36 South's Rich Haworth: Pricing Future Volatility

"Never let a good crisis go to waste." —Winston S. Churchill

At the outset, any thought about future volatility is essentially meaningless. Volatility occurs when something unexpected appears on the horizon. If the event was known it would already be reflected in the asset value and the adjusted price would reflect no volatility. So what do we think about the PRICE of volatility in the future? On this notion we are on more certain ground. We can say with some confidence whether a price is cheap or expensive but we cannot predict whether a position will pay off.

If a croupier at a casino was allowed to vary the payout on a roulette table and offer 100 to 1 on a single number, where the real odds are only 37 to 1, the payout is clearly favourable, even if the odds have not changed. Given enough time the value of the payout will prevail. It is the same with volatility. When the price of volatility is below its long run average it is worth adding to a portfolio for protection and convexity. What then subsequently occurs is in the lap of the gods.

Having said all of the above, we are at the tail end of a 30 year debt and credit bubble that looks as though it is going to end in debt implosion, deflation, war, hyperinflation, or one or more of the above. It is hardly the stuff that low volatility environments are made of. Paradoxically, we have observed over many cycles that volatility forecasting is extremely counterintuitive and the current complacency can be interpreted by more astute tea leaf readers as a warning of an impending tsunami. Despite this outlook, opportunities in volatility at bargain prices are available in certain places, especially if lessons from the past are utilized.

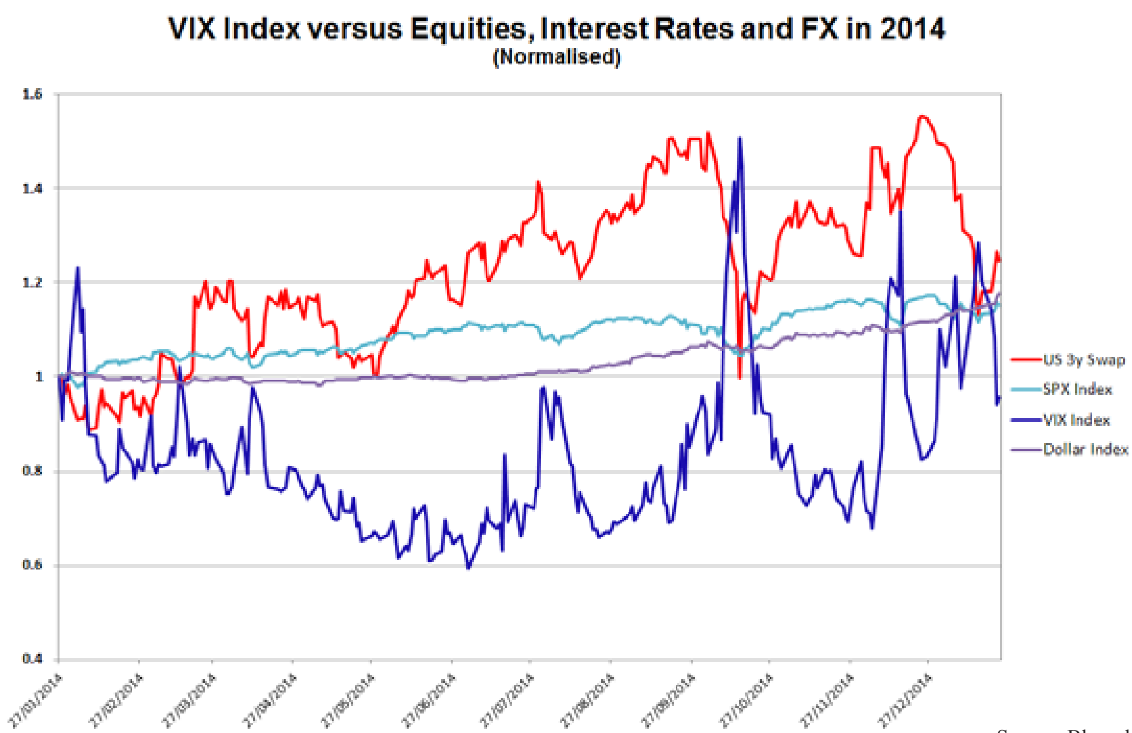
Volatility investing in 2014 was more of an art-form than ever. You would expect that when the VIX spiked in October, the volatility driver was surely equities. But it turns out on the chart of VIX versus asset classes (S&P 500 index for Equities, Dollar Index for currencies and the US 3 year swap rate for interest rates) the major driver of volatility was, in fact, US interest rates.

The point of this illustration is that you may have been invested in instruments that gave exposure to volatility in currencies and equities, but unless you had interest rate receiver swaptions, then you missed the lion's share of October volatility.

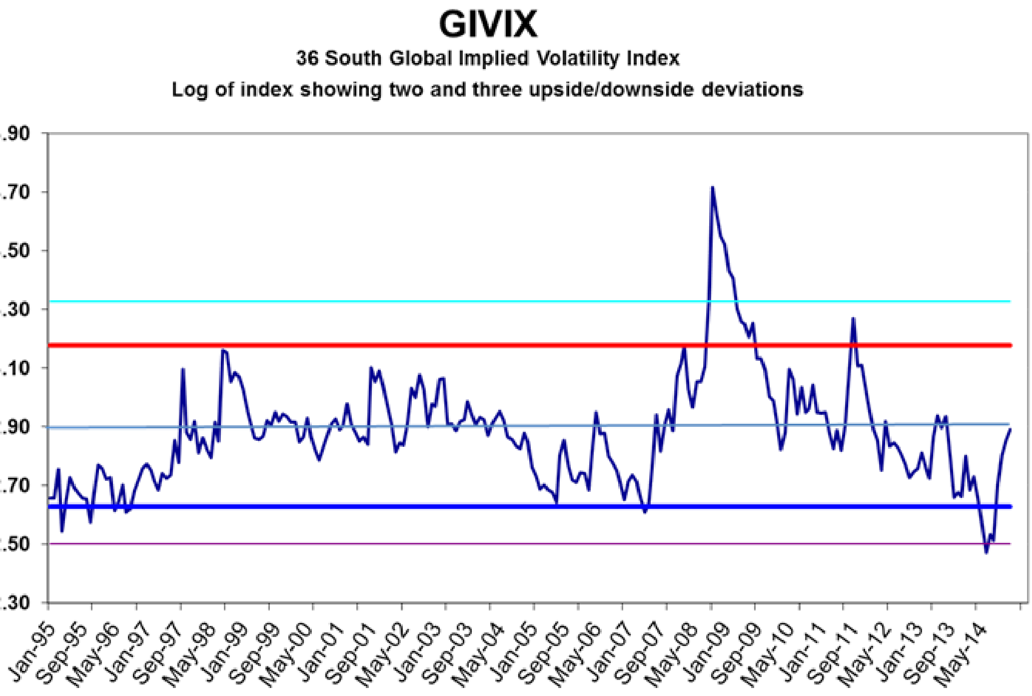
Volatility is no different to other asset classes if one believes that the price paid is critical. Due to the inherent nature of volatility, anticipating volatile events is hard and accurately predicting and timing black swan events is impossible. Fortunately, volatility priced into financial markets is much more predictable, being notably cyclical and mean reverting.

To ascertain whether volatility is cheap or expensive, 36 South utilize multiple tools including their proprietary 36 South Global Implied Volatility Index (Bloomberg: GIVIX INDEX).

The GIVIX uses front month at the money (ATM) implied volatility on a range of financial and commodity markets to give an overall snapshot of the implied volatility surface. The index shows that volatility is below its long term average; however it has risen recently from extremely low levels



Source: Bloomberg



Source: 36 South

in 2014, not seen since 36 South started compiling the GIVIX indices. Only time will tell whether last year was the bottom of the volatility cycle, but at current levels, the price is still right.

Hurdles to volatility investment and tail risk hedging include an aversion to underperformance versus beta in good times, and an irrational bias against negative carry strategies, even at the expense of long term outperformance. However, this prejudice is exactly why investors that embrace volatility as an uncorrelated source of return are able to extract alpha from this space.

As the bull markets in bonds and equities continue, there is greater need for truly uncorrelated and diversified assets in portfolio allocation. Due to the unprecedented actions and policies enacted by central banks in recent years, there is a real risk that bonds and equities correlate to 1, at exactly the wrong time... i.e. the next market correction. This will create the need for a true diversifier that is uncorrelated to traditional assets in times of market stress.

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Weakness in commodities markets and global growth, as well as the threat of deflation hint that interest rates will not increase significantly in 2015. This will prolong access to cheap credit and continue to inflate the next asset bubble.

The best equity market returns seem to be in the years immediately after a stock market crash (like 2009). Volatility investing and tail risk protection gives investors the ability to allocate capital at this critical stage of a cycle. Having long volatility assets in a diversified portfolio gives the liquidity and money required at opportune times to purchase assets at distressed prices.

Rich Haworth

Rich Haworth is an investment analyst at 36 South, where his core duties involve monitoring existing investments and analyzing potential investments. Responsibilities include conducting industry and company specific research and due diligence, and assisting the Investment Management Committee in new product development and implementation.

For more information about 36 South Capital Advisors, visit www.36south.com