



GLOBAL VOLATILITY SUMMIT 2013

February 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.

Saiers Capital
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.

Final preparations for the 2013 Global Volatility Summit, taking place on February 25th in New York City, are underway. 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 geopolitical, regulatory, and market events which could impact the financial markets this year.

Following a fairly muted year overall for realized volatility in 2012, January also experienced extreme lows in realized volatility. However, we do not believe this will set the tone for the markets in 2013. The volatility of volatility has been moving and should create further opportunities in the space this year. We look forward to exploring the potential themes that could impact the financial markets in 2013 at the Global Volatility Summit. There are four interesting panels of experts who will express their opinions on what we might expect in 2013 and how to take advantage of these opportunities.

The Global Volatility Summit remains dedicated to educating investors and providing you with thoughtful and timely updates from leaders in the volatility space. We asked BlueMountain Capital Management to share thoughts on the volatility markets and the opportunity set that 2013 will present.

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

Investors once again spent a great deal of the past year on edge, worried about the ongoing Arab unrest, the European sovereign crisis, and the U.S. fiscal cliff. But toward the end of 2012, we finally witnessed some divergence in macro environments across the globe. While the U.S. was nervously awaiting the fiscal cliff, Asia was rallying on the improving Chinese economic picture and Japanese political changes.

Although markets were difficult to navigate in 2012, the realized volatility of stocks was once again low enough that owning options did not pay off. Paradoxically, losing money on hedges and long volatility positions is becoming as routine as the uncertain markets which create the very desire to own this protection. Since “emerging” from the credit crisis in mid-2009, realized volatility in the S&P 500 has been as follows: 16% in the second half of 2009, 18% in 2010, 23% in 2011 and just 13% in 2012. At the same time, longer-term implied volatility levels are much higher; they have remained at or above realized volatility levels since the crisis. For example, variance swaps on the S&P 500 that expire in two years (December 2014) ended the past year at around 25% implied volatility. This is higher than the actual volatility experienced in each of the past three years – macro shocks and continual bad news notwithstanding. Unless an investor expects a repeat of 2008 (or the 1930s), current pricing for longer-dated volatility looks prohibitively high for hedgers.

Table 1: Realized Volatility versus Implied Volatility in Two-Year Variance Swaps

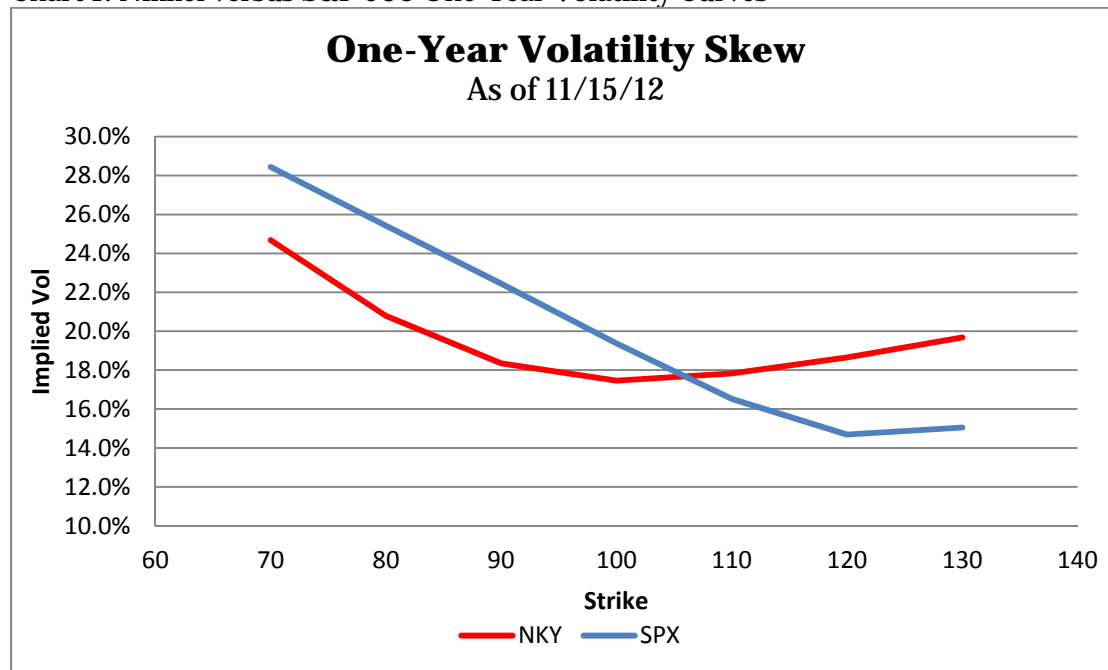
	Period	SPX	SX5E	NKY	HSCEI
Realized Volatility	H2 2009	16%	21%	21%	29%
	FY 2010	18%	24%	21%	24%
	FY 2011	23%	29%	24%	32%
	FY 2012	13%	21%	16%	21%
2yr Variance swap	YE 2012	25%	28%	29%	31%

So why does this risk premium in volatility products continue to persist year after year? The answer is relatively simple – strong demand for protection (volatility), combined with a lack of natural sellers of volatility, keeps prices elevated. Demand for volatility comes from a variety of sources. Some investors are forced by their business model, mandate, or regulation to buy options; insurance companies that sell variable annuity products are an often mentioned example. Other investors buy options so they can sleep better at night, to time a down move in the market, or importantly, to protect a portfolio, either in equities or a different asset class where hedges are not readily available. On the supply side of the equation, increasingly fewer people can sell options because of the high capital requirements. Since these requirements factor in extreme market moves like 2008, the reserves that a prudent investor must hold against selling options will often make the return profile of the strategy unattractive. Even the venerable (and under-taxed) Warren Buffett noted that his companies would stop selling out-of-the-money stock market options when they are required to post daily margin for short-term fluctuations in the market value of the trades.

In order to take advantage of the risk premium in volatility without exposing investors to the unlimited downside risk inherent in short option trades, we look for relative value trades across regions, instruments, tenors, and asset classes. While implied volatility is currently too high in most markets, there are several differences across regions and products which present us with alpha opportunities without having to take outright long or short positions in volatility.

In most markets, when stocks go down, volatility increases. Since the 1987 crash, this phenomenon has been priced into the options markets globally, causing downside skew (out-of-the-money put volatility is greater than out-of-the-money call volatility). However, in Asia, we have recently seen a new trend emerge where demand for out-of-the-money calls is also creating upside skew. The reason behind this change is that structured products (called “Uridashi”) have become a larger part of the volatility market in Japan, and they lead to unusual option buying. Uridashi cause dealers to get short volatility as spot prices increase – therefore as the market rallies, dealers have to buy upside calls (long volatility). As a result, Asian volatility curves behave differently than European and U.S. volatility curves, and this creates very interesting relative value trading opportunities.

Chart 1: Nikkei versus S&P 500 One-Year Volatility Curves

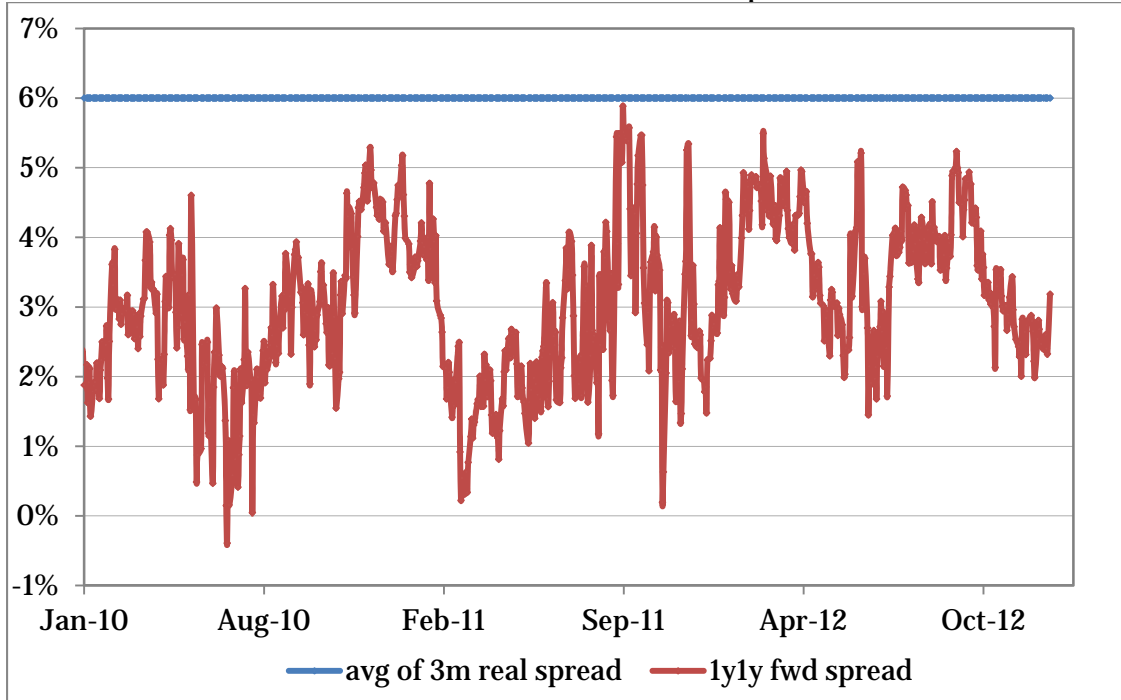


There are other interesting supply and demand differences between Asia and the U.S. in volatility products. In general, U.S. investors tend to buy volatility to hedge their portfolios, while Asian investors sell volatility through both structured products and more vanilla options. As a result, buying Asian volatility (when cheap) against selling U.S. volatility (when rich) is often attractive, particularly since realized volatility in the U.S. is typically lower than in Asia. Of course, there are nuances and potential pitfalls to each market, so when structuring these relative value trades, it is important to have a deep understanding of the volatility market in each country.

Finally, the growing popularity of VIX products and related ETNs have had a significant impact on the shape of volatility curves in the U.S. At times last year, the S&P 500 volatility curve was much steeper than other volatility curves elsewhere in the world. In other words, markets “expected” volatility to increase more in the U.S. than in Europe or Asia. This relationship presented attractive relative value trades between the U.S. and other regions – particularly “out

the curve” in forward-starting products where the difference in volatility expectations between regions was high.

Chart 2: Forward versus Realized Eurostoxx – S&P 500 Spread



For instance, an investor could buy forward-starting volatility in Europe (where problems may not be resolved in the near term) and sell forward-starting volatility in the U.S. (starting after the fiscal cliff time period, at which point the financial markets may refocus on Europe). By starting these trades in the future, investors could A) take advantage of the steep U.S. volatility curve (i.e., high future implied volatility) relative to the European curve, and B) avoid exposure to sharp market moves prior to the start of the trade. It is worth noting that near the end of the 2012, the front end of U.S. volatility curves flattened materially as the fiscal cliff became a near-term concern.

So what will 2013 bring for the markets? For starters, while we would not be surprised by higher realized volatility than in 2012, we expect that sellers of options will once again make money, and buyers of options will lose money. We believe the best opportunities to generate alpha will come from mispricings in volatility through relative value trades across regions, instruments, and asset classes.