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How Lipschutz downsized to bigger things

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By Helen Avery

Bill Lipschutz was once considered one of the world's top-five FX traders. Now managing currency hedge fund company Hathersage, he talks to Helen Avery about why FX is catching the eye of institutional investors and how he sees the trend developing.

"ONCE A DEALER, always a dealer", was once the motto of the Association Cambiste Internationale, the international society of foreign exchange dealers headquartered in Paris. For Bill Lipschutz, principal and director of portfolio management for currency hedge fund company Hathersage, nothing could be truer. Lipschutz joined Salomon Brothers as a newly graduated MBA in 1982 when foreign exchange trading was the realm of commercial banks, and in just six years he built an unparalleled FX trading business at the investment bank.

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Bill Lipschutz

By the mid-1980s Salomon held more than 50% of the FX option open interest (outstanding open contracts) and accounted for 50% of the daily FX option trading volume on the Philadelphia Stock Exchange, at that time the premier marketplace for FX options trading. By the end of the 1980s, Salomon was making as much money with 21 traders worldwide as Citibank was with 70 dealing rooms, and Lipschutz was regarded as one of the world's top-five FX traders. When he relinquished his position as managing director and global head of FX in 1990 it was with the intention of taking early retirement. But within 14 months the lure of the markets was too much and Lipschutz and a team from Salomon set up their own currency trading hedge fund company.

“I was taking a few courses at NYU, Lewis [Broad] and I were doing a bit of trading on our own account and thought why not try this as a business with more personal flexibility than we would have at a large company,” Lipschutz says. “So we set up two programs – one that trades spot, one that trades spot and options. Initially we started with all of our own money. Although ultimately we essentially replicated our operation at Salomon, it took us nearly 18 months to properly develop the necessary internal procedures and controls, accounting practices, documentation and the like. We even had to rewrite our pricing models from scratch.”

Given its 15-year lifespan, Hathersage is relatively small. It runs just under $200 million on behalf of 14 clients. Lipschutz is the principal trader, operating out of his spacious apartment in New York’s trendy NoHo precinct where he has lived since his days at Salomon Brothers. It’s where he invites clients, and as such it seems more of an office than a home. There is the obligatory black leather couch, the works of art on the wall and a handful of trading screens and telephones. The seven other employees – a second trader, a risk manager and compliance officer, a director of research, a director of client services, two trade support people and an IT manager – are located elsewhere in Manhattan, on Long Island or in Connecticut. All met as students at CornellUniversity, at Salomon or socially and have known each other well for almost 20 years. “Most of us started out at big firms,” says Lipschutz. “We decided that we wanted this to stay small, geographically flexible and extremely focused. Each person’s role is very specific and each person is very experienced and very good at what they do. In the early 1990s even a small operation had to have formal offices and lots of visible support staff – I call it ‘the mahogany and marble on Park Avenue look’ – in order to begin a dialogue with institutional investors. That isn’t the case now – large or small, virtual works.”

When Lipschutz and his colleagues founded Hathersage it was easy to be small. FX was not widely seen as an asset class but was mostly traded as part of an overall portfolio of market exposure by global macro traders and hedge funds. And most institutions used FX as an overlay to hedge currency exposure elsewhere in their portfolio, often hiring an external FX overlay manager. Over the past two years, however, interest in foreign exchange as a separate asset class has been increasing. It’s part of the universal shift to searching for alpha – by investors looking for returns or multi-sector managers wanting to diversify their products.

A truly relative market

FX is indeed an attractive market on its own account. It is highly liquid and is a truly relative market, unlike the stock market, which has an inherent long bias. “One currency is always bought against another, so in all cases the bet is relative – that one currency’s exchange price will appreciate or depreciate versus another. There is no long or short,” says Lipschutz.

Studies also suggest that currency markets have no beta and that all profits derived from trading FX in active management are considered to be from alpha or manager skill. That makes it extremely attractive to institutions wanting to port alpha onto other asset classes. “We are looking at possible structures with commercial banks that hold portfolios of bonds,” says Lipschutz. “They are looking at holding bonds whose coupons would be indexed to Hathersage’s trading in FX.”

Lipschutz is a discretionary trader, trading solely in G7 currencies; he believes such trading has recently become more attractive to investors. “When I came into the market there was no on-desk computing power,” he says. “Nor were there any robust databases that could be used for backtesting. We were essentially all fundamentally based macro discretionary traders at that time. We all read a great deal of economic analysis, gathered new information continuously and maintained extended networks of peers who we could ‘what-if’ with. Today there are readily accessible databases that provide historical 24-hour price data at five-minute intervals going back 15 years or more, so naturally many, many systematic traders have emerged. In fact the barrier to entry had become so low that for a period in the early 2000s, virtually all new FX traders and FX advisories were systematic – it was no longer deemed necessary to have developed a global information network or to have experienced several global economic cycles and weathered several financial market meltdowns.

“I don’t believe that anyone has the key to the kingdom. There are many ways to get from point A to point B. As such, I believe that true portfolio diversification cannot be achieved using only systematic active currency traders. It has been demonstrated that many FX systems have shown a tendency towards high correlation with one another – particularly during periods of financial market stress. Allocators understand that the inclusion in a portfolio of discretionary FX managers, who as a group tend to be non-correlated with systematic FX managers, is desirable and are acting accordingly.”

Lipschutz also argues that most systems have an inherent bias in them, leading to certain kinds of trades. “It is well acknowledged that the most profitable market environment for FX trading is a trend – in particular a trend that unfolds over a medium- to long-term time horizon,” he says. “Generally, systems are designed to capture a trend. A key to profiting from a trend is the ability to stay in the trade and not be shaken out during periods of price consolidation or correction. If the system is holding a positive carry trade, it will be easier to stay in that trade over time, as the positive carry accrues to the position. Conversely, if the system is holding a negative carry trade, it will become increasingly difficult to stay in the trade over time as the negative carry weighs on the trade’s profitability. It stands to reason then that most models will have a bias towards holding positive carry trades.” Discretionary guys are reliant on differing information that means there is not that rigid bias.

Lipschutz predicts that institutional investors, rather than entering the currency market through fund vehicles, will opt to invest through managed accounts. Funding makes much more of a difference in FX than, say, equities. Hathersage is set up to offer only managed accounts for a variety of reasons. Managed accounts allow each mandate to be tailored to the individual client and have enabled the firm to focus on trading, rather than portfolio valuation and handling of money.

"An investor can set up their account at the financial institution of their choice, which will then extend them the terms of collateral for that account," Lipschutz says. "Usually an investor will only be required to provide collateral equal to a small fraction of the notional value of the account. Sometimes the financial institution will make a pure credit extension. We're not involved in any funding transactions – we do not handle client money. Once trading begins, the financial institution will value the portfolio every day, usually on a real-time basis, as they need to know what their own credit exposure is to the investor at all times. We report performance and calculate fees based solely on that third-party mark to market, so the issue of portfolio valuation is also off the table for us."

Risk management benefits

For investors, managed accounts have benefits from a risk management perspective. Lipschutz says: "In FX, the collateral required by banks can range from none to 3% depending on an investor's relationship with the bank. Given that the bank will track the valuation on a real-time basis in order to protect its own interests, it will certainly liquidate an account portfolio before the value of the collateral can be lost. In a pooled vehicle, however, an investor has to put up the entire notional size of the investment. While it is true that an investor could not legally be liable beyond that amount, the investor will in fact always have a great deal more capital at risk in the so-called 'limited liability' pooled vehicle format. Furthermore, in a managed account, as the investor doesn't have to put up the entire notional size of the account, he/she can invest the difference between the notional account size and the required collateral amount elsewhere. In a pooled vehicle, the manager will invest the cash, usually in T-bills – currently yielding 5% – and then charge a performance fee on that interest earned. Clearly, institutional investors are looking at these differences very closely."

Hathersage offers its investors further loss-reduction provisions by keeping leverage on average at less than one times notional investment size and by using options. Lipschutz has grown up with the options market. "When I started, the equity options market was undeveloped, the FX options market was non-existent," he says. "Indeed I got my position at Salomon based on the fact that I had specialized in options theory in graduate school. These days nearly all business graduates have an understanding of options theory. As late as the early 1980s equity options at Salomon and elsewhere on Wall Street were used either to hedge positions on the bloc equity desk or to express a limited risk directional view on an individual stock. For example, if the bloc desk ended a day long Texaco and Shell stock, we needed to hedge that exposure. But the firm might have already been at exchange position limits in Texaco options (at that time there were limited over the counter equity options available) while at the same time Shell options might have been deemed prohibitively expensive. So what would we do? We might buy an array of Chevron options – various strikes and maturities. But what mixture? The precision of the hedge was not important. An overall reduction of risk was. And so I developed an ability to think in gross hedging terms. To begin with, I knew nothing about

FX, but knew that through options I could always know what my maximum loss would be. It worked out well."

By using options and a drawdown overlay, Hathersage's monthly drawdown is strictly limited to 5%. "We all think we're smarter than the market from time to time," Lipschutz says, "and traders really do get married to their positions. Not limiting downside variance is a sure-fire way to put yourself out of business. Investors want a product that won't blow them up.

"In a portfolio of net long options, potential losses are limited. As our portfolio is not highly leveraged, we seldom lose a great deal of money all at once. To get down even 2.5%, we have generally had a succession of losing trades, and at that point it is usually clear to us that we are not in sync with the market, so we often neutralize (delta-wise) the portfolio around that drawdown level. If that doesn't stop the bleeding, then we start liquidating. We only trade in G7 currencies so it is easy to get out. We've been down 5% just one month since inception. But we've been up in excess of 10% six months."

It's a far cry from Lipschutz's time at Salomon. "There were risk management tools in place, but Salomon was committed to nurturing young traders," he says. "I had a lot of rope. There was a loss limit that each trader was allowed before being fired, but none of the traders were actually told what that limit was. Indeed, I found out later when I became management that, when it came to developing traders, loss limits varied from trader to trader depending in large part on their individual ability to manage the stress of what they were doing."

The chances of losses in active currency management as it becomes more popular concern Lipschutz. He says: "Institutional investors looking at active currency management are sure to turn to their currency overlay managers with whom they already have a relationship. And the overlay managers are bound to say: 'Yes, we can do that'. But the reality is that the two types of currency management require different skill sets. One is concerned with risk reduction while the other is risk seeking. These are two different mandates. And on the manager side, more are becoming aware of the attractiveness of active currency management, but they have very little experience. After 10 years of an abnormally low global interest rate environment, rates are now rising across the G7 and volatility is increasing. That means managers that are new to the game are likely to make a few mistakes and they could be costly."

Dilemmas of growth

As the market is growing, Lipschutz himself finds his firm in a difficult position. Hathersage was set up to focus solely on trading, offering a small number of clients a personalized service. Lipschutz clearly lives to trade, indeed there would be little to stop him from taking on more assets if he wanted to grow the firm. He has the experience of running $3 billion to $5 billion in open positions after all. "It's not about the zeros," he says. "We know that our approach works with big numbers."

As a result, Lipschutz and his partners haven’t been actively marketing their services, but it seems inevitable that the firm will have to reconsider its stance.

This partly explains Lipschutz’s decision to return to the public eye. More than most, he knows that in times of competition money talks. He says: “To be a relatively small player puts a lot of demands on your service providers – the sell-side banks and other financial institutions. As discretionary traders, information is our lifeblood and we need to trade large enough volumes to continue to command the attention of our counterparties, and to make it worth their while to exchange timely information.

“We’ve always thought of ourselves as a trading firm, but we’re in a changing environment now in active currency management. We have to be prepared to service not only our existing, but also potential clients and we’re putting the resources in. Still, for me, it’s about getting up each morning not knowing what the markets are going to be focusing on. Interest rate differentials, GDP, trade deficits, political uncertainty? We have to figure it out every day. It’s always fun. It’s always interesting. That’s really why we set up Hathersage and why we continue to do what we do.”