Insane Markets and How To Think About Manager Selection

Insanity

- The US credit rating gets downgraded and US treasuries rally.
- The ECB shoots morphine into an insolvent European banking system and it is the banks that rally most.
- China leads global economic growth and its stock market performs most poorly.
- Europe is in a serious recession whereas the US is in a mild recovery, yet European stocks rally as much as US stocks.
- Global risk levels remain elevated and investors are increasingly jumpy yet VIX and other measures of risk aversion signal calm.
- Italy, Spain and Greece are still on the Euro. And the currency is appreciating despite a massive round of quantitative easing. Its even more surprising that Germany is on the Euro.
- With the BoE, BoJ, ECB all frantically monetizing debt and printing money, gold has weakened. And inflation has not accelerated. Since output has not recovered, this must imply an acute deceleration in the velocity of money.

For the global macro trader and the fundamental investor alike, these are confusing and treacherous times. The logical thing to do, is often to do nothing. Go to cash and hold mostly one’s accounting currency, with a small allocation to gold and a bigger one to USD.

The professional money manager, however, very often cannot or is not incentivised to hold cash. Do investors want to pay fees to a fund manager to carry cash? Would investors pay fund managers for their decision to carry cash? Yet investors are often happy to pay fund managers to carry consistent, chronic negative levels of cash. This is effectively what one gets in a levered investment fund or product.

In the meantime investors become ever more disenchanted with professional fund managers who seem to be as confused as everybody else.

In the long run markets cannot stray too far from fundamentals. Yet there is a paradox. The further we look forward, the less certain is our view of the world. And in the short term, psychology, greed and fear, errors in judgment, conspire to drive markets in chaotic fashion…

Hedge Fund manager skill versus the rising tide lifting all boats: We all understand how a rising market can make a long only equity fund manager look like a star. But what about a hedge fund manager operating an equity long short strategy? Sometimes, a long term, non-directional theme can provide a hedge fund manager with an edge. What initially starts out as skill can with time become a repeatable strategy. Take the Euro for example. Since the early 1990s, European rates began to converge and European stocks began to trade along industry and sector lines more than national ones. This has been a
20 year theme which has only unraveled in the financial crisis and only when European country risk began to dominate idiosyncratic and sector risk.

An even longer term theme has been the 30 year trend in (falling) interest rates and bond yields. Yield curve dynamics around this secular theme have provided hedge funds very profitable opportunities over the years. Again, what began as skill in identifying the trend, and recognizing its underlying causality, over time has become a repeatable strategy.

The risk to these strategies arises when a significant or important secular theme ceases or wanes and a new one begins. Initially, fund managers who traded in blind ignorance to the causality of the old theme, but who understood the local trends and dynamics around it, lose money. Their returns at best are likely to become highly inconsistent. This is because they never understood the environment they used to be in, they only knew what it looked like, or had a feel for its rhythms.

The world post 2008 certainly looks like this for a great many fund managers. At the same time, there is an emerging group of managers who ‘get it’ and whose returns will gain in consistency over time.

Identifying these new managers is the key to a successful alternatives investment program. Sticking with the establishment is likely to result in poor risk adjusted performance.

The skills and the approach to finding new talent are uncommon. The current approach of interviewing managers ad nauseum, digging into their track record and their past careers is of limited use. By definition, if a new theme has taken hold and one seeks the best new managers to monetize that theme, past track record is of limited relevance. Being able to detect new talent requires an open mind and a closeness to markets and an understanding of economics at the level of the managers one engages.