

Portfolio Manager's Opinion: Why Emerging Markets Macro Now?

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Introduction

During the past 18 months, many global macro managers have struggled to provide attractive returns. This comes during a time when markets have been perceived to be exceptionally volatile; presumably the ideal environment in which macro strategies are expected to flourish. In this piece, we offer some market observations that suggest recent macro returns, while poor, don't appear to be an outlier given the various market trading conditions we are seeing. We also develop a timing framework for macro managers and suggest that after an 18 month fallow period, macro investments have a better chance of offering solid performance going forward. Finally, we restate the case for emerging markets as an attractive subset of the macro investing space. For those investors who are willing and able to take advantage of strategy drawdowns to establish new investments or add to existing positions, now may be the time to revisit macro.

Historical Background

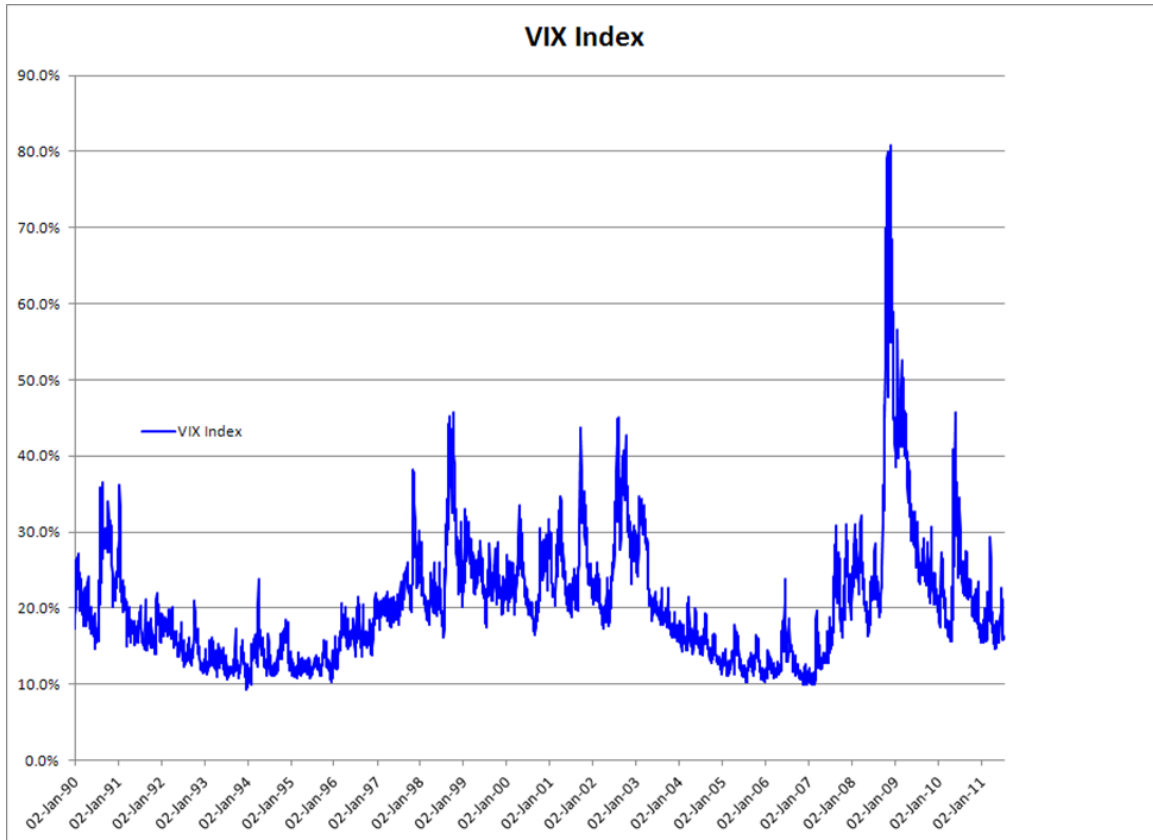
Global macro managers have been providing attractive risk adjusted returns for over 40 years, capitalizing on the various imbalances during periods of inflation, recession, political strife and all forms of government intervention. Macro strategies have historically been adept at providing ballast to a portfolio during times of market stress. In the aftermath of various market dislocations, when one asked the question: "Who made money from this disaster?" the response was often "global macro" or "quantitative macro" managers. For example, during 1987, Paul Tudor Jones returned nearly 200% while George Soros, who had a difficult October, still managed to return 14% for the year. When Barings failed in 1995 as a result of Nick Leeson's disastrous foray in Nikkei futures, quantitative macro funds run by John W. Henry (owner of the Boston Red Sox baseball team and Liverpool soccer club) returned nearly 39% including back to back 15%+ returns in Feb/Mar 1995. In that same year, Dunn capital nearly doubled investor's capital, including a 41.4% gain in Feb/Mar as the scandal broke (all figures are reported net of fees). The credit crisis of 2008 was no different, when the only alternative strategies to make money as a whole were short selling, macro, and CTA (quantitative macro). This came during a year when the S&P dropped 38.5%.

Recent Trends

The ability to weather market downturns and provide positive returns during difficult markets with low correlation to most major asset classes has long been the draw for macro investments. However, recent returns are less than attractive. Using the HFR Macro Index as a gauge, macro investments returned -8.8% in 2009 and -1.7% in 2010. The figure through June 30th of this year is -2.1%. The inability for macro investors to deliver attractive returns during 2009-2011 has been noticeable in light of U.S. equity market total returns approaching 55% during the same timeframe (using the S&P 500 as the benchmark). Investors express dismay that macro strategies have delivered poor returns, especially given the recent high volatility that markets have experienced. This is where perception has drifted from reality.

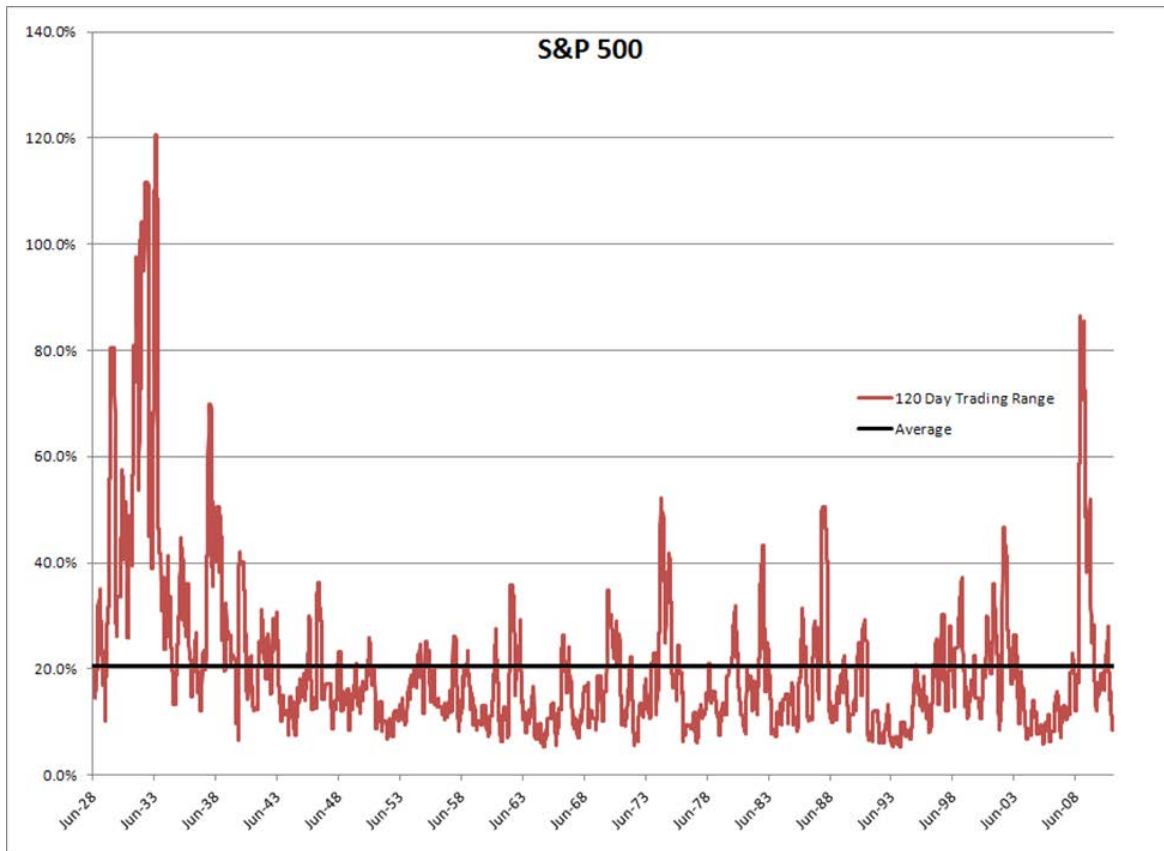
Market Volatility

Post 2008, major measures of volatility have been in a nearly continuous state of decline. First, we looked at the VIX Index. This measure of equity volatility has averaged 20.3% since January 1990. The average for 2010 was 22.6%, and the average for 2011 (through July 8th) has been 18%. While the markets have seemed volatile, they have not been, or at least not exceptionally so.



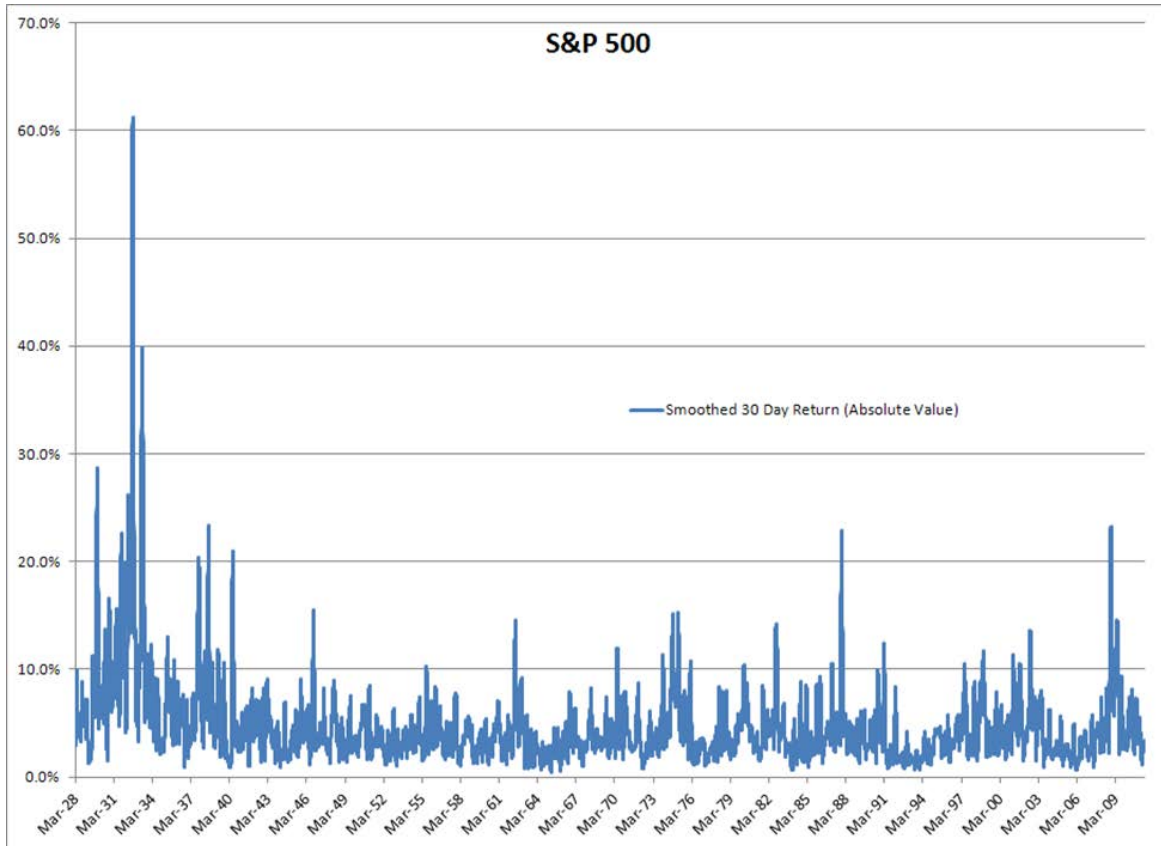
Another way to measure volatility is to look at the size of the recent trading ranges compared to historical measures. Here, we looked at the 120 day trading range (approximately six calendar months) using the S&P 500 Index going back to 1928. During this timeframe, the average range¹ has been 20.6%. For 2010, the average was 17.4% and for 2011 year to date (through July 8th) the average is 17.0%. As of this writing, the figure is 8.5%. To put this in perspective, the recent six month trading range in the bottom 10th percentile of all observations going back to 1928. The headlines for this year are clearly playing tricks on investor's minds because quantitative measurement shows that the equity market has not been that volatile recently.

¹ Range is defined as the absolute value of the 120 day range divided by the 120 day peak price.



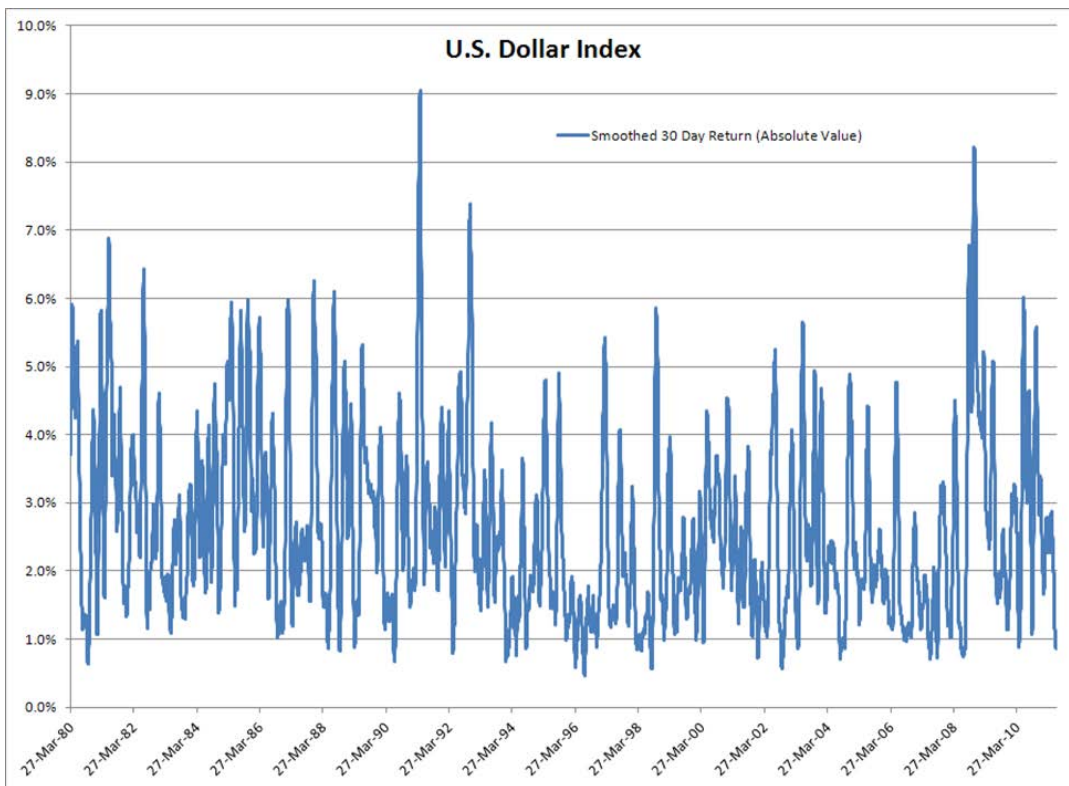
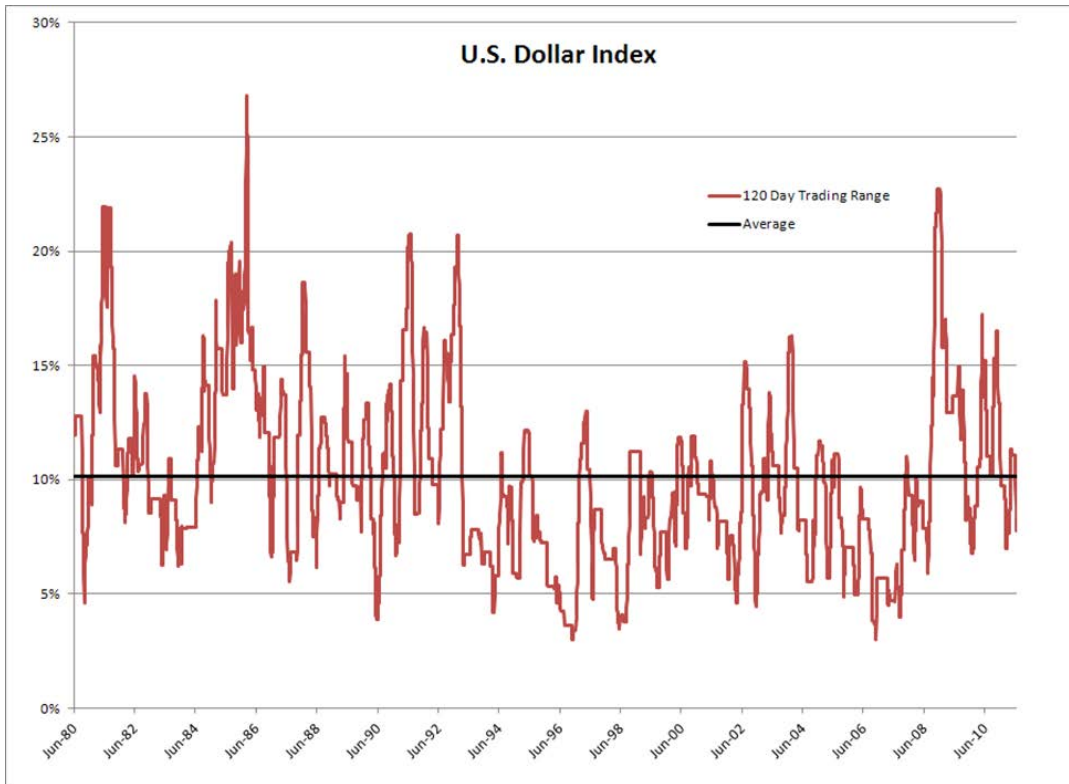
Macro managers have historically demonstrated the ability to profit from strong price trends, and it is possible that prices have made big moves without exhibiting much volatility. For example, 1993 or the last half of 2006 can be characterized as such environments. We also looked at the price return over the trailing 30 days and a measure of trend. Again, we evaluated data back to 1928. Over the entire timeframe, a smoothed measure of the 30 day return has averaged 4.7%.² For the 2010/2011 period, the data averaged 4.5% and 3.2%, respectively.

² Using the absolute value of return.



We have recently experienced an equity market where prices are not making much directional headway, and doing so in a fairly quiet fashion. However, macro managers by definition are multi-asset class, and typically globally diversified. Therefore, we decided to look at similar measures in the currency market to see if there have been missed opportunities.

Using the U.S. Dollar Index as a proxy, the average 120 day trading range since 1980 has been 10.2%. The 2010/2011 figures are 11.8% and 9.5%, respectively. As a recent comparison, the figure for 2009 was 13.3%. The latest observation of 7.8% puts the trading range in the bottom 30th percentile going back to 1980. Therefore, in the currency markets we have also seen tighter than usual trading ranges. We also looked at the total price movement over a smoothed 30 day period. The average figure since 1980 is 2.6%. For 2010/2011 the numbers are 3.2% and 2.1%, respectively. The latest observation at 1% ranks in the bottom 5th percentile.



When using the currency market as a proxy, we again find ourselves in a market environment that is not making much price progress one way or the other, and doing so in a fairly quiet manner. The perception of volatility again appears to be higher than the reality.

Timing Macro Investments

The age old question from investors evaluating an investment strategy that is in the midst of a drawdown is: “When should I buy?” Typically, the unwillingness or inability to pull the trigger during a downturn means that investors end up chasing performance. The evidence suggests that chasing performance is not a good strategy. In this exercise, we looked at developing strategies to time macro investments. We evaluated three alternatives to a macro investment strategy:

- 1) Buy & hold
- 2) Buy strength
- 3) Buy weakness

For the purposes of this exercise, we drew on the track record of the aforementioned John W. Henry. We used his numbers as an example because of their longevity and their monthly detail.³

Compound Return	19.6%	Volatility	36.3%
Average YOY Return	26.9%	Downside Volatility	29.0%
Maximum Drawdown	-43.6%	Correlation to S&P	-0.08
		Downside Correlation	-0.40

The track record has several features that make it representative of a macro investment:

- 1) High absolute returns;
- 2) Higher volatility relative to other alternative strategies;
- 3) Downside volatility measure lower than overall volatility;
- 4) A return to downside volatility ratio below one;
- 5) Low or negative correlations to equity markets; and
- 6) Lower correlations during down months for equity markets.

It is the last feature that makes macro an especially interesting strategy, but all can be attractive additions to a diversified portfolio. We then looked at how the three investment strategies might fair utilizing the same underlying investment.

- 1) Buy and hold
A single investment on day 1, with no further additions or withdrawals.
- 2) Buy strength
Investment made in any month following the portfolio reaching a new high water mark.⁴ Once the investment is made, it is held for 12 months.
- 3) Buy weakness
Investment made in any month following the portfolio experience a drawdown of 20% or more.⁴ Once the investment is made, it is held for 12 months.

³ Net monthly returns from Oct 1984 to June 2011, “Financials and Metals” portfolio.

⁴ Investment made with a one month lag to allow for manager’s publication of the return data.

A comparison of the strategies based on average 12 month returns:

Buy and hold	+25.9%
Buy strength	+26.0%
Buy weakness	+35.4%

For investors who are contemplating establishing or adding to macro investments, adding during a period of strategy weakness appears to be a winning approach.⁵

The Case for Emerging Market Macro

Many market participants have been gravitating towards the view that “emerging markets are the place to be.” We agree, and thus, in this section we discuss some reasons why we believe that emerging markets macro is in the early stages of a long term opportunity. When evaluating the late 1960s to early 1980s in the developed world, we believe that the following five developments created the conditions which the great macro players of the era (think Soros, Steinhardt, Tiger, Tudor and Caxton, among others) rode to generate epic track records.

1. Important demographic shifts (baby boomers move into workforce);
2. De-pegging of currencies (1971 move off the gold standard);
3. Legislation to increase private sector savings (401k act of 1978);
4. Increased global trade (1979 Tokyo round of GATT); and
5. Deregulation, privatization, and lowered tax rates (Thatcher/Reagan revolutions).

We believe that the same conditions are now in place in the emerging markets:

1. “Green revolution” baby boomers move into the workforce;
2. 1994-2001 de-pegging of most emerging market currencies;
3. Led by Chile (‘80), legislation to increase private sector savings. EM pensions now USD 1.8 tr, compared to USD 100bn in 1990;
4. 1994 NAFTA/1995 WTO finally address “North-South” trade issues; and
5. Deregulation, privatization, and lowered tax rates: 1979 China, 1986 Vietnam, 1991 India, 1993 former Soviet Union, etc.

Starting conditions are very similar now to those prevailing in the developed world 30 years ago. Just as it took a generation to unwind the existing imbalances (high interest rates, low equity valuations, underinvestment in infrastructure, etc.), we think the emerging markets are set for a long period of outperformance. The attractiveness for emerging markets macro as a subset of traditional macro investments is enhanced by the fact that there is currently very little competition in the EM macro space. Less efficient markets combined with less competition will offer investors better returns in the future. While we acknowledge that competition will increase quicker in emerging markets than they did in developed markets, we see no reason not to capitalize on the opportunity while it lasts. Given the recent poor performance of macro funds, we think this offers an especially attractive entry point for investors.

⁵ We admit the study is narrow in scope given the analysis of only one return stream.

Outlook

“Is it safe?”

- *Dr. Christian Szell, Marathon Man*

This is the certainly a topical question on investor’s minds as they contemplate adding or increasing exposure to macro funds. The post 2008 environment has been difficult for the macro investment style. We have shown data in this paper that suggests some (if not most) of the poor performance can be attributed to unusually quiescent markets, a feature that does not suit macro managers. What we have also shown is that this type of quiet market is not normal. We believe that each day we spend in tight ranges with no price progress, the closer we move towards a resolution of the imbalances that are clearly building up. Our sense that the likely catalyst for moving markets into a high volatility or directional environment will come from Europe. Regardless of where the impetus comes from, we believe that macro strategies will live up to their reputation of profiting from market dislocations or prolonged trends. We also believe that adding to the strategy after a difficult run increases the expected returns going forward. We think it is safe to begin adding to emerging markets macro ...