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HEDGE FUND MANAGERS AND THE SWISS BLACK SWAN

HOW MACRO AND OTHER TRADING STRATEGIES WERE AFFECTED BY THE SWISS NATIONAL BANK'S SURPRISE DECISION TO REMOVE ITS CURRENCY PEG TO THE EURO

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HEDGE FUND MANAGERS AND THE SWISS BLACK SWAN[1]

In our review of 2015 Themes and Opportunities issued at the start of the year, we highlighted the idea that the likelihood of rate rises in the US and further stimulus in Europe and Japan may create opportunities for macro hedge fund strategies.[2]

Less than a week later, the Swiss National Bank (SNB) removed its currency peg to the euro and the Swiss franc experienced the biggest one day move ever for a G10 currency. The decision was unexpected and left many market participants facing the wrong way, not least because the SNB had reaffirmed its commitment to the peg just days before.

This note looks at the impact on macro and other trading strategies. Opportunities for some can present challenges for others; in this case, very few were able to take advantage when the opportunity presented and, for most, the event was more of a challenge. However, manager responses to extreme events can illuminate decision making. This event also provided a test of portfolio managers' risk management capabilities. Most managers weathered the event, a small number profited and a few were shown to have serious weaknesses.

One further point to note is that the year has already seen significant moves in a number of markets. Most macro managers have made a strong start to the year, notwithstanding any losses on their Swiss franc positions, which reinforces the comments above about greater differentiation in economic policy creating opportunities for macro and other trading strategies.

[1] A black swan event is one that comes as a complete surprise and has a major impact. Arguably, this may not have been a true black swan event as some investors did foresee the risk, although most did not.

[2] Our "2015 Strategic Research Themes and Opportunities" paper highlights a number of investment ideas for the current environment.

WHAT HAPPENED?

The Swiss franc has long had a status as a safe haven currency. Following the global financial crisis, many investors moved funds into Switzerland, causing the currency to appreciate and making the Swiss economy uncompetitive. On 6 September 2011, the SNB introduced a currency peg to the euro that tied the Swiss franc to an exchange rate of SFr1.20 to the euro.

This peg held for over three years but required continued intervention by the SNB to sell Swiss francs to maintain the peg. In recent months, as expectations of European quantitative easing grew and the euro weakened, the flows into the Swiss franc intensified, necessitating ever greater intervention by the SNB to maintain the peg. Eventually, the SNB capitulated and on 15 January 2015, it removed the peg and cut interest rates to -0.75%.

The Swiss franc soared on the announcement, taking it to almost 0.85 against the euro (an extraordinary move of over 40%), before reversing to close at around 0.99 on the day. The Swiss stock market fell over 8% on the news.[3]

The impact on market participants

The large and unexpected move in the currency took its toll. Investment banks reported losses, in some cases over USD100m. Several retail currency brokers had to seek emergency funding and at least one collapsed. Many hedge funds were also exposed and a few have closed as a result of losses they sustained.

How macro and other trading strategies fared

Like others in the industry, most trading strategies were caught by surprise. We have access to daily returns for an investment platform[4] and analysis shows that the impact on the day was predominantly negative. Fortunately for most, 2015 had got off to a strong start and even after any losses on the day, returns for the year to date remain broadly positive.

Focus on Mercer A rated managers

We contacted our most highly rated macro, CTA and currency fund managers immediately after the event and got a range of answers. We also asked some managers with broader trading strategies (e.g. multi-asset strategies) although did not expect them to be affected to a significant degree by the currency move. This was the case but there were a number of secondary effects, such as the response of Swiss equities and other currency movements, that magnified the overall performance impact on portfolios.

In this note, we focus on the effect on macro, CTA and currency funds as they were the strategies most likely to be impacted by the events of 15 January. Most of the managers that we surveyed were largely unaffected, meaning that the impact on performance was 0.2% or less. However, there were some that had significant positions and the range of returns on the day was +27% (a currency manager) to -11% (a macro manager). We cover both below along with discussion of other managers.

A few A rated managers were well positioned

One currency manager used a smart combination of directional and volatility positions.

They positioned the portfolio to be short Swiss franc vs euro via options. If the SNB made its rates even more negative, they expected to make money from their short position as the Swiss franc slowly fell. If the peg broke, they would lose slightly from being short the Swiss franc but gain significantly from the increase in volatility, which is what happened in the end. The position had been in portfolios a long time and was an ongoing drag on performance, although the gain when the peg was removed has more than compensated.

A couple of other managers who complement trend following models with fundamental indicators were also long and profited on the day.

[3] Not all companies will be affected in the same way by the rise in the currency. For example, Swiss stocks that rely on exports of locally produced goods (eg Swatch) will suffer more than global companies (eg Novartis). Growth forecasts for Switzerland were also sharply reduced.

[4] The returns cover over 100 managers with a range of different styles.

Some A rated managers had no exposure

Not everyone had exposure to the Swiss franc. In some cases, this reflected a long standing policy of not investing in currencies that are not allowed to trade freely. That, in itself, is an important risk control. This type of restriction is most often used by quantitative managers but some discretionary managers chose not to trade the Swiss franc for the same reason.

Most were short

Many managers were short Swiss franc. They had held this position (to varying degrees) during 2014 because they expected it to suffer along with the euro. The euro itself was seen as likely to weaken due to expectations of further quantitative easing initiatives in the face of low European growth and the threat of deflation. For many, losses on the Swiss franc were partially offset by gains on their short euro positions. Discussions with several managers showed that they had given thought to their Swiss franc positions and their expectations for SNB actions but had concluded (wrongly) that there would be little or no change in the peg and that other policy measures would be used to support it. The SNB reaffirmation of the peg days before removing it helped underpin these views.

Some trend followers had short Swiss franc positions because it had been weakening against the US dollar for some time and so was in a trend. For these managers, the Swiss franc exposure would typically have been well diversified so that any impact was limited, although we note that one reported a loss of 4% from Swiss franc exposure on the day (but is still up for the month to date). Generally, trend followers were helped as any losses on the day were offset by strong returns from trend following in the early weeks of 2015.

Overall, most who had been short Swiss franc on 15 January did not suffer too badly as they had adopted prudent sizing or used options and/or were well diversified.

Some who had been short avoided losses – do managers make their own luck?

Although discretionary managers had been short the Swiss franc in 2014, we found that several had closed their positions in recent weeks. One manager, who had been reducing his exposure and then closed his final position on 12 January, explained in an investment update dated 14 January that the risk/reward was becoming increasingly unfavourable. While the timing of the final trade may have been fortuitous, it also demonstrates good sensitivity to the risk environment.

A large multi trader macro fund told us that they had banned all short Swiss franc positions a week before the announcement as they were monitoring SNB activity in support of the currency peg and realised the pressures that were building up. Although they had avoided losses on the day, they were frustrated at not putting on positions that would have profited from the break in the peg. We heard something similar from another large manager who thought that they would have been down 5% if their short Swiss franc trades from Q4 2014 had still been in place. They had gone so far as to get prices for trading strategies that would profit from a rise in the Swiss franc, but had not expected a move of this scale and did not implement the trades in the end.

So even though the SNB's decision to remove the peg appeared as a bolt from the blue, there was evidence that pressure on the SNB was building up to those who could see the signs and not everyone was surprised.

Maybe there was some luck involved, but we wonder whether good managers make their own luck. The managers who expressed their short Swiss franc positions via options based strategies could also be seen as falling into this category as they were wrongly positioned but limited the downside to the loss of option premium.

Managers who lost money raise some questions over risk management

There were several managers who experienced more significant losses. In most cases, the incorrect positioning (being short Swiss franc) was compounded by having a large exposure that, with the benefit of hindsight, was arguably too large. Their risk management processes also did not identify the potential risk in portfolios, particularly where they were using standard industry measures such as VaR. This is where we were able to identify potential weaknesses in portfolio construction and risk management at some managers and which has highlighted areas for further investigation.

Having said that, not all managers who experienced losses necessarily had a failure of risk management. For example, those who offer higher risk strategies will naturally have been taking bigger positions and that will be reflected in the performance reported. These results should be viewed in relation to the risk taken and the manager's typical return profile.

To understand the issue of position sizing, it is necessary to look at the impact of volatility as a measure of risk. Managers typically size positions by using volatility. This allows for smaller positions in more risky, more volatile investments and, conversely, produces larger positions in less volatile investments. The problem with this type of approach is that use of historic volatility to size Swiss franc/euro positions understated risk as the SNB's action to manage the currency peg was keeping volatility low. Many managers had larger positions than they should have had as a result. Equally, those managers using value at risk (VaR) to identify risk in portfolios did not identify Swiss franc as a significant exposure, again due to the impact of recent abnormally low volatility.

While most managers use standard risk reports based on VaR, interpretation of the numbers needs to be sceptical and take account of potential market abnormalities or distortions. The use of scenarios to stress test portfolios can help to highlight risks not revealed by standard analysis. Having said that, this was such an abnormal event that stress tests would have been unlikely to include it.

HOW HAVE WE RESPONDED?

When we review managers we spend time discussing the way they make decisions and their risk management processes. However, the way managers come through extreme events provides valuable insight into decision making and risk management in practice and can be particularly informative. As we comment above, in some cases, questions have been raised over the quality of risk management at managers. Equally, the response of others has reaffirmed our confidence in their strategies and their status as our highest conviction managers.

For those managers who disappointed, we have wanted to understand the factors behind their decision making but we do recognise that very few people expected the peg to go and so most were caught out by the decision. In a very few cases, we have been sufficiently concerned by the management of the Swiss franc exposure to feel that this raises deeper issues that require follow up investigation and possibly review of the rating. This does not necessarily mean that a downgrade would automatically follow. In the case of the manager who lost 11% on the day, we recognise that although the loss was significant, the track record is strong, the manager was able to explain the thinking that had gone into the position (but admitted that the size was too large) and the response was thoughtful, so we have retained conviction in the A rating.

We downgraded one global macro manager where we were surprised by the extent of the exposure to the Swiss franc. The 8% loss was large in relation to the manager's low historic realised volatility. Coming after organisational changes that we had thought had potential to reverse indifferent performance, it left us feeling that we should not give the manager the benefit of the doubt any longer. The manager seems to have come to the same conclusion as, shortly after we proposed the downgrade, he announced that he would be returning funds to investors.

We have also proposed making the A rating for a couple of managers provisional. One is a currency manager that suffered a 5% loss where we would like to understand more about its positioning ahead of the SNB's decision to remove the peg and the manager's subsequent response. The other is a global macro manager that lost 8% as the second largest risk taker had a short position in the Swiss franc. In this case, we have retained conviction in the manager's ability to add value but we have made the strategy provisional ahead of our next onsite when we want to gain comfort that the team and business remain stable.

Overall, we have seen a good test of managers' decision making and risk management processes. On the whole, they came through the challenge well. To the extent that the event provided an opportunity as well as a challenge and has been part of a larger number of significant price moves this year, it reinforces the view that 2015 should be a good year for macro and other trading strategies to add value for investors.

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