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AM
FX

Tactical Global Macro

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Penguins have long necks … and they have knees.

Current Views

Flat

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Day One advice for new hedge fund PMs

Over the last six months, there has been a mass influx of new hedge fund PMs. Many of these traders have left bank trading seats to explore potentially greener pastures. I have occupied both seats, and so today I offer some advice to all you new hedge fund PMs. I present this advice with the utmost humility; I have had plenty of good years and plenty of disappointing ones.

Here goes:

1. **Understand the metagame.** Your contract probably has a stop loss in it, but you should also be 100% certain what your real stop loss is. The two numbers are probably not the same! Also, what kind of intraday, daily and weekly volatility will your boss find mildly, or very disturbing? There are the printed rules of the game and then the actual rules. Make sure you know both. Stay away from management pain points.

   Your first goal is to prove yourself as a good risk manager. Self-policing is important. Nobody wants a phone call from management, ever… But especially not in Year One.

2. **Start slow.** You want to show the firm what a good hire you are by putting up a 3% return in Month One. If anything, though, that will probably set off alarm bells for high volatility, not elicit high fives for stellar returns. If you are going to succeed at a hedge fund, that success will be measured in years, not months. Play the long game and get settled before you get aggressive. There is substantial path dependence in a hedge fund seat.

   Sprinting out of the gates is a bad strategy!

   No matter how strong your view when you sit down on Day One, there is too much path dependence. You cannot be max aggressive. Even if you are placing what you think is an 80/20 bet, if the 20% comes up, you are hobbled, your confidence is impaired and that can threaten your liftoff. It's not worth the risk.

   Start slow, build the base and be like a call option with limited downside and unlimited upside. You cannot have the same risk appetite on Day One with zero P&L in the coffers as you can have on Day 274 when you are up 15 million dollars. In an ideal world, you should always vary your risk appetite based on conviction and market opportunity. But in the real world, you need to start slow and build risk over time.

   Also, there is something special and scary about the zero bound in P&L. Let's say a hypothetical trader named Steven Kirk wants to make $10 million this year and his stop loss is $4 million. He will find that going from +$2 million to +$1 million feels significantly less bad than going from +$500k to -$500k, even though both are P&L declines of $1 million. Any red number next to your name feels bad. This is consistent with loss aversion theory which tells us that if a gain gives us *x* pleasure, a loss of the same magnitude gives us *2x* pain.

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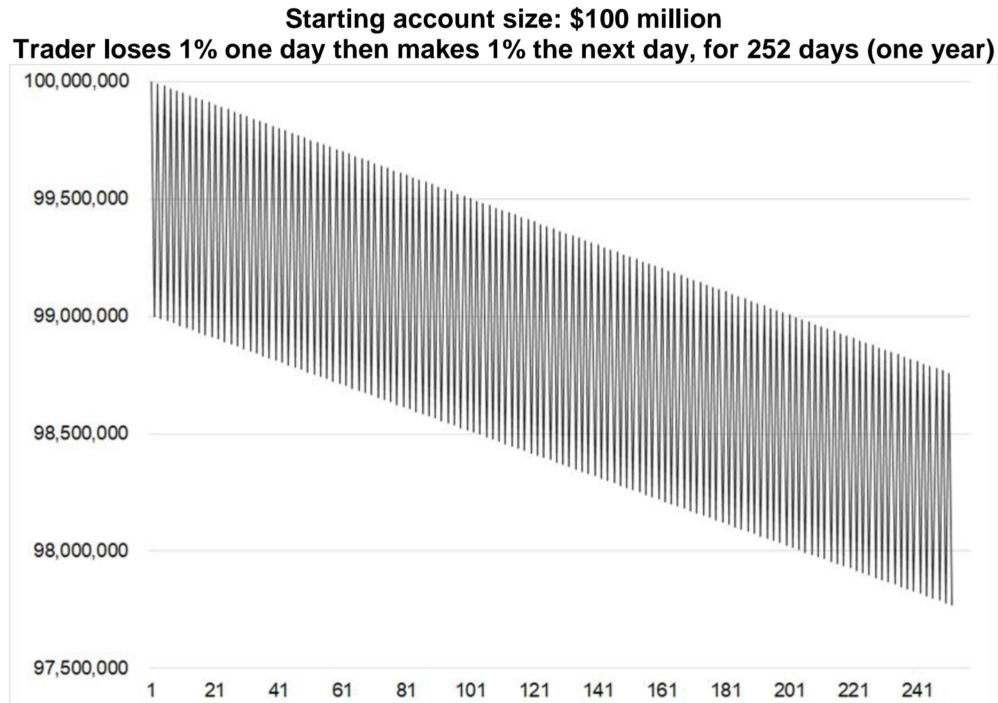
This is not all just psychological, though. As Steve's P&L falls below zero, his ability to take risk (his leverage) decreases. There is a non-linear real-world impact of losses as he moves below zero and closer to his stop loss. When you are below zero P&L, you wear a slowly-tightening straitjacket.

Remember: even if your stop loss is $4 million, you are in big trouble trading-wise way before then, because you will need to reduce your position size in order to avoid getting the shoulder tap. Also, if you start with a big loss, you run into the Problem of Percentages. As you probably know, if you lose 1%, you need to make more than 1% to get back to flat. That's annoying. Here is a chart for your enjoyment:



This volatility drag is painful and important.

The goal is to get safely away from the zero bound and then when a mega-opportunity arrives and you have a cushion… Go for it. If Steve is +$1.5 million on February 25 and there is a fantastic opportunity, he is in a position to risk a bigger chunk of cash on the idea without worrying about sinking underwater.

3. **Play your own game.** Nobody is watching you as intensely as you are watching yourself. Don't avoid a trade because it "seems dumb" or is too micro, etc. Your job is to make money and generally the only thing your boss cares about is your vol and your P&L. Do you want to be smart, or make money?

4. **Avoid style drift.** If you have been a spot FX trader your whole life, and you go to a hedge fund, your brain is going to be like: "Whoa look at all these flashing numbers, this looks fun!" Kid in candy store. Don't start piling into a short wheat position just because you can. Of the people I have seen rapidly and unceremoniously booted from hedge funds, style drift was often a big part of the story. They hired you because you have an edge in your product(s). Yes, there is a lot to learn by touring other assets and markets, but make sure you spend most of your time focused on markets where you are expert.

5. **Be careful when they increase your capital!** When you perform well, you will probably get an increase in capital. Remember that you are trading and getting paid in dollars, not basis points. If you make 10% on your initial allocation of $100 million, then they up you to $200 million and you lose 5%, you're back to flat. That's not good! If your allocation doubles, don't just double all your position sizes right away. Scale into your new capital.

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Also keep in mind that the moment your capital increases is the moment you are most likely to be overconfident. A) You have been crushing, otherwise the increase would not have happened in the first place and B) the increase itself is strong validation for your ego. Don't be overconfident! In fact, the day you get an increase in capital, you should turtle a bit and get defensive until the overconfidence risk passes. Time is the best cure for every extreme emotion.

6. **Identify where the world is in the macro cycle.** Are you joining as a commodity PM in 2012? As an FX carry trader in 2006? As an oil trader in 2016? The fact that you have been hired to the role you were hired for might have information content. Also, unless you are a very short term trader, the stage of the cycle should impact your trading bias. In early 2009, after the Fed, Treasury, Europe and China changed all the rules, one famous investor put a Post-It note on his monitor that read "Long or flat". Depending on what product you trade, a similar Post-It might be appropriate.

7. **Find other ways to add value.** Sure a PMs main value is the P&L, but people that add value in other ways have more runway. Be an information hub, volunteer to meet investors, overcommunicate with your risk manager, walk around the floor and get to know people. If you are more than just a number, your implicit stop loss is wider and you have a greater probability of success. Furthermore, there is information in talking to people. If 19 out of 20 PMs at your firm are bearish stonks, it's time to add to your longs.

8. **Relax and have fun.** It's hard to have perspective when you sit down at a hedge fund for the first time. On the one hand, the stakes seem higher than ever. That is scary. On the other hand… You made it! You're living the dream. Look around and see how far you have come. You are probably there for a reason.

Believe in yourself, relax and get to work.

Have a wise day.

Good Luck ↕ Be Nimble

Thank you Marwan and Paul for their contributions to this piece. The first draft only had five points, so three of the ideas in here were their direct contribution.

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Owls have long legs.

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