

## FQ Perspective

by Max Darnell

Over the last two to three years, there has been a surge of interest worldwide in the global form of Tactical Asset Allocation (TAA). Geographically new interest in this product has come from everywhere between the US and Kazakstan, although more from the US and Europe. Most of these investors refer to it as “Global Macro” rather than TAA, and their objectives are typically absolute return objectives rather than in the area of overlay management. Either way, our own assets under management in this product are a multiple of what they were three years ago. What’s behind this?

Interest in individual investment strategies waxes and wanes and waxes again, largely as performance does, so it would be natural to assume that performance is driving this. That’s partly true, but only partly. Global Tactical Asset Allocation has, indeed, worked well over the last decade. However, we don’t think that performance alone is what has drawn investors to this product area. What we think is driving interest in this product has more to do with its maturation over the years from a narrowly defined investment product with limited benefits into a

nearly ideal investment product, in particular, a type of multistrategy product.

Investors today increasingly appreciate the multiple benefits of multistrategy products. These benefits include a more consistent generation of alpha resulting from greater investment breadth, and a better

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**The emergence of TAA as a multistrategy, Global Macro product has, we think, as much or more to do with appetite for multistrategy as it does the product’s own performance success.**

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alignment of performance fees with aggregate, net-of fee results – the only results that matter. Furthermore, investors today are badly in need of alpha-oriented products that don’t suffer – as the vast majority of products do - from material capacity constraints. Transparency, not only of positions and risk, but of investment methodology is increasingly important to investors. And finally, investors are increasingly aware of the need for investment managers

to be nimble in today’s markets. That requires the use of highly liquid instruments, and an investment approach that can be opportunistic when opportunities change. Tactical Asset Allocation, or Global Macro, brings all of these benefits to the table in a manner that few, if any, other investment products do!

## So What About Performance?

This is not the first time that we’ve seen a surge in interest in TAA. In the late 1980’s, interest peaked after Domestic US TAA had delivered strong returns from having been underweight stocks when the market dropped 20% in October of 1987. The chief alternative to TAA at that time, Portfolio Insurance, was meant to provide capital protection in the face of declining stock or bond prices, but it was unable to react quickly enough to deliver on its promise.

Driven by TAA’s own strong returns in the late 1980’s, and driven by its relative success in the face of Portfolio Insurance’s failure, the assets under management in TAA grew quickly. Then, across the 1990’s, interest in the global version of TAA



grew at a modest pace, while interest in the domestic-only version of TAA actually diminished. The waning of interest in Domestic US TAA was driven both by clients switching from domestic to global TAA, and by the difficulties that domestic TAA had in the face of the persistent outperformance of stocks over bonds in the US. As we've described in previous Partners Messages, Domestic TAA depends entirely upon there being volatility in the relative performance of stocks and bonds. If one is going to profit from a strategy of shifting into and out of asset class exposures, then there needs to be a similar shifting of return leadership over time in these asset classes. If one asset always outperforms the other – as stocks did relative to bonds in the late 1990's – then there's no value to be gained from shifting back and forth between these exposures.

TAA's performance has been excellent so far this decade, but that, quite frankly, isn't any different from its performance in the 1990's. What is different is its relative performance. Relative to conventional assets, and relative to other sources of alpha, TAA has delivered a better return. *Domestic* TAA may have struggled in the late 1990's (as did some *highly constrained* global TAA *overlay* mandates), but *global* TAA did not – for First Quadrant, 1997 was the only difficult year then. Does that explain the recent rise in interest in TAA? Is it as simple as returns generating interest in the product area?

## The Importance of Breadth

When investors focus on Information Ratio (IR) as a key characteristic in their selection of investment strategies and/or investment managers, they are implicitly saying that they place a high value on the consistency with which managers can deliver results. If two managers deliver the same

average return, but one has a lower period by period volatility in results than the other, then the manager with the lower volatility of results, i.e., with the greater consistency<sup>1</sup> in results, is preferred.

**Individual market inefficiencies are subject to cycles of expansion and contraction, which leaves profit opportunities to experience cycles of profitability and loss.**

The challenge in delivering consistent results is that the sources of alpha themselves provide highly variable opportunities for profit. Inefficiencies go through phases of expansion and contraction. Take simple relative valuation, for example. It is not the case that there's a steady supply of cheap and expensive stocks to buy and sell respectively. Instead, relative cheapness and richness tends to cluster. There are times when valuations are compressed, offering little opportunity to profit from a valuation-based strategy, and there are times when

**The profit cycles of various market inefficiencies tend to be dis-asynchronous, which means diversification of alpha sources works strongly to the investor's advantage.**

valuations are stretched and offer significant profit potential. The periods where valuations move from being compressed, i.e., "fairly valued," to being stretched are periods where valuation strategies necessarily fail. As fairly valued stocks or modestly cheap stocks grow cheap or cheaper, active strategies that rely upon a reversion to fair pricing will, by definition, be

unprofitable. When these valuations converge back towards fair value, that's when a valuation strategy will be profitable. The fact that such "mis-valuation" behavior tends to cluster with overall valuations going through cycles of expansion and contraction suggests that there is a common, or "systematic" risk embedded in valuation strategies, but that is a subject for a future Partners Message.

The point is that the profitability of all strategies that seek to exploit individual market inefficiencies are exposed to cycles of profitability. A failure to fully appreciate this fact partially explains the fact that investment managers tend to be hired just before their performance weakens, and fired just before their performance recovers. To the extent to which individual investment managers focus on only one type of market inefficiency, or on a narrow set of market inefficiencies, their performance will suffer from this cyclicity in the opportunity set. It's not simply that their skill varies across time – that's often the wrong interpretation – it's that their opportunity for profit varies across time.

This problem can be solved either by the investor who hires a group of active investment managers each exploiting different market inefficiencies, or it can be solved by the investment managers themselves. We'll come back later to the question as to why it may often be better to look to the individual investment managers to solve some or all of this problem themselves with a single product rather than looking to the investors to do so across multiple products. In the meantime, we'll simply say that the solution to this challenge is to rely upon a diverse set of market inefficiencies, i.e., to develop "breadth" in the opportunity set.

The rewards, or profits, to exploiting various market inefficiencies tend to be uncorrelated, or dis-synchronous. What allows one to bring better



consistency to the delivery of alpha, therefore, is breadth in the set of market inefficiencies being exploited. This is what the Fund of Funds model is principally about. Fund of Funds seek to provide exposure to as uncorrelated a set of alpha engines as possible. By doing so, they “smooth” out the aggregate alpha. Why? Because when some inefficiencies are failing to generate their rewards, others are delivering the goods.

So breadth in the range of market inefficiencies is the first key to delivering consistent alpha. Without it, one is subject to the unavoidable cycles of profit and loss that the expansion and contraction of all market inefficiencies subject one to. How one optimally uses this breadth will be the subject of another future Partners Message where we talk about Tactical Risk Allocation. Suffice it to say at this point that mere diversification of alpha sources is sufficient to providing higher consistency in the generation of, and delivery of, alpha.

### How Tactical Asset Allocation Has Increased Its Breadth

At its inception, Tactical Asset Allocation was focused on a single dimension of return, relative asset class performance. In its domestic form, TAA sought to profit from the relative performance of stock and bonds, with cash acting as a defensive alternative to both. When globalized - First Quadrant was the first to globalize TAA in 1989 – it remained focused upon this single dimension of return. What globalizing TAA did for us initially, and for those who followed, was to diversify the asset class decision across multiple markets. TAA applied to individual countries is exposed to substantial idiosyncratic risk that can be diversified by taking the same type of bet in multiple markets simultaneously.

The introduction of active currency as a separate and independent source of alpha was the first important step in the direction of a multistrategy product. For us, the next step came in 1995 when we introduced a volatility arbitrage component to TAA. The point of interest there is that volatility arbitrage tends to yield its best rewards when the markets are quiet, while the asset class selection strategy tends to yield its best rewards when the markets are volatile and uncertain.

**The measure of breadth in TAA has grown substantially over the years.**

As such, volatility arbitrage represents a wonderfully engineered fit that smooths the alpha substantially across market cycles.

Subsequent to that, we, and a small number of other TAA managers developed strategies that derived alpha

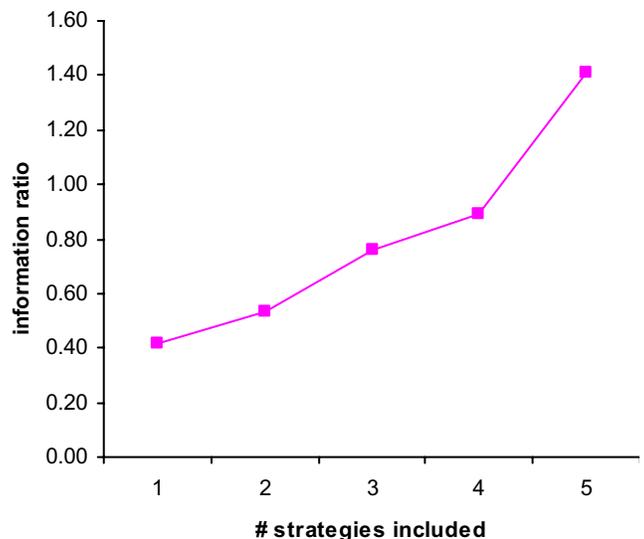
from making explicit country bets within the equity and fixed income asset classes. While it is true that the old style of TAA held implicit bets on markets within the asset classes, they were driven by views on relative asset class performance on a country by country basis, which means that they failed to represent a source of alpha that was truly independent of the asset class decision. In our case, we moved to making a global asset class decision rather than making a country-by-country asset class decision, and, therefore, separated out on a pure basis the return derived from country selection within the asset classes.

Importantly, not only do the statistically measured correlations approach zero (i.e., they are statistically independent) amongst these five separate investment strategies – global asset class weightings, relative equity market selection, relative fixed income market selection, currency selection, and volatility arbitrage – but the drivers of return in each of these dimensions are conceptually independent of each other. Conceptual independence gives greater substance to the statistical incidence of independence, which means that in times of market stress, the independence is more likely to be maintained.

As can be seen by the chart<sup>2</sup> below, this increase in breadth has enhanced substantially the quality of alpha generated by TAA. An information ratio of 0.3 to 0.4 would be considered a success in managing only the asset class decision. With the addition of these additional, largely independent strategies – country selection for both stocks and bonds, currency selection, and volatility arbitrage – the information ratio reaches to 1.0 or beyond.

The set of common characteristics of TAA managers grows weaker from here. Some remain focused primarily

Advantage of Combining Multiple Strategies





on either the asset class decision or the currency decision. A small number have broadened beyond that to include, for example, the intra-asset class weighting decisions. You may find duration tilts, plays on credit spreads, commodities, arbitrage strategies, and/or equity style tilts, for example, in TAA managers' portfolios today.

### The Mathematics of Breadth

How many independent strategies might you find in a TAA managers' portfolio today? Some may say four or five. Some may tell you it's close to twenty. Others may tell you that the number of independent sources of alpha number close to one hundred. Independence should be measured not by the number of positions, nor by the number of pairs of positions in the portfolio. Breadth isn't as simple as that.

Take our own product, for example. We say we have four or five strategies at work (depending upon whether you consider volatility to be – as we typically do- a component of the asset class dimension (i.e., a "beta bet"), or a separate, fifth strategy). The pair-wise correlations of these strategies are all close to zero, which suggests four or five dimensions of independence.

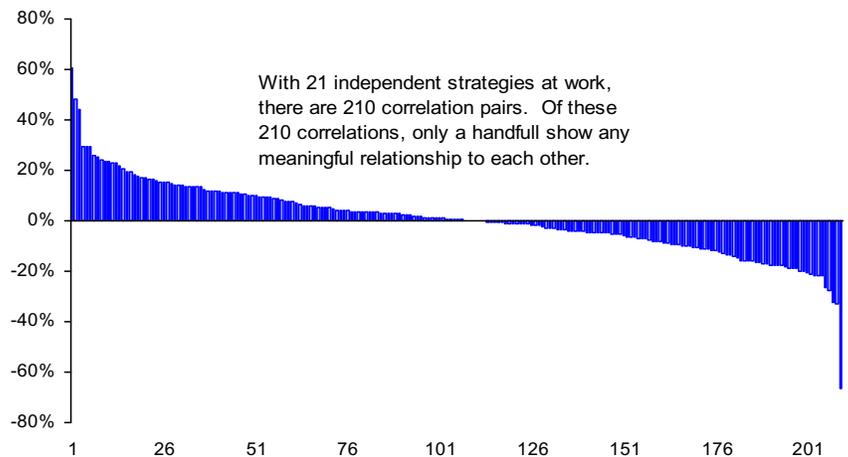
Alternatively, we could point to the twenty-one different market inefficiencies that we exploit within these four or five areas. These all have average pair-wise correlations that are also very close to zero. Only 15 of the 210 individual pair-wise correlations have correlation measures that exceed 20%, and only 1 exceeds 50%. That sounds like a very, very rich source of independent sources of alpha... and it is. One would find a significant number of uncorrelated pairs if one looks at the asset level as well. This would lead us to find perhaps a hundred or more seemingly independent bets. We, however, think that true independence

should be identified at the level of the market inefficiency rather than at the asset level.

The fact of the matter is that pair-wise independence doesn't necessarily lead to greater and greater breadth. As you incrementally increase the number of strategies, low pair-wise correlations will hide the fact that there is less and less that is new in the way of breadth being introduced into the portfolio as a whole. Furthermore,

grows. Good ideas will be harder to come by, and true independence (breadth) will be more difficult to find as well. Such a shape need not pertain if managers find, through time, new ideas that have either or both higher information ratios or new sources of breadth, but our point is that such discoveries will be in the minority of what is added through time.

Twenty-one Largely Independent Strategies At Work



investment managers will tend to find it increasingly difficult to find equally good ideas as they expand their universe of strategies. After building in their best ideas, they'll have to look to their second best, then third best, and so on, which means that the enhancement each additional idea brings to the overall portfolio will tend to diminish with each incremental strategy added. As the quality of the ideas diminishes, and as the true measure of independence falls with each incremental addition, the impact of risk-adjusted return will also tend to diminish.

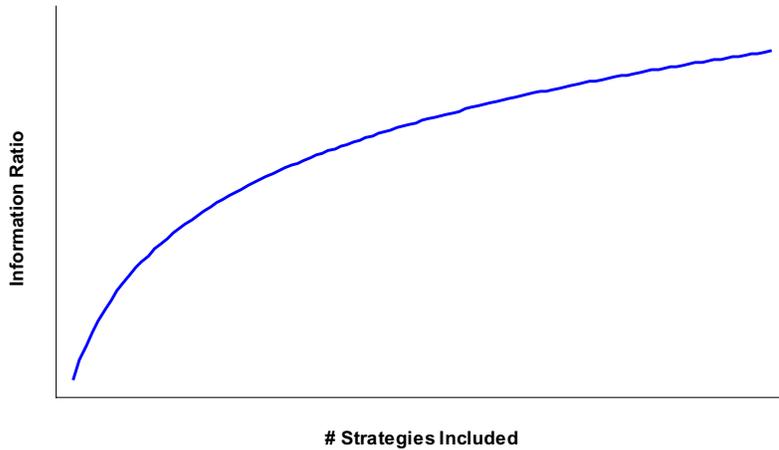
As the stylized chart on the next page shows<sup>3</sup>, incremental improvements in the Information Ratio are likely to grow more and more difficult to obtain as the number of strategies

### The Advantages of a Multistrategy Product

Pension funds, endowments, foundations, proprietary trading desks and individual investors tend to have multiple strategies at work in their portfolios. These strategies will typically be run as separate efforts by separate, independent individuals or firms. There may be a strategic decision made about which strategies fit best together in the overall portfolio, but once they are put into place, they are managed and treated separately. This is typically true in a Fund of Funds portfolio as well, although Fund of Funds will sometimes measure and manage the collective risk of the collection of independent and externally managed funds.



Diminishing Returns to New Strategies



A multistrategy product, on the other hand, is different in that the various strategies being put to work are all run internally by a single firm. To the more academic mind, “theory of the firm” questions naturally arise here. Why should there be firms that organize and manage multiple product lines? Wouldn’t it be better for investment firms to organize around individual specialties? In the Global Macro world, you might expect to find one firm that is best at managing the currency decision, another than is best at managing the global asset class decision, and so on. Wouldn’t putting together a portfolio of these products run by *different* firms, i.e., a “best of breed” portfolio, produce the best portfolio result?

There are many answers to why the management of different investment strategies will come to be organized and managed under one roof. To start with the most obvious first, there may be economies of scale in doing so. Different strategies may rely upon some degree of common investment skill and some degree of common investment or market knowledge. Certain configurations of intellectual capital, in other words, may be leveraged most efficiently within the confines of a single, multi-product firm.

Another reason why multi-product firms arise is that there is leverage in brand and reputational capital. This is an issue the hedge fund world will have to reckon with in the years ahead.

**Multistrategy products have a significant advantage in the way they can tactically allocate risk through time.**

The more brand and reputational capital is at stake, the more incented the managers are to do a good job for their clients and to deal ethically with business issues. Firms that lack significant reputational capital won’t necessarily “do bad things,” but the possession of it signals to their clients and prospects that more is at stake if they do. When 10,000 firms exist in the same space in the hedge fund world, significant reputational capital will be found lacking.

Most important to the client, there are significant performance advantages to be gained when firms possessing multiple strategies deliver those strategies in a single managed fund or product format, i.e., in a multistrategy format. The first is a tactical advantage. There are potentially huge advantages

in being able to manage, on a tactical basis, the allocation of risk to an array of independent investment strategies. To do so requires (a) expert knowledge about the changing opportunities for profit, and (b) the flexibility to respond to those changes. Who do you expect knows best when the opportunities in one’s own investment space are likely to be large and when they are likely to be small? We would assume that it is the managers of the individual strategies themselves who monitor this most closely and should, therefore, be the first ones to observe changes in their opportunity set.

Ideally, if one strategy faces below average opportunity to generate return while another strategy faces a better than normal opportunity set, assets, or risk, could be shifted tactically towards the areas with more potential reward. Unfortunately, outside of multistrategy products, portfolio managers are not incented to go back to their client and tell their client when their opportunity set is low. In fact, to the contrary, an investment manager who suggests a reduced allocation today because the opportunity set may be smaller than normal, would fear that they may not get those assets back when the opportunity returns to more normal levels in the future. Not only might they not get the assets back later, but they would lose their fee income in the meantime. They say nothing, therefore. Similarly, a Fund of Funds manager who takes

**Multiproduct strategies bring into play a better alignment of fees with aggregate client objectives.**

assets away from a fund manager may lose access to that treasured capacity for good.

On the other hand, when run under the umbrella of a multistrategy product, these incentives can be



realigned to be consistent with the overall, or aggregate performance of the product. Individual strategy managers might, for example, have incentives that are related both to how their own strategy performs as well as to how the aggregate portfolio performs. In this way, they'd be incented to encourage a reduction of their assets when opportunities are low, and to argue for an increase when opportunities are large. Within systematically run portfolios, e.g., Tactical Asset Allocation portfolios, such tactical adjustments to the allocations of risk within the portfolio may be, and in fact are, done systematically without putting any relationships or claims on future capacity at risk.

The second major advantage of running a multistrategy product lies in the area of performance fees. Fees can and do act as a significant drag

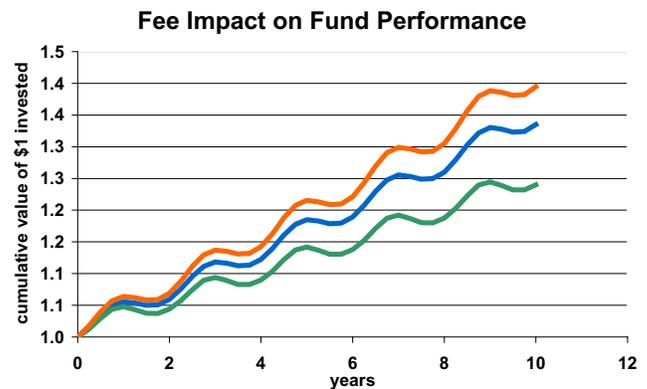
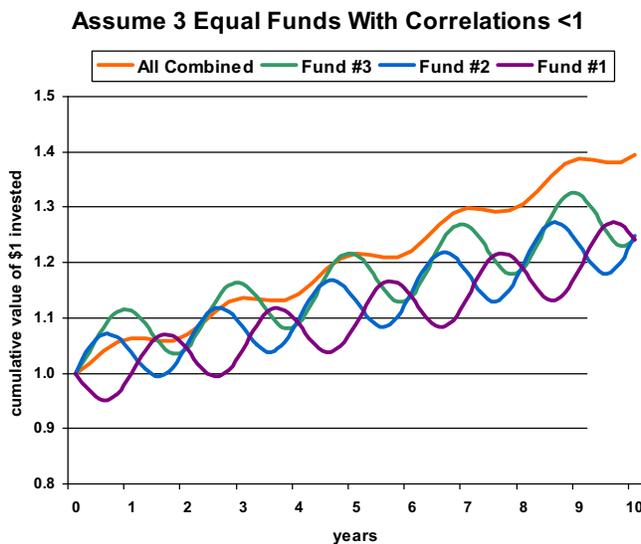
on aggregate portfolio performance. They are a significantly greater drag on performance when fees are charged at the individual strategy level rather than at the aggregate portfolio level. The stylized charts below demonstrate the concept at work here.

In brief, when investors pool multiple products together where each product has its own independent performance fee schedule attached, the volatility of the combined net-of-fee result, and the cumulative net-of-fee return are both degraded (the volatility rises, and the return falls).

### What Makes Global Macro Almost Ideal

What makes Global Macro almost ideal is the advantage that it has in these various areas. Global

Macro faces unusually low friction in tactically shifting the allocation of active risk from one strategy to another (when the opportunity in the first falls while the opportunity to the second is on the rise). The forwards, futures and index options markets that Global Macro managers most typically use have some of the lowest transactions costs (including market impact cost) of any financial instruments. Tactical shifts in risk allocation are cheap for TAA managers, therefore. Because the strategies involved are all "owned" by these TAA managers, they are able to put all of the right incentives in place for portfolio managers to help direct risk allocations towards those strategies with more potential near-term and away from those with less. Since Global Macro managers who have their roots in TAA tend to use systematic approaches, many



1. Cumulative NAV gross of fees
2. Cumulative NAV when performance fees are charged at total fund level (2)
3. Cumulative NAV when performance fees are charged at sub-fund level (3)

**Total Fund Fees (2):** Assumed performance fees of 20% charged quarterly with a 1.5% hurdle rate based on the equal weighted performance of each sub fund. **Sub-Fund Fees (3):** Assumed performance fees of 20% charged quarterly with a 1.5% hurdle rate for each of the three sub-funds.

Assume three funds, equal in terms of return and volatility, that have low correlations to each other, generate a total fund performance that has less volatility and a higher return.



of these decisions fall outside the biases associated with human or social influences.

TAA, in its modern form, brings substantial breadth to the investment portfolio. No longer is TAA focused dominantly on one single source of return – the asset class decision. Today, TAA managers bring together, in one portfolio, a wide array of different dimensions of return, and an even wider array of individual market inefficiencies that they exploit within these dimensions of return. This ever widening search for return through a wide array of assets and asset classes and across the globe has led many to refer to TAA as a Global Macro product, albeit a far more diversified and risk managed approach than what most people would think of as being Global Macro.

Furthermore, Global Macro managers who have their roots in TAA tend to hold substantial reputational capital. The leading firms that did tend

to have long tenures and have built up substantial goodwill: a refreshing difference when contrasted with the vast majority of firms offering nontraditional investment product. They, and their product also tend to offer much desired transparency. Transparency means many different things to many different people. To some, it means position transparency; to others, it means risk transparency; to yet others, it means process transparency. TAA managers tend to score at the highest end of the transparency spectrum in these respects.

In all, it must be said that good performance has led investors to turn their attention once again, to Tactical Asset Allocation. What they have found when they looked this time, however, is a substantially more interesting product than when interest peaked last time. TAA in the form of Global Macro brings to the table some of the most attractive attributes of any product out there.

#### Endnotes

- <sup>1</sup> Consistency doesn't mean the same thing as "batting average" here, i.e., it doesn't refer to the % of positive results, it refers to how stable the results are period by period.
- <sup>2</sup> These information ratios should be considered to be examples only. Different time periods will produce different information ratios, and differences in the marginal contribution that each strategy makes to the overall information ratio (which is why we have not identified the order in which each strategy is added – we don't want conclusions being drawn from this specific sample period about the relative capabilities of each of the five strategies). This sample data was drawn from a simulation of our live, historical signals from 1999-2004. The start date, 1999, is chosen because that was the year in which the last two of these strategies were added. Each strategy achieves an annualized volatility of excess return of 5%, and, for simplicity of the exhibit, each strategy is added with equal weight to the composite of strategies.
- <sup>3</sup> This stylized exhibit happens to derive from a line-of-best-fit associated with the incremental addition of each of the twenty-one strategies that FQ currently employs in its own TAA work. The exhibit assumes that you add your best ideas first (i.e., those with the highest information ratio).

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