Case Study 2: Equity Volatility Dislocation

MRA
MACRO RISK ADVISORS

Client Type	Large Credit Focused Hedge Fund
Asset Class	Volatility
Portfolio Scenario	In 2010, the combination of the uncertainty around Greece, the Flash Crash, potential regulation of OTC derivatives and a crowded risk exposure precipitated a short covering event . The result was a substantial pricing dislocation in long dated equity volatility.
Client Request	After reading some of the work that MRA had done to illustrate the event and the opportunities that resulted, the client asked us to perform scenario analysis to help evaluate potential trades.
MRA Deliverables	▪ Use network of market contacts to explore why the dislocation has occurred and to gain insights on whether it would persist. Speaking with sell-side derivative traders, insurance companies, pension funds and hedge funds, MRA was able to better understand the impact of positioning. ▪ Provide the client with historical perspective on the extent of the dislocation through a series of quantitative back-tests. ▪ Isolate historical periods of market stress (LTCM, tech bubble, 9/11, Enron, credit crisis) and provide metrics for understanding draw downs of short volatility strategies during these periods. ▪ Discuss risk/reward objectives with clients to understand best method for implementing strategy in the context of potential mark to market risks. ▪ Build model to illustrate alternative methods for gaining short volatility exposure including variance swaps, short straddles, long puts and put spreads on realized variance all of different expirations. ▪ Walk client through the alternatives and help client find a seller of put option on realized variance.
Result	Client implemented recommended trade and has realized substantial profits.