



Compiled by
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GLOBAL MACRO HEDGE FUNDS

How they work

Last month's article illustrated how an allocation of a portion of your portfolio to absolute return funds (often referred to as alternative investments) can reduce your overall risk and enhance your returns. Most investors with a traditional portfolio made up of shares, property and fixed interest are buying investments that they expect to increase in price. There is a directional bias in these portfolios as the portfolio only performs well if the prices of the underlying investments increases. However, the prices of these traditional assets are strongly interlinked and a portfolio tends to suffer whenever markets weaken, which results in higher portfolio volatility. Absolute return funds are designed to make money in either rising or falling markets and therefore an allocation of a portion of your portfolio to these types of alternative investment strategies can enhance your return whilst simultaneously lowering the overall risk of your investment portfolio.

This month I will look at a particular alternative investment strategy known as global macro investing. The most famous investor using this style of investment is legendary hedge fund investor, George Soros. In 1992, he became known as 'the man who broke the Bank of England' by selling pound sterling in the belief that the United Kingdom would be forced out of the European Exchange Rate Mechanism (ERM). On 16 September 1992 this investment paid off for George Soros and his investors when the British pound fell below its minimum level in the ERM resulting in profits in excess of one billion dollars.

WHAT IS GLOBAL MACRO INVESTING?

Most fund managers buy stocks and bonds by analysing companies and industries and then basing their investment decisions on fundamental information like the quality of management, competition, profits and P/E ratios. These managers focus on the micro issues that affect these companies and attempt to control risk by thorough fundamental analysis. A manager might choose a portfolio of well managed companies but still perform poorly if the overall market declines. However, many alternative investment managers prefer to take a macro approach to investing in that they attempt to look at the big

picture and the interrelationship between different economies and markets in order to uncover investment opportunities.

Global macro managers typically use a top-down global approach to investing. They analyse changes in global economies that are influenced by economic, political or government-related events and through this analysis they look for investment opportunities that might occur as a result of these events. For example, when shifts in government policies affect interest rates which in turn affect a range of financial instruments such as currencies, stock and bond markets or commodity prices, global macro managers make investments that are designed to profit from these changes.

Successful global macro managers anticipate these events and policy changes often making their investments via highly liquid derivatives which enhances their investment returns whilst simultaneously limiting the downside risks by utilizing strict risk controls. These managers aim to achieve consistent, absolute returns that are uncorrelated to global equity and bond markets. Preservation of capital is of paramount importance so global macro managers aim to manage risk rather than avoid it. The portfolios are designed with rigorous risk management frameworks to manage risk in a consistent manner. The manager is able to quantify the risk in each investment and is therefore able to precisely match the risk and return. Portfolios are also regularly stress tested to ensure the funds can withstand the unexpected events that affect markets.

One of the major advantages of the global macro strategy is the ability for fund managers to take positions in multiple markets across a wide variety of investment instruments. Unlike conventional fund managers who have most of their assets invested in one market, the global macro manager can look for opportunities around the world. Hence, the reference to the key word 'global'. As a result of this flexibility global macro funds can avoid bear markets in one country and take advantage of bull markets in another. This is known as relative value investing where the prospects of a particular type of investment are better in one market than in another.

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For example, your next door neighbour put his house up for sale and it was very similar to your own house. If you sold your house to buy your neighbour's house then it is highly unlikely that the price of the two houses would vary greatly as they were on the same street in the same city affected by the same local economy. However, if you were taking a global macro view and you owned real estate in Los Angeles and in Sydney then you might consider selling the LA property which has a weak real estate market and buy more property in Australia. In this case you are evaluating the same asset class (property) but taking a relative value global view to allow you to make the best investment decision.

HOW DO GLOBAL MACRO MANAGERS DECIDE WHERE TO INVEST?

Global macro funds are able to allocate capital across asset classes, sectors and regions which allow the manager a very wide investment mandate. Through rigorous analysis global macro managers attempt to identify mispriced assets based on macroeconomic analysis. These managers can take positions in stocks, bonds, currencies, interest rates and commodities markets. A global macro manager has the ability to go long (buy assets expected to appreciate) or short (sell assets expected to decline in value) as well as use leverage to enhance returns. Global macros managers take concentrated positions – ideally with limited downside but with huge potential upside.

There are two types of trades used by global macro fund managers. Trades can be either directional or relative value. Directional trades tend to be a trade based on taking a position on an isolated price movement. For instance, a manager who believes the Australian dollar will continue to appreciate will sell US dollars and buy Australian dollars. Trades based on relative value attempt to take advantage of mispricing between two different assets. For example, a manager might sell US equities

due to the economic fundamentals of the US and buy Chinese equities due to the strength of the Chinese economy.

Different fund managers have different investment styles. Some managers will base their trades on their subjective opinion of market conditions drawing on their experience and analytical skills. This is often referred to as a discretionary approach.

Other managers use a systematic approach that uses technical analysis tools or pre-defined rules to identify profitable trading opportunities. Often managers will use both of these approaches to varying degrees using their subjective opinion and experience to confirm or refute trading ideas generated by the technical analysis tools.

As George Soros once said, "I don't play the game by a particular set of rules; I look for changes in the rules of the game."

Successful global macro managers are able to look at the world and the complex relationships between economies, currencies and government policies and identify events that effectively change the rules of investing and create lucrative opportunities for investment.

IS NOW A GOOD TIME TO INVEST IN A GLOBAL MACRO STYLE FUND?

The term 'globalization' is used commonly these days to describe our changing world. No economy exists in isolation and can be affected by world events beyond the control of a single government. Nowadays, capital flows freely around the world and will go where it is best treated. It has been said that arguing against globalization is like arguing against the laws of gravity.

Investment managers are realizing that economic or investment analysis can no longer be conducted on a purely domestic basis. The speed with which capital is capable of moving means that any economy can be disrupted by international capital flows that are due to external considerations beyond the control of



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local governments. This is essentially the basis of global macro investing.

In the current environment, the mood is constantly changing between recession fears and hopes of a continued economic recovery. Concerns about the high levels of sovereign debt coupled with high unemployment levels in Europe and the US make the sustainability of the current economic recovery unclear. It is against this backdrop that global macro fund managers who are nimble and unrestrained by a single market will be able to generate superior returns.

Most Australian investors have significantly over-allocated their assets to local property investments and local shares with significant under-allocations to international investments. Whilst buying and holding shares, good quality companies and property for the long-term is a valid strategy, the GFC showed that factors beyond the control of investors or local governments can significantly affect the value of your investments. As an investor, you need to ask yourself the question "How can I further diversify my investments to reduce the risks of economic shocks that are beyond my control?" Investors need to consider adding investments that are not strongly correlated to their existing investments by investing in alternative strategies that can produce positive returns in both rising and falling markets and are non-correlated to traditional investment assets. These alternative strategies will increase the diversification of the portfolio resulting in lower overall risk which protects investors from having a purely directional bias in their portfolio.

Although the Australian economy continues to do well and the AU\$ is powering towards parity with the US\$, a strong currency in turn creates new risks for investors. On the surface, all would appear to be rosy but the fact is Australia does not exist in a vacuum. A stronger currency has flow-on effects like reduced competitiveness for exporters and impacts inflation levels. So, while Australia does well, uncontrollable factors occurring outside Australia can prevent local investors from realizing the true value of their Australia-based investments. Smart investors are actively looking for investment opportunities that can counteract these risks and smooth out a portfolio's returns. Allocating a portion of your portfolio to alternative investment strategies helps to produce more consistent returns.

WHAT CHARACTERISTICS SHOULD I LOOK FOR IN A GLOBAL MACRO FUND?

The key factors investors should consider before investing in a global macro fund are:

• Skilled management

Managers of global macro funds should have proven investment skills across multiple asset classes and tend to back their investment judgement by investing their own capital alongside their investors.

• Rigorous risk control systems

Capital preservation is of paramount importance and fund managers need a rigorous risk management framework which allows for comprehensive risk controls that protect against downside risk. These risk controls usually incorporate comprehensive models that can stress test portfolios to ensure that the fund can withstand unexpected events that affect markets.

• Liquidity

As global macro funds often have fewer positions that are concentrated, it is important they use highly liquid investment instruments. During the GFC, many types of hedge funds were highly leveraged into illiquid investments. Investor funds were frozen and could not be redeemed in a timely manner. When

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investing in a global macro style fund it is important the fund provides investors with options for easy redemption of their investments.

BENEFITS OF INVESTING IN A GLOBAL MACRO FUND

According to the Dow Jones Credit Suisse Hedge Fund Index, global macro funds have been the top performers in the hedge fund sector so far this year. The benefits of investing in global macro hedge funds can be summarized as:

- Global macro strategies have historically outperformed other hedge fund strategies;
- Global macro strategies have historically have outperformed the broader equity market;
- Global macro strategies have delivered the above performance with less volatility; and
- Global macro strategies have delivered the above performance with a low correlation to traditional asset classes.

Source: Dow Jones Credit Suisse Hedge Fund Indices

In summary, I believe that global macro funds should be able to profit from strong emerging market currencies and commodity opportunities while staying nimble enough to adapt to changing market conditions. As John Templeton once said, "if you look around the world for investment bargains you will find more opportunities and better bargains than if you look in one place".

Personally, I like the idea of increasing my diversification by investing in assets that can deliver positive returns regardless of what is happening in the share market. I plan to follow my own advice and invest a significant portion of my capital in alternative investment products like global macro funds.

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