July 2017

A Period of Subdued Volatility

"Stability leads to instability. The mores table things become and the longer things are stable, the more unstable they will be when the crisis hits." – Hyman Minsky

...Realized (actual) and implied (anticipated) volatilities hover near their lowest levels ever. The most commonly referenced measure of equity market implied volatility, the VIX has traded at an average of 11 since late April. To put this level in context, since 1990 when the VIX was first created, the index has closed below 10 on only 16 days; seven of those days have been since May 1, 2017. The average closing of the VIX between 1990 and 2016 was about 20 versus a 2017 year-to-date average of roughly 12. Similarly, realized SPX 500 volatility has fallen, with the one and six month levels both at seven. ON these measures, 2017 is the least volatile year since 1965.

Not surprisingly, there is a fair bit of commentary attempting to justify today's historically low levels. The most prominent explanation is that the low realized volatility, which results when asset prices march steadily upward with very few interruptions, naturally causes quantitative models to predict a continuation of subdued volatility, i.e. low implied volatility. Some suggest that dampened market fluctuations result from the consistent bid for equities provided by capital flows into passively managed index funds. Many cite limited realized volatility in underlying U.S> and global economic measures such as economic growth and inflation and conclude we are in a new era of stability. Finally, there is the abiding view that central banks will reliably deploy accommodative monetary policy to arrest any downward market moves.

These explanations almost certainly contain elements of truth, but it is hard not to see a bit of sophistry as well. While there may be a mathematical answer for why volatility is low when nearly every financial asset trades at all-time highs, common sense might suggest the opposite conclusion.

Why does extraordinarily low volatility matter? The answer lies in volatility influence on risk-taking and, by extension, leverage. In any elevated market, one very important thing to identify is where leverage exists in the system – both that which is obvious and more perniciously, that which is hidden. While leverage is not directly responsible for every financial disaster, it usually can be found near the scene of the crime. Structural leverage linked to low realized volatility may well prove destabilizing and the precipitant, or at least an accelerant, for the next financial crisis. Realized volatility is a critical reference point for a substantial amount of investment activity. For many investors, the level of market volatility determines the level of risk incurred both in their portfolios as well as in many investment products. The lower the volatility, the more risk investors are willing to or, in some cases, required to incur.

Specifically, realized volatility is the essential input for Value-at-Risk (VaR) calculations, and determines the degree of leverage incorporated in a variety of quantitative and structured investment strategies. For instance, the models used by both risk parity and volatility targeting funds, which use volatility levels to determine asset allocations, have been signalling “risk-on” for some time. This has resulted in steadily increased portfolio leverage as realized volatility has fallen across asset classes. Additionally, certain structured short-volatility ETFs have algorithm-based selling and buying programs that automatically lever up and, critically,d own based on realized volatility.

Over the last several years, one of the most reliable winning betes has been shorting volatility in just about any asset class. Investors have generated significant returns with high Sharpe ratios by capturing the spread between higher implied volatility and lower realized volatility. As realized volatility has remained low, profits have mounted and assets deployed in these volatility-targeting and short-volatility trades have grown tremendously. However, it is hard to ignore that this strategy becomes less and less attractive as the absolute level of volatility declines and the spread between implied and realized volatility falls. As the saying goes, “what a wise man does in the beginning, a fool does in the end.”

Although it is impossible to calculate with precision, the volume of assets whose performance is, in some manner, linked to volatility likely runs in o the hundreds of billions of dollars. As such, any spike in equity markets realized volatility, even to historical average levels, as the potential to drive a significant amount of equity selling (much of it automated). Such selling would, in turn, further incresae volatility which would call for more de-leveraging and yet more selling.

We cannot know whether a dramatic increase in volatility is imminent or even inevitable, nor can we be certain that a spike in volatility would have cataclysmic results...although it certainly could. One thing, however, is for sure: anyone who is directly or indirectly shorting volatility at the current lows is betting current benign environment will persist. Our experience would suggest that, “benign” and “persist” are not words normally associated with one another. In addition to our areas of regular focus, we have exposure to hedges designed to help protect the portfolio from a sustained change in the volatility environment.

Our primary task, of course, is not to predict when or even why the market might decline. Rather it is to remain disciplined in the context of the opportunity set in front of us and to vigilantly manage risk in the portfolio we own. As we have said on many occasions, just because the market is expensive does not mean every stock is expensive. Our search for attractive investments, while requiring patience, determination and healthy skepticism, has identified a number of attractive opportunities. The pattern of a handful of stocks driving markets higher while others become neglected is familiar, and is one that can provide significant opportunity for those with a longer-term horizon. In Q2, we initiated two new equity positions, rebuilt an exposure in one company we owned in the past, and added to numerous investments that have been in our portfolio for some time. Of course, at the same time we search for new investments, we have also taken advantage of the robust prices the market is willing to pay for many of our holdings.

In the second quarter alone, we sold four real estate assets with gross proceeds to Baupost of over $150 million. We also monetized two private equity investments with significant gains: one that returned more than $500 million in gross proceeds to Baupost in May and another that generated more than $200 million in additional gross proceeds at the beginning of July. This disciplined approach to selling will always be a hallmark of our process….

As has been the case for longer than we would have imagined, we remain in a market that is broadly expensive and largely indifferent to risk. This continues to be a time for patience and, above all, caution. If there is anything to be taken from Hyman Minsky's words, it is that no one should be lulled into a false sense of comfort by the illusion of stability which surrounds us. We, most assuredly, are not.

As always we are grateful for your support.

Jim Mooney
President
Head of Public Investments