

MARKET INSIGHT

When the Roaring Stops

February 2020

As we begin this next decade, we are reminded of the era one hundred years earlier, often described as the “Roaring Twenties” or the “Golden Age.” It was, for many developed economies, a time of peace and prosperity after what was then known as the “War to End All Wars.” But as much as the era invokes imagery of a joyful exuberance and vibrant cultural revolutions,¹ of shiny new cars and bold fashion choices, it should also serve as a cautionary tale. As we know now, the Roaring Twenties ended with a screeching halt, and the unanticipated market crash led to a protracted depression and (indirectly) another world war.

Today’s Twenties

In the early weeks of 2020, our unprecedented bull market continues to roar. Risk assets had yet another positive year in 2019, with equities, credit, and commodities all advancing. The volatility environment continued to be subdued, relative to its long-term history. But against this rosy backdrop, fundamentals have weakened. Growth and manufacturing have slowed, notably in the Eurozone and China. The broad trend away from globalization and toward protectionism continued, posing further headwinds for the global economy. And while risk appetite was generally resilient, defensive assets such as gold and bonds also had an up year, suggesting at least some uncertainty about the bull market’s longevity.

This disconnect between risk appetite and fundamentals creates a challenge for allocators. On the one hand, going to cash can be hard to justify, as the opportunity cost of sitting out this bull market can be prohibitively high. On the other, we suggest that it is increasingly imperative to consider how to protect realized gains before the

next market downturn. Many pension plans are close to their funding statuses, many foundations are near their targets, and many companies are earning more than they are paying out. Market crashes and economic recessions may be notoriously difficult to predict, but “cannot predict” is different from “cannot prepare.”

Why Global Macro, Why Now

We believe the global macro space offers the ideal investment opportunity for this kind of environment. First, the highly liquid nature of most global macro strategies is a nice complement to portfolios with significant capital allocations to illiquid assets, which have become increasingly popular over the last decade. Additionally, because global macro managers typically invest in liquid assets, they are often able to respond nimbly to rapid changes in the opportunity set. In other words, global macro has the potential to deliver upside capture should risk assets continue to advance, but also downside protection should markets experience a correction or downturn.

Commodities trading involves substantial risk of loss.
Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.



If we take a brief detour into global macro's philosophical ancestry, its origins are tied to this specific investment objective (the potential for both upside capture and downside protection). When markets crashed in the late 1980s, investors began to look for a superior form of protection to outright portfolio insurance, and found tactical asset allocation programs an attractive alternative. Investors then applied the same principles of domestic tactical asset allocation to a global framework, or GTAA (Global Tactical Asset Allocation). GTAA is a particular form of macro investing in which the largest constraint is an asset class decision. For many investors, though, a fixed, highly concentrated asset class bet was an unnecessary constraint in pursuing diversifying returns. This led to the emergence of "Global Macro," which can be viewed as a less constrained form of GTAA – a way to express global macro views where the asset class decision is just one of many.

Although we believe global macro investing to be a rare opportunity to "have your cake and eat it too," it is important to stress that our enthusiasm comes with a caveat: Not every application of global macro has the potential to deliver downside protection when markets are under pressure. Forms of macro investing that are heavily reliant on trend, momentum, and currency carry may at times be fairly correlated to global equities. Such approaches may deliver very attractive returns when markets are advancing, but may not offer the desired diversification when trading turns defensive. Avoiding such exposures takes discipline, rigor, and continuous oversight, but we believe a systematic strategy with very low correlations to major asset classes provides a superior marginal contribution to most investors' portfolios.

Our Potential Solution

Since its founding in 1988, First Quadrant has aimed to provide unique investment insights through its alternative product offerings. One of the early pioneers of GTAA, we have leveraged our decades of systematic macro research to create Global Diversified Macro (GDM), a true "go anywhere" strategy that implements macro ideas without fixed asset class constraints. The strategy

will hit its three-year anniversary in April 2020, but much of the underlying intellectual property has been used in live portfolios for far longer.

Global Diversified Macro seeks truly diversifying returns. We expect our strategy to deliver positive return in a wide variety of market environments and to be lowly correlated – not only to traditional asset classes, but also to other macro strategies. Over its live track record, we have been pleased with our ability to deliver our expected results. From April 2017 (inception) to December 2019, Global Diversified Macro has realized annualized double-digit returns, with low negative monthly correlation to equities and low positive monthly correlation to bonds.²

We believe our diversifying results are attributable to a differentiated investment process. Our process is systematic, which facilitates a more repeatable and transparent approach than many discretionary strategies. However, the individual insights are anchored in fundamental investment ideas, rather than the "black box" techniques that some quantitative firms have espoused. Our investment approach is rooted in a deep understanding of how different groups of market participants will respond to market catalysts. As a result, we are able to nimbly adjust to changes in the market environment in an effort to provide alpha that we believe is underrepresented in many existing portfolios. This dynamic nature of GDM provides a unique opportunity to position the portfolio for potential success regardless of the market environment.

Conclusion

Looking back on the 1920s with the benefit of hindsight, we observe how a lack of preparation contributed to arguably the worst depression in modern market history. With more foresight and more diversification, today's investors have the potential to avoid this kind of scenario, without going to a pure hedge or cash. We believe every investor should be asking, "If the current bull market were to end tomorrow, would my portfolio be meaningfully diversified?" By learning a lesson from the past, we can better prepare for the future.





Endnotes

¹We recognize, of course, that we are being overly reductionist to make a point. This description of conditions of the time is an overly broad generalization, and unfortunately, not every demographic benefited from this economic boom and cultural shift.

²MSCI World Index: [-0.16](#); FTSE World Government Bond Index, Currency-Hedged: [0.10](#) (Source: StyleAdvisor). For index definitions and trademark language used in this document, please visit <https://www.firstquadrant.com/index-definitions> for further information.



Composite Information

Global Diversified Macro	Total Return Gross	ICE BofAML US 3-Month T-Bill Total Return	Value-Added Gross ¹	Total Return Net ⁶	Value-Added Net ^{1,6}	Composite 3-YR Standard Deviation Gross (Annualized)	Benchmark 3-YR Standard Deviation (Annualized)	Number of Portfolios ⁴	Composite Dispersion [%]	Total Composite Assets ^{3,4} (Millions USD)	Total Firm Assets	Total Firm AUM (Including Notional Values) ^{1,4,5} (Millions USD)
2017 (Apr - Dec)	+6.0%	+0.7%	+5.2%	+6.0%	+5.2%	-	-	<5	-	4	11,209	26,276
2018	+16.6%	+1.9%	+14.7%	+16.6%	+14.7%	-	-	<5	-	3	6,474	20,077
2019 ²	+10.0%	+2.3%	+7.7%	+10.0%	+7.7%	-	-	<5	-	3	6,041	16,166

See additional disclosures for important information concerning this composite and the effect of fees. ¹Supplemental Information. ²All Performance and AUM data is preliminary. ³Includes market values for fully funded portfolios and the notional values for margin funded portfolios, all actively managed by First Quadrant. ⁴At End of Period Reported. ⁵Includes market values for fully funded portfolios and the notional values for margin funded portfolios, including active mandates and active/passive mandates, all managed by First Quadrant and non-discretionary portfolios managed by strategic partners using First Quadrant, L.P. investment signals. First Quadrant is defined in this context as the combination of all discretionary portfolios of First Quadrant, L.P. and its strategic partners, but only wherein FQ has full investment discretion over the portfolios. ⁶From inception to the most recent period presented, the composite consists of one portfolio, which is non-fee-paying.

Global Diversified Macro Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss. **GENERAL DISCLOSURES** First Quadrant, L.P. claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. First Quadrant, L.P. has been independently verified for the period 1995-2018. The verification reports are available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. First Quadrant ("FQ" or the "Firm") is defined as the combination of all discretionary portfolios of First Quadrant, L.P. and its strategic partners but only wherein FQ has full investment discretion over the portfolios. First Quadrant L.P. is a registered investment adviser and is an affiliate of Affiliated Managers Group, Inc. A complete list and description of the Firm's composites is available upon request. **COMPOSITE DETAILS** Composite Description: (Creation Date: September 2018) The Global Diversified Macro composite includes all portfolios that use FQ's multi-asset, global macro approach and may be managed to varying risk targets at the total portfolio level. This is a total return strategy with an objective to provide consistent, long-term capital appreciation, with returns that are uncorrelated to common equity betas; in essence, it targets a long-term average equity beta of 0.0 over a full market cycle. It takes long and short positions in stock and bond index futures, interest rate futures, commodity futures, and currency forwards and futures. T-bills are used for collateral management. Additionally, the strategy has the discretion to invest in other asset types not limited to cash equities, index and currency options, swaps, and exchange-traded funds. Effective December 2018, the benchmark was retroactively changed from the Ibbotson 30-Day T-Bill to the ICE BofAML US 3-Month Treasury Bill Index to serve as a better representation of the investment strategy. The ICE BofAML 3-Month T-Bill Index is an unmanaged index that measures returns of three-month Treasury Bills. Portfolio Criteria: There is no minimum balance requirement for a portfolio to be included in this composite. **Calculation Methodology:** Valuations and returns are computed and stated in U.S. dollars. Composite returns are presented net of non-reclaimable withholding taxes on global cash equities. Dividend and interest income is accounted for on an accrual basis. Performance includes reinvestment of dividends and other earnings. Individual contributions and withdrawals are permitted to occur on a daily basis. Monthly investment results for the portfolio are calculated using a daily time-weighted rate of return formula. Annual composite returns are calculated by geometrically linking the monthly returns. The dispersion of a composite is calculated using the asset-weighted standard deviation formula. Only portfolios managed for the full calendar year are included in the dispersion calculation. As this composite contains five or fewer portfolios, a measure of dispersion is not statistically representative and is therefore not shown. The portfolios may utilize leverage at FQ's discretion. The returns presented will reflect this leverage. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns (if applicable) over the preceding 36-month period. The standard deviation is not presented for periods in which 36 months of historical composite returns are not available. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. **Derivatives:** The strategy utilizes derivative instruments to achieve desired exposures. Derivatives are financial instruments, which derive their values from underlying securities. Futures contracts are exchange traded derivatives that specify a purchase or sale of an asset at a specified price on a specified date in the future. Forward contracts are over the counter derivatives that allow for the purchase or sale of an asset in the future at a currently agreed-upon price. An option is a contract that grants the owner the right to purchase or sell an underlying asset at a specified price on or before its expiration date; however, the holder of the option is not obligated to take any action. A swap is a derivative contract designed to exchange a set of future cash flows between two counterparties at predetermined dates in the future. Generally, in these arrangements, one counterparty will pay a cash flow pegged to a floating interest rate, while the other counterparty will pay cash flow based on the performance of the underlier. There is a risk that a derivative may not perform as expected, thereby causing a loss or amplifying a gain or loss for the strategy. With some derivatives, there is also the risk that the counterparty may fail to honor its contract terms, causing a loss for a portfolio. **Investment Management Fees:** Portfolios carry a base fee of 1.00% with a 20% incentive fee. The gross performance returns presented include the deduction of all trading commissions but do not include the deduction of management fees. Performance results presented net of investment management fees are based upon the actual management fee charged each portfolio in the composite, and are net of any performance-based fees. From April 2017 to the most recent period presented, the composite consists of one proprietary portfolio, which is non-fee-paying. **Market Impact on Returns:** In the first week of February, 2018, constrained liquidity triggered unexpected volatility in global equity markets, which benefitted the portfolio. In the same month, a prevailing positive outlook on Sweden's economy was dampened by reports of a slump in housing prices and weaker-than-expected inflation data, which contributed to a more cautious tone in the February minutes of the Riksbank. A short position in the Swedish krone contributed to notable positive returns to the portfolio during this period.

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