July 2013 Newsletter

2014 Event Details

Date. Plans are already underway to secure a convenient date for the 2014 event.

Please continue to check the website updates and newsletters.
(www.globalvolatilitysummit.com).

2013 Event Recap

The fourth annual Global Volatility Summit ("GVS") took place on February 25th in New York City. Ten volatility and tail hedge managers hosted an audience of over 350 people.

Keynote speaker. Sal Khan, founder of The Khan Academy and author of *The One World Schoolhouse* gave an insightful presentation on using technology to innovate the way education is provided across the globe.

Special Guest Speaker. Mike Edleson followed up to his 2012 GVS talk about the decision to implement a tail hedge, with an informative discussion on implementation of a tail hedge and how to identify the right managers for your mandate. Mr. Edleson's presentation is available on the GVS website.

Managers. The following managers participated:

Blue Mountain Capital
Capstone Investment Advisors
Fortress Investment Group
Forty4 Fund
Ionic Capital Management
JD Capital Management
Parallax Fund
PIMCO

2013 July research piece

The GVS is an evolving community of managers, investors, and industry experts, with the goal of educating the investment community about volatility strategies and how they can play a role in institutional investment portfolios. We rely on the feedback and guidance of this community to shape the event and line-up of speakers each year. Plans are underway for the 2014 event, so please let us know if you have any feedback on this year's event or topics you would like covered at next year's event.

Across the spectrum of asset classes and global markets, there is usually something interesting occurring which creates opportunities for volatility managers. In June, fixed income markets began reversing the bullish, carry friendly trend that had been firmly in place all year. Volatility markets were not prepared for the end of QE3 and responded violently as short dated interest rate volatilities increased by more than 100%. In contrast, US equity markets did not experience nearly the amount of volatility we saw in fixed income.

Julian Ings-Chambers of Fortress Convex Strategies Group has shared a timely piece on the reaction to the Fed's recent indications of "tapering" and the cyclicality of liquidity and volatility.

Cheers,
Global Volatility Summit

Monthly Update: Global Volatility Summit

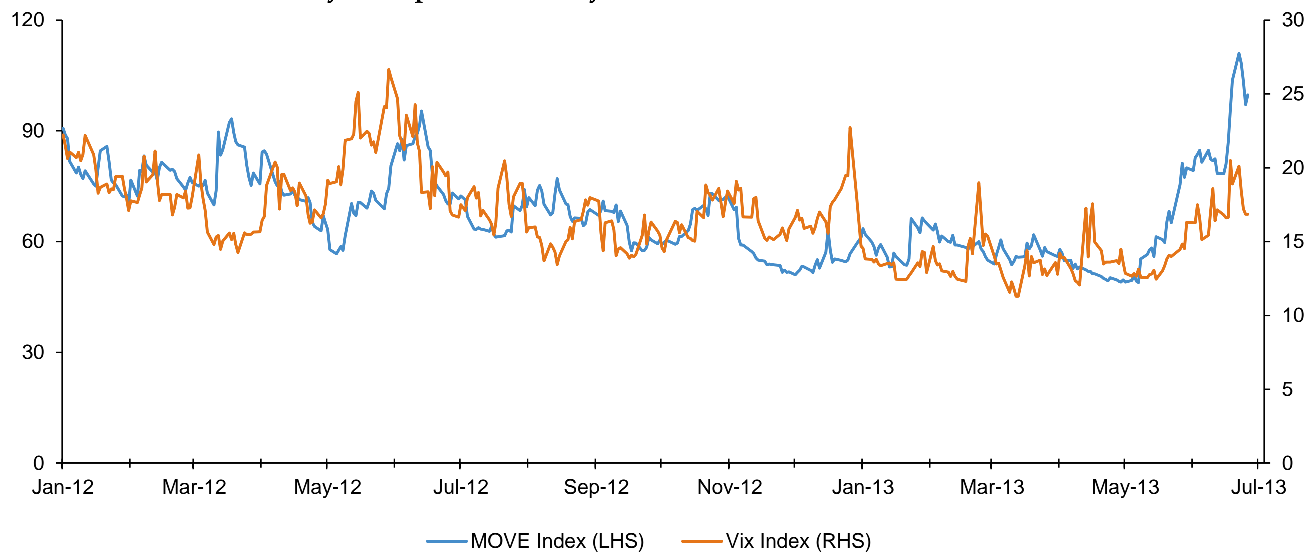
Fortress Convex Strategies Group

July 2013

Please see the Disclosures at the back of this letter for important information regarding this document.

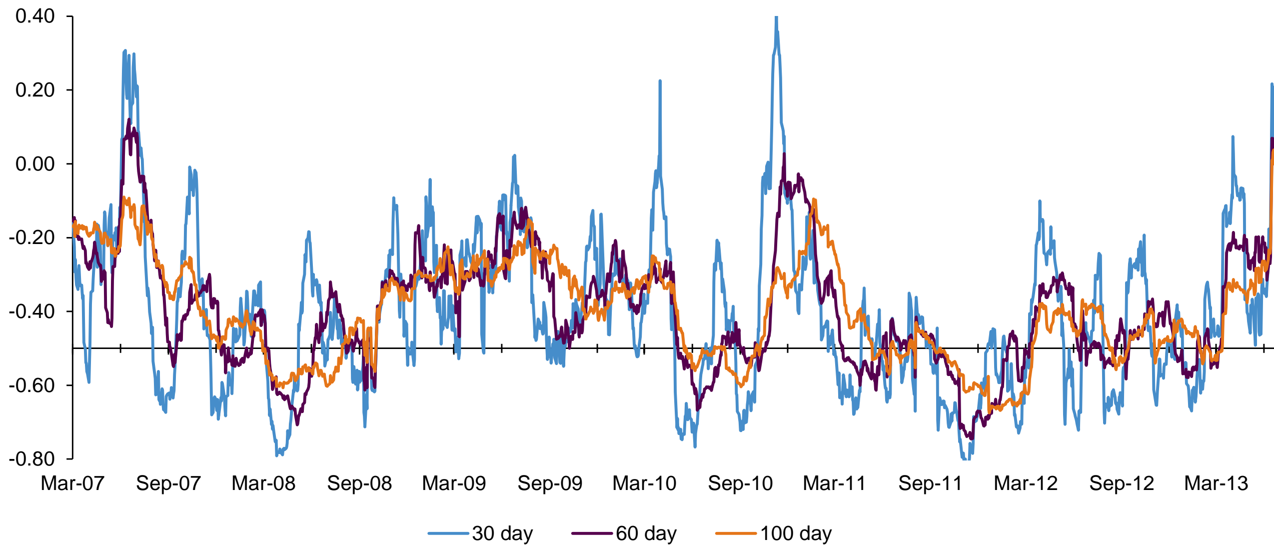
We often comment that liquidity and volatility can be opposite sides of the same coin. In our view, this is just common sense; one would expect that expanding liquidity should suppress volatility, and conversely, contracting liquidity would be expected to increase volatility. As markets and economies progress inevitably through their cycles, the expansion and contraction of both policy-driven and privately determined liquidity plays a fundamental role in volatility dynamics of markets. Thus, we do not find it overly surprising to see markets, for the first time in a number of months, jump into revived levels of volatility that are in line with the Federal Reserve's indication that it may be approaching an end to its latest, and in many ways grandest, foray into liquidity expansion. We certainly do not claim to know if Chairman Bernanke will truly end his multi-year liquidity experiment – empirically, the BOJ's experience indicates that it is harder than it looks – but if (or when) it does come to an end, there is a fair chance that it will have ongoing implications for market volatility. The mere suggestion of "tapering," at least in the near-term, certainly pulled market-implied volatility off the recent, and in general, post-crisis low.

Merrill Lynch Option Volatility Estimate (MOVE) Index vs. VIX Index



Source: Bloomberg, as of July 2013.

Also of interest, and likely related to a potential end of liquidity expansion, is the recently realized phenomenon of positively correlated movements between bond and equity prices. One of the standard tenets of traditional portfolio management is the principle of offsetting risk of growth weighting with allocations to negatively correlating fixed income positions. This risk offset has been a great boon to portfolios over the last several market shocks, where the policy response to falling asset markets has been to lower interest rates. In turn, this has resulted in consistent risk mitigating performance from the fixed income books of many funds, and not uncommonly, a growth of the weightings into such strategies. However, what happens if that risk mitigation becomes a risk amplifier? What if negative correlation turns positive? We refer to this as a Right Hand Tail event (as opposed to a Left Hand Tail or deflationary shock), where shocks in inflation (*e.g.*, Asia Crisis) or credit (*e.g.*, periphery Europe) lead to rising interest rates, whether policy-driven or otherwise, which in turn leads to falling asset prices. Right Hand Tail events can be particularly painful to asset portfolios, and are uniquely risky at a time where yields are at historical lows, and not coincidentally, fixed income weightings are at their highs.



Source: Bloomberg, as of July 2013.

Historically, markets have continually exhibited cycles, across and through different and shifting economic structures and policy regimes. Calls for "the end of the business cycle" have yet to be realized, at least so far. One interesting analogy for systemic shocks drawn from the literature on "complex systems," is fire danger in national parks. It is an empirical regularity that seasonally, temperature rises and the grass dries out. As such, the biggest risks to a dangerous "fire season" are: (1) there has not been a fire recently and (2) it was a wet winter/spring. Both of those risks result in more grass to dry out when the hot weather returns. In this analogy, one could equate the wet season to the period of expanding liquidity, the density of grass as the extension of leverage through the system, and the hot summer as the inevitable turn in the cycle. Once the increasing dense grass is dried out, it could just be a matter of time before something sets it off. The challenge in analyzing such a "complex system" arises from determining the source of the risk – it revolves not only around observed fires, but also the extent of accumulated fuel. Fire seasons usually start small, but can jump and grow non-linearly, contingent on the density and dryness of the grass. Could the market activity of the last few weeks be the start of the fire season? It remains to be seen. Interestingly, the latest Bank for International Settlements Annual Report published on June 23, 2013, might be suggesting such risks are worth considering.

Of course, the world is a big and diverse place. We have seen the Bank of Japan go to even greater levels of QE as of late (which, surprising to some, has led to far higher interest rates), even as the PBOC allowed (intentionally or otherwise) far greater tightening in its domestic market than anything yet orchestrated by the Fed. The point being, there are many unknowns out there, and some reasonable potential of being at some sort of inflexion point in the continuum of liquidity expansion and contraction. We believe volatility might be a timely and worthy diversifier for many sorts of investment portfolios as we approach the hot season.

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