Open Dialogue with Perry Kaufman

Asian Financial Forum 2011, 18 January

"The Impact of Global Investing on Asian Markets – A Quantitative View" was the subject of Perry Kaufman's AFF 2011 Open Dialogue session, 18 January. Mr Kaufman, a United States-based analyst, develops fully computerised hedge-fund strategies and partners with the companies that use them. He is the author of *Trading Systems and Methods*. Now in its fourth edition, the book is considered a standard reference in the industry.

Market Noise

Mr Kaufman kicked off his presentation by introducing the concept of "noise" – a key element in his investment philosophy. He defined noise as erratic price movements relative to the net price change over a considered time horizon. When noise is high, he said, there is a lack of direction.

Mr Kaufman argued that the level of noise depends largely on the maturity of a market. In a mature market, there are numerous players buying and selling for different reasons and over different time horizons, thus adding noise to the underlying trend of the price.

Mr Kaufman said that the United States equity markets have the most noise while emerging markets have the least. The US market has a high concentration of pension funds. These, he said, do their investment on behalf of their scheme beneficiaries, and their investment positions will expand when more join the schemes regardless of the prevailing market sentiment. As a result, with more market participants from diverse groups such as investors, hedge funds and market makers, market trends may become too noisy to identify. The level of noise tends to be higher in markets in which access is easy.

Over the past 20 years, the level of noise has shown an increasing trend in most regions except for the Latin America. Generally, the increase of noise indicates the improving maturity of the markets along with greater participation.

Noisy Markets

Mr Kaufman argued that the level of noise can be used to determine investment strategy. When a market is "noisy," mean reversion trading is the best strategy.

When there is little noise, trend-following should be the employed approach. Using empirical studies on Asian markets, Mr Kaufman noted that the profitability of the trend-following strategy is negatively correlated to the level of noise, which is consistent with his theory.

“If the market has the same net movement but has more noise, it takes you longer time to identify when to get in or out, and your net profit gets smaller. It is what happens progressively in the US stock market,” said Mr Kaufman.

Interest Rate Variable

Turning to interest rates, Mr Kaufman said that they “drive the performance of global macro-hedge funds. Central bank policy follows the pattern of, for example, easing rates a little, then watching to see the reaction, then easing again. These create sustained trends, first in the short maturities, then longer, then in FX and less in the equity indexes. But interest rates are the key to understanding the major price moves.”

It’s all Greek

Asked about the hedge-fund industry and its role in the global financial downturn, Mr Kaufman said that hedge funds and derivatives had been unfairly maligned. He used the near collapse of the Greek economy to make his point. “After all, they didn’t make the rules that allow Greek workers to retire at 53 with 80 per cent of their salary,” he said. “It seems just another ‘not my fault’ position. Credit default swaps simply give the investor a chance to express their confidence in the Greek government, or to protect any investments they might have in Greece.”

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