

CHAPTER 1

INTRODUCTION TO GLOBAL MACRO HEDGE FUNDS

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The global macro approach to investing attempts to generate outsized positive returns by making leveraged bets on price movements in equity, currency, interest rate, and commodity markets. The *macro* part of the name derives from managers' attempts to use macroeconomic principles to identify dislocations in asset prices, while the *global* part suggests that such dislocations are sought anywhere in the world.

The global macro hedge fund strategy has the widest mandate of all hedge fund strategies whereby managers have the ability to take positions in any market or instrument. Managers usually look to take positions that have limited downside risk and potentially large rewards, opting for either a concentrated risk-taking approach or a more diversified portfolio style of money management.

Global macro trades are classified as either outright *directional*, where a manager bets on discrete price movements, such as long U.S. dollar index or short Japanese bonds, or *relative value*, where two similar assets are paired

on the long and short sides to exploit a perceived relative mispricing, such as long emerging European equities versus short U.S. equities, or long 29-year German Bunds versus short 30-year German Bunds. A macro trader's approach to finding profitable trades is classified as either *discretionary*, meaning managers' subjective opinions of market conditions lead them to the trade, or *systematic*, meaning a quantitative or rule-based approach is taken. Profits are derived from correctly anticipating price trends and capturing spread moves.

Generally, macro traders look for unusual price fluctuations that can be referred to as far-from-equilibrium conditions. If prices are believed to fall on a bell curve, it is only when prices move more than one standard deviation away from the mean that macro traders deem that market to present an opportunity. This usually happens when market participants' perceptions differ widely from the actual state of underlying economic fundamentals, at which point a persistent price trend or spread move can develop. By correctly identifying when and where the market has swung furthest from equilibrium, a macro trader can profit by investing in that situation and then getting out once the imbalance has been corrected. Traditionally, timing is everything for macro traders. Because macro traders can produce significantly large gains or losses due to their use of leverage, they are often portrayed in the media as pure speculators.

Many macro traders would argue that global macroeconomic issues and variables influence all investing strategies. In that sense, macro traders can utilize their wide mandate to their advantage by moving from market to market and opportunity to opportunity in order to generate the outsized returns expected from their investor base. Some global macro managers believe that profits can and should be derived from other, seemingly unrelated investment approaches such as equity long/short, investing in distressed securities, and various arbitrage strategies. Macro traders recognize that other investment styles can be profitable in some macro environments but not others. While many specialist strategies present liquidity issues for other, more limited investing styles in charge of substantial assets, macro managers can take advantage of these occasional opportunities by seamlessly moving capital into a variety of different investment styles when warranted. The famous global macro manager George Soros once said, "I don't play the game by a particular set of rules; I look for changes in the rules of the game."

SUMMARY

Global macro traders are not limited to particular markets or products but are instead free of certain constraints that limit other hedge fund strategies. This allows for efficient allocation of risk capital globally to opportunities where the risk versus reward trade-off is particularly compelling. Whereas significant assets under management can prove an issue for some more focused investing styles, it is not a particular hindrance to global macro hedge funds given their flexibility and the depth and liquidity in the markets they trade. Although macro traders are often considered risky speculators due to the large swings in gains and losses that can occur from their leveraged directional bets, when viewed as a group, global macro hedge fund managers have produced superior risk-adjusted returns over time.

From January 1990 to December 2005, global macro hedge funds have posted an average annualized return of 15.62 percent, with an annualized standard deviation of 8.25 percent. Macro funds returned

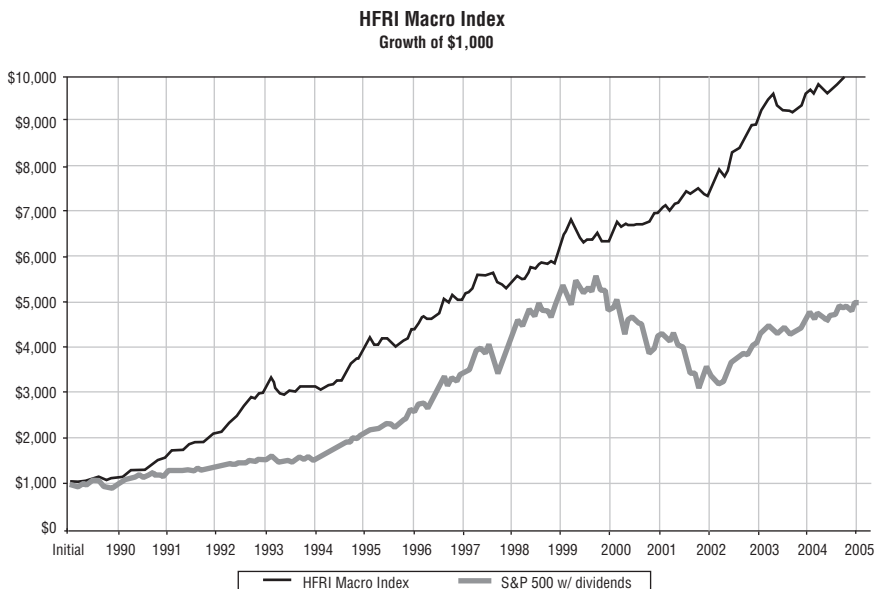


FIGURE 1.1 Comparison of HFRI Macro Index with S&P 500

Source: HFR.

over 500 basis points more than the return generated by the S&P 500 index for the same period with more than 600 basis points less volatility. Global macro hedge funds also exhibit a low correlation to the general equity market. Since 1990, macro funds have returned a positive performance in 15 out of 16 years, with only 1994 posting a loss of 4.31 percent. (*See Figure 1.1.*)

In light of the correlation, volatility, and return characteristics, global macro hedge fund strategies are a welcome addition to any portfolio.