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BOOK REVIEW

Mark Kritzman, Senior Editor

GLOBAL MACRO: THEORY & PRACTICE

By Andrew Rozanov
(*Reviewed by*
Cel Kulasekaran)

This anthology was inspired by requests from institutional clients of Permal who have US$8 billion in global macro funds under its management. Its objective is to serve as an authoritative, introductory, and comprehensive text for the general reader. Souede, Chairman and CEO of Permal, reaffirms his commitment to global macro which has attracted interest since the crisis of 2007–2009. Souede hopes that the book will help the investor better understand global macro strategies and what it can do to their portfolio. Rozanov has made a distinctive effort in aggregating insights of fellow practitioners into this anthology.

1 History, origins, developments (Ch 1), and discretionary versus systematic (Ch 2–4)

In his introductory essay, Andrew Rozanov defines global macro as a strategy that, like other hedge funds, strives to generate attractive risk-adjusted absolute returns under all market conditions. Global macro, however, also possesses five unique properties in its (1) global scope; (2) risk taking across multiple classes; (3) top-down positioning for broad markets and asset classes; (4) use of liquid markets and instruments; and (5) asymmetric trade construction (i.e., limited downside and unlimited upside). Comments by his fellow contributors in this edition further clarify what the nature of macro strategy is. While Rozanov articulates some uncertainties facing the manager in the near future, he sees no essential difference between Soros' trading and Keynes' investing strategies (Keynes followed an investment strategy in the 1920s that might be termed global macro).

In discretionary macro, says Kenneth Tropin, portfolio managers trade global markets on a view of fundamental macro drivers across economies. Discretionary macro funds typically trade on futures and foreign exchange as well as cash and derivative markets. In discretionary global macro trading, a portfolio manager determines when to buy or sell various instruments based on a range of fundamental and technical inputs. Generating alpha from macro trading is challenging and a non-stationary problem. Investment firms, which are complex organizations that evolve over time and should establish appropriate cultures and operational infrastructures to solidify their ability to succeed.

In contrast to discretionary strategies, Menachem Sternberg describes systematic macro strategies as having a strong focus on volatility-based risk controls as well as money and position management. These strategies accomplish this by rigorously screening, sizing, and dynamically adjusting each individual position and portfolio over time. Factor analysis, neural networks, machine learning, price patterns, and rule-based artificial intelligence often underlie the models or algorithms. Historically, these strategies have benefited from turning points in the economic environment or periods of rising uncertainty in the global economy – periods when other investments tend to fare poorly.

Igor Yelnik, in a particularly entertaining piece, shows how successful allocators to global macro are able to navigate between discretionary and systematic frameworks according to what combination makes the most sense for their portfolios. He describes this balance as an optimal mix of art, science, and sport. Computers are no replacement for the skilled human manager who must remain in charge; such a manager must have a unique combination of skills, similar to those of a well-trained scientist with a pragmatic approach and a big picture vision.

2 Analytical challenges (Ch 6) and emerging market scenarios (Ch 7)

Next, Grant Wilson describes the role of a global macro strategist. He starts by comparing fundamental roles between a financial economist and a macro strategist. The financial economist analyzes and predicts movements in the economy, whereas the macro strategist focuses primarily on the financial markets. Analytical function involves strategists deploying a range of techniques to understand each macro topic, a basis for forecasting direction and volatility. In contrast to fundamental macro strategy that responds only to economic drivers, behaviorist schools such as the author's focus on how financial markets respond to stimuli.

Gene Frieda notes that for emerging markets, higher GDP rates do not translate to stronger asset returns, asset price booms mistaken for structural breaks, nominal interest rates are divorced from nominal growth rates and are more sensitive to exchange rates, and ability to absorb shocks with traditional policy mechanisms is limited.

3 Risk management (Ch 7) and geopolitical risks (Ch 8)

Value at Risk (VaR) is a generic name for a family of methods used to measure aggregate uncertainty about the near future risk of loss in a portfolio containing a number of different financial instruments. In spite of issues and challenges and abuse, Barry Schachter believes that risk manager's toolbox should continue to include VaR. Schachter maintains that among other quantitative models and approaches, risk cannot be perceived narrowly.

David Murrin draws good parallels between Elliot wave principle and Mandelbrot's fractal dynamics which underlie all phenomena. Murrin introduces the concept of asymmetric slow buildup and fast release from geophysics but gives no mention of parallels in mathematical studies of dynamical systems, which have a long history. Murrin further postulates five-stage life cycle of an empire: regionalization, ascension, maturity, overextension, and decline. He then uses a comparative study of the British and American empires to illustrate with remarkable detail and accuracy of the mechanisms that bring about these oscillations.

Murrin notes that while extra financial risks (environmental, social, and governance) are recognized and priced into market, geopolitical ones are not as well understood and therefore not fully priced in.

4 Prime brokerage (Ch 9) and leverage (Ch 10)

The next two chapters describe how global macro managers will continue to rely on large and sophisticated prime brokers to support their trading activity across multiple geographies and asset classes. It also suggests that the capital utilization or the ratio of margin requirements and net option premium costs to total equity of portfolio may be a more relevant metric for global macro's leverage status.

5 Institutional portfolios (Ch 11) and hedge funds perspective (Ch 12)

Simon Fox (Mercer) provides a succinct, solid overview of the use of global macro strategies in institutional portfolios. Institutions allocate global macro exposure as general alternatives to equity and fixed income allocations. Fundamental systematic or model-driven exposure remains dominant across his client base, with very few investors operating on a purely discretionary technical basis. Global macro adds value through asset allocation and currency management rather than security selection; clients access via long only equity and bond mandates. Fox also suggests that it is useful to divide total portfolio into base and growth portfolios. Operating in a space that provides access to niche betas and market inefficiencies is also beneficial. Fox concludes by illustrating potential diversification benefits within a blend of global macro managers.

Omar Kodmani and Rozanov note that from the perspective of fund of hedge funds, global macro managers outperform other hedge fund strategies. Global macro strategies are the most liquid and are also good insurance against left tail risk.

6 Large institutional investors with long-term investment horizons (Ch 13–14)

In his article on large institutional investors, Arjan Berkelaar notes that discretionary global macro has historically offered very solid returns with low risk and reasonable diversification benefits in traditional portfolios. In contrast, managed futures offered lower returns and Sharpe ratios but provided stronger diversification benefits; these are attractive means of mitigating tail risk in portfolios with equity exposure. Berkelaar stresses that it is important to build a diversified portfolio of global macro managers, to understand theoretical basis of the algorithms for systematic strategies, and to take a long-term view when investing in discretionary global macro strategies.

Gerlof De Vrij and others provide a European perspective on things. Long-term investors share low tolerance for large drawdowns, which necessitates the use of a more dynamic asset allocation and overlay strategies. Global macro mandates are useful as part of alternative risk budget, as an alpha overlay, or as a successor to tactical asset allocation. They document sources of active returns in global macro–which includes time-varying returns on risky assets, broader universe of eligible instruments, more efficient portfolio construction, inefficiencies from home bias and asset class silos, and differing objectives of non-profit-maximizing agents. Regarding leverage and risk, the key issue is which to assign greater weight to. Principal agent conflicts arise from differences in investment horizons, career risks, irrational preferences for specific asset classes, and focus on bottom-up rather than top-down approach, as well as lack of ownership, dedication, and responsibilities.

In summary, the book gives a good overview of the foundations of macro strategies and the major themes which drove and shaped its successes in the past decades, and leaves the reader with a lot to think about what themes, advantages, or derivative overlays are likely to drive and shape such strategies in the future. The implications of Murrin's description of the "asymmetry of slow build up and fast release of geopolitical risk" to "tail risk mitigation" are particularly interesting. This may present an opportunity to construct more accurate models (in addition to generating profits), such as models that recognize the impact of environmental issue on economic growth. However, Murrin's model is Eurocentric, a viewpoint that has been challenged by those who believe that the world has been multipolar for a longer period of time than that which is normally considered. This would suggest that the catastrophes experienced lately are in fact the norm, although the character of the drivers may differ. Murrin fails to show that the character of recent cycles differs from previous ones in the higher degree of connectivity.

In conclusion, this anthology meets the objective of serving as an introductory, authoritative, and comprehensive introduction to what constitutes the theory and practice of global macro for those interested, although some of the generous offerings of plots are squeezed into half a page in the print edition and thereby rendering them difficult to read. However, the text's approach to the history, issues, and future issues of global macro makes this a thought-provoking text for the more serious reader as well.