

VOLATILITY IS BACK!

After an extended period of calm and buoyant markets, February was a bit of a wake up call to investors as markets sold off and volatility surged to levels not seen since crisis times. This spike in volatility, coming during a so-called “Goldilocks” period of strong growth and modest inflation, caught many investors off-guard as equity markets lurched downward on the back of fracturing short volatility investments. The sudden return of volatility has sparked a debate as to what it means for markets going forward. Volatility, often viewed as a gauge of investor fear, is seen by many as a headwind for markets. As contrarian investors, we disagree. Volatility provides investment opportunities as periods of panic often trigger irrational sell-offs opening up pockets of value to be exploited by long term investors.

Volatility makes its comeback

Over the course of 2017, this was one of our key contrarian themes as we built up positions in stocks geared into a normalisation of volatility from all time lows. While we were convinced that it would normalise, the difficulty was predicting when it would occur and what would trigger it. For us, perhaps unlike many others, February was an encouraging month; not just in terms of relative outperformance as some of our volatility plays began to work, but mainly in validating our longer term view that volatility is normalising and that this should benefit our funds as a result.

Betting against the short volatility trade

2017 was a difficult year for finding contrarian investment themes. Synchronised global growth, strong corporate earnings and loose monetary policy combined in support of broad market strength. However, the remarkably sanguine behaviour of equity markets to bouts of uncertainty, whether geopolitical or other, led us to believe that volatility could be an interesting contrarian idea. Our analysis suggested that the short volatility trade was more widespread than thought as systematic strategies such as short vol ETFs, risk parity, vol targeting and CTAs crowded in. This suppression of volatility fed back into risk models supporting increased leverage and further market appreciation. “Volatility was dead” concluded some investors and market commentators. We had heard this before when investing in emerging market exposed stocks, luxury

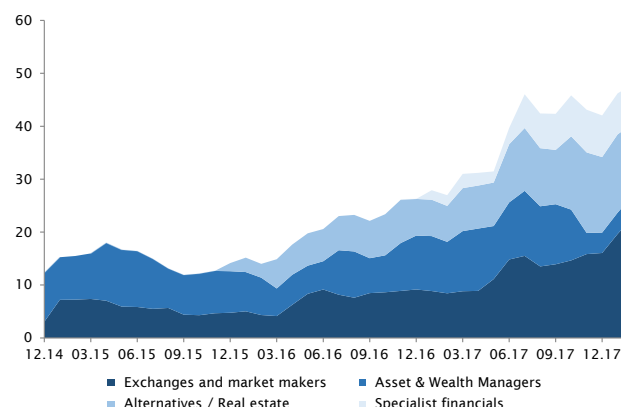


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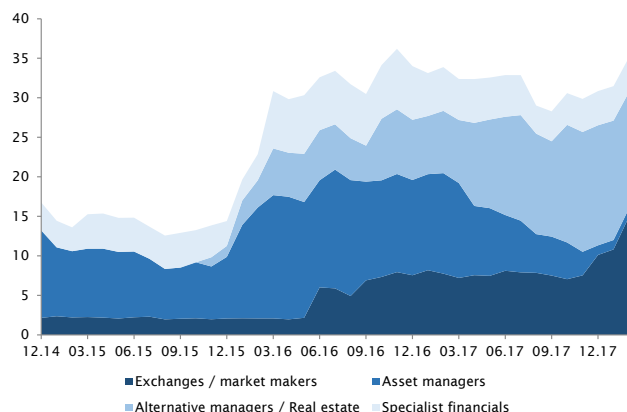
goods and many other contrarian themes, and it rarely proved to be the case. We saw this as an opportunity and began building positions in market infrastructure stocks that would benefit from increased trading activity if and when volatility began to pick up. On the other side, we reduced our positions in our asset management companies in the belief that these would struggle in more choppy markets. We complemented our existing positions in the stock exchanges by adding other market infrastructure companies like Flow Traders (a leading ETF market maker) as well as the inter-dealer brokers TP ICAP and NEX Group. This gives us exposure to volatility across equity, fixed income and FX markets.

European Mid and Small cap strategy: financials weighting (%)



Source: SYZ Asset Management
Data as at: 28 February 2018

European all cap strategy: financials weighting (%)



Source: SYZ Asset Management
Data as at: 28 February 2018

One month's vol spike does not necessarily mean a structural normalisation, although we are encouraged by the developments in February. The path of monetary tightening and gradual withdrawal of central bank liquidity will, we think, lead to a pick up in volatility over the longer term which should benefit the positions we have added. We remain optimistic that this contrarian theme will play out in the coming years.

Daring to be different

Investing against consensus is often difficult and at times uncomfortable. Push back on a contrarian theme is inevitable and it is natural to reassess the thesis in the face of differing and opposing views. We gain conviction from our detailed research process and long term investment horizon which gives the theme time to play out. We admit that we were a bit early on some of our volatility investments and this was a headwind during 2017. However, predicting when and how volatility would normalise was always going to be a challenge. We search for value and assess the downside risks while generally paying less attention to catalysts. Our view is that if we can see a catalyst, so can others and it is invariably largely priced in by the time we conclude our research. This means that being early on an investment theme like volatility is not unusual for us, but we hope to offset this by capturing most of the upside when the market catches up to our thinking.

Another output from our investment style and process is that our portfolios tend to look very different to others. For example, within financials, the consensus view is that banks are the best play on a rising rate environment. We don't necessarily disagree, but these are not the kind of companies that we typically like. In this instance our preference to play volatility normalisation is closely linked to higher rates, but we are obtaining this exposure via better quality market infrastructure companies and at more appealing valuations. Our hope is that our process leads to differentiated stock picking, but portfolios that are complementary in terms of performance and style. We believe our play in volatility is a good example of this in action.