36 South Views

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Crying wolf: A bettor's guide

The English idiom 'to cry wolf' is derived from *The Boy who Cried Wolf*, one of Aesop's fables. It is a well-known idiom meaning 'to give a false alarm' or 'to make false claims', where subsequent claims are not believed as a result of the original falsehood.

Imagine that there is a village in the remote countryside where you live and work as a shepherd. It is easy living but there is a potentially devastating event – the decimation of your flock by wolves.

To counteract this threat there is a boy hired by the village on a permanent basis to keep a look out for wolves. Unfortunately he is quick on the trigger and cries wolf when there are none (about three in five times), making him notoriously unreliable.

As a shepherd, this helps, but not much. So how does a shepherd look to further hedge his portfolio against losses from wolves?

There is only one effective way to do it – buy wolf options which pay off 10x per dead sheep killed by wolves.

Most don't bother taking out wolf protection, although the few wise shepherds that do, differ only in the way that they take profit.

There are TWO ways to monetise these wolf options. One can either sell them back to the "market" when the boy cries wolf or hold them and get paid off on the number of dead sheep times 10, i.e. when the dreaded event actually happens.

In the first case, realising that the boy cries wolf more often than not, you would take profit when he cries out, given that "unhedged" shepherds will buy wolf options as a knee-jerk reaction to his cry. It works nearly every time, easy to run and if very satisfying to make this additional source of income.

In the second case, you stand pat on your wolf options, knowing that your objective is to protect against the actual appearance of wolves and resultant reduction in the number of your flock, even though it is a far rarer event. The problem with the second method is that each time the boy cries wolf, your wolf options will improve substantially in value, only for this value to melt away as other shepherds realise it is not true once again. It is expensive to run but at the time that wolves actually appear, your profits will more than compensate for premium spent and what you lose in sheep.

The same is true for the markets. There are two types of asset price movements/volatility in the world according to Brownian motion at least – noise and drift.

The last three market 'episodes' (August of last year, January and the Brexit fallout in June of this year) have been of the noise variety. Central banks take a bow…

Markets recovered (almost unbelievably) quickly.

Noise is when a market oscillates wildly but essentially goes nowhere. This can affect a portfolio mainly through volatility drag. It is like a seaworthy ship in a storm. You will in all likelihood live to see another day but it will be uncomfortable. It is also the equivalent of the boy crying wolf when none appears.

Drift is when the prices move from point A to point B, normally outside the range of expectations and normally quickly. In this respect 'drift' is a misnomer. Of major concern to portfolios is the risk of irreparable

loss, the chance that prices will 'drift' downward and never recover. Here the boy cries wolf; they appear and order lamb chops!

Both represent volatility as we know it.

Funds that look to profit from volatility are essentially positioning themselves for either noise or drift.

Funds that position themselves for noise **cannot benefit substantially from drift**. They are continually taking profits leaving no positions which can make excess returns.

Funds that position themselves for drift **cannot benefit substantially from noise**. They do not take quick profits so give back short term gains when the markets reverse.

Why is this even relevant?

These two types of volatility funds have different characteristics and should never be confused as to their FUNCTON.

'Noise' or 'gamma' or 'relative value' long volatility funds are normally more benign negative carry, they can make the volatility premium in times of uncertainty and their role is one of a **diversifier** in a portfolio.

'Drift' or 'vega' or 'directional' or 'tail risk' long volatility funds have a more aggressive negative carry. Their role in a portfolio is to provide asymmetrical high returns in high volatility directional environments, i.e. 1987, 2008. Their role is essentially portfolio risk mitigation in these times.

Why am I saying this?

Brexit.

There is an ongoing confusion. Clients expect 'drift' funds to make excess returns in 'noise' environments and are disappointed when 'noise' funds don't make excess returns in 'drift' environments.

As I write today, the markets have experienced noise, i.e. up and down. Most of our strategies are of the drift variety. We experience higher returns when the markets drift downwards and return the profits when they go back up. Why? We cannot remain positioned for a large scale move if we take profits, i.e. reduce the positions, unless we have perfect timing which we don't (hint: no-one has).

If this current noise turns into systemic drift, we expect to provide commensurate returns.

The market never experiences just 'noise' or just 'drift'. One is the rising uncertainty of an imminent danger, one is running from that danger. It would be naïve to assume all economic dangers are chimeras which central banks will rescue us from.

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