36 South Views

BY RICHARD "JERRY" HAWORTH

Volatility is no proxy for risk

Risk reward… yeah right.

Interest rates have gone to zero. This has been so well reported on that there is almost nothing more to say on the matter except that it has sown the seeds of a future tragedy.

But there is a second order effect that, to my knowledge has not even been reported on. As all manner of investment funds watched as their rate of return dwindled, they have increasingly looked to selling correlation and volatility bets in order to produce higher returns.

With respect to volatility, this can and has resulted in a short-term, self-fulfilling prophecy. If there are so many options available on an asset, those who had bought these options tend to dampen volatility in an effort to lock in profits as the markets gyrate. This in turn emboldens writers of options as not only is the realised volatility falling, so is the implied volatility. Hell for option buyers, heaven for option writers!

So zero interest rates have the effect of reducing volatility as a second order effect (and credit as well but that is another story).

Now if volatility is a proxy for risk (which it is although it shouldn't be), then if volatility has gone to zero there is by definition NO RISK, therefore we should invest everything we have in the riskiest assets. Shouldn't we also borrow an infinite amount at positive carry and make the reward infinite? Yes we should!

And yes, investors are doing a similar thing the world over. Volatility is falling as the apparent risk is not even on the horizon.

Risk parity should be at the forefront of the charging of this light brigade.

What could possibly go wrong?

Correlation and volatility, the kind that is bad for portfolios, could return like two of the horsemen of the apocalypse.

Correlation between bond prices and equity prices goes towards one as they both fall, creating severe losses in portfolios and commensurate VOLATILITY as investors and managers panic.

The rise in implied realised volatility creates losses in written option portfolios which in turn create more volatility.

And all because investors were lulled into risky (probably levered) markets in search of yield, emboldened by the fact that volatility is low therefore risk must also be low.

Because volatility is a proxy for risk… isn't it?

PHAEDO Plato

By Zeus, Socrates!

It seems you are right once again!

Time for your hemlock.[1]

1 Bader, David. (2005) One Hundred Great Books in Haiku, London, England: Penguin Group; p. 5

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