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.

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

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.

The fourth annual Global Volatility Summit is just days away! The theme for the 2013 event 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.

Global equity markets thus far in 2013 have experienced multi-year lows in realized volatility. We are not convinced, however, that this will set the tone for the markets in 2013. While on the surface it might appear we have re-entered a low volatility regime, much like that during 2005 to 2007, volatility of volatility has been moving and we expect to see extremes on both ends of the realized volatility spectrum. The Global Volatility Summit will provide a forum for managers, consultants and investors to opine on their views of what we might expect in 2013. We are eager to hear from a broad range of market participants on what this year might bring.

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 *Josh Thimons, Executive Vice President and Portfolio Manager at PIMCO* to share his recent piece on the Fed's recent change in communication strategy and the impact it might have on levels of market volatility.

As a reminder, event details are available on the website (www.globalvolatilitysummit.com).

Cheers,

Global Volatility Summit

Josh Thimons

10 January 2013

The Federal Reserve, in its December 12 policy release, made a significant change to its communication policy that is likely to have the unintended consequence of greater market volatility. Prior to this meeting, the Fed used calendar guidance – stating it "anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015." This date-based guidance was replaced with language linking future policy to economic variables instead. Specifically, the Fed:

> ***"…anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored."***

The Fed's motivation for the change in course is well-intentioned and has some appealing qualities relative to the previous approach. First of all, with the new guidance the market is able to better predict how the Fed will react to a change in incoming data. As the economic situation improves (or deteriorates) the market can, on its own, adjust expectations regarding the expected liftoff from zero interest rate policy to a shorter (or longer) period of time from now without explicit guidance from the Fed. The previous calendar guidance troubled the "doves" on the Fed because whenever the Fed had to extend the date it unintentionally sent a message to the market that the Fed had downgraded its economic outlook – when in reality the Fed did not intend to suggest that the outlook had deteriorated, but simply that it hadn't improved enough to suggest higher rates were imminent. This feature of extending the calendar date created an adverse-feedback loop. Likewise, the "hawks" on the Fed disliked the calendar guidance because in the event the economy improved unexpectedly, the Fed could find it difficult to withdraw policy accommodation at an appropriate pace, introducing the risk of substantial inflation. In a rare "bipartisan" compromise out of Washington DC, in the current polarized climate, two sides of a negotiation found a win/win solution.

Or did they?

Critics will claim that the Fed is trying to apply a too-precise model to a problem it doesn't fully understand how to diagnosis. Cynics will point out that since one of the variables the Fed is targeting (inflation) is not based on actual inflation but rather projected inflation that the Fed controls itself, it is a bamboozle – as well as a thinly veiled attempt to prioritize the employment side of its mandate ahead of the inflation side. But right or wrong, the Fed has taken the markets one step further down the path of experimental and untested policy. And markets may soon discover that this latest step to prove counter-productive to one of the Fed's other objectives – the suppression of market volatility.

On August 9, 2011 the Fed introduced calendar rate guidance – initially targeting "mid-2013" – in an attempt to assuage markets in the throes of debt-ceiling generated volatility. The policy move worked brilliantly. In the subsequent seven trading sessions, the VIX index declined from 48% to 32% and the MOVE Index of interest rate volatility declined from 118 to 88. The trend lower in both volatility markets has been maintained essentially ever since. The logic behind the Fed's move was to reduce market uncertainty regarding future Fed policy – to assure markets that the Fed's steady hand on markets was not going away anytime soon. In doing so, market volatility was suppressed, term-premium in yield curves diminished, risk-premium in equity markets reduced and investors were generally encouraged to take more risk.

To be fair, the Fed clarified in the minutes to that FOMC meeting that the guidance was conditional and that if economic data improved, the Fed maintained "flexibility to adjust the policy rate earlier." However, markets perceived it to be much more of a commitment than a forecast. Perhaps the Fed's proposal was not of the "married-with-children" variety, but it was thought by most to be at least an "engaged-with-comingled-bank-account" degree of commitment. With its recent communications change, the Fed has downgraded its relationship status with zero interest rate policy to "until-something-better-comes-along."

And that something better is an unemployment rate that has sneakily declined from an October 2009 peak of 10% to the most recent reading of 7.8%, and at the recent pace it will be less than the Fed's 6.5% threshold for considering raising rates before mid-2015. However, PIMCO's New Normal growth forecast indicates a much slower rate of descent in the unemployment rate than that. Furthermore, we believe if unemployment does, indeed, experience such a sharp decline it is more likely to be driven by a continued decline in the labor force participation rate rather than real output gap compression. Nonetheless, incoming economic data will increasingly matter more to investors as they calibrate future Fed policy.

We expect increased market volatility under the new communication regime, particularly around economic data releases. Investors with an understanding of the Fed's now increasingly transparent reaction function will find opportunities to profit in the volatility markets.

With calendar date guidance, interest rate markets largely shrugged off employment data – with the Fed tied to a date, a few tenths of a percentage point on the unemployment rate did not materially change the perception of future Fed policy. Now, however, incoming data is more critical and will drive market volatility. According to our model of the Fed's reaction function, presently every ¼ of a percent unexpected change in the unemployment rate is likely to lead to roughly an 11 basis point change in the five-year Treasury yield. This relationship will become even more sensitive should the unemployment rate continue to decline. Additionally, markets will need to deal with the subsequent volatility driven by the debate over whether the unemployment rate change was driven by real economic or transitory factors and the third order effect of the Fed communique ratifying or contradicting the market's interpretation. The equity market will have to battle with a push and pull of its own – one that characterizes markets dependent upon monetary policy. On the one hand equity markets benefit by

signs of an improving economy but on the other hand equity markets are hurt by the prospect of sooner withdrawal of monetary accommodation and rising policy rates.

The Fed's new communication strategy may, in fact, be a more sensible policy prescription than calendar rate guidance. However, the likely unintended consequence of such a move is a heightened level of market volatility, which could undo some of the hard fought progress the Fed has made in influencing asset markets and risk taking behavior. We believe investors should expect an end to the now seventeen month old trend lower in market volatility.

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