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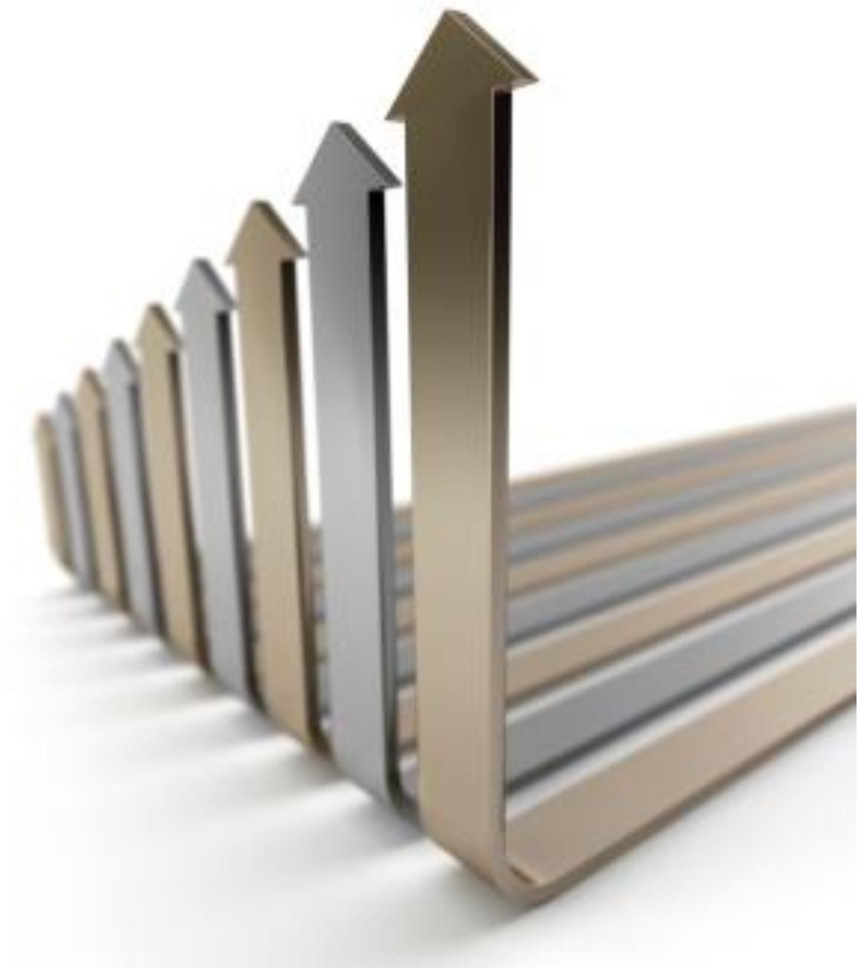

Chasing Returns:
The Dangers of Linear Thinking

KD Foster, The PRICE Futures Group

As my old boss Jeff Gordon (one of the Turtles) used to say, "good times follow bad and the other way around". I would laugh because it is a truism - of course good times follow the bad. The question is - when does the change happen?

Jeff said the real reason was to remind me, and himself, that our trading performance was cyclical and to avoid linear thinking. People are hardwired for linear thinking, looking at the present or recent past and projecting that into the future. The truth is closer to the disclaimer at the bottom of a performance table, "past performance is no indication of future results". While we still need to look at the past for indications of how something will work going forward, we don't want to fall into the "linear thought trap".

How do we predict future returns?

Serial correlation measures the predictability of future returns based on the recent past. If a trader has been up six months in a row, what is the probability of it continuing? While trend followers count on serial correlation in the markets they trade, CTA performance does not show very much of it. A paper titled, "An econometric model of serial correlation and illiquidity in hedge fund returns" by M. Getmansky, A. W. Lo, and I. Makarov of the MIT Sloan School of Management (March 2003) evaluates the serial correlation of different hedge fund styles. Using regression analysis on TASS data for the period from November 1977 to January 2001, they concluded that the average serial correlation for Pure Managed Futures is -0.1%.

What does this mean to us?

CTA performance is cyclical and drawdowns are inevitable. While it is human nature to chase returns because we think whatever we have just experienced will continue, human nature is wrong. Don't buy the CTA who just had a great run, do your homework and buy a good CTA who has had the inevitable drawdown. Remember, the path of least resistance is usually the wrong one in our business. If picking investments was easy, everybody would be rich.

Where do you go from here?

Evaluate a potential CTA based on the environment they perform best in using both qualitative and quantitative analysis (click here for more tips on evaluating CTAs) then look for an entry point. While your entry point depends on your own risk tolerance and attention span, here are some things to look at:

- Historical drawdowns, both length of time and percentage lost.
- Recovery time, how long to reach a new high.
- Run-ups, length of time and percentage return and what followed.

Above all, don't let emotions like fear and greed guide your investment decisions. Contact our team of managed futures experts for more information on CTA selection and how to invest in managed futures the right way.


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Select the Right CTA in 3 Steps

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