Alternative Investments

Over the Hedge *by the Investment Advisory Group*

A periodic exploration of topics in the hedge fund industry

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Global Macro: Renewed opportunity

Global macro has been the best performing hedge fund strategy over recent years.

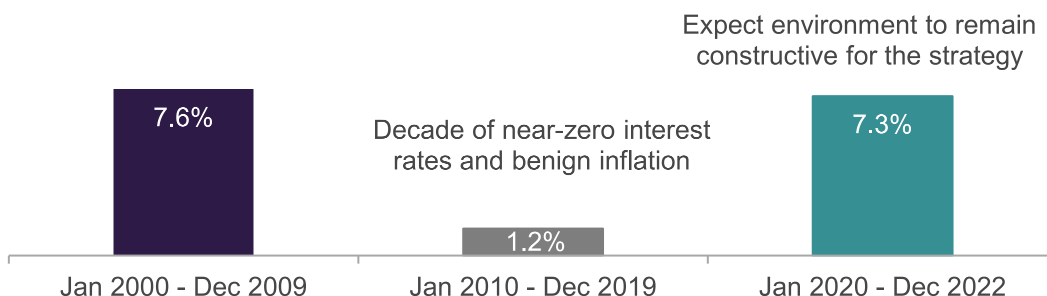
Zoom in: For most of the last decade, near-zero interest rates and benign inflation created an environment in which the asset classes typically associated with global macro, particularly global fixed income, foreign exchange and commodities experienced little volatility.

- This made it difficult for global macro managers to generate returns, paling in comparison to those generated prior to the Great Financial Crisis (GFC).

However, the global environment has become favorable for macro hedge funds.

- Global central banks are more active, inflation has been elevated and geopolitical risks have risen, driving a recovery in performance.

Global macro annualized returns



Source: HFRI; HFRI Macro (Total) Index

Most importantly, global macro strategies can provide valuable diversification benefits to portfolios, given the unique array of asset classes and investment methodologies used.

- Additionally, the current market environment should provide a performance tailwind.

Explore further:

On the following pages we expand on the opportunity for investment in global macro:

- Global macro explained
- Manager styles
- Asset classes
- Current environment and outlook
- Drivers of recent performance
- Value as a diversifier

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The Micro on Macro

What is global macro investing?

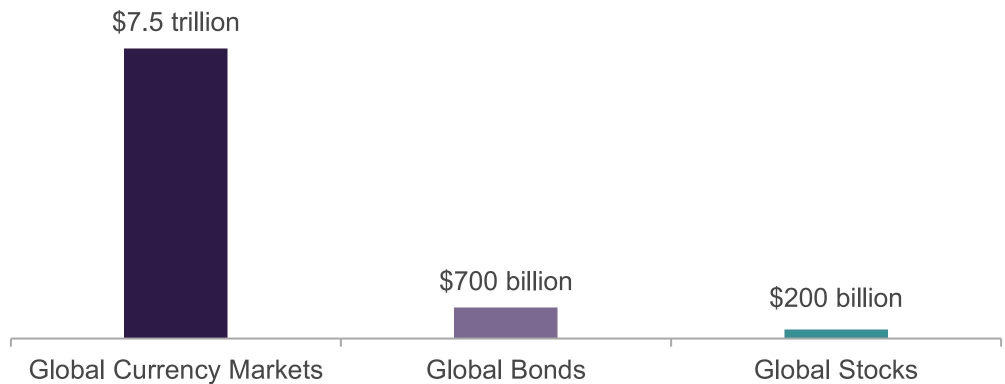
Despite being one of the oldest hedge fund investment strategies, global macro can still be somewhat difficult for investors to understand. Given its “go anywhere” approach, it has been the preferred investment methodology of some of the world’s best known and most talented money managers including George Soros, Louis Bacon and Paul Tudor Jones.

Although it can encompass virtually any asset class, its primary markets of focus are:

- Currencies
- Sovereign bonds
- Interest rates
- Commodities
- Equity indexes

One thing that many of these markets have in common is liquidity. Typical global macro asset classes are some of the most liquid in the world as measured by daily trading volumes:

Daily trade volume
(rounded estimates)



Sources: SIFMA, BIS, Tradeweb, World Federation of Exchanges; as of 2021

This global canvas and ample liquidity allow managers to exploit their ideas–taking advantage of price movements in both directions–via a variety of asset classes, and to quickly pivot as circumstances and opportunities ebb and flow. In addition, macro investing often employs an array of instruments that include cash, option, forward and futures contracts and other sophisticated derivatives.

- These allow global macro managers to generate returns not only from directional price movements but also from sources such as interest rate carry, a foreign currency investment strategy in which one borrows from a country with low interest rates to invest in another with high rates while managing the currency exchange rate risk between the two.
- Also of note is volatility trading, through the use of various option and derivative structures, and there are other sources as well.

There are two primary types of global macro manager:

1. Discretionary managers
2. Commodity trading advisors, more commonly known as CTAs or managed futures advisors.

Both trace their origins back to the late 1960s and early 1970s when global currency volumes expanded significantly as the U.S. ended the dollar's peg to gold. This period also coincided with the introduction of futures contracts on financial instruments as well as dramatic price increases in commodities, as inflation, particularly in the U.S., rose markedly. At the time, both types of managers exploited those opportunities using different investment techniques and continue to do so today.

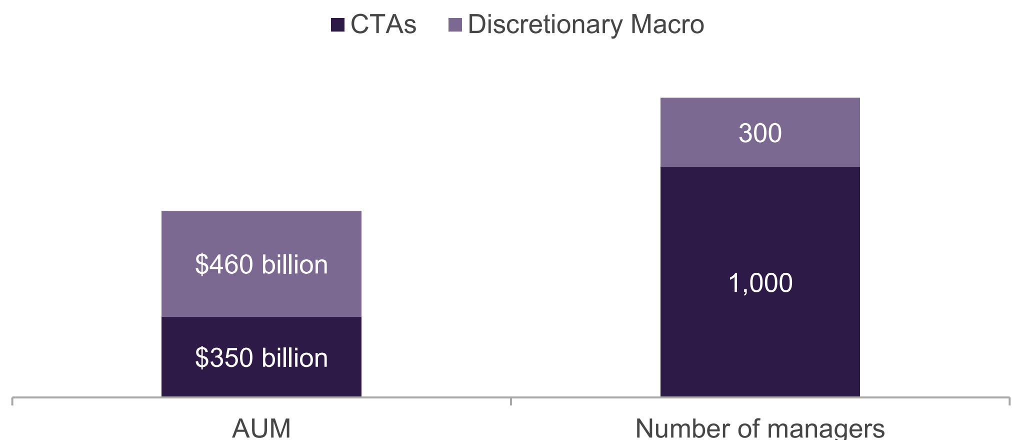
Discretionary managers typically have a single portfolio manager or an investment team which develops investment ideas from fundamental and quantitative research into areas that may include macroeconomic statistics, governmental policies (both monetary and fiscal) and technical price and trading flow data, amongst others.

- The portfolio manager or team then decides, for example, in which markets and with what instruments it will implement those ideas and the size of the resulting positions.

Commodity trading advisors (CTAs), on the other hand, usually develop and employ a quantitative and systematic investment methodology, and allow these "systems," or what are essentially computer algorithms, to decide:

- What to buy and sell
- When to buy and sell
- And the size of the positions

Once in place, the systems are generally allowed to operate with limited human intervention.



Sources: IASG, HF Journal, Abbey Capital, BarclayHedge; as of 2022

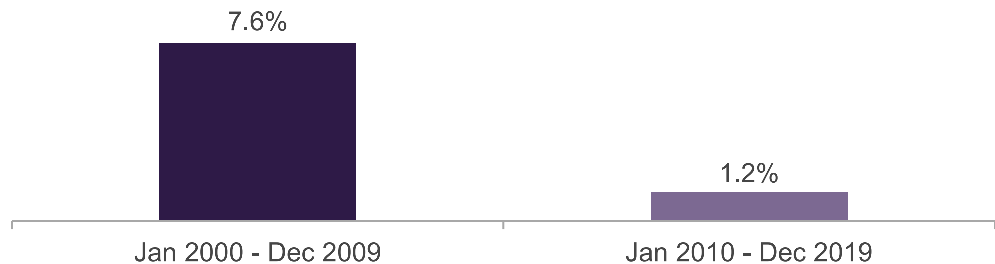
A renaissance?

Like with most actively managed investment strategies, changes, or volatility, in the level of prices and other metrics are critical to performance of global macro managers on both an absolute and relative basis.

- However, in the last decade or so, bookmarked by both the 2008 Global Financial Crisis (the "GFC") and 2020 COVID pandemic, the world's central banks kept interest rates at or near zero in an effort to support economic activity. They were able to do so as inflation remained subdued in the developed world.

These two factors: zero interest rates and benign inflation, created an environment in which many of the asset classes associated with global macro – including currencies, fixed-income and commodities – experienced little change. The one exception was equities, as extremely low interest rates increased the value of a company's future cash flows leading to ever rising stock prices with hardly any pullback.

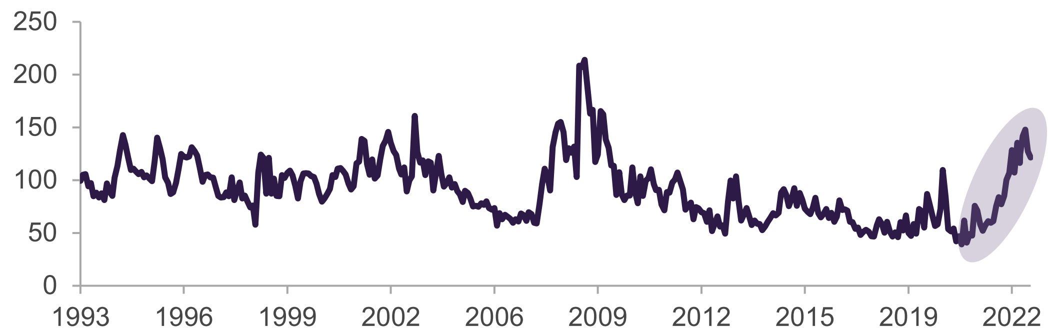
- During this period, it should not be surprising that global macro managers as a group struggled to perform. And while managers were able to generate positive returns, these still paled in comparison to those generated in the years prior to the GFC.



Source: HFRI Macro (Total) Index

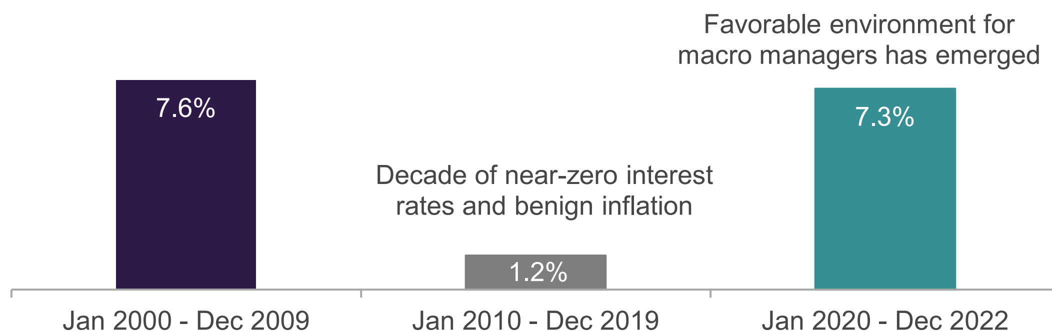
Today, the environment has changed dramatically. Price inflation, which began with commodity price increases as the world emerged from COVID, quickly got the attention of the world's central banks which began raising interest rates aggressively, albeit at different times and in different levels of magnitude, to combat it.

- These rate changes have spillover effects, impacting foreign exchange relationships, the shape of yield curves and the prices of bonds and commodities.
- Perhaps most importantly, they've raised the level of volatility across virtually all asset classes as shown in this chart of the MOVE Index, a measure of bond market volatility:



Source: Bloomberg

As a result, global macro managers have taken advantage of these opportunities:



Source: HFRI; HFRI Macro (Total) Index

Global macro's role in a well-diversified portfolio

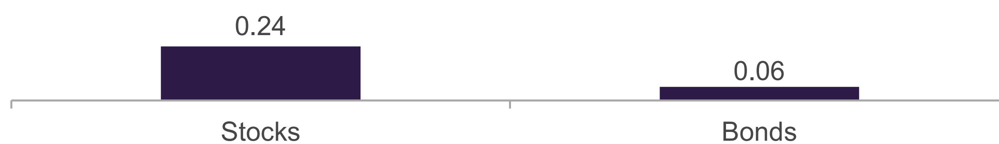
The value of diversification is a well-established tenet of financial theory and, as a result, investors seek out stocks, bonds, real estate and private equity, as well as other asset classes, to construct their portfolios.

- Global macro strategies are unique in this regard as they provide investors an opportunity to gain exposure to a variety of investment strategies and asset classes that would be difficult to achieve through traditional investment vehicles.
- Additionally, global macro managers ability to position in ways to take advantage of positive as well as negative price movements, and to use a broad range of instruments further enhances the diversification they can provide.

The value of global macro managers as diversifiers can be quantified via an analysis of their historic correlation to equities and fixed-income.

- Correlaton is a statistic that measures the degree to which two assets or, more specifically, their return streams move in relation to one another. A correlation of one indicates that the two move in lockstep, while a correlation of zero means that they move independently.
- When seeking diversification, investors have been well-served by adding investments to a portfolio where the correlation to the existing investments is below 0.50 and, ideally, closer to zero. Over the last 25 years, global macro managers have had only a 0.24 correlation to stocks and 0.06 to bonds, making them valuable diversifiers:

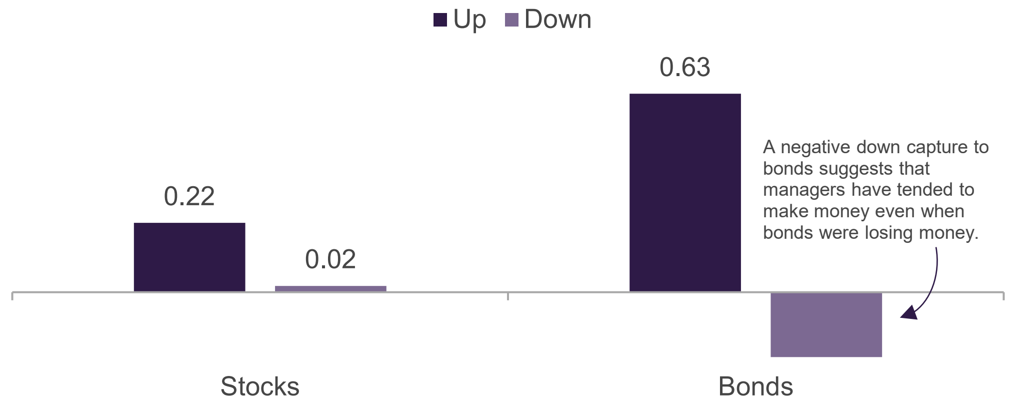
Global macro correlations to stocks & bonds
(Jan 1998 - Dec 2022)



Source: HFRI Macro (Total) Index, S&P 500 Index, Bloomberg Barclays US

In addition, the components of these modest correlations have been quite favorable as measured by upside and downside capture ratios.

- An investment's upside and downside capture ratios measure how much an investment tends to make or lose when another market, such as stocks or bonds, goes up or down.
- In the case of stocks, macro managers have tended to make approximately five times more when stocks have gone up than they have lost when stocks have gone down.
- When compared to bonds, global macro managers have tended to make money regardless of whether prices have risen or fallen.

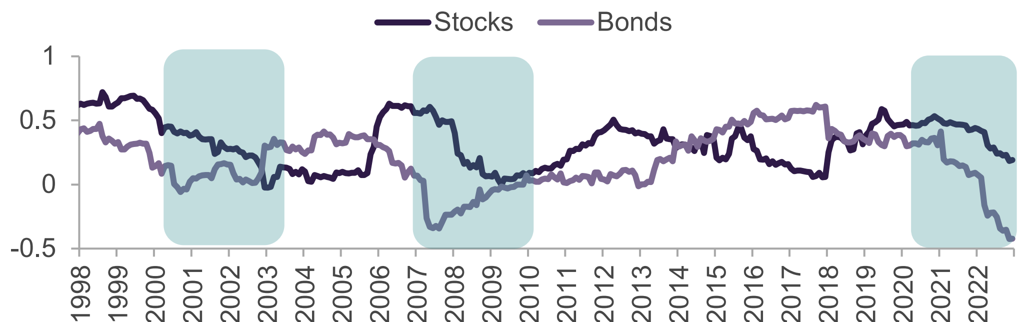


Source: HFRI Macro (Total) Index, S&P 500 Index, Bloomberg Barclays US Aggregate Bond Index

It is also insightful to note how correlations to stocks and bonds have varied historically. As seen in the chart below, the diversification value of global macro has asserted itself when investors have needed it most, with correlations falling to stocks and rising to bonds during

- The 2000-2002 "Tech Wreck"
- The 2008-2009 Global Financial Crisis

More recently, correlations have fallen to both stocks and bonds, a helpful development when both stocks and bonds have lost money.



Source: HFRI Macro (Total) Index, S&P 500 Index, Bloomberg Barclays US Aggregate Bond Index; based on three-year rolling windows

Recent performance and outlook

The recent robust opportunity set has led to solid performance from global macro managers in 2022 as measured by the HFRI Macro (Total) Index which gained 9% for the year. Managers have made money short fixed-income and equities and long the U.S. dollar (against a variety of currencies) and commodities.

Looking ahead, the environment remains favorable as the expected persistence of central bank policies, inflation, geopolitical tensions and their downstream effects will continue to drive levels of elevated volatility and directional market movements from which skilled global macro managers should continue to benefit.

Final thoughts

Properly accredited investors should carefully consider the potential of global macro strategies in their portfolios. As in most hedge fund investing, global macro manager selection and monitoring are critical to successful outcomes when allocating to this strategy. It also may come as no surprise that capacity may be difficult to come by, particularly with the managers who have consistently performed at the top of their peer group.

When investing in hedge funds, investors should remain aware of the inherent risks, including the use of leverage which can exacerbate losses, the potential illiquidity of underlying positions particularly during periods of market stress and the inability of an investor to quickly convert a hedge fund investment to cash due to fund redemption terms to name a few.

Aside from the performance tailwind a particular market environment may provide, global macro's unique array of asset classes and investment methodologies can provide valuable diversification to not only traditional assets but also to other hedge fund strategies as well.

Thus it should be considered as a core holding as part of a well-diversifed hedge fund portfolio. As has been seen historically, this diversification has been particularly helpful during periods of market stress, elevated volatility and increased central bank activity including the years 2000-2002, 2008-2009 and the recent period beginning in 2020.

Index and statistic definitions

The MOVE Index – Merrill Lynch Option Volatility Estimate is a well-recognized measure of U.S. interest rate volatility that tracks the movement in U.S. Treasury yield volatility implied by current prices of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries.

Stocks performance represented by the S&P 500 Total Return Index - a stock market index that measures the stock performance of 500 large companies listed on stock exchanges in the United States and assumes that dividends received from each company are invested back into that company's stock.

Bonds performance represented by the Bloomberg Barclays US Aggregate Bond Index - the broadest measure of the taxable US bond market, including most Treasury, agency, corporate, mortgage-backed, asset-backed, and international dollar-denominated issues, all with investment-grade ratings (rated Baa3 or above by Moody's) and maturities of one year or more.

Macro Hedge Fund performance represented by the HFRI Macro (Total) Index – an index that reflects the performance of a subset of investment managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods.

An investment cannot be made directly into an index.

Correlation – a measure of the degree to which two return streams move in relation to each other. Correlations have a value that must fall between -1.0 and +1.0

Downside Capture Ratio - a measure of a portfolio's performance relative to another asset class when that asset class is losing money. The Downside Capture Ratio is calculated by dividing the return of the portfolio during the down-market periods by the return of the market during those same periods.

Upside Capture Ratio - a measure of a portfolio's performance relative to another asset class when that asset class is making money. The Upside Capture Ratio is calculated by dividing the return of the portfolio during the up-market periods by the return of the market during those same periods.

Sources

SIFMA – Securities Industry and Financial Markets Association is a United States industry trade group representing securities firms, banks, and asset management companies.

BIS - The Bank for International Settlements (BIS) is an international financial institution[2] owned by central banks that "fosters international monetary and financial cooperation and serves as a bank for central banks."

IASG - a provider of advisory services and investment tools to the alternative investments industry.

HF Journal - The Hedge Fund Journal is a monthly magazine focusing on the global hedge fund industry.

Abbey Capital - an alternative investment fund manager that specializes in managed futures.

HFRI – is a provider of hedge fund index information. It delivers more than 200 indices for hedge fund benchmarking and performance measurement.

BarclayHedge – is a provider of alternative investment data and indices.

Tradeweb – offers institutional, wholesale and retail market participants advance technology and platforms to price discovery, order execution and trade workflows.

World Federation of Exchanges – a global industry group for more than 250 exchanges and clearinghouses around the world.

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