Global Arbitrage Fund – Newsletter Q2 2020

Dear Investor,

We hope and pray that you and your family are safe in these tumultuous times. Wars, famines and natural disasters tend to be localised and it has been nearly 100 years since we have seen anything of this magnitude – thus when people say it is unprecedented, it is first time they might mean it literally.

When we forecasted in our last newsletter that 2020 was expected to be a volatile year, we didn't expect it to be of the magnitude we saw in Q1. Every market participant was probably surprised – the young likely didn't know what a correction could look like, and the old were surprised by the sheer pace of it.

In any such markets, risk management will bound to be a focus of discussion. As a follow up to our previous write up, our thoughts on risk appear even more timely. The rest of newsletter is structured into four parts:

- Performance update
- Risk management
- Team & infrastructure update
- Outlook

Before we head into the business end of this letter, we are happy to announce that your fund has won the best Arbitrage & Market Neutral fund award at the AsiaHedge Awards 2019 in January 2020, which recognizes excellence in the Asian hedge fund industry. Small pleasures in tough times.

Performance update:

Your fund has returned 1.9% this quarter. Convergence arbitrage accounted for 1.71% of the returns, while risk arbitrage deducted -0.76% of our returns and relative value added 0.95%. Risk arbitrage is where our pro-carry and/or anti-volatility hedge trades sit, thus their negative contribution is not surprising. Looking at the contribution proportion through the asset class angles, FX contributed 0.76%, commodities 0.95%, volatility 0.19% while rates and equity contributions have been marginal. The usual disclaimers apply that the breakdowns are best estimates since the same instruments sit across in multiple strategies etc. This quarter had been a challenging one. Liquidity dried up and spreads have widened to 5x-15x their normal levels even in markets like FX. Credit had no bids by mid-March.

In January, we primarily made our money from commodity and credit arbitrage. As things unfolded in China, we were of the view that market was underpricing the pandemic risk and we positioned ourselves for capturing opportunities that will arise from expected future dislocations. By mid-February, we had deployed ourselves for the quarter. In hindsight, we were hasty as the dislocations increased as time passed by. When the opportunity set increased (and thus some adverse mark to market in February), we did put on some risk-arbitrage trades in March that would hedge the portfolio if there was a sudden reversal of this spike in volatility. Once we realized that this situation persisted, we removed some hedges quickly, but some still stay on our books as part of overall portfolio management. FX and RV strategies contributed to returns in March.

We had to extensively manage our collateral as realized intraday volatility was 80-100% in some of the assets we trade. We took opportunities to unwind but did not add and thus scaled down positions to give ourselves wiggle room for the mark to market fluctuations and VaR shocks that might arise. We must admit we didn't expect central bank reactions would be so swift and the varied impacts of their actions on different corners of the market – swaps, liquidity, risk premia etc. But we recognized early that this was a market where risk management must be in driver's seat and market views will need to play second fiddle.

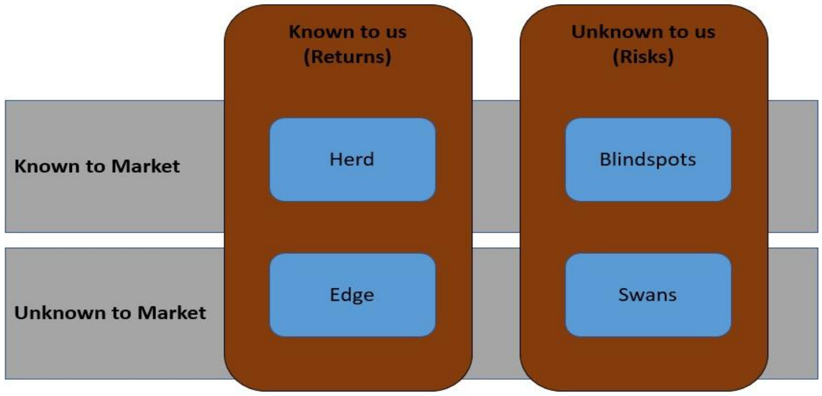
In the end we humbly accept that no matter how many times one thinks that they have seen the narratives; the market always presents a path that surprises. It has been our ability to manage risk that has contributed to returns in March rather than our views. By the end of March, our biggest concern ends up being whether we will have functional markets by the end of next month. Given that convergence arbitrages are expensive to unwind, this worry has been a big factor in our attempts to lighten the risks on our books.

Risk Management

Investment management is an interplay between two elements. The first is the formulation of views and the construction of a portfolio based on these views. Anyone who is investing or conducting asset allocation must have a view. Paraphrasing Pete Seeger, you are not allowed to be neutral, and even having no view is also a view. Some might be better at it, some might poor, but in the end, everyone has it. Our views get reflected in the trades we do and in our asset allocation. The entire financial eco system is nothing but an ensemble of these views. This is the also most visible aspect and thus a lot of literature exists about getting better at it – alphas, risk-premia harvesting, portfolio optimisations etc.

The second element is the identification of risks and this is unfortunately a much more difficult task. Donald Rumsfeld had summarised it succinctly with his now famous statement "*there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know.*" So, one has to account for not only those things that one knows can go wrong (in this case our views going wrong) but also for those variables whose very existence we don't know yet. In fact, a significant part of our time ends up in trying to move variables from unknown unknowns to known unknowns.

Johari window is a framework to help understand relationships with self and others. We modify it a little bit to make it more suitable to the investment world.



Portfolio performance is an interplay between the fund manager's views, risk management framework and finally time. Too little focus on risk and one might not end up generating any returns, even if in the end, the views turn out to be right. Too much focus on risk management, what you are likely to have is a middling fund with processes resembling a government bureaucracy. Discretionary fund management is the art of marrying these to achieve the desired goals.

We are sure that as post-mortem of 2020 is done, one will identify that this crisis had a mix of everything from the past – a bit of credit issues like 2008, a prospect of depression like 1929, oil shocks (though to downside) like 1974, tech bubble like 2000 and hedge fund blow ups like 1998. The last one is particularly relevant for us. As markets have become more efficient and volatility lower, low risk trades have been levered up to generate returns; in risk parity funds that target volatility and in relative value funds that identify mis-pricings. Being an arbitrage fund, we belong to the latter category. Management of this leverage is critical for long term success of such fund and that requires the right balance between two elements mentioned earlier.

While we can't speak for other funds, what helps us is our team culture. We work tirelessly to ensure that we have ingrained the dialectics between risk management and market views. It is this combination that ensures the return profile is what we have today. It also helps us that we are not afraid to have near zero return months, and our primary concern is to avoid losing money. That doesn't mean we have no risk appetite or have no losing trades – far from it, we are guilty of having more losers than we desire. But each new trade made is always looked from its marginal utility to the portfolio.

So how a trade enters the portfolio depends on the strategy style. Convergence Arbitrage is mostly driven by capital and return consideration along with tail risk assessment. In Risk Arbitrage statistical relevance plays an important role. Then a fundamental factor analysis to assess whether there is good reason for the spread to be at such an extreme level – essentially is there a momentum or mean reversion. Finally, diversification benefit for rest of the portfolio is also important. For Relative Value trades, first and foremost, fundamentals factors are looked at that we believe will make the trade work in our favour. Second in importance is positioning, flow and price action considerations. Finally, a study of how the spread has behaved historically and how things might be different this time.

GAF as a fund likes volatility since it leads to dislocations. But extreme volatility is undesirable as market structure breaks down. We like orderly dislocations. Based on historical behaviour we know that as volatility kicks in, our opportunity set expands – thus many times we tend to add trades which are pro-carry and anti-volatility to smoothen our return profile. Early 2019 was one such example and that added to our returns in a low volatility year, while Feb-Mar 2020 is another instance where we added such trades but this time that subtracted from the performance and we are perfectly fine with it.

We have another example in trading Russia around 2014-15 where the depreciation of currency and the volatility made managing cash and positions quite challenging. We had to scale back our positions elsewhere and monitored the prospect of possible capital controls, waited out the peak panic to generate returns while at same time left a fair bit on table and exited as unknown unknowns appeared to increase. This is a theme which we hope you will find repeatedly in our newsletters - **risk management is an integral part of investment process.**

Team & Infrastructure Update:

We have nearly finished implementation of our third-party risk system. While the base set up is complete, we are looking at ways to improve the delivery and quality of information for our decision making as well as inputs to our risk team. Our inhouse quant is working on the quality of life improvements.

Unfortunately, CoVID-19 and market volatility had meant that various onboarding processes that were pending are taking much longer than expected. We are still in process of adding our third Prime Broker for FX to help us in fixed income arbitrage. Our technology infrastructure to trade Taiwan is now in place. We will have added ability to trade Brazil late next quarter and plan to bring that to our algo platform as well. Similarly, Indian markets which were due to get added to our algorithm set up is expected to be complete in early Q2.

CoVID-19 has also seen us test some of our BCP abilities. Our Indian team moved to a new office in March, and as Mumbai headed to a slow shutdown, we have created split teams and added infrastructure for the team to perform their duties from comfort of their homes. The city is now locked for the past three weeks and we have been working from home.

Outlook:

CoVID-19 is an exogenous variable to our financial eco-system. What this means is that it makes it hard to predict what can happen, and at best one can only think of possible scenarios and prepare how best to react to them. Our best case is that by late summer the virus naturally recedes, and the stimulus that is there in system will boost asset prices greatly. A second scenario involves deep economic shocks while consumption and supply chains are disrupted. This should see a much lower growth and emerging markets would be hit hard. Adding to this is the prospect that typical flu pandemic cycle comes in three waves and second is most intensive. The third scenario is something where we are not sure what consequences could be. The governments, if they can't control the virus, decide that the economic cost of lockdowns is too severe, and they just try to live on and deal with collateral damage. But volatility is here to remain.