Roundtable discussion

swissHEDGE regularly invites top funds within the quarterly topic to take part in a round-table discussion. This time, we have invited three reputed CTA funds to share their views on their specific strategies, and to shed some light on some of the key issues and opportunities they are faced with in the current market environment.

FX Concepts LLC («FX Concepts»)

Fund: Global Currency Program
Firm AUM: USD 11.4b
Representative: Philip Simotas, President

Lynx Asset Management AB («Lynx»)

Fund: Lynx (Bermuda) Ltd.
Firm AUM: USD1.6b
Representative: Svante Bergström, Managing Director

Wadhwani Asset Management («WAM»)

Fund: Keynes Leveraged Quantitative Strategies Fund, Keynes Quantitative Strategies Fund
Firm AUM: N/A
Representative: Sushil Wadhwani, CEO

Q: What are the main performance drivers for your investment strategy?

FX CONCEPTS: Our currency program is a systematic strategy that takes advantage of the two principal characteristics of the currency markets – namely trend and carry. The model is centered on a portfolio construction process that builds and dynamically balances portfolios of trend-following and carry positions.

LYNX: Performance is mainly driven by exploiting trends in fixed income, currencies, commodities and stock indices. 60% of our returns can be attributed to trend-following strategies. The remainder comes from counter-trend models that profit from short term trend reversals, inter-market models that use multiple market inputs, and short term models that trade intraday.

WAM: In 2008, the largest contributors to our strong returns were our directional models. But although they had less capital allocated to them our other two model groups - the relative value and higher-frequency groups - both generated positive returns. Of note also was that all four major asset classes were profitable for us, and our models achieved this by being long and short at different times of the year in the same asset, ie they repositioned themselves to make money even though prices had reversed. As we enter 2009, our model has reduced exposure to fixed income, and is now slightly longer equities than it has been for a number of months. However, these positions can and may change, sometimes quite quickly, both between asset classes and between model groups.

More fundamentally, our strategies attempt to capitalise on some of the investment insights of Keynes, who characterised the market as a «beauty contest». Some of his insights are also consistent with modern behavioural finance.

Q: What are the key risk factors in your specific strategies? How do you manage them?

FX CONCEPTS: The investment process includes three major components to its risk management. The first two components are quantitative and systematic. The third risk management component is qualitative and comes principally from a discretionary overlay that our CIO runs on top of the model's positions.

Our portfolio construction process is based upon a form of mean variance optimization which requires expected risk forecasts as part of its input. The two quantitative components to our risk management relate to the set of algorithms that are designed to build risk forecasts during normal periods versus a separate set of algorithms that we use to forecast risk during periods of market stress or non-normal periods. Using a mean-variance optimizer, the model builds a portfolio that maximizes the portfolio's forecasted return subject to a series of constraints. The key constraint is the portfolio's risk budget. Thus accurate risk forecasting is a key element to the forecast. In addition, we recognize that certain market environments have no precedent when it comes to quantitative management and therefore require qualitative input.

LYNX: One major risk is extreme volatility due to an external event, causing a major disruption in the marketplace. We are dependent on markets remaining liquid and trading fairly continuously. Erratic market behaviour with prices jumping discontinuously with low liquidity would most likely lead to losses for our strategies. These factors are hard to guard against completely. The best way, in our opinion, is to only trade the most liquid markets available. This means staying away from emerging markets for example, giving up some potential diversification but minimizing the risk of getting caught in unfavourable market situations.

Another risk is prolonged periods of non-trending market behaviour. Historically, markets have oscillated between trending and non-trending periods. If markets stopped exhibiting strong trends from time to time, our strategy would most likely suffer. To mitigate this risk, we use other types of models alongside our trend-following models. These models are not dependent on strong trends to profit. Instead they seek to profit from mean reversion tendencies, inter-market relationships or intraday patterns.

WAM: The key risks we face are generally those the rest of the industry faces also. I would mention performance risk and counterparty risk as being key. In terms of managing drawdown risk, we deploy a range of tools and approaches. A portfolio optimisation process is applied to enhance our reward-risk ratio and this is supported by sophisticated deleveraging rules, position limits, 'take-profit' algorithms and stop-loss mechanisms.

Counterparty risk is an issue that has assumed central importance for our industry, and we address it proactively and diligently. In general, our approach is never to compromise on quality when it comes to the selection of counterparties, and to sensibly spread such risk insofar as it is pragmatic and efficient to do so. We monitor all of our counterparties on a very regular basis.

Q: How do you differentiate yourself from your peer group?

FX CONCEPTS: Portfolio construction, portfolio construction, portfolio construction. It's not necessarily that we have the best USD/JPY forecasting model on the street, but over the years we have been successful at building a process that is able to assemble a myriad of model signals, spread across a universe of over 30 currencies, into coherent portfolios. Portfolio construction has been the principal source of our success.

LYNX: Using multiple systems has now more or less become the norm among CTAs. However, when we started working on our programme in 1996, this was not the case and we believe we were one of the first trend-followers to incorporate non-correlated strategies into the classical CTA framework, giving us a head start over our competitors. We believe we have come a long way in designing and implementing non-correlated strategies to enhance the returns generated from traditional trend-following.

Being a part of Brummer and Partners, a leading hedge fund firm in Scandinavia, is also a great benefit. With administration, legal, compliance and sales handled by Brummer, the Lynx team can focus on the core tasks of system development, trading and programming.

WAM: In respect of differentiation relative to the wider hedge fund universe, our returns show little or no correlation to any of the major asset classes or mainstream hedge fund strategies. Our correlation to the major asset classes is close to zero.

When it comes to CTAs in particular, we believe that our use of non-price information – such as sentiment indicators or economic fundamentals - enhances our reward-risk ratio relative to pure trend-following strategies. In addition, our 'multi-strategy' approach, with fund returns being generated by nearly twenty different models, affords us the ability to generate returns through much of the cycle, rather than just at one point. In particular, our relative value and higher frequency models are likely to help performance when our directional models do less well.

Q: What is your biggest challenge today?

FX CONCEPTS: There are many … but one of our top priorities for the last few years has been to ensure that our models don't hold any hidden biases toward carry that may have accumulated in our research over the last several years. Given the way markets traded for most of this decade, it would be very easy to unknowingly overfit a quantitative model to generate attractive back tested returns. About two years ago, we began a research effort to weed out elements that we believed to be overly reliant on the influence of carry on price action. This served us well in 2008.

LYNX: The biggest challenge is making sure the firm stays ahead of our competitors in terms of performance as the assets under management grow. To ensure this, the firm invests considerably in research and development. A great deal of effort is also invested in keeping the cost of trading low by improving our execution algorithms and infrastructure.

WAM: There are many, but one of the challenges that we devote much time, energy and resources to addressing is the obvious need to ensure that all of our models are performing as well as they possibly can. To that end, we are scrupulous about hiring the very best people we can find to build and run our models, and consistently vigilant about ensuring that those models are robust and responsive to changes and stresses in their respective markets. The refinement of our existing model suite and being innovative in the development, design and testing of new models is something we attach the very highest priority to.

Q: Liquidity factors have gained importance recently. How has this affected your strategy, the markets you trade in, your returns and business?

FX CONCEPTS: While liquidity has thinned, volatility has increased. So the net result is that our models no longer have to take as large a position in order to fill their risk budgets. The net impact our strategies, or the markets we trade in, and our business overall is not that significant. It's too early to tell if there will be any long term impact to liquidity as a result of the recent market turmoil. We can see liquidity returning to the market and bid/offer spreads shrinking as we move further away from the height of the crisis in September/ October.

LYNX: Since it has always been our policy to trade only highly liquid markets, the recent liquidity concerns are not extremely important. We constantly monitor liquidity and the market impact each trade has to ensure that the cost of trading does not exceed the cost assumptions in our back-testing. We have seen a slight decrease in liquidity lately but it has not affected the performance of our strategies in any significant manner.

WAM: Liquidity considerations have always been a high priority for us. As I have mentioned already, our investment strategy is - and has always been - to trade mainly in the highly liquid futures and f/x markets. We have reduced our exposure to individual equities over the last year in a desire to be in more liquid strategies. Our allocation model always allowed for differential transaction costs and has also responded by somewhat reducing our exposure to markets where bid-ask spreads widened by more. So it’s probably fair to say that our own investment strategies have not been greatly affected.

Q: Does the subsequent unfolding of the current crisis create opportunities for your strategy?

FX CONCEPTS: Absolutely. Any crisis that forces dislocations in markets, where participants struggle to find new equilibrium levels, creates trends – which is one feature our models aim to capture. Our CIO, tells me that this period looks more like the markets during the 1970s and early 80s than any he has since. (I started in the markets in the mid 1980s.) This makes a lot of sense to me since for the first time in two decades markets are experiencing monetary and fiscal policies across the developed countries that are at odds with one another and at very different points in their cycles. This provides a very fertile backdrop for currency moves and a much different environment than what we saw in the 1990s and 2000s.

LYNX: The crisis has so far proven to be very profitable for us. There is a tendency for our strategies to perform well when there are big shifts in the global economy, either to the upside or to the downside. Increased volatility in the form of strong trends usually leads to good performance for all trend-followers.

WAM: At the risk of stating the obvious, the current crisis has been global in its reach – it has affected and is continuing to affect all geographies and all asset classes. In terms of magnitude it has been the most severe dislocation we have seen since the 1930s. It seems likely to us that 2009 will see further significant volatility in world markets, across all asset classes, and this environment is one which creates great opportunities for our strategies. Historically, simulations suggest that our directional models do best when volatility is high.

Naturally, it also creates risks – environments such as these can ruthlessly expose weaknesses in models and one needs to be continually alert to this possibility and work to constantly refine and improve them. But if

effectively executed, there is no doubt that significant opportunities exist.

Q: Do you expect the level of volatility to remain elevated through the coming year?

FX CONCEPTS: Yes. Volatility will most likely come down from the extremes we saw in the fourth quarter but still remain elevated.

LYNX: It is hard to see the current crisis blowing over anytime soon. We will probably see shorter periods of recovery and reduced volatility but we expect volatility to remain high during next year. We are witnessing one of the greatest meltdowns in modern history and for everything to return to normal next year would take a miracle. Also, government intervention is never a good sign (but may be profitable for CTAs) and this time around the interventions is on an unprecedented scale.

WAM: We believe that market volatility is likely to be above long-run averages in 2009, yes. There are likely to be further significant price moves in major asset classes. In the relatively near-term it is likely there is going to be a move towards greater quantitative easing on the part of the Central Banks, and quite possibly significant fiscal stimuli. To put it crudely, if quantitative easing works then inflation could reappear on the horizon as a major risk quite quickly. However, there is considerable uncertainty about whether quantitative easing will work - if it doesn't then there is likely to be more downside for economies. Either scenario has implications for all the major asset classes.

Q: Do you expect the low correlation of your strategy to traditional and non-traditional indices to persist going forward?

FX CONCEPTS: Yes. You will see correlation of our strategies continue to drop versus equity indices for a very simple reason. The long term uptrend for equity markets from previous years has been over since Q4 2007 and as a result, returns on a rolling basis have turned negative. This will force the correlation down when matched against our own recent performance which has been positive for the last several years.

LYNX: In our view, there is nothing to suggest otherwise. Correlations can rise temporarily during periods with strong stock markets but there is no evidence pointing to a higher correlation in the long term.

WAM: Yes, we do. The low correlation of our strategies relative to major asset classes and indeed most hedge fund strategies is not dependent on where we are in the economic or market cycle, nor on any other time-sensitive factor. It is our intention that our strategies should continue to offer investors a clear source of diversification.

Q: What differentiates your research process and how do you monitor the shelf-life of your models?

FX CONCEPTS: Our research process can be viewed as an effort to quantitatively express an existing trading or economic theory. This compares to the notion that many have of quantitative «black-box» modelling where the developer («quant») allows the data to build the model. Non-parametric modelling is the buzzword that many use to describe this process. As a result of our research process, we have a much better chance of anticipating when our models are likely to run into trouble.

The question of shelf-life is harder for us to answer. A good model is not a static entity but instead constantly adjusted over time. Each time we experience a drawdown is an opportunity to potentially discover a previously unknown weakness to our model. With time, a properly designed model should get better.

LYNX: It is our philosophy to give our research team a great amount of creative freedom. We as managers encourage our employees to approach a broad range of fields and topics in an effort to find new approaches to model design. The average time to develop a new model is approximately three years and the reason for this is that a great deal of ground-research usually goes into finding a new model or approach. The standards are very high when it comes to accepting a new model which also contributes to a fairly long development time. The model must increase the Sharpe ratio of the total portfolio both in the short term and the long term. It must also meet the criteria of model stability as mentioned above. Finally we critically evaluate the underlying premise of the model and the probability that the concept will hold up in the future.

Twice a year we make adjustments to the model portfolio. Our goal is to make small, incremental changes in an effort to continuously improve the portfolio while at the same time maintaining stability in the management process to safe-guard against future performance becoming radically different from past performance.

WAM: Our research process is based on the very extensive experience and knowledge of our research team, whose professional backgrounds are very diverse. This

has enabled us to build our current model suite. But we never take our models for granted and we take every opportunity to further refine and improve them.
Furthermore, we devote extensive research resources to developing new models in areas where we perceive there to be particularly attractive opportunities. Recently, this has focussed on the higher-frequency area and we are excited about some of the results from this work. Obviously, each model is continually monitored closely, and emerging inconsistencies with historical simulations are quickly investigated. In certain exceptional circumstances, we might elect to suspend or even retire a model, for example in the event of extreme regulatory intervention or uncertainty. This will, however, be very rare.

Q: What is your outlook for your strategies for 2009? What trends do you see as potential sources of return?
FX CONCEPTS: With volatility projected to remain elevated, the currency markets should continue to serve up some meaningful trading opportunities in 2009 so we are optimistic in our outlook. The odds of us getting the details of each currency move are formidable, but the general concept that US efforts to reflate the economy are likely to lead to a prolonged dollar decline at some point in the near future, is likely to be on target.
LYNX: We are optimistic about the future performance of our strategies. It is not difficult to envisage big trends in the USD and global interest rates going forward. The commodity bull market will also probably resume its course at some point, generating enormous opportunities.
WAM: While it is impossible to predict with any degree of certainty what the outcome of 2009 will be – and one could argue that the task of prediction is harder this year than usual – what we have done is to structure our strategies such that we can generate returns equally well in different environments.
As we have pointed out, we believe that 2009 will see continued macroeconomic volatility, implying significant moves in major asset classes, and this sort of environment is likely to present funds such as ours with interesting opportunities.

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