GLOBAL VOLATILITY SUMMIT 2013

January 2013 Newsletter

2013 Event Details

Date. February 25th, 2013

Details. A one day summit to educate investors on the universe of volatility funds and tail hedging managers.

Location. 82 Mercer, SoHo, New York City

Event Update

Keynote speaker. We are excited to report that Sal Khan, founder of The Khan Academy and author of *The One World Schoolhouse* will be speaking at the event.

Managers. The following managers will be speaking at the event.

Alphabet Partners
Blue Mountain Capital
Capstone Investment Advisors
Fortress Investment Group
Ionic Capital Management
JD Capital Management
Parallax Fund
PIMCO
Pine River Capital Management

Please continue to check the website for registration, updates and tentative agenda (www.globalvolatilitysummit.com).

2012 Event Recap

Keynote speakers. General Stanley McChrystal gave an insightful presentation on volatility in the Middle East, and The Honorable Rahm Emanuel (Mayor of Chicago) was interviewed by Charlie Rose and discussed the current volatility seen in politics.

Attendees. The 2012 event was a huge success with over 360 attendees including 15 hedge funds in the volatility and tail hedging space, the world's largest pension funds, insurance companies, endowments and foundations.

Happy New Year!

Preparations for the 2013 Global Volatility Summit, taking place on February 25th in New York City, are in full swing. While the 2013 Global Volatility Summit focused on "years past", the theme for 2013 is "the year that could be". We hope to shed some light on investors' fears of situations that could escalate in the coming months and years which could potentially have significant impact on the financial markets.

Political and economic events in the preceding year carved out new opportunities in the volatility landscape for 2013. Because significant amounts of risk capital had been on the sidelines in recent months, it is believed that as this capital is injected into the markets again, it will create price dislocations. This combined with an increase in volatility of volatility, should add to the opportunity set for managers in the volatility space.

The Global Volatility Summit remains dedicated to educating investors and providing you with thoughtful and timely updates from leaders in the volatility space. As such, *Ionic Capital Management* shared their thoughts on volatility as we enter into a new year of challenges and opportunities.

As a reminder, registration for institutional investors is available on the website (www.globalvolatilitysummit.com). Please register as soon as possible since space is limited.

Cheers,
Global Volatility Summit

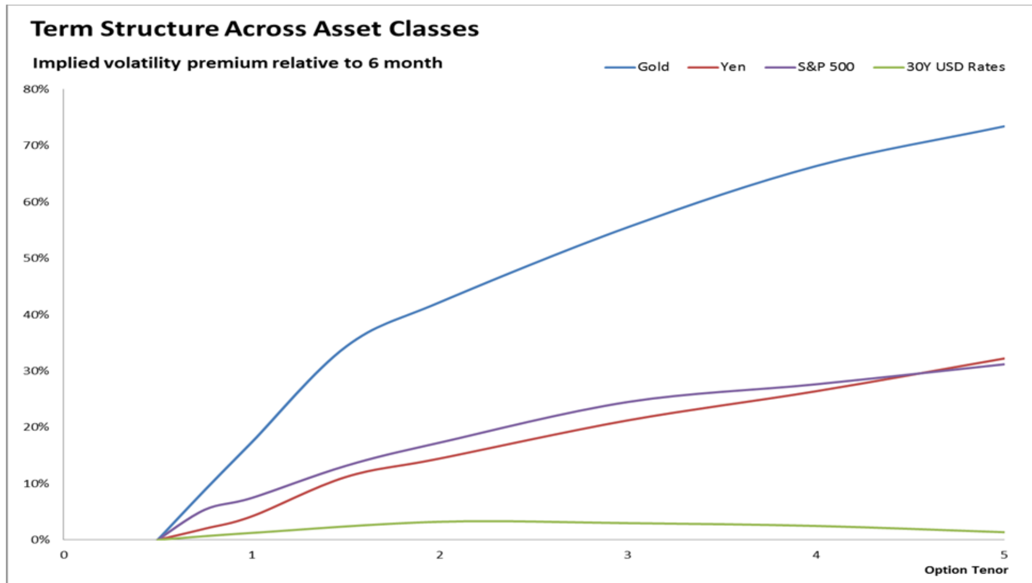
Opportunity abounds in volatility markets for the sophisticated investor after staggering declines in implied volatility in 2012 (see table below). An important driver of these large drops in implied volatility has been central bank invention in markets in an effort to create the "perfect economic environment" to spur growth. However, even with volatility at significantly lower levels than a year ago, option decay can act as a costly headwind to positions and investors need to carefully analyze the market to uncover the best strategies to buy volatility. Three important aspects of the volatility market that should be factored into position selection are term structure, skew, and cross-asset correlation.

Implied Volatility Comparison

	12/31/2011	6/30/2012	12/31/2012	YTD Change
Commodities				
3M Gold Implied Volatility	22.25	18.84	12.91	(42%)
3M Silver Implied Volatility	41.50	33.90	23.47	(43%)
3M Copper Implied Volatility	37.49	25.44	18.47	(51%)
Currencies				
JPM Global FX Implied Volatility	12.56	9.69	8.07	(36%)
British Pound 1-Year Implied Volatility	12.67	9.95	7.60	(40%)
JPM Emerging Market FX Implied Volatility	13.73	10.48	7.42	(46%)
Turkish Lira 1-Year Implied Volatility	16.96	12.66	8.88	(48%)
Chinese Renminbi 1-Year Implied Volatility	4.32	2.59	2.25	(48%)
Interest Rates				
Deutsche Bank USD Gamma Index	81.60	64.10	54.90	(33%)
Deutsche Bank USD Vega Index	97.20	83.30	77.70	(20%)
Equities				
Financials 1-Year Implied Volatility (XLF)	32.68	26.89	22.61	(31%)
S&P 500 1-Year Implied Volatility	24.20	20.86	18.84	(22%)
Emerging Markets 1-Year Implied Volatility (EEM)	32.36	26.98	22.81	(30%)
Eurostoxx 1st Volatility Future (FVS1)	32.75	26.20	18.75*	(43%)

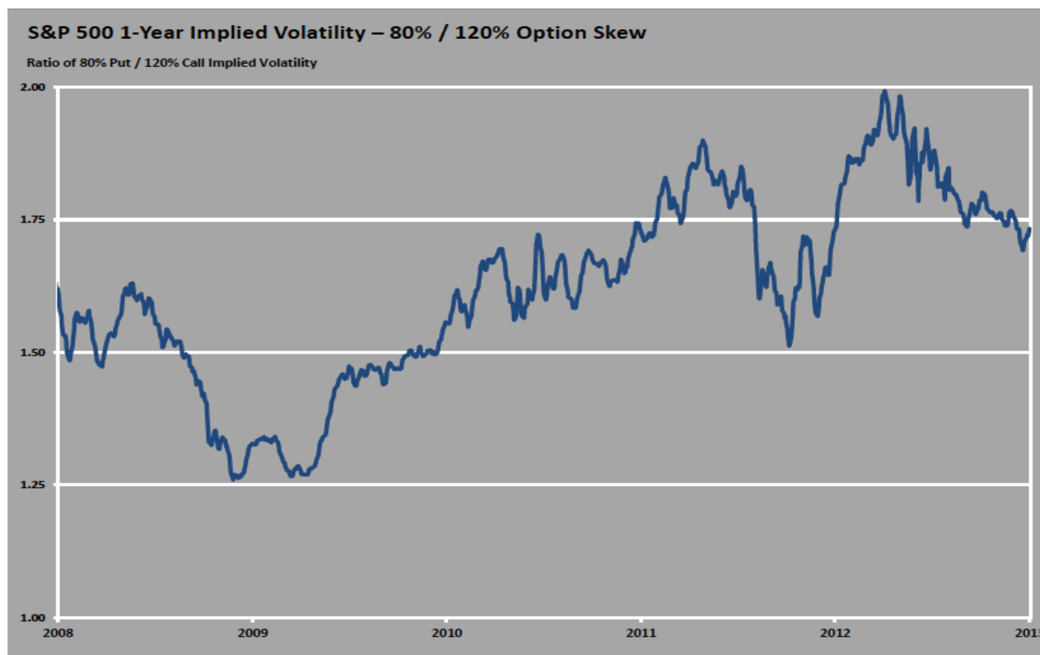
** Data from 1/2/2013* *Source: Bloomberg*

While the Fed's active market participation has been a major dampener of realized and near-term implied volatility in nearly every market, the upward sloping term structure of most volatility curves (as shown in the graph below) suggests a degree of nervousness and uncertainty over how the recent, unprecedented central bank actions will play out in the longer-term. With volatility curves so steeply upward sloping, it can be costly to buy longer-dated volatility in equities, foreign exchange and commodities as options decay rapidly. While there are pockets of opportunity in these markets, blindly buying long-term "tail hedges" can be very expensive. The shape of the US rate volatility curve, however, is flat to downward sloping, allowing an investor to buy long-term volatility at lower levels than short-term volatility. The shape of this curve is especially interesting given that the interest rate market is the market that the Fed is directly using to execute its strategy and therefore should be most impacted when the Fed exits.



Source: Bloomberg

Like option term structure, the level of skew also reveals a degree of fear that is hard to see when just looking at single point, short-duration, at-the-money option prices. Despite the S&P 500 1-year at-the-money options falling nearly 25% in 2012, which would imply a market less worried about downside risk, option skew remains elevated and almost identical to where it closed 2011 (see chart below). One-year options with a strike of 80% of the current S&P level trade at an implied volatility that is 1.7 times the implied volatility of an option with a strike that is 120% of the spot level. In other words, the market is willing to pay significantly more for downside protection than upside exposure despite the fact that recent realized volatility has been low.



Source: Bloomberg

In addition to high option skew and steep term structure in many markets, cross-asset correlation remains elevated (see table below). The inverse correlation between the S&P 500 and investment grade credit spreads (represented by the CDX index spread) is especially high as asset prices march higher across the board. While the rising tide is lifting all boats today, the high levels of correlation also suggest that there is far less benefit derived from diversifying investments across asset classes than historically, leaving portfolios exposed to across-the-board sell-offs. Efforts to protect against this vulnerability partly explain increased demand for out-of-the-money puts and longer-dated options as well as the high skew and steep term structure that can be observed in most option markets. Portfolio hedges, however, need to be constructed across asset classes as these correlations will not persist indefinitely.

Weekly Pairwise Correlation	S&P 500	Euro	10-Year Treasury Yield	IG CDX Index Spread
S&P 500	1.00			
Euro	0.61	1.00		
10-Year Treasury Yield	0.74	0.77	1.00	
IG CDX Index Spread	(0.93)	(0.70)	(0.83)	1.00

Source: Bloomberg

The volatility landscape is highly complex but rife with opportunity. While some options are quite expensive others are currently priced at attractive levels. In fact, many of the most common tail hedges are among the most expensive options in the market. There are, however, specific and large dislocations in the volatility markets despite tremendous macro-economic uncertainty. Historically, these dislocations would not have persisted as bank proprietary trading desks, now operating at a fraction of their pre-crisis size, would have squeezed them back into line. Investors who have the sophistication and tools to dissect these markets are in a position to uncover exceptional value.

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