Crossbow Partners
Experience & Discipline

London Trip Report

Thoughts from leaders and Macros playing defense

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Executive Summary

Some prominent hedge fund managers attending an industry conference considered that given their growing AUM, performance and research are key to drive their business. The motto was "be different" (as this is where alpha is) and/or be large to have resources to constantly find new alpha sources.

Computational power is definitely a game changer for the industry. It allows quants to take very fast investment decisions out of an exponentially increasing amount of data and thus to seize part of the discretionary managers' edge.

While there will always be humans behind machines, quantitative strategies should continue to grow in AUM and in their ability to take investment decisions.

Most Macro managers visited thought that we are currently in an environment characterized by two conflicting forces:

- *Synchronized global growth with US still in a leading position*
- *Main central banks exiting or going to exit their QE programs*

Managers considered the US economy as holding up (although it will probably drive the next recession) and expected higher DM interest rates later this year. There was no clear consensus on the USD due to different views on the impact of higher US interest rates, current accounts, trade war, etc. Most managers were short S&P 500, either as a hedge or against longs in EM equity indices.

Many managers were in trading rather than in investing mode and while overall not necessarily bearish, they were certainly more on the defensive side. The recent political developments in Italy added shorter-term concerns and triggered further risk reduction among some managers.

JP Morgan European Thought Leadership Forum

1. State of the industry

On the question of what will drive their business during the next 5y, answers from managers varied as they are involved in different strategies:

- For a pure quant manager, the key driver will be R&D
- A fundamentally, discretionary based manager mentioned performance as the (persistent) number one criteria
- A large manager offering discretionary and systematic strategies also mentioned research as key criteria, due to the need to constantly find new alpha sources, as available alpha per unit of risk has been decreasing with HF AUM increasing over years. This means hard work (and substantial investments) on complex problems, which for example gave rise years ago to alternative risk premia strategies.

Accordingly, the discretionary manager was of the opinion that a reason for the sub-par performance of HFs in recent years is that too many managers did the same or similar investments, while alpha is found in difficult decisions. Regulation also played a role here recently, as a manager mentioned that since MIFID II, his analysts are consuming way less Street research and produce more in-house research, which could lead to more differentiation across HFs.

Managers agreed that the exponential growth in computational power is driving a profound change in the HF industry. Machine learning models exist since decades, but machines were not available to deploy them back then. Their speed is obviously a revolution and the discretionary manager thought that an advantage of discretionary HFs in the past was their ability to react faster than other market participants, but this advantage has been taken over by the quants. However, he also thinks that the ability to (more or less) predict where the economy and markets will be in the future remains an edge of the discretionary managers. The quant manager explained that globalization creates so much interconnections between companies that an analyst cannot analyze these companies anymore and especially in a timely manner (in opposition to a less globalized world 20y ago) and that this is now for the quants. There is obviously also an exponential growth in available data and although most of these data are garbage, some are definitely useful to find new return sources. Even the quant manager emphasized that AI is much hyped and that it is not to forget that machines are programed by humans. On the question of which of the humans or machines will assist the other, it was clear for the quant manager that humans will assist machines.

On the subject of corporate culture, the discretionary manager mentioned the collaborative approach as most important as it ultimately also benefits to performance. The quant manager was on the same page as a majority of R&D projects actually fail and never get implemented in live trading. This together with the task of solving complex problems requires collaboration. Interestingly, a cultural change expected by the discretionary and quant manager is that all analysts in the future will write code to simplify their task and improve efficiency. Finally, all managers said that it is not in their culture to fire people when they are down few to many percentage points or negative several months in a row.

When asked about the best investment opportunities in coming months and years, and although Chinese securities was a focus for the quant manager and risk arb was attractive for the discretionary manager, they all agreed that paying close attention to correlation between securities and markets traded will be the most important.

2. Global Macro: Navigating the globe

Several Macro managers on the panel had an EM bias. Generally, they thought that the backdrop for EM remains supportive although the Fed is hiking, as several EM countries have today better current accounts than before and average inflation within EM is at historical low level. However, dispersion remains across EM and some countries are not in a good position and while 2017 was a relatively "easy" year for EM, 2018 is expected to bring more differentiation.

On a more global scale, a manager explained that we are exiting a unique market structure created by the major CBs following the GFC and that we are now in an inflationary period, forcing CBs to remove liquidity, which will prove very challenging to equity and fixed income markets. This manager was also bearish USD, based on the fact that the large European and Japanese current account surpluses (which had been mainly directed towards the US), will be quite powerful when coming back to their home markets. On the USD subject and on Trump's protectionism measures directed against China, another manager mentioned that China has here clearly the potential to fight back.

When discussing Latam, Argentina seemed to be the best opportunity for the EM managers. Although the country has difficult problems to solve, it appears as a good story as it is committed to the IMF program and managers favor an FX exposure. Brazil has the steepest curve in the region, which creates opportunities, but there are lot of uncertainties regarding the next presidential elections and no one sees a convincing candidate winning. Egypt was considered as a crowded trade by a manager.

Looking at Europe, it was said that Italy will probably continue to cause problems. The clear consensus was to stay away from Turkey until the June 2018 election, but thereafter it could become attractive.

When asked about risks that are currently underestimated by the markets, one manager mentioned the transition from QE to QT, which could prove very challenging for risk parity portfolios. Another manager mentioned the very serious liquidity issues within fixed income that institutional investors are facing, making them unable to act as before and ultimately causing sharper market repricing, as it was the case in Argentina and Brazil.

On the evolution of investing in EM, a manager explained that the abundance of data provided nowadays by EM is the major change, as there was basically no or only few data back in the 90's. The investing activity thus went from investing based on rumors to investing based on abundant data, which forces managers to have systematic processes in place to capitalize on these data.

3. Systematic strategies: The trillion dollar question

Asked about the growing AUM size of the systematic strategies universe, their diversifying return streams was given as a main reason for the growth. Specifically, risk premia strategies were a revolution, as they opened up a much larger spectrum of investments. Given those growing AUM, a quant manager mentioned that they measure and monitor crowdedness constantly and that it is not a new issue for the industry. It was also mentioned that quant strategies overall are probably slower than most people think. Crowding manifests itself differently across factors and every strategy will suffer from alpha decay, which forces quants to constantly develop new models to capture different effects.

One manager was of the opinion that despite subdued performance in recent years, trend following has probably not deteriorated, but it is rather the market's correlation structure which has changed. Also, when simulating trend following strategies over multi-decades, periods of underperformance as the current one are actually observed.

On the convergence between discretionary and quantitative strategies, it was mentioned that there are always discretionary decision behind quant strategies, such as selecting factors and models. Although the managers thought that a discretionary approach is more appropriate for less liquid strategies and strategies where less data are available, they think that a quant approach is more appropriate when lots of data are available and that many discretionary managers are working to get more quant oriented in order to better exploit the growing amount of available data.

Manager visits

Managers visited during the trip were mainly Macro funds and most managers were of the opinion that we are currently in an environment characterized by two conflicting forces:

- Synchronized global growth with US still in a leading position, however in the last leg of its cycle
- Main central banks exiting or going to exit their QE programs (US again in a leading position)

With somewhat more granularity, a (usually contrarian) manager agreed on the global growth theme, however not on its synchronization aspect, as this manager perceives a desynchronization phenomenon between G3 and EM, as several emerging countries and especially China still suffer from a highly leveraged private sector, which still has to be cleaned, while US, Europe and Japan are in a much cleaner situation.

Several managers considered that we are now in a transition period where higher US interest rates play a central role. As a consequence, they have been running low risk this year and especially after February's market downturn. Many managers have thus been in trading rather than in investing mode and while overall not necessarily bearish, they were certainly more on the defensive side.

The recent political developments in Italy (including the proposal of professor Giuseppe Conte as Prime Minister by Five Star Movement and the League) obviously added shorter-term concerns to the overall picture and triggered further risk reduction by some managers. Several thought indeed that the situation could get quite serious and trigger a larger market sell-off, although Europe is now structurally in a better position that few years ago. Another manager was also concerned but thought that the situation would remain contained (based on valuable local contacts showing that Italians ultimately don't want to leave the EU).

Regarding positioning, as most managers expect higher interest rates in DM later this year, they were running short duration positions especially across US and Europe (most consensus positions). Some managers did cut this exposure following the Italian events, some others maintained their trades (at least as of the time of the meetings). There was however no clear consensus on curve positioning, as one manager had steepeners and another one flatteners on the US yield curve. There was also no unanimity on the USD across managers due to different views on the impact of higher US interest rates, current accounts, trade war, etc. Most managers with an equity exposure were short S&P 500, either as a hedge or against long positions in EM equity indices in the case of a Macro EM

manager, which considered EM equities as still relatively cheap. Overall, managers had a cautious, trading oriented approach due mainly to current political uncertainties.

On the energy side, and although the bullish oil trade is becoming more consensus, fundamentals are still very strong especially due to the large supply gap caused by the lack of investments in non-OPEC ex-US production that US shale oil production will not be able to compensate. The largest downside risk to the bullish scenario is a global recession.