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How To Apply A Global Macro Offset

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Employing a 'wide angle' macro approach results in a portfolio with a more eclectic array of asset types as compared to core asset managers. Such a portfolio has non-correlated performance characteristics that can enhance risk-adjusted returns.

The question that therefore arises is how to embrace a wide-angle macro approach … one that could offer an offset to the more mainstream approaches?

More and more, asset and liability managers are struggling with the challenges of fast-changing trends of global impact. Indications of global warming, neoliberalism, populism, hyped political economy, urbanization, and converging human values would qualify as some of these. Not to be forgotten is the granddaddy of all global secular drivers: the Medusa-headed dynamic of 'changing demographics' in all of its guises and complexities.

Extended Longevity

No doubt, the most financially rapacious of all is extended longevity. The era has arrived where becoming old is no longer a blessing given the high financial cost. Adding to the complexities of the current environment is desperate and unproven experimentation with monetary policies on a global scale. The very foundations of valuation have become unreliable. The list goes on.

Considering the continuance of such a maelstrom of challenges, an urgent question beckons: how to embrace these elements and unknowns into an asset management decision-making process that seeks opportunity? To only pursue narrow investment approaches – perhaps implying an agnosticism to the matters of era, 'macro,' and global shift – would appear to invite vulnerability.

Last October my colleague, Tyler Mordy, wrote in this space about the topic of 'Why Macro Matters.' Few will have disagreed with his arguments. Everyone

has sensed the pervasiveness of change for some time as already discussed and this was well before the global financial crisis (GFC) erupted upon unsuspecting policymakers.

Actually, it was the dying ebb or reversal of the underlying growth drivers of the post-WWII world that produced the GFC and not the other way around. The objective lesson here, therefore, is to get out in front of global macro trends … seeking advantage from them as opposed to reactionary avoidance.

We here propose to take the next practical step and provide an outline to our macro approach … in other words, 'the how.'

A Macro Approach

There exist some implacable debates with respect to active investment management; certainly, the ongoing tussle of active versus index as well as 'active macro' versus 'active bottom-up.' We have always considered both to be necessary; not because they are ideally complementary, but because practicing both allows one to capture more information necessary to formulating investment policy and managing risk. Yet, there remains no small number of practitioners that adamantly decry macro information.

We have always thought stock-picking fundamentalists can at times be caught in an exercise of 're-arranging the deck chairs on the Titanic.' No number of rearranging chairs will have escaped the effect of the macro driver at work … in this case, a sinking ship.

An unforeseen macro trend or event can easily overwhelm the influence of bottom-up selection criteria (witness years 2007 to 2009). It would have required an enormous outperformance of a bottom-up stock-picker in order to counteract the negative impact of bad asset mix (i.e. only holding stocks). At the very least, 'macro' can better identify total risk as well as help manage its mitigation.

So, in a sense, with respect to investment philosophies, as ecumenicists, embracing a diversity in one's investment processes does not water down discipline. In fact, quite the opposite. It should stand to improve results over time.

One approach incorporates three main components at the policy-making level:

- Ascertaining long-term secular trends: a total global top down analysis of significant events and trends
- Identifying pertinent 'asset types' as opposed to asset classes: these asset types have unique drivers associated with the super trends
- Positioning and implementing strategy: this is a process of putting the building blocks together and positioning them to reflect active strategies with the budgeting of risks and drivers intertwined with this process

All three components are active, continuously monitored, and modulated through scenario-testing; and identification of a 'significant change (SC).' An SC could be anything that changes the underlying premise of a strategic view.

Very Wide Net

To pursue a macro approach, one needs to cast a very wide net. A global 'top down' perspective is required which means being exposed to as much thoughtful information as possible. These perspectives may intersect the broad topics of money, political economy, and, believe it or not, sociology and anthropology.

These latter two categories may seem out of place. We think not. A fact that was rediscovered during the post-GFC environment was that there is no such thing as an inviolate economic coefficient. These will always change over time and if one remains too reliant upon any one coefficient remaining static, a setback is risked. Again, why?

It is because, of course, financial markets are human constructs; not those of another mammal. It remains the human animal (animus) that drives markets and constantly shifts its predilections, mass behaviours, and expectations (whether rational or not).

For example, it is not rational for passengers on a laden boat to rush to the starboard side all at the same time. It will topple the boat. But this can occur nevertheless because everyone is acting independently in their own interest. It is the fallacy of composition at work here. That is why we believe that it is necessary to monitor 'human' consensus views and sentiment trends – focusing upon behavioural extremes.

A top-down macro approach discipline should see a list of all material trends and phenomena worldwide that could potentially have an effect on asset markets compiled, creating a super trends and tactical views document.

These trends tend to be broad in nature and may be driven by human behavioural swings, political economy, and shifts in consensus views whether rational or not. The most monumental of such behavioural shifts today is demographics. The many different trends and impacts that spin-off this thematic dynamic is wide, including longevity and both population explosions and busts occurring simultaneously.

'Human Trends'

The key to understand is that these are 'human trends' for the most part. Technology also contributes significantly here. However, not to be denied is that most themes are an expression of changing human values. Most certainly, this is the case for the demographic challenges that the world faces today. A specific example of this would be post-familialism.

Having selected thematic trends that are investable, an inventory of key portfolio building blocks, whether opportunistic, defensive, or for diversification purposes, is taken. This leads to a selected list of asset types.

We use this term 'asset types' rather than 'asset classes because there are assets that behave just as distinctively and differentially as the core asset classes of bonds, stocks, or cash, for example. An equity sector, a geographical region, or a commodity at times can all qualify as a separate 'type.'

Primarily, what determines eligibility as an asset type is a common driver … mostly an economic one, but not exclusively. The most accepted example of an asset type that is driven from a common driver or sets of drivers is the industry sector. Sectors tend to have common drivers; these being different from others.

The definition of a driver can overlap with that of an asset type to the extent that the asset type is determined by a common factor. However, rarely is the performance of an asset type defined by just one factor driver. There may be several that influence the investment behaviour of a single asset type.

As a portfolio may be comprised of many asset types, a regulatory exercise is necessary. How much exposure is there to a given factor … too much … too little? Adding all the different exposures to a given factor, the manager must determine the net overall exposure.

Once the building blocks needed to populate a portfolio are established, the focus moves to identifying outperforming assets – the strategy formulation phase. It determines the number of active positions employed in portfolios.

The next and final step is one of setting final calibrations of risk and driver exposure. Essentially, that is the portfolio implementation step. All the 'building blocks' are placed in the portfolio and their final positions derived from an iterative process of managing exposure to a given driver and risks, while also achieving a minimum diversification.

Useful Offset

As was established in the previous article in this series, the object of a global macro approach is to seek an offset to the more traditional or narrower bottom-up approaches. Asset holdings driven by narrow selection disciplines – whether, domestic, regional, or global – will tend to share similar risks and drivers.

In contrast, employing a 'wide-angle' macro approach results in portfolios holding a more eclectic array of asset types, therefore producing a much more independent and non-correlated performance characteristics compared to core asset managers. **BPM**

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