

## Managing Downside Risk with Global Macro Strategies

SOLUTIONS & MULTI-ASSET | AIP HEDGE FUND SOLUTIONS TEAM | INVESTMENT INSIGHT | SEPTEMBER 2019

Today, investors are faced with equity markets at all-time highs and trillions of dollars in fixed income generating negative yields. The expected return outlook for traditional asset classes is weak, and with volatility near all-time lows, the likelihood of an uptick is high. Historically, global macro has held up well in these types of markets, in part, because of a long volatility bias and active hedging. Amid concerns about potentially unsteady and down markets, we believe two of the strategies employed by global macro managers are particularly worthy of consideration today: long volatility and tail risk.

AUTHOR



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### What is Global Macro?

Global macro is an investment style that is very diverse: Managers have the flexibility to take long **or** short positions in **any** global market using **any** liquid financial instrument. These strategies can be highly opportunistic and have the potential to generate strong risk-adjusted returns in challenging markets.



**DISPLAY 1**

**Historical Correlation Between Global Macro and U.S. Equities**

HFRI Macro and S&P 500 12-month Rolling Correlation (01/1990 – 07/2019)



Source: Bloomberg and Hedge Fund Research Inc.

Provided for illustrative purposes only. **Past performance is not indicative of future results.**

**Designed to Behave Differently**

Historical spikes in market volatility and major inflection points in central bank policy measures have shown us that correlations among asset classes are not stable. Indeed, during severe market dislocations, diversification benefits across asset classes can quickly evaporate

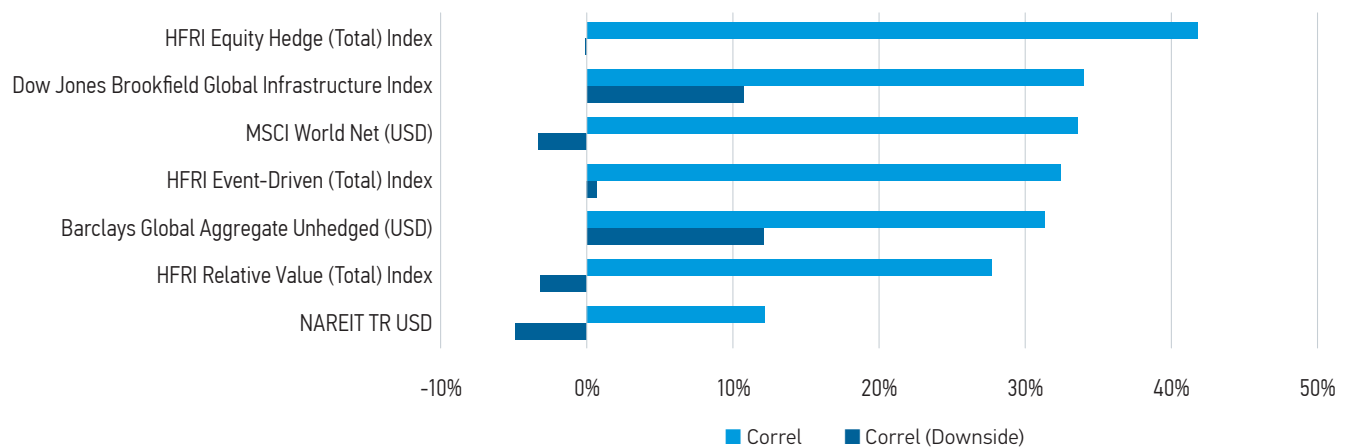
as correlations spike. Historically, global macro has bucked this trend. For example, as illustrated in *Display 1*, correlations between global macro, as proxied by HFRI Macro (Total) Index, and U.S. equities actually decreased during the technology bubble and the credit crisis.

Looking across asset classes more broadly, global macro has historically exhibited relatively low correlation to bond markets as well as to other hedge fund strategies, particularly in crisis periods (*Display 2*).

**DISPLAY 2**

**Global Macro Has Exhibited Low Correlation to Other Strategies**

January 2005 through July 2019

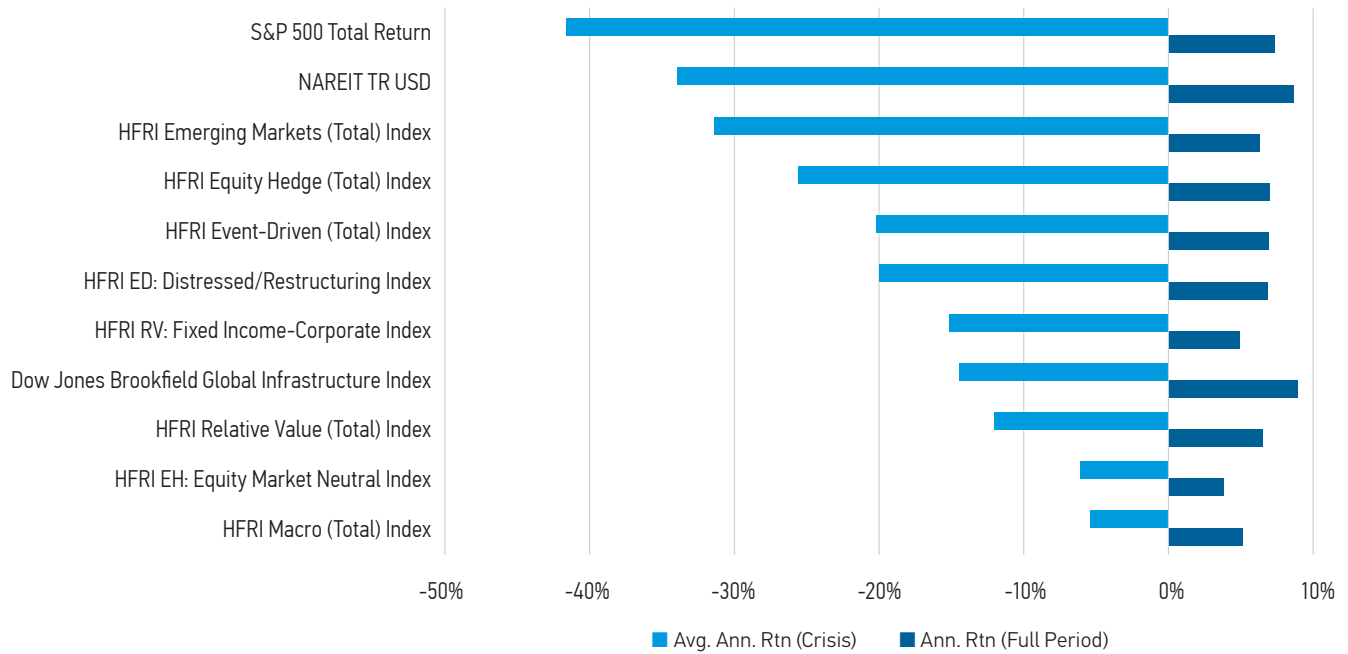


Source: Hedge Fund Research Inc. for HFRI indexes; Bloomberg for all other indexes.

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**DISPLAY 3**  
**Global Macro Performance During Crisis Periods**

January 1998 through July 2019



Source: Hedge Fund Research Inc. for HFRI global: indexes; Bloomberg for all other global: indexes. Provided for illustrative purposes only. **Past performance is not indicative of future results.**

**Performance in Challenging Markets**

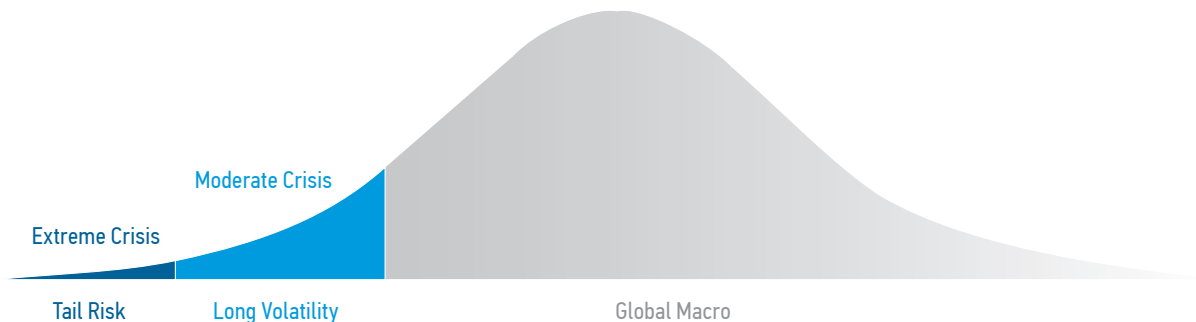
On an absolute return basis, global macro has tended to hold up well during market crises (*Display 3*) as such market conditions often give rise to attractive

trading opportunities on which global macro managers can potentially capitalize.

Indeed, certain global macro strategies are designed with the aim of

outperforming in precisely these sorts of environments (*Display 4*). Among the most notable of these are dedicated long volatility and tail risk strategies.

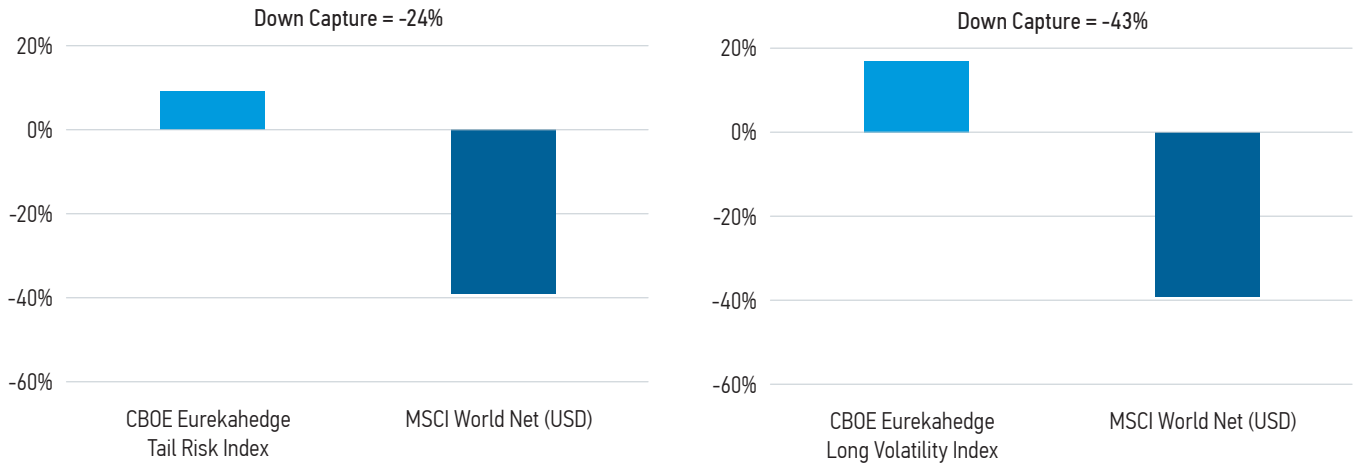
**DISPLAY 4**  
**Illustrative Market Return Distribution**



Provided for illustrative purposes only.

**DISPLAY 5**  
**Historical Down Capture Statistics**

January 2008 through July 2019



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**A Closer Look at Long Volatility Strategies**

A closer look at the historical performance of long volatility and tail risk strategies reveals dramatic downside risk mitigating characteristics (*Display 5*).

Long volatility strategies have a high degree of exposure to, or a long bias to, the level of market volatility. They tend to exhibit positive correlation to market volatility and negative correlation to equities over most time horizons. In other words, they are designed to seek to

deliver positive returns during periods of market turbulence. Historically, they have delivered.

“Tail risk” strategies comprise a subset of the long volatility universe that exhibits a high degree of convexity, a level of payout that is outsized in comparison to the change in an underlying variable, to large increases in market volatility or declines in equity prices. They are characterized by opportunistic and hedging positions that are intended to deliver positive returns during dramatic market declines. As shown

in *Display 5*, they too have historically proven successful over time.

**The Cost**

Of course, no investment strategy is without risk or cost. Long volatility strategies tend to be structured with options and other insurance-like products. Options are highly liquid derivative instruments that allow investors to target very specific exposures—for instance, a specific commodity, currency or index—but the cost of holding them in benign markets is not insignificant (*Display 6*).

**DISPLAY 6**  
**Return Payoff Histogram**

Degrees of Losses



Provided for illustrative purposes only.

Tail-risk strategies tend to be less costly to carry. Benefiting from greater convexity profiles, their potential payoffs can be considerably larger than long volatility exposures. However, those payoffs would only occur during more extreme market conditions.

While the potential benefits of these strategies are clear, it is important to determine the appropriate size of an

allocation. Investors will want to be sure that the peace of mind and potential payoff provided by these strategies make sense in the context of associated costs and the portfolio's overall target return and volatility level.

### **Conclusion**

Over time, global macro has demonstrated its ability to perform differently from other asset classes and

to weather difficult market conditions, making it, in our opinion, a valuable component of any well-diversified portfolio.<sup>1</sup> In addition, we believe that long volatility strategies, including tail risk strategies, have the potential to reduce drawdowns in investor portfolios during volatility shocks and market downturns by seeking to generate positive returns amidst market dislocations.

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<sup>1</sup> Diversification does not eliminate the risk of loss.

**GLOSSARY**

**High Convexity:** Positive return expectation (payoff profile) in crisis markets

**Negative Carry:** Negative returns during normal market

**Sharpe Ratio:** A measure of an investment's return versus the risk required to achieve it

**Theta Decay:** A measure of the rate of decline in the value of an option because of the passage of time.

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