Asset Management: Man Versus Machine

Rene Levesque
Founder, Mountjoy Capital
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The debate about the advantages and shortcomings of discretionary versus systematic asset management frameworks is interesting, particularly pertaining to Global Macro hedge fund strategies. There have been a few industry-sponsored events on the subject, but very little is mentioned about how each has influenced the other.

The two approaches have benefited, and continue to benefit, from a symbiotic relationship. It is through these interrelations that one may obtain a better understanding of the elements that are vital to the generation of (1) absolute return and (2) protection of capital.

Understanding their genesis can actually teach us much about the philosophy and discipline leading to absolute returns. Both approaches originate from the Bank's proprietary trading desks. The discretionary came first, from which evolved the systematic approach.

As global banking organizations with leveraged balance sheets started taking on an increasing amount of capital market risk in the midst of the deregulation of the financial markets (the "Big Bang"), their heightened sensitivity to loss of capital was clearly communicated to the risk-takers, i.e. the proprietary traders.

These risk-takers quickly understood that there was a very low tolerance for allocating leveraged capital while waiting for the market to monetize their positions. Thus, the concept of absolute return and protection of capital framework became commonplace.

By virtue of the imposed rules of engagement, absolute return became an active and disciplined process: "active" in the dynamic allocation of capital and "disciplined" in the retrieval of capital no longer being rewarded by the market. Additionally, discretionary risk-takers quickly realized that the most liquid markets best allowed them to be active without leaving a footprint and allowed them to be disciplined in liquidating positions in the midst of the most stressful market episodes, thus dialing down portfolio risk.

Since it was difficult for discretionary risk-takers to effectively apply an active and disciplined framework with an abundant number of positions in the book, they kept their portfolio to a few positions. They focused their attention on only a few markets. This allowed them to monitor capital flows carefully, monitor relevant news and price action, and maintain an ongoing pulse of relevant issues to formulate and express themes.

The benefits of diversification require more hands and eyes and/or a systematic application of clear rules dictating position entry level, sizing and exit points.

Basis of the Systematic

Essentially, the construct and philosophy of a pure price-based systematic global macro strategy (or what some generally refer to as Trend Followers) adheres to the principle of "allocating capital to ideas to which the market is currently receptive and then retrieving that capital when the market is no longer receptive." The underlying model predefines "receptive" in terms of confirmed price trends within a specific timeframe and predefines "no longer receptive" through a specific price stop. Note: This is an over-simplification, for illustrative purposes, of most trend-following strategies. Some do incorporate multiple timeframes, each with fixed or variable voting rights. Further, the sizing of positions is calibrated given the security's volatility, cross-correlation, liquidity, strength of trend indicator, etc. Volatility is often measured and discounted in the models on a daily or, in some cases, on an intra-day basis.

As a positive/negative price trend is confirmed for a security, the system will implement a long/short position in that security that will remain in the portfolio as long as the price remains above a predefined fixed or trailing price stop.

The system is free of behavioral biases. It is not "overconfident" as it objectively discounts the price action and acts accordingly. There is no "disposition effect" as it will systematically dispose of (or reduce) any positions that no longer fit the predefined rules of engagement. [Note: For an in-depth description of behavioral biases, see "Destructive Behavioral Biases: Obstacles to Absolute Return" May 6th 2013, Family Office Review.]

In essence, the systematic trend-following manager seeks to replicate the active and disciplined (free of behavioral biases) discretionary global macro manager while allowed to implement the process across many more markets. He dynamically allocates capital and then, when the market is no longer receptive, retrieves the capital given pre-established rules to protect capital.

Additionally, one can make the argument that the systematic trend-follower's portfolio represents the implementation of implicit long-option positions. Basically, they are willing to participate in a confirmed price trend and assume the cost (or premium) equal to the spread between the current market price and the established stop-loss level. Generally, the longer the timeframe defining the trend, the wider the price spread, implied option premium, or magnitude of the stop-loss.

Systematic Versus Discretionary

There are few reasons to ask the systematic manager why the portfolio is long a specific security. The only reply is "because it's going up." They do not undertake fundamental analysis to formulate a directional view. On the other hand, the discretionary manager does analyze fundamentals to formulate and express a directional view. However, in some cases, a number of them may implement some shorter-term positions that are contrary to their fundamentally-derived, longer-term views. A manager may formulate a long-term bullish view on gold but may short the commodity to take advantage of a shorter-term price dislocation or trend. Why? Because the market is then subjected to other factors, i.e. technical and supply-demand imbalances or other shorter-term elements dictating the prevailing price action. Consequently, the discretionary manager may, at times, adopt a "discretionary trend-following" style that is coherent or contrary to the fundamental findings. The manager understands that market forces may be overwhelming and that they are difficult to fight. The experienced discretionary manager understands that the objective is not necessarily to be "right" per se but simply to generate returns. The discretionary manager may understand why the security is trending upward as well as intermediate price resistance or support points to which the systematic manager is oblivious.

The principal disadvantage of the systematic manager is the inherent dogmatic nature and application of predefined timeframes. This issue has clearly hurt most systematic managers in the last few years. The markets have trended over the much longer term but have behaved in a rather "choppy" pattern in the shorter and medium term. The recent and ongoing risk-on and risk-off sequences serve as an example. This has resulted in multiple hit-and-miss scenarios by the systematic managers who continually hit the shorter-term imposed stops and, therefore, miss the longer-term price trends (i.e. constantly paying implied option premiums without the relevant benefits).

For the discretionary manager, price movement serves as a confirmation of a researched thesis as well as a source for idea generation. Price trends are identified using technical analysis and may then be investigated at the fundamental level to better understand their underlying basis. The manager may then be able to formulate a theme or view (contrary or coherent) to the prevailing trend. The timeframe and direction is discretionary.

Fundamental analysis also allows the discretionary manager to identify sensitive price points where a current trend may encounter resistance and/or reversal. These are more difficult to accomplish through a systematic framework and have proven costly to the systematic managers.

Trend reversals represent a major impediment to systematic trend followers. Price resistance, while waiting to confirm a new trend or reversal, represents allocation of capital to a position that is not currently yielding any return to the portfolio.

Both the systematic and discretionary global macro strategies have a legitimate place in a portfolio, particularly when the objective is absolute return and the protection of capital. One must understand the relevant limitations and advantages of each, and how they can accomplish investment objectives.

Editor's note: To contact Rene Levesque, please visit www.mountjoycapital.com

