36 South Views

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To make matters worse…

As I was reading a McKinsey report[1] on behavioural strategy last month, there was one statement that resonated deeply with me:

> *"the culture of many organisations suppresses uncertainty and rewards behaviour that ignores it."*

Of course it does.

It's highly likely this is WHY investors tend not to invest in volatility funds when the case to add them to a traditional portfolio mix, i.e. correlation benefits and expected return profile, is overwhelming.

Implied volatility of option prices is our perception of how much we must pay to hedge against uncertain outcomes. Uncertainty IS volatility and volatility IS uncertainty; it is what we don't know we don't know. If we knew it, it would be reflected in the asset price already!

Therefore implied uncertainty IS implied volatility; it is the market's perception of how much uncertainty/ volatility we should expect in the future.

At the moment, most asset classes are at multi-decade lows. The market's perception is that there will be a small range of outcomes in our future. We have a counterintuitive bias at work which views future uncertainty based on recent experience. This is not a particularly useful bias to have when the underlying phenomenon is cyclical in nature! E.g. an earthquake occurs on average every hundred years. If it has not happened for three hundred years earthquake insurance should be at its most expensive rate – not cheapest, as it is likely to be imminent despite more recent evidence.

> *"Seldom do we see confidence as a warning sign—a hint that overconfidence, over-optimism, and other action-oriented biases may be at work."* (The case for behavioural strategy, McKinsey)

Over-optimism in the financial markets translates directly into a perception that there is greater certainty about the range of potential outcomes for financial assets which then translates directly into lower volatility and option prices. The converse is also true.

In financial markets, when insurance is most worthwhile, it is at its cheapest.

We must sympathise with investors at this juncture.

To approach an investment committee to invest in a long volatility fund is hard. Such a fund, bought when volatility is cheap, is "a hedge against an avalanche, when you can't even tell me how the avalanche is going to start or which snowflake is going to cause it."

Or perhaps: "this time is different, we haven't had an earthquake in 300 years! There won't be another one."

It is also hard to convince an investment committee to invest in a fund with negative carry, especially at a time when interest rates are low and any yield garnered is hard won. In my experience, investors remain almost exclusively focussed on this negative carry with never a thought for the other side of the coin: the

[1] *The case for behavioural strategy*, article in McKinsey Quarterly, accessible at https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-case-for-behavioral-strategy

high expected returns in a high volatility, normally risk off environment which are associated with this negative carry.

It is easier to follow the behavioural bias and to supress uncertainty in organisations by incentivising people to ignore it.

Trying to explain to a committee why they should invest in something as a hedge without any real idea of what they are supposed to be hedging against will often throw up such responses/roadblocks as:

- If the market is down 50%, we will be in the same boat as everyone else.
- It is too expensive.
- The central bank put will save us.
- We cannot afford to underperform our peers.
- We will time it.

And so it goes…

The antidote?

> "*Superior decision-making processes counteract action-oriented biases by promoting the recognition of uncertainty.*
>
> *For example, it often helps to make a clear and explicit distinction between decision meetings, where leaders should embrace uncertainty while encouraging dissent, and implementation meetings, where it's time for executives to move forward together.*
>
> *Also valuable are tools…that force consideration of many potential outcomes."* (The case for behavioural strategy, McKinsey)

The uncertainty which investors should be focussed on is tail risk: the low-probability, high-consequence kind.

Left shoulder uncertainty (down 10%) is high-probability, low-consequence and can be safely ignored from a hedging perspective. However having this hedge is palliative so is widely adopted. (Probably the reason why so many people play the slot machines versus the higher stakes games even though the odds are totally skewed the wrong way!)

That one sentence:

> *"the culture of many organisations suppresses uncertainty and rewards behaviour that ignores it."*

explains why organisational culture makes matters worse in the context of portfolio management and risk management.

For our current investors and all investors who are long volatility at these levels, we salute you. It is the right thing to do.

Like I often used to say to my kids when taking an unpopular but necessary decision regarding them:

"I am responsible for your character, not your happiness."

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