Cover Story

U.S. Rates To Drive Wedge Between Global Volatility Regimes

*The U.S. economy is set to depart firmly from Asia and Europe as the U.S. Federal Reserve commits further to a rate rise sometime in 2015. In light of recent comments from U.S. Federal Reserve Chair **Janet Yellen**, it seems a rise is more about when, not if, with each meeting here on in seen as a potential event where rates could increase. Hedge funds at this year's Global EQD Conference in Las Vegas noted the move will be a catalyst for a volatility regime change. Meanwhile, the participants also spell out potential limitations in systematic indices. **Daniel O'Leary** reports.*

U.S. equity volatility could depart significantly from European and Asian volatility if the Federal Reserve decides to increase rates later this year.

Joseph Aiken

Regarding the relationship between rates and equity volatility, Vishnu Kurella, portfolio manager at hedge fund Caxton Associates, said 10-year Treasury rates would likely need to move to 3.5-to-4% to act as a catalyst to equity volatility.

Speaking on the Buyside Strategies panel, Kurella added a lot of volatility selling was emanating from structured product issuance in Asia as a yield generation tactic. "If you have higher rates, you also have more premium to spend on options [in principal-protected products]," he said. "I think [higher rates] will change the complexion, whereas right now many investors are just so starved for yield."

Despite caution over global economic turmoil, most notably Greece's debt crisis, the Federal Reserve set a dovish tone in its latest meeting minutes released in July. The central bank looked to set the ground work for future rate rises, noting future hikes will be detailed in an "implementation note" explaining the move. The Fed has not increased rates in more than nine years.

Joseph Aiken, founding partner at Malachite Capital Management in New York, added the turmoil following a rate rise could be unlike anything ever seen. "If you had a huge shock in rates, and there is a mega unwinding of these trillions of government bonds, I think that would spook the market," he said.

Pierre de Saab, head of asset management at Dominice & Co in Geneva, added about 53% of all government bonds currently yield less than 1%. "We think the only way to safeguard your wealth is to invest in real assets, like equities and real estate," de Saab said. "When the next crisis comes, the really weird thing about it is that very probably, after the initial shock, you would note that the safe assets that you needed to hold prior to the event wasn't bonds, but, unlike previous crises, equities and other types of real assets."

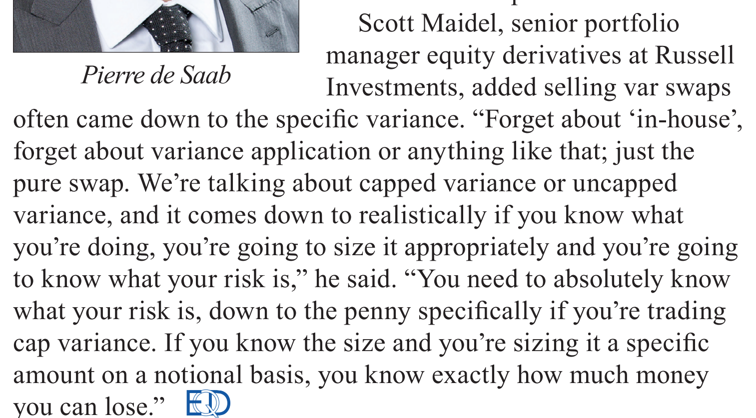
Investors have largely been long rates volatility this year, with sellside strategists noting equity allocations could prove the safe haven trade of 2015. With an increase in rates looking increasingly likely, some traders in April were seen positioning for the potential effects in equity and volatility markets, with variance selling particularly attractive.

The hedge fund speakers were largely against var swap selling, noting blindly selling tail risk was typically a recipe for disaster. "There is a utility function to making money; if the market is down 20% overnight, we need to come in and have very strong returns," Aiken said. "We're not a tail risk fund by any means, so we're not going to make 500% in that event. I don't know when the next crisis is going to be, but we're going to have one, and it's going to be on something, some event, and… as a hedge fund strategy, we need to perform for our investors in that case."

Pierre de Saab

De Saab added var swap selling was too risky. "If I work in a bank and everything goes bad, the worst that can happen is that my employer fires me and so on," he said. "As a fund manager, the argument is very simple: I'm invested in my fund, that's my money too. I don't want to bear the risk of a large drawdown that I could have with such a position."

Scott Maidel, senior portfolio manager equity derivatives at Russell Investments, added selling var swaps often came down to the specific variance. "Forget about 'in-house', forget about variance application or anything like that; just the pure swap. We're talking about capped variance or uncapped variance, and it comes down to realistically if you know what you're doing, you're going to size it appropriately and you're going to know what your risk is," he said. "You need to absolutely know what your risk is, down to the penny specifically if you're trading cap variance. If you know the size and you're sizing it a specific amount on a notional basis, you know exactly how much money you can lose."



Systematic Strategies

'Take A View'

Funds Highlight Limitations of Systematic Products

Systematic products are not a catch all solution and should not replace "good ol' fashioned view taking," with buyside hedge fund participants noting numerous inherent problems in an overcrowded market.

Rules-based quantitative indices have been talked up this year by the sellside, as investors seek cheaper ways to manage volatility and alpha. Firms in Europe have seen increased interest from pension funds to access risk premia models, which allow such investors to monitor risk premia across multiple asset classes when allocating to different strategies. There has been particular interest seen from pension funds and discretionary mandates from private banks in Switzerland, as well as pension funds in the Nordics and Canada. Ken Kwalik, vp and head of portfolio management & trading, equity solutions group at Goldman Sachs, noted systematic products are also increasingly popular with retail high net worth individuals. "From my clients' perspectives—from our point of view—the big thing there is how do you protect people against their own behavioral biases?" he said. "That's probably the biggest thing that we battle, that we manage. Having systematic rules around what we're doing certainly helps."

Vishnu Kurella, portfolio manager at hedge fund Caxton Associates, noted systematic products are not always better than simply taking a view on the market. "Systematic trades can be difficult... you have to understand why the edge is there," Kurella said, while speaking on the Buyside Strategies panel. He added investors still had to monitor other factors in the market in order to understand exactly what made the systematic trade attractive.

"In the last year, some of these selloffs and unwinds have been pretty extreme," Kurella noted. "I think the first three months of the year, if you were long European equities it was a five Sharpe [ratio] trade. That's a pretty great trade and any systematic trade would love to be five Sharpe. And then you gave up 10% pretty quickly and why did that happen? You had a bunch of [investors] unwinding. So these are the types of things you have to pay attention to the other factors of what's really driving the market, [positioning], and why is that opportunity there."

Joseph Aiken, founding partner at Malachite Capital Management in New York, added there were also issues with the back testing of some systematic strategies, particularly those that sell volatility. "Rules-based volatility selling strategies, which tell you to sell vol all the time, besides right before the vol spike, I think are a bit suspect," he said. "In reality the rule usually amounts to, 'Don't sell vol for the shock in 2008' and sometimes it's "2008 or 2011", so I think that's something that you have to be a little bit wary of. Then the strategy supposedly identifies the end of the crisis so that you can get back in. Obviously there's no crystal ball that's going to allow you to nail that."

U.S. pension funds, while wanting to cut fees associated with hedge fund allocations, have been slow to take up systematic products offered by the sellside banks. Fund managers told EQD late last year, however, risk premia indices that help them easily manage volatility, such as strategies that sell volatility on selected exchange-traded funds or execute roll-downs on the Chicago Board Options Exchange Volatility Index futures, were the most likely to spark their interest. Managers note, while a number of decent strategies exist, there are a lot of products to wade through.

Kwalik added there have been problems around liquidity recently, particularly in times of stress. "Banks' appetites for selling vol and taking on warehousing risk… hasn't really been there and that's led to an exacerbation of the supply realized premium," he noted. "That presents an additional opportunity to take advantage of that through various structures, to again enhance someone's view on whether they want to get into the market, against when it's under invested, or somebody that maybe wants to strategically or tactically exit the market. Showing back testing certainly helps, but also being able to switch over at times, and be more active around certain events… some leading indicators that you can be smart about and at least educate clients on really helps move the whole idea, the whole concept forward."

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— Pierre de Saab, Dominice & Co.

Pierre de Saab, head of asset management at Dominice & Co. in Geneva, added one of the central points of systematic products — that they reduce costs—was not always that accurate, as most had a multitude of hidden fees. Performance of some notes had also been poor, he said. "Many certificates have had performance last year of minus 20-25%, so very bad," de Saab said. "Also a lot of investors now realize that even though the tagline about the fees seems to be lower, in reality, there are a lot of hidden fees." There are fees for the index—much like a management fee—and there are also some hidden costs such as the spread charged when the strategy rebalances itself," he said. "Then there is the structuring fee the

bank charges when it launches an investable product. Finally, when you trade the product in the secondary market, you pay a bid-ask spread that can be several percent, whereas you invest and redeem in a fund at zero cost."

Kurella added investors can also get carried away with back testing; people need to spend more time understanding why the markets react the way they do. "One of the favorite trades in relative value vol space is long Asian vol, short S&P [500] vol," he said. "It looks good on the back test, but [a significant part of the market] is short S&P vol, because S&P vol screens to be the most expensive. In October [2014], if you had this trade on, guess what didn't go up much? Hong Kong vol and Kospi vol. In fact, because of structured product exposures, even longer-dated EUROSTOXX vol went down, despite EUROSTOXX [spot level moving significantly lower]. [When assessing a trade], you have to understand why this trade looks so good in a backtest. If it's not protected in a selloff, you're really more exposed than you might think."

Scott Maidel, senior portfolio manager equity derivatives at Russell Investments, added most institutional investors do take a hard look at systematic strategies before investing and negotiating on fees. "When you think about systematic strategies, you can bucket them into a variety of things; is it tail risk? Is it dedicated short? Is it long short? But when you think about the same sort of concept and you apply it to the traditional asset classes, we're having the same conversation that one could have had for equities and fixed income; is it passive, active or maybe a bit of both? maybe a bit of the core satellite approach, where you're gaining certain risk premiums by systematically doing vol selling, but doing it perhaps in a little more sophisticated way than just simply selling VIX futures or selling a delta hedged strangle?"

Scott Maidel

He noted systematic products allowed portfolio managers to embed things like tail risk, or control and define the risk. "You're not doing it so simple, as of course some of the long and short ETNs are doing, and then on the flipside of that, again, complementing that with things that you cannot achieve in a quantitatively driven approach to seeking a certain exposure, like just simply shorting volatility in a very risk managed way. And, that's when I think you can cross over into looking at perhaps funds, for example."