Managed Futures and Global Macro

By *Anonymous*
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Since their beginning in the 1970s, which paralleled the inflation driven commodity rally, managed futures funds have traditionally invested in listed exchange markets: financials and commodities.

Their management style can be discretionary or systematic. The systematic managers rely on computer driven quantitative models (black box) to make market decisions. Most of these systems are market trending with stop loss-reverse models. They avoid the human factor linked to the decision process.

The separation line between global macro funds and discretionary managed futures funds has become somehow blurred; Some managed futures funds that started accumulating more assets under management sought the over-the-counter markets which offered better 24 hour liquidity , product diversity (such as swaps and other derivative products) and geographic diversity (such as emerging market currencies and securities not traded on listed exchanges).

Global macro funds, on the other hand, often use the futures markets to express their views on commodities.

Why have managed futures and global macro lost their supremacy?

In this latest drive towards alternative asset management over the last two to three years, investors' request for alternative asset management initially went towards equity hedge funds (market neutral and long/short) and relative value strategies.

There was a relatively small flow of capital to managed futures and global macro strategies. This was perhaps in part due to the still lingering negative memory associated with LTCM (ironically a relative value statistical arbitrage fund), and the general perception that equity hedge fund strategies are less risky than managed futures, because of the higher leveraging one can achieve in the futures markets relative to equities.

Why did managed futures and global macro perform well recently?

Managed futures and macro strategies have outperformed exceptionally well this year because of risk aversion: Geo-politics and the risk of war, corporate governance issues, and the general weakness of the G7 economies after years of bullish exuberance.

These have caused structural macro economic shifts, which in turn generated sustainable trends, particularly in the currencies and commodities markets, and which other hedge fund strategies are not exposed to.

Why did managed futures outperform the global macro funds?

The reason managed futures outperformed global macro so far this year is because managed futures are more focused on trading commodities than global macro. Commodities, such as gold and crude oil, have had trending markets in 2002.

In addition, some global macro funds trade emerging markets instruments and currencies, which have been difficult to trade because of the choppiness caused by the general risk aversion in the financial markets and the economic situation in Argentina, and more recently, the political situation in Brazil.

In trending markets such as the ones we experienced this year, systematic black box trending models tend to outperform other strategies including discretionary managed futures and global macro because they effectively remove the human factor in decision making.

On the other hand, few black box models(essentially the short term models) can exit or reverse their positions because they are slower at responding to market turnarounds than their discretionary counterparts. This was clearly obvious in the performances of October 2002 where managed futures experienced the sharpest draw down.

What are the perceptions associated with these strategies, specifically the black box models?

Depending on the degree of conservatism in their portfolios, fund of funds, in their pursuit of smooth returns, have typically run portfolios with low exposure in managed futures and global macro strategies to the benefit of relative value and equity hedge fund strategies. This has stemmed from the higher volatility statistically attributed to managed futures and global macro.

At the extreme, there is a school of thought amongst some fund of fund managers that shuns the use of these strategies (mostly black box models) and who believe that their returns are not generated by exploiting market inefficiencies but by following market momentum .

One can argue though that market inefficiencies and dislocations are actually the cause behind the trends that are initiated to adjust these same inefficiencies.The strength of these trends is dictated by how extreme these aberrations were at the outset.

Relative value strategies such as credit spreads are healthy strategies to hold in a portfolio where market situations are stable and close to equilibrium. More complex factors such as issuance volume, maturity, and implied volatility levels influence the returns of strategies such as convertible bond arbitrage.

Managed futures and global macro strategies (and in particular black box models) tend to outperform when market dislocations reach an extreme, resulting in swings from risk appetite to risk aversion, as we have experienced since the peak of the equity market in 2000. By the same token, they do not necessarily underperform when market conditions are stable or exhibit risk appetite as some trending also develops under these conditions.

Oddly enough, while managed futures and global macro funds tend to be perceived as too volatile, the blow-ups in the hedge fund universe over the last few years have been in equity and relative value strategies.

Ultimately, as more fund of funds pile into the "less volatile" arbitrage strategies or the less directionally sensitive long/short and market neutral equity strategies, the opportunities for acceptable returns may get depleted just as the profits of arbitrage trades diminish when too many players get into the game.

This may be particularly true if market conditions do not return to the kind of environment we saw in the late 1990s. Fund of funds may have to start relying more on selecting managed futures and global macro managers in order to differentiate themselves from their competitors.

By Bashar Azzouz

Mr Azzouz worked as a trader for Tudor Investment Corp and Graham Capital.
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