

FQ Perspective

by Max Darnell

A number of reflections seem in order given both the investment activity of these last few days and weeks, and given a certain set of erroneous perspectives that we've observed. Some of our comments will be correctly read as a defense of our own competitors in the global macro space. While we do not have knowledge of what risks our competitors are taking, we do have solid grounds for challenging certain perspectives that are founded upon the same minimal knowledge that we hold about their products and portfolios. Given that we are doing very well in this market environment we, unlike those who are not doing so well, are in a position to deliver those challenges without appearing to be on the defensive.

What's Going On Out There?

Let's begin by taking a distant step back from what we and our competitors do and consider what's taking place in the markets broadly. We have one point to make that we think is being missed, or at least under attended to. To get to that point, we must first frame the issue with the following well known facts:

Investors have, in recent years, broadly shown a very strong appetite for return. Some investors such as pension funds have a high need for return to meet their return objectives, while some other investors have simply developed an appetite for high return after having tasted double digit returns in the 1990's. This appetite is coupled with low return expectations and low interest rates. Together, these have encouraged some investors to use leverage to magnify lower expected returns so as to reach desired expected return levels. Add to this mix a glut of liquidity globally which has driven asset prices higher – thus driving future return expectations lower, all of which adds all that much more pressure to take more risk and use more leverage. With realized and option-implied future volatility having held to low levels for an extended period, some investors have succumbed to the pressure to assume volatility will remain low and therefore justify taking on more risk than may be appropriate to longer-term risk characteristics.

One of the most important consequences, as we see it, is that all of this led to the entry of short-term investors into less liquid markets. What qualifies an investor as having a short-term investment horizon? Clearly a short-term investment objective qualifies. Hedge funds classically fall into this camp. Investors that are either highly leveraged or with very limited tolerance for disappointing returns qualify too. Investors with shorter-term investment horizons will have moments of great difficulty when holding less liquid assets. Forced selling will occur. Asset prices spiraling downward and liquidity drying-up are the result. Contrast those investors with endowments and foundations who have traditionally held less liquid assets, but who aren't forced to run for the door when the prices of those as-



sets weaken because they're not highly leveraged and they have a longer-term investment horizon.

This entry of short-term players into less liquid markets has been, we expect to find, a very important part of the story unfolding over the last few days and weeks. Was credit, for example, less liquid than it had appeared to be? That appears to have been the case. In defense of others, it was not obvious. The liquidity of the credit market that exists today had never been tested before because it didn't exist before – not when you take into account the fact that a large share of the participants involved today and the instruments available today are new to that market. If we're right, more risk unwinding should be expected. In the course of that, undervalued assets will be sold.

What To Expect From Global Macro

Returning closer to home, are the results of some global macro funds in line or out of line with expectations? There are two properties of systematic global macro – the product that we and a number of other very well known firms manage – that make the product stand out. First, the product, having broad access to opportunity across the globe and to multiple asset classes, has tremendous breadth. This allows global macro managers to deliver highly diversified strategies, and that diversification allows global macro managers to deliver higher than normal risk adjusted returns. Second, unlike most other alpha focused products, there is an unusually low correlation amongst the managers themselves. The advantages of investing in a diversified basket of global macro managers are higher than in possibly any other product area except currency where correlations are similarly low.

Running highly diversified strategies does not guarantee positive returns all the time. What you should expect

from such strategies is that they'll deliver higher than average risk-adjusted returns, and when they do underperform, their underperformance will tend to be modest relative to the risk they are taking. What is modest underperformance? That depends upon whether "insurance" is in place or not – a subject we'll come back to below – but for strategies that don't buy insurance against short-term underperformance, modest underperformance means shortfalls that are equal to or less than the risk that is being taken. Modest underperformance for a fund taking 2% risk would be 1%-2%, or 7.5%-15% for a fund taking 15% risk.

Objects May Appear Larger Than They Are

Double digit losses may appear large, but that's only due to the magnification of risk. This is a point that our clients know well, but given the drama created about certain returns that we've seen in the press, it is worth some emphasis.

A 16% loss is not necessarily larger than a 2% loss. You think I have my math wrong, right? If the annualized risk associated with a 16% loss is 16%, and if the annualized risk of the product generating 2% losses is 2%, then a 16% loss is equivalent to a 2% loss. Investment returns should always, under all circumstances, without exception... be scaled by the risk they take.

If you're not 100% convinced, take the case of global macro specifically. A client that has given us \$100m to run at 10% risk would have risked \$10m and earned roughly \$7m year to date, while another client who has given us \$1b to run at 1% risk would have risked \$10m and earned \$7m. In other words, a 7% return and a 0.7% return are identical when adjusted for risk in this example. Investors in global macro have moved to higher and higher risk levels in recent years by investing fewer dollars to the strategy and raising the risk levels on

those dollars. At the fund level, the dollars at risk may very well be the same, and the scale of returns should not be feared. There are some losses taking place that merit the drama, but not any such examples exist in the global macro space that we are aware of.

Insurance Is For Those With Limited Financial Means

It's important to be clear about the difference between products sold as absolute return and those sold as alpha products. Global macro is an alpha product, not an absolute return product. This simply means that over the long-term, the return to global macro should be largely independent of market returns. The correlation of global macro returns to the returns on individual asset classes should be low.

Alpha products will experience positive and negative returns across the profit cycle. They do not insure against losses, and because they do not insure against losses, they are not expected to deliver positive returns all the time. Absolute return products, on the other hand, should be insuring against losses if they aim to deliver on their promise of positive returns all the time.

Insurance comes in many forms, but they all come at a cost. Buying options is expensive, so while buying options can protect a portfolio from certain types of negative outcomes, the negative impact on long-term results is quite substantial. Dynamic hedging strategies like portfolio insurance are also costly. Selling into a falling market to avoid short-term losses typically means locking in recent losses and passing on the opportunity for future gains. We have never seen an approach that insures against losses that doesn't come at a hefty price.

For those who have a need to insure, it is our opinion that they should not pay for insurance at the individual asset or fund level by asking their managers to provide guaranteed products or to ask their managers to apply



portfolio management techniques that tightly constrain against modest negative outcomes (insuring against extreme outcomes is sensible in certain situations). Instead, they should focus insurance, if truly needed, on the net risks in their portfolio that remain after taking account of the diversification effects of their individual investments.

Diversification is the Protection of Choice

Diversification is the right alternative to insurance for most investors. Combined with a recognition that short-term volatility has little more than an emotional cost in most cases (the Pension Protection Act in the US is raising at the margin the economic cost of short-term volatility), investors with well diversified portfolios are far better off not paying for insurance at the individual investment level, and should not be trying to avoid, therefore, short-term losses that occur at the individual investment level.

Global macro offers nearly unprecedented opportunities for diversification, and we believe that there are very few investors who choose to invest in only one global macro manager as a result. While some managers have been underperforming, there are others – like us – who have been enjoying strong outperformance. That’s not typical of investment products, so we’re not too surprised to see people react with concern when one or more managers is underperforming. Most managers in individual product categories tend to have relatively high correlations with each other, but in global macro, the correlations are much lower. Portfolios of global macro funds with low correlations are probably doing perfectly fine right now.

Two Very Different Types of Quant

The news in the press has been universally negative about quants. This needs to be challenged directly, as there are very different types of quants, and some have done very well in this environment. Differentiating between them is important.

There’s a very big difference between learning from the past and assuming that the future will look like the past. Nobody who says that “history repeats itself,” means that in the literal sense. The future never looks like the past. There are forces at work – social, geopolitical, physical, – that will be at work in the future in much the same way that they have been observed in the past.

It is imperative, therefore, that we learn from the past about these mechanisms, these forces, these relationships, and that we carry these lessons about how the world works into the future. We will use what we’ve learned in the past, but we will use them to face situations that we’ve never seen in the past. That’s precisely what we do at First Quadrant. We use history to study what market and economic factors influence market and asset behavior, and we use that to predict outcomes that we may have never seen before.

There is another type of quant that does it quite differently, however. There are those who do extrapolate from past to future. Past returns are expected to repeat; yesterday’s past winners are expected to be tomorrow’s winners. Statistical patterns are expected to repeat. These quants are known as having their focus in the rear view mirror. Their decisions are said to be led by computers and data, not by their understandings of finance, economics and

the markets. That’s not us, and that’s not who most of our direct competitors are either – including those who have underperformed recently. The statistical quants are, from what we read and hear, the ones who have really been hurt in recent days and weeks.

In Short

Diversification is the best insurance against individual manager underperformance, and we know of no other investment products, other than currency, where the benefits of manager diversification are greater than in global macro. The diversity of managers in global macro means, by definition, that one should expect modest underperformance from some of the managers while other managers are outperforming. One manager’s (or a few managers’) difficulties are rarely, in this space, a reason for long-term performance concerns about that manager, nor are they a reason for concern about the category of managers broadly. We have not lost confidence in our own competition! We can’t advise investors on this matter, because we don’t have the details about competitors holdings, but calm and patience are most likely the right choice.

On the surface it appears that the institutional quality global macro managers are in aggregate doing well enough, and the press has made far too much out of the facts that it has in hand. We can’t know how this will unfold short-term, but from our perspective, the opportunity set is looking richer and richer. We expect our alpha to be volatile in the days ahead, but we expect the positive alpha to continue to accumulate.

