GLOBAL VOLATILITY SUMMIT

July 2017 Newsletter

Dear Investor,

The Global Volatility Summit ("GVS") brings together volatility and tail hedge managers, institutional investors, thought-provoking speakers, and other industry experts to discuss the volatility markets and the roles volatility strategies can play in institutional investment portfolios. The GVS aims to keep investors updated on the volatility markets throughout the year, and educated on innovations within the space.

Argentière Capital has provided the latest piece in the GVS newsletter series.

Cheers,
Global Volatility Summit

Event

The ninth annual Global Volatility Summit ("GVS") is scheduled for Wednesday, March 14th, 2018 at Pier 60 in New York City. Alongside our featured volatility managers, we are excited to announce the addition of a Quantitative and CTA manager panel, featuring prominent portfolio managers in the space to share their views on the volatility markets and resulting impact on these strategies.

2017 MANAGER PARTICIPANTS

Allianz Global Investors
Argentière Capital
Capstone Investment Advisors
BlueMountain Capital
Capula Investment Management
Dominicé & Co
Fort LP
Graham Capital Management
III Capital Management
Ionic Capital Management
Man AHL
Parallax Investment Advisors
Pine River Capital Management
R.G. Niederhoffer Capital
True Partner

2017 Event Recap

The 8th Annual Global Volatility Summit was held on March 15, 2017 at Chelsea Piers in New York City. Presenting to and networking with a well-attended crowd was an exciting lineup of 15 hedge fund managers, plus industry experts, hedge fund consultants, and institutional investors addressing the use of volatility, hedging, CTA and quantitative strategies within institutional investment portfolios.

26th July 2017

Price of Portfolio Protection At All-Time Low

Investors cannot have helped but notice the historically low levels of implied and realized volatility that have characterized the financial markets over recent months. One of the primary implications of the collapse in implied volatility in equity markets is that the price of insuring a portfolio against a fall in equities has hit all-time lows. This is despite significant risks which continue to exist a result of external factors such as Central Bank policies and geopolitical uncertainty. Furthermore, increased leverage and toxic positioning continue to grow in response to these benign market conditions. Below we illustrate some simple examples to demonstrate how the price of portfolio insurance has collapsed in the last 12 months and why there has rarely been a better time for investors to use volatility as a means of providing protection for their portfolios.

Volatility in Equities is Mispriced

Implied volatility in financial markets is at all-time lows, particularly in equities. In the last 10 years the monthly VIX expiry has fallen below 11 on only one occasion (21 June 2017), while implied volatilities in equities across regions have been trading at multi-decade lows. Observers in both the financial and mainstream press have been remarking on the disconnect between volatility in financial markets and the level of 'uncertainty' for a number of months now. What is clear is that this disconnect is not being driven by fundamentals, but rather by a combination of factors which have been suppressing both implied and realized volatility. One factor that has driven the fall in the price of volatility is the huge increase in the supply of volatility from yield enhancement products and systematic volatility-selling strategies as investors search for alternative sources of returns in a low rate environment by selling options.

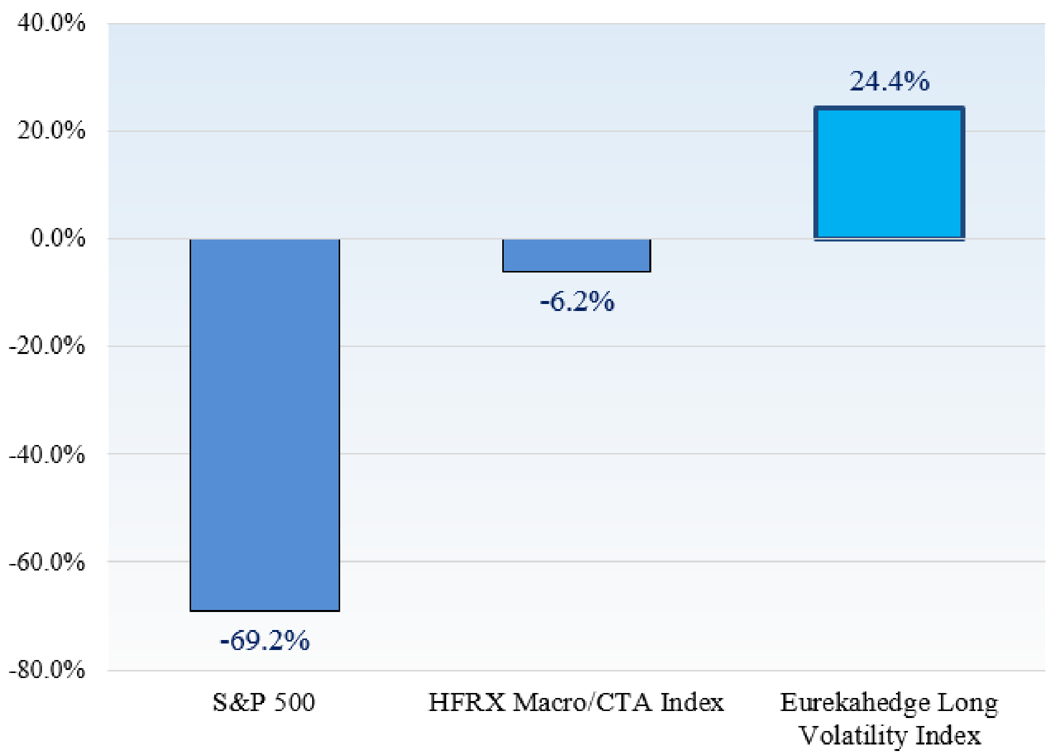
Another factor which further contributes to the low volatility environment is a peculiar and potentially dangerous 'Feedback Loop' which was described in the Wall Street Journal recently ("Are Traders Creating a Bizarre New Feedback Loop", WSJ, April 7, 2017). The article describes the phenomenon whereby the low volatility environment encourages more option selling, creating a self-reinforcing feedback loop and a large build-up of highly leveraged, short volatility positioning. Investment strategies such as Volatility Targeting and Risk Parity can further add to this toxic short volatility profile by increasing their leverage when volatility is low, and being forced into unprofitable trading (selling low and buying high) when volatility increases. When a destabilizing event of sufficient size occurs, leverage and positioning can reverse quickly, causing volatility to explode as the feedback loop unwinds and short positions are covered.

Volatility as Portfolio Insurance

Owning options (or being long volatility) can be directly compared to owning an insurance policy. Whether it is owning a simple put option to protect against a fall in markets, or owning car insurance, health insurance or hurricane insurance, the owner is paying a premium which will provide them with a payout should a loss occur. Owning volatility is, in our opinion, by far the most effective way for an investor to insure their portfolio against potential losses from a fall in equity markets or a rise in volatility. While traditional 'risk-off' assets such as bonds or gold can no longer be trusted to offer the diversification they once did due to a breakdown in correlations in recent years, typical hedge fund diversifiers such as CTA's or Discretionary Macro strategies, despite displaying a relatively low correlation to equity markets, actually provide very little by way of protection against a fall in equities.

To illustrate, since 2010, the HFRX Macro/CTA Index has delivered a correlation of +0.10 to the S&P 500, compared to a -0.45 correlation between the Eurekahedge Long Volatility Hedge Fund Index and the S&P 500 . Furthermore, in the 15 months since 2010 that the S&P 500 has fallen by more than 2% in a month, the HFRX Macro/CTA Index lost a total of -6.2% in those months, while the CBOE/Eurekahedge Long Volatility Hedge Fund Index gained +24.4% . In our opinion, volatility is the only asset class that can provide investors with true portfolio protection when equity markets fall.

Figure 1 - Macro/CTA vs Long Volatility: Performance in months when S&P 500 is down



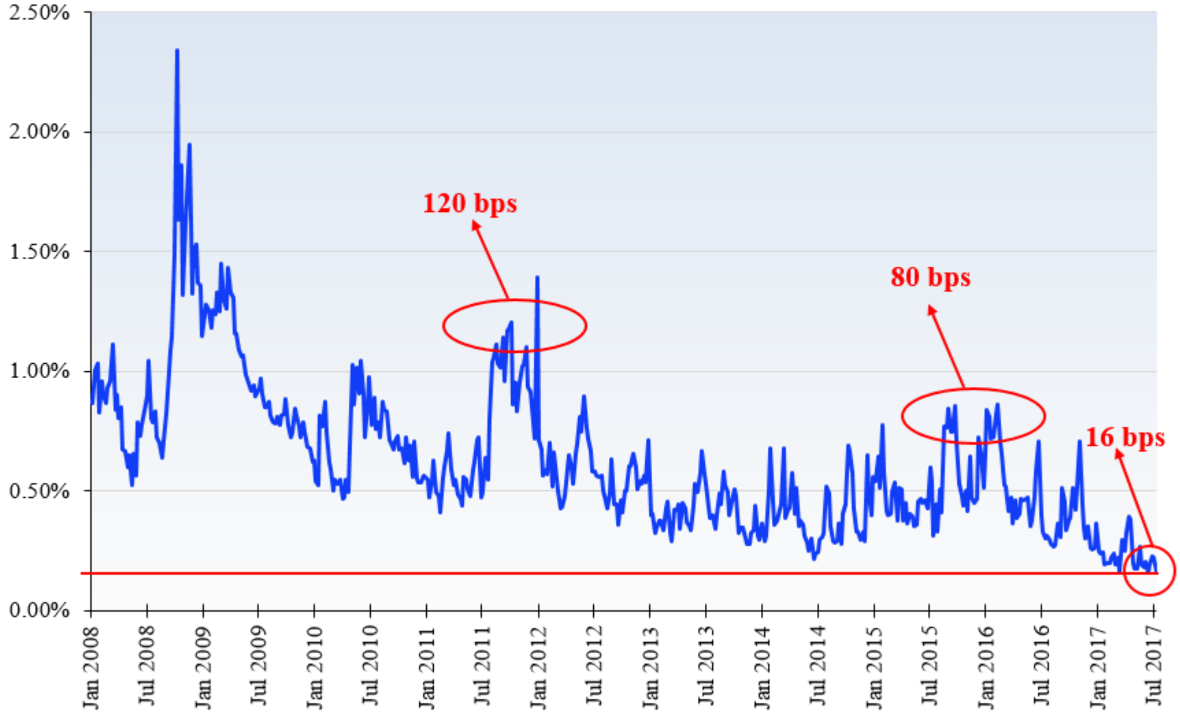
The chart shows the aggregate monthly performance of the S&P 500, the HFRX Macro/CTA Index and the Eurekahedge Long Volatility Index in the 15 months since January 2010 when the S&P 500 fell by 2% or more

Source: Bloomberg, HFRI, Eurekahedge

Out-Sized Payoffs from Owning Volatility

One benefit of the collapse in implied volatility globally is that the price of insuring a portfolio against a fall in equity markets has now reached all-time lows. To illustrate using a simple example, the graph below shows the price of a 1 month 97%-93% put spread on the S&P 500 over the last 10 years, one of the simplest trades to deliver protection in the event of a fall in equities. This position will make money at expiry if the S&P 500 declines by more than 3% over the next month, up to a maximum payoff of 4% if the S&P 500 declines by 7% or more over that period. This put spread has fallen in price by over 75% in the last 16 months to trade at just 16bps today, the lowest price in over 10 years.

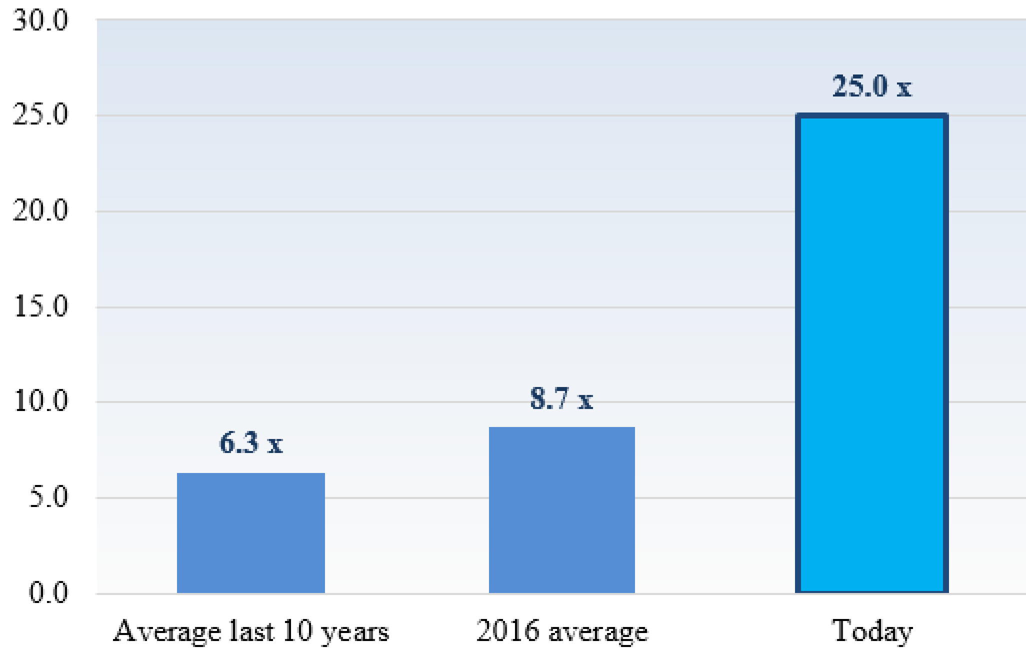
Figure 2 - Price of 1 month 97%-93% put spread on S&P500 has collapsed:



Source: Bloomberg

To understand the protection that this trade provides, at a cost of 16bps for a maximum payoff of 4%, the put spread will return 25x its cost (2500% return) should the S&P500 fall by 7% over the next month. This compares to the average payoff for the same trade of 6.3x over the last 10 years and 8.3x in 2016. At a time when equity markets are at all-time highs and amid increasing uncertainty over Central Bank policies and political instability, the risk reward of buying downside protection at all-time low levels looks compelling.

Figure 3 - Payoff from 1 month S&P 500 97%-93% put spread is at all-time highs today



The chart shows the maximum payoff ratio relative to cost of a 1 month S&P 500 97%-93% put spread on the S&P 500 based on the average price over the last 10 years, the average price in 2016, and the current price as of 14 July 2017

Source: Bloomberg

Catalysts For Increased Volatility

The ultimate question for investors is to identify what the catalyst will be that trips markets out of the benign regime that we have been experiencing. While there is significant leverage that can lead to a powerful and self-sustaining unwinding of positioning and an increase in volatility, trying to time such an event is notoriously difficult. Nevertheless, there have been a number of signals during the last quarter which point to some fundamental changes in market structure and price dynamics which we see as encouraging for volatility. These include geopolitical signals (the S&P 500 falling 1.8% on 17th May following heightened concerns about the investigation into the Trump administration), technical signals (the sell-off in several large technology names in early June in the absence of any related news) and signals related to Central Bank policies (in recent weeks it has become evident how hyper-sensitive markets have become to any communication from Central Banks that hint towards a change in policy).

Fortunately for investors, at the current levels of volatility, the risk of further compression in implied volatilities is significantly reduced, and it is now possible to construct a portfolio which is long volatility with positive carry. As such, an investor can essentially be paid while they wait. This strategy requires active portfolio management, risk management and a high level of expertise in managing volatility portfolios.

Contact Us

Please contact us should you seek more information about the opportunity set in volatility, and Argentière's expertise in managing long volatility portfolios:

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About Argentière

Argentière Capital AG is an alternative investment management firm headquartered in Zug, Switzerland with additional offices in Chicago. Argentière deploys capital across a range of liquid strategies, seeking to identify and take advantage of the most attractive risk-adjusted opportunities across markets, with a particular focus on volatility strategies. Argentière seeks to generate attractive risk adjusted returns which are uncorrelated with broader markets through utilizing a sophisticated and robust risk management framework and an institutional quality infrastructure. Argentière is registered with the SEC as an investment adviser and with the CFTC as a commodity pool operator. Additionally, Argentière Capital AG is licensed by the Swiss Financial Market Supervisory Authority ("FINMA")

Important Information