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Diversified trend follower

Advisor tries to capture long-term volatility

By Michael Fischer

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Vital Statistics

Assets under mgt	\$4.8 million
Minimum investment	
Global Diversified Program	\$25,000
Managed account	\$5.0 million
Registration	SFA; CFTC
Fee structure	
Management fee	2.0%
Incentive fee	20.0%
Avg commission	\$12
Ratios	
Avg margin-to-equity	18.4%
Ann comm-to-equity	1.8%
Roundturns/\$M/million	1,500
Auditor	
Melvyn Davies & Co	December 2000

Before opening his own firm, Paul Mulvaney worked for several derivatives trading firms, including Bankers Trust and, from 1993 to late 1998, Merrill Lynch in its debt, foreign exchange and tangible commodities sectors, structuring and trading options on all those underlying markets.

Mulvaney Capital Management opened in March 1999 with a service agreement with GNI in London, which manages the trading advisor's Mulvaney Capital Global Diversified Program. GNI provided initial seed capital for the program, and continues to raise assets for it. In addition, it provides a risk management overlay and more standard administration and infrastructural support.

Mulvaney is currently the only employee of his firm, but expects to hire a professional soon to focus on nontrading aspects of the operation, which have outgrown his ability to manage alongside the trading and research.

Broad diversification

The trading program's basic strategy is diversified, long-term trend following. Mulvaney initially considers all the liquid financial and commodities markets that trade futures, then narrows down the field to 150 markets by eliminating those that don't have enough open interest and those that don't have a developed options market.

Next he runs an algorithm to weight all these markets appropriately, which takes into account cross-correlation and volatility. He also tweaks the theoretical outputs from that algorithm to adjust for the fact that he currently manages only about \$5 million; he cannot afford too much fractionalization of the contracts, he says.

At the conclusion of this winnowing

process, he ends up actively trading some 50 markets, with the intention of breaking each individual one into its prime components. He cites, for example, the yield instruments in the US and Germany.

The German 10-year instrument, he says, has a German component and a 10-year component. His asset allocation algorithm tries to determine exactly what the magnitude of each of those is. Ultimately, when he groups together the 10-year yield components in the different jurisdictions, he does not end up with an overweighting in that sector. Likewise, he would also be concerned about his overall exposure, say, to the US yield curve.

Many of the algorithm's output weights necessarily are mathematically trivial, says Mulvaney, noting that markets such as coffee and sugar really do not correlate to anything else. Ultimately, he says, these just become more of his standard weighted units.

The financial sector, on the other hand, presents a complex problem, he says. Cross-correlations exist between every two instruments, and those correlations shift over time. As a result, the program's asset allocation has to be run dynamically.

The program's average holding time for a trade is five months, and winning trades average around one year. Mulvaney's timing system looks for initial statistically significant breakouts and then adds capital incrementally in any given market so that his initial commitments of risk capital are very low. He tries to build on a position as and when he has unrealized profits that allow him to do that.

In his view, there is long-term volatility that manifests itself in major price dislocations in markets. Take oil, which

went from the low teens in Q1 1999 to the mid-\$30s in Q4 2000. Or the euro, which dropped from \$1.17 in January 1999 down to \$0.82 in October 2000.

"These are big moves, and it's that kind of long-term volatility that I'm trying to capture."

But at the same time, his defensive strategies are focused on avoiding short-term volatility, which also exists and can swamp the long-term trendiness. A recent example of this short-term problem is in the gold market.

Gold was under pressure this year until early April, drifted, spiked in mid-May from the mid-\$270s up to above \$290, then came right back down again to its current \$260 level. Like many trend followers, he was stopped out of the market.

Mulvaney says this is an example of very violent short-term volatility that goes beyond what he can avoid being disturbed by. But he adds that, while there was a massive move involved and he had the fullest position on at the lows, the overall loss wasn't significant in the portfolio because his strategy is so diversified.

"Mature trending markets are susceptible to price reactions," he says. And this is an area on which he intends to focus much of his research attention.

Beyond his broad diversification, long-term perspective and incremental capital allocations, Mulvaney takes a proactive approach to risk management by operating strict stop-loss levels on every market; these are based on market volatility and technical structure.

He also massages the global leverage in the portfolio: If he has a 15% decline, he will ensure that his position size drops faster than the rate at which the capital has been run down. He tries to stay ahead of the curve, he says.

High points and low

The program has a compound annualized return of 14%, which compares very favorably with the median of the Zurich diversified subindex. The program is volatile. Annual standard deviation is 27%, but downside volatility is at

Mulvaney Capital Management Ltd

PERFORMANCE HISTORY

May 1999– April 2001

	Global Diversified Program	Median of Zurich Diversified Subindex	S&P
Return (%)			
Annual comp rate	13.98	4.50	(2.09)
1999 (8 mths)	1.09	(0.92)	11.00
2000	24.51	10.73	(9.09)
2001 (5 mths)	3.21	(0.44)	(5.01)
May estimate	(0.72)		
Risk (%)			
Annual std dev	27.41	17.01	17.75
Semideviation	16.03	10.09	12.11
Maximum decline	(15.25)	(15.80)	(23.04)
Return/Risk			
Sharpe Ratio	0.32	(1.00)	(1.00)
Comparison with Zurich Diversified Subindex			
R-Squared	0.42		
Alpha	0.23		
Beta	1.87		

a slower rate of 16%.

The program recently came off its worst month since opening two years ago, a decline of 15.3% in April. The loss, says Mulvaney, was driven primarily by the financial sector, where it experienced reversals in currency markets (on large exposures in the yen, the Canadian dollar and the Australian dollar) and in bond markets worldwide and short rates.

The program also took small losses in the stock index sector. In the tangible sector, cocoa had rallied about 55% from its low to the end of March, but eased in April because of weather changes in West Africa. Silver and gold rallied against what had been the prevailing trend. And in the livestock sector, cattle and hogs in which he had been long eased as the foot-and-mouth crisis in Europe abated.

"Ultimately, the major losses were in the financial sector; but losses piled up because totally uncorrelated markets reversed as well."

Bad as that was, Mulvaney takes heart from the program's performance on a rolling one-year basis through March 2001: a gain of 70%.

The program had excellent returns in fourth quarter 2000, gave back some of

that in January, then surged ahead in February and March. In November and December 2000, the program was long natural gas, which also explains January's loss because there was a pull-back in natural gas.

Also in the fall of 2000, the move in short-term interest rates accelerated. And a short position in the yen was a good trade through the end of March, as was the Australian dollar. Other winning positions during that period were precious metals and cocoa.

Looking ahead

Until recently, Mulvaney has been managing approximately \$5 million in GNI client money. GNI plans soon to launch the GNI-Mulvaney Fund (in Grand Cayman and Delaware versions) with \$5 million in seed capital from GNI's parent, Old Mutual.

Longer term, other products are in the pipeline. Mulvaney is currently doing research that he hopes will allow him to use options much more widely. That may involve some modifications to the existing Global Diversified Program, but more likely will give rise to a separate program when he can identify investor appetite. ■

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