

FOCUS ON

# SYSTEMATIC TRADING

Alternative investment specialists Dr Guenther Dobrauz-Saldapenna of PwC and Nils Beitlich of Credit Suisse discuss the state of the financial markets, potential future developments and how to respond to the current environment with Prof. Mark Blyth of Brown University as part of their Swiss Strategies think tank



**Dr. Guenther Dobrauz-Saldapenna**

heads PwC Zurich's Asset Management R&C Services practice. Earlier, he practised with Deloitte and as an attorney. He also was Legal Counsel to a VC/PE firm and to a hedge fund group. He holds a PhD in investment law, an MBA degree, and is co-founder of the Swiss Strategies Group.

**P**utting on one's thinking cap and looking at macro data these days seems to be an activity that should warrant a surgeon general's warning. Being our usual selves, we originally tried partying through all of this with a stiff upper lip and by focusing on ways of boosting counterparty monitoring systems and improving risk response measures. But we soon realised that this party was probably already over. So we went back to the drawing board to get our heads around the fundamentals and figure out how to calibrate systems for the stormy weather that most likely lies ahead. Since we were taught at university that 'tres faciunt collegium', we invited Prof. Mark Blyth – one of our favourite thinkers of today – to offer his insight.

**GUENTHER DOBRAUZ-SALDAPENNA:** Above all, we wonder what the consequences of the prolonged cheap money strategies will be, as currently pursued by governments around the globe. How will this affect the financial markets and who will have to pay at the end of the day?

**MARK BLYTH:** We have to distinguish between cheap money strategies that alter the monetary base and those that add liquidity. QE, the big one out there, adds to the latter directly and the former only indirectly. If you look at the Fed's balance sheet you will see that QE takes the form of an asset swap. Assets of value X (book at least) are swapped for cash, which the banks then park back at the Fed in their accounts at 0.25% interest as catastrophe insurance. The money is not being lent out, which is precisely the problem. The Fed, in turn, is becoming the sole owner of entire classes of assets. So cheap money policies are providing asset protection and liquidity in a slump. They are not causing inflation. Some folks see QE pushing up commodity prices as evidence of inflation, but commodities prices were rising before QE more sharply than they are now, so the causality is not clear. Who pays at the end of the day depends upon who buys inflation-vulnerable assets now, and the problem is that we are in a self-enforced, policymaker-induced, double-dip where no one is buying – except the monetary authorities themselves. After five years of recession and unemployment we could use a bit of inflation. The problem is how to generate it. It's hard to get inflationary expectations going in a slump, as the Fed and the ECB are finding out.



**Nils Beitlich**

is head of Alternative Investment Research at Credit Suisse. Previously he was a quantitative and qualitative research analyst with a leading hedge fund group focused on systematic trading strategies. Nils holds CAIA certification, and is co-founder of the Swiss Strategies Group.



**Mark Blyth**

is Professor of International Political Economy and faculty fellow of the Watson Institute for International Studies at Brown University. He writes about finance, other complex systems, and why people believe silly economic ideas despite buckets of evidence to the contrary.

**NILS BEITLICH:** More and more investors in search of yield seem to seek shelter with long-term government bonds and ones issued by corporate entities. How safe are these really and how fast can investors react in case central banks one day raise interest rates again? Are we in a bond bubble? Is there anything investors can do to hedge against what is (or has been) building up?

**MARK BLYTH:** Safety is the trade-off made for low yield. Yet the notion of both 'risk-free assets' and 'high yield plus safety' are dangerous – as collateralised debt obligations (CDOs) showed us all so clearly. Similarly, Greek bonds, before the giant moral hazard trade that was the euro, used to pay 22%. That they did so again reflects reality. The world is in a period of post-crash uncertainty where probabilistic thinking and standard correlations often break down. In such a world, investors seek safety since they don't know what to expect, thereby undermining the very correlations they rely upon to be safe (the eggs in one basket/endogeneity problem). So bonds are safe until they are not, but we don't know when that will be. However, the day they are not safe is contingent upon (barring massive exogenous shocks) when other assets become attractive again, which, putting hyper-inflationary panics to one side, would bespeak an actual economic recovery. If investors are not blinded to the possibility of things getting better after such a long slump, there is no reason that they cannot reallocate their positions and take advantage of a move out of bonds if and when it happens. On its own, given the lack of alternatives and the end of the long bull market in equities, the main risk to bond investors comes from a period of financial repression to reduce debts. That is tougher to guard against, but not impossible.

Even assuming that investors might find the right point to exit bonds, they will still need an alternative to reallocate their assets. From a systematic hedge fund's perspective, this is a very favourable situation – especially for those who provide low equity market-correlated returns with manageable volatility. So amidst all the doom and gloom, as always there is a beacon of light. ■