The return of global macro: why investors should be wary of irrational expectations.

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With the collapse of LTCM in 1998, global macro investing / trading suffered a severe blow in terms of acceptance in the markets. Because of many highly leveraged hedge funds, investors and counterparts lost serious money, markets were at the brink of destabilisation and the regulators had to come to help. Hedge funds which use so-called global macro strategies were suddenly out of fashion. In 2000, Soros and Robertson left the global macro business and restructured their activities. It seemed that global macro would disappear as a major strategy, traded by only a small number of fund managers, and other strategies such as long / short equity would dominate alternative investment strategies. However, in 2002 many investors noticed the positive performance of global macro (+14% in the CSFB Tremont Sub Index) and felt that they should consider investments into it. Hence many firms will launch new funds to satisfy this new demand. However, some established funds have recently returned capital to their investors due to the lack of opportunities or the smaller return potential. In this paper we will analyse global macro investing and discuss the potential rewards and risks for investors.

From prop trading to hedge fund management

While many investors and market participants think of global macro as THE hedge fund strategy, this is not the case. The hedge fund concept as developed by AW Jones was based on a leveraged portfolio of long and short positions in stocks to insulate against market moves. However, global macro is, as we will discuss later in more detail, a general term describing either aggressive long or short positions in very liquid markets or some kind of arbitrage or relative value in global markets. Global macro has long been the privilege of treasuries or trading desks of large money center banks or investment banks in order to generate trading income. For decades, banks have been employing global macro strategies as part of their client business (as market makers providing liquidity) and for their proprietary positions. In many cases, global macro requires a substantial balance sheet, counterparty limits and sophisticated pricing tools. When Soros attacked the British Pound in 1992, the general public learnt of the existence of hedge funds and global macro. Many proprietary traders have set up hedge funds over the last five years as banks have become more risk averse and prefer the steady income from services rather than volatile trading income.

This trend started in the mid 1990s, when Citibank decided to cut most prop trading, and later investment banks like Salomon Brothers followed in a similar fashion. The European hedge fund industry emerged out of the proprietary trading culture of banks and investment banks. This applies to global macro, discretionary trading, convertible bond arbitrage, merger arbitrage, et al., however not to long/short equity whose managers usually gained experience at traditional long equity houses.

The transformation of prop trading into hedge fund management also helped to enhance the risk management side of the business. Concepts such as Value at Risk were imported from the treasury side of the banks to hedge funds. In many cases, the banks have been instrumental in helping their ex-traders with setting up and seeding new funds. Today, we find the best of ex-JP Morgan, Salomon et al traders running hedge funds in global macro (Blue Crest, Endeavour). In some cases, the hedge fund operations are based in the same building as the banks or in their vicinity. However, the next growth for gobal macro funds will probably come from traditional asset management firms and smaller hedge fund boutiques. After the successful launch of a long/short equity hedge fund business, the traditional asset management firms are now diversifying into other strategies. In addition to that, many smaller hedge fund platforms are also studying whether they should hire traders and launch hedge funds in this category. On the demand side investors have rediscovered global macro, mainly due to the strong returns of global macro in 2002 and the more disappointing results in other strategies, in particular long/short equity which many investors perceived as an «all weather strategy». While in 2000 and 2001 many new long/short equity or other equity related hedge funds were launched (with mixed success), in 2002 a trend for global macro launches was kicked off. We believe that 2003 will see a much higher percentage of new fund launches in that strategy. The potential for the strategy and the managers will be discussed in the following.

Global macro: directional versus relative value/arbitrage

Global macro is a broad term describing strategies of hedge funds, traders or investors who take long or short positions based on macro economic and market flow analysis. As described above, the treasury departments or trading desks of banks and investment houses have been running prop books in cross markets for many decades. Global macro strategies can be of either directional or relative value/arbitrage nature.

This classification means that the global macro manager uses his macro view to implement a strategy (directional, arbitrage or relative value) aiming to produce outstanding returns, as opposed to the micro approach of long/short equity or merger arbitrage. Hence global macro is mainly top-down, but requires bottom-up for its proper implementation. Depending on the mandate, a global macro fund can trade in any asset class such as fixed income, currencies, commodities, equity indices, derivatives, any markets such as G13, emerging markets fixed income (Brady), or any combination thereof.

In directional global macro strategies, we include discretionary and systematic trading funds. In the relative value and arbitrage domain, we group hedge funds trading in fixed income arbitrage (yield curves, credit arbitrage) or other arbitrage styles using a global view.

Risk and risk management

For many market observers and traditional investors, global macro does not represent a real investment strategy. They criticise global macro for attacking currencies or destabilising markets. This is correct to the extent that many global macro funds have large short positions in assets and they usually turn over their books a lot (50 – 100 times per year). But so do banks. However, global macro fulfils two important functions that add value to the markets:

a. global macro funds are basically providers of liquidity as they trade markets actively.

b. they put their and their investors' capital at risk.
Because of the potential high leverage and loss of capital, adequate risk management has become key in global macro. Value at Risk (VaR) systems such as RiskMetrics or in-house models are now key for any serious fund. However, because of the increasing application of derivatives (second and third generation) the models will not necessarily capture all risks. The three major requirements for any serious hedge fund are: transparency to the investor, an independent risk manager and an experienced team of portfolio managers / analysts.
Because of the complexity of global macro, the barriers of entry are higher than in other strategies. We believe that global macro hedge funds should operate like treasury departments of banks or trading desks of investment banks using highest quality systems, having a full process in place and employing top staff.
For the investors, global macro adds value as it is a completely uncorrelated strategy to major markets providing a hedge in times of stress (this is the case for directional funds rather than relative value).

Evaluation of markets and opportunities

While in the early 1990s, more than 50% of all hedge funds were classified as global macro, more than ten years later the number of global macro hedge funds has shrunk to around 10%. This offers great opportunities for new hedge fund managers as fewer players can mean more opportunities. However, the markets have also changed over the past ten years: there are less major global currencies, less yield curves and some markets have become less liquid now (e.g. some bond markets). Emerging markets Brady and global bonds still have excellent liquidity and EM currencies are also interesting alternatives. Other advantages are the better pricing tools, information systems (Bloomberg terminal, web-based tools, e.g. super-derivatives to price 2nd and 3rd generation derivatives, financial markets software and computing power in general). Hence the global macro manager of 2003 needs to have a much higher level of knowledge and expertise in markets in order to be successful.
We believe that, because global macro is the most difficult and intellectually demanding style, there are not many good hedge fund managers. Talent is usually recruited from prop trading desks, currency dealers and derivatives exchanges. Due to decrease in trading desks in the City and on Wall Street, less talent will be developed in the long run.
Global macro performed well in 2002 (+14% according to CSFB Tremont Global Macro Index). However it was a relatively easy year due to the trends in interest rates, bonds, commodities and equities. 2003 will be a tougher nut to crack, and many new funds will have to demonstrate that they can really make money in these markets. The major risks are high volatility, trend-less markets and higher than usual correlation between different markets. In 2002 one major hedge fund (Medallion) returned capital to its investors due to lack of opportunities, the size of the fund and the limited profit potential. This means that existing investors need to replace these investments, while new entrants will also look for suitable funds to invest.

How can investors decide when to invest in new funds?

Because it is in general difficult to find a good global macro hedge fund manager with track record and still open, it is important to find talent as early as possible. Major firms like Caxton, Medallion et al are closed or return capital. The performance of the hedge fund industry in 2001 and 2002 shows that global macro plays an important role in asset allocation from a performance and hedging perspective. How can investors overcome these obstacles and find good managers?
Ideally, the manager has a portable track record from a prop desk. Alternatively, his reputation as trader, the quality of the new team and the depth of ideas can serve as indicators. However, we are extremely cautious on any global macro manager without experience or suitable environment. Proper due diligence and on-going monitoring are of para-

mount importance, once the manager is discovered. The operational platform is crucial.

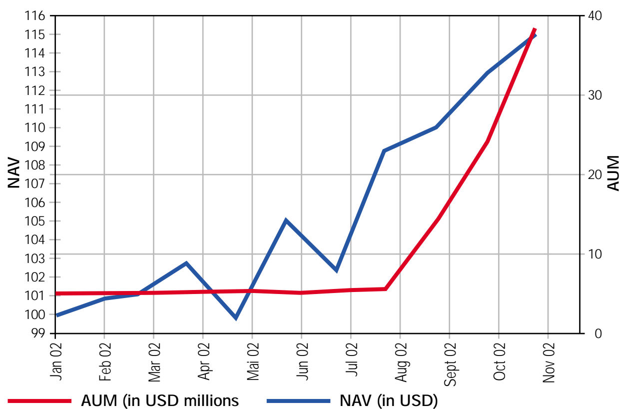
Analysis of global macro funds

In the following, we will analyse four global macro managers who offer different approaches and are in different stages of their development:

Case Study 1: fund with short track record, traditional asset management firm. This fund is a relatively new fund set up in 2002. The firm is the asset management arm of a private bank. The managers have been working together for years and have been running long-only active mandates in bonds. The fund was seeded by the firm and marketed once a short track record was established. Risk management is in compliance with Allenbridge Hedgeinfo's benchmark standards. The fund trades in fixed income, currencies and derivatives in all markets (G7, credit and EM). AUM USD 40 mm. Firm: USD 6 b.

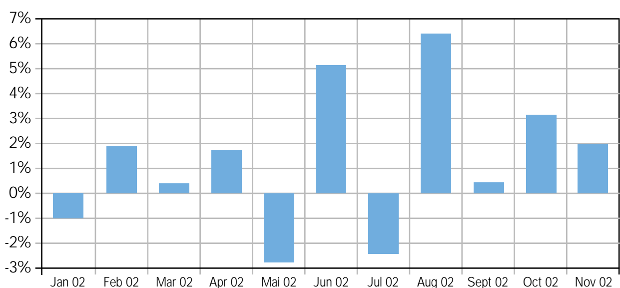
Chart 1 depicts the NAV versus assets under management. Strong performance (+15% for Jan - Nov 2002) has led to

Chart 1 | NAV vs Assets under Management of Diversified Fixed Income Hedge Fund



Source: Allenbridge Hedgeinfo; HF Manager | Observation period: Jan 2002 - Nov 2002

Chart 2 | Monthly Returns of Diversified Fixed Income Hedge Fund



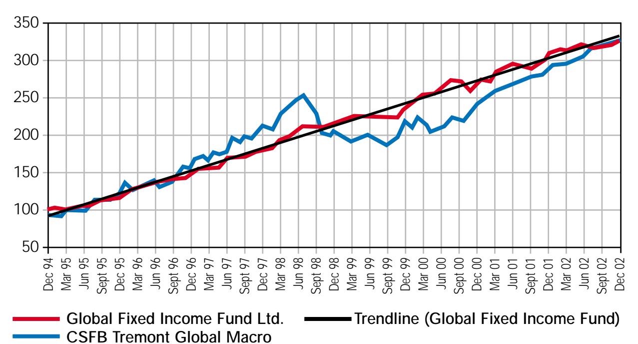
Source: Allenbridge Hedgeinfo; HF Manager | Observation Period: Jan 2002 - Nov 2002

inflows, which we expect to continue. We believe that the fund will reach triple digit levels of AUM soon and will close at USD 500 mm. An interesting offering.

Chart 2 shows the short monthly track record. The fund has had three down months out of an eleven months observation period (72% positive).

Case Study 2: fund with long track record, large hedge fund manager. This is an established hedge fund with an eight years track record. The firm is a major global macro hedge fund player with USD 6 b of AUM, set up mote than 10 years ago. The fund's track record is nine years, AUM USD 2b.

Chart 3 | Comparison of Global Fixed Income Fund and CSFB Tremont Global Macro Index



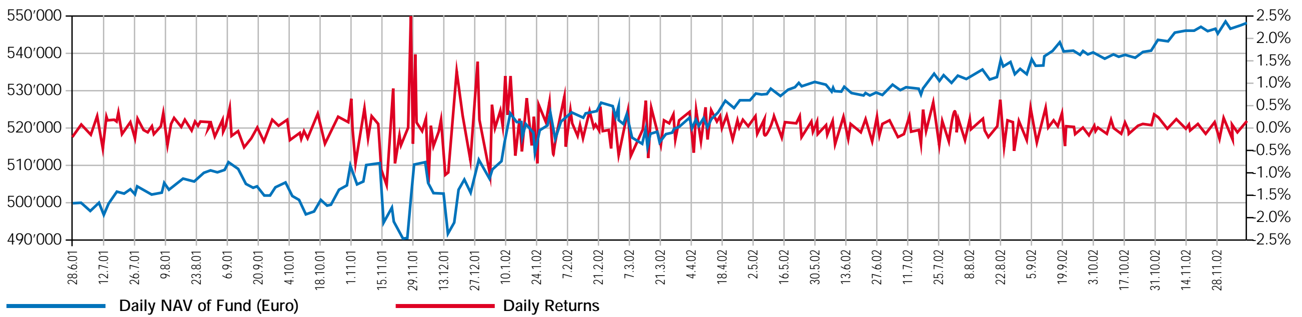
Source: Allenbridge Hedgeinfo; CSFB Tremont | Observation period: Dec 1994 - Dec 2002

The fund has an excellent track record (see trend line) and compares favourably against the Index, which is far more volatile. However, returns are lower than in the past (only +4.2% Jan - Nov 2002), with 12 month rolling volatility of 5.37%. In the event of continuous weak performance, we should expect redemptions. A sister fund (which suffered a down year of -6%) suffered substantial redemptions in assets at the end of 2002.

Case Study 3: fund with short track record, but institutional firm. This is a fund with a track record of more than 18 months. The style is unique in that it trades only bonds in a long / short market neutral fashion with a leverage of 3times on both sides. The institutional character of the firm (firm is owned by one of the largest banks in the world) and the daily liquidity distinguish this fund from most other hedge funds in general and global macro in particular.

Chart 4 shows the daily NAVs and daily returns. The fund was up 7.05% with volatility below 5%. Out of 360 observations the fund was up 197 times and down 163 (ratio 55% win versus 45% loss), which is lower than case study 1 and

Chart 4 | Daily NAV vs. Daily Returns

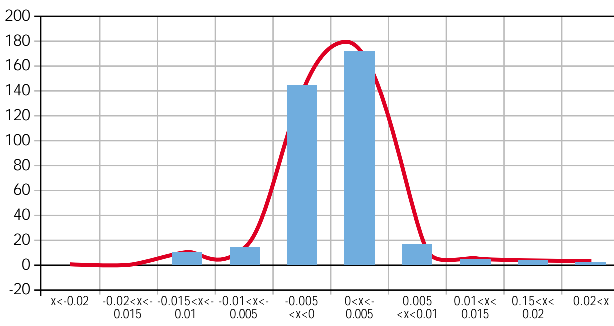


Source: Allenbridge Hedgeinfo; Bloomberg | Observation period is June 2001 - Dec 2002

case study 2. Largest daily drawdown -1.32%, best day +2.57%, mean 0.04% (all daily figures). It is important to note that this fund has daily NAVs and is a market neutral fund. The style is unique, but we believe that we will see more products like this.

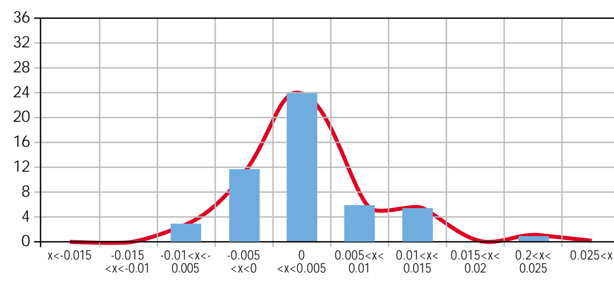
Chart 5 shows the distribution of daily returns. The fund has a normal distribution with some positive skew and some tail risk (on both sides).

Chart 5 | Distribution of Daily Returns



Source: Allenbridge Hedgeinfo; Bloomberg

Chart 6 | Distribution of Weekly Returns



Source: Allenbridge Hedgeinfo; HF Manager

Case study 4: new fund, but manager has previous track record. The last example covers a new fund launched by an experienced prop trader, who previously ran a portfolio (sub fund) for another global macro manager. The track record serves as an indication what this fund can offer. The fund started trading in November with less than USD 100 mm AUM. The fund will soft close at USD 250 mm. This is a fund that offers most of the criteria for an early investment (experience, track record, good team, professional investment banking like operation).

Chart 6 shows the distribution of weekly performance over a period of approximately one year. The performance shows a normal distribution, positive skew with some tail risk (to the upside). Median +0.17%, best week +2.0%, worst week -0.72%. Out of 51 weeks the fund was up in 36 weeks (70%). This is a very good result, given weekly numbers. However, the observation period is small.

Conclusion

Global macro has become fashionable due to positive performance in 2002 and the short memory of investors. While many new funds offer interesting opportunities, there is a risk that investors will rush into global macro based on past performance. Due to the lack of good existing managers there is a need to consider new funds for investments. The combination of new funds and expectations based on past performance could become quite dangerous and we are very cautious as to the quality of many new global macro funds. However, as a strategy it offers great diversification and hedging in any portfolio.

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