

VOLATILITY

VOLATILITY CAN MAKE YOUR P&L SMILE



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Which managers, that trade volatility, would do well in a situation like this...?

Based on the low equity volatility (with a floor of around 10-12%) we have recently witnessed anyone with a long volatility position that stays and/or is even more long volatility as the market drops.

A position that is generally long volatility is usually quite expensive to carry if nothing happens. As volatility can also drop back quite quickly once markets cool down, someone with a long vega-gamma or long volatility of volatility position would do quite well.

Would you say it is underlying specific ... i.e. FX vs. equities-indexes vs. fixed income?

If the market correction is driven by a general increase in uncertainty then it doesn't matter. If the event is more specific, as is the case with credit, then you have to see which asset class is the one most affected. On this occasion currency volatility was less affected than fixed Income and equity volatility. Also financials and builders were clearly more affected than others as the trigger was quite specific - i.e. the credit problems of the sub-prime US segment. However, as credit worries spread, other sectors and asset classes get hurt as well. Credit tends to be capable of starting a domino effect - as in today's global markets the credit web is very complex and far reaching...

Since the inter-connection between markets increase, the correlation of volatility increases and falls (rapid increases of volatility are usually followed by sharp drops. Volatility of volatility can be as high as 200% when actual volatility is only 25-30%).

Would you say it is determined by the time interval and the pre-set levels at which they trade ...?

The fastest one will always be able to exploit erratic moves much better than someone with an intermediate time horizon and trading frequency. If a portfolio is set up in a way that it automatically provides excess payoffs in a substantial market dislocation it is much easier to be the fastest than if you have to start changing your book once the market starts to move. Most prudent traders will always be long "the wings" and long "teenies" which means having long positions in far out of the money options that are nearly worthless but can become very valuable once markets start to become erratic.

Volatility is mean reverting. That means it has to be traded to get maximum effect. That means pre-set levels are more important than time intervals.

To set levels, it is helpful to look at the theta/gamma (cost/benefit) ratios in combination with historic moves. It is easier to make the right decisions when measuring the dislocation on an objective scale. Discretionary decisions tend to be coloured by the hype and excitement in the market.

Since a lot of funds are model driven... i.e. the challenges they are braced with...

The challenge is always that volatility trading is not Physics. All models, however good they are, are only models. To come as close as possible to reality is the essence. To correctly model the connection between short and long term volatilities is key. This is especially crucial when the market approaches from extreme levels as volatility behaves quite differently at very high and very low levels from what it does when trading at intermediate levels. The winners usually understand what their models do and what they don't, and act accordingly.

How they can/do they optimise performance in times like these...

The only certainty in an environment like this is change. So one needs to position oneself in a way that allows for swift changes in exposure from long to short and vice versa. People

that bulk up with their positions one way do extremely well for a week and blow out the next. Volatility based products allow you to construct dynamic portfolios. The optimal strategy is to set up your portfolio in a way that your portfolio's dynamics are in line with what the market does e.g. focussing on gamma in short but swift moves and focusing on vega in extended significant moves. Ideally your portfolio would move from one exposure to the other once certain thresholds of market moves are breached. In a quick moving market there are also much more arbitrage opportunities than in quite markets. However the margins need to be locked in rather quickly as they can disappear as quickly as they appear.

When would they stand to lose?

Model driven traders generally lose when the way the market moves changes. Nowadays this happens in a significant way about every two to three years. It used to be seven to 10 years but the time intervals in which market behaviour changes are getting smaller. So there is more turnover among purely model driven traders. Last years winners are this years losers. The good news is, that volatility arbitrage works best and is most reliable when the dependency on the underlying model is reduced to a minimum. In this aspect, volatility is unique.

The role of leverage ...

Leverage per se is not necessarily as evil and dangerous as many think. It becomes dangerous if it is used on strategies that try to trade very diverse assets against each other. The more similar the assets and products traded, the less severe the impact of liquidity and credit squeezes. This is another feature of volatility. There is no product I know with so many similar contracts. This however doesn't deter many to sell highly leveraged positions in unrelated assets as arbitrage.

And how are they best prepared to surf a tide like this...

Discipline is key here. Sometimes trading very diverse assets or products may seem to offer exceptional margin. But margin needs to be scaled by risk. If one loses the discipline to do so - it's usually the first step over the cliff.