Volatility Outlook

Grey Swans: What You Don't Know WILL Kill You

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Formulating an outlook on volatility is akin to throwing darts at a target while blindfolded. Volatile events are inherently unpredictable; otherwise the expected risks would already be priced into asset values. Black swan events by definition are unforeseen. And even though impossible to predict, we can prepare. Grey swan events, conversely, are volatile events that can be anticipated with the use of superior analysis and macro-economic foresight.

Since the onset or extent of volatility cannot be predicted, most volatility investors rely on the assumption that bad news is contagious and expect that, while positions may not be the same, this shouldn't matter if the volatility is systemic and affects other asset classes. However, several volatile selloffs in 2015 were idiosyncratic and not systemically contagious. Such isolated events made capturing these moves difficult. For example, the selloff in German Bunds in May, whilst large on a relative basis, had no spill-over into other asset classes, or even other instruments in the same asset class. The chart on the next page shows the movement in the 10-year German Bund as shown by the Sep 15 futures contract (RXU5). Bund volatility spiked in tandem with the interest rate move, while both the Sterling 90D Sep 15 future (L U5) and the Eurodollar Sep 15 future (EDU15) did not sell off to the same extent. Therefore for a profitable opportunity, the choice of instrument and the trade timing had to be precise.

There are two ways to benefit from volatility; either by buying volatility when it is priced cheaply and hoping for a systemic event, or by positioning for a perceived grey swan event using volatility assets. As mentioned, volatility is notoriously difficult to forecast and black swans are by definition unknown. We need to look no further than last year's price action in commodities.

Oil and most other commodities continued to weaken as concerns over the health of the Chinese economy intensified. To the dismay of resource investors, commodity output was not cut back, despite recent falling demand and negative price action. Additionally, in this low interest rate environment, it was relatively cheaper to service debt rather than close and reopen mines.

Consumption is moving to countries that are more opaque, and pricing is becoming more short term. These factors are expected to lead to a greater level of commodity volatility going forward. But again, if there is no contagion across asset classes – like in the German Bund example – then capturing this volatility will require exact timing in the right asset.

So even though the causes of volatility are normally unknown and can be idiosyncratic, many investors use volatility assets as a diversifier in their portfolio and also as a tail hedge. Tail risks can be effectively hedged using general volatility assets because when 'tails' occur, the underlying events are normally systemic in nature.

Volatility assets have been cheap in recent years where option premiums have been undervalued. This is mainly due to market participants cannibalising volatility premium to enhance yield in their portfolios. So is this a good time to buy volatility assets?

Sometimes it is worth overpaying for volatility assets when positioning for a grey swan event that appears unknown to most investors but seems anticipated by a smart few. The dilemma with purchasing protection against a potential black swan event is that it may or may not be too expensive. The counterintuitive nature of long volatility positioning is that positions are cheap when no one wants them and expensive when everybody needs them. And yet the propensity for large volatility is at its greatest when it comes as an unexpected surprise. This is where exceptional macro-economic foresight is required for timely risk management.

Despite challenging timing difficulties, tail hedges are an important addition to a portfolio. In left-tail events, return of capital becomes more paramount than a return on capital. Using convexity within a portfolio protection strategy allows for a disproportionate, non-linear reduction in risk if bought at the right price, which is further enhanced if correlation is low. Having "a loosely correlated or negatively correlated asset with very little volatility doesn't have the

Comparing German Bunds, Sterling & Eurodollar Sep 15 futures over 2015 (Non-Normalised)

Source: Bloomberg

ability to add significant diversification to an overwhelmingly volatile return stream like that of equities" (Croce, Ph.D, R, Guinn, R & Robinson, T. (2014). The Free Lunch Effect: The Value of Decoupling Diversification and Risk. Salient Whitepaper #2014-01, p.5.). When the cost of left tail protection becomes too great, a larger allocation to cash is usually a better risk versus reward. However, even cash is not safe with the lack of return and potential erosion of purchasing power. Reallocating to cash is primarily a de-risking exercise as opposed to a diversifying measure. The former lowers portfolio return while the latter is more beneficial as it aims to minimise this impact.

One potential grey swan event for 2016 is what happens to asset prices when interest rates rise. This year may see greater changes in forward rates and skew as opposed to volatility levels. As interest rates dropped to zero and below, the forward curve of yielding assets fell into backwardation. With call options pulling to par, this affected skew and volatility and pushed forward pricing into unchartered territory whereby the few assets that provide a stable return in the zero interest-rate policy (ZIRP) environment actually had the greatest forward discount. This may reverse when interest rates increase in the future, and the jostling for position as the forwards are re-priced may come with accompanying volatility. Since the inception of ZIRP, there has been an interest rate tailwind to call option buying, adjusted for, by the market, in the form of skew.

Changes signalled by central bankers regarding interest rate policy suggest that intelligent investors should contemplate what actions the banks shouldn't undertake and then probably accommodate exactly those scenarios in their planning.

Other possible grey swan events in 2016 include China, Brexit and Greece. Chinese economic concerns are far from over, as clearly illustrated in the first week of 2016; the Greek debt tragedy is seemingly forgotten but is still there; and the uncertainty surrounding the impending Brexit vote, all suggest a continuation of idiosyncratic events in markets and a greater possibility of a systemic shock.

Volatility assets are usually priced in response to recent history. This tends to be myopic and ignore larger trends if they lie outside the immediate past. Investors have the tendency to sell volatility risk to produce yield which, when overdone like now, provides exceptional opportunities to invest in volatility assets. Most investors should prepare for black swan events by buying volatility assets when priced attractively. For the privileged few prescient investors with the ability to identify grey swan events, buy volatility assets for positioning in front of oncoming events.

"May the odds be ever in your favour"

—Suzanne Collins

The views and opinions expressed in this article are those of the author and not necessarily those of 36 South Capital Advisors LLP.