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Bloomberg - Hedge Funds Can't Resist This Volatility Trade That's Been Losing Money

By Klaus Wille and Simone Foxman - October 16, 2017

Does the lack of worry in global financial markets worry you? A growing number of hedge fund managers are counting on it.

Brevan Howard Asset Management, 36 South Capital Advisors, One River Asset Management and at least three other firms are rolling out new funds designed to protect investors from rising market turbulence. While so-called long volatility strategies have been some of this year's worst performers, everyone from Nobel laureate Richard Thaler to BlackRock Inc. Chief Executive Officer Larry Fink has warned that the unusual state of calm in markets may not last.

"This is a multi-decade opportunity to buy volatility," said Richard "Jerry" Haworth, who co-founded 36 South in 2001 and more than tripled investors' money in the firm's Black Swan Fund during the global financial crisis. 36 South launched its new product, called the Lesedi Fund, on Oct. 2, according to documents obtained by Bloomberg News.

If Haworth is right, sanguine investors around the world could face a rude awakening. Indicators of expected swings in stocks, bonds and currencies have fallen toward multi-year lows, while valuations for just about every major risky asset class are climbing. That's despite heightened uncertainty over U.S. economic policy and the prospect of war with nuclear-armed North Korea. Thaler highlighted the dissonance in a Bloomberg TV interview after winning the Nobel Prize in economics last week: "We seem to be living in the riskiest moment of our lives, and yet the stock market seems to be napping."

The big question for long volatility managers is whether they can convince investors to embrace what has been a losing bet in recent years. Like insurance policies, the funds tend to act as a cash drain most of the time and only pay off when volatility spikes. With markets as calm as they are now, investing in a long-volatility strategy can feel like hiring someone to throw your money away.

While the funds surged 46 percent as a group during the crisis in 2008, they've lost 9.1 percent this year and are down 17 percent over the last five years, according to Eurekahedge Pte. The five-year drop is the second worst among 20 categories after tail risk, a supercharged cousin of long volatility that bets on extreme market swings.

The past few years "have created a whole graveyard of long-volatility funds," said David Frank, the New York-based chief executive officer of Stonehaven LLC, which helps connect investors with alternative money managers.

Some asset allocators are convinced a turnaround is coming. Michael Preiss, who helps rich families invest their money as a Singapore-based portfolio strategist at Taurus Wealth Advisers, is advising many of his clients to prepare for an increase in market tumult.

“The most mispriced asset class in the world is volatility,” said Preiss, whose firm helps oversee about $1.9 billion. “Quite a bunch of our clients are in discussions with us at the moment about whether to add volatility strategies.”

That should be music to the ears of hedge fund managers like Brevan Howard. The firm is expected to start a long volatility fund soon, people with knowledge of the matter said. Funds planning similar launches this year include Astrid Hill, founded by Millennium Management alumnus Arun Singhal in Singapore, and One River Asset Management, a manager of $700 million led by Eric Peters in Greenwich, Connecticut, according to Singhal and One River marketing materials obtained by Bloomberg News.

Global Sigma Group, founded by former SAC Capital trader Hanming Rao in Boca Raton, Florida, opened a volatility fund in June that currently has a long bias, according to Emerging Manager LLC, which provides marketing and consultancy services to Global Sigma. Grupo BTG Pactual SA’s asset management unit started a global volatility fund on Oct. 1, according to an investor presentation.

“The low volatility environment just doesn’t make sense when you step out of markets and look at the real world,” said Steve Jacobs, BTG Pactual’s London-based head of asset management.

Trump, Kim

Topping the list of worries for many observers is the war of words between North Korea and U.S. President Donald Trump. A North Korean official warned on Monday that a nuclear war “may break out any moment” as the U.S. and South Korea began joint naval drills off both the east and west coasts of the peninsula.

“People are on tenterhooks,” said Chauwei Yak, co-founder of Gao Capital, a hedge fund research platform in Singapore.

Even if cooler heads prevail and the countries avoid an armed conflict, volatility bulls can point to plenty of other potential catalysts. One of the biggest is tighter monetary policy at the world’s major central banks. The Fed has been raising interest rates since 2015 and will begin reducing its balance sheet this month, while the European Central bank is expected to unveil plans for cutting asset purchases soon. The Bank of England may boost borrowing costs next month for the first time in more than a decade.

China is another looming concern. While the nation’s record debt burden has fallen off the radar of many investors this year, it continues to expand beyond levels that preceded financial crises in other emerging-market countries.

“The opportunity is right now,” said Astrid Hill’s Singhal, who plans to start trading in his volatility fund by year-end with an initial target size between $50 million and $100 million. “One of the biggest fears I have is I miss it.”

Of course, many forecasters -- including 36 South’s Haworth -- have made similar pronouncements over the past few years only to watch volatility move inexorably lower.

And in a lot of ways, that made sense: global economic growth has been stable and inflation has remained under control in most parts of the world. With bond yields hovering near historic lows, selling options (the contracts that underlie volatility gauges like the VIX Index) has become attractive for investors who care more about earning extra income than protecting themselves against market turmoil that may never materialize.

Even if more investors start to position for a jump in volatility, hedge funds aren't their only options. Lower-fee exchange-traded funds linked to equity volatility, such as the ProShares VIX Short-Term Futures ETF, have grown increasingly popular in America. There are also hundreds of futures and options tied to stocks, bonds and currencies that allow institutional investors to position for bigger market swings without the help of a hedge fund manager.

To increase the appeal of his long-volatility strategy, Haworth focuses on reducing the "negative carry," or steady bleed of cash, that accompanies calm markets. That's gotten easier these days as prices for options and other volatility-linked derivatives have fallen.

"Nobody wants to lose 10 percent a year, even if there is an expectation they make 500 percent by year ten," Haworth said.

He's hoping it won't take that long for his trades to deliver.

"For every day there is no volatility, the odds on volatility coming are actually increasing," Haworth said. "We have to be patient."

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About Stonehaven, LLC

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