

36 South Views

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Vol space vs. deep space

We hosted our annual Volatility Investing Event in London on Wednesday with the metaphorical theme of "space".

It is an interesting analogy...

"Vol space" and "deep space" have quite a bit in common.

Both are vast in size and scope. Volatility assets are estimated to be at least \$100 trillion notional, about the same size as the global bond market.

They both are complex, counterintuitive, with a lot of unknown unknowns but plenty of opportunity to discover "value".

The traditional asset markets would be planet Earth. It is well known, fairly predictable and most investors walk along well-trodden paths, i.e. bonds, equity and property.

But something happened in 2008... like a meteorite hitting the Earth... the Global Financial Crisis.

Traditional diversification failed, nearly entirely, saved only by bonds.

Correlations went haywire.

Funds deemed safe went into liquidation, losses snowballed which highlighted the negative convexity and negative asymmetry which existed in investor's portfolios.

In short, traditional portfolio management was found wanting.

The investment management space found itself in need of tools to manage not just the standard risk and return but also correlation, convexity and asymmetry.

Enter the volatility space... where convexity and asymmetry are found in abundance, the perfect tools for managing these second and third order portfolio risks.

But memories are short, sellers of escape pods deem the chance of another event most unlikely and therefore are happy to sell the ability to access the safety of space inexpensively.

Investors on planet Earth agree: "panic over, nothing more to see here move along".

But crises are inevitable, as is our wilful blindness... somewhere deep in space a meteorite hurtles toward Earth.

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