

VOLATILITY

MEAN REVERSION IS DRIVEN BY PAIN AND PLEASURE RATHER THAN GREED AND FEAR



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Do you agree with the statement that even the best volatility fund managers are not immune to losses? Why or why not?

No one is immune to occasional losses. The assumption I am making in such a case is that we are referring to losses that are not major when compared with the assets being managed.

Of significance would be whether those losses arise from a well diversified statistical arbitrage or relative value strategy, or from an unbalanced concentrated bet. In the case of the former, some trades are expected to lose and some are expected to gain with the majority gaining, assuming always - equal bet sizes. Then, the occasional losses are just part of the expected payoff distribution. In case of the latter, however, losses are often the result of "bad luck" - and suggest that the strategy being followed is one that is based on luck as opposed to skill. This is cause for concern.

Hence it is important to determine and understand what caused the drawdown rather than fret over the fact that it exists. The nice thing about volatility is that keeping relative prices at unreasonable levels is very expensive. Mean reversion for closely related products therefore tends to be exceptionally reliable.

What makes it so difficult to avoid losses?

Most volatility fund managers bet directionally, even though they claim otherwise. Most also tend to bet with insufficient diversification and on absolute value rather than really arbitrage volatility which usually means betting on relative value.

Then again, if a manager did everything right, he/she would still have to contend with occasional negative payoffs as the market is not always rational. However, if the individual "bet" size is small enough and the positions placed are well diversified, it should not impact the overall performance substantially. Relative value can be estimated with high certainty and reliability, in contrast to absolute value, which cannot.

Drawing on your experience, what are the lessons you have learnt that help you stem and minimise losses?

- Bet on relative value rather than absolute value and look for arbitrage opportunities rather than trying to pick the bottom and top.
- Gaining exposure to volatility is quite expensive and directional.
- Getting exposure to "volatility of volatility" can be nearly free and in the ideal case it is completely non-directional. So one stands to make money irrespective of whether it goes up or down. (frequency vs. direction)
- Another key is to constantly create new positive risk profiles.

What differentiates volatility as an asset class? Peculiarities?

As volatility is mean reverting, it must be traded rather

than invested in to achieve market independent, optimal returns. It has a limit to the upside and the downside. Also, the holding costs increase with the level. Normal assets don't usually get more expensive to hold when their prices rise. Therefore mean reversion is driven by pain and pleasure rather than greed and fear.

If prices are driven apart too far, it is very painful to hold a position that bets on prices moving even further apart. This makes things mean revert quite reliably and quickly.

Finally, there are a huge number of products that are based on the same underlying asset which are inter-connected to each other via strong relative value and forward relationships. So there is an abundance of arbitrage opportunities as the multitude of contracts allow for a very precise estimation of relative value, even though absolute value would be difficult to assess.

Who should be investing in volatility? Why?

Anyone seeking truly market independent returns or those seeking to leverage, protect or yield enhance their portfolio in an efficient manner should have a closer look.

To achieve market independent returns, however, significant skill and infrastructure are required. So, for most investors it's likely to be more efficient to "outsource" this to a competent hedge fund.

Volatility offers true alpha if used correctly. It also allows for very precise tailoring to meet customised risk profiles and payoffs. In effect - it allows an investor to sell exposure they do not want or need and from those proceeds, they can acquire those that they want or need.

What should an investor bear in mind when he/she evaluates a volatility manager?

- To spend sufficient time to find out if the bets are directional or are truly non-directional.
- Directional exposure can be gained simply and cheaply by any investor. True alpha generation however is the domain of experts.
- Lack of diversification and many underlying securities in the portfolio are usually simple signs of hidden directionality.
- In many cases it might be worth getting outside advice to assess the soundness of a strategy
- In general, any strategy with less than 30-50 similar but largely off-setting positions will most likely be quite directional.
- Finally, any strategy that is highly model dependent has hidden risks that are often hard to assess.

By the way, in response to the growing needs, we have just set up a new firm, which among other things, offers consulting services aimed at helping investors set up their own derivatives pricing, trading and risk management capabilities as well as helps them evaluate and deploy derivatives based strategies effectively.