INSIDE THE HOUSE OF MONEY

Top Hedge Fund Traders on Profiting in the Global Markets

STEVEN DROBNY

Foreword by Joseph G. Nicholas

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The social objective of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future.

—John Maynard Keynes

Once we realize that imperfect understanding is the human condition, there is no shame in being wrong, only in failing to correct our mistakes.

—George Soros

After a certain high level of technical skill is achieved, science and art tend to coalesce in esthetics, plasticity, and form. The greatest scientists are always artists as well.

—Albert Einstein

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Foreword

I first met Steven Drobny several years ago at an exclusive hedge fund conference run by Drobny Global Advisors, an independent global macro research and advisory firm that he runs with his business partner, Dr. Andres Drobny (no relation). Although hedge fund managers have a reputation for being reluctant to discuss their market views and trading strategies, several dozen of the top managers sat in the same room, presented favorite trades, and engaged in lively debate about world markets.

What I found most interesting about having all these managers gathered in one place was that a different dimension of global macro investing was revealed. Global macro is a vast strategy comprising many substrategies, styles, and specialties. Each global macro hedge fund manager approaches the world of trading opportunities in a unique way, playing to his or her particular strengths. Each represents a facet of global macro, but only as a group does a picture of the whole of global macro take shape.

This book is unique in that it lets readers into the room. Because it is done in interview format, it captures an element of frank debate. And because it offers a broad selection of the top managers within global macro, the debate is multidimensional.

Readers will quickly find that no two managers are alike. There are classically educated ones and others who left school at an early age, ones who have been trading for themselves their entire careers and others who rose through the ranks of traditional banks, ones who sit on the pulse of the markets in major financial centers and others who prefer to remain far away.

For curious investors, traders, and money managers, this book provides an inside look at how the best fund managers approach world markets and offers subtle insights into how these managers approach their craft. For anyone in the business of investing, it will lead to a higher understanding of global market dynamics.

For the lay reader, this book offers a rare glimpse into the somewhat closed world of hedge funds, where high intensity and enormous stakes are part of everyday life. Instead of indulging the glamorous image of hedge fund managers often presented by the media, this book, through its first-person accounts, illuminates a far different world of thoughtful, careful, yet smart and creative professionals working hard to increase their investors' worth wherever in the world the opportunity presents itself.

Joseph G. Nicholas
Founder and Chairman of HFR Group
Chicago
January 2006

Preface

Hedge funds are everywhere today. The term *hedge fund* used to conjure images of speculators hunting for absolute returns in any market in the world, using any instrument or style to capture their prey. The managers of the original multibillion-dollar mega-funds, such as George Soros or Julian Robertson, became well-known figures because of their speculative prowess. Yet they were also accused of such modern ills as attacks on developed world central banks and capital flight in the third world.

After the stock market crash of 2000, hedge funds came into their own by proving to be a superior asset management vehicle. As most global investors were suffering year after year of negative returns, hedge funds performed. This encouraged a wave of institutional money to flow into such alternative investment vehicles. At the same time, given the superior flexibility and attractive compensation structure of hedge funds, the most talented financial minds migrated over in what became a mass exodus from The City and Wall Street.

As hedge funds have matured, they have become more of a business. The tremendous inflow of capital has altered the freewheeling image of more than a decade ago. This shift has spawned a more formalized industry where managers often implement rather narrow, specific strategies and where investors in hedge funds no longer tolerate down years or even down months of performance. Competition has smoothed returns, both on the upside and the downside, and lower returns have led to questions about hedge fund fees.

Amidst this evolution and change in the hedge fund business, one strategy has remained true to its original mandate of absolute return investing, seeking outsized returns from investments anywhere in the world, in any asset class and in any instrument: global macro.

Global macro investing is still a relatively unknown and misunderstood area of money management but increasingly of interest. Given that my firm, Drobny Global Advisors, advises global macro hedge funds on market strategy and counts most of the top funds as clients, I am often asked the question, "What is global macro?"

The classic definition—a discretionary investment style that leverages long and short positions in any asset class (equities, fixed income, currencies, and commodities), in any instrument (cash or derivatives), in any market around the world with the goal of profiting from macroeconomic trends—often fails to satisfy. What I think people are really asking is, "How does one define what the top global macro money managers actually do?"

That's a trickier question. Global macro is the most difficult of the hedge fund strategies to define, simply because there is no definition. Just as the term *hedge fund* can be used to describe a wide variety of investing styles, so too *global macro* does not mean just one thing. Global macro has no mandate, is not easily broken down into numbers or formulas, and style drift is built into the strategy as managers often move in and out of various investing disciplines depending on market conditions. Even professional hedge fund investors struggle at times to decipher what global macro managers actually do.

To help my inquisitors, I searched for books and research papers on the topic to recommend but found very little of value. This is surprising given the tremendous growth of assets and sophistication in the hedge fund business over the past few years and the fact that the public still associate hedge funds with the doyen of global macro, George Soros.

Another reason the lack of literature on global macro is odd is that global macro variables influence all investment strategies. When a mutual fund increases its cash position, an endowment allocates to real estate, or an equity long/short hedge fund goes net long stocks, they are all making implicit global macro calls—even if they are not aware of it. Their investment decisions are subject to changes in the world economy, the U.S. dollar, global equities, global interest rates, global growth, geopolitical issues, energy prices, and a multitude of variables of which they may never have heard. As such, an understanding of the global macro picture would seem of the utmost importance to the wider investment community.

This book attempts to fill the gap in the literature. With the dearth of quality information out there about global macro, the next logical step was to speak directly to the smartest global macro managers I knew. With the benefit of the access afforded through my business, I was able to draw on a host of resources to do just that.

The original plan for these discussions with practitioners was simply to discover what global macro means to them, but the conversations proved to be much deeper. I learned how the best minds in the business think about risk, portfolio construction, history, politics, central bankers, globalization, trading, competition, investors, hiring, the evolution of the hedge fund business, and a variety of other details. As a result, a more involved research project developed.

After these initial discussions, I set out to speak with a broader selection of today's top global macro hedge fund managers. In search of the widest possible variety of views, I interviewed managers who have different product specialties, diverse backgrounds, and varied mandates. I chose to focus on fundamental discretionary managers rather than those who depend solely on technical patterns or computer-driven trading models, because fundamental discretionary managers rely on their own judgment above and beyond any analytical tools they may employ.

As it turns out, there is no simple way to define what the top global macro managers actually do. Rather, global macro is an approach to markets in the way that science is an approach to the unknown. As in science, many different approaches can be used to tackle a question and, while many fail, several wildly different paths can lead to success. It is in the course of the development and testing of market hypotheses where the art or the genius lies.

Although global macro funds tend to be idiosyncratic, I found that all global macro managers begin with a broad top-down approach to the world before drilling down into the fine details. It is in the process of drilling down where they differentiate themselves, ending in a wide variety of specialties. In a sense, global macro is evolving into global micro, whereby today's managers derive their investment edge through having the latitude to express their micro expertise in various specialties and markets.

I found other similarities among the managers in that they all love what they do, are incredibly hardworking, and are extremely smart. Yet despite their intelligence and strong opinions, they all seemed open-minded and flexible when it came to being challenged by the market or their colleagues. This flexibility and willingness to admit that they could be wrong is, in a sense, how good hedge fund managers limit their downside risk and cut off the left side of the return distribution. When it comes down to it, no matter the specific style of the manager, the goal of all global macro hedge fund managers is to produce superior risk-adjusted absolute returns for their investors and themselves.

In the end, this book does not answer the question, "What is global macro?" Instead, it offers an inside look at how some of today's best and the brightest practitioners think about their area of expertise. Hopefully, this book will simultaneously help to demystify what today's global macro managers actually do and show why there are so few who truly excel in this endeavor. If you learn as much from reading these interviews as I did conducting them, I will consider this research project a success.

I begin with a word from Joseph G. Nicholas, founder and chairman of HFR Group, who offers a professional investor's perspective of global macro. Nicholas has been investing in global macro hedge funds since the 1980s and now manages over $4 billion in hedge fund assets via HFR Asset Management. He founded the leading hedge fund data firm, Hedge Fund Research, in 1992 and has since authored several books on hedge funds and hedge fund investing.

Next, I briefly highlight some of the key historical events in global macro to offer background and perspective which should prove helpful while reading the interviews. I attempt to show the evolution of global macro from its origins with John Maynard Keynes to George Soros, and then on to the future where increased competition and specialization are leading today's global macro manager into the realm of global micro.

Finally, we go "inside the house of money" via a collection of 13 interviews with top global macro practitioners, each of whom offers a unique perspective on global markets. The interviews were conducted all over the world between October 2004 and July 2005.

CHAPTER 1

Introduction to Global Macro Hedge Funds

By Joseph G. Nicholas
Founder and Chairman of HFR Group

The global macro approach to investing attempts to generate outsized positive returns by making leveraged bets on price movements in equity, currency, interest rate, and commodity markets. The *macro* part of the name derives from managers' attempts to use macroeconomic principles to identify dislocations in asset prices, while the *global* part suggests that such dislocations are sought anywhere in the world.

The global macro hedge fund strategy has the widest mandate of all hedge fund strategies whereby managers have the ability to take positions in any market or instrument. Managers usually look to take positions that have limited downside risk and potentially large rewards, opting for either a concentrated risk-taking approach or a more diversified portfolio style of money management.

Global macro trades are classified as either outright *directional*, where a manager bets on discrete price movements, such as long U.S. dollar index or short Japanese bonds, or *relative value*, where two similar assets are paired on the long and short sides to exploit a perceived relative mispricing, such as long emerging European equities versus short U.S. equities, or long 29-year German Bunds versus short 30-year German Bunds. A macro trader's approach to finding profitable trades is classified as either *discretionary*, meaning managers' subjective opinions of market conditions lead them to the trade, or *systematic*, meaning a quantitative or rule-based approach is taken. Profits are derived from correctly anticipating price trends and capturing spread moves.

Generally, macro traders look for unusual price fluctuations that can be referred to as far-from-equilibrium conditions. If prices are believed to fall on a bell curve, it is only when prices move more than one standard deviation away from the mean that macro traders deem that market to present an opportunity. This usually happens when market participants' perceptions differ widely from the actual state of underlying economic fundamentals, at which point a persistent price trend or spread move can develop. By correctly identifying when and where the market has swung furthest from equilibrium, a macro trader can profit by investing in that situation and then getting out once the imbalance has been corrected. Traditionally, timing is everything for macro traders. Because macro traders can produce significantly large gains or losses due to their use of leverage, they are often portrayed in the media as pure speculators.

Many macro traders would argue that global macroeconomic issues and variables influence all investing strategies. In that sense, macro traders can utilize their wide mandate to their advantage by moving from market to market and opportunity to opportunity in order to generate the outsized returns expected from their investor base. Some global macro managers believe that profits can and should be derived from other, seemingly unrelated investment approaches such as equity long/short, investing in distressed securities, and various arbitrage strategies. Macro traders recognize that other investment styles can be profitable in some macro environments but not others. While many specialist strategies present liquidity issues for other, more limited investing styles in charge of substantial assets, macro managers can take advantage of these occasional opportunities by seamlessly moving capital into a variety of different investment styles when warranted. The famous global macro manager George Soros once said, "I don't play the game by a particular set of rules; I look for changes in the rules of the game."

SUMMARY

Global macro traders are not limited to particular markets or products but are instead free of certain constraints that limit other hedge fund strategies. This allows for efficient allocation of risk capital globally to opportunities where the risk versus reward trade-off is particularly compelling. Whereas significant assets under management can prove an issue for some more focused investing styles, it is not a particular hindrance to global macro hedge funds given their flexibility and the depth and liquidity in the markets they trade. Although macro traders are often considered risky speculators due to the large swings in gains and losses that can occur from their leveraged directional bets, when viewed as a group, global macro hedge fund managers have produced superior risk-adjusted returns over time.

From January 1990 to December 2005, global macro hedge funds have posted an average annualized return of 15.62 percent, with an annualized standard deviation of 8.25 percent. Macro funds returned over

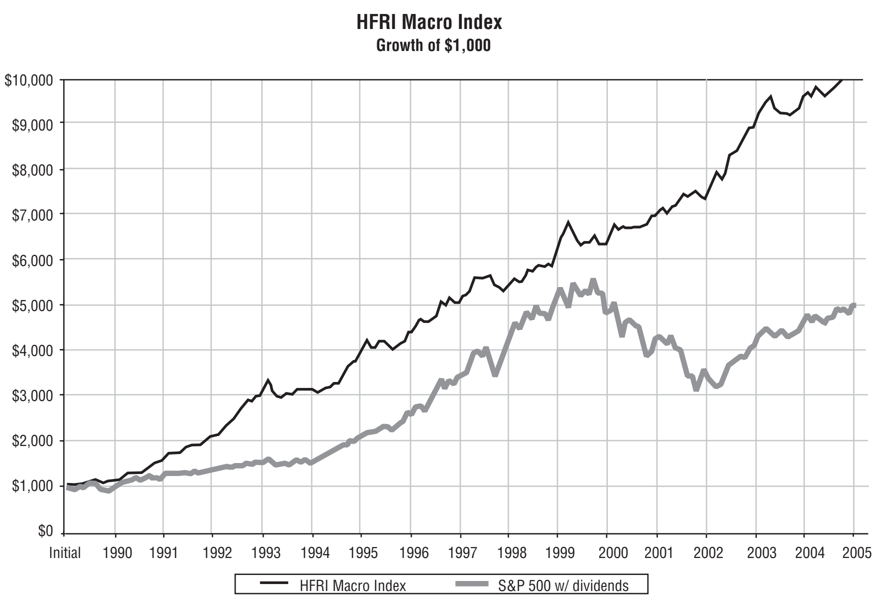

FIGURE 1.1 Comparison of HFRI Macro Index with S&P 500
Source: HFR.

500 basis points more than the return generated by the S&P 500 index for the same period with more than 600 basis points less volatility. Global macro hedge funds also exhibit a low correlation to the general equity market. Since 1990, macro funds have returned a positive performance in 15 out of 16 years, with only 1994 posting a loss of 4.31 percent. (*See Figure 1.1.*)

In light of the correlation, volatility, and return characteristics, global macro hedge fund strategies are a welcome addition to any portfolio.

CHAPTER 2

The History of Global Macro Hedge Funds

The path to today's style of global macro investing was paved by John Maynard Keynes a century ago. For an economist, Keynes was a renaissance man. Not only was he the father of modern macroeconomic theory but he also advised world governments, was involved in the Bloomsbury intellectual circle, and helped design the architecture of today's global macroeconomic infrastructure by way of the World Bank and International Monetary Fund. At the same time, he was also a successful investor, using his own macroeconomic principles as an edge to extract profit from the markets. Some say he was the first of the modern global macro money managers.

In the words of Keynes' biographer Robert Skidelsky, "[Keynes] was an economist; he was an investor; he was a patron of the arts and a lover of ballet. He was a speculator. He was also confidant of prime ministers. He had a civil service career. So he lived a very full life in all those ways."

Keynes speculated with his personal account, invested on behalf of various investment and insurance trusts and even ran a college endowment, each of which had different goals, time horizons, and product mandates. Upon his death, he left a substantial personal fortune primarily a result of his financial market activities.

Evidence of Keynes' investing acumen can be found in the returns of the King's College Cambridge endowment, the College Chest, for which he had total discretion as the First Bursar. A publicly available track record shows he returned an average of 13.2 percent per annum from 1928 to 1945, a time when the broad UK equity index lost an average of 0.5 percent per annum.

(*See Figure 2.1.*) This was quite a feat considering the 1929 stock market crash, the Great Depression, and World War II occurred over that time frame.

But, like all great investors, Keynes first had to learn some difficult lessons. He was not immune to blowups in spite of his superior intellect and understanding of global markets. In the early 1900s, he successfully speculated in global currencies on margin before switching to the commodity markets. Then, during the commodity slump of 1929, his personal account was completely wiped out by a margin call. After the 1929 setback, his greatest successes came from investing globally in equities but he continued to speculate in bonds and commodities.

Skidelsky adds, "His investment philosophy . . . changed in line with his evolving economic theories. He learned a lot of his theory from his experience as an investor and this theory in turn modified his practice as an investor."

Keynes' distaste of floating currencies (ironically his original vehicle of choice for speculating) eventually led him to participate in the construction of a global fixed currency regime at Bretton Woods in 1945. The post-World War II economic landscape, coupled with the ensuing Cold War–induced peace and the relative stability fostered by Bretton Woods, led to a boom in

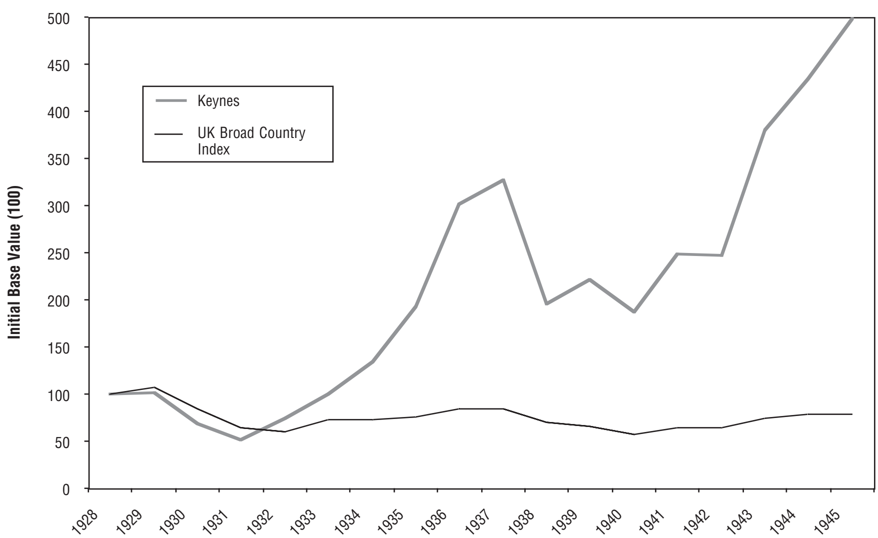

FIGURE 2.1 King's College Cambridge Chest Fund and the UK Broad Country Equity Index
Source: Motley Fool.

developed-country equity markets starting in 1945 and lasting until the early 1970s. During that time, there were few better opportunities in the global markets than buying and holding stocks. It wasn't until the breakdown of the Bretton Woods Agreement in 1971, and the subsequent decline in the U.S. dollar, that the investment universe again offered the opportunities that spawned the next generation of global macro managers.

POLITICIANS AND SPECULATORS

Recent history is riddled with examples of politicians attempting to place blame on speculators for shortcomings in their own policies, and the breakdown of Bretton Woods was no exception. When the currency regime unraveled, President Nixon attempted to lay blame on speculators for "waging an all-out war on the dollar." In truth, his own inflationary policies are more often cited as the underlying problem, with speculators a mere symptom of the problem.

As Andres Drobny (Drobny Global Advisors) describes it in his interview:

> *Speculators definitely don't [drive markets]. There's an old debate in economics as to whether speculators are deviation "dampeners" or deviation "amplifiers." Milton Friedman, the eternal optimist, argued that if people see an anomaly, they'll pick on it and limit how far that anomaly goes. I think both are right at different times. Sometimes speculators add to volatility; other times they dampen it. The important point is, they don't influence the trend. Underlying pressures combined with policy decisions drive market events.*

THE NEXT GENERATION OF GLOBAL MACRO MANAGERS

The next round of global macro managers emerged out of the breakdown of the Bretton Woods fixed currency regime, which untethered the world's markets. With currencies freely floating, a new dimension was added to the investment decision landscape. Exchange rate volatility was introduced while new tradable products were rapidly being developed. Prior to the breakdown of Bretton Woods, most active trading was done in the liquid equity and physical commodity markets. As such, two different streams of global macro hedge fund managers emerged out of these two worlds in parallel.

The Equity Stream

One stream of global macro hedge fund managers emerged out of the international equity trading and investing world.

Until 1971, the existing hedge funds were primarily focused on equities and modeled after the very first hedge fund started by Alfred Winslow Jones in 1949. Jones's original structure is roughly the same as most hedge funds today: It was domiciled offshore, largely unregulated, had less than 100 investors, was capitalized with a significant amount of the manager's money, and charged a performance fee of 20 percent. (Allegedly, the now standard 20 percent performance fee was modeled by Jones upon the example of another class of traders who demanded a profit sharing arrangement that provided the proper incentive for taking risk: Fifteenth-century Venetian merchants would receive 20 percent of the profits from their patrons upon returning from a successful voyage.)

The A.W. Jones & Co. trading strategy was designed to mitigate global macro influences on his stock picking. Jones would run an equally weighted "hedged" book of longs and shorts in an attempt to eliminate the effects of movements by the broader market (i.e., stock market beta). Once currencies became freely floating, though, a new element of risk was added to the equation for international equities. Whereas managers using the Jones model sought to neutralize global macro–induced moves, the global macro managers who emerged from the international equity arena sought to take advantage of these new opportunities. Foreign exchange risk was treated as a whole new tradable asset class, especially in the context of foreign equities where currency exposure became a major factor in performance attribution.

Managers from this stream such as George Soros, Jim Rogers, Michael Steinhardt, and eventually Julian Robertson (Tiger Management) were all too willing to use currency movements as an additional opportunity set to be capitalized upon. They were already successful global long/short equity investors whose experience in global markets made the shift to currencies and foreign bonds seamless in the post–Bretton Woods world. In the early days of this new paradigm, these managers saw little in the way of competition. Over time, though, as their superior returns attracted larger amounts of capital, the funds were increasingly forced to trade deeper, more liquid markets and thus move beyond their core competence of stock picking. At the same time, competition intensified.

The Commodity Stream

The other stream of global macro managers developed out of the physical commodity and futures trading world that was centered in the trading pits of Chicago. It developed independently although simultaneously with the equity stream.

The biggest global macro names to emerge from the commodity world, however, did not come from the Chicago epicenter but instead learned their craft from the most forward thinking of commodity and futures trading firms: Commodities Corporation of Princeton, New Jersey.

The founder of Commodities Corporation (CC), Helmut Weymar, is said by many to be the father of the commodity stream of global macro. Weymar, an M.I.T. PhD and former star cocoa trader for Nabisco, founded CC along with his mentor and legendary trader Amos Hostetter, wheat speculator Frank Vannerson, and his former professor, Nobel Prize winner Paul Samuelson, with the goal of providing an ideal environment where traders could take risk without worrying about administration and other distractions. The management of CC had a solid understanding of risk taking and offered an incredibly open framework in which traders thrived. CC incubated or served as an important early source of funding for some of the best known global macro managers of all time, including Bruce Kovner (Caxton), Paul Tudor Jones (Tudor Investment Corporation), Louis Bacon (Moore Capital), Michael Marcus, Grenville Craig, Ed Seykota, Glen Olink, Morry Markowitz, and Willem Kooyker (Blenheim Capital), to name a few.

Commodities Corporation was originally set up to take advantage of tradable physical commodities, and traders were siloed such that each focused exclusively on one commodity market. As world trade opened up in the 1970s and 1980s, global macroeconomic influences started to play a larger and more important role in determining the price movements in the commodity markets. Being accustomed to the sometimes extreme volatility, and having the knowledge of the macroeconomic influences on their specific markets, the firm easily moved into trading currency and financial futures as those markets developed. For CC traders, as long as there was volatility, they were indifferent to the underlying asset.

Commodities Corporation traders involved in all products became known as "generalists." While CC founder Hostetter had been trading stocks, bonds, and commodities since the 1930s, the first successful generalists to emerge at CC were plywood and cotton trader Michael Marcus and his young assistant Bruce Kovner. Kovner especially pushed CC toward a more global macro style of trading, which meant trading all products, anytime, anywhere. He also started another trend in the organization, namely, leaving the firm to set up his own fund. Started with the blessing and initial capital from CC, Kovner's fund, Caxton, is now one of the largest hedge fund management groups in the world as measured by assets under management. Likewise, several other CC alumni are managing some of the largest hedge fund complexes today. Many credit their success to lessons learned at CC about risk management, leverage, and trading. As a testament to its success, Commodities Corporation was purchased by Goldman Sachs in 1997 after evolving into more of a fund of hedge funds investment vehicle, with many allocations still out to original CC traders.

MAJOR GLOBAL MACRO MARKET EVENTS

For the purposes of this book, we are going to use the experiences of the global macro pioneers, such as Soros, Robertson, and Tudor Jones to discuss some of the important episodes in the global macro arena over the past few decades, mainly because macro markets were dominated by these managers until 2000.

What is interesting about these episodic moments in global macro history is not what happened to the macro trading community, but rather that the lessons learned from these events served as the education for today's generation of global macro managers.

Today's managers, many of whom are alumni of the original global macro fund managers, earned their stripes during the ensuing crises and events. While Keynes had his 1929 event to learn about the positive and negative effects of trading on leverage, which he subsequently incorporated into his trading style and translated into future success, today's managers had the 1987 stock market crash, the sterling crisis of 1992, the bond market rout of 1994, the Asia crisis of 1997, the Russia/LTCM crisis of 1998, and finally the dot-com bust of 2000. (*See Figure 2.2.*) The ways that today's managers look at markets, control risk, and manage their businesses include lessons learned through these important events.

The Stock Market Crash of 1987

Although the U.S. stock market crash of October 1987 is now a mere blip on long-term stock market charts (*see Figure 2.3*), as indexes fully recov-

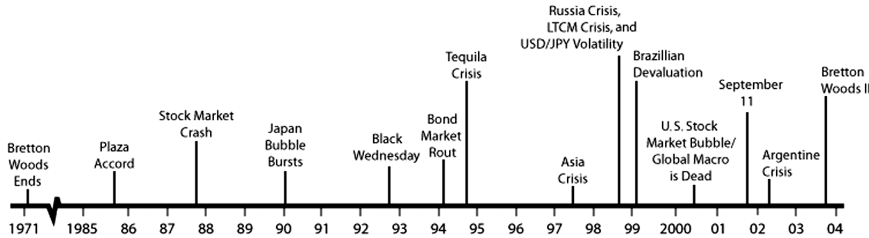

FIGURE 2.2 Major Global Macro Market Events since 1971
Source: DGA.

ered only two years later, the intensity of Black Monday for traders who lived through it has certainly left its mark. Most notably, the notions of liquidity risk and fat tails were introduced to the wider investment community without mercy. Entire portfolios and money management businesses were obliterated on that day as margin calls went unfunded. Indeed, even so-called "portfolio insurance" hedges didn't work as the futures and options markets became unhinged from the cash market.

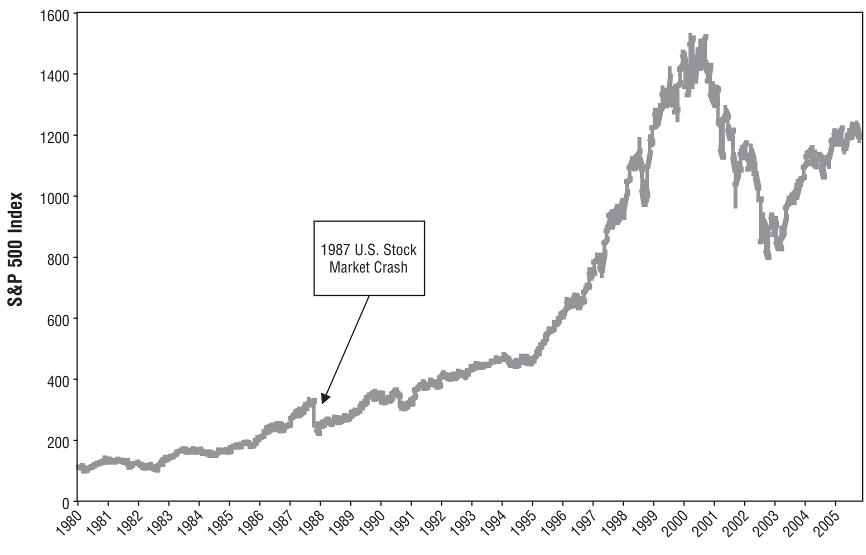

FIGURE 2.3 S&P 500 Index, 1980–2005
Source: Bloomberg.

FAT TAILS

"Fat tails" are anomalies in normal distributions, whereby observed outcomes differ from those suggested by the distribution. In other words, extreme occurrences can be more frequent than otherwise theoretically expected. Because markets are governed by human behavior, under- and overreactions to various data and indicators and the herding instincts of participants sometimes push prices to extremes, explaining the prevalence of such extreme but infrequent events in reality.

Yra Harris (Praxis Trading) explains in his interview later in this book what he saw that day on the floor of the Chicago Mercantile Exchange:

> *It was eerie and scary because you just didn't know the extent of everything. People were clearly hurting badly but you just didn't know how badly. I've traded through a lot of devaluations and debacles but I've never seen as many people pulled off the floor by clearinghouses as I did that day. The pit was practically empty, which actually turned into a great opportunity to trade the S&Ps. I went into the S&P pit and starting making markets because nobody else was. Spreads were so unbelievably wide that it was pretty easy to make money just scalping around. Honestly, I couldn't help it.*

Global macro managers from the equity stream, including George Soros, got hurt in the 1987 crash. Just prior to the crash, *Fortune* magazine ran a cover story entitled, "Are Stocks Too High?" in which Soros disagreed with the notion. Days later, Soros lost $300 million as stocks collapsed (yet Soros Fund Management still ended the year up 14 percent). Meanwhile, Tiger Management posted its first down year (–1.4 percent) only one year after an *Institutional Investor* article, noting Tiger's 43 percent average annual returns since inception in 1980, sparked the next wave of hedge fund launches.

For global macro traders from the commodities stream, however, the 1987 crash served as a windfall event. Paul Tudor Jones in particular was elevated to star status when he famously caught the short side of the stock market and the long side of the bond market by identifying similarities between technical trading patterns in 1987 and the great crash of 1929. (*See Figure 2.4.*) Jones's Tudor Investment Corporation returned 62 percent for the month in October 1987 and 200 percent for the year.

The year 1987 also marked the introduction of a new Federal Reserve chairman in Alan Greenspan. Greenspan came into office in August 1987 and his first act a few weeks later was to raise the discount rate by 50 basis points. This unexpected tightening created volatility and uncertainty in the markets as traders adjusted to the style of a new Fed chairman. Some argue that Greenspan's rate hike was actually the cause of the subsequent equity market meltdown a month-and-a-half later. Immediately after the stock market crash, Greenspan flooded the market with liquidity, initiating a process that came to be known as the "Greenspan put." The Greenspan put is an implicit option that the Fed writes anytime equity markets stumble, in hopes of bailing out investors.

Former Federal Reserve chairman William McChesney Martin famously observed that the job of a central banker is to "take away the punch bowl just when the party is getting started." Alan Greenspan, on the other hand, seemed to interpret his role as needing to intervene only as the partygoers are stumbling home. As he has claimed, bubbles can only be clearly observed in hindsight, such that the role of a central banker is to

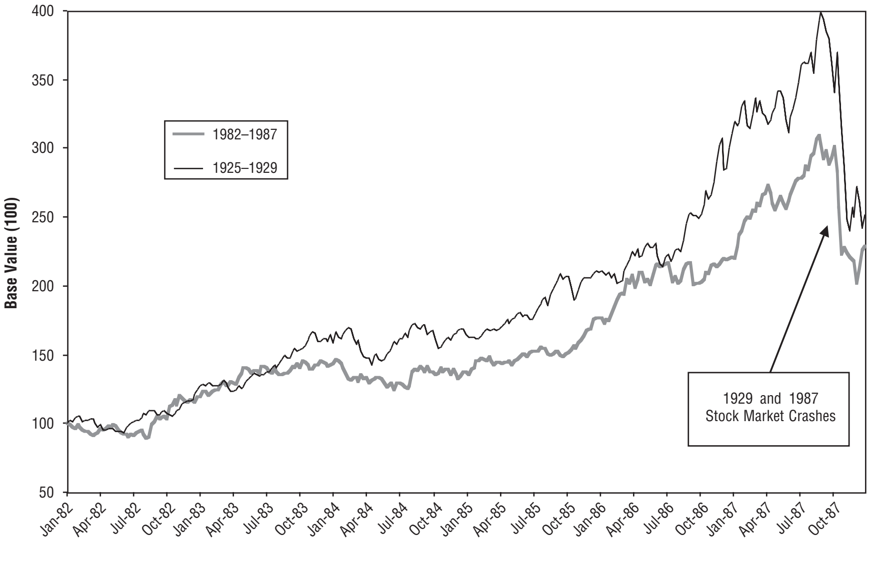

FIGURE 2.4 Dow Jones Industrial Average: The Late 1920s versus the Late 1980s
Source: Bloomberg.

soften the impact of the bubble's bursting rather than to take away the fuel for the party.

Black Wednesday 1992

The term *global macro* first entered the general public's vocabulary on Black Wednesday, or September 16, 1992. Black Wednesday, as the sterling crisis is called, was the day the British government was forced to withdraw the pound sterling from the European Exchange Rate Mechanism (ERM)—a mere two years after joining—sending the currency into a free fall. The popular press credited global macro hedge fund manager George Soros with forcing the pound out of the ERM. As Scott Bessent (Bessent Capital), head of the London office of Soros Fund Management at the time, noted, "Interestingly, no one had ever heard of George Soros before this. I remember going to play tennis with him at his London house on the Saturday after it happened. It was as if he were a rock star with cameramen and paparazzi waiting out front."

The ERM was introduced in 1979 with the goals of reducing exchange rate variability and achieving monetary stability within Europe in preparation for the Economic and Monetary Union (EMU) and ultimately the introduction of a single currency, the euro, which culminated in 1999. The process was seen as politically driven, attempting to tie Germany's fate to the rest of Europe and economically anchor the rest of Europe to the Bundesbank's successful low interest rate, low inflation policies.

The United Kingdom tardily joined the ERM in 1990 at a central parity rate of 2.95 deutsche marks to the pound, which many believed to be too strong. To comply with ERM rules, the UK government was required to keep the pound in a trading band within 6 percent of the parity rate. An arguably artificially strong currency in the United Kingdom soon led the country into a recession. Meanwhile, Germany was suffering inflationary effects from the integration of East and West Germany, which led to high interest rates. Despite a recession, the United Kingdom was forced to keep interest rates artificially high, in line with German rates, in order to maintain the currency regime. In September 1992, as the sterling/mark exchange rate approached the lower end of the trading band, traders increasingly sold pounds against deutsche marks, forcing the Bank of England to intervene and buy an unlimited amount of pounds in accordance with ERM rules. Fears of a larger cur-