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Global cooling (in volatility): the calm before the storm?

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Being a True Partner

Global cooling (in volatility): the calm before the storm?

2019 saw rising temperatures and risk assets, but a cooling in volatility

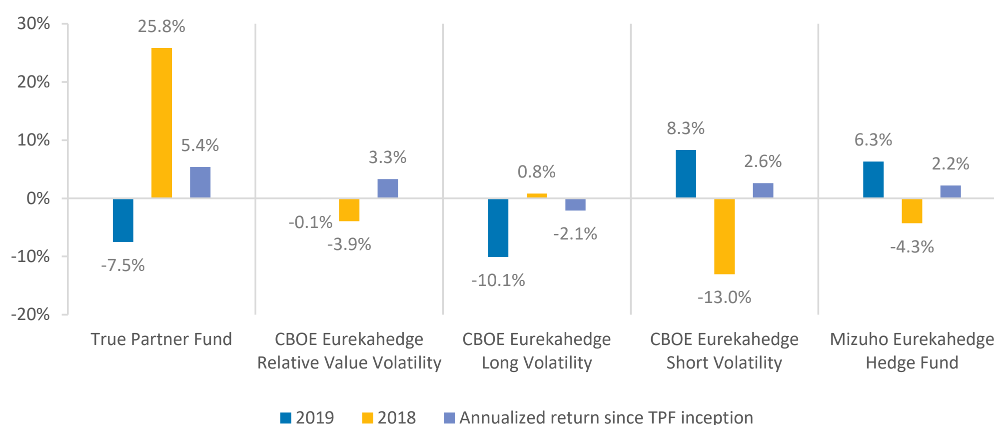
From a weather perspective, the year 2019 was characterized by many extremes: global ocean temperatures reached record highs[1], and across the world weather patterns have become more volatile. For risk assets, it was also a year of records, with new highs in stock markets and all-time lows in bond yields. While we have unfortunately seen severe weather events strike several times during the year, markets have experienced relative calm. That has meant for volatility it has been a year of severe cooling, with sharp declines in most measures of equity volatility. Unfortunately, this created a challenging environment for True Partner and many volatility funds.

After declines in 2018, global equity markets had one of their strongest ever years in 2019, with the MSCI World Total Return (Hedged USD) up +28.4% and the S&P 500 Total Return (Net) up +30.7%. Both indices delivered higher returns than in the recovery years of 2003 and 2009, helping long biased investors in a range of strategies. Meanwhile, the risks that had caused worries entering the year were largely set aside. The VIX Index of US equity volatility fell from 25 to 14, the V2X index of European equity volatility fell from 24 to 14 and in Japan the Nikkei Stock Average Volatility Index fell from 29 to 15 – below its level at the end of 2017 and its lowest year-end level since 2006.

After being up +25.8% in 2018, the True Partner Fund was down -7.5% in 2019, a disappointing performance. After outperforming the CBOE Eurekahedge Relative Value Volatility Index by almost +30% in 2018, the Fund underperformed the index in 2019, but True Partner again outperformed the CBOE Eurekahedge Long Volatility Index. As many know, while our strategy is relative value, our correlation and beta profile have historically been closer to the Long Volatility Index. Since inception in 2011, the True Partner Fund has had a -0.4 correlation and a -0.4 beta to MSCI World; over the same period the RV Volatility Index has had a +0.6 correlation and +0.2 beta to MSCI World, while the Long Volatility Index has had a -0.7 correlation and a -0.3 beta to MSCI World.

While frustrated by our 2019 return and focused on what we can do better, we know that it is only a one standard deviation event given our 11% annualized volatility, so we should be cautious about over-learning lessons from one tough year. We are happy to say that since inception the True Partner Fund has still comfortably outperformed the Relative Value, Long and Short Volatility Hedge Fund indices, and the broader hedge fund index.

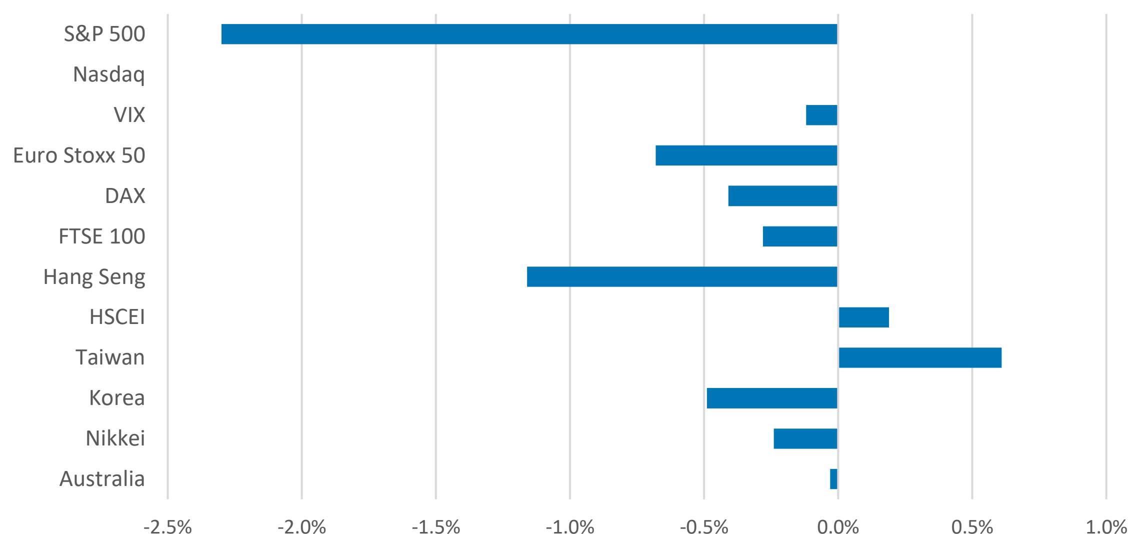
True Partner Fund vs. Hedge Fund Indices[2]



[1] https://www.nytimes.com/2020/01/13/climate/ocean-temperatures-climate-change.html
[2] Sources: Bloomberg, True Partner, Eurekahedge. True Partner Fund returns are Class B, USD, net of 2/20 fees.

In 2019 the Fund experienced small losses in most markets, with gains in Taiwan and the HSCEI and the largest losses incurred on S&P 500 options. The directionality of positions varied by market over the course of the year, but the S&P 500 losses were mostly incurred on long volatility positions.

True Partner Fund: 2019 Gross Attribution by Market



Surprise policy stimulus helped markets rise and volatility fall

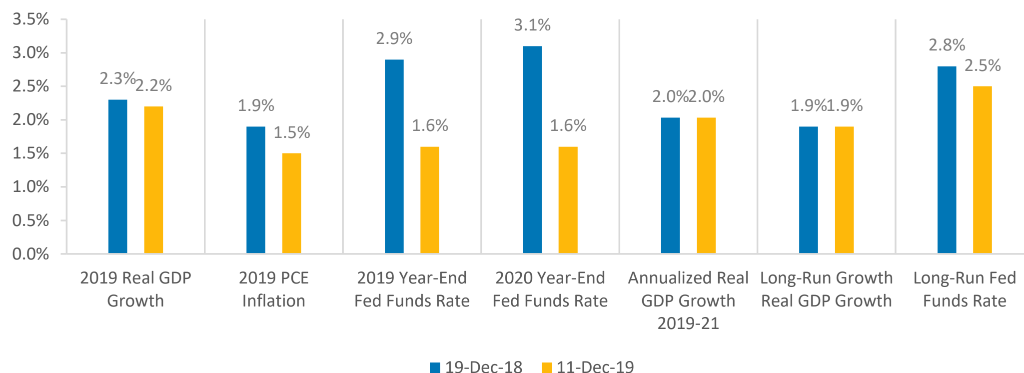
Looking at 2019 as a whole, equity markets were buoyed by a positive monetary policy surprise, the associated easing of broader financial conditions, and positive developments in trade policy (with a couple of wobbles), as fears of an escalating US/China trade war receded and a phase one deal was reached – though we would point out there is still a lot left to do to resolve the trade disagreements.

In Q4 2018 fears of slowing growth and higher rates helped drive a sharp sell-off in risk assets, following which the Fed turned dovish. Entering 2019, the Fed's "dot plot" projection was still suggesting multiple rate hikes during the year, to take rates from 2.375% to 2.875%. At the December 2018 Fed meeting (remember it hiked rates but lowered its projections at the meeting), not a single member submitted projections expecting cuts in 2019. Given what happened to rates in 2019 it's interesting to recall that President Trump – not always the market's favorite economist – tweeted before the meeting that he thought it was "incredible that the Fed is even considering yet another interest rate hike".[3]

Rather than the projected two further hikes in 2019, the Fed instead turned very dovish, cutting rates three times to 1.625% and starting to expand its balance sheet again to ease liquidity strains in funding markets. Multiple other central banks around the world also eased policy, including the ECB resuming QE. Helped by this stimulus, 2019 US real GDP growth is expected to come in only 0.1% below the Fed's December 2018 projection, with annualized growth over 2019-21 the same as projected a year ago. Given where rates now are, this kind of large positive policy surprise will be very difficult to repeat in 2020.

[3] https://www.cnbc.com/2018/12/19/fed-hikes-rates-by-a-quarter-point-.html

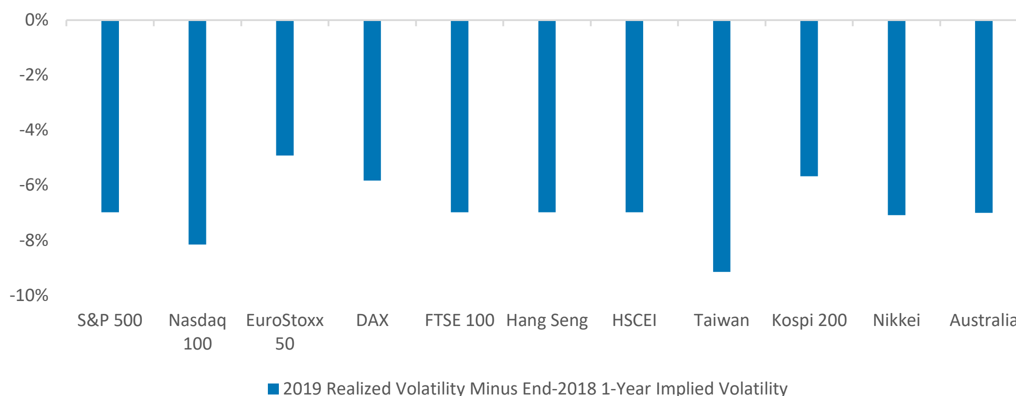
Median Projections for Year-End Value from Fed "Dot Plot", Dec 2019 vs. Dec 2018[4]



Realized volatility came in well below market implied volatility entering the year

Volatility markets were also surprised by the about turn from the Fed. Entering 2019, 1-year implied volatilities ranged from 15% (Australia) to 25% (Nikkei) across our traded markets. 1-month implied volatilities – where we tend to focus much of our trading – were generally similar, but a little higher. In the end, realized volatilities came in on average 7 percentage points below the 1-year implied levels, or 35% below in relative terms, with relatively little differentiation by market. On a rolling basis, monthly realized volatility also came in below implied in most markets, in most months. Even in the two sell-off months of May and August, the reaction was somewhat subdued, particularly in Asia.

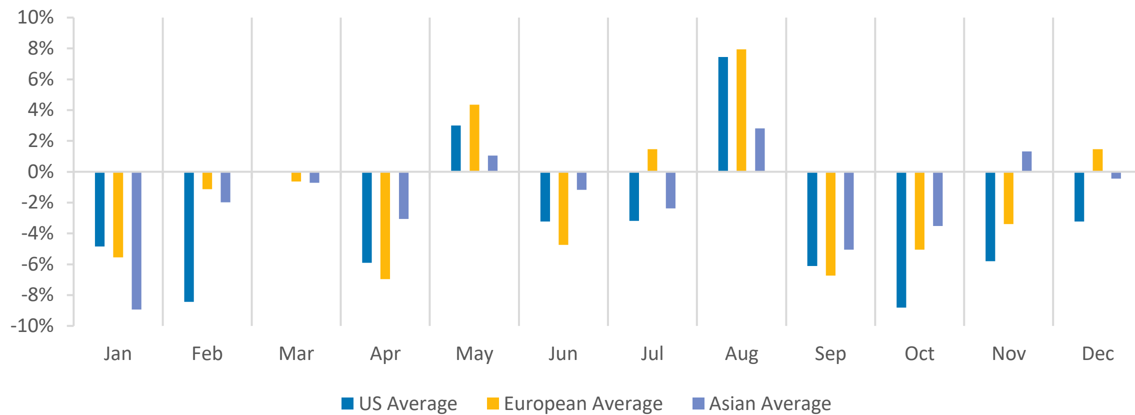
2019 Realized Volatility vs. 1y Implied Volatility as of End 2018[5]



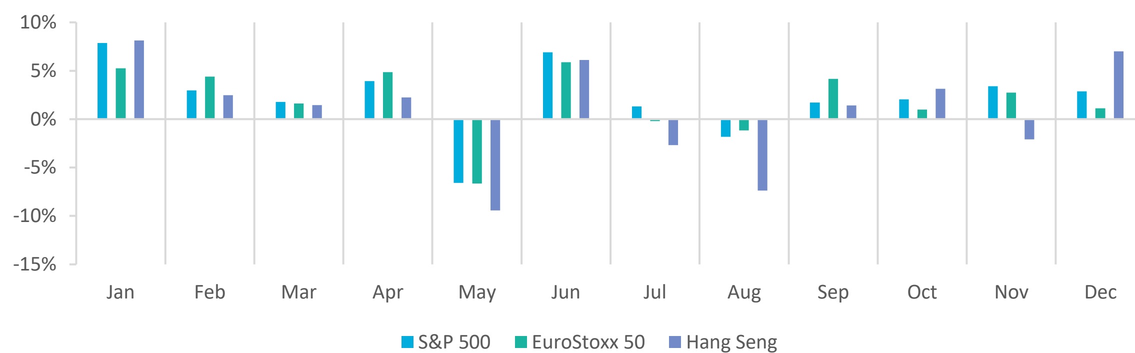
[4] Sources: Federal Reserve, True Partner https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20181219.htm, https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20191211.htm

[5] Sources: Bloomberg, True Partner. Kospi 200 value is the simple average of the last two trading days of December and the first trading day of January as liquidity is more limited beyond 6-month maturities.

Monthly Realized vs. Start of Month Implied Volatility by Region in 2019 [6]



Monthly Market Returns in 2019 – Major US, European and Asian Indices [7]



Volatility spread opportunities were limited

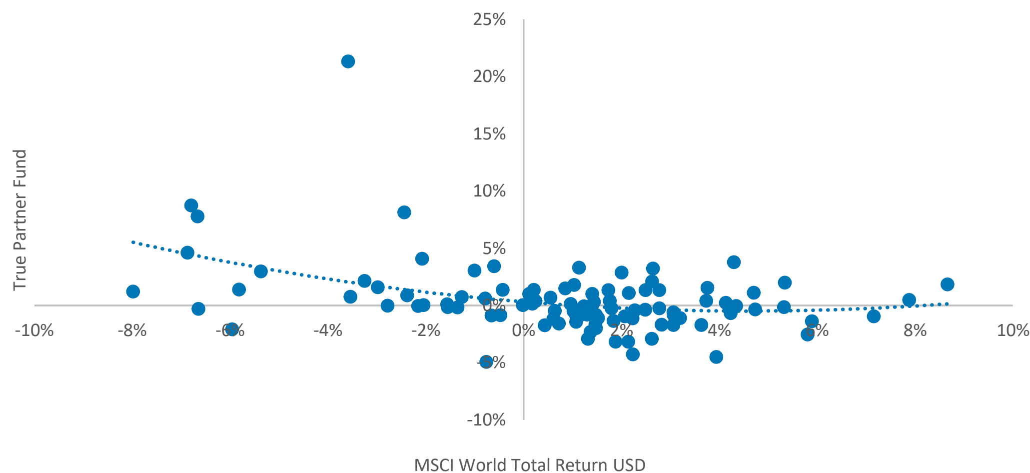
As our regular readers and investors know, periods of market uncertainty and unease typically create the best alpha opportunities for our strategy, as volatility spreads shift quickly due to varying changes in sentiment, flows and realized volatility. That enables us to deploy our 24-hour, global trading capability and technology edge to quickly identify and capitalize on dislocations. Perhaps unsurprisingly given the strong market returns, but to our disappointment, 2019 gave few opportunities for strong alpha.

On the chart at the next page, we show the monthly returns of the True Partner Fund on the vertical Y axis, and the monthly returns of the MSCI World Total Return USD on the horizontal X axis. The Fund has shown a negative correlation to the MSCI when the index is down, and almost no relationship when the index is up. We cannot promise to be up in every sell off, but we know that for many of our investors this is an important point of differentiation relative to most other assets and hedge funds.

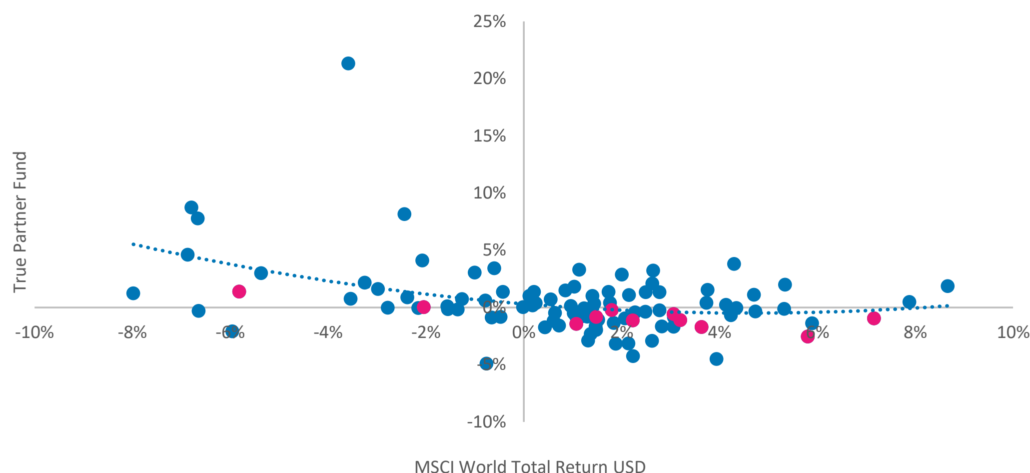
This relationship has resulted in the Fund having a negative beta to the MSCI of approximately -0.4 since inception in July 2011. From a beta-adjusted perspective, 2019 looks less bad for us, but we were disappointed to fall some way short of our historical annualized alpha of +9% per year, resulting in a negative year for investors. In the second chart below we show the same data but highlight the 2019 data points. We can see that the returns were well within the range of historical experience, but there was lower alpha than the historical average.

[6+7] Sources: Bloomberg, True Partner

True Partner Fund vs. MSCI World Total Return USD – Monthly Returns [8]



True Partner Fund vs. MSCI World Total Return USD – Monthly Returns, 2019 Highlighted [9]



Why was spread trading more challenging?

We never like being down but were feeling ok at the end of Q1 2019, having retained most of our Q4 2018 profits in the risk on rally of Q1 2019. After gaining +5.9% when the MSCI World fell -12.9% in Q4 2018, the Fund gave back a little less than half this return (-2.3%) in Q1, while the MSCI World almost fully reversed its gain, being up +12.9% in Q1 2019. However, performance in Q2 and Q3 was disappointing. While the MSCI World was up in both quarters (and +5.7% over the whole period), there were short lived bouts of market unease in May and August that threw up only limited opportunities.

In May, the MSCI World fell -5.6%, while in August a month-end rally kept the decline to only -1.9%. True Partner continued to provide diversification in these months, generating positive returns while equities and broad hedge fund indices were down. However, spread behavior was relatively subdued, limiting alpha opportunities, and we were surprised by the under-reaction of Asian volatility in August to what was quite a large market sell-off (Hang Seng down -7.4% for the month, with a peak to trough drawdown of -9% early in the month, and larger if one

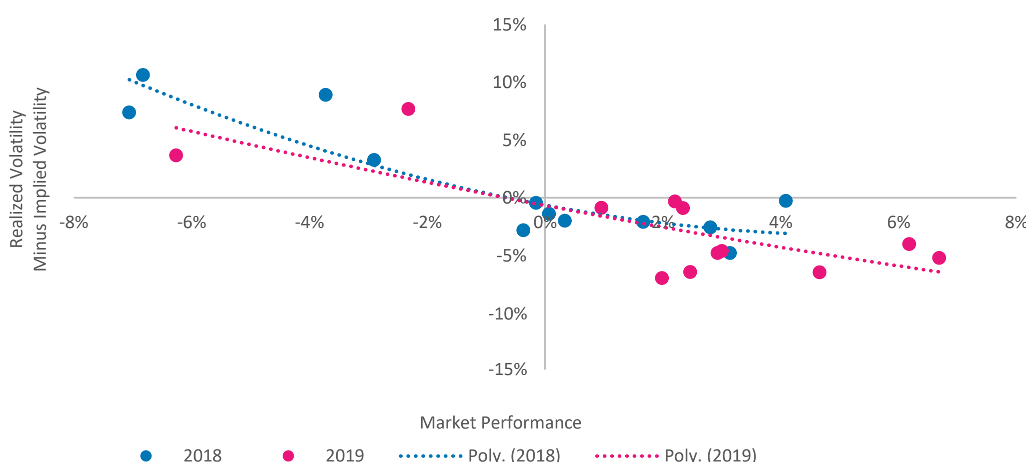
8+9 Sources: Bloomberg, True Partner

includes the end of July sell-off). This resulted in smaller profits than we had hoped for in August.

While we trade individual RV relationships, rather than at the regional level, and reposition daily, not monthly, the charts below help illustrate this. In each chart we show the difference between 1-month realized and 1-month implied volatility on the Y axis (so a positive number means that realized volatility came in higher than the market was expecting) and the market return on the X axis. To construct these series, first we construct regional data for the US, Europe and Asia by taking a simple average of the markets we trade in each region. We then average the US and European series to compare Asian vs. non-Asian volatility.

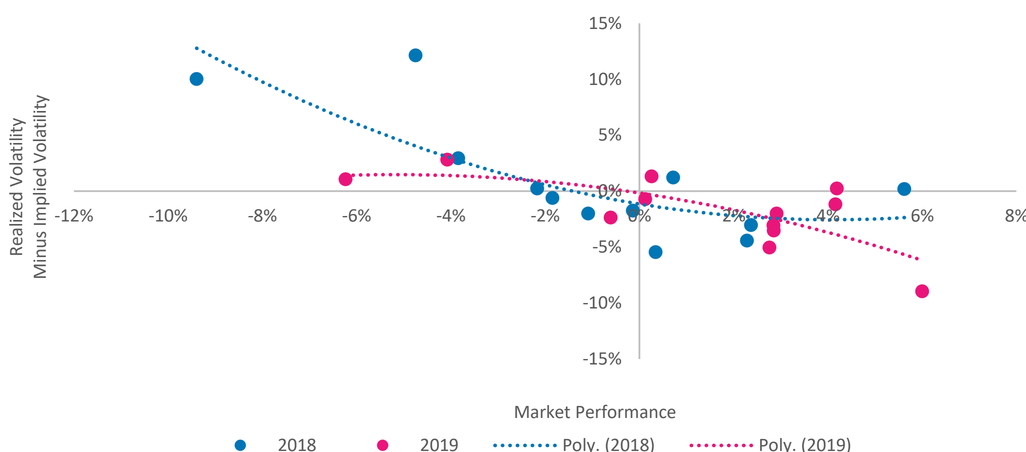
The first chart shows that non-Asian volatility had similar reactions to big up and down months for the underlying equity markets in 2018 and 2019, as shown in the first chart below, with a negative relationship between the volatility 'surprise' and the market return.

US and European Realized vs. Implied Volatility, 2018 and 2019 [10]



The chart below shows the Asian volatility 'surprise' vs. the performance of the underlying Asian indices. In 2018, Asian volatility reacted similarly to non-Asian volatility, with even higher rises in realized volatility (relative to implied) on downside moves – a help to long option positions. However, in 2019, realized volatility had a subdued reaction (relative to implied) making it a relatively unrewarding long position in what was a large sell-off for the market. While Hong Kong has often hit the headlines due to political tensions and protests in 2019, from a market perspective it has been remarkably calm on a relative basis.

Asian Realized vs. Implied Volatility, 2018 and 2019 [11]

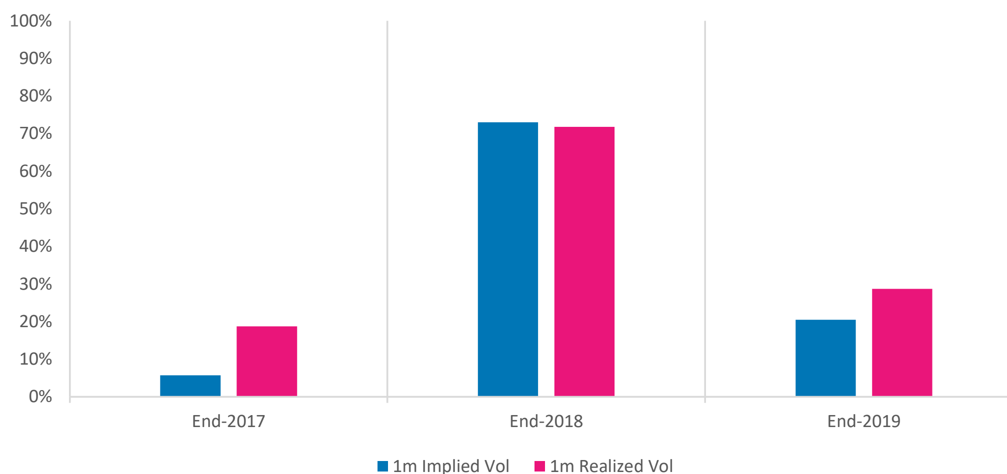


[10+11] Sources: Bloomberg, True Partner

Volatility is back in the bottom quartile again

So, what will the next 12 months bring? Our trading is driven by our proprietary relative value views, rather than a macro view on volatility, but we know from experience that it is easier for the market to be surprised when the world expects calm. At the end of 2018, on average 1-month implied and realized volatility were around the 70th percentile across our traded markets. As of the end of 2019, implied volatility is back to the bottom quartile, while realized is just into the third quartile, suggesting more room for spikes that could create dislocations.

Year-End Implied and Realized Volatility Percentile [12]



Market consensus suggests low conviction in equity longs, while credit has potential gap risk

Expectations for market returns and the stage of the cycle can also influence investor reactions to events. It is a common refrain that equity valuations are very high – and indeed Robert Shiller's famous cyclically adjusted P/E ratio is now at 31x in the US, above its 2007 peak (27x). There are other signs of excess too, such as the proportion of loss-making IPOs returning to around its tech bubble high.[13] We share the common concerns but are more interested in how perceptions of value will affect investor behavior.

Over the last couple of months various brilliant minds have been providing their forecasts for 2020. What history tells us is that however talented individual strategists are, as a group they tend to be optimistic. As the New York Times recently pointed out, citing research from Bespoke Investment Group, the median strategist forecast for the S&P 500 has been positive every year for the last 20 years (remember that stocks have fallen for 6 of those 20 years)[14], and their median forecast has, on average, been almost twice as high as the actual index return (average median forecast of +9.8% vs. an actual average gain of +5.5%.[15]

In that light, we find it particularly interesting that entering 2020 the median strategist forecast for the S&P 500 was only 3,241 – only +0.3% above the closing level of 2019. Furthermore, as the Wall Street Journal recently noted, much of the projected +9.6% growth in earnings is expected to come from rising profit margins – despite very low unemployment and rising labor costs. [16]

Credit markets also have some interesting dynamics. As the New York Fed's Liberty Street Economics blog pointed out this month, corporate bond issuance is increasingly at the lower end of investment grade and the net leverage of

[12] Sources: Bloomberg, True Partner
[13] https://www.wsj.com/articles/money-losing-companies-mushroom-even-as-stocks-hit-new-highs-11578608209
[14] For those intrigued, the consensus forecast for 2008 S&P 500 returns was for an +11.1% gain – this miss accounts for a significant part of the on average over-optimistic bias.
[15] https://www.nytimes.com/2019/12/23/business/retirement/index-fund-investing.html
[16] https://www.wsj.com/articles/great-expectations-for-stocks-in-2020-might-be-dashed-11578236400

non-AAA investment grade firms now exceeds that of high yield firms. Meanwhile research notes that institutional investors such as insurance companies often divest from bonds that fall below investment grade and that large or distressed transactions often incur higher costs. That may also make credit vulnerable to a shift higher in economic risks – or simply to disappointment in profit margins.[17]

Political and economic risks remain

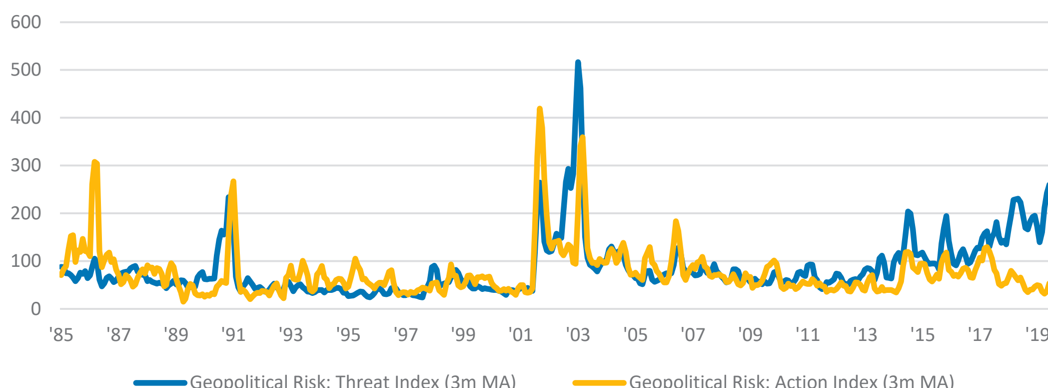
The US election on November 3rd is clearly the big political event of the year, and we will be watching for short-term opportunities as investors position around the various events leading up to this over the coming months. This election could have unusually large implications for corporate earnings, as tax policy is a major area of divide.

The frontrunners for the Democratic nomination have all proposed at least a partial repeal of the 2017 Tax Cut and Jobs Act (TCJA), so if the Democrats take control of the Senate, corporate tax rates seem likely to rise. Whether that would be good or bad for the US, it should have implications for equities. Recall that the TCJA cut the federal statutory corporate income tax rate from 35% to 21%. At the moment, markets seem to be assuming a base case that the Democrats will not win control of the Senate and the Presidency. That may be the modal outcome according the polls – but it is far from a foregone conclusion. Prediction markets currently imply a 30% probability of a Democrat majority in the Senate,[18] suggesting markets should price a reasonable chance of higher taxes.

Markets have rallied on positive trade news, but risks remain. There has been optimism around the phase one US/China deal but there is much work left to do to progress from there. Japan and Korea are engaged in an ongoing and politically influenced trade dispute. Brexit may also prove on an ongoing concern for the FTSE 100 and European equity markets, with UK Prime Minister Boris Johnson having set a hard deadline for a trade deal that has been publicly undermined by European Commission President Ursula von der Leyen.[19]

The US/Iran skirmish has also reminded the world of the bigger potential geopolitical threats. Interpreting the various uncertainty indices is difficult as uncertainty does not have a linear translation into higher risk. However, we find it intriguing that the biggest gap ever between "threat" and "action" came just before January's US/Iran skirmish.

Geopolitical Risk – Jan 1985 to Nov 2019[20]



[17] https://libertystreeteconomics.newyorkfed.org/2020/01/whats-in-aaa-credit-rating.html; on liquidity see https://libertystreeteconomics.newyorkfed.org/2017/06/market-liquidity-after-the-financial-crisis.html and https://bankunderground.co.uk/2019/08/19/does-liquidity-spill-over-in-the-credit-market-the-case-of-cds-and-corporate-bonds/

[18] US PredictIt 2020 Senate Party Control Democratic, as of January 10, 2020

[19] https://www.bbc.com/news/uk-politics-51028614

[20] Data from http://www.policyuncertainty.com/gpr.html based on the paper: Caldara, Dario and Matteo Iacoviello, "Measuring Geopolitical Risk," working paper, Board of Governors of the Federal Reserve Board, 2017".

Economic policy uncertainty also remains elevated, and central banks have even less room for maneuver in 2020, after substantial easing in 2019. Meanwhile, there is increasing pressure on governments to increase fiscal spending and benefit workers at the expense of corporate profits, which could pressure inflation rates and therefore bonds.

Global Economic Policy Uncertainty Index – GDP Weighted (Jan 1997 to Nov 2019) [21]

Traditional diversifiers are increasingly expensive, with less upside

After strong gains in 2019, most developed market government bonds now have a negative real yield again and there are over $11 trillion of bonds trading at a negative absolute yield, according to Bloomberg[22]. With US 10-year yields at 1.8%, German 10 year yields at -0.2% and Japanese 10 year yields at 0.0%[23], one popular topic is whether bonds can continue to provide the same diversification they have in the past, as the floor in yields is a meaningful step closer than it was at the end of 2018. Despite the bond rally last year and the fall in yields more generally, it's worth remembering that negative yielding debt ended with a negative total return[24], which gives some pause for thought as to its long-term portfolio purpose. That is leading some investors to seek diversification in other areas, including in volatility funds.

Trading outlook

We don't know which of these macro risks will grow into volatility events – but we find it hard to believe that all will pass unnoticed. For now we expect the rear-view mirror lesson of 2019 and much of the post crisis period – i.e. that buying the dip and selling volatility spikes is the way to trade – to still have a strong influence. That leads us to be more rigorous than ever in our analysis, and cognizant of both the costs of time decay and the knee-jerk volatility selling into events. However, we believe that it is also important to also be patient and not to forget the bigger market picture.

While aggressively selling volatility into spikes was endemic in markets over 2019 – and we must admit, successful – we believe that just as in meteorological trends, the fact that everything can seem calm for a time does not mean that risks have disappeared. While the frequency and severity of events in any given year is hard to predict in advance, we are confident that the global cooling of volatilities we have witnessed in 2019 is not a sustainable 'new normal'.

[21] Source: https://www.policyuncertainty.com/global_monthly.html
[22] Source: Bloomberg Negative Yielding Debt Index Market Value, as of January 10, 2020
[23] Source: Bloomberg, as of January 10, 2020
[24] Source: Bloomberg Negative Yielding Debt Total Return Index

As we saw in February 2018, sometimes even the largest and most deliberate hands holding the short volatility trade cannot withstand the infrequent but large jumps that are characteristic of the behavior of equity market volatility. Such events can create large trading opportunities for those who have been patient enough to wait. That does not mean sitting with a static position – but rather being thoughtful each day and focused on the highest conviction trades, and not being afraid to position in size when there are big opportunities.

With few optimistic on asset returns and limited room for additional monetary policy stimulus, if many traders do seek to sell volatility into market sell offs it could set up interesting opportunities as positioning could become more crowded as risks increase. If markets don't quickly revert to an upward trend, downside potential may become more of a focus, with larger risks to unwind. That may mean some vol sellers will have to quickly cover their short volatility positions in a falling equity market.

Our outlook means that, for now, risk levels in terms of gross and net vega exposure are likely to remain relatively low while markets are quiet, but we keep focused on trading 24 hours a day, ready to increase risk rapidly if markets become more exciting. While the wait can be frustrating, we know from experience that it is important not to be blinded to the potential to jumps, as such changes can happen quickly, and the biggest opportunities may only be there for minutes or hours in a day. That was the case in February 2018 (more than once) and such focus has also been rewarded in some of our previous best months in the past.

True Partner is grateful for the strong support of our investors in 2019

From a business perspective, we have experienced strong growth in our assets under management in 2019 and are happy to have surpassed the milestone of $1bn in AUM as of December 2019. The IAM True Partner UCITS Fund launched in July, making our relative value strategy available to a wider range of investors. The UCITS Fund now has over $200mn in AUM and continues to enjoy strong growth. We are grateful for the continued support of our existing investors and have been humbled to welcome many other new investors from across the world.

We have continued to invest heavily in our technology and have also further strengthened our team, with the addition of Robert Kavanagh as a partner and Head of Investment Solutions in December. Robert joined us after spending 15 year at Goldman Sachs. Robert has extensive experience in evaluating volatility strategies and other hedge funds and working with a range of investors. He will be working with our investors, helping us to further expand our business and ensuring that our co-CIOs and PMs can remain at their screens as we grow. We look forward to introducing Robert to many more of you in the coming months and to his contributions to the business this year.

As we grow, we will remain focused on managing capacity in a prudent way. That may lead us to soft close the True Partner Fund this year. We would encourage investors who may wish to upsize their positions to make us aware of your potential growth plans in 2020, so we can manage capacity accordingly and avoid any disappointments.

Finally, we wish all our readers a happy and profitable 2020. We are working hard to deliver on your trust in 2020 and look forward to what we believe will be exciting market opportunities ahead.

The True Partner Team

About True Partner Capital

True Partner Capital is a team of former market makers and IT specialists that have been working together for more than 15 years.

Their combined expertise on trading, execution and risk management as well as the proprietary trading technology, allows the team to identify and capitalize on trading opportunities.

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The Fund is not registered under the Investment Company Act of 1940, as amended, in reliance on an exception thereunder. Interests in the Fund has not been registered under the Securities Act of 1933, as amended, or the securities laws of any state; they are being offered and sold in reliance on exemptions from the registration requirements of said Act and laws. Neither the Fund's Operative Documents, nor the offering of its limited partnership interests, have been reviewed or approved by U.S. federal or state regulators. Interests in the Offering are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, The Federal Reserve Board or any other governmental agency. The interests issued by the Fund are offered or otherwise made available only in accordance with available, applicable private placement or offering rules.

An investment in the Offering is illiquid and there are significant restrictions on transferring the Funds' limited partnership interests. There are no secondary markets for the Fund's limited

partnership interests and none are expected to develop. True Partner has sole discretion regarding the allocation of the Fund assets. The Fund represents a speculative investment and involves a high degree of risk. The Fund's portfolio, which is under the sole trading authority of True Partner, is principally an Equity Volatility Arbitrage fund. This lack of diversification may result in higher risk.

A private fund is generally not subject to the same regulatory oversight and/or regulatory requirements as a mutual fund. The Offering is not required to provide periodic pricing or valuation information to investors. Investments may involve complex tax structures resulting in delays in distributing important tax information.

Certain instruments may have no readily available market or third party pricing. Performance may be volatile as private funds may employ leverage and other speculative investment practices that may increase the risk of investment loss, and adherence to risk control mechanisms does not guarantee investment returns. Additionally, fees may offset an investor's profits. A comprehensive list of potential risk factors is outlined in the Offering Documents.

Investing in the financial markets involves a substantial degree of risk. There can be no assurance that the investment objectives described herein will be achieved. Investment losses may occur, and investors could lose some or all of their investment and successfully overcoming barriers to entry, e.g., legal and regulatory enterprise does not guarantee successful investment performance. No guarantee or representation is made that the Fund's investment program, including, without limitation, its investment objectives, strategies or risk monitoring goals, will be successful and investment results may vary substantially over time. Investment losses may occur from time to time. Nothing herein is intended to imply that the Fund's investment methodology should be considered "conservative", "safe", "risk free" or "risk averse." An investment in any fund should be discretionary capital set aside strictly for speculative purposes.

Certain information contained in this document contains: forward-looking statements" which can be identified by the use of forward-looking terminology such as "may", "will", "should", "expect", "anticipate", "target", "project", "estimate", "intend", "continue" or "believe" or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events or results or the performance of the Fund may differ materially from those reflected or contemplated in such forward-looking statements. Forward looking information is subject to inherent uncertainties and qualifications and could be based on numerous assumptions. Forward looking information is provided for illustrative purposes only and is not intended to serve as, and must not be relied upon by any investor as, a guarantee, an assurance, a prediction or a definitive statement of fact or probability.

Performance Methodology: Past performance is not an indicator of future performance. Annualized Returns or Performance figures for True Partner Fund are based on Class B shares and are shown on a net basis after the deduction of a 2% management fees and a 20% performance fee, trading related and other expenses that an investor would have or actually paid.

The indexes' performances do not reflect the deduction of transaction costs, management fees, or other costs which would reduce returns. References to market or composite indexes, benchmarks or other measures of relative market performance (indexes) over a specified period of time are provided for your information only and do not imply that a portfolio will achieve similar returns, volatility or other results. The composition of an index may not reflect the manner in which a portfolio is constructed in relation to expected or achieved returns, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility or tracking error targets, all of which may change over time. Indexes are used as performance benchmarks only, as True Partner does not attempt to replicate an index. The composition of the indexes is not necessarily similar to accounts managed by True Partner. The prior performance of the indexes will not be predictive of the future performance of accounts managed by True Partner. An investor may not invest directly in an index.