20 Years in Funds of Hedge Funds

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HDF Point of View

Trading strategies: providing return in difficult markets

The financial crisis is lasting. In these troubled market conditions, a number of hedge fund strategies are temporarily having difficulty in generating returns because of the massive deleveraging in the banking system and in some funds. However, short-term trading strategies are resisting fairly well, providing some return with low correlation to that of any other asset class.

Trading strategies: anticipating flows

Trading strategies differ from fundamental analysis strategies. The latter seek opportunities in terms of value, with an in-depth analysis of all types of securities or company balance sheets. Fund managers using fundamental analysis tend to operate over a medium-to-long term horizon, as it may take time for the relevance of their analyses to be recognised by the market and hence reflected in prices.

As opposed to fundamental strategies, trading strategies attempt to analyse the buy or sell flows on different financial instruments to identify trends over several hours to several weeks or even several months. They trade on a variety of asset classes; shares, bonds, foreign exchange rates or commodities, with little long-term directional bias. They deal with liquid instruments that enable them to be responsive, capable of rapidly changing their positions, and may easily find themselves in net long or short positions. Often, fund managers had worked in trading rooms in the past, where making quick profits is encouraged, regardless of the direction of markets. There is a strong culture of short selling, and when these traders move into fund management, they favour the creation of alpha. These profiles differ from traditional (or long-only) fund managers, who too often have a long bias, an approach that is governed by market exposure ("beta").

There are three main types of trading strategies:

- **Global Macro strategies** attempt to anticipate the buying and selling flows on different asset classes based on recent movements in other asset classes, or on changes in global macro-economic environment, such as changes in the monetary policy of central banks, fiscal policies, or even on changes in economic growth or inflation.
- **Systematic trading strategies** attempt to predict buying and selling flows based on past prices using a variety of historical databases, following the principle that the past tries to explain the future. In that process, they use mathematical, statistical or macro-economic models. These models decide to take positions (long or short) on several asset classes and are most often applied systematically. Human and subjective trading decisions are rarely taken by these managers. In this category, we need to distinguish between "trend followers," who attempt to identify trends over the medium- or long-term, "high frequency" trading strategies, which are more responsive and have a shorter horizon. The “high-frequency" models try to analyse and model the behaviour of other market players (behavioural finance) based on recent flows, transaction volumes and market dynamics.
- **Discretionary trading strategies** rely on the talents of traders in anticipating flows reactively, TAKING AN OPPORTUNISTIC SHORT-TERM STANCE. In contrast to Global Macro funds, discretionary traders are often specialists in one asset class. They try to analyse market dynamics, understanding the positions taken by different players, and exploiting punctual events, such as the announcement of corporate earnings or the release of economic statistics that are likely to shift the prices of all types of instruments.

Rigorous selection criteria

All trading strategies are of course not profitable at all times, and as for any investment strategy, it is necessary to select the best fund managers. For example, given the large number of transactions that are often dealt with by these managers in a day, there should be some special focus on controlling their execution, operational risks and potential leverage effects. One should also make sure that their assets under management remain reasonable compared with the liquidity and depth of the markets in which they operate so as to ensure that they can quickly reverse their positions at any time, remaining responsive and flexible. More specifically, one should feel comfortable that Global Macro fund managers can generate a sufficiently large number of trading ideas per year thanks to well-dimensioned teams of traders and risk control procedures. On systematic trading strategies, one should check the level of transparency in the operating principles of systematic models in order to make sure that all players are not actually doing the same thing and that they are following rigorous stop loss procedures. Regarding discretionary traders, one should ensure that they have strong personalities and expertise, i.e. they need to have a sufficiently long experience in the qualitative and quantitative analysis of market movements.

Favourable conditions for trading strategies
For these trading strategies to work, there must be enough changes in macro-economic situations in different parts of the world. There needs to be some volatility in prices, in addition to substantial buy and sell flows from traders. A degree of liquidity is also necessary so as to be able to buy and sell quickly. We also need uncertainty; trading strategies are often capable of detecting the nervousness of different players in uncertain conditions, and hence take advantage of it, as nervousness is sometimes synonymous with a loss of common sense and irrationality.
This is currently the case: banks and other institutions are now cleaning up their balance sheets at whatever cost, freeing up liquidity and restoring their levels of regulatory capital. Central banks and regulators regularly intervene through different means to try to halt crisis. Yield curves are distorted in very different ways from one another, as are credit spreads. Exchange rates are highly volatile, not to mention the price of raw materials… This volatility in all asset classes, which reflects uncertainty at both the micro-economic (companies) and macro-economic levels (states), currently favours trading strategies.

HDF
The performances of our HDF Trading fund of funds illustrate the value provided by trading strategies during the crisis. In our multi-strategy portfolios, we have increased the weight of trading strategies and are steadily continuing to do so. However, we also recognise the value provided by fundamental strategies - those that focus on the values of instruments - as these strategies provide the most value over the long term (Link to the HDF Trading Brochure). The time will come when fundamental strategies will strongly benefit from the current market correction.

Your usual commercial contact at HDF remains at your disposal for any additional information you may require.

http://www.hdf-finance.com +33 1 4417 1234 investorsrelations@hdf-finance.fr