Sunday Supping for June 17th, 2018

Sunday Supping written whilst watching Netflix rather than the World Cup

Photo Credit: The Guardian

Question of the Fortnight...

CAIA recently released an article (written by Axiom) that mentioned fundamental managers 'highest conviction' assets are often the main driver of weightings in a portfolio. The article suggests fundamental managers should be utilising more quantitative tools to deliver higher Alpha. In this technological age, can manager convictions still play a role in bringing Alpha to investors?

Helen Thomas, Founder and CEO of BlondeMoney says: It depends on the kind of manager. When I worked for a fully discretionary macro fund, the main PM felt that he wouldn't hold a trade without full conviction and that diversification was nonsense! He held only 4 positions at any one time. The other PM held more so there was a natural diversification in the portfolio as a result.

Dining Out with the Alternative news this past week in case you missed it...

Outside of the G7 commentary, **Monday** saw the World Finance site provide a brief interview with the CIO of the largest pension fund in Mexico (Afore XXI Banorte) passionate about his expansion into international Alternative assets; citing the duration they offer, the positive returns and his fiduciary responsibility to use a full investment regime. BizTimes talked about the growth in the Family Office structure around Wisconsin, and the consequential growth of PE investments by family offices around the region (and indeed around the world). Outside of seeking higher returns, one F.O. noted the surge is attributable to the arbitrage between the public and private markets i.e. private markets are less expensive thanks to illiquidity, size and operating teams.

Tuesday saw news dominated by two world leaders meeting for a small handshake as Asia Asset Management talked Asian Pension Funds and alternatives. Malaysia's two biggest Pension Funds are taking aggressive measures to continue/increase allocations to Real Estate and Infrastructure plays to limit downside risk and diversify portfolios.

Wednesday witnessed the feedback from the highly hyped meeting of Donald and Kim (a PR coup for Kim) as a calmly hawkish Fed chair Jerome Powell said 'the economy is doing very well' and hiked rates up to 2%. Pundits are saying: a. expect a further 2 rate hikes in 2018 and 3 in 2019 b. assets are still expensive c. are rates being increased now in anticipation for the next economic downturn d. we have moderate inflation pressure. The Business Insider commented on recent Harvard research that followed 29 hedge funds pitching over 5 years. According to PhD student Patrick Luo hedge funds love to pitch stocks in a public forum (which tend to be up 20% prior to the pitch), but have a propensity to exit the position after pitching.

Thursday saw the opening of the World Cup soccer/football tournament and if you have a trader with a team in the competition don't be alarmed when his/her trading volume drops by 33% during a game. We saw some global game play by Mario Draghi as he called a halt to the decade long ECB money stimulus (by end of 2018). And the Institutional Investor commented on Preqins biggest investors into Private Equity. 359 investors exceed the billion dollar allocation mark e.g. Kuwait Investment Authority has $52.4bn invested, Canada Pension Plan Investment Board has $54.8bn. This allocation dominance allows more influence on access to oversubscribed deals, fee negotiations and shaping standards.

Another report on the bullish attitude towards Alternative assets was released on Friday. iCapital Network and Hedgeweek reported high net worth advisors are keen to maintain and increase exposures to PE and Private Direct deals for return and diversification goals (HFs had a mixed reaction). Private Direct deals are the most interesting, despite the shortage of high quality deals, access, high mimimums and illiquidity. And Zerohedge linked to an article in The Economic Collapse blog that infers US unemployment is closer to 21.5% than the 3.8% touted by government, and if the same methodology that was used for inflation in the 80s was utilised now, US inflation is actually at 10%?

The weekend saw the continuing oil uncertainty as OPEC prepares to meet next Friday. Hedge Funds were optimistic about a possible $100 per barrel scenario but as Saudi Arabia and Russia push for increased production (decided over a world cup match) shorts have since been increased. And investors are finding new ways to bet volatility will fall, despite hawkish central banks, trade tariffs and some emerging market risk. According to Business Times, hedge funds hold the largest number of shorts in the CBOE Vol Index and are now looking at a range of strategies across global equity and debt markets e.g. taking the other side of the embedded call option on capital-guaranteed notes, combining volatility bets with going short correlation, to play the volatility strategy to its fullest.

Getting To Know the Industry…

Normally we have our new segment 'getting to know the industry' here, but thanks to a fascinating markets conversation with a good friend (whom we met through our last hedge fund), we decided to hear her thoughts on the catalyst for an coming financial crisis i.e. ETFs.

Helen Thomas is one of our regular experts for our fortnightly question and is the Founder of BlondeMoney, a macroeconomic consultancy and research specialist company she launched in 2017. Having graduated from Oxford, she worked at Merrills in FX, was a partner at a Global Macro hedge fund and advised the Chancellor of the Exchequer George Osborne during that little financial crisis we had in 2007/2008. Currently she is a board member of the CFA, UK and a few years back was the lead researcher for the book "Masters of Nothing".

What do you think the issue is with ETFs?

ETFs were a great idea. They combined the investment into a fund with the ability to trade it at any time on an exchange. Instead of buying 500 stocks in the S&P, you could buy the SPY ETF, which closely tracks the performance of all those stocks. Same returns, but cheaper and more efficient; what's not to like? The reality is that they contain a design flaw. The tracking process comes about because market makers arbitrage away differences in price, between the underlying and the ETF. If they deviate, there should be a risk-free return because they're the same thing, right? But, arbitrage only works when there is liquidity. And the liquidity in an ETF is dependant on the market makers and their creation agents, the APs (Authorised Participants). They aren't obligated to make a price, and if it's too hard to get hold of, say, a high yield bond, then they step away from pricing, say, the HYG ETF. It's nothing to do with Blackrock or Vanguard; they're just the shop front. If you go in to buy some chewing gum, it won't be there if the suppliers stop delivering.

What alarms you about the current situation in the ETF market?

In 2007, CDOs equated to one-fifth of the market capitalisation of the S&P500. The ETF market, at 6 trillion, is now of a similar size. The ETF market is now just too unwieldy. The hedging process that allows the APs to provide ETFs means that their flows are dominating the market: they're all the same way, all at the same time. The hedging is usually done automatically, so the orders hit the market in milliseconds of receiving the risk. The hedging process relies on correlation. Even Latin American equity ETFs, such as the ILF, have a 70% correlation with the S&P500. That means you can clear 70% of the risk immediately by trading an S&P500 future. Or, why not use the SPY ETF? Yes, ETFs are used to hedge ETFs.

Managing all of this risk are the Delta One trading desks of banks and brokers. They can make decisions on whether to hedge the remaining 30% of that ILF flow, for example. If they choose not to, they are taking prop risk. Banks are taking on hidden leverage on the back of ETF flows. Oh, and their capital charge is lower if the risk sits on the Delta One desk, because those positions are for 'market making purposes'.

Hidden leverage and unpredictable liquidity are the hallmarks of every financial crisis we have ever seen.

How do you see markets unfolding down the track if things don't change with ETFs?

So ETFs depend upon functional liquid markets. We are now at a turning point when central banks are turning off the Perma-QE taps. Liquidity, having been pumped in, is being sucked out. The virtuous circle where QE drove money into passive investments which compressed credit spreads, lowered volatility, and led money back into risky assets - that's about to turn into a vicious one. We have already seen the tremors. The "Volmageddon" of February has set the process in motion. Volatility begets volatility as it feeds into risk models of long-term money managers as well as option delta hedgers. We are seeing drive-bys in market after market: Facebook, Russia, Argentina, Turkey, and now Italy. Everyone has to adjust their exposure to risk. Which changes the price of risky assets. Which is used to calculate risk. And so on.

There are no macro narratives now, only the unwind of an unstable market structure.
