O L Y M P I A
C A P I T A L
MANAGEMENT

Macro hedge funds: a response to the crisis

by Guido Bolliger, Co-Chief Investment Officer
and Laurent Dupeyron, Deputy Managing Director

Olympia Capital Management

The global economy is in the worst recession of this century. The US property bubble and the credit bubble have burst, negatively impacting the performance of some hedge fund strategies. Under these circumstances, we would like to take this opportunity to draw our readers' attention to the performance of some hedge fund strategies in an uncertain economic and financial climate. We believe that Global Macro managers have aligned their style with the economic climate expected to prevail in 2009.

The purpose of this article is to explain why the Global Macro strategy is attractive to investors during a macro-economic environment which includes:

1) A sharp slowdown in the growth outlook for corporate profits, which is expected to continue to hurt equity markets
2) A sharp rise in credit spreads, which will put high pressure on corporate credit
3) An unprecedented rise in budget deficits, which could lead to substantial hikes in government rates for long maturities
4) High volatility
5) An overall reduction in market liquidity

We shall begin by describing Global Macro managers' strategy and the financial instruments they use. We will then explain why this strategy is so well adapted to the current market.

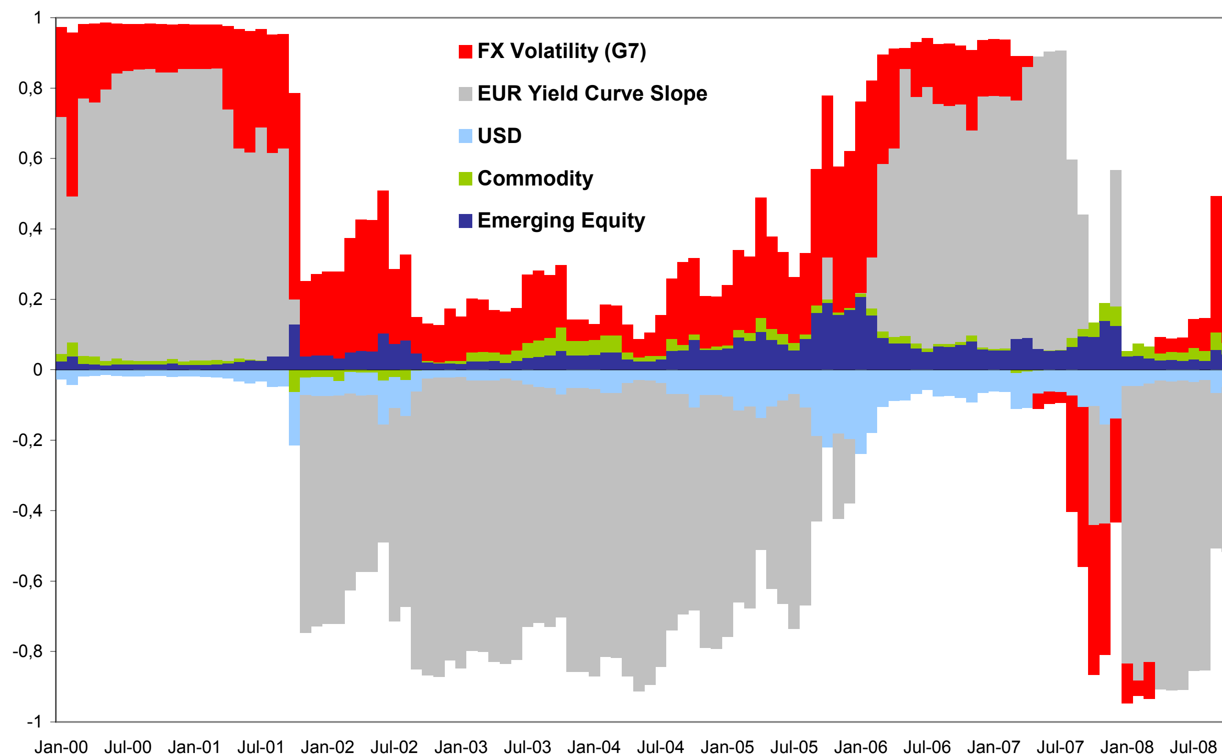
Global Macro strategy

Global Macro managers use a top-down investment strategy. They determine forecasts for the main macro-economic factors (economic activity and inflation as well as budget, monetary and economic policy of the main governments and geopolitical risks), which are in turn used to establish forecasts for the different asset classes, namely: equity, short rates, long rates, volatility, forex and commodities. These forecasts can be based on a purely qualitative or quantitative analysis, or a combination of the two approaches. The most reputable managers often seek advice from former politicians or members of central banks which help them anticipate political turmoil that could affect markets or monetary policy changes that could impact currencies and rates.

Once the forecasts for the different asset classes are determined, the managers use either a purely directional (e.g. short-selling on US equity markets) or a purely relative (e.g. buy corn and sell wheat) approach. Profit opportunities will be proportionate to the difference between the market prices and forecasts determined by managers. In other words, the strategy comes out

extremely profitable when the market consensus is significantly different from the equilibrium price forecast by managers. This is generally the case during periods of high uncertainty.

Graph I illustrates the dynamic exposure (standardised betas) of a benchmark index in the Global Macro strategy to various risk factors. It clearly reveals the Global Macro managers' deftness in their strategy allocation. For instance, Global Macro managers were positively then negatively exposed to the volatility of G7 currencies (red area). There has also been a sharp reduction in exposure to emerging market equities (blue area) since the beginning of the credit crisis in July 2007.



Graph I: Dynamic exposure of the HFRI Macro index to various risk factors

Financial instruments used by Global Macro managers

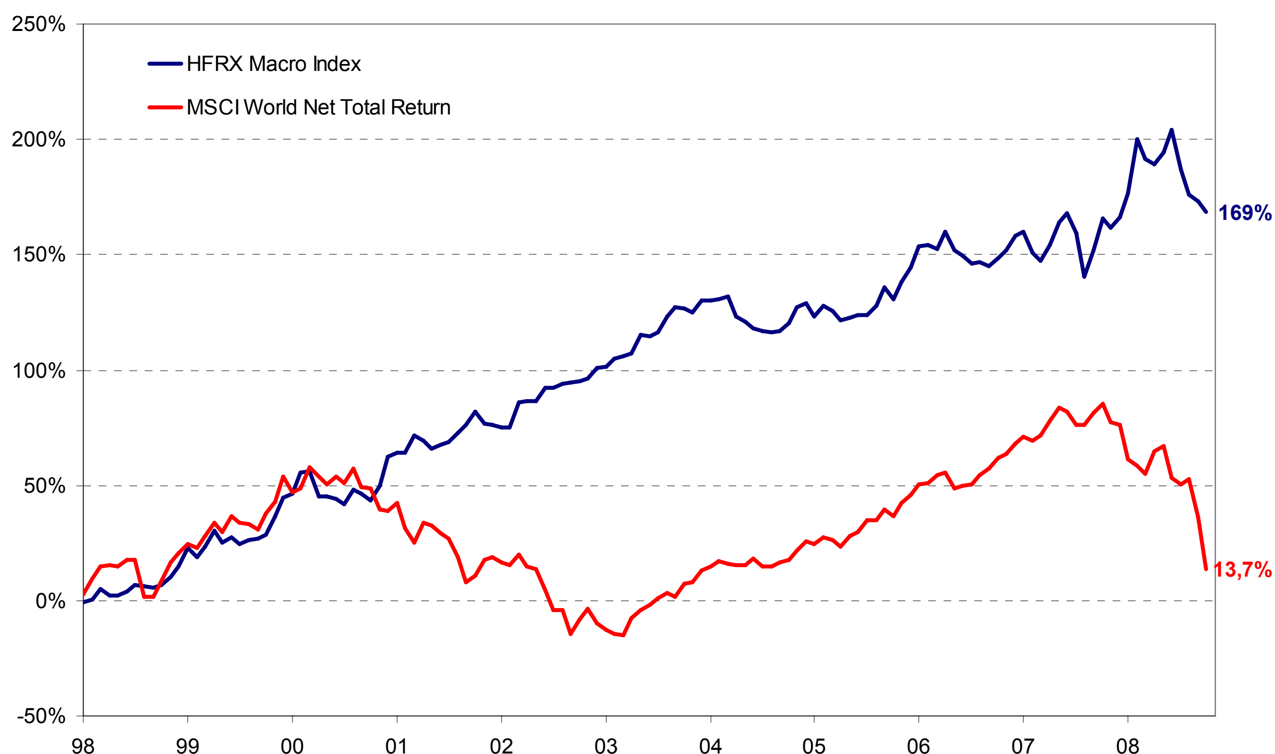
Global Macro managers have no restrictions in choosing the nature and type of instruments they trade. As such, they can easily go from one asset class to another or from one opportunity to another. For most of their transactions, Global Macro managers use derivatives (primarily futures, swaps and options) traded on underlying instruments to obtain exposure to the equity markets, interest rates, currencies or commodities indices. Direct investment in equities or individual bonds is not exceptional but generally comprises only a very small portion of their portfolios.

The instruments used are among the most liquid in the market. As a result, Global Macro managers can liquidate their portfolio quickly and at a low cost when market risk becomes too great or their forecasts change. Moreover, the use of derivatives allows them to take advantage of the leverage effect without exclusively seeking out external sources of financing such as prime brokers.

Global Macro managers have traditionally generated extremely attractive returns, both in absolute and relative terms, with regard to the risk incurred, as shown in Table I and Graph II below.

	Annualised Return	Standard spread - annualised	Maximum Drawdown-{} -	Correlation coefficient
HFRX Macro Index	9.6%	9.7%	(11.2%)	-
MSCI World Index (net dividends reinvested)	1.2%	15.2%	(46.0%)	0.2

Table I: Performance of the HFRX Macro and MSCI World indices From January 1, 1998 to October 31, 2008, in USD



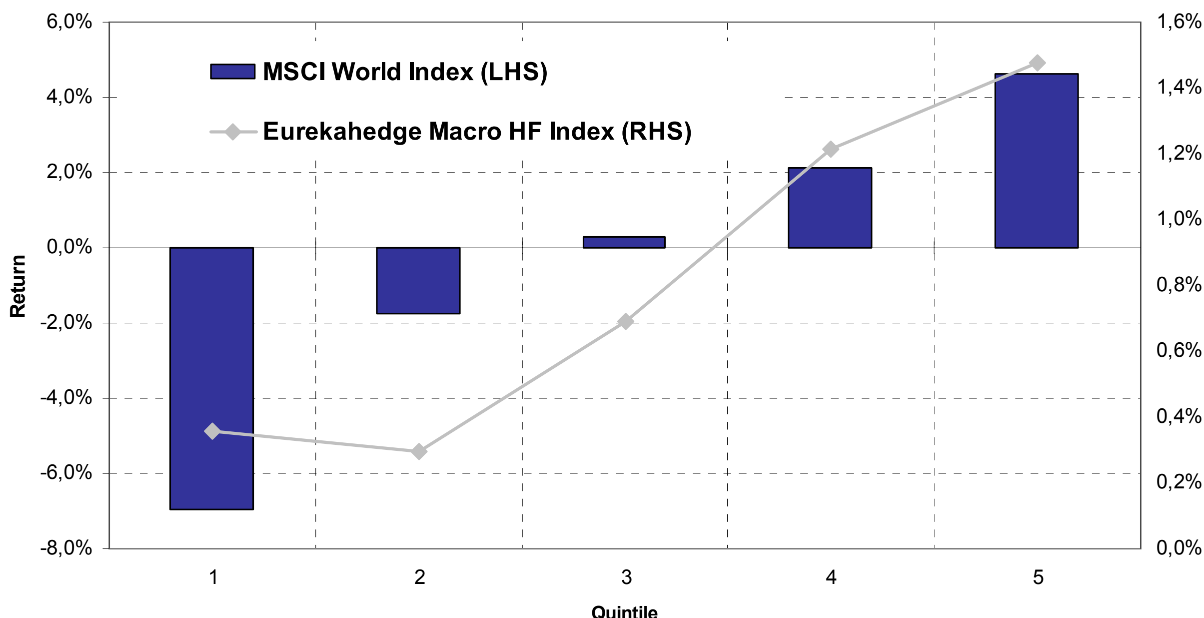
Graph II: Total returns of the HFRX Macro and MSCI World indices From January 1, 1998 to October 31, 2008, in USD

Global Macro strategy against the current economic backdrop

At end 2008, the economy is sluggish and highly uncertain. Over the past nine months, we have seen increasing government intervention on financial markets, virtually nationalising some economic sectors. The macro-economic uncertainty has caused a sharp increase in volatility across all asset classes which had seen abnormally low volatility between 2003 and 2007. As mentioned earlier, we believe that this strong volatility will continue over the next few months. Risk reduction for investment banks and hedge funds has dried up liquidity in some market segments. It will take several more months before liquidity comes back to normal levels. As such, illiquidity risk will remain high on the financial markets. We believe that the cost of credit will also remain high over coming months, which will probably hurt investment strategies that use prime brokers to finance their leverage.

Several factors suggest that the current market environment will enable Global Macro managers to come out ahead. First of all, Global Macro managers are positively exposed to market volatility. When all asset classes post low volatility, the strategy tends to turn in unattractive risk-adjusted profitability. In the absence of volatility, Global Macro managers apply very directional strategies and tend to increase their betas, thereby reducing their alpha.

Graph III plots out the relation between the performance of global equity markets and that of Global Macro managers. The performance profile of Global Macro managers resembles the purchase of a call. This position features positive sensitivity to market volatility.



Graph III: Performance of Global Macro managers compared with equity performance From January 1, 2000 to October 31, 2008, in USD

Secondly, Global Macro managers, through their flexibility, will be capable of harnessing the return of all asset classes to their equilibrium price. Significant uncertainty has prevailed on financial markets over the past few months. No clear consensus seems to be emerging as to the consequences of the financial crisis either on the economy or on government intervention. This dispersion of macro-economic forecasts in addition to forced selling across most asset classes has brought about major imbalances which present opportunities for the Global Macro strategy.

Thirdly, unlike other strategies (e.g. fixed income arbitrage), Global Macro managers should not be affected by the above mentioned reduction in liquidity since the instruments they trade are among the most liquid on the market. On the contrary, as a liquidity provider, the strategy could even benefit from the increase in the price of liquidity. However, it is advised to proceed with caution as some managers can deviate from their initial mandate by applying less liquid strategies: as such, at Olympia, we have carefully tried to avoid "macro" managers who, for example, attempted to diversify into structured credit in which the liquidity parameters are not as favourable.

Moreover, Global Macro funds thrive on trends. Although some (CTAs) have a more short-term strategy than others, most of them benefit from the existence of trends. Uncertainty is high for the time being, but we believe that in coming months, clear trends will begin to emerge for the most common themes applied by these funds, namely monetary policy, inflation and currencies.

Furthermore, the Global Macro strategy is the only strategy capable of harnessing the significant positive and negative interdependence between asset classes that is currently prevailing on the market. For instance, in the past few months, the profitability of commodities and equities has been

closely linked. Similarly, long-term US government bonds have developed a very negative correlation to the profitability of equities. Consequently, Global Macro managers can play asset classes off each other in order to capture the benefits of this interdependence. They can harness it by using the impact that their forecasts will have on a given asset class on other asset classes.

Lastly, these macro-economic strategies seem to be less affected by the current market chaos than others: the controversy over short selling has little or no impact on them. The reduction in credit provided by banks has also had a low impact. We also know that these funds are less affected in their strategy and management than "micro" funds, whose added value lies in the fundamental analysis of companies and therefore whose relevance is now extremely challenged due to liquidity issues.

By increasing the portion of the Global Macro strategy of our multi-strategy funds over the past year, we at Olympia have not only chosen the strategies with the best performance, thus enabling us to outperform the benchmark indices of multi-strategy hedge funds in a number of cases, but we have also significantly improved the liquidity profile of most of our portfolios. As a result, we have thus far managed to avoid changing the liquidity terms of our flagship fund.

December 2008