

Is Global Tactical Asset Allocation a Hedge Fund Strategy?

By

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In this article I offer some thoughts that may hopefully be useful for investors at the stage of allocation of risk to alpha generating strategies as a whole and between hedge funds and global tactical asset allocation (GTAA) in particular. I will not discuss which solution is better and which worse, but rather attempt to analyse the distinctions and similarities between two phenomena that have lately received a lot of traction.

What is GTAA?

Do you remember those not very remote times when pension funds, especially in Europe, were not particularly keen on GTAA, but instead allocated excessive risk to plain vanilla equities? The 1980-s and 1990-s happened to be the time of a bull market. Pension funds enjoyed high equity returns and followed a tacit conviction that the markets would go up forever. Everything had gone delightfully well until stock markets crashed in 2000. Then, after lying for some time under a palsy of suddenly appeared huge deficits, the institutional investors began to seriously look for alpha. Hedge funds and GTAA drew the rapid attention of both institutional investors and their consultants.

However, some people had understood the importance of alpha and of tactical selection between asset classes as one of its reliable sources already in the 1980-s, and a few TAA products were launched then. Nowadays GTAA from a few exquisite brands is available in different forms and shapes, both off-the-shelf and tailored to customer's needs.

Without going too deeply into the history of their evolution, we will say that now a typical GTAA process consists of mainly four sub-processes, four sources of alpha that are independent from each other and could in many cases be run on a standalone basis. These four dimensions are:

- **Asset Class Selection.** An output of this model would be long or short positions in global stocks, global bonds and cash². One can think of global stocks or global bonds as of respective world indices, not necessarily weighted according to market capitalization. They may also be weighted by GDP or just equally.
- **Stock Country Selection:** This model compares country stock markets to each other and results in a dollar-neutral long-short portfolio of equity markets.
- **Bond Country Selection:** Ditto for bond markets.
- **Tactical Currency Allocation:** This model's recommendations are long and short positions in currencies. These positions add up to zero³.

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² If an investor prefers to think of his portfolio as a whole, not of GTAA independently, he may prefer to use the word 'overweight' for long positions and 'underweight' for short positions, because the long position increases the weight of the asset in his overall portfolio, and the short position decreases the weight.

³ Approximately, given variations in P&L.

Some products include one or two more dimensions like commodities or curve plays but those often stumble upon capacity issues. Emerging markets are also sometimes added to the set but capacity becomes an issue there as well being unable to take decent risk, to say nothing about higher costs of trading. Up to 13 developed equity markets, 7-8 bond markets and 9-10 currencies can be traded without limiting capacity too much.

Implemented via futures and forward contracts, GTAA strategy does not require any capital allocation except for one needed to meet margin requirements. It can overlay practically any asset mix. Therefore, it is not just an alpha, it is a portable alpha! Usually investors port it on cash or on a traditional equity-bond mix. Recently we have seen emergence of mandates where GTAA was combined with portable beta: for example, GTAA was ported on FTSE-100 replicated using futures.

GTAA is delivered to investors in forms of funds with different underlying assets (but still chiefly with cash), managed accounts, total return swaps or structured notes.

On the top of that, usually GTAA optimisers are built in such a smart way that individual risk requirements of clients can be met.

Is GTAA a hedge fund strategy? Of course, it is!

Any hedge fund's objective should be **alpha** generation, and GTAA does nothing else but produce alpha. Comparison of forecasted returns of asset classes, different markets within an asset class leads to a portfolio where bets are made on a global basis. Moreover, risk in modern GTAA products is reallocated dynamically between the sub-processes and between markets. Where a greater opportunity is seen, the risk taking increases and vice versa. That closely resembles the global macro approach. As in many cases GTAA products are model driven and only allow little discretion at the stage of trading, why would we not call them 'Systematic Global Macro'?

Another similarity is involvement of **skill** as a cornerstone of success of any alpha generating process. From the beginning, hedge funds have been associated with seasoned traders making money in all market environments and bringing desired return to investors. Later, when systematic processes appeared, they did not require such impressive traders as before but did demand skill at the stage of model creation.

GTAA products are usually model driven. These quantitative models are based on different sets of factors and could be classified as purely fundamental, purely technical or a mixture of the two. These factors are used to detect magnitude of mispricing of the markets traded. Once this is done, the information goes into an optimiser that produces a recommended portfolio. And, on the top of that, there are risk management procedures, also often very formalised and systematic by nature. Development of all of this does require skill. It demands continuous research efforts as market inefficiencies tend to vanish over time. Leading GTAA houses employ strong teams of researches whose only task is finding and quantifying new inefficiencies and looking for better ways of portfolio construction. It is becoming more science than art, and while execution still remains a very important part of the game, the need for truly exceptional skill has been migrating towards the model development.

Both majority of hedge funds and GTAA providers boast **low correlations** with traditional asset classes and, in some cases, with other hedge fund strategies.

Capacity is an issue for most hedge funds and may become an issue for GTAA managers as well.

With the **fee structure**, like hedge fund managers, GTAA managers usually prefer to receive a management fee plus a performance related fee.

Instruments traded are not cash equities or bonds, in both the cases of GTAA and many hedge funds that are free to trade derivatives for both alpha generation and risk control purposes.

GTAA products are often **packaged** as hedge funds.

Is GTAA a hedge fund strategy? Of course, it is not!

Any hedge fund's objective should be **alpha** generation, but do they always achieve that goal? A host of recent studies shows that hedge fund returns can be explained with beta exposure for about a half. Different studies show different numbers, and different strategies provide different beta exposures but still there is so much beta in hedge fund returns that some widely respected asset managers have begun to offer products that endeavour to replicate hedge fund returns. Have you seen any product that would dare replicate GTAA returns?

A few funds of funds, eager to only deliver alpha to their investors, attempt to trade beta exposure away based on both historical time series of returns and on their understanding of underlying strategies. I cannot say that I am a fan of such an approach but the fact of the matter is that the presence of beta in hedge fund returns is now a very well known fact.

On the other hand, unless a GTAA product has an intrinsic bias to equities or bonds, or to some specific country markets, it would be very hard to classify its returns as beta.

That leads us directly to the issue of **fees**. Firstly, GTAA managers usually only charge their performance fee for the alpha they deliver. Further, when a product is packaged as a hedge fund, a cash (or some other applicable benchmark) hurdle is often introduced.

In a hedge funds case, an investor usually has to pay for both alpha and beta as they become inseparable for him. What on earth could that beta exposure be for which one would be willing to engage him, or herself, into long lock-ups and to pay 1.5-2% in management fees and especially 20% in performance fees? Perhaps, it could be some very exotic beta that is really hard to access, but is that the kind of beta sold by an average hedge fund to an average investor?

Clear differences arise as we cast even a superficial glance at **competition**. How many long-short equity hedge funds are there? How many fixed income hedge funds? Thousands. On the other hand, how many GTAA managers do you know? A dozen. Maybe a few more. It is interesting to note that despite this apparent lack of diversity of offerings there are not too many newcomers in the area. Does it have anything to do with complexity of the models? I think, not - quite sophisticated models abound in the hedge fund world. In my personal opinion, the main reason is a clear division of the asset management industry between equity and fixed income specialists, almost two different professions. As this division is unlikely to disappear, as the markets are huge, it is hard to believe that the inefficiencies the GTAA managers exploit will evaporate anytime soon. One way or another, as a result, GTAA managers do not pursue same opportunities, as is often the case in many hedge fund strategies. So their alpha is not that scarce and not as fiercely fought for.

Another interesting implication of this is **risk control**. With VaR having become widely accepted measure of risk, it is calculated by thousands of managers in exactly same way. What might happen if their risk controls trigger exits at the same time, and if the market were not deep enough to accommodate all those trades? Simply put, there is a danger that in such an event nobody would stand on the other side of the trade, and the snowball would roll down the hill crushing everyone on its path. Theoretically, that may be the case with GTAA strategies as well, but they are

probably more immune to this problem than others due to less crowding and, in some cases, due to the contrarian nature of some of the models' components. This latter feature allows the managers to be "prepared" for the unexpected as they often take their positions early.

We already mentioned **capacity** constraints as a similarity. No, GTAA strategies are not limitless. However, their resources are much deeper than those of traditional hedge fund strategies and measured in tens of billions of dollars.

Capacities of most hedge fund strategies are very limited. What happens as a result? Funds that have not reached their individual capacity ceiling yet keep accepting the money. The managers think they still have some room for growth. However, because many people have very similar approaches and chase the same ideas, they do not notice when and how overall strategy capacity is exceeded. Does anybody measure it?

This, by the way, is one of the reasons for "everybody losing at the same time" effect. We could see macro events that influence seemingly different strategies simultaneously. Consider a fixed income arbitrageur playing a credit spread game and an emerging market manager. Any recollections of 1998?

Another issue is **breadth** of strategies. GTAA usually evaluates at least 30 markets taking independent bets that may vary in size over time⁴. Different from a typical classic global macro approach, exposure is rarely concentrated in a small number of large bets and large position swings rarely happen.

We mentioned low **correlations** with traditional asset classes as a similarity. However, correlations between hedge fund managers within particular strategies are on the rise. The same is true about correlations between strategies. Still neither correlations between GTAA managers have increased, nor have their correlations with traditional asset classes or with hedge fund strategies.

Now, how easy or difficult is it to **select** good hedge funds? I think it is an incredibly hard task. There are so many good funds that do similar things that many institutional investors prefer to avoid the choice and to go fund of hedge funds route, pay another layer of fees and end up with bond type of risk (as they wished) but also with bond type of return (not something they dreamt of). Selection of good GTAA managers is not that complicated. They are few, and most offer products of institutional quality.

⁴ While 30 does not look too big a number at the first glance, especially if compared with the equity managers' universe, the word *independent* is key here. If reduced to a number of independent bets, even an equity manager's position will unlikely look significantly better diversified, if at all.

Also, many institutional investors shy away from hedge funds due to fear of low **transparency**. Indeed, strategies are not always clear, reasons behind decisions are often impossible to understand, instruments traded like illiquid assets or complex derivatives are difficult to price. In all honesty, I am not sure that every investor would know what to do with all that information should they gain access to it. However, the demand is there, and the number of hedge fund managers offering their products in discretionary account format is increasing. GTAA, on the other hand, was originally offered as a discretionary account product and may provide practically real-time reporting of trades, with hedge fund **packaging** having arisen only relatively recently.

Flexibility is another feature that makes a difference. It becomes really handy when investors seek to incorporate GTAA into their portfolio. A product that can be as

easily designed to deliver 30% volatility as well as 1% is a very convenient building block. Also, sometimes investors have short-selling restrictions or want to exclude some markets or even some sub-processes. While quality of alpha would be compromised in such set-ups, in many cases GTAA engines can be used to manage such accounts.

Conclusion

GTAA and hedge funds do have a lot in common. However, similarities should not overshadow the differences. When risk is being allocated to alpha products, one should think carefully not only about past distributions of returns, but also about changes that those distributions are likely to experience in the future.

Fundamental trends that are observed now in the industry are showing certain signs of convergence between GTAA and hedge funds but the distinctions inherent to GTAA are here to stay for years to come. Those distinctions are significant enough to justify separate risk budgets for hedge funds and GTAA products in pension funds' portfolios.