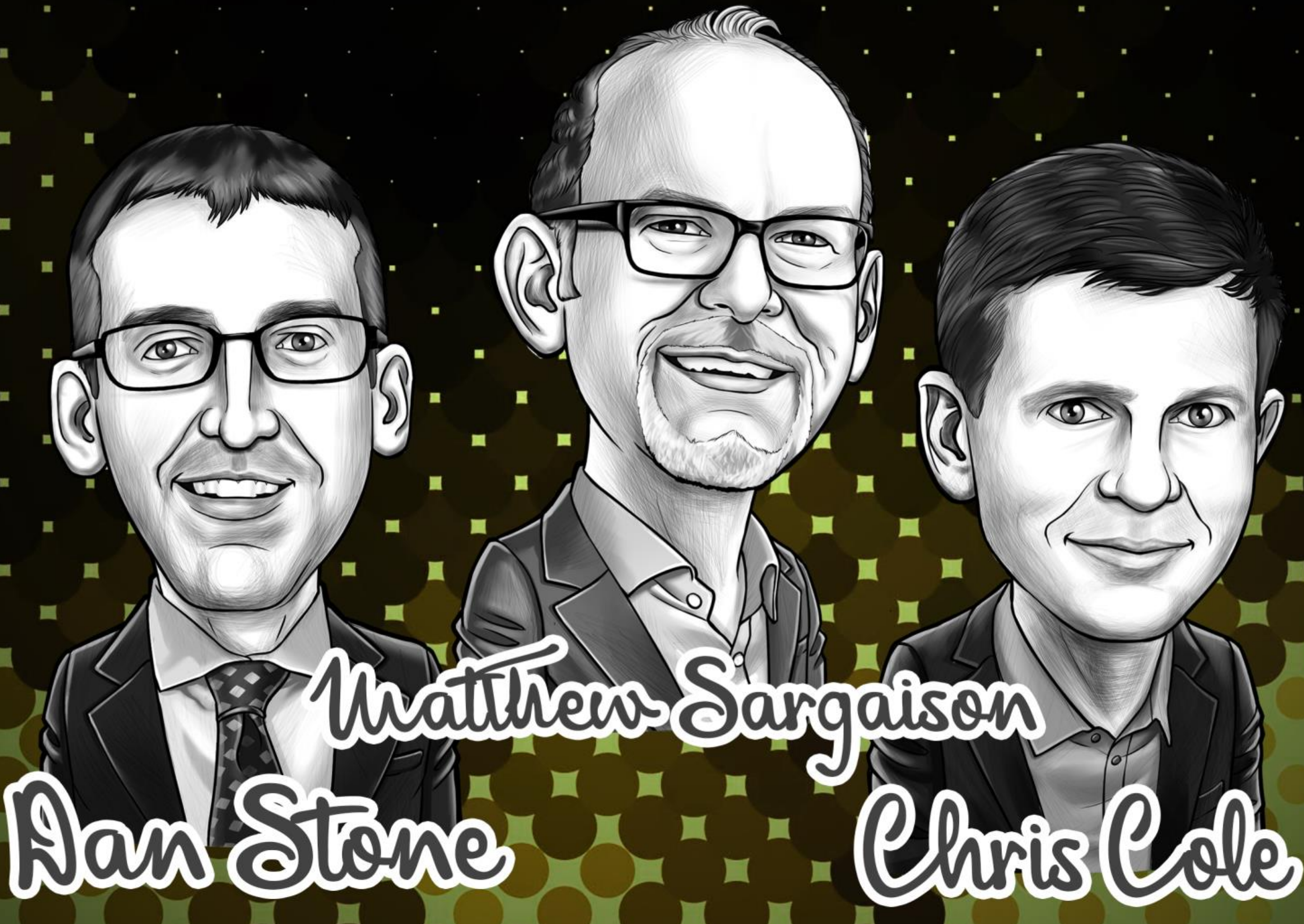
TOP TRADERS ROUND TABLE

EPISODE #23



"This is where the populism intercedes with the market risks. I think people look at these risks as independent risks, so they're not looking at them and how they interrelate with the ecosystem of financial products, as well." ~ **Chris Cole**

The following eBook serves as a detailed transcript of Episode #23 of the Top Traders Round Table Podcast. You can find show notes and more information on this episode right here: toptradersunplugged.com/rt23

I sincerely hope these interviews serve as a useful resource for you in your career and endeavors in the world of trading. If you have indeed enjoyed these shows, please consider giving the podcast a rating and review on iTunes. It would help spread this knowledge to traders everywhere.

As you read this transcript, remember to keep two things in mind: all the discussion that we'll have about investment performance is about the past, and PAST PERFORMANCE DOES NOT GUARANTEE OR EVEN INFER ANYTHING ABOUT FUTURE PERFORMANCE. Also understand that there's a significant risk of financial loss with all investment strategies and you need to request and understand the specific risks, from the investment manager, about their products before you make investment decisions.

Niels: Welcome back to Top Traders Round Table, a podcast series on managed futures brought to you by CME Group and the Managed Fund Association, where our guest host today, Chris Solarz, continues his conversation with Chris Cole, Dan Stone, and Matthew Sargaison, where they discuss global macroeconomic market risks, volatility trading, and tail risk hedging. So, without further ado, let's rejoin the conversation.

Chris S: I think, just to loop this back to our initial comments, I think the suppression of volatility has come at the hand of quantitative easing which pushed interest rates down to zero around the world. Even today there are still eight to ten trillion dollars of negative yielding sovereign bonds. This has lead to this reach for yield, which has lead to deterioration of credit quality. It's also lead to the short vol products where you're selling premium and collecting the coupons, and everything works well until one day it doesn't work well.

In the good old days of hedge funds, prior to 2008, short vol strategies were high yield credit, like long/short equity was the short vol strategy.

Dan: I would say it still is.

Chris S: Of course, it still is.

Dan: It still is, and even bigger, yeah.

Chris S: But, what I've seen, which is so amazing, it's people are coming, and that's the name of the fund. It's called the short vol fund; it's very explicit. They're not dressing it up. You didn't see any of these until really over the past five, eight years. They're very explicit, and this is what they're doing.

It does work over time, and that probably is a positive expected value proposition over time. But, no one wants to take that pain. I think that's the big worry that there are a lot of institutional portfolios that have a lot of pain to come if and when it all builds up to this big event.

Matthew: It's not a hedge fund strategy. It's a risk premium, of sorts, with very low expected long term return. But, if you get in an environment like you have, then you certainly see people running into the game, which actually exacerbates the problem.

We talked a bit about the QE moving into QT here in the U.S. In Europe it's not clear to me that we're going to see the same unwind. I think Draghi will blink because he hasn't managed to revive the European economy as well as the Fed has.

The worry to me is actually his next step because the asset approach didn't really work as they wanted to is to go all out. It will be helicopter money. It will be a people's QE just, basically, to stop the Italians from trying to pull out of the European Union at the same time as the Brits. If you do that, then you end up with an inflationary pressure which we haven't seen for a very long time. It probably does have some other impact on the economy and probably also helped to drive down... So, temporarily it will probably support the equity market, but then it screws up the fixed income market even more.

Chris C: It's a fascinating point, and it's an amazing point. Let's just imagine for a second that they turn around, and they decide to print money to go reinvest it and do public works projects. I'm not making a political argument whether this is good or bad, I'm just stating let's imagine this hypothetical scenario.

Well, you end up having all this money where they just give out helicopter money to help people and to pay off student loans and all these sorts of things. Let's just imagine this happens. It's immediately inflationary, but what you might end up seeing in that scenario is a massive uptick in interest rates catching up with inflation.

By the way, what caused the '87 unwind of the major short vol trade was actually, people don't realize this, inflation was lower in '87 than where it is today. So, you had a quick increase in rates, up three hundred basis points in a period of five months that then caused credit stress, that then caused a big short vol trade to unwind. So, this is where the Populism intercedes with the market risks. I think people look at these risks as independent risks and they're not looking at them in how they interrelate with the ecosystem of financial products as well.

Dan: I would say the theme of monetary policy divergence, if it expands, that's one that is by definition very favorable for currency vol, in particular, major market currency vol, which at the end of the day, is ultimately about these interest rate differentials.

Chris S: Yeah. From the discretionary traders that I talk to, a lot of them are very bullish about this upcoming environment. For one, we're off the lower bound of the short end of interest rates. For the first time in nine years, with the Fed at 2.5% and cuts priced in for 2020, we could really make a fair game that it's a two way market for the first time in years. The Fed could cut, or they could increase interest rates. That's very interesting.

It's great for active managers. It's good for interest rate traders. I think that's a bigger theme as well. Hindsight, of course, is 20/20, but when you have a bull market, when you have low interest rates, and you have low volatility, you want to be with passive investments. It's a time like now when everything is in play, when you have sideways markets, and particularly when you have a bear market that's when you want to be with active managers.

It's not necessarily just long volatility managers, it's not volatility arbitrage managers, but really anyone who keeps a market neutral portfolio, if they're a discretionary trader, discretionary macro, the old school thematic macro, interest rates in FX, this could have a very good 2019-2020. So, I think we're getting a lot of interest back into active management, which, effectively, is all of hedge fund strategies.

Chris C: Well, anyone who makes the classic hedge fund... Somehow hedge fund morphed into short vol or risk premia. There's a classic hedge fund, the classic hedge fund manager is, we think of the cowboy days of legends like Paul Tudor Jones, where you're making macro bets, and you're trying to find... If you think about that concept of macro or CTAs, they're trying to create optionality. They're trying to own some form of optionality inexpensively. Whether that's through an intelligently structured position, whether it's through a strategy that seeks to buy into different momentum, you're trying to own long optionality. That's what classic hedge fund investing is.

We're going back to an environment where it's going to be profitable to make opportunity from change. That change, to this point, it doesn't have to be all left tailed. It could be left tailed. It could be the market drops twenty percent. It could be the market goes up fifty percent in some sort of insane reflationary change of regime. But, either way, it's going to be a wonderful time to make opportunity from change as opposed to the last ten years which has been trying to squeeze juice out of a short vol trade, no matter how that's expressed.

Chris S: That's right.

I think one of the dirty secrets of the nouveau hedge funds is that they're masquerading beta as alpha, selling short volatility as a real hedge fund strategy, and largely getting away with it until now.

Well, if it suits you guys, I would still love to hear more about some specific trades or specific themes that you are finding particularly exciting at this moment in time, in your portfolios.

Matthew: So the one thing, we haven't touched, clearly from my perspective, a lot of what we're doing, as a CTA, is be as broad as we can possibly be. We look at a lot of markets, and time frames. We intentionally run a slightly faster than average long term CTA trend style with the intention that that is what's going to deliver slightly more positive skewness to the return. It's more of a long term strategy than you otherwise get.

It's been painful in the same way that running a long vol strategy is painful. Yet, exactly as you'd expect, come December, it's a better environment to be in, and in the future we still think it's a good position to have. So, there's nothing new in it, but it feels like, despite how last year was from a return perspective, it is still a good environment for us.

Chris C: We focus on long volatility, but on both tails, both tails of the return distribution. But, we think in terms of systems and not trades, necessarily. We think in terms of systems. But, if I have to highlight certain themes that I see, a vol term structure is very flat. That means it's relatively efficient to carry known volatility positions at this level in the event that you have a break in volatility.

Vol of vol is below averages right now. So, that's pretty interesting. Actually, skew has come down. So, I think one of the things that is really intriguing is that even though we had performance in long vol, in periods like December, it was not so much the volatility that paid off (and maybe we'll talk about this later), but it was more the deltas and the gammas inherent in the positions that paid off. Vol didn't pay off that well.

One of the reasons for that is, I think, big institutions just were so hedge fatigued that they don't want to pay up for volatility of volatility, they don't want to pay up for skewing more, they don't want to buy implied volatility, they don't want to bid it up. They are essentially saying, "Why do I need to buy fire insurance when the Fed will put out my fire for me?"

That could be a very costly mistake. But, long story short, what it means is that many different dimensions of volatility are actually very affordably priced right now. That can be played systematically or in a discretionary framework in a way that can profit if there's a break in vol either on the right or left tail.

Chris S: Dan, is there any asset class where vol is particularly cheap from your perspective?

Dan: I would say in both interest rates and currencies, and, in particular, long-dated vol. It's back to this concept of the flat term structure. So, in interest rates and currencies, you can find even in the downward sloping term structure - so, the long-dated implied volatility at a discount to short-dated implied volatility. So if you buy the long-dated option with the passage of time, you roll up the curve. This gives you an element of positive carry.

Now, the world is aware of the trades. We say the vol universe is aware of these trades, but it maybe shied away because of the frustration of waiting for that vol pivot. But, the argument is that this is not the moment in time to let that frustration steer you someplace else. The fundamentals are extremely compelling. The valuations stand out. The carry is attractive. The asymmetry is at a record high.

Chris S: Yeah. I think this was the frustration for a lot of investors in vol funds or tail risk funds in February. Because February shook out with the biggest VIX one day spike in history earlier in the month, you can imagine short vol managers lost money. But, interestingly, by the end of the month, most long vol managers lost money because the backend vol didn't move at all.

What's the scenario where we really do see this spike in the backend where you can really profit from being long-dated vol?

Dan: I'd say, ultimately, this has events in the vol regime changing. One of the things is thus far the vol regime has not yet changed. There are signs that it's maybe going to happen shortly. But, so far at least the old mind-set still stands, which is that the Fed or central banks are the guardians of the markets and that reflexively you're supposed to sell vol into the spike. So, that is, again, a core part of having the average derivative trader trades.

To go back to what Chris was talking about earlier, which I think is really important, the mind-set used to be 180 degrees opposite. When my career began in the mid-90s, you were taught always be long vol structurally because vol always goes up, therefore always buy the dip.

You go through this sequence of events: '97 you have the Asian crisis, '98 you have Russia default long term capital implode, '99 we get the NASDAQ bubble (so it's the vol event to the upside on the right tail), 2000 the NASDAQ bubble busts, 2001 you get September 11 (so the ultimate idiosyncratic event), 2002 you have accounting scandals (World Com, MCI, and so on), so you have six or seven years of major vol events every year. So, that was the perspective.

So, just at the same moment that everyone decided you should be long vol for sure, of course, it proves to be the exact wrong strategy. So, likewise today it feels like this mind-set that vol can never rise will be broken. But, the natural inertia that vol has, I think, is causing people to be confused about where we may ultimately end up.

Chris C: If you want to have a sense on how forward volatility is priced which, in many ways, is also how the long end of the vol term structure is priced, just do a moving average on historical vol. It reflects behavioral biases, and now you have an entire generation of traders that don't even know what a real crisis is. They were playing with toys in their crib or were in elementary school during the last major financial crisis. They have no institutional knowledge of what a real elevated vol regime looks like.

When does that long end of vol term structure come up? Well, you go back historically (I think I put this in my recent letter) we graphed corporate leverage - so corporate debt to GDP. We are now at all-time peaks of corporate debt to GDP. It's at about 47%. We've never reached that height. But, that graph, which goes up and it goes down, perfectly tracks the long term vol cycle dating back to the 50s.

So, if you want to start to understand when that vol regime is likely going to change, what we see is there is this period of time where corporate debt peaks, then there's a deleveraging cycle, and then volatility begins to increase, and the average vol begins to increase. It is intrinsically tied to that debt leverage cycle.

So, obviously, the Fed could extend that cycle another year or two or three years if they want to. But, at a certain point, the piper has to be paid. Is that going to be in a year? Maybe, likely. Is it likely to be within ten years? Almost certainly. Five to ten years? Almost certainly. But, if you're an institution you're not seeing that, and you're just calibrating your models to the last five years, I think you're making a big, big mistake.

Chris S: Well, I think this is a nice transition into the third part of our discussion. I want to talk specifically about hedging the way that institutions are looking at their portfolio. I think what's interesting is that most… In fact, I think a lot of investors don't understand the basic concept, sometimes, that you simply can't be long volatility and be paid to be long volatility. You can't own insurance and be paid, monthly, to own that house insurance.

So, I think this is a tricky concept and that sometimes it's mis-sold in the fact that you can be long vol and long carry. That's the holy grail of any type of investing, and it so rarely happens that we almost shouldn't talk about it.

But, I think it's particularly troublesome for example for pension funds which are, not only underfunded, but they know they want to be hedged: that the rest of their portfolio is long-biased and to put that hedge in their portfolio, it's a negative expected value proposition. So, it's sometimes challenging to marry both these worlds when you know that it will lose money.

A lot of people have… After 2008 and into 2009, there was a big inflow into global macro strategies, long volatility strategies, tail risk strategies and trend following strategies. In a lot of ways, anything long-biased has outperformed all four of these sub-strategies. People are fatigued now. People are tired, and they know they should have some kind of hedging, but they hope that diversification in portfolio construction can help them. Perhaps that won't be the case.

So, I'd love to hear from you guys about your investors who are using your long volatility products, where does it fit? Who are the most popular investors that are seeking this type of protection? Dan?

Dan: I think that there are a couple of camps. There are some of the larger, more sophisticated institutional investors that have had the ability to think about some of these issues on a deeper level. So, they would understand that, yes, you do not make money in all scenarios. That's the fundamental trade-off.

But, I think they also recognize that long volatility trades, even tail trades, may not have a negative expectation at this moment in time and at this point in the cycle. So, although those trades will lose money if the market rallies, as a part of a diversified program, that's fine. But, they make significant money when you most need it, and the right trades with a positive expectation make money over the full market cycle.

So, I think that's the most sophisticated are after. Is there a strategy out there that still gives you a positive expectation that has a meaningful negative correlation? Because it's so hard to find negative correlation in the hedge fund world or just in the investment world more broadly right now.

Chris S: We often have clients come and ask for uncorrelated, orthogonal strategies - uncorrelated to their long equities. So, I joke, "So, you want something that's lost money for every year for nine years?" And they say, "Oh no, no, we want something that has also made money." I think that's a big problem because these strategies have been hurt. Right now you don't want to look at the trailing five-year returns because you'd probably discount almost all of these responsible long volatility type of tail risk investments, even though, from this point going forward, the proposition is very different than it was five years ago to today.

Matthew, how about you, what are your clients seeing? How are they using your products?

Matthew: Well, just to add to what you were saying there, not only do they want to have positive carry, uncorrelated returns, with positive returns, they also want to pay far less than they paid a few years ago for that same thing. There are a few things that we see. One is there's a bifurcation, at least on the CTA side, with people who look at what trend following was, intentionally, as still an alpha. If you go for the full breadth, then you are actually looking in as many markets as you can get to. Then, there's still enough diversification to find pockets where the trends exist, and you can pick up from it. It's been a tough environment, but that has worked OK.

But, then far more institutional investors tend to be focusing on exactly the opposite. They want the most concentrated, lowest cost, but focused trend following which is only structurally aligned with their portfolio. So they want, more or less, cap-weighted positions around the S&P and Euro stocks and treasury bonds because those are things that they are actually structurally worried about in the downturn. So, they want to have a guarantee of a hedging ability in those areas.

One of the things that I think we have also seen interest in is looking structurally at what the risks around the bond portfolio are. So in a way, it's less now about buying funds; it's about buying solutions, and I'm putting my fingers in the air to put quotations around that. But, there's a lot more dialogue about what portfolio modelling needs to go on to find the right balance. Look at the correlations between the equity market and fixed income market in the rising yield environment and reacting to those environments, specifically, which will naturally come up. We sort of saw that, actually, back in January, before the February thing. The treasury bond market was starting to suffer quite a lot of stress, and it took a while for people to start thinking about forward valuations and say, "Actually, this may be this is also going to impact the markets."

So, there's quite a lot of discussion, and I think the sophisticated investors are trying to come and have proper conversations. It's not just about one strategy. It's not a single long vol. Let's be as far down the terms of structures, so we don't worry about the carry we're paying away, because that typically hasn't helped anyway. It's about working out the different components that can add value.

We've done a whole bunch of paper writing about the kinds of active strategies that work best in all structures. A lot of it isn't just about vol trading. It's even things like quality stock action, tilting portfolios in that direction around the times when you see stress in the markets because actually, you want to step back away but not take your exposure off completely.

Chris S: Yeah.

Matthew, I'd love to hear your view on trend following at the moment. If we're sticking with our Game of Thrones Analogy, it's not that winter is coming for trend following, I think winter is already here.

Matthew: It has been for a while.

Chris S: It's been here for years. Even the most ardent supporters have thrown in the towel. It has been so challenging.

Matthew: Strange enough, we've not found that the smarter investors have walked away. So we're not releasing much of that in our space. The industry has still clearly grown since the financial crisis, and that's not gone away completely. I do, I share the concern that actually, it's not necessarily that trend following itself, but a lot of the time it's been the risk scaling, the effective vol strategizing which will actively see deleveraging every time we start seeing spikes up.

I can't talk to the clients walking away because I think there's actually still an understanding that this does have some potential left side protection value. So, as long as it's within the larger portfolio and it's not seen as a single line item that you worry about in a given year. It's still less costly, potentially than just running the naked long vol.

Chris S: Yeah. I think this has been a long cycle and it has been this quantitative easing cycle over the past, call it a decade. Over that time we've seen underperformance of active management at the hand of passive management. We've seen the underperformance of trend following and the momentum strategy. Most importantly, for the majority of hedge funds that are long/short equity, we've seen the underperformance of value at the hand of growth.

I think, if you look something like over the past 100 years, value has outperformed growth by something like 8, 9, 10%, on average for 100 years, but for the past ten years has been the other way around. So, it's been the fangs that have lead the way. So, the question, for a lot of the hedge funds, has been, "Who has the biggest position in the growthiest names?" And the value guys have been killed.

I think if it gets flipped around we could very easily see the outperformance of discretionary global macro. A value will come back in favor, and it will be more of a stock pickers market when we have a more normalized market, which I think we've already seen over these past twelve months.

Chris C: Then cycle follows the leverage cycle. One of the last periods of time where there was significant outperformance of momentum over value was before the 2007, 2008 crisis. Then, before that, there was a very long outperformance of momentum over value just prior to the dot com crisis.

So, it actually is a sign of blow-off tops in markets, or of a peak regime. It doesn't mean it can't continue for another year, two years. But, when you see that divergence, it's worth taking note.

To add a little bit, I just completely reiterate, I think a lot of our clients take a mosaic approach, and they say, "I want to have this long vol exposure," and they'll broadly define long volatility. Long volatility could be what Dan and I do, actually going out and purely buying volatility or optionality. It could be creating synthetic gamma through CTAs, or it could be smart global macro managers that create synthetic optionality, but they take a mosaic approach.

I think one of the big themes this cycle, going back in the '90s you sit back and say, "What was the best positive carry, diversifier, long vol manager was owning investment grade fixed income. Because every single time it was positive carry. Every single time you had a drop in interest rates that ended up performing really well. So, it ended up in this cycle where people said, "I get this exposure through fixed income."

Well, fast forward to today, to get the same convexity out of your bond portfolio you have to have rates go deeply into negative territory to get the same convexity that you got in 2008. So, I think many of our smartest clients are saying, "While we want a diversifier, we don't trust fixed income as a diversifier."

The disaster scenario is where stocks and bonds go down together at the same time. That's a disaster scenario, and it's one that I've talked at length about in some of my research papers. But, another disaster scenario is if stocks drawdown 40% and fixed income gets you 4%. That's also a massive disaster for an already underfunded pension system because treasury bonds and high quality fixed income really performed in '08. It could just be stocks down a lot and bonds not giving anything. It's another big reason to look towards alternative forms of long volatility exposure that can perform when your 60/40 stock/bond split is 100% loser or not doing much for you then you know that vol can perform in that regime shift.

Chris S: Thank you, Chris. That was a perfect way to wrap it up. We are bumping up against our time limit here, so I want to thank my guests Chris, and Dan, and Matthew for coming on the show. Thank you very much, guys, and thanks to everyone for listening. Take care.

Niels: And there you have it. Thank you so much, Chris for a great and wide-ranging conversation about current risks, market volatility, and tail hedging opportunities. I hope you were able to take a lot of useful information from today's conversation onto your own investment journey. If you did, please share these episodes with your friends and colleagues and send us a comment to let us know what topics you want to bring up in the upcoming conversations with industry leaders in managed futures.

From me, Niels Kaastrup-Larsen and our sponsors CME Group and the Managed Fund Association, thanks for listening and I look forward to being back with you on the next episode of Top Traders Round Table.

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