Alternative Investments
and the
Global Macro Strategy
Insights for Individual Investors

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Introduction

Malcom Gladwell (Gladwell, 2000) introduced the concept the "Tipping Point", the point at which a series of small changes or incidents become important enough to cause a larger significant evolutionary change. For many the dual crises of the popping of the Technology Bubble in 2000 and the Global Financial Crisis in 2008, created a tipping point causing modern portfolio management to experience a significant regime change and evolve. Portfolio Management[1] theories were developed in the mid to late 1960's and taught at universities. They were based on the simple assumption that markets were efficient and investors were rational, non-emotional, decision makers. In that controlled environment, optimal portfolio performance and diversification was largely achieved by using the traditional asset allocation mix of 60% stocks and 40% bonds.

The past decade revealed that correlations between assets have a tendency to go to one in times of stress, decision makers' actions are far from rational and theories developed in the 1960's did not protect portfolios from experiencing significant draw-downs during crisis periods. In response to such crises, many investors concluded that if one cannot generate returns or control risk, it's best to focus on costs. We have seen an alternative interpretation of this cognitive error, which is congruent with how institutional investors have reacted to such events. The better solution would be the introduction of alternative investments into the asset allocation portfolio.

The new optimal portfolio is now, 50% equities, 30% bonds and 20% alternatives. The introduction of alternatives increased the risk adjusted returns, minimizing draw-downs during crisis periods for the portfolio. Simply put, the introduction of alternatives allows for the capture of what is now being referred to as "Crisis Alpha"[2]. To minimize the realization of draw-down and increase the risk adjusted return of a traditional 60/40 portfolio, our research reveals one solution would be for Portfolio Managers to introduce a global macro hedge style into their portfolios.

Problem

When investors are asked what they want from their investments, a common reply is "I want high returns with no risk". In lieu of the 10% GIC no longer being available, we are left to advise that an investor's goal should be to optimize the allocation of their capital among a set of potential investments. The objective in the portfolio construction phase is to generate an optimal tradeoff between risk and return. The portfolio optimization problem is simple enough; choose an optimal mix of assets that maximizes return while minimizing risk. The key to solving this problem is not to lose any money, or as Portfolio Managers say, minimize the draw-down in the portfolio, (specifically in periods of negative crisis, minimizing losses enhances the risk adjusted return of the portfolio over time). Unfortunately, the portfolio theory that was developed in the 1960's failed to achieve its key requirement during the last two negative crisis events, the popping of the Technology Bubble and the Global Financial Crisis. A focus on low correlation is imperative to improve the consistency of returns so that investment goals can be achieved. The traditional asset classes did not provide the benefits of diversification that were expected during these periods.

Solution

The lower the decline and less time it takes to recover from periods of loss (low draw-down), the better the chance the portfolio will deliver the expected compounded returns. Through efficient diversification, a portfolio's draw-down can be minimized and over time maximize the power of compounding. The data presented in Table 1 compares two portfolios, the classic 60% stock, 40% bond portfolio to a portfolio of 50% stock, 30% bond and 20% alternative. The sample period is from the beginning of January 1, 2000 to December 31, 2016. The results show that the portfolio which introduces alternative investments, achieves a higher rate of return with a lower level of risk. Both portfolios employed the S&P 500 Index for stocks and the Barclay's Aggregate Bond Index. The alternative asset in this simple experiment was the Global Macro Index. The conclusion that was reached is that Portfolio Managers can optimize the performance of their portfolio, have higher returns, less volatility and smaller draw-downs, when alternatives are added to a traditional 60/40 asset allocation portfolio.

Table 1: Adding Alternatives to a Portfolio Increases its Efficiency

January 2000 - December 2016	S&P 500	*60/40	**50/30/20	Global Macro
Mean per Year	3.6%	4.5%	5.4%	8.2%
Standard Deviation	14.9%	6.8%	5.4%	4.0%
Sharpe Ratio	.17	.51	.81	1.77
Largest Draw-down	-52.4%	-22.9%	-14.4%	-3.9%
Months to Recovery	49	20	9	5

* "60/40" is a portfolio that contains 60% S&P 500 Index and 40% Barclay's Aggregate Government Bond Index.

** "50/30/20" is a portfolio that contains 50% S&P 500 Index, 30% Barclay's Aggregate Government Bond Index and 20% Barclay's Global Macro Hedge Strategy Index.

Source: Bloomberg

When an analysis is done comparing the different alternative strategies, the evidence presented in Table 2 suggests, using the Sharpe Ratio[3] as our guide, that the Global Macro Strategy generates the best risk adjusted returns. In addition, the Global Macro Strategy also generates the smallest draw-down at only -3.9% with 5 months recovery.

The Global Macro Strategy is a go anywhere strategy, having the ability to invest in stocks, bonds, currencies, commodities, physical precious metals, both long and short, options and futures, It has the unique ability to participate in a bull market, as well as benefiting from bear markets. It is flexible enough to profit from rapidly changing regimes, themes, or political movements that may occur in the global economy from time to time. Global Macro Managers assume that somewhere and somehow there is a way to profit from the current global environment. During periods of crisis, traditional Portfolio Managers may be constrained by investment mandates, institutional forces[4], or behavioural reasons. This can result in forced action that collectively generates predictable opportunities that can be exploited if the Portfolio Manager has the flexibility, and the ability to identify and adapt to the new reality. Markets follow cycles and it is the ability of Global Macro Managers to capture what we call "Crisis Alpha" that sets this strategy apart. We believe that crisis can be taken advantage of in many ways. A change in political leadership that opens up a country to foreign capital, will be seen positively to the global investment community and if anticipated, could create significant value to a portfolio.

Table 2: Comparison of Alternative Strategies

January 2000 - December 2016	Mean per Year	Standard Deviation	Sharpe Ratio	Largest Draw-down	Months to Recovery
Hedged CTA	3.9%	6.4%	.45	-9.9%	15
Global Macro	8.2%	4.0%	1.77	-3.9%	5
Equity Neutral	4.0%	2.8%	1.11	-6.3%	35
Equity L/S	5.8%	5.8%	.83	-14.3%	13
Multi Strategy	7.1%	4.5%	1.36	-19.3%	13
Distressed	7.4%	7.0%	.92	-35.3%	23

Information presented was calculated using Barclay's Hedge Fund Index data.

Source: Bloomberg

Conclusion

The goal of Global Macro is to generate controversial investment themes that can be backed up by logic and research which creates value for the unit holders of the portfolio. Global Macro Managers benefit from periods of structural change. The objective of the Manager is to spot anomalies, mis-priced assets, major shifts in economic patterns, and political movements. The first building block of the strategy is top down macro-economic analysis. The best managers have the unique characteristic of having a higher degree in economics[5] coupled with the ability to value assets. Incorporating a Global Macro Alternative Strategy to a portfolio compliments traditional bottom-up strategies, such as long only equity or fixed income. Simply put, adding alternatives to the classic asset allocation portfolio increases the risk adjusted return of the portfolio. When the Portfolio Managers are engaged in the portfolio construction phases, they should seriously consider the benefits that a Global Macro Strategy will give in terms of portfolio optimization.

Endnotes

[1]The efficient market hypothesis assumed decision makers were rational and did not make mistakes. Furthermore, all information was contained in stock process and that insurance could be bought to perfectly insure the portfolio. Diversification was achieved using Morningstar style boxes, i.e. growth vs. value (price to book), size, and where the head office of the company was located.

[2]Crisis alpha is the return created by investing in a controversial investment. It can be captured by the asset either appreciating or deprecating in value. For example, buying assets in a country exiting a political crisis, or shorting an asset when a country is entering into a political crisis.

[3] Indicates the average return minus the risk free return divided by the standard deviation of the return of the investment. The measure is used to compare performance when adjusting for risk.

[4] For example, requirements to be fully invested during the financial crisis.

[5] With a discretionary global macro, traditional bottom up financial analysis takes a back seat to top down economic and geopolitical analysis.

Reference

Gladwell, Malcolm. The tipping point: how little things can make a big difference. London: Abacus, 2015.

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