In the hunt for yield where can you find new sources of volatility?

As mainstream markets evolve, structured products that focus on volatility are becoming central to risk management and investment.

Structured products – focused on FX, emerging markets, rates and quantitative investment strategies (QIS) – were once seen as exotic; now these volatility-related products are becoming an increasingly mainstream tool for both risk management and investment.

The explanation, according to Anthony Morris, Global Head of Quantitative Strategies, Fixed Income, is the gradual evolution of financial markets in recent decades. “Traditional products, such as long-only equities or bonds, are no longer a sufficient means for investors to achieve their goals,” he says. A large part of the reason for this is the transition from cheap valuations – bond yields of 15% and equities with single digit P/E ratios – to expensive valuations over the past 40 years.

> ***“In the past, investors who were worried about an equity market crash just put money into cash bonds because as equities went down, bonds went up. But now bonds can’t provide the same shock absorption because yields are so low, especially after a decade of quantitative easing, while the scope for price losses should bond yields rise is considerable,” says Morris. “Consequently, people need to try new things to find value and create robust defensive strategies.”***

A potential solution for investors facing this conundrum and seeking to reduce risk is structured products, including QIS such as trend following or structured rates products like yield curve steepeners. “These products can give investors defensive risk-off protection in a world where bonds no longer provide it,” says Morris.

Similarly, for investors seeking to earn additional carry, a typical strategy in the past was to slide down the yield curve; longer maturities typically offered a significant pick up in terms of return, explains Morris. “That doesn’t work anymore given the flat yield curve. However, the volatility curve continues to be steep in places, so people have naturally migrated to this market to find carry.”

A proven track record

While financial markets have steadily become more expensive for decades, the genesis of structured products that reference volatility is more recent.

In 2012, investors were worried about a hard landing in China. The traditional volatility product solutions for investors looking to hedge would have been to buy puts on China-linked equity indices, or puts on proxy currencies. But these typical hedges usually have high negative carry. They were especially bad value when the market was already fearing a downturn, as it was at this time.

Nomura wrote a paper that showed how empirical hedges based on established patterns – so-called trend following – could offer much better value; it recommended hedges that replicate the general pay-off structure of put options without the high negative carry. That paper inspired a trend-following product that has now been running for six years.

"It has proven itself repeatedly, including the EM bear market of 2014-2015," says Morris.

> ***This year emerging markets have come under pressure again, as investors have become concerned about the potential for a trade war between the US and China and the prospect of default by some developing countries. Those investors that turned to trend following have again been vindicated; Nomura's trend following product is up 7% compared to declines of up to 15% in emerging market indices.***

Discovering new ideas

Volatility products come about in a variety of ways. Clients may approach banks with specific product requests having identified a challenge and a solution through their own risk management processes. In other circumstances, banks proactively develop solutions where they see tactical opportunities in terms of market timing or strategic imperatives such as the impact of regulations. They also update existing products to take account of new conditions or opportunities, such as a sharp fall in emerging market currencies.

As well as responding to client approaches, banks involved in structured products bring relevant ideas to investors' attention through education activities. In emerging markets, Nomura trades with local banks to source risk and distributes it to hedge funds or other investors that want exposure to EM rates, FX or inflation. "Until recently, many investors were unaware of this opportunity to gain exposure to emerging markets," says Idriss Amor, Head of Structured Rates Trading, Emerging Markets EMEA. "Informing them about this opportunity and how to trade it has been valuable for clients."

Investor events are also important opportunities to discover new products or markets. "Clients from Scandinavia are familiar with volatility strategies and use them extensively," says Paul Howell, Head of Asset Side Rates and Hybrids Structuring, EMEA. "But at our 'Volatility of the World' seminar in June, which was attended by more than 50 clients, they came across trading opportunities – across various asset classes that they were previously less aware of. These strategies could help them manage risks, earn additional carry or respond to changing market conditions."

Sometimes clients want a more consultative approach to product selection or creation. "While there are products that meet the broad needs of the insurance industry or asset management sector for example, it is also possible to create solutions for clients' specific needs and circumstances. They may want to discuss a strategic challenge, such as a capital problem, for example, and a tailored solution can add a lot of value," says Howell.

Lowering costs and broadening access

> ***Low costs are a key attraction of structured products for many investors. For instance, QIS index products allow investors to gain access to opportunities that will perform in a similar way to investments in volatility products – but at much lower cost, notes Tim Owens, Global Head of FX and Index Structuring.***

Sometimes in order to lower costs, a bit of lateral thinking – and a clear understanding of clients' characteristics or expertise – is required.

"Emerging markets tend to be more volatile than developed markets so many investors want to hedge risk," says Amor. However, that higher volatility means hedges can be expensive. "Sophisticated clients can use those market characteristics as a strength: they have a better understanding of local market conditions than international players. They can use that knowledge to buy protection on rates but lower the costs associated with this by selling volatility via a structured format. Similar approaches are possible in many emerging markets to allow clients to hedge exposures at a lower cost than using an interest rate swap, for example."

In other situations, smart use of structures (rather than simply low costs) are necessary to broaden access to volatility products. "Some clients are unable to trade derivatives, which makes it difficult to access the volatility market and hedge risk or take advantage of investment opportunities," says Howell. One solution for such clients is volatility bonds (which were popular pre-crisis but have recently come back into vogue given low levels of volatility), which offer long volatility exposure (often customised to clients' specific needs) in a format they can invest in.

Recycling risk – from East to West

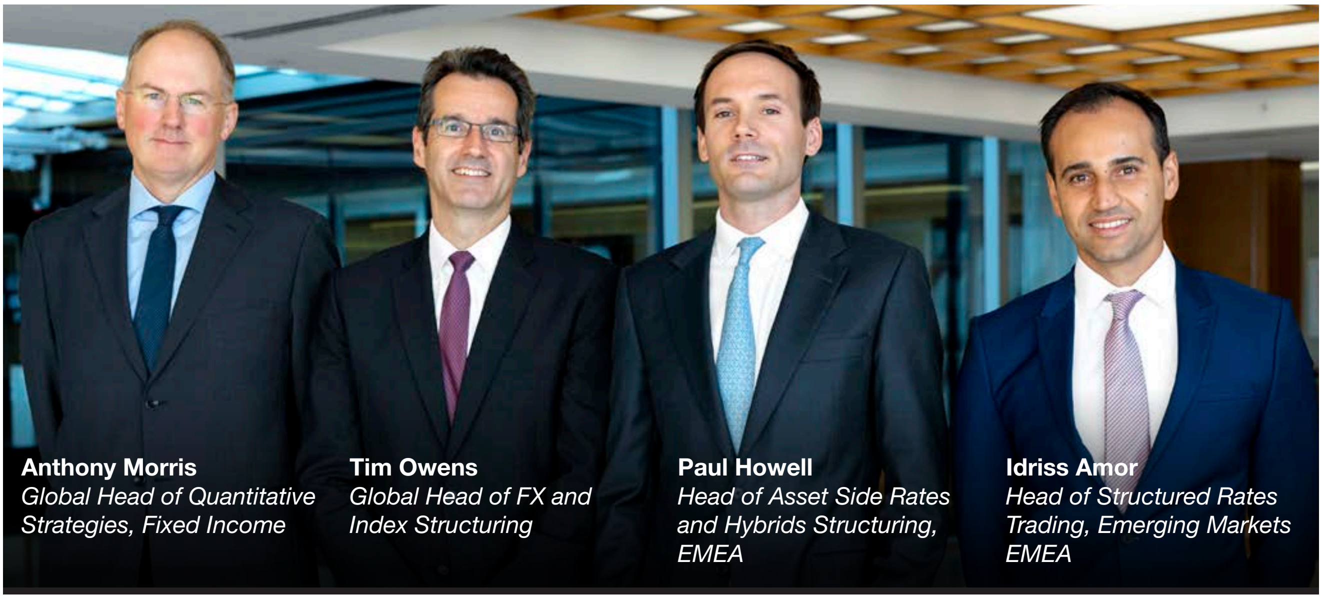
An important component of any successful structured products business is the ability to recycle risk. For example, if Nomura sells its retail investors in Japan products that offer carry opportunities in Brazil, Turkey and other emerging markets, it creates significant volatility positions in emerging markets. "In order to make the product work, a way has to be found to recycle that risk," says Howell.

One smart approach is to split the risk into component parts.

> ***"Japanese retail investors are primarily interested in profiting from a directional view; these directional risks can be more easily offset whereas the volatility risk associated with those positions is more difficult to lay off," says Howell.***

"The solution is to find attractive opportunities for European investors that are willing to take some of the offsetting volatility risk and profit from perceived dislocation in the volatility market – bringing together East and West."

The ability to recycle risk in creative ways is especially important in emerging markets given that many are illiquid, notes Amor. "Sometimes it is necessary to warehouse risk for a certain period before it can be recycled, so it is vital to have a research and structuring team with strength in emerging markets to be able to understand the risks and take such positions. But if you can't recycle, you quickly reach capacity. The skill is to recycle risk in the best format possible: risk can be sourced and sold in completely different formats – a transformation has to take place."



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