Investing in Global Macro

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Introduction

In 1992, when George Soros made one billion dollars by betting against the british pound, the media coverage that followed was enormous and a broad audience became aware of global macro trading. The initial admiration for his achievement was soon followed by disapproval from the investment community and various governments for this type of trading. The public started to associate macro hedge funds with highly leveraged trading by powerful and ruthless managers and that therefore, the world would be better off without them.

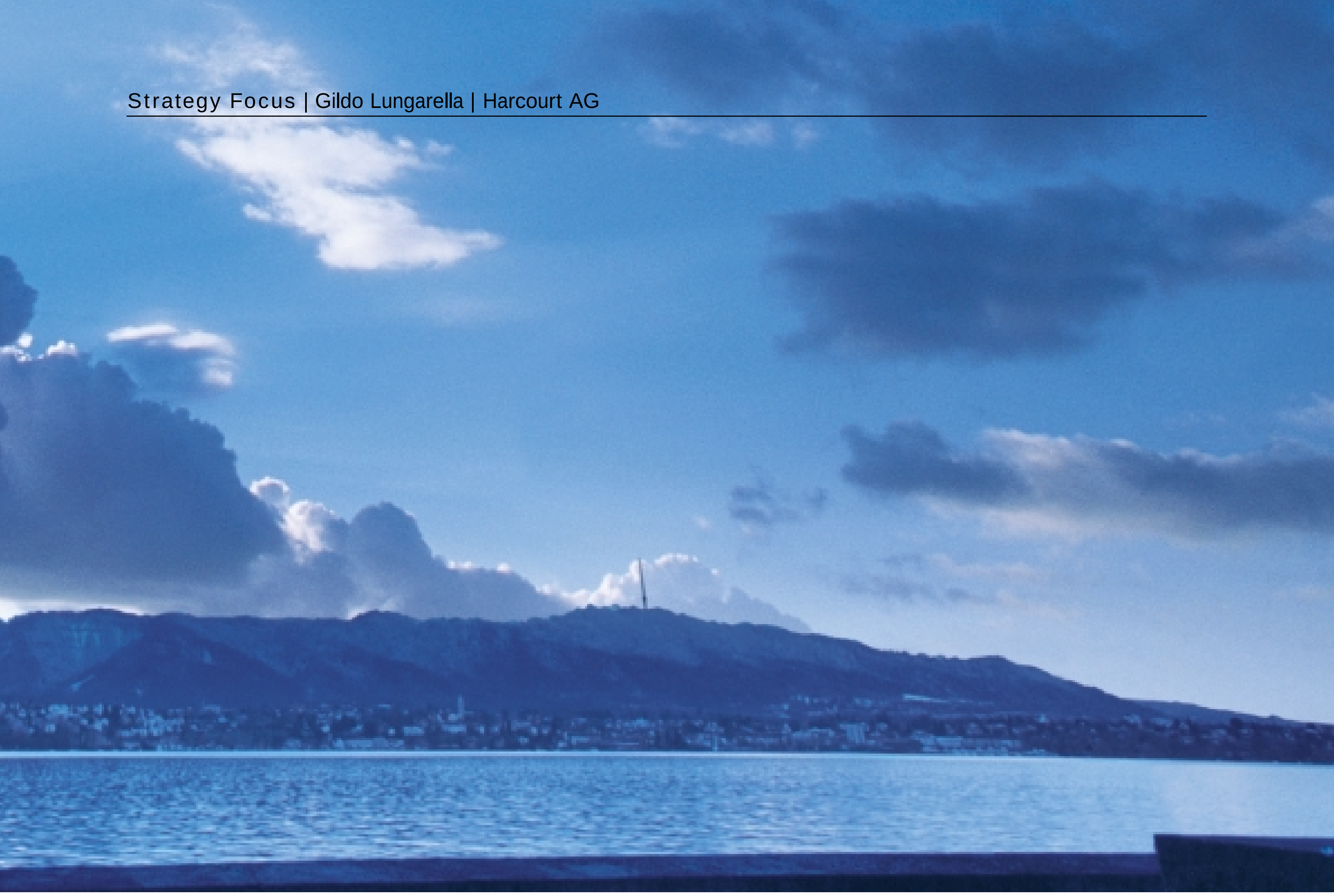
Macro trading has, like most hedge fund strategies, evolved since then and undergone different maturing cycles. The acceptance of global macro hedge funds has improved and the recent good performance is attracting an increasing number of investors to the strategy. The following article will take a closer look at global macro funds and highlight some interesting aspects of this strategy.

Trading the macro moves

This investment discipline is based on fundamental macroeconomic research and generally employs a «top-down» global approach. International monetary, political and economic trends are some of the parameters that the managers are looking at in order to come up with broad economic assumptions and to identify mispricings in global markets. The detection of macroeconomic trends is the basis of macro hedge fund strategies. The macro manager generally makes bets on liquid financial assets in order to profit from changes in global economies.

Cooking a macro meal

Macro trading is usually completely discretionary and is the result of subjective views on macroeconomic information to anticipate market direction. The way that global macro managers approach the markets is not at all homogeneous. There are many different ways to capitalize on macro trends, and there is a wide universe of investment possibilities to implement macroeconomic thinking. Piles of information like central bank publications, survey data, confidence indicators, liquidity measures, forecasting agencies, political commentators and of course personal contacts are used to



form views on market opportunities and to assess the probabilities of potential alternative scenarios. Unlimited numbers of economic variables have to be tracked and processed, and this research effort can be very labour intensive. Should such analysis result in a relatively high probability of a certain scenario, then the corresponding trading positions are taken. In order to determine the right entry moment, the fundamental analysis is then combined with traditional technical price analysis. It is the combination of both that is used to time the investments and which triggers the final decision.

Market conditions and macroeconomic scenario analysis determine whether positions remain for longer or shorter periods of time. «Old style» macro trading is mainly directional, but as the interdependencies between the economies of different countries and corresponding financial markets are increasing, more opportunities for arbitrage trading are created. When mispricings exist between markets that are not matching their macroeconomic reality, then macro arbitrage opportunities emerge. Detecting macro arbitrage opportunities that can be arbitraged away is not easier than finding the next trend but the markets are more liquid than a decade ago. They are traded in large volumes and capital is capable of moving at high speeds. As macro funds tend to trade the same themes in the same global markets, they get hurt when liquidity disappears but when a trade is structured from a non-directional perspective, the risk exposure can be reduced. This complementary strategy improves the overall diversification of the portfolio as macro arbitrage is uncorrelated to directional trading and might be efficiently applied during market periods of less trends and higher unpredictability.

While most macro managers have a discretionary approach and rely on the skills of an individual manager, there are also funds that use a disciplined model driven approach. These managers have replaced subjective macroeconomic analysis with a systematic way of looking at economic data. Common to them is the belief that markets move on average and over time in a manner consistent with economic fundamentals. The managers try to identify specific fundamental data and key economic drivers of financial markets (e.g. equity, bond, currency) which explain the long-term behaviour of these asset classes. The assessments of the current status of the economy or any forecasts are then typically combined with long-term price based models. This investment process is highly structured, repeatable and relies on the application of modelling in a disciplined manner rather than on any individual's trading talents.

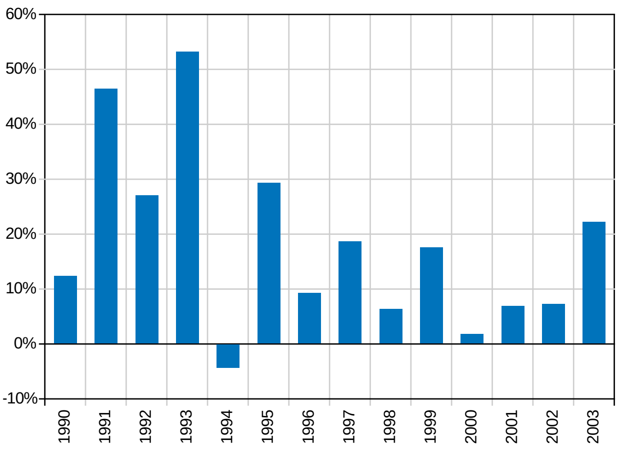
The ingredients

As macro events affect most financial instruments, in anticipating such events the manager attempts to profit by investing in markets that have a high probability of being influenced by these moves. The battle fields of the macro traders are the global financial markets and they mainly trade interest rates, currencies, stock indices; and to a lesser extent the energy and precious metals markets. The investment focus can be on specific regions or countries or across multiple sectors. Positions are implemented through cash and derivative instruments.
While managers have «carte blanche» and can trade any market, they recognize the importance of being able to get out of trades and will therefore rather trade liquid markets. They also have to consider if other managers might place similar bets and if a trade is too crowded or not. While the main focus of the managers is always on financials, commodities are getting more attention again. Hedge funds have built up sizeable positions in base and precious metals and energies. The gold rush is back and the popular gold and silver markets have reached trading levels not seen since many years. These markets have always benefited during periods of global uncertainty. Also, the weakening dollar helped the metals and some of the base metals have rallied even stronger, producing spectacular trends. Also, before and after the war in Iraq, the price of crude oil and other energy markets has exhibited strong price moves.

The performance of global macro trading

Information technology has enabled the wide and speedy dispersion of information that once was very difficult to access. Some argue that the increased information flow has reduced the potential for macro funds to make money on a macroeconomic outlook and to spot overlooked inefficiencies. However, the fact is that macro funds continue to prosper and produce interesting returns for investors. For conventional macro funds, the historical goal was high returns with a more tolerant attitude towards risk (see Chart 1, the HFRI Macro Index is used to represent the macro funds).
1994 was the only year the index had a negative performance (-4.30%). In 1993, interest rates declined and bond markets rallied; in early 1994, the Federal Reserve started to change the direction of interest rates upwards by aggressively raising rates. This caused the bond markets to crash and was one of the worst bond bear markets. Global macro hedge funds suffered as they had large long positions on european bonds. The market volatility of the late 1990s was also not an optimal environment for global macro funds. Simple stock trading strategies generated high double digit returns and leveraged macro funds were not particularly attractive. Running a multi-billion global macro portfolio was challenging and in the year 2000 Tiger Management closed and Soros supposedly retired due to huge losses and inferior performance.

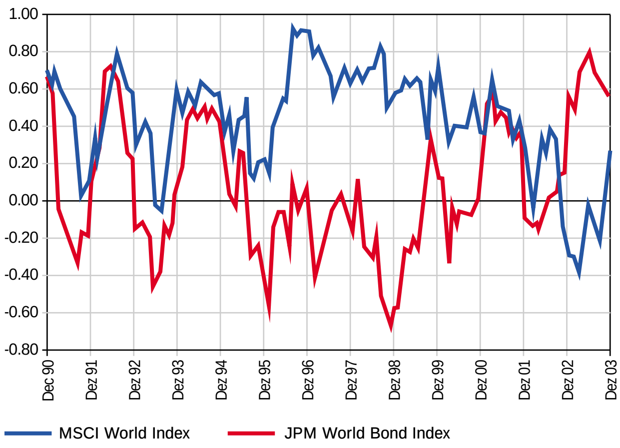
Chart 1 | Yearly returns of the HFRI macro index



Source: HFR

Macro funds can offer a great profit potential if global trends are forecasted correctly. It is interesting to know that if we add up all the negative performing months of the MSCI World Index of the last fourteen years (Jan 90 - Dec 03) then the result is -245%. For the same period during the MSCI World Index down months the HFRI Macro Index achieved a performance of +18%. This means that in months when the global stock markets were not doing well, global macro funds actually managed to produce a total outperformance of +263%. They generally outperform global stock markets during down months as they have access to a wider range of uncorrelated assets and apply strict risk control rules. In defence of equity markets, we have to mention that for the same period the sum of all MSCI Index up months was +324% while the HFRI Macro Index was only up +211%. Macro funds are generally not too highly correlated to the equity markets. Chart 2 shows the 12 months rolling correlation of macro funds versus global stock and bond markets. For the above analysis period, the correlation between the two indices is 0.41 but macro managers can go through cycles where they tend to be more correlated with the equity markets. As we have seen from our above simple exercise, they have the potential to

Chart 2 | 1 year rolling correlation



Source: MSCI / Harcourt

Table1 | HFRI macro index statistics (monthly data)

Data Period:	Jan 90 - Dec 03
Average Return p.a.	17.2%
Standard Deviation p.a.	8.6%
% Positive Months	71.4%
Sharpe Ratio (4%)	1.53
Best Month	7.9%
Worst Month	-6.4%
Maximum Drawdown	-10.7%
Correlation: MSCI World Index	0.41
Correlation: JPM World Bond Index	0.13

Source: HFR

reduce the downside risk of a traditional portfolio and are thus able to provide an efficient portfolio diversification. Table 1 shows the impressive performance statistics of macro funds for the last 14 years. With an annualised return of over 17% and a drawdown of less than 11%, macro hedge funds can easily compete with other hedge fund strategies and traditional asset classes.

2003 was a very good year for macro funds as the HFRI Macro Index managed to perform in excess of 20%. March was the most difficult month for macro traders as the long-awaited start of the war in Iraq led to a surprisingly sharp correction in major interest rate, currency and equity markets. Throughout the year, the powerful rally in the fixed income markets which then collapsed offered significant opportunities. Currency trading also proved to be profitable as the USD continued its decline and weakened substantially against most major currencies, during which it reached an all time low against the Euro. Also, commodities contributed their share to the performance. The energy markets were influenced by the war in Iraq and both base and precious metals reached respectable price levels in 2003.

Risk management

In the early days of global macro investing, portfolios tended to be more concentrated and performance was highly dependent on the outcome of very few trades that were often leveraged up substantially. Managers would usually take significant risks in the pursuit of profit, with risk management merely a secondary consideration. The use of large leverage in order to increase the performance impact is what distinguished macro hedge funds from other hedge funds. The performance was volatile but high returns could be achieved through this tactic.

In the late 1990s, some major macro players made headlines by closing their funds due to disappointing performance and the former shine of global macro funds started to loose some of its brilliance. Managers significantly reduced risk appetite and investors correspondingly started to demand stricter risk management regimes. Markets have become more unstable and in a trendless or volatile market it is more difficult to trade on macroeconomic views. When managers are confronted with adverse circumstances by directionless markets, then effective risk management becomes paramount. Leverage is still employed today, but the focus is more on consistency of returns. The risk management culture has definitely changed and managers look to optimally diversify portfolio holdings in order to reduce risk. While not all macro managers have only one performance profile, they have a clear preference for major liquid markets so that positions can be easily increased or decreased; liquidity risk is therefore evaluated constantly. The risk management framework can range from simply having strict stop-loss limits for individual positions to a more dynamic risk analysis that includes scenario analysis, VaR, liquidity and stress testing analysis. A continuous risk assessment is typically applied to different levels of the portfolio to check if the values are consistent with any constraints imposed. In the past, macro funds were perceived of being reluctant to disclose any portfolio information and some investors hesitated to invest in macro funds due to this general lack of transparency. That has improved as many macro managers today make an effort to provide investors with more frequent and detailed portfolio data and higher transparency.

Attracting smart traders

Big macro funds with a proven and established long-term track-record do in general raise substantial assets which, after a certain level, can no more be handled by just the original trading team. Once the assets exceed the trading capacity, then only by diversifying and carefully distributing the assets across a larger group of traders with complimentary skills can additional capacity be created. Successful macro traders have the choice to start their own company or to join a larger company if the potential is attractive enough. How do macro funds manage to attract and retain high-quality traders? For talented traders the pitfalls of starting an own hedge fund business can be numerous, especially if they lack entrepreneurial experience. The major benefits for a trader to join a recognized macro manager are that he/she can make use of an existing infrastructure and can focus completely on the management of the portfolio as they are usually not involved in the daily management of the company. There will be no pressure for the macro trader to raise assets. Once the fund management is confident that the candidate has all the attributes required to succeed in the long run, then the trader gets allocated enough assets to start trading. The allocation to the trader is increased if the performance is in line with the expectations and may be offered the prospect of starting an own in-house fund. The disadvantage of joining an existing macro group is the loss of independence and if only in-house assets are allocated, then the trader is exposed to the risk of having only «one client», so to speak.

Conclusion

Only ten years ago, global macro funds were dominating the hedge funds industry, representing more than half of the assets of the industry. Currently, it is estimated that less than 10% are invested with macro funds. The power of macro funds has diminished and they no more significantly influence or are destabilising financial markets. Some heavyweight players are still around and new ones are emerging, but the investment landscape has changed for all managers. The game is played differently now. While extended low volatility periods and inaccurate views of the global macroeconomic status can still hurt their performance, they operate now within a tighter and more disciplined risk control framework.

One of the strengths of macro trading is the ability to quickly react to changes in macroeconomic conditions and to implement trading ideas without many constraints.

Institutional investors should consider having an exposure to this asset class as global macro trading offers the potential to generate attractive risk adjusted returns, especially in the current environment of geopolitical and economic uncertainty.