EQDerivatives
Commentary & News
November 22, 2016

BlueMountain Capital Management

Dahan: Diversification, Platform Key To Relative Value Vol Edge

There are very few hedge fund strategies that offer low correlation to the market and are able to consistently outperform amid differing macroeconomic backdrops. Relative value volatility funds, however, continue to offer such benefits to investors. ***Rob McGlinchey*** *spoke to BlueMountain portfolio manager* ***Sarah Dahan*** *on how she marries a diversified approach to scoping opportunities in cross-asset volatility markets with access to a firm-wide platform.*

Sarah Dahan is one of the most established relative value portfolio managers globally. Beginning her career in 2005 at JPMorgan, Dahan worked in prop trading across agency mortgages and mortgage options, moving to BlueMountain in 2008 where she currently runs the firm's volatility and cross-asset strategies across different markets and regions. Her team is comprised of three portfolio managers, with dedicated quants, researchers and execution traders supporting the team as part of the wider BlueMountain platform.

In managing BlueMountain's relative value volatility strategies, she has been able to execute a strategy that seeks low correlation to the market and takes a differentiated approach versus other hedge fund strategies; including those active in other volatility-specific strategies such as a long vol and macro funds that actively trade options.

"Industry professionals often refer to volatility as being its own asset class and I think there is truth to that. When you think about volatility it's not a zero sum game to the same extent that other asset classes are – there is a lot of flexibility as to how you risk manage the product," said Dahan. "If you are a macro fund, they often use vol as a way of accessing convex directionality. A macro fund may have a view on USD/JPY and buy an option to express their view and a vol fund may think that USD/JPY vol is too expensive compared to Nikkei vol, and because both hedge the product differently they may both get to a positive PnL, for example. I think that is quite unique."

Where BlueMountain tries to find an edge is through identifying opportunities that arise from market dislocations, whether that is regulatory or product driven or even from the different objectives arising from the roles of different types of global investors in the marketplace. Those investors can include macro accounts active in options trading, hedgers, and retail investors in Asia hunting for yield, which is expected to continue amid the low interest rate environment.

"So you have a concentration of people with different objectives and that is a very important recipe to create opportunities for relative value vol managers. When you think about the steepness of the vol curve in Europe and Asia, they are not that steep and sometimes they are inverted; meaning long-dated volatility is priced lower than short-dated volatility. On the flipside in the U.S. you have a very steep vol curve, what is that telling you? Is it telling you that the U.S. market thinks ahead there is a lot of uncertainty and in the Europe and Asia there isn't? Probably not," said Dahan. "What it is telling you is that in one geographical location you have retail investors pressuring the long-dated vol at the backend because of this supply and demand imbalance, while in the U.S. investors are using the backend for hedging purposes. And lately we've found far fewer actors able to take the other side of that trade at the back end due to regulation or other such reasons. So that is amplifying in my mind the different opportunities that exist for relative value volatility managers."

Like other relative value volatility managers, BlueMountain seeks to profit from dislocations created by structured products or regulation. BlueMountain's diverse expertise across markets and asset classes makes the firm well placed to intervene in markets where dislocations occur and opportunities arise.

Equity repo is one such area that illustrates the diversity of BlueMountain's coverage of the market, where the portfolio management team doesn't just focus on the so-called first degree impacts emanating from regulation and the impact of structured products on vol, but also the so-called second degree impact. Given banks' inability to warehouse risk, coupled with the issuance of structured products remaining somewhat elevated, banks have had to increasingly hedge their exposure with Eurostoxx 50 forwards, which has put pressure on medium- and long-term equity repo rates.

"Investors tend to focus on the impact of these first degree risks, which can sometimes overshadow second degree impacts. There really is a difference in how those risks are managed now, and that's been a source of opportunity for us," said Dahan. "For example, when you have an autocallable issued, the retail investor is selling a long dated put with a barrier and a knock out. If those investors are short a long-dated put, dealers then have an inverse position in the options and are short forwards, hence long the dividends and long repo. Dealers now have fairly strict guidelines as to the positions they are able to warehouse; as such, forwards begin to trade at a premium and that's the time when the repo parameter becomes attractive from an arbitrage perspective."

Dividends and dispersion are other examples of products and strategies where BlueMountain is active and diversified, allowing it greater flexibility to screen opportunities. Following the 'Brexit' correction earlier this year, Dahan's team witnessed the inability of the banks to warehouse risk in a falling market – banks have a convexity exposure to dividends through structured products and when spot moves, bank exotic desks need to rebalance their dividend exposure, which is becoming more acute given that they are unable to warehouse certain risks to the same extent they used to.

"What is interesting on the back of that, particularly in the case of market stress, is that the dividend options may be relatively overvalued compared to index options. Fundamentally you have one asset class which has a narrower distribution than the index itself. Yet on a day-to-day basis the beta gets exacerbated by the needs of those exotic desks to rebalance and we therefore are able to find opportunities as dislocations widen," said Dahan.

Such a scenario emphasises again that BlueMountain is not only focused on trading one product, nor is it limited to being solely active in listed instruments. Managing risk effectively is therefore key when implementing such diversified strategies.

"We generally have tried to have a pretty diversified range of opportunities where we are able to intervene. Given the changing nature of the markets, it is important to not reduce the zone that you are involved in and therefore be limited by the products you use. You want to have that diversification but you have to have a disciplined risk management process that ensures the risk to the very relative value basis we take is sufficiently diversified," said Dahan. "Another source of diversification is through listed vs OTC. When you have some funds that are 100% listed in terms of where they are participating, sometimes you actually want to be able to have the flexibility to intervene in the market where the opportunity is the most compelling. Also, I like the idea of being able to act in both listed and OTC markets as it multiplies the opportunities available - sometimes there is opportunity to be found at the crossroads between both instruments."

Being part of the larger BlueMountain platform provides other added benefits to Dahan and her portfolio management team, allowing them to work across a diversified set of asset classes and markets. The volatility portfolio managers at BlueMountain have access to fundamental research analysts across single names and sectors, they have a collaborative ethos across the group, while being active in volatility markets for more than 10 years has allowed them to develop risk and screening infrastructure that is fitted to modern markets and is distinct from other managers.

"We have here a team of fundamental research analysts and it's pretty rare for someone like us to be able to speak to those analysts. Those discussions help us form single name, sector and single name div views and that's fairly unique. Obviously we have a very collaborative culture at BlueMountain and that feeds through to the way that those portfolio managers that are responsible for different strategies communicate with each other. For example, it's very useful when trading credit vol that I have an ability to have a very expert person that will know exactly what is going on in the credit market that I can source information from," said Dahan. "I think also in terms of the infrastructure, being part of a larger platform and being involved in the vol space for more than 10 years means we have been able to invest in our infrastructure from a risk and screening perspective and that's important. You need access to sophisticated risk management infrastructure relative to, for example, an equity long/short fund."

Looking ahead, some portfolio managers active in volatility arbitrage, particularly through OTC products, have become increasingly concerned by the ability of banks to provide liquidity and facilitate trades. As regulation and balance sheet requirements increase on banks, many of those firms have become nimble and have innovated by offering efficient products such as gamma swaps and corridor variance swaps for relative value volatility portfolio managers to build risk in a specific underlying.

Dahan believes that increased opportunities will arise as banks become limited in warehousing risk, but prefers to approximate risk more through vanilla as opposed to exotic options. "We have been using exotic options in moderation. As an example, the corridor var swap has become more popular over the last two years but we have been moderate in terms of usage," said Dahan. "We tend to prefer to approximate the risk with vanilla building blocks, but I think conversely there have been some opportunities that have arisen from the limited ability to warehouse risk as expressed through these exotic options."

