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A Study by Tom Basso

➤ When to Allocate to CTA? – Buy Them on Sale

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When to Allocate to a CTA? Buy Them on Sale

Editor's Note:

Most investors have their own ideas about how to select a manager. A question that comes up after selecting the investor is when to invest. This study deals with some of the statistics and psychological issues in buying a manager in a drawdown on performance.

By Thomas F. Basso
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Background on the study:

In late 1996, I noticed that we were in a slight drawdown (less than 10%) in our World Currency Program and that many CTA programs were in a drawdown or having a rough year. One client had already closed down, I had already received a few calls of concern over the drawdown and new money coming in had slowed to a trickle. All this was happening while I was personally investing more in the markets, our programs and watching risk levels get to the lowest levels in over 2 years. I was very bullish on what we were doing, but investors seem to not be jumping on the opportunity. This led to the question, why don't allocators invest in a CTA during drawdowns.

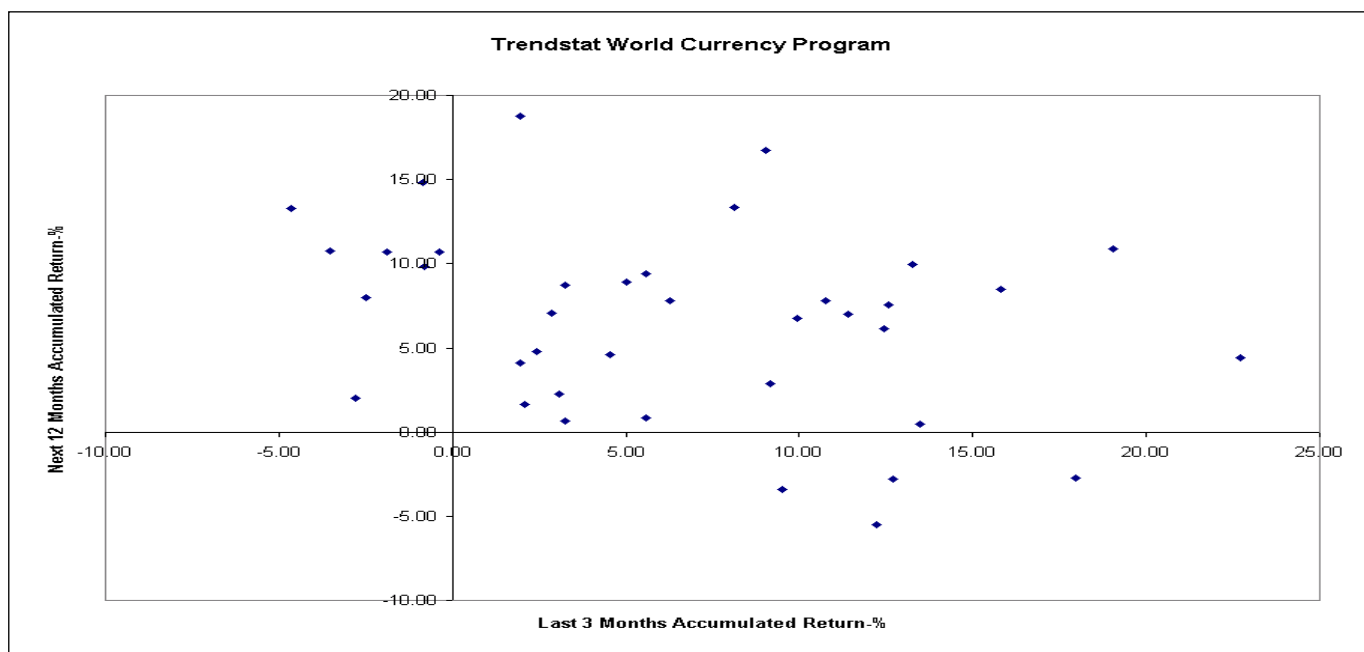
I haven't met a CTA yet that wouldn't say privately that he would tend to buy his program on a drawdown, particularly systematic traders. But investors seem to not add money when, to traders, it seems to be most logical to do so. I decided to look into the idea and report the results of the study.

How the study was constructed:

First, I looked at our own programs, figuring I wouldn't have to get permission from others to publish the results. Trendstat's World Currency Program monthly performance data was loaded into a spreadsheet and I calculated all the 3 month trailing 3 months of accumulated performance. Along with those data, I calculated the next 12 months rolling accumulated performance. Then, I plotted them on Figure A, a scatter diagram with the x-axis showing the last 3 months and the y-axis showing the next 12 months. I concentrated on the west side of the diagram, where all the data showed a decline over the last three months.

Comparing all the data in the northwest quadrant of the diagram (next 12 months were positive) with those data in the southwest quadrant (next 12 months were a loss), we see that there were no data in the southwest quadrant, while there were a number of points in the northwest quadrant. The chance of the next 12 months being profitable after a 3 month drawdown was clearly in favor of buying the drawdown.

Figure - A

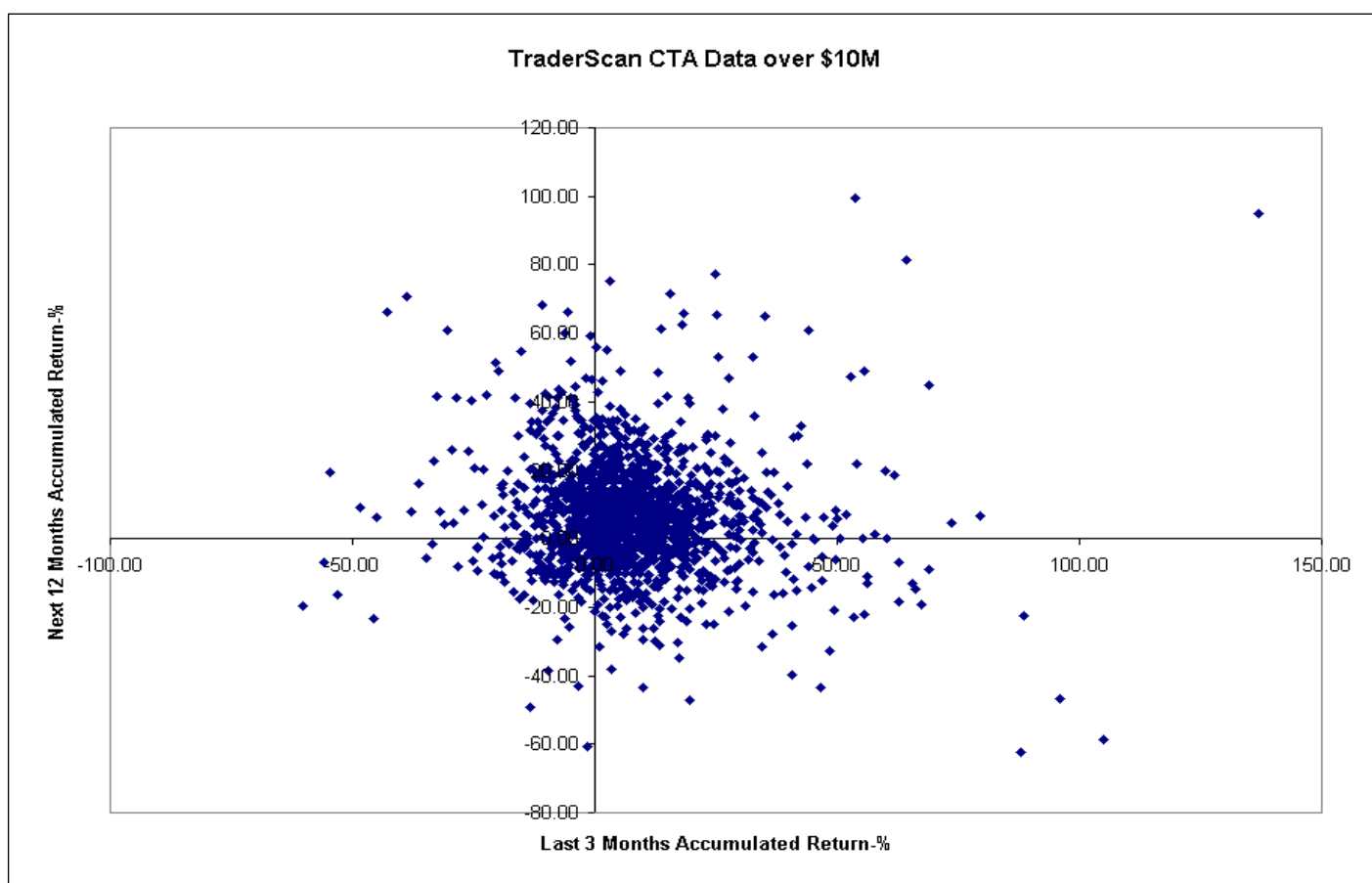


A larger universe of traders:

I downloaded data on all the CTAs in the TraderScan database (<http://www.traderscan.com>) covering over 100 CTA programs and prepared the computer to handle the larger sample size. I filtered the data for all CTA data with assets over \$10 million to make sure I concentrated on established CTAs that were liable to have the cash flow to stay in business over the long-run. I ended up with 1569 data points.

More data; same results. The shotgun pattern of the larger universe (Figure B), is centered in the positive northeast quadrant and the ratio of northwest to southwest quadrants is 318 to 146 or about 2.1 to 1. In other words, *the investor buying into a 3 month drawdown would have 2.1 to 1 odds of having a positive return over the next 12 months.*

Figure – B



How about pulling money after good performance?

The reverse of buy the drawdowns doesn't seem to follow in the statistics. On the right (east) quadrants of the Figure C, there are 742 data points in the northeast and 363 in the southeast. *This means that investors would have had a 2.0 to 1 chance of 12 months profits following a 3 month rolling period of profits.*

What's wrong with this picture?

Two assumptions were necessary to complete this study. I'd like to point them out so that investors can assess the assumptions' importance. Since the TraderScan database includes CTAs that are in business now, the study clearly has survivorship bias. That is, the database does not include those CTAs that went out of business. In order to make the study meaningful, an investor must assume that they are able to select CTAs that will stay in business over the long run. The second assumption is that the CTA, over the long run, will produce a profit. Buying into a drawdown doesn't make much sense if the CTA is not going to be around in 12 months or that he/she is not likely to ever produce a long-term profit for the investor. But, what investor has ever invested in a CTA believing the CTA would disappear or produce losses. I would guess these assumptions would not be a problem to most in the real world.

Sounds great - Why don't investors invest on drawdowns?

I believe the answer to that question lies in the investing psychology of buying a drawdown. The human mind can easily extrapolate 3 months of negative returns into "how long at this rate will it take to lose 50% or everything?" Rather than seeing the bargain and the positive return to risk, they see only the negative and forecast more of the same into the future.

As has been noted by many notable, experienced traders over the years, successful investing means doing some things that may make you uncomfortable. You need the courage to do the things that others find difficult or impossible to do. This study hopefully provides some psychological support to those investors that have been unable to buy drawdowns up to now.

The bottom-line to investors:

If you're comfortable with the assumptions I used, the statistics are very clear. The odds making a positive return over the next 12 months are improved if you invested with a CTA on a drawdown. As one sharp client of mine said, "I like to look for a CTA that's a quality operation, then wait 'till I can buy them on sale." Return to risk ratios should be higher and client satisfaction higher. If you can screen your CTAs on other qualitative or quantitative criteria, to find the "best", so much the better. You will have better odds of positive returns over your portfolio if you always find a CTA that will be there for the long run with positive returns. CTAs would be delighted to have clients buy their drawdowns, since more money would come in as the CTAs fee revenues were declining. The concept is win-win for everyone involved.

