Marc Malek, managing partner

Spotlight: Conquest Capital

Conquest Capital's trend "index fund" pioneer Marc Malek discusses the commoditisation of trend-following, and how analysis of market risk appetite has helped his firm return to the top of the short-term trading league tables

It will be ten years in June since Marc Malek's New York-based Conquest Capital launched its CTA replication program, Conquest Managed Futures Select (MFS).

MFS was one of the first in a slew of such products that have since come to the market, particularly in the '40 Act space recently. And Malek's approach, to develop an "index fund" of trend-following, pre-empted a debate that has come to the fore in recent years: is trend-following largely a commoditised beta strategy? And should investors pay 2/20 for it?

In 2004, Malek coined the term "exotic beta" to describe a persistence of behaviour in a number of hedge fund strategies, notably among longer-term trend-following CTAs. "Smart beta" and "alternative beta" have since joined the lexicon.

In the course of developing more models and considering improvements to Conquest's flagship Macro CTA strategy, Malek was examining its long-term trend component.

While believing that longer term trend-following was a great diversifier, Malek concluded it was not what is typically considered an alpha strategy. Cross-correlation analysis on each area of hedge funds revealed something he recalls was "quite stunning".

"All these strategies sold themselves as alpha strategies," he says. "But if they were all really alpha strategies then you would expect very little cross-correlations among the managers."

What Conquest found was the opposite. And one sector of hedge funds that had the highest cross-correlations was trend-following CTAs.

Malek says the correlation analysis indicated that the best opportunity for alpha existed in the short-term trading space, where there were more options to trade. And he saw an opportunity to differentiate Conquest from his competitors, by making Conquest Macro a strictly short-term strategy.

"I came to the conclusion that in order to differentiate ourselves, what we were going to do was to jettison the long-term trend-following component of what we did; given that I thought it was mostly exotic beta and that people could get it in a different, more efficient way."

Malek's conclusions were summarised in a paper that came across the desk of one of the largest Ivy League universities. They agreed with the premise and approached Conquest in early 2004 about starting a fund. But with three conditions.

One was that it had to be completely non-optimised: freely delivering trend-following beta. It also had to be 100% transparent, so no "black box". It had to have a flat management fee with no incentive fee. And more importantly, says Malek, it had to deliver the CTA space to them.

"It was an interesting exercise for us; not a great money generator at the time but nevertheless, from an intellectual level, an interesting exercise."

Hedge fund replication

In 2004, few were talking about hedge fund replication. Mount Lucas Management had developed a moving average futures index in the late 80s, and Bridgewater had been publishing research in the area. But Conquest was a pioneer in delivering a mechanical trading replication fund.

Malek says there are two broad schools of thought on how to do this. Conquest's approach was that in order to replicate the performance of hedge funds, you have to replicate the process by which they trade.

Malek says the other approach, adopted by many banks in 2007 in a wave of product launches, is to use techniques such as factor modelling or pay-off distribution to replicate the returns themselves.

"The problem with that is the endeavour of replicating the returns is very unstable," he says. "It might work well in long stretches of risk-seeking or risk averse markets; however, it completely disintegrates when markets are going through changes from one environment to another. It is just simply not fast enough to factor in those changes."

Malek adds: "And unfortunately for banks, 2008 came right on the back of these products, and they all got pretty much blown out of the water."

To replicate the CTA industry by process, Conquest adopted trend-following, as the dominant strategy of the sector.

"And we opted for breakout strategies because mathematically it was a more elegant solution," he says. "But essentially the process is interchangeable; you can use any trend-following technique."

Conquest selected a range of 55 markets to trade, based on a survey of 20 of the largest CTAs, using an average of their sector allocations and most commonly used markets, while also maintaining some geographical diversification. But rather than adopting the 30- to 60-day breakout lengths used by most CTAs in the study, Conquest incorporated time frame diversification into MFS, with support from the university endowment.

As Conquest was looking at time frame diversification, its analysis for breakout strategies ranged from two or three-day breakouts at the low end to a 200-day breakout at the high end.

I'm not saying there is no alpha. I think there is. It's just not as prevalent as people think. To a large extent what hedge funds have done is alternative beta and charged alpha prices for it

Malek says figuring out how many different time frames the program would trade was simple as the endowment was taking a $50m account. And the maximum number of strategies that could be traded to minimise the slippage between a $50m portfolio and a $500m portfolio came to 20, he says.

Conquest initially thought of using equal settings, five days apart. But analysis showed that the correlation between the timeframes was not linear. The correlation between a five-day and six-day breakout was a lot less than six to seven, and became almost identical at the 30- or 40-day breakout timeframe.

Conquest instead settled on logarithmic spacing to avoid the unintended result of equal settings creating a portfolio that was not truly diversified across timeframes, but more heavily correlated with long-term trend-followers.

Among the 20 MFS strategies, around one third use breakouts under 20 days, around one quarter between 20 and 60 days, and the remainder are longer term.

"Since we launched MFS it has done very well compared to the CTA indices. And it has had a very consistent 70% to 80% correlation to these indices," says Malek.

New school/old school style-drift

While correlations among trend-followers remains high, Malek is among many commentators to observe a divergence in approaches.

"If you look at the trend-following industry from the beginning in the 1970s to the early and mid-2000s, it was all a very homogeneous space. Everyone was doing the same thing," he says. "But starting in the mid-2000s, we started to see some bifurcation into what I call the old school CTAs, and the new school CTAs."

The reason, Malek says, is twofold. In order to lower the volatility of their returns a lot of the "new

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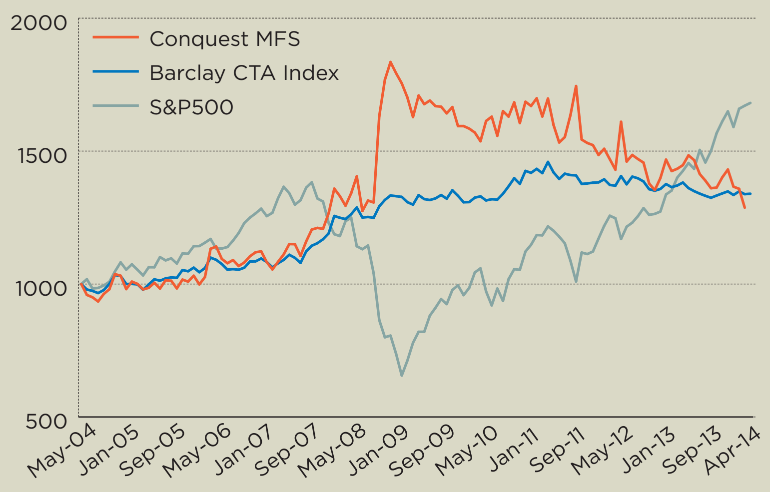

Source: BarclayHedge, S&P and Conquest Capital school" CTAs have essentially started employing more frequent adjustment of their positions based on the volatility of the markets that they trade.

"But the cost of it is in periods of high volatility in the market, where I believe CTAs tend to do very well," he says. "These guys are essentially giving up their edge because given the high volatility they will have very little position in the market and underperform."

Malek says even in 2008, a stellar year for CTAs, there were big differences in performance. MFS returned 51.9% during that year, including a 24.9% gain in October, when Lehman blew up. Others had equally good results. But Malek says because volatility had expanded so much during the year, some CTAs went into the last quarter with almost no positions and as a result didn't take "full advantage" of the volatility that happened.

"The way I see it is CTAs are a strategy that people associate more with tail risk protection and diversification. In risk-seeking environments there are many other hedge fund strategies that do better than CTAs do.

"To me it's inconceivable that you have an investment in a CTA where you don't take full advantage of the tail events that happen.

"They happen very infrequently but this is where CTAs can add a lot of value."

Another area that Malek finds "disconcerting" is the addition by some CTAs of long risk strategies such as FX carry. He says those CTAs can look comparatively "very good" in risk-seeking periods.

But, he adds: "It's really because of the style drift by adding these long risk exposures."

Malek says Conquest has had many discussions with clients about the possibility of including a long risk component to its programs. "It makes sense from a portfolio theory perspective," he says. "Because you're taking two uncorrelated assets with positive expectancy and putting them together."

But he adds: "If individual CTAs start taking it upon themselves to improve their returns by adding that long risk, they are not only stepping on the toes of the portfolio they are in, the other strategies; they are also for the future providing a less clear stream of returns depending upon what happens in the market."

Malek says FX carry, for example, is a strategy that most of the time gets "really hurt" in risk averse periods.

Since Conquest MFS was launched, many lower cost trend-following, or core-momentum beta products, have entered the marketplace, particularly in recent years, either from existing CTA managers seeking to diversify their business, or new entrants to the space.

Malek welcomes the competition. "This is what I've been advocating for over ten years now," he says. "I'm not saying there is no alpha. I think there is alpha. It's just not as prevalent as people think.

"I think to a large extent what hedge funds have done is alternative beta to the market and charged alpha prices for it," he explains. "What we are trying to do is separate these two: let's call beta, 'beta', and let's call alpha, 'alpha'.

"I think as this idea develops and increases in acceptance then ultimately the result will be that investors will see that the majority of hedge funds, not just CTAs, will have to lower their fees to be closer to the beta level because they just don't have alpha."

He thinks the differentiator in these new products will come as much from the process of doing trend-following as the fees they charge, which he says is still "in flux", ranging from 1/10 to a simple 70bps management fee, or lower.

And for the funds that do have real alpha, Malek thinks the price of that alpha is "going to go up significantly". Conquest MFS, like Macro, is currently offered through managed accounts or an offshore fund.

So has Malek got plans to launch a version of MFS in a '40 Act wrapper, to make it available to retail investors? He says Conquest is in discussions with a potential partner with a view to a launch later this year.

"The models are ready and the systems are ready, it's just the legal wrapper that sometimes can take longer than anticipated," he says.

Conquest Macro

As short-term traders made an explosive start to 2014, Conquest stood out at the top of the league tables with a 13.1% return in January.

Conquest Capital's flagship Macro program had endured a dismal 2012, and stuttered again at the start of 2013. But improvements to the systematic program, implemented in February last year, have

FROM WAR GAMES TO WALL STREET

Conquest Capital Group was co-founded in 2001 by Marc Malek, a former worldwide head of the exotic FX derivatives group at UBS.

Born in Lebanon, Malek was sent to the US in the late 1980s by his parents to escape the prolonged civil war that had occupied most of his childhood. He graduated with a degree in Mathematics from Reed College in Oregon and a degree in engineering and applied science from California Institute of Technology (Caltech).

While at Caltech, he did extensive research on neural networks and was awarded a grant from the Pentagon to conduct "scenario analysis" research with computer-based decision systems, which involved optimising the locations of tanks on battlefields.

It was suggested to him that the same analysis could be applied to the financial markets, and his resulting published report landed him a job at Solomon Brothers in 1992 as a financial analyst. He passed up an offer to join Oracle, a then emerging tech company, to join the Wall Street bank.

In 1993, Malek was hired by KB Currency Advisors, a $400m hedge fund and financial advisor, where he traded currency options and worked on developing proprietary trend-following systems.

Malek joined UBS in 1995, where he held senior level positions among its FX desks in New York, Tokyo and London, rising to become executive director in charge of FX proprietary trading in Europe.

In 1999, he left the bank to go it alone and was a principal of Avalon Asset Management and Enterprise Asset Management until co-founding Conquest in 2001 with Richard Silver, a former UBS head of foreign exchange Asia and global head of proprietary trading.

Silver was to sell his membership interest in Conquest in 2007, and Proctor Investment Manager, a then $8bn private equity firm, purchased a 17.5% equity stake. Proctor remains a silent partner to this day.

seen it perform better in the prevailing risk-seeking environment, delivering an estimated 18.6% return in the 12 months to the end of Q1.

The difference in performance by hedge funds in risk-seeking regimes and periods of market risk aversion is a research area Conquest has long been occupied with. A 2005 Conquest study found a strong relationship between market risk appetite and performance, with hedge funds performing significantly better under risk-seeking regimes.

The study led to the creation of the Conquest Risk Aversion Index, now published on Bloomberg, which offers a prism through which to analyse the returns of investments in the different market environments, and a tool that can be used to tailor asset allocations and trading.

"For the longest time most of the research in Conquest Macro has been dedicated to how we can improve our performance in risk-seeking periods," explains Malek.

"We never had any issues generating very large amounts of profit in risk averse periods. The one question we been working on for the past seven or eight years, if not more, is: 'How can we keep our returns the same in risk averse periods, while improving them in risk-seeking periods?'"

The marked improvement in the past 12 months has been the result of incorporating more of the analysis on risk environment into how Conquest allocates capital and risk among its different strategies, says Malek.

"We took down some of our strongest biases for risk averse performance to get more dynamic, based on the risk environment," he explains.

Malek says he views market risk appetite as spending about 70% of time risk-seeking, and about 30% of the time being risk averse.

"What I believe we have today is a strategy that will still return 30%-plus annualised in risk averse periods, but will return somewhere between 5% to 10% in risk-seeking periods," he says.

"So going forward I think we should be, in normal market conditions, about a 15% average annual strategy. But more importantly, the bulk of that return will come from risk averse periods. So we will be an absolute return strategy with a very strong portfolio benefit as well."

While Conquest's assets peaked at nearly $1bn in 2011, like many CTAs it has suffered from outflows in recent years.

As of 1 May the firm was managing around $280m, roughly split across its two core strategies: Conquest Macro, which is offered at 2/20 fees, and the lower cost Conquest MFS.

It's up to the investor to decide whether we're going to be in a volatile period or non-volatile period and decide what investment is best for them then

Malek says Conquest's current investors are its oldest and largest, including the university endowment, who have been clients for more than ten years. Other investors were lost due to "performance, the liquidity and nature of what we do". He adds that Conquest also has quite a large chunk of "seasonal investors".

"When the VIX goes below 15 and stays there for a couple of months they redeem, and when the VIX goes above 20 and stays there for a couple of months they come back," he says.

Malek says Macro's mandate is to be an absolute return strategy and to achieve the most of its returns in periods of risk aversion. It consists of four independent strategies: short-term long volatility, trend-following and counter-trend strategies, and a risk capture strategy.

"One way to look at it is an alternative to short sellers. If you compared Conquest Macro to short-sellers you see it's done a much better job," he says.

MFS, meanwhile, is designed to be the "purest, most efficient way to capture trend-following," he explains.

He says Conquest aims to make both the Macro and MFS the best they can be within their categories, but adds: "It's up to the investor to decide whether we're going to be in a volatile period or non-volatile period and decide what investment is best for them then."

The core programs will soon be joined by a "best ideas" all-weather product that Malek reveals Conquest has been developing to launch later this year.

"This is one investment that you don't have to think of what risk environment you're in. This is just an absolute return strategy. And it should stand the comparison to any investment over the same period."

He says it will combine many sub-strategies that Conquest has been working on in the past few years and be offered as a traditional 2/20 institutional product.

So what of Conquest's prospects for the future? Malek says the last five years have been "horrendous" for trend-following as well as many other trading strategies, in large part due to "unprecedented" central bank interventions. But it's not something that can go on forever, Malek says.

"I feel we're closer to the end of this tunnel than we are in the middle of it," he says. "We have moved from an easing bias of the Fed to a tightening bias. I can see hope in that action; that we are on our way back to more normal market function.

"Given the changes that have happened in the last five years, where so many people exited the fixed income world, where so many people exited a lot of the trading strategies, as we come back to normal we can see an environment with a higher level of volatility than the one we left five years ago.

"And I think that can only be very good for whoever is still standing when that volatility comes back." CTA