36 South Views

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The eye of the needle

There are so many really interesting discussions regarding investing in volatility assets lately, that I think it is worth taking a closer look – especially given that we are coming to the end of the year, and it has been a particularly difficult one from a long volatility performance point of view.

Firstly, volatility comes in two flavours: noise and direction. We are in the minority, being fund managers who primarily invest in volatility direction or vega (P&L exposure to implied volatility rising and falling).

It is attractive to invest in these assets primarily because volatility direction is negatively correlated to traditional asset performance and has asymmetrical payoff potential.

It is self-evident though that we will therefore have negative performance when volatility direction is down!

We are also pan asset class because, more often than not, the real performance comes from a proxy asset. E.g. in 2008 interest rate options massively outperformed equity options.

We hold bullish and bearish positions because we don't pretend to be able predict market direction.

So the forecast of future volatility is primarily what we are interested in. i.e. implied volatility. Whether you like it or not, when you buy an option, you imply a future volatility and give the market a clue as to what the crowd estimate is.

When irrational drivers of option buying or selling dominate the market, like cheap call overwriting (selling cheap options to provide yield), the market is unwittingly implying a future volatility.

Whether they know it or not, the market participants are implying that the market is going to display very limited volatility, in fact they are implying that everything that is known about future volatility is imbedded in the option prices, i.e. there will be no 'unknown unknowns'.

Punchy call given our history as human beings!

The huge gains we have witnessed in asset markets seem to have been driven predominantly by extremely low interest rates and the view that the 'central bank put' is still in place. Central banks have signalled their intention to start the hiking cycle which has been met with extraordinary complacency from where we sit. An asset that yields 2% needs to drop 50% in order to yield 4%!

Our global macro future depends now on whether central banks will respond appropriately to inflation by raising interest rates toward their natural rate.

The natural rate I will take to mean the rate which equates the supply and demand of capital WITHOUT artificial supply!

Too light a hand and we will risk serious inflation, too heavy and we risk serious deflation.

Through the eye of the needle we must fly.

What could possibly go wrong?

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