

MONEY MANAGERS

ANNUAL REPORT & DIRECTORY

Why Macro Matters

BY: TYLER MORDY

Reprinted with permission from:

BENEFITS AND PENSIONS
MONITOR

October 2017 Issue

Why Macro Matters

This year marks the 10th anniversary since the onset of the global financial crisis and the credit crunch that changed the world and, in many ways, serves as a demarcation line in reshaping economies, financial markets,

BY: TYLER MORDY

politics – even our culture. And it remains unfinished business.

Few predicted that the topography of the post-crisis period would be so foreign: freakish monetary policies that dragged interest rates below the previously-unthinkable zero boundary, advanced economies stuck in ‘slower for longer’ growth phases (with lost decades now stretching into quarter-centuries in countries like Japan), and alarmingly rapid wealth convergence of the developing world with the developed one (where China’s near 40 per cent contribution to global growth last year dwarfs the contribution of other major economies).

All of this is new territory. And the ground is constantly shifting with collateral effects in international markets running far higher than normal. For example, the tentacles of the Federal Reserve’s post-crisis monetary easing reached far beyond American borders. Policy convergence became the rage where central bankers had no choice but to try to outdo the effects of one another. Of course, currency volatility soared in this environment and remains elevated today.

Many more of these ‘super trends’ have taken hold since 2008. Some were crisis-borne; others had deeper roots dating back a few decades. But because economic and financial factors have become more inter-connected than ever before, each of these trends is now truly global in scope. It’s more important than ever for investment managers to incorporate a top-down global view of the world even where they are constrained within one particular asset class or strategy. New realities are calling for new approaches.

Although their processes are often misunderstood, all macro managers take a top-down view of the world and allocate capital across a broad spectrum of geographies and countries, while utilizing multi-asset exposures including equities, fixed income, cash, commodities, and currencies. From this base, each employs a fundamental or technical process to identify and analyze macroeconomic and geopolitical themes, trends, and opportunities to dynamically manage the portfolio’s asset allocation.

Traditional Approaches

Compared to macro managers, traditional approaches are typically benchmark-centric and focus on conducting ‘bottom up’ company research or analysis. These approaches also commonly

structure portfolio policy by having fixed weights to a few asset categories – typically Canada, U.S., and EAFE equity and domestic fixed income.

Where did these conventions come from? Some brief history is helpful here. The work of Harry Markowitz, the father of Modern Portfolio Theory, led to the widespread use of mean-variance optimization, where portfolios are constructed based on historical returns, standard deviations, and correlation co-efficients.

The result is typically the classic ‘60 per cent stock/40 per cent bond portfolio,’ which lies on the so-called efficient frontier. These are all quantitative approaches (well worth a Nobel Prize or two), but, crucially, are dependent on backward-looking input data. But how often has the past looked like the near



ANNUAL REPORT & DIRECTORY

future? To be sure, 60/40 is a reasonable starting point in constructing a balanced portfolio. But investors can do better.

Global macro strategies have other attributes which allow them to deliver strong risk-adjusted returns independent of equity or bond market movements. Although portfolio policies may have certain equity or bond constraints, global macro managers are not overly restrained by benchmarks and will deploy capital only in markets that offer attractive relative valuations. Where appropriate, commodities can also provide an offset to traditional equity and bond market exposures because they often respond to different risk factors.

Active currency management is another important tool for the macro manager. Because of the size and liquidity of the currency market and its minimal correlation with equities and bonds, active currency management can have an outsized effect on risk and return man-

agement. These unique qualities mean that global macro strategies often do not move in lockstep with classic bottom-up stock and bond portfolios.

Regardless of investment policy, macro managers believe that it is essential for institutional investors to incorporate a world perspective in an increasingly interconnected and globalized world.

ETFs And Macro Thematic Processes

Some of the above evolution is driven by the advent of the exchange traded fund. On the surface, the benefits of ETFs are clear – increased liquidity, greater transparency, instant diversification, and lower costs. Who can argue with that?

But these are just advantages of the ETF structure itself. The game-changing benefit of ETFs lies in the sheer breadth of asset content now available. ETFs have colonized virtually every asset class globally. One can now easily invest in investment classes like Chinese bonds, gold, and foreign real estate. Only 10 years ago, this complete toolbox was still unavailable to investors. Viewed in that light, ETFs have caused a paradigm shift for the portfolio construction process and created high demand for investors with multi-asset class experience.

Of course, all of the above rely on an integrated investment process that can repeatedly add value. After all, ETFs are just the tools. They are not the end portfolio solution.

Many of these ETF macro processes were surprisingly resilient through the global financial crisis and beyond. The key differentiator was a focus on a global perspective. A global focus allowed for better risk management as well as access to a wider range of opportunities.

Success In Practice

One such institution using forward-looking approaches is Concordia University.* Led by the university's treasurer and investment officer, Marc Gauthier, Concordia has championed an innovative methodology in managing the university's pension plan.

Following the global financial crisis, Gauthier and the pension committee set out to analyze their existing strategy and

determine any gaps in their approach. At the heart of their analysis was a focus on risk management, with an emphasis on determining any vulnerabilities in their current approach.

Their analysis led them to completely overhaul the investment strategy. Departing from the traditional balanced construct, the new pension plan now integrates a wider set of asset classes and strategically includes managers that have a more macro thematic view of the world.

Gauthier and Concordia's efforts have generated interest around the world and the pension plan's approach is now recognized as an innovative and leading example of intelligent risk management.

Looking Ahead

Every major financial event leads to changes in investor behaviour and the global financial crisis was no different. What is clear is that the world in which we invest today bears little resemblance to the past. That doesn't mean investors should repudiate many of the basic principles that have served investors well – diversification, maintenance of low transaction costs, and so on. But it does mean we need to revisit our approaches.

Portfolios today must be highly diversified, not only across asset classes, but also across global risk factors. Compared to traditional asset allocation approaches that are typically backward looking, fixed, and statistically driven, macro approaches are forward looking, dynamic, and informed by global macro trends. When included in a portfolio of strategies, a global macro strategy provides a key offset to the classic bottom-up approach. In this new landscape, the value of managers with global-macro, multi-asset class experience will become increasingly evident.

BPM

* Concordia University is a client of Forstrong Global.



Tyler Mordy
is president and CIO of
Forstrong Global.

