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The magical elixir

I've just given a talk at a conference in Abu Dhabi.

The talk was entitled *"Volatility - poisoned chalice or magical elixir?"*.

When I speak publicly, I always cover the same ground and as such, don't expect few insights but, sometimes, I get positively surprised.

The first insight is that a passive approach to volatility is nearly always harmful to an investment portfolio. This is mostly mathematical in nature, as higher volatility affects compounding negatively due to volatility drag, as well as a loss of compounding time.

The next insight is how potentially harmful using volatility as a proxy for risk is. This can lead to risk complacency in asset allocation and sizing. Think volatility targeting and risk parity in this regard.

However, volatility can be a magical elixir as well.

The main driver of an option's premium is a forecast of future volatility. Through the options market, we get a price for volatility for most assets and asset classes in the world.

These volatility prices get distorted by many factors, including institutional flows and last, but not least, the counterintuitive nature of volatility itself, which leads most volatility investors to tend to do the wrong thing at the wrong time.

Therein lies part of the magical elixir - the alpha that's available to harvest in the volatility investment space.

This we have known for a long time, so no real insight here.

In addition, there are very few assets in the world that lend themselves to tail risk hedging.

Volatility assets i.e., options, are the most reliable of the small subset of negatively correlated assets which have asymmetry, convexity, are liquid and of investable size, making them the only frontrunner for left tail strategies.

Again, no real insight here.

The big insight came to me when I realised how asymmetrical the time spent between strategies which maximise gains and strategies which minimise losses is.

The "maximising return" ground is very well trodden whereas "minimising losses" is the road less travelled on, in spite of the benefits between the two being roughly the same from a compounding point of view.

Why investors spend so little time on minimising losses should be, and is, a mystery.

The benefits to compounding of investing in the tails, particularly the left tail, are far bigger than one would think.

A good analogy is the lap times in the Le Mans 24-hour race.

The biggest lap record break came in the year they invented disc brakes, not the year that engine improvements were made.

To the victor go the spoils… the investor that both maximises returns AND minimises losses will, by definition, outperform over time.

Who knew?