Epsilon Theory

In the Flow

Why Your Long-Vol Allocation Isn't Working

March 4, 2019

We've had an influx of new ET Professional subscribers over the past few weeks, so I thought I'd lead off this email with a quick review of what you can expect from these In the Flow notes. But first, thank you! ET Pro is the culmination of everything that Rusty and I are building at Second Foundation, and we truly see our ET Pro subscribers as our partners. So please … think of yourself as our partner, too, and don't hesitate to give me a shout or drop me a note with any ideas, questions or suggestions. Also, your fellow ET Pro subscribers are a pretty amazing resource in themselves, roughly evenly split between institutional allocators (foundation and endowments, public and private pensions), RIAs, institutional asset managers, and independent investors (family offices and hedge funds). If there's ever a question you'd like to pose to the group, please let me know and I'd be happy to shepherd that process along in a way that respects everyone's desired level of anonymity and participation.

ET Pro is where Rusty and I marry our narrative research with our investment experience to deliver (we hope!) useful and actionable investment ideas, whether that's a specific trade or an allocation recommendation. What we're not doing is building a model portfolio or something like that, both because you don't need us for that and because of the range of subscriber interests and day job responsibilities described above. My personal market experience is primarily as a hedge fund PM, so my brain tends to think in that direction, but Rusty's experience as an allocator and our shared experience working for an institutional asset manager and RIA should broaden our recommendations enough to be useful to everyone without watering them down. Again, feel free to give us a shout directly if you have questions about how to apply our ideas specifically to your interests and responsibilities.

Typically we will write about our investment ideas in a general sort of way as free-to-read website content, and then discuss the specific implications here on ET Pro. For example, yesterday we published a free-to-read note titled "**Heads I Win, Tails You Lose**" (PDF attached). Here's the money quote from the piece:

- Everything that has shifted in the relationship between State and Market has shifted to prevent a systemic-ending deflationary shock like 2008 from ever happening again. *So it won't*. If you have prepared your portfolio to protect you from a nasty deflationary shock like a Euro crisis or a China crisis or a Fed crisis – what I call the Three Horsemen of the Investment Semi-Apocalypse – you are building a Maginot Line. You are fighting the last war. You should prepare for the next war. You should prepare for the Fourth Horseman – Inflation – because this horseman is riding in *as a* *response* to a deflationary shock or in *the absence of* a deflationary shock. Either way, fast-motion or slow-motion, THIS is the vector of the next system-redefining process.

- While passive large-cap equity indices may not fluctuate so much over this new Zeitgeist, at least not in real terms … your portfolio (particularly an institutional or ultra high net worth portfolio) almost certainly will, especially in real terms. Why? Because the bond market ain't a political scorecard. Because everything you think you know about portfolio diversification will fail when the Fourth Horseman rides into town. Because emerging markets are going to be *crushed* before this is over. Because every professional investor's inflation-investing muscles have atrophied to the point of helplessness. Because you think long-vol and crisis-alpha are things.

What I'll be doing in these In the Flow notes over the next few weeks, then is reviewing those last five general observations:

1) Persistently higher bond market volatility without political narrative protection;
2) Diversification challenges in an inflationary regime;
3) EM sensitivity and, more importantly, vulnerability to DM debt monetization;
4) How to think about stock/sector selection from a narrative and changing Zeitgeist perspective;
5) Why long-vol and crisis-alpha strategies sound great but aren't working;

and discussing how you might implement each of those views in various portfolios and strategies.

So today some thoughts on long-vol and crisis-alpha, with the specific observation that funds built on these principles aren't working and I think are unlikely to EVER work given the way they are constructed. It pains me to say this, because some of my favorite people in this business are long-vol managers and my self-described philosophy for a robust social life in markets and politics is to be "long volatility and short abstraction". Or at least that's what it says on my Twitter bio.

But here's what I've seen in looking at the last few months of performance for these funds. They made a little bit of money in November and December as the market fell out of bed, but not as much as you thought they would, and then they got smoked in January as the market recovered, losing a lot more than you thought they would. Now maybe you've seen long-vol funds that didn't fit this pattern, and if yes, I'd love to be shown that I'm wrong (or at least overly generalizing) in this observation. Like I say, I'm a long-vol guy deep in my bones, so I'd really like to be wrong here. But I don't think that I am.

The problem, I think, is not in having a general long-vol philosophy. **The problem is where you think a volatility shock is going to emerge and how you implement your long-vol position.** My strong belief, and this goes back to last October's ET piece "**Things Fall Part (part 3) – Markets**" (PDF attached) is that the volatility shocks that all of these long-vol funds are implemented to protect against – a Fed-driven recession, a China-driven credit/currency crisis, an Italy-driven Euro crisis – are both expensive to insure against because they are consensus worries (so there's a high negative carry to put these positions on) AND can only really make money if the deflationary shock that each of these potential events creates were to overwhelm the policy defenses created over the past ten years.

My point is that long-vol and crisis-alpha strategies are implemented to fight against the last war – a deflationary shock from a liquidity crisis in an asset class that's crucial for the financial system – rather than the next war. To be clear, I am NOT saying that it's impossible for the last war to spark up again through some new vector into the financial system like China or Italy. What I'm saying is that there's no way you're going TO GET PAID for taking out an insurance policy against the last war. Even if China drops the trade war atom bomb by letting the yuan float, or even if Italy drops the eurozone atom bomb by openly flouting ECB budget rules and daring Germany to kick them out, these deflationary shocks will be met by all of the QE and narrative arsenal that New York and Frankfurt and Tokyo have developed over a decade. And the system will win. Why? Because in the immortal words of Mario Draghi, they are well and truly prepared to "do whatever it takes" – no matter how incomprehensible it would have seemed 15 years ago, to prevent the 2008-style deflationary collapse from EVER happening again.

So what ALWAYS happens in these situations, and what I believe is EXACTLY what happened to long-vol and crisis-alpha strategies over the past few months, is that they were late to put on positions that make money from increased capital market vol in November and December. Why were they late? Because these positions are not cheap, and so you have to wait until the vol move is "confirmed" before you push your chips all-in. But then as soon as the vol move IS confirmed, that's when the big guns of anti-deflationary policy start to fire. So these funds get fully committed to their long-vol positions just as vol peaks, and they get whipsawed mercilessly when markets rebound like in January.

Like I say … I'd love to be wrong about this. But I don't think I am.

So where CAN you get paid with a long-vol implementation? First, it's got to be a non-consensus worry, so that the negative carry in setting up and maintaining the position doesn't eat you alive. Second, it can't be predicated on a deflationary shock, because that's where all of the big guns of monetary policy are focused. I think there are aspects of wage/price inflationary pressures here in the US that fit both of those requirements, and that's what Rusty and I will be exploring in our ET Pro research this month.
