

March 2011

Macro hedge funds still matter

'The current dominance of macro-economic factors on global investments means that the strategy remains as relevant today as it has ever been.'
James Skeggs, Newedge Prime Brokerage (*Source: newedge.com, 3/2/11*)

Key issues

As market gyrations expanded over the past few years, some more established names in this sector have drawn back from trading, leading questions as to the validity of this strategy.

Key recommendations

Macro is still capable of delivering good non-market correlated returns. However, new mid-size managers are likely to have the ambition to outperform the better-named behemoths.

Mid-way through 2010, one of the stars of the hedge fund game, Stanley Druckenmiller, gave an indication as to just how tough the trading environment had been, by announcing his imminent retirement and the closing of the fund. This, combined with the travails of other well known star managers, has led some commentators to question whether the game is up for macro-hedge fund strategies.

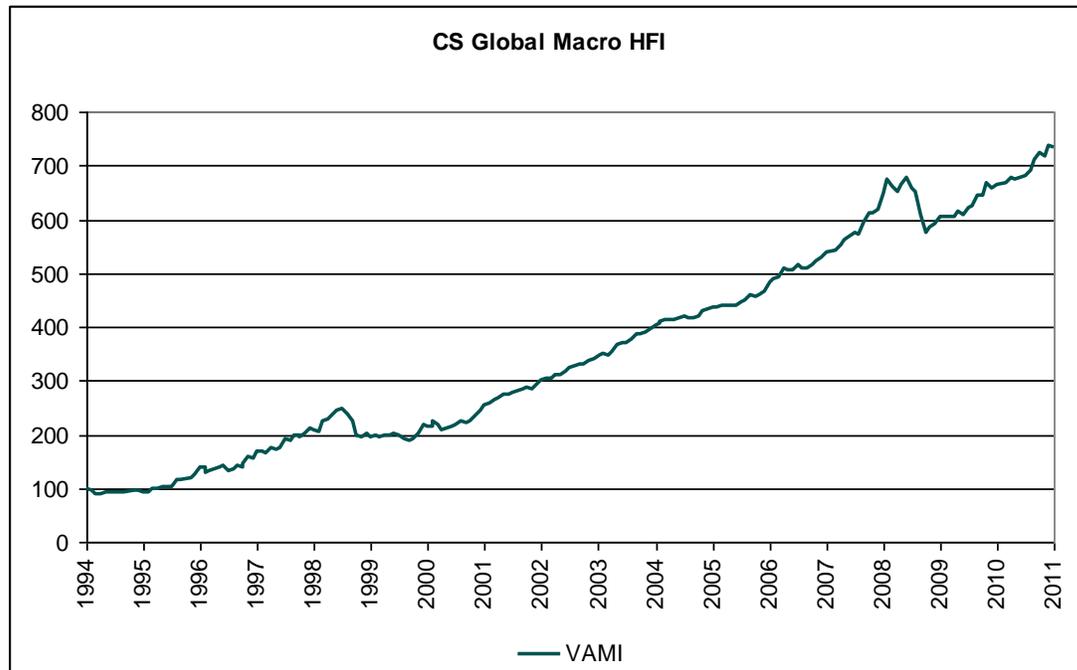
However, it seems it may be premature to pull the rug from this style of investing. It may be more relevant to search out the *next* generation of managers ready to carry the torch for bold macro trading.

Why Macro?

Investors first started looking at hedge funds because they wanted protection from "beta" or market-based risk. However skilled the manager, if the generic product invested in is a bear market, you are going to lose money. This is where the "hedge" epithet comes from, giving the manager a clear understanding that pure market-based performance will not be tolerated. The investor is looking to see through this and receive performance that is not subject to the vagaries of the market.

Macro hedge funds are a subsection of this product. Here, the investment strategy is designed to benefit from the manager's successful views on the direction of macro trends such as currencies/interest rates/commodities and stock index futures.

This strategy has been successful over a long period of time. Most famously, hedge fund stars such as George Soros, Alan Howard, etc., have used their skills to make great bets on the market.



Source: CSFB

Following the bursting of the internet bubble in 2000 and the prolonged bear market in the developed world’s stock markets that only ended in 2009, many investors have sought these type of returns. For the 00s in particular, this has been a very effective strategy.

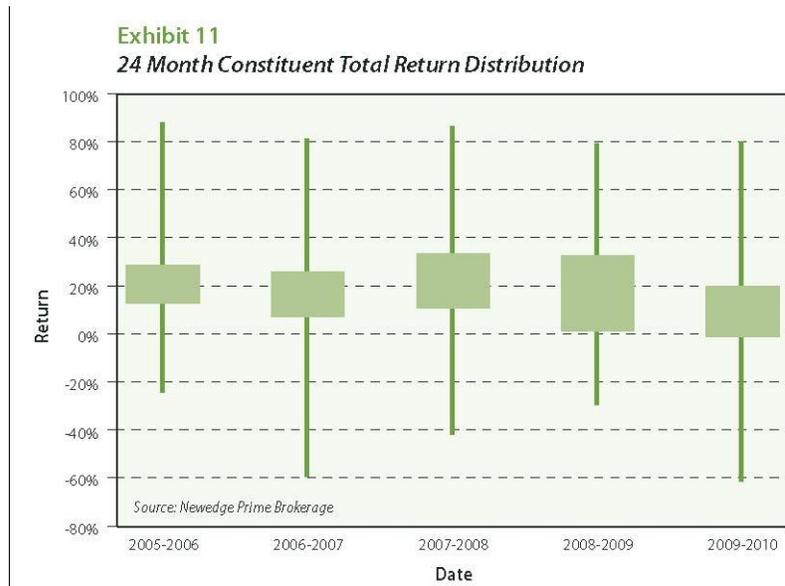
Is the market more difficult or volatile now?

It is true to say that a generation of traders had never seen a market meltdown like that of 2008/09. The collapse of prime names such as Lehman and Bear Stearns would have been thought impossible. As James Skeggs puts it, ‘it has been commented that the recent market environment has been difficult for macro traders. Is this just anecdotal, or is this supported by the numbers?’

It is certainly true that some hedge fund managers were good at latching on to certain trades, like the yield convergence of European sovereigns up to the birth of the euro. Other unforgettable trades, like the collapse of the ERM and sterling’s ejection, made reputations and fortunes for the likes of Soros.

More junior investors may cast their minds back to the history books and consider earlier market moves such as **October the 19th 1987, when the S&P 500 dropped 24% in one day, equivalent to a collapse of over 300 pts!** Other infamous trades include the Russian debt default of 1998 that put paid to LTCM (who were founded by a Nobel prize winner), the collapse in the NASDAQ in 2000/01 falling over 70%, and, on a more positive note, the astonishing rise in emerging market equities over the past decade. Volatile markets are the norm. As Nassim Taleb puts it **'we don't understand the world as well as we think we do and tend to be fooled by false patterns, mistake luck for skills, overestimate knowledge about rare events (black swans), as well as human understanding.'** (Source: Nassim's home web site)

The dispersion of funds performance widened during the financial crisis, but overall macro weathered the storm



Too big to play

George Soros more or less retired from trading several years ago. Brevan Howard, with their \$35 billion, have decamped to Switzerland and struggled to make returns in 2010. Other big names such as COMAC (\$6bn), Balestra and Clarium have also struggled.

If the markets are still there, are the big boys telling us something?

The way forward

Old traders never die, but they do lose their ambition. If you have several billion in the bank and have just domiciled in Switzerland, the pressures of 24-hour trading and market swings can get to you. As **Stanley Druckenmiller put it, 'while the joy of winning for clients is immense, for me the disappointment of each interim drawdown over the years has taken a cumulative toll'** (*guardian.co.uk 19/8/10*). You need to be really hungry to want to sustain the agro.

It is going to be the smaller start-ups where the action is now going to happen. It has been a tough time to be a non-established name since the financial crisis. Investors have gravitated towards the well known names and have largely been happy to ignore smaller funds.

Research on this sector has established that indeed these start-ups are a good source of performance. Studies at Pertrac Financial of over 4,000 funds in the 1996-2009 period demonstrated this, 'Both smaller and newer funds outperform those of larger and older funds on both an absolute and risk-adjusted basis' (*Examination of the impact of fund size and age on Hedge fund performance September 2010 4th annual report*).

Conclusion: Still a successful play

Macro strategies are attractive for the simple reason that they are simple, liquid and transparent. Unlike many new investor fads such as frontier markets or mortgage-backed securities, **macro is easy to get into and easy to get out of. The only question is the skill of the manager.**

Greater returns can now be found in this sector by careful manager selection of newer – and smaller – funds.

Model Portfolio

While February still proved a successful strategy for our over-weight equity strategy, it would be remiss of us to fail to pass comment on what has been a turbulent start to March. External political (Middle East) and geological (Japan) forces have impacted heavily on the risk environment.

It is too early to understand quite how badly the Japanese economy has been affected. However, it has vindicated our investment portfolio's nervousness about this part of the world. Some western commentators have been calling for this as a turning point, and the precursor for dramatic monetary easing that may lead the way to a broader re-floating of the economy.

Our view is to be cautious, and to better understand the consensus style Japanese decision-making that may lead to little concrete action.

As to other equity markets, we are heartened by the Fed's apparent response to rising oil prices. Rather than see (as the ECB has) a danger of impending inflationary pressures, Bernanke seems to be following his predecessor Arthur Burns in calling for even greater stimulus as consumer demand faltered. Please see a useful explanation of just how much monetary stimulus is coming.

If Market Keeps Falling, Fed Will Keep Printing: 'Dr. Doom'

Falling stock prices will be met only with more money injections from the Federal Reserve, Marc Faber, the so-called "Dr. Doom," told CNBC. <http://www.cnbc.com/id/42085935/>
(Source: CNBC.com, 15/3/11)

Accordingly, we will remain constructive in our outlook as monetary policy is still very much on our side.

ACM Model Portfolio
February 2011

Asset class	Benchmark	Bloomberg				Contribution	
						SAA	TAA
			SAA	TAA	Over/under	SAA	TAA
Cash			5.0%	5.0%	0.0%	0.00%	0.00%
Fixed income			25.0%	10.0%	-15.0%		
Government bonds							
			25.0%	10.0%	-15.0%	-0.01%	0.00%
Corporate bonds							
Equities			40.0%	50.0%	10.0%		
US			18.0%	20.0%	2.0%	0.58%	0.64%
Europe			12.0%	15.0%	3.0%	0.27%	0.34%
Japan			4.0%	3.0%	-1.0%	0.15%	0.11%
Asia ex-Japan			4.0%	6.0%	2.0%	-0.08%	-0.12%
Emerging market			2.0%	6.0%	4.0%	-0.02%	-0.06%
Hedge Funds			20.0%	25.0%	5.0%	0.21%	0.26%
Eq hedge			5.0%				
Conv Arb			3.0%				
ED			3.0%				
Fixed income			3.0%				
Macro			3.0%				
CTA			3.0%				
Real Estate			5.0%	10.0%	5.0%	0.21%	0.43%
Commodities			5.0%	0.0%	-5.0%	0.27%	0.00%
Total			100.0%	100.0%	0.0%	1.59%	1.60%

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