Alternative Investing

Demystifying Managed Futures

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Commodity trading advisors (CTAs) managed approximately $320 billion as of the end of the first quarter of 2012, running “managed futures” funds that invest long or short in futures contracts on a variety of commodities, such as metals, grains, cotton and other physical goods, as well as futures and forwards on equity indices, Treasury bonds and currencies. But how do these managed-futures funds actually work and why? Though these funds have existed for decades and attracted large amounts of capital, they have not been well understood, perhaps because they have been operated by opaque funds that charge high fees.

In this paper, we show that simple trend-following strategies — specifically, time series momentum strategies — can explain the returns of managed futures funds. A time series momentum strategy goes long a market when it has experienced a positive excess return over a certain look-back horizon, and goes short otherwise.

Trend-following strategies only work if market prices exhibit trends, but why should price trends exist? We discuss the economics of trends based on initial underreaction to news and delayed overreaction as well as the extensive literature on behavioral biases, herding, central bank behavior and capital-market frictions.

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