September 2021 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.

1798 Lombard Odier Investment Managers has provided the latest piece in the GVS newsletter series.

Cheers,
Global Volatility Summit

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LOMBARD ODIER
INVESTMENT MANAGERS

Investment viewpoint

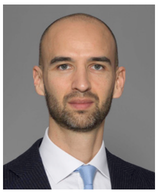
Investing in volatility: the case for extreme multidimensional diversification

For professional/qualified investor use only • Alternatives

September 2021

At a glance

- As a result of our original publication, "Investing in volatility: the recipe for success," we have exchanged with many investors, counterparties, and stakeholders and have had countless discussions and analysis on the dynamics and the opportunities within the derivatives universe.
- While our previous paper outlined the recipe for what we think makes a strategy successful, this paper highlights how vital it is for a manager to approach the opportunity set with maximum adaptability.



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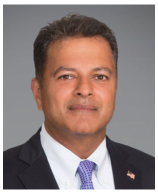

Alkesh Gianchandani
Head of US Investor Relations

Introduction

In our previous publication we established the existence of strong and sustainable opportunities in the volatility space. Our conviction is that rising adoption of derivatives among end users, combined with high barriers to entry for absolute return investors, creates a favorable landscape for true volatility specialists.

Rather than trying to predict the future, volatility managers should target market dislocations that are independent of the global macro landscape. Aware of the challenges faced by purely long or short volatility managers, we reaffirmed our conviction in a market-neutral and opportunistic approach to derivatives through our ADAPT strategy.

Each trade opportunity comes from a dislocation arising from a mismatch in supply and demand in the market. The number of opportunities up for consideration becomes a primary driver of performance for arbitrageurs. Hence the importance of tapping into a very large universe to maximise chances of finding attractive trades.

How can the need for an extremely robust framework be reconciled with the flexibility of investing in the widest possible universe?

At a first glance, the two concepts seem to be in conflict. On one hand, investment discipline is the paramount of derivatives investment. On the other, we firmly believe that a narrow mandate is detrimental to long-term performance. The result of being too specialised is that there are, at times, a lack of opportunities, which leads investors to force their capital into less attractive trades. We are firm believers in innovation and that accessing the widest possible universe is key.

In our view, reconciliation both can be achieved by setting strict limits at the trade and portfolio-construction levels, helping to ensure there are almost no boundaries on creativity and the investment universe.

It is vital to set thorough limitations for trade implementations and portfolio construction…

Building a very diversified portfolio in a complex universe requires superior discipline in structuring trades and constructing a portfolio. Staying in control at the trade level requires a structuring effort to build asymmetric payoffs, where the downside is known and negative convexity is avoided. This should not only prevent the portfolio from outsized losses but also protects positive performance generated by other parts of the strategy. It also means that some trades should be excluded because they are either too complex to model or their dynamics are not fully transparent and makes them difficult to monetise.

At the portfolio level, staying in control requires a robust and dedicated risk management framework. The risk methodology needs a specialised process that maps portfolio risk across multiple dimensions. Setting strict boundaries around risk factors ensures that the portfolio remains robust and balanced.

…But it is equally imperative to explore the derivatives universe without constraints

Once a solid investment framework is established, relative-value volatility managers should be able to go far beyond the traditional axis of diversification such as geography and asset classes and pursue ‘extreme multidimensional diversification’.

For portfolio performance to be truly uncorrelated from the macro environment, one should aim for a large collection of trades that perform well in very different scenarios. Having trades with different maturities, trading frequencies and degrees of complexity is key given that in the derivatives space the path is as important as the destination.

Being able to trade a wide variety of instruments (excluding the ones flagged above) is fundamental to enhancing creativity and being able to capture different sides of dislocations. For example, consider the dispersion theme: a vanilla implementation will be more effective at capturing changes in implied volatility levels while a volatility swap implementation can capture realised volatility without slippage. We do not favor one tactic over the other, but we think it is critical to have the flexibility to do both.

More generally, the derivatives space is very fragmented and non-specialist investors typically look at a very specific area of the market and will often trade one type of instrument. The ability to trade the full spectrum of products, from vanilla listed options to over-the-counter solutions, allows the manager to capture more dislocations and offers a much wider range of implementations. In our view, managers should not be dogmatic and be adaptable enough to switch from one implementation to another including during the life of a trade.

Conclusion

We believe investors must prepare for every environment by being adaptable and emphasising trade and portfolio construction.

Having the widest possible universe not only increases chances to identify mispricings and dislocations, it also helps maintain the quality of the trades and the portfolio. A wide mandate allows managers to completely step away from one area of the universe if the risk-reward dynamic isn’t compelling. It allows he or she to be patient and wait for opportunities to return, and in the meantime, deploy capital elsewhere while maintaining a very balanced and diversified profile.

Therefore, we believe relative-value volatility managers should pursue extreme multidimensional diversification. To attain this, they need the flexibility to operate in the widest possible universe – and beyond.

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