Stenham Trading - Global Macro

Introduction

The recent market volatility in October and November is a timely reminder of the importance of having an allocation to decorrelated trading strategies in a broader asset allocation framework. In this paper we discuss some of the hedge fund strategies that fall into this classification and to which we currently allocate. There are other strategies in this space which we do not currently allocate to for top down reasons. We also assess how these strategies can help mitigate risk in times of stress and why we believe the opportunity set looks promising going forward.

We first introduce the different strategies. While each of these strategies may be different in terms of products traded, investment style and risk management, the commonality between them is the fact that a more volatile market environment makes for a more interesting opportunity set.

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Discretionary global macro

Discretionary global macro hedge funds perform fundamental research to assess economic data such as GDP growth, employment, inflation and whether monetary policy as a reaction function is appropriate or not. They look for trading opportunities to identify potential discrepancies between fundamental data, central bank policy and market determined asset prices. Trades are implemented in a discretionary manner. Typically the greatest opportunities are presented when there are changes in regime and inflection points. These strategies tend to do better in market environments that are more volatile with changing central bank behaviour and tend to struggle in periods of low market volatility. Risk is typically expressed through interest rates and currencies and, to a lesser extent, equities, credit and commodities.

Fixed income arbitrage

This strategy relies heavily on quantitative inputs to identify and exploit inefficiencies in pricing between two highly correlated instruments, typically in G3 sovereign bond markets. Usually the relationship between these securities has a mathematical bound. Inefficiencies generally arise for technical reasons including differing behaviour by market participants with varying economic objectives or opportunities arising from regulatory constraints. These strategies have performed well when there is increasing volatility and movement along the yield curve and they tend to struggle in an environment of pegged interest rates and low volatility along the yield curve. Typically funds incorporate portfolio hedges to protect themselves in a deleveraging scenario, which can present a risk to this strategy. Risk is typically expressed through bond futures, cash bonds, interest rate swaps and options.

Commodity trading

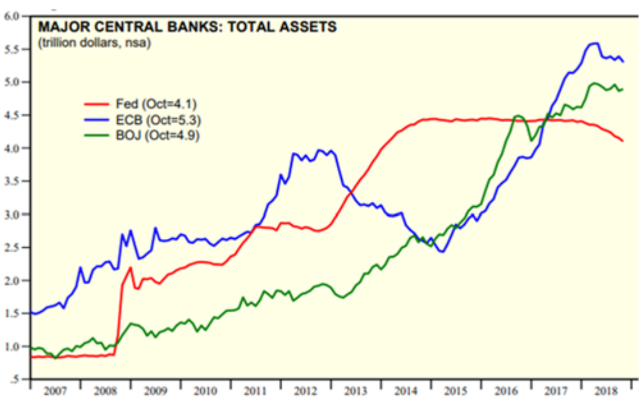
Commodity hedge funds perform fundamental supply and demand analysis on underlying commodities markets and look to identify opportunities when asset prices have not fully reflected these changes. In a benign environment the market is efficient and affords less opportunities. In recent years with the advent of shale oil and gas production in the US and the increasing importance of renewables in Europe, there has been disruption in the oil, natural gas, power and carbon credit markets. This has created idiosyncratic opportunities both on the long and short side. Commodities tend to be decorrelated to broad asset markets over the medium and long-term and can be a useful diversifier to portfolios. Risk is typically expressed through commodity futures and options.

Volatility arbitrage

Here we focus on volatility arbitrage and long volatility strategies as we tend to avoid short volatility strategies due to their inherent left-rail risks. Volatility arbitrage tends to avoid taking a directional view on overall market volatility. The strategy focuses instead on identifying mispricing between the implied volatility embedded in an option's price and the realised volatility the underlying asset exhibits. Funds will look to go long cheap implied volatility and short expensive implied volatility. This can be between individual equity securities or between various sectors and market indices globally. While most risk is typically focused on equities, this strategy can also be extended to currencies, interest rates, credit and commodities. The greatest trading opportunities are often presented in periods of heightened market volatility where less sophisticated users of options are nervous and seek fear based hedges at non fundamental prices. These managers use benign environments to build up long volatility positioning in assets with suppressed volatility, as greed often leads to complacent market participants selling volatility to harvest carry and improve returns either explicitly or via structured products. Long volatility strategies on the other hand look to identify cheap implied volatility to go long by researching inefficiencies along the volatility surface across various asset markets to position optimally for a potential rise in volatility.

Why Invest in These Strategies Now?

Post the financial crisis in 2008, central banks had embarked on an extensive quantitative easing program and effective forward guidance which has not only helped revive global growth from the depths of the financial crisis but also successfully boosted asset prices and suppressed market volatility. Quantitative easing over the past 9 years is now giving away to quantitative tightening where central banks are not only raising rates and tapering asset purchases, but also in the case of the US Federal reserve reducing its' balance sheet. 2018 has been a transition year in our view and it is no coincidence we have seen bouts of volatility in February and more recently in the last few weeks. We believe, as is often the case in any economic cycle, imbalances have been built up in the more benign market environment of recent years. We remain concerned about the explosive growth in assets in passive and carry seeking short volatility strategies especially those with embedded leverage where we have seen leverage increase in order to generate returns in a low volatility environment.



Source: Haver Analytics

Currency Volatility has declined as central bank balance sheets have increased

Source:Bloomberg, CVIX Index

We believe the returns for beta-led strategies will become more difficult and it is important to build an allocation to decorrelated strategies in a broader asset allocation framework. Further, lower levels of market volatility have provided very interesting entry points for many of our managers into core trades such as the ones outlined below.

Current Trade Examples

Discretionary global macro - Long volatility positions in EUR/USD exchange rates

With a widening interest rate differential between the US & Europe, the cost of hedging EUR/USD has increased leading some market participants to sell options on EUR/USD. This has increased the supply of volatility into the market, resulting in EUR/USD exchange rate volatility being artificially suppressed. We believe this offers very interesting risk/reward as volatility has the potential to increase given the political turmoil in Europe, including the Italian political situation, questions around the German political landscape post Angela Merkel and the succession plan for the European Central Bank as Mario Draghi's tenure comes an end.

Fixed income arbitrage – European Bond RV as ECB embarks on normalization

The ECB has been the biggest buyer of sovereign fixed income in Europe which has successfully suppressed volatility in European bond markets. With the ECB continuing to taper asset purchases and increased volatility in the Italian bond market our managers expect improved trading opportunities into 2019. More importantly, the market will turn its focus on a potential ECB rate hike into the summer of 2019. One interesting trade is to have a long cash bond position versus short an interest rate swap on the same bond which performs when market perception of counterparty risk increases and investors prefer the safely of owning a cash bond.

Volatility Arbitrage – Long European and Asian index volatility

The sharp rally in equity markets in 2017 led to an increase in structured product issuance in Europe and Asia particularly in auto-callable notes. As the dealers issue these notes, they end up being long volatility and have to hedge their positions by selling volatility. The dealers typically supply 1 year and 2 year volatility, which has resulted in interesting dislocations. Our managers are focused on identifying these dislocations and finding optimal points on the curve to build long volatility positions which will benefit either in a market normalization or a stress event.

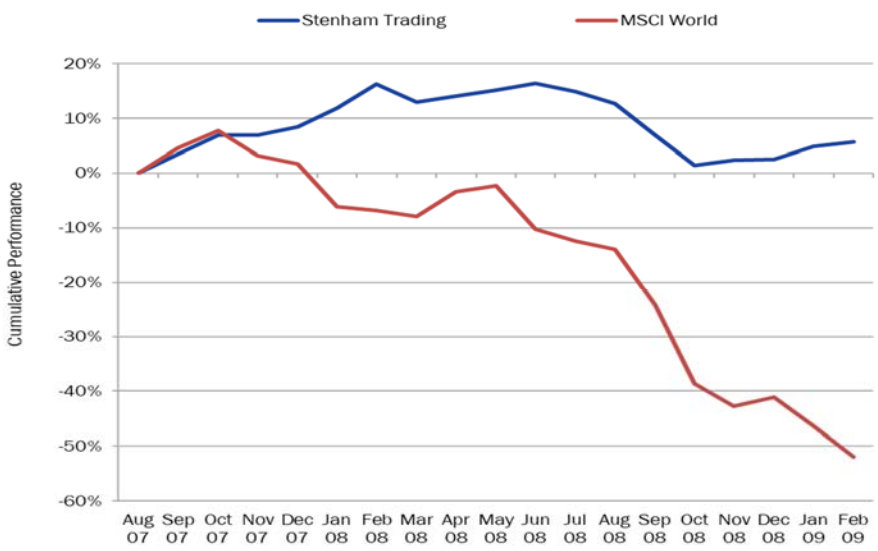
Commodities Trading – Long Carbon Credits

Commodity funds have been bullish on prices of carbon credits for the last 12-18 months. From a political and regulatory perspective, there has been a strong incentive for European authorities to boost the price of credits to encourage the move to clean energy, especially within the context of global warming and the Paris climate accord. The recent success of Green parties in European elections continues to suggest broad support for these measures. From a technical perspective, the Europeans have introduced a "Market Stability Reserve" which will start on 1st January 2019. The MSR aims to support the price of carbon credits and reduce supply of certificates coming into the market. These measures have already resulted in a sharp rally in carbon prices for the year 2018 but our managers believe there is considerable upside heading into 2019.

Stenham Trading

Stenham has been investing in these aforementioned trading strategies since the late 1980s and is considered one of the most experienced and sophisticated investors in the space. Stenham Trading invests in a high quality group of funds employing these strategies, many of whom closed to new investors but where Stenham has been able to obtain preferential capacity.

Stenham Trading has a long history of capital preservation in more volatile market environments including the financial crisis in 2008 (see below). More recently Stenham Trading performed well in 2016, a year which witnessed more volatility around Brexit and the US elections, and has once again outperformed traditional assets YTD 2018. Stenham Trading can lag traditional assets in benign market environments such as 2017, however **we believe this decorrelated return profile can be a valuable addition to most portfolios.**



Source: Stenham, Bloomberg. Past performance is not a reliable indicator of future results.

Historically performance of broad trading strategies has been quite correlated to volatility in interest rates and currencies. When currencies and interest rates move more, there are greater trading opportunities. The chart on the next page shows how the broad investable macro hedge fund index has moved with currency volatility.

Macro Index Performance and Currency Volatility

Source: Stenham, Bloomberg

As currency volatility picked up from all-time lows in the middle of 2014, when the US Federal reserve embarked on its' interest rate hiking policy, macro performance has rebounded. Stenham Trading has performed in-line with equities and outperformed bonds with very low drawdowns and correlations.

July 2014 - October 2018	Stenham Trading	MSCI World (Price)	JP Morgan Global Agg. Return
Return	16.02%	15.98%	-0.64%
Annualized Volatility	3.81%	10.42%	4.29%
Max drawdown	-2.56%	-13.05%	-6.59%
Beta	N/A	0.03	-0.37

Source: Stenham

Stenham Trading has also protected capital strongly in recent years during volatile months for equities and bonds.

Stenham Trading: Three Years to October 2018

Ten worst months for Equity Index

Date	MSCI World	Stenham Trading
Oct-18	-7.42%	-1.19%
Jan-16	-6.05%	0.25%
Feb-18	-4.30%	-0.49%
Mar-18	-2.42%	0.48%
Oct-16	-2.01%	1.12%
Dec-15	-1.87%	-0.69%
Jun-16	-1.28%	-0.06%
Feb-16	-0.96%	-0.34%
Nov-15	-0.67%	1.88%
Jun-18	-0.17%	-1.34%
Average	-2.71%	-0.04%
Total	**-27.15%**	**-0.38%**

Beta: 0.07
Three Years

Ten worst months for Bond Index

Date	JP Morgan Global Aggregate Bond	Stenham Trading
Nov-16	-4.42%	2.38%
Oct-16	-3.44%	1.12%
Nov-15	-1.84%	1.88%
Apr-18	-1.82%	2.35%
May-16	-1.22%	0.09%
Sep-17	-1.15%	0.07%
Sep-18	-1.12%	0.69%
May-18	-0.95%	1.53%
Oct-18	-0.94%	-1.19%
Aug-16	-0.84%	0.35%
Average	-1.77%	0.93%
Total	**-17.74%**	**9.28%**

Beta: -0.26
Three Years

Source: Stenham, Bloomberg. Past performance is not a reliable indicator of future results, Stenham Trading returns net of 1% fees.

Conclusion

We believe there is limited risk premia in broad asset markets today. Quantitative tightening and central bank policy normalization is likely to result in an increase of volatility in most asset classes. Market participants have been lulled into a false sense of complacency on the back of the very easy monetary policy adopted in recent years. This has resulted in significant capital inflows into passive strategies focused on beta and alternative risk premia. Furthermore, leverage employed has been increased in a benign environment. The losses suffered by these strategies in February and October 2018 only offer a minor taste of what is to come in our opinion.

We believe investors should look to build an allocation to decorrelated strategies in their broad asset allocation framework. Stenham Trading is well constructed to generate non-directional, alpha oriented returns and we believe trading strategies will outperform asset markets if the market environment becomes more volatile. Sophisticated allocators seem be of the same view as evidenced by the institutional investor survey from Credit Suisse as of June 30th 2018.

Strategy Preferences by Investor Type

Top 5 Strategies per Investor Type Ranked by Net Demand

Investor Type	Strategy	Net Demand
Pension	**Macro - Discretionary**	**31%**
	Fixed Income Arbitrage	29%
	Macro -Systematic	20%
	Managed Futures	14%
	Event Driven - Distressed	13%

Source: Credit Suisse

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