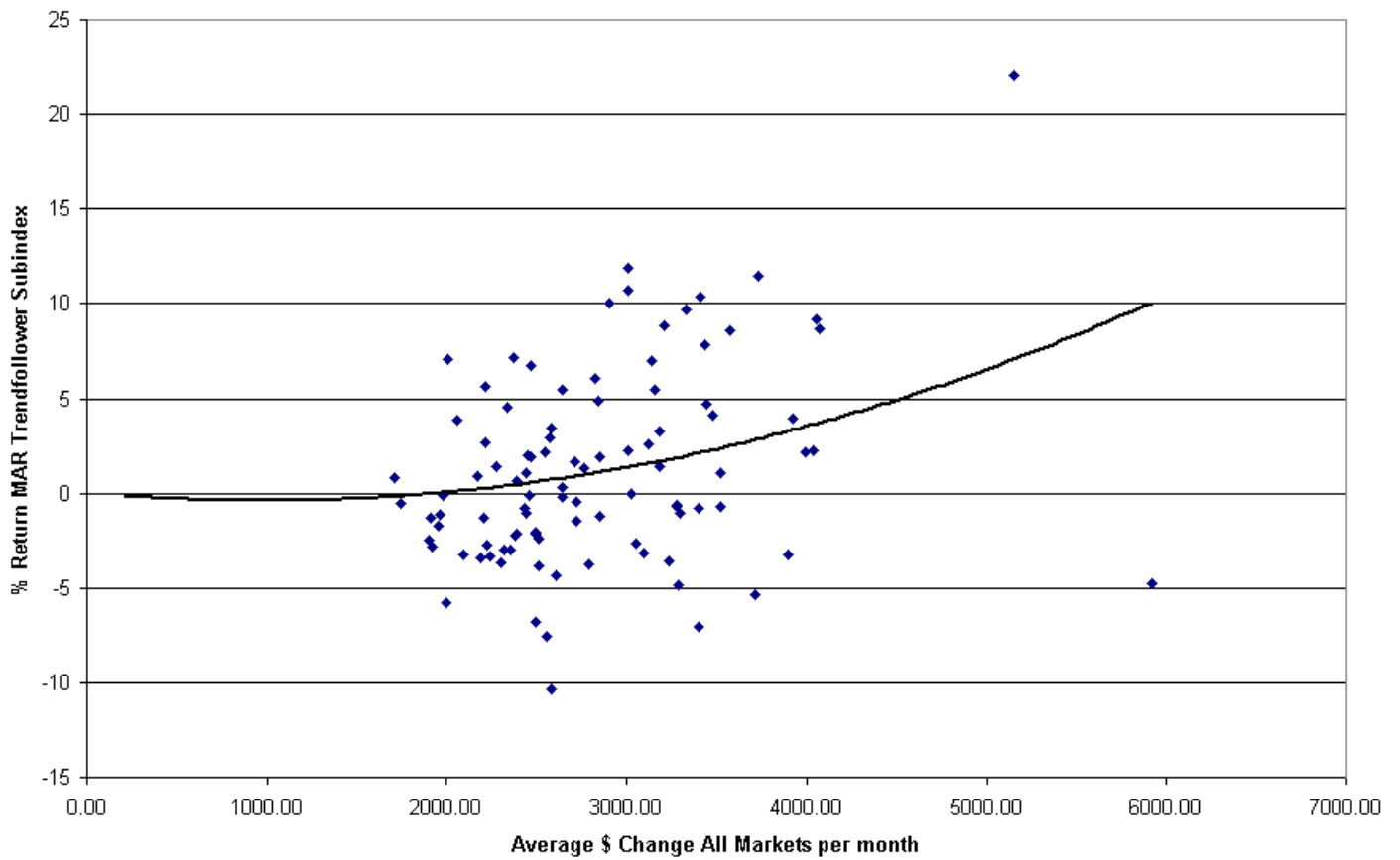
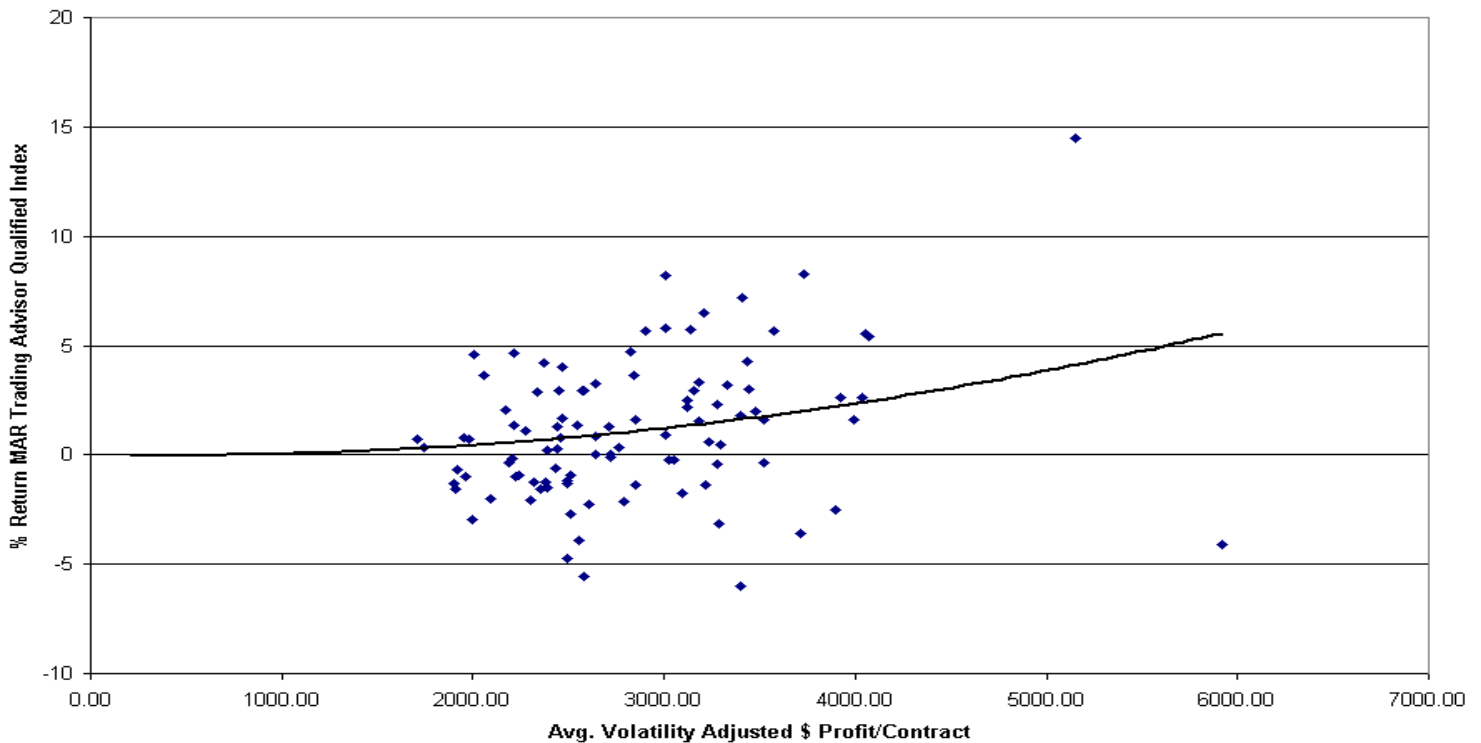


Figure E takes the concept up to the final level. I used MAR's Trading Advisor Qualified Index, which included the largest number of traders in the industry. The results continue to show a relationship between larger changes in prices producing more probability of large profits in the industry. **When markets move very little, we should expect industry losses.** When markets stay quiet for long periods of time, we should expect extended losses for many CTA's.

Figure E

**MAR Trading Advisor Qualified Index vs Average Volatility Adjusted \$ Profit/Contract**



### Using the results:

When I hear the debates in the managed futures industry over whether or not we are an asset class, or whether or not to label ourselves “skill managers”, I see little in the way of what is driving our returns. This study seems to be telling us that the movements in the markets drive returns in the industry. Skill may have some bearing on extracting more or less of those movements for the client's portfolio, but **the underlying force driving our profits and losses is whether or not market prices move up or down significantly. Small changes in price or sideways market action does not work well for trend-followers like us.**

If an institution wanted exposure to soybeans in their portfolios, then I would call that a different asset class than investing in a buy-and-hold stock portfolio. It's important to point out that I would call it a different asset class if the soybeans were bought and held or traded with a trend-following technique. The profits and losses will be heavily driven by the change in the price of soybeans. If soybeans do not move up or down, then both the buy-and-hold investor in soybeans and the trader that tries to capitalize on movements in both directions, will struggle to produce a profit. If we'd like to lump all the commodity markets together and call that an asset class, that would be fine with most CTA's. The more non-related items you can put into a portfolio, the smoother that diversified portfolio's returns become.

## Trend-following; A logical strategy to investing in managed futures:

More than anything else, this study confirmed what I've believed for years; that letting your profits run and cutting your losses short works over the long-run. Trend-following techniques let a profitable run continue, while getting out of positions going against you. With the advance of computer techniques like neural nets and genetic algorithms to trade the markets, there's a fear that trend-following may not work in the future or that the markets have changed and trend-following is not the way to go. This industry fear is, not surprisingly, strongest after a large industry drawdown. Then along comes another big move in some market, trend-followers make big profits and everyone's belief in trend-following techniques is restored.

The study indicates that price changes in the markets drive industry returns. Institutions typically want to expose themselves to possible non-correlated returns in markets that they haven't traditionally been exposed to. The answer seems clear to me. These investors should look to the managed futures industry, with its concentration of trend-followers, to exploit profits in those markets they seek to participate in. When the prices in those markets move, the institutions should expect a positive return from a diversified portfolio of CTA's.