

## The EurekaHedge Monthly

Interview with Paul Mulvaney, Principal of Mulvaney Capital Management

EurekaHedge

Mulvaney Capital Management is a London-based commodity trading advisor, regulated by the FSA in the UK and the CFTC in the US. The program is a long horizon systematic trend-capturing program allocating capital in all major sectors of the financial and commodity markets.

### 1. *How do you define your approach?*

Systematic trend-following with an extremely long-term investment horizon.

### 2. *What are the essential elements of your system?*

The system essentially buys into uptrends and sells into downtrends across a broad portfolio of financial and commodity markets. Its edge lies in its ability to capture more of those trends by being extremely well diversified, and to distinguish between noise and the significant price action that might justify a position reduction. In simple terms, we tend to stay in trends longer than other traders.

I started to develop the 'bones' of the system back in 1995 while I was trading options at Merrill Lynch in New York. I experimented with a wide range of technical trading rules and came to the conclusion I still adhere to: simple works best. That's an empirical observation on my part, but it's a contention I have encountered repeatedly in the enlightened literature. (There are, of course, snake-oil salesmen who write overly complex books on technical trading methods!)

Over time, I improved the system by applying conventional mathematical solutions to trading problems -- for example, how to weight instruments to take into account correlations. By 1998, it had crystallised and become largely similar to the current form. It is still driven more by econometric considerations than by technical analysis.

### 3. *What are the key characteristics of your trading approach, and how do you differentiate yourself from your peer group?*

Trend-following is a well-populated style group, but by no means homogeneous, so it's difficult to categorically define my peer group.

We are quantitative and systematic, very broadly diversified, and have the longest time horizon of which we are aware. On average we have held positions for six months.

Econometric price distributions are the key motivation of our trading approach, especially fat tails. From studying price return distributions we can gain all sorts of insights into what is or is not likely to work - insights that are not apparent in conventional price charts. There is a huge battery of quantitative techniques (generically 'options theory') which can be applied to trading futures.

The use of options theory is integral to the system: the return stream generated by the system is just a manufactured or synthetic derivative of price action. It can be evaluated and hedged like any other derivative. Bear in mind that the Black & Scholes framework is much more than a call or put option formula: it describes a system of dynamic relationships. Applying options hedging techniques to trading futures led me to develop a probabilistic trailing stop mechanism.

I am very committed to systematic as opposed to discretionary trading. Being systematic enforces discipline and the need to develop a framework.

Fortunately - since I have run the system and executed the trades for over 1,200 consecutive trading days so far - I still relish the trip to work to run the system. It's the highlight of my job.

I run the signal generator every morning, analysing data when most of my markets are closed. The process takes about 30 minutes. I could automate it further, but the balance is perfect as it is; the current procedure allows me the minimum interaction with the market that I consider necessary.

Typically, we do four trades per day, and we do not react to intraday price action. On average we hold 40 positions, but this can vary between 34 (lowest since inception) and 45 (due to the relatively small size of our asset base, the full instrument set).

4. *Which markets do you trade and do you have a core market?*

There is no such thing as a core market for us, since by nature we are diversified to capture any trends which may emerge.

We trade all market groups, and are active in 45 different markets at present. These allow us to pick up all the major independent sources of alpha. We plan to trade a few more markets for market access reasons when our AUM grows. We trade all markets with equal portfolio emphasis. For example, we don't regard interest rates as more or less important than livestock. The optimal mix of markets is determined by the system's asset allocation algorithm.

5. *Describe your stop-loss process.*

Our goal is to deliver an average net return of 20% per annum, while not exceeding a 25% drawdown. This constraint drives the stop-loss degearing rules.

More fundamentally, though, we only ever exit positions after adverse price action to ensure we don't suppress the profit potential in the few really big trades that come along. Thus, we don't exit positions at target prices or try to lock-in profits. My research has shown, within my paradigm, that would be detrimental to performance.

The stop-loss mechanism is based on probability theory and is applied automatically across all trades in all markets. In layman's terms, the more probable it is that a trend has ended, the more of the position the system exits. In options terms, the system regards stop-loss orders as short options positions and chooses strike prices that ought to be relatively easy to manage. Stop losses are never manually overridden. That would be an absurd notion, given the amount of research time I have devoted to designing a labour-saving computerised solution.

I would argue that the most important thing is not entry price, which gains so much attention, but the method used to exit. Exiting losing trades is trivial; exiting profitable trades takes a little more thought. Typically, only 20-25% of our trades are profitable in the long term, but these tend to be very big winners.

#### *6. What's your background?*

At school I was among the first generation of mathematicians who programmed computers. I remember literally punching cards in the late 1970s. The cards got sent away to be run on a mainframe computer and we got the results a few days later!

I studied computer science and mathematics at Manchester and then completed an MSc in management science at Imperial College, London. Unsurprisingly, the course at Imperial had a very quantitative bent. When I graduated in 1986 there was a big push by the banks for quant graduates, so I found myself beginning a career in finance.

I've always focused on trading derivatives. I began trading with Midland Montagu in London for four years, then moved to Bankers Trust in London and Tokyo for two years, then to NatWest for a year and then to Merrill Lynch in London and New York for six years.

#### *7. What makes a good trader in your opinion?*

Discipline and objectivity, without a shadow of doubt, would come first on my list. They are characteristics an individual is born with, but they must be developed.

It takes discipline to repeat the same, often mundane, tasks day after day, and my trading approach is about dogged consistency, rather than flashes of inspiration. Also, an immense degree of objectivity and lack of emotion is needed to systematically develop a methodology and adhere to it. In the early stages of system design I had to battle to believe what the numbers told me, rather than what my prejudices told me. Trading is about what 'is' happening rather than about what 'should be' happening.

8. *What is the maximum capacity of your strategy?*

The MCM system trades extremely infrequently. Without any adjustments to the technical trading strategy, but accepting a slightly lower weighting to tangible commodities, we could absorb \$500 million. However, in the long run, I plan to introduce a number of modifications which would allow us to trade significantly more than that. Firms operating similar strategies manage billions of dollars.

9. *Do you have a typical investor?*

No. Our investor base is very diverse. We have several pension funds, several funds of funds, a private bank and a growing number of high net worth individuals. We have investors on three continents - this is a global business.

10. *What are your plans for 2004?*

I'm pleased to say we had an excellent 2003, nearly doubling our AUM and delivering 29.28% net of fees. Since the program's inception, we've returned an average of 19.54%. None of our marketing people were in the saddle on 1 January 2003 and we're only just beginning to see the fruits of their efforts. So in 2004 we expect to at least double assets again.

We plan to make a number of strategic hires in the coming year, including a senior professional on the business side and a trader on the investment side.

We're also in the process of obtaining a Dublin listing for the MGM Fund. This should be completed in the first quarter.

*Mulvaney Capital's Global Markets Fund is domiciled in Bermuda, with Refco as clearing broker and Argonaut (Bermuda) as administrator.*

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