# Roundtable Discussion

## Introduction

**swissHEDGE regularly invites reputed hedge funds to join a roundtable discussion in which to share their views on a particular topic. This time, we have invited three global macro funds to talk about diverse and current issues such as skills required for the strategy, transparency, allocations of institutional investors, and the impact of growth/asset size on the return potential for managers.**

**Millennium Global Investments Ltd, London**
AUM: USD 1,400 m
Representative: Mark Astley, Fund Manager
Michael D. Huttman, Fund Manager

**Tactical Global Management (UK) Ltd, London**
AUM: USD 650 m
Representative: David Tucker, Director of Marketing and Client Service

**Vega Asset Management, Madrid**
AUM: USD 7,000 m
Representative: Robert F. Slutz, Chairman

Q: Why should the investment community be interested in global macro funds?

MILLENNIUM: If you think about what is the best environment for global macro funds it is when you have fundamental disequilibria whether it be economic, financial, political or even social which result in evolving trends in financial markets. This is very much the situation that the world finds itself in today, with major structural economic and financial imbalances between North America, Europe and Asia and the arguably the most unstable geo-political environment since the end of the Cold War. Hence, we believe there exists substantial alpha generating potential across the four major macro asset classes of foreign exchange, fixed income, equity and commodity markets.
TGM: The investment community is interested in constructing portfolios of investments that meet their requirements in terms of risk and return. Global macro funds provide investors with exposure to profitable opportunities that are fundamentally different in terms of the pattern of returns relative to other styles of investments.
VEGA: Global macro funds should be of interest to the general investment community both from a timing perspective as well as an investment style perspective. In terms of investment style, macro managers offer investors a broad investment opportunity set, investing generally in liquid, easily priced securities that provide returns that are uncorrelated to the equity and bond markets. Because macro funds typically are not confined to a particular region, macro managers are well positioned to take advantage of major regional or global economic trends. Though typically focused on sovereign fixed income and currencies, macro managers have the flexibility to express their views in a wide variety of asset classes and financial instruments which can be extremely liquid and easily priced. At Vega, liquidity is a key factor determining the markets and financial instruments in which we invest, with the vast majority of our investments concentrated in G-10 fixed income and currencies. Lastly, global macro funds generally have little correlation to fixed income or equity markets, thereby providing a great source of portfolio diversification.
Macro funds are also attractive from a timing perspective given that the evolving economic trends and pockets of political uncertainty provide a «target rich» environment for global macro managers. Some would go so far as to argue that the current international economic environment constitutes one of the most favourable markets for macro investing in recent history, given the expectation of major directional shifts in economies and financial markets.

Q: Do you see an increasing interest among institutional clients for macro funds?

MILLENNIUM: This is definitely the case. For a while, during the global technology equity boom or «NASDAQ-ing» of the world during 1999 and 2000, macro strategists had a difficult time as investment strategies based on a «value» framework were replaced by those based exclusively on momentum and many doyens of the industry either closed down or shifted focus into other strategies. Since the bursting of the bubble in early 2000, traditional relationships

have broadly reasserted themselves and, given the fundamental disequilibria described earlier, the investment environment has returned to one which is fertile for macro managers. This fact has not been missed by the investment community and the demand for macro funds has been steadily increasing over the past couple of years. We see this as a trend which will continue for the foreseeable future.

TGM: Yes, we do in terms of the emergence of specialist global macro fund-of-funds. Although there has been more specialist funds emerging over the past 12 months, the proportion of assets invested within global macro has reduced over the past five years relative to the growth in the total market, although performance has been positive over the last year.

VEGA: Though historically certain classes of institutional investors (principally university endowments and pension funds) have been reluctant to invest in macro funds, we have seen a marked increase in institutional interest in macro strategies as evidenced by the nearly $6b in net inflows into our funds during the 2003 calendar year. Global macro strategies sparked investor interest in 2002 when global macro funds returned 14% (according the CSFB Tremont Index) while other hedge fund strategies, most notably equity long-short, disappointed. Most investors have been attracted to global macro because of the uncorrelated nature of global macro fund returns to the equity and bond markets.

Q: How are you dealing with the increasing transparency requests by the investment community?

MILLENNIUM: Transparency as to our investment process is something we are comfortable and familiar with. We put out a monthly newsletter which details performance contribution across the asset classes and we write a half yearly «Global Macro Outlook Letter» which details our major themes for each of the asset classes for the coming months. We are also happy to discuss current positioning with people that are actually invested in the fund.

TGM: The trade-off that a manager faces is on the one hand a desire to have clients who are knowledgeable of their strategy as this provides clients with a level of comfort and sets expectations correctly with a requirement to ensure that the market does not know live positions that may either be copied or squeezed. In the latter case you might have a large position that needed to be rolled such that you had to sell the old contract and buy the new one. This will tend to push the old contract down relative to the new one. Someone who knows that this roll is about to happen could take out positions ahead of you by shorting the old contract and buying the new contract, thereby frontrunning our need to roll the position.

VEGA: The demands for increased transparency from the institutional investment community have not been a concern for us as we have always provided significant transparency to our investors. On a weekly basis we offer our investors our Value at Risk report detailing for each fund the key trade strategies and their risk factors. The majority of institutional clients find our level of disclosure more than sufficient. While some clients insist upon full disclosure, most institutional clients understand that it would not be prudent on our part to provide full transparency of the portfolios for fear of jeopardizing the profitability of the positions.

Q: Are high assets under management an advantage? Are capacity limits of a concern to you?

MILLENNIUM: The fund size is currently at USD213m and we have the ability to express our investment views across the markets we choose using the appropriate instruments. We are investing in extremely liquid markets. Capacity is less of a concern compared to some other strategies and we see capacity of the fund at around USD1b given the current liquidity of the markets and resources of the firm.

TGM: A manager benefits from growth in assets by investing in research and development (R&D). We invest a significant portion of revenue in our investment strategy R&D. Seven years ago when TGM was set up, we started with a staff of 10. Today we have a staff of 30. The growth in staff has been in both the investment team and also in the marketing, client service and back office areas. The growth in the non-investment areas indirectly assists our investment R&D efforts as when a firm is small the investment team ends up getting involved in many non-investment activities of the business. Capacity is something that we monitor carefully. We only trade in the futures markets for the major bond and equity indices where liquidity is not a concern at this time.

VEGA: The funds we manage have become stronger with the increase in assets under management. Importantly, we are organized so that our traders do not execute all trades through one prime broker or counter party, but rather trade directly with more than 20 different major financial

institutions. The greater asset levels have meant greater trade volumes with these banks and therefore better service on trade execution. Having many counterparties diversifies our market risk so that no single entity knows the totality of our funds' risk. Additionally, and in the case of our Vega Global Fund specifically, the increased asset size has enabled us to attract more top senior trading talent to manage risk for the fund, and in doing so generate uncorrelated trade ideas and improve the diversification of the portfolio.
At the current time, capacity constraints are not a concern. In our view, the size of the asset pool we can manage effectively is primarily a function of the liquidity of the assets we trade and the investment opportunities present in the market. Given that we trade only very liquid instruments, primarily G-10 fixed income, liquidity is abundant and growing. Given that we continue to see tremendous directional and relative value trade opportunities, we have not encountered any problems effectively deploying capital.

Q: Will the growing competition make it harder to repeat attractive returns?

MILLENNIUM: It is true that there have been more macro funds starting up in the last couple of years, but again, given the liquidity and depth of the markets in which we are investing, this space is a long way from becoming crowded. In addition, given that the macro community retrenched significantly during the late 1990s, we do not believe that the style has been exploited to its limits.
TGM: Global macro is an area where there are a range of styles and the opportunities are extensive. As a result, this style of management is less sensitive to the effects of increased number of managers.
VEGA: We do not believe that growing competition will be a negative influence on our ability to generate returns. However, we believe it is important to recognize the fact that hedge funds are becoming a much more significant influence in the markets we trade and therefore price movements may be more exaggerated than warranted by fundamentals alone. For this reason, we try to avoid crowded consensus trades whenever possible. However, we point out that we do not believe the increased competition will in any way have a negative impact on market liquidity. Given the depth and wide diversification of the markets and instruments in which macro funds invest, it is a strategy that is far less vulnerable to such market capacity restraints that may be found in hedge fund strategies such as Merger and Convertible Arbitrage which depend on a much more limited universe of assets. By the same token, the performance of macro funds do not tend to be highly correlated, one to the other – a function of the wide divergence of economic views and even greater diversification of the means of expressing these views.

Q: How do you manage your fund so that it can survive significant market turbulences unharmed?

MILLENNIUM: We believe that key to sustainable long term returns is a rapid truncation of downside risk and we are not the sort of macro managers that are prepared to ride through large drawdowns as the price for running large risk exposures. As a result, we focus very much on risk management to prevent such drawdowns in times of turbulent markets using a combination of statistical and more pragmatic non-statistical risk approaches which are complementary and effective in limiting drawdowns. We target a maximum downside limit of no greater than 2.5% in any one month and have comfortably achieved our goal by never having breached a 2% drawdown month.
TGM: A key characteristic of the TGM Eagle Fund is that is managed in a market neutral manner. In other words, the long positions in equity markets are funded by short positions in equity markets and overall we have a net zero exposure to overall market movements. As a result, our strategy is protected from «significant market turbulences». A similar feature is incorporated in our bond strategy.
VEGA: Over our more than seven-year track record we have proven that we can survive turbulent markets. First, we maintain well-diversified portfolios with uncorrelated trade strategies. For instance, the Vega Global Fund at any time carries more than 100 distinct strategies. More importantly, we invest in a closely-monitored risk environment in which we employ strict guidelines limiting the amount of risk we may carry on a daily basis. In our view, investing within a disciplined risk framework is paramount to ensuring long-term investing success.

Q: What could be the worst economic scenario for your strategy?

MILLENNIUM: The worst economic scenario would be the global converged «village» with a synchronised global economic cycle with very little change in the economic aggregates, low cyclical amplitude and virtually no uncertainty in the monetary and fiscal policy outlook throughout the world resulting in no or few market trends. This is

obviously not the case at the moment nor do we anticipate this to exist in the future. The global economy is an extremely dynamic and complex system driven by a myriad of factors in different regions and countries and so to imagine that divergences will completely end is a very low probability event. However, despite the fact that the global economic cycle today exhibits far less volatility than in the 1970s when runaway inflation was the norm, financial markets continue to trend and provide many opportunities for global macro strategy.
TGM: The strategy in the TGM Eagle Fund is based on our research about the future global economic prospects. The worst economic scenario for our strategy is when markets are not focussed on economic fundamentals but rather driven by other considerations. However, it is our experience that markets inevitably shift their focus back to the economic fundamentals once the short-term distraction passes.
VEGA: There is really no economic scenario in which our strategy would be unable to profit. However, a trendless market with low volatility would be the scenario in which it would be most difficult to make money.

Q: Where do you see risks for the global macro managers that could undermine its success?

MILLENNIUM: Trendless, range trading markets provide the most difficult conditions for traditional macro managers (although many now also employ relative value macro strategies to augment returns from directional macro trading). While all markets enter periods of range trading and reduced volatility, it is highly unlikely for all markets to do so at the same time and therefore if the macro fund exploits the full range of asset classes (and not just fixed income and foreign exchange which have traditionally been regarded as the «home» of macro) then opportunities will always exist. Should assets invested in macro strategies rise to truly gargantuan sums, far beyond the current levels, then the opportunities for the style in aggregate are likely to diminish but as mentioned above we believe that we are nowhere close to such a limit.
TGM: Global macro management skills are in short supply. Over the last few years this has not been an area that has grown as strongly as others. The limited supply of quality global macro management could temper the success of growth in this style of management.
Vega: Like so many activities, the greatest risk probably lies in the individual managers diverging from what they know and do best. This pitfall is especially true in the area of risk discipline. The cornerstone of our approach is that our funds are actively managed not only to their respective return targets but also to risk and/or volatility limits. On a number of occasions in our history, this discipline has led us to curtail the risk in one or another of the portfolios or to pull back from a highly volatile market to await a definition of the direction events would take. In a similar fashion, it is important to remain focused on those instruments and markets that form the backbone of the firm's expertise. The promise of high returns in relatively unfamiliar markets can be a highly alluring call to disaster.

Q: In your view, what will be the key for a successful macro manager going forward? What should be the particular skills that a macro manager needs?

MILLENNIUM: The key will be the same as it always is; objectively identifying both economic trends and points of inflexion and executing trades at the right time. Our process at Millennium uses a multi-factor approach so that we consider as many inputs as we believe have explanatory value in order that we minimise the risk of being blindsided. We also spend an inordinate amount of effort on timing the execution of our strategy as even a correct strategy can lose money if the timing is too early or late. Global macro is by definition a trading strategy and hence, timing of trade implementation is critical. Global macro also does best when significant market trends occur and the biggest risk to exploiting a trend is when points of inflexion occur and hence, the identification of potential turning points is also critical (e.g. the major global bond reversal in June 2003).
TGM: The key requirements for success are a robust and repeatable process for forecasting and a disciplined methodology for risk adjusting these forecasts and implementing strategy.
VEGA: The most critical factor for success of a global macro manager (and the easy answer) is to correctly position strategies to take advantage of macro trends. Further, as we anticipate continued volatile markets, the successful macro manager should also have the ability to be nimble with trading strategies focused on liquid markets. This is not enough, however; it is only one side of the coin. Macro managers, as ever, must have a strong risk management discipline. It is not enough to know how to make money, it is equally important to know how not to lose it. Finally, macro managers must have the ability to understand, price,

and trade new instruments while making significant and constant investment in new technologies and risk management infrastructure.

Q: How do you see the outlook for macro managers going forward, and what is your market outlook for the immediate future?

MILLENNIUM: As we begin 2004, the conditions appear set for a mini economic boom with a synchronised and increasing growth outlook across for almost all regions of the world. The propulsion behind such a boom has come from the stimulative policy mix adopted by global monetary and fiscal authorities in recent years, with the United States being at the vanguard of this trend. The second half of 2003 witnessed the beginnings of traction from this policy mix as economic activity picked up markedly. Given the significant inertia built up particularly in North America and Asia, the global economic prospects for 1H 2004 are bright. Strategically, therefore, for 2004 as a whole we favour that the persistent uptrend in global equity markets will continue led by Asia, higher government bond yields globally led by the US, a weaker US dollar versus Asian currencies in particular and rising commodity prices as reflationary tendencies persist. However, the markets are discounting a very different world from mid-2003 when some of these trends first emerged and hence, trading tactics in 2004 will be very different from those used just six months ago.

TGM: There are two styles of macro managers to highlight here. The first is momentum style. These managers look for trends that they expect to continue and exploit these. These managers are looking for the continuation of recent trends such as the weakness in the USD. The second style is economic and forward looking such as TGM. Our current global macro themes include in relative terms the Japanese bond market to underperform and Australian bonds to outperform global bond markets. In equities we are expecting european equities to outperform asian equities. In currencies we expect Sterling to outperform the Euro and the Australian dollar.

VEGA: Yields in the US are too low from a fundamental perspective. The US is running a current account deficit of around 5% of GDP and a fiscal deficit of close to that amount. Its currency is in the midst of a devaluation that is widely expected to continue. Finally, its economy is responding well to massive fiscal, monetary and external stimuli, even though lagging indicators (inflation and unemployment) are still sluggish. Yet, five-year nominal and real rates are 3.25% and 1.25% respectively. These rates are not enough to attract the massive levels of external funding that the US economy needs to maintain its combination of high consumption levels, large fiscal deficits, rebounding business investment and minimal savings, particularly given widespread expectations for a continuing depreciation of the USD.

Market positioning and technicals are currently supportive of US fixed income. First, real money investors remain underweight with respect to their benchmarks, and this continues to provide buying pressure to the market. Second, extremely low short term rates mean that short positions are very expensive in terms of carry and roll down, making leveraged investors reluctant to hold them. Finally, though private investors' appetite for US assets has evaporated, asian central banks have so far taken up the slack and become the buyer of last resort for US fixed income assets as they attempt to prop up the USD supporting their trade surpluses. Whereas the fundamental aspects of US fixed income described above will not change any time soon, the technical aspects currently supporting US fixed income markets are volatile and subject to sharp changes. This is particularly true of the willingness of asian central banks to continue accumulating US debt. Consequently, we expect to see sharp moves in the year ahead that will provide us with plenty of opportunity for profitable trading. In Euroland, a tug-of-war continues between positive data from forward-looking indicators and negative economic news, particularly as regards consumer spending. Though we expect actual economic data to improve in the coming year, we think that the economic cycle in Euroland will be a muted and lagged version of that in the US. Furthermore, the strong EUR will be a restraint on ECB tightening. We think that EUR fixed-income continues to offer value relative to the US.

In Japan, real GDP rebounded in 2003, and japanese leading indicators continue to improve. However, the end of deflation is not yet in sight, as nominal GDP growth was essentially zero. Though we remain bearish on the long-end of japanese rates, we see some value in the front end given that the end of the zero interest rate policy is not yet in sight. Thus, we believe steepeners in the japanese curve remain attractive.