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36 South's Jerry Haworth: Every Ten Standard Deviation Event Starts Life At Two

by Robert McGlinchey

The recent global equities downturn following the U.K. electorate's decision to vote Brexit in the European Union referendum last week is yet another example of the market following a very similar pattern to that of 2007/2008, according to Jerry Haworth, principal and CEO of 36 South Capital Advisors. He noted that the fund is sticking with its tried and tested monetizing strategy as complacency in long-dated volatility persists despite recent downward spot pressure.

"The first thing I do notice in this market is that it is rhyming with 2007-2008. So, for example, last August China shot across the bow, followed by a rally into Christmas, then there was a weak January, then a rally right through May to the beginning of June and a pull down in the last few days. That's quite concerning," said Haworth. "Long-dated vol hasn't gone up as much as short-dated vol and we have seen that trend time and time again in the past. What really happens to long-dated vol up until 30 is everyone plays the whack-a-mole and beats it down again. When there is a substantial move through 30 then you'll see long-dated vol pick up again."

Following the results of the E.U. referendum vote on Friday, the Eurostoxx 50 dropped to below 2,700, the cusp of the range of peak vega in the index, which participants say is between 2,400 and 2,700. As spot declines, autocallable products referencing the index breach their knock-in barriers and subsequently having an effect of driving long-dated volatility higher. This is because the vega begins to fall off at a much quicker rate from the exotic books exposure to autocallable dVega/dSpot risk, causing those desks to buy back vols at a quicker rate.

Despite the decline in spot, long-dated vol in the Eurostoxx 50 has yet to gap higher. According to JPMorgan strategists, they expect 2,600 and below to drive a change in dynamics to a spot down / vol up regime in long-dated volatility. However, moves by portfolio managers to unwind hedges in recent days as spot has moved higher has brought about a subdued effect on vol. "These exotics desks are long vega currently but I think if the market goes down 35-40% that's where I think there will be a radical change in the vol sentiment," noted Haworth.

For Haworth, he is sticking with 36 South's tried and tested strategy and holding off from monetizing positions following Brexit. The fund manager, which specializes in obtaining cheap convexity through long-dated option exposure across asset classes, is well positioned to outperform should an extreme move in spot and volatility occur, he added.

"Some people say why don't you monetize some of what you are making along the way now. Every 10 standard deviation events starts its life out as a two standard deviation event, so we have our own monetization strategy that is tried and tested over the last 14 years and we will stick to that," said Haworth. "The main question you have to address is have you got enough for what your objectives are in your portfolio? So, if the market is down 25% and you want to be down 20%, are you sized correctly and that is key. We don't really put ourselves out there unless we really think there is a grey swan that is mis-valued, i.e. we don't put ourselves in front of specific events as we tend to catch it when it is getting systemic."