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Research Note

(Informational – Not Investment Advice)

Fading the Crowd: Contrarian Futures Strategies as a Complement to Trend

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Executive Summary

Contrarian investing is an investment style in which investors strategically take the other side of a market trend. Sell when others buy. Buy when others sell.¹

These principles can be applied to individual instruments or even an entire market.

A contrarian believes the value of an instrument is below its intrinsic value, thus representing an opportunity.

Contrarian future strategies provide structural diversification. It should not be a replacement. Trend following strategies can prove great results during sustained driven markets but suffer prolonged drawdowns during choppy market regimes.²

1. Defining Contrarian Futures Strategies

Short-Term Mean Reversion:

Target prices that stretch too far from their historical average. Once short-term buying/selling exhaustion hits, price is expected to snap back to mean. Prevalent on shorter time frames (days to weeks).³

Counter-Trend / Reversal Models:

Traders may enter positions, opposing immediate short-term price momentum using overbought or oversold technical indicators.

Relative Value & Spread Reversion:

Cross-Market Pairs: Trades correlation between related asset classes, when normal pricing and relationship breaks down temporarily.

Inter-Commodity Spreads: Trades structure linked pairs (ex. Gold vs. silver) back toward historical price ratios.

¹Werner F. M. De Bondt and Richard Thaler, “Does the Stock Market Overreact?,” The Journal of Finance 40, no. 3 (1985): 793–805. See Data Source 2.

²Tobias J. Moskowitz, Yao Hua Ooi, and Lasse Heje Pedersen, “Time Series Momentum,” Journal of Financial Economics 104, no. 2 (2012): 228–250. See Data Source 3.

³Stefan Nagel, “Evaporating Liquidity,” The Review of Financial Studies 25, no. 7 (2012): 2005–2039. Nagel treats short-term reversal returns as a proxy for returns to liquidity provision. See Data Source 4.



Calendar spreads: Can trade the price gap between front and back month futures contracts when structure (contango/backwardation) strays from fundamentals.⁴

2. What Contrarian Futures Trading Is NOT

Contrarian futures trading is not short volatility. It does not sell naked options or take uncapped tail risk.

To generate income with options selling, you target theta decay. Contrarian strategies trade directional signals based on price, spread, or position and signals.

There is a defined payoff. Hard stop-losses. Active price/reversal signals.

3. Why Contrarian Strategies Earn a Return

Exploiting Behavioral Biases:

Contrarian strategies can exploit behavioral biases. Markets overreact to news headlines.⁵ Retail and institutional investors are shown to buy/sell together at market tops and bottoms.⁶ Unemotional contrarian traders can exploit these biases.

Providing Liquidity to Forced Sellers

Can profit from supplying buying/selling power. May receive a liquidity premium for operating contrary to urgent order flow.⁷ Can exploit strict mandate rules on large institutional forced buying/selling.

Key Advantages

Short Trade Duration: Capital isn't tied for long periods of time (days to weeks).

Drawdown Cushion: When market transitions, trend-following strategies struggle.

Immediate Performance Response: Rather than waiting for major macroeconomic shifts to facilitate, contrarian strategies can monetize liquidity squeezes.

Disadvantages

Strong Momentum: Headline-driven price accumulation can provide high risk if a fundamental shift facilitates.

Asymmetric Payoffs: Contrarian strategies may focus on frequent small gains. A sustained trend breakout can wipe profits. Trend following strategies absorb frequent losses for massive extended payouts.

4. Role in a Diversified, Uncorrelated Futures Portfolio

⁴CME Group, "What Is Contango and Backwardation?," CME Institute; and CME Group, "Trading Energy Calendar Spread Options" (white paper). See Data Source 5.

⁵De Bondt and Thaler (1985), cited above, document investor overreaction to unexpected and dramatic news and subsequent price reversals.

⁶U.S. Commodity Futures Trading Commission (CFTC), "Commitments of Traders (COT) Reports." The weekly reports break down each Tuesday's open interest by trader category, showing how different groups are positioned. See Data Source 1.

⁷Nagel (2012), cited above, finds that expected returns from liquidity provision rise sharply in periods of market stress, when liquidity suppliers withdraw.

**Where It Fits in a Portfolio:**

Can balance portfolio diversification by providing a steady source of returns that doesn't require long-term commitment.

Result: smooths out cyclical performance slumps.

Skew Pairing Dynamics:

Combination of trend following and contrarian strategies can skew the shape of return. When trend models lose, contrarian trades can help pay for these losses.

Correlation Across Market Regimes:

In strong trend regimes, trend models capture large profits; contrary models can take small stop-outs or remain flat.⁸

In choppy regimes, trend models wash capital while opposing models can generate steady returns.

As a result, total drawdown depth and duration can be smoothed out.

5. How Allocators Should Evaluate a Contrarian Manager

Analyze what signals are based on: technical indicators, CFTC crowd positioning,⁹ fundamental relative-value spreads, etc.

Verify the manager enforces hard stop-losses their risk model can handle.

Look for varying performance and adaptability in different market conditions.

6. Conclusion

Contrarian futures strategies can demonstrate how they can prove as a vital tool of diversification, smoothing out cash flows, and cushioning portfolios during chopping market regimes. They are a highly effective complement to trend following strategies, not a replacement.

Data Sources

1. CFTC Commitments of Traders (COT) Reports: U.S. Commodity Futures Trading Commission. Descriptions, report types and data downloads.

<https://www.cftc.gov/MarketReports/CommitmentsofTraders/index.htm>

2. De Bondt, W. F. M., and Thaler, R. (1985). "Does the Stock Market Overreact?" The Journal of Finance, 40(3), 793–805.

<https://doi.org/10.1111/j.1540-6261.1985.tb05004.x>

⁸Moskowitz, Ooi, and Pedersen (2012), cited above, find that time series momentum performs best in extreme markets and that persistence in returns partially reverses over longer horizons.

⁹CFTC, "Commitments of Traders (COT) Reports," cited above. The CFTC publishes the data but does not make trading recommendations based on it.



3. Moskowitz, T. J., Ooi, Y. H., and Pedersen, L. H. (2012). "Time Series Momentum." Journal of Financial Economics, 104(2), 228–250.
<https://doi.org/10.1016/j.jfineco.2011.11.003>
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4. Nagel, S. (2012). "Evaporating Liquidity." The Review of Financial Studies, 25(7), 2005–2039. NBER Working Paper 17653.
<https://doi.org/10.1093/rfs/hhs066>
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5. CME Group. "What Is Contango and Backwardation?" (CME Institute) and "Trading Energy Calendar Spread Options" (white paper).
<https://www.cmegroup.com/education/courses/introduction-to-base-metals/what-is-contango-and-backwardation.html>
<https://www.cmegroup.com/articles/whitepapers/trading-energy-calendar-spread-options.html>

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