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36 South Views

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For whom the golden bell tolls…

Investors often ask us how we, as a volatility fund with an emphasis on crisis protection, can be up after such a bull run. The answer is simple, we don’t limit our ideas to just the left tail. The right tail is important as well.

Hence, we can have positions, which we call our twin tail positions (that can pay off in both left and right tail), which have been doing the heavy lifting this year so far.

While I was thinking about the twin tails, I remembered a research paper by Chris Cole titled *“Volatility at World’s End”*[1]. Chris can say in one sentence what I attempt to in nine. Chris has taken a break from the industry, but I sincerely hope he comes back. Our world is richer for his ideas and writings.

He starts off:

“Imagine the world economy as an armada of ships passing through a narrow and dangerous strait leading to the sea of prosperity. Navigating the channel is treacherous for to err too far to one side and your ship plunges off the waterfall of deflation but too close to the other and it burns in the hellfire of inflation….
…Print too little money and we cascade off the waterfall like the Great Depression of the 1930s… print too much and we burn like the Weimar Republic Germany in the 1920’s… “

Further on he says…

“In our postmodern economy it is very difficult to separate the reality of fundamental economic growth from the illusion of central bank backed-prosperity”.

We had 2008 and 2020 and our absolute fear of deflation led the printing presses to work three shifts. The problem is nobody told them to stop. Hence, we now have runaway asset price inflation, which gives the appearance that everything is ok, dandy in fact, but the reality is that it is only the top 10% which benefits, thus adding to already severe inequality.

Macron is trying to warn them as we speak, but nobody on the gravy train wants to listen. So, it will continue…..

If the right tail is the clear and present danger, why would you buy left tail risk at all?

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[1] https://www.asx.com.au/content/dam/asx/investors/investment-options/vix/volatility-at-worlds-end.pdf

The bottom line is this…. in a volatile environment where things swing wildly to the extremes (an environment I believe we are entering), a traditional portfolio will get killed by one tail or the other or by volatility drag.

Equities are a great hedge only if inflation is mild. If equities burn hot, inflation will burn hotter, leading to a real loss of value. At the end of the Zimbabwe hyperinflation, the whole market cap of its stock market was 27 million USD! Equities just couldn't keep up.

Even if we have a 10-year bull market, it will be interspersed with panics. Even if you don't join the panic yourselves, these down periods lead to slower compounding due to risk aversion and time lost.

So, the left tail needs to be hedged, if you can find the hedge at the right price.

As we speak, the golden bells are tolling. They toll for thee. They are telling us that smart money is moving into real assets using money from the overpriced financial asset casino.

It tells us that central banks no longer trust each other's paper.

It is akin to rats leaving a sinking ship…. It portends a financial storm.

We have wandered into the hellfire of inflation and are enjoying it, as the negative consequences are yet to be felt. Central banks will try to cool it, and the markets will suffer significant setbacks as reality bites once again.

Which, in turn, sets up the next runaway boom with printed money, and so on and so forth…. until it doesn't.