THE GLOBAL MACRO EDGE

- INTRODUCTION –

JOHN NETTO

"Intelligence is the ability to adapt to change." Stephen Hawking

Up early on a sunny Sunday morning in L.A., I was bent on getting a fast start to the workshop hosted by one of the greatest media minds in the world, Joel Roberts. Outside our conference room at the Intercontinental Hotel in Century City were Landon Donovan and the rest of the U.S. Men's soccer team. Just a year earlier at the 2010 World Cup Finals, the United States was nearing the end of an exhausting scoreless match against Algeria. Then in the final minutes of the game, when prospects seemed grim, Donovan scored and the U.S. won 1-0. Unbelievably, now they were standing right in front of me, headed for the Rose Bowl to play Mexico in the Gold Cup.

Maneuvering through the men adorned in red, white, and blue got me thinking and invoked questions about the impact each of us has on matters greater than our individual selves. And I asked myself, "What can I do to make an impact, make a difference, do something bigger than myself?"

Having spent nearly nine years in the Marine Corps, with almost half of that stationed in Japan, this was not a new thought or challenge to me. However, since transitioning from the austere structure of military life to an ephemeral disposition as a professional futures trader, I realize that there is still more I can do to help people.

As the soccer team faded from view, my Blackberry buzzed and brought me back into the conference room. It was a message from John Wiley and Sons wanting to publish my second book sharing new strategies on how to invest in the markets. A range of emotions overcame me. I was thrilled with the opportunity to push the literary envelope again, but also a little overwhelmed because I

understood just how much work goes into producing a book that is both informative and enjoyable to read.

Still caught up in the moment, I shared the exciting news with everyone. Not to pass up a learning opportunity for myself or the rest of the attendees, Joel promptly enquired, “Congratulations. Now tell me…What myths do you bust and what problems does your book solve, Mr. Netto?”

The silent response combined with the blank expression on my face was a harbinger of the work to come over the following four years.

The Biggest Myths on Wall Street: Why They Exist and the Problems They Cause

Like many people, I instinctively go straight to the solution when I attempt to show value in a process, service, or product. However, I have learned instead to dig into, examine, internalize, and articulate the problem. This strategy makes arriving at the right solution a far more feasible objective. So when I embarked upon the mission of becoming a more successful investor, I recalibrated my perspective regarding the problems I was attempting to solve.

The Global Macro Edge will explain, through a compendium of talented market practitioners, that the challenges facing investors, traders, and financial advisors are the byproduct of a half dozen myths. Together **we will examine what these myths are, why they exist, and the problems they cause**.

1. **More risk equals more return.**
2. **Money always finds its most efficient home.**
3. **Emotions are your biggest enemy.**
4. **Diversification is the only strategy you need**
5. **Today’s markets offer fewer opportunities**
6. **Compensation should be based on returns**

These are the six largest areas of misunderstanding in the market--misunderstandings that can prevent investors from creating wealth for themselves. By understanding how to prevent, manage, and solve the challenges these misconceptions create, you are putting yourself in an incredible position for success.

Myth #1. More risk equals more return

Conventional investing asks, "What was my return?" *The Global Macro Edge* asks, "**What was my return per unit-of-risk?**"

Unbeknownst to some investors, they may not be getting compensated fairly for the risk they are exposing to their portfolios. The process of understanding where the breakdown occurs happens at two key points. The first can happen during the process of constructing a portfolio and putting in place a risk budget. The second may occur after you have created your risk budget and the investment strategies you have chosen are not congruent with the market environment.

As *The Global Macro Edge* will explain, one of the biggest risks to your position, strategy, or portfolio is a byproduct of what regime, or environment, the market is currently in. Strategies in one type of regime may do exceptionally well, while they struggle in another. Many investors lack the expertise to effectively evaluate what the current market regime is and which strategies will perform the best. Failure to identify which regime is in place and which strategies are appropriate for that regime can lead to not being properly compensated for the risk you are taking.

For example, in 2014 US economic data significantly outperformed their European and Asian brethren. In the past, an uptick in US data could be associated with a rise in treasury yields and a strengthening US dollar. However, due largely to a powerful combination of unprecedented Central Bank influence in Europe and Japan, as well as global disinflation fears, there was a huge demand for investment-grade government credit. This demand sent yields of European and Japanese debt to record lows.

So while US economic data surged in the second half of 2014, US treasury yields finished 2014 near lows. The regime of disinflation and Central Bank influence materially affected the risk profile of a person positioned for a rise in US Treasury yields.

While US Treasuries were frustrating short sellers, US Dollar bulls were richly rewarded under this same regime of strengthening US economic data. The dynamics helping to drive the rally in global treasuries were also putting downside pressure on both the Japanese Yen and Euro against the US Dollar. Therefore, while US Treasuries finished 2014 with yields at lows (reflective of a more somber US economic environment), the US Dollar was in full rally mode.

Understanding the idiosyncratic aspects of a particular market regime should be a driving factor in how you allocates your risk units. Long Dollar and short treasuries "should" have traded with a much higher correlation, given the stronger US data; however, those two trades had vastly different risk profiles and returns.

The second key factor in why more risk does not always equal more return occurs when you are constructing a risk budget around a portfolio. **A risk budget is a predetermined downside threshold where trading will cease in order to prevent further losses**. Without a risk budget, an investor is theoretically willing to lose his entire investment.

As we saw in the period from 2009-2014, passive investment strategies performed extremely well, both nominally and risk-adjusted. This performance led some investors to be enamored with potential returns and refrain from asking critical questions, such as:

- How much risk is the portfolio exposed to?
- What, if any, pre-determined exit strategy exists?
- Do I, or my financial advisor, have the insight into what factors could lead to a sharp sell-off in my portfolio's assets?
- What sort of technology is being used to regularly monitor for an outsized move in volatility, correlation, or concentration?

Failure to sufficiently ask and answer questions like these is why some investors end up believing they can earn a greater return by simply taking on more risk. In reality, most investors do not have a process to either create a risk budget or select regime-appropriate investment strategies.

You do not have to risk more to make more, you just have to risk smarter to make more. The processes outlined in this book will provide you with the tools to make these smarter choices.

Myth #2. Money always finds its most efficient home

Multiple factors prevent many market participants from utilizing their capital in the most efficient manner. This occurs at nearly every level and time horizon in the market hierarchy. Below are just a handful of reasons:

1. Legacy and bureaucracy issues
2. Lack of technology
3. Central Bank and political influence
4. Regulatory limitations
5. Inability to invest 401k money outside of select company choices
6. Style box constraints when allocating to managers

One of my biggest "aha" moments was when I realized the process of allocating capital to the most talented managers and those with the best strategies was flawed. Typical cosmetic issues like fund size, length of track record, capacity constraints, and lack of assets under management can be more influential when deciding on an allocation than the robustness of a manager or strategy.

Clearly, the foregoing issues are important and need to be factored into any potential allocation. **However, this realization about the inefficiency in allocating capital was profound for me. It helped me understand at the most basic level one of the many reasons why opportunity exists in the market**. If the system is NOT set up to place capital in the hands of its most talented practitioners - for whatever the reason - the result is an opportunity for the more educated, disciplined, and resourceful to benefit. **So while money may eventually find its most efficient home, the lag in that process creates tremendous opportunity**.

The hedge fund world is a great place to find alpha[1] and an even better place to overpay for beta[2]. There are a number of exceptionally talented large money managers consistently illustrating just how much opportunity exists in the investment universe. However, most investors do not have the in-depth understanding of market dynamics, risk-centric technology, or infrastructure to differentiate between skill and good fortune.

[1] Skill in producing a superior risk-adjusted return.
[2] Returns that came about from being invested in the market, not necessarily one's investment skill.

In a perfect world, investors would be able to invest capital and manage their portfolios by using ten non-correlated managers just as easily as using 100. The profile of the portfolio would encompass everything from high velocity emerging managers to well established funds, with every move governed by a risk budget. Yet, reality shows that the administrative burden and lack of technology makes this a challenging endeavor for most investors. Moreover, such barriers only intensify the problem of capital not finding its most efficient home.

Because of these limitations, some investors who seek true absolute return strategies end up investing in more established, larger funds, thereby experiencing "beta migration." Beta migration is the tendency for a fund to shift from an absolute return profile to one resembling more of a benchmark strategy. As many funds get larger, they invariably compare themselves to a benchmark. The problem with this is that investors are now beginning to pay active manager fees for passive managing styles.

If the process of allocation is not optimal, then investor portfolios can develop gaps. **These gaps contribute to a loss of efficiency in capital**. When investors do not have the expertise, technology, and risk measurement tools to assess whether their portfolio is running at a peak level, the problem tends to worsen before it gets better.

The Global Macro Edge will provide you with the insight to close those gaps and help run your portfolio at its peak level.

Myth #3. Emotions are your biggest enemy

While we are repeatedly advised never to let our emotions guide our investment decisions, our own emotions are a tremendous repository of information about the animal spirts of the market. Many market participants believe that using their emotions in the decision making process can prohibit their success. This is because nearly all of us have made an impulsive decision that led us to buy a market at an extreme high, or selling it at a major low.

Painful experiences like these prejudice most investors against embracing their impulses as **a goldmine of information and a viable way to tap into the "emotionality" of the markets**. Being able to consciously identify, compartmentalize, and integrate your emotions into the trading process can be a tremendous source of **"behavioral alpha."**

Understanding this concept is key, as the majority of efforts to enhance performance in today's markets targets three areas.

1. Build more robust price-pattern recognition systems through a variety of technical tools.
2. Enhance the array and depth of economic forecasting models. And last,
3. Harness the power of market sentiment through social media.

These are all viable endeavors and an active part of The Protean Strategy explained in the forthcoming pages of ***The Global Macro Edge***. **However, the next wave of alpha will be to tap directly into the emotionality or animal spirits of the market.**

We are all living, breathing organisms who react in comparable ways when the market behaves in a certain manner. Many of us, despite our experience and pedigree, succumb to the same emotions and impulses. **Harnessing that information at an individual and collective level will be both the greatest challenge, as well as largest source of alpha generation in the next 20 years!** Despite the potential this area offers to enhance risk-adjusted returns, many market participants are hesitant to embrace it, nor do they have a process for tapping into its potential.

The Global Macro Edge **will outline ways to tap into this rich source of market information**.

Myth #4. Diversification is the only strategy you need

One of the most memorable lessons I took away from Marine Corps Recruit Training was when my Drill Instructor shouted, "Recruit Netto, no plan survives the first encounter with the enemy!" There are no autopilots in asset management. Superficially, building a portfolio of absolute-return strategies based on past performance and "reasonable" projections should suffice. However, the market is a dynamic, living organism necessitating that we stay open-minded and possess knowledge of the variables that influence her.

One of the biggest challenges to investors, or those advising investors, is to grasp the nuances behind the strategies to which they are exposed. Even if they do understand the various idiosyncrasies, **oftentimes they do not possess the technology to measure the strategy on a "return per unit-of-risk" basis in a timely manner**. Such protocols can assist investors in seeing whether the performance is deviating in a way that would require repositioning.

Conventional methods of measuring performance occur on a monthly, quarterly, or even annual basis and focus on nominal returns. In some cases, this frequency of data assessment and focus just on top line performance is not enough to detect events like outsized volatility moves, position concentration issues, and overall model decay. Both **frequency and focus** can make it very challenging to maintain attractive risk/return profiles for the life of the investment.

The Global Macro Edge **will illustrate multiple ways provided by an array of experienced market practitioners on how to maintain true portfolio diversification and enjoy its benefits**.

Myth #5. Today's markets offer fewer opportunities

One of the biggest misconceptions ***The Global Macro Edge*** will attempt to correct is the belief that there were more opportunities in the past when, on the contrary, there are numerous opportunities in today's markets. Human psychology is such that we always look back with fond nostalgia to the past. Unfortunately, this can inhibit an investor from objectively assessing new opportunities. Because of our penchant to romanticize yesteryear, many investors stop vigilantly looking for ways to evolve and find newer, more profitable investment strategies.

There are a few factors that perpetuated this myth. First, from 2009-2014, Central Banks assisted in lowering volatility by helping remove the risk in markets through incredibly accommodative traditional and non-traditional monetary policy measures. The second factor is the dislocation of many liquidity providers as banks and trading desks began to reposition for increased government oversight and regulation.

With volatility near multi-decade lows and traditional liquidity providers leaving the market, opportunities for price discovery became scarcer. To further compound the frustration of traders and active money managers, risk assets went through significant appreciation from 2009-2014, or what market historians will define as **"The Golden Age of Passive Investing."**

The Sharpe Ratio of a 50/50 combination of stocks and bonds from 2010-2014 yielded the highest five-year Sharpe ratio of any period since 1977

(when bond futures could formally be tracked).[3] A Sharpe Ratio measures the returns of a stock, index, or portfolio on a risk-adjusted basis. The higher the Sharpe Ratio, the better the portfolio has performed on a risk-adjusted basis.

Below is a list of the best five-year Sharpe Ratios of a portfolio comprised of 50 percent bonds and 50 percent stocks:

#1: 2010-2014 - 6.20

#2: 2009-2013 - 3.55

#3: 2003-2007 - 1.85

#4: 1995-1999 - 1.59

#5: 1982-1986 - 1.50

This is great for passive investors who buy and hold, however, less enticing for traders who are looking to benefit from a more volatility-rich environment.

Fortunately, although not as highly publicized, the events of 2008 also led to tremendous advances in risk-centric technology. Why is this important? **The more efficient the braking system, the faster you can drive your car.** Professional racecar drivers go north of 200 miles an hour. This is not only due to their driving skills, but also because of an efficient braking system that enables them to slow down just the right amount to maintain speed and not waste energy.

Possessing risk-centric technology is like having an efficient braking system – it enables an investor to respond to events in a smarter way. More than any time in history, we now have the ability deploy our risk units in a more robust manner, efficiently aggregate trading information, and access global strategies and managers.

In the past, one of the biggest barriers to investing in a manager or strategy was how to manage the risk, whether from a measurement standpoint, liquidity, or even ongoing risk enforcement. Now, with the ability to actively enforce risk controls across an array of managers, investors with know-how can take on

[3] Source: Kevin Dressel, Bluegrass Capital Management

exposure in multiple non-correlated strategies from a single account structure. This is a game changer!

Combine risk control with the dislocation of manager talent from traditional liquidity providers such as banks and trading desks, and there is tremendous opportunity for those with the right account structure and technology. As a result, achieving a superior risk-adjusted return is more attainable *than at any other time in history* by a more diverse group of investors.

Unfortunately, the majority of investors don't have the tools to efficiently sift through the onerous amount of available information and reap the benefits. The reality is that many are not aware of, much less proficient at, how to merge the abundance of talent, strategies, and technology in a risk-controlled manner. This barrier prevents them from benefiting from the next generation of market opportunities.

***The Global Macro Edge* will outline strategies and structures that will help you take advantage of these opportunities**.

Myth #6. Compensation should be based on return

The question of what is the right price to pay for a return has been with us since the dawn of the markets. For the majority of investors the process of what to pay only looks at the end return, without factoring in the risk taken to achieve that return.

The decision to allocate resources to a strategy should ultimately be based on how well it **maximizes return per unit-of-risk**. Despite looking for managers and strategies that embody this statement, the vast majority of investors do not complete the final step of the investment process. The final ingredient is putting in place a goal-congruent compensation structure. This structure should reward managers for maintaining superior risk-adjusted returns, while not overpaying them should their results deteriorate.

Most investors follow a Draconian compensation protocol and pay a percentage of the nominal performance, while having no provisions to either raise or decrease the compensation based on other risk measurements of the portfolio. **This absence of a dynamic pay structure punishes both investors and managers.** The inability to incorporate a versatile and equitable compensation structure can serve as a key obstacle for both an investor and money manager in consummating a deal.

The solution is an incentive framework that can work retroactively. The framework should be based on **returns relative to max drawdown and the capital efficiency of the strategy.** This allows investors to reward managers for alpha, while not overpaying for beta. ***The Global Macro Edge*** will outline the details to this solution.

The secret to debunking these six myths and solving the problems they cause is having the market acumen, risk-centric technology, and unwavering discipline to pursue the one true goal: maximizing return per unit-of-risk.

Welcome to *The Global Macro Edge.*