

INVESTMENT IDEAS

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The only certainty now is that everything will keep changing

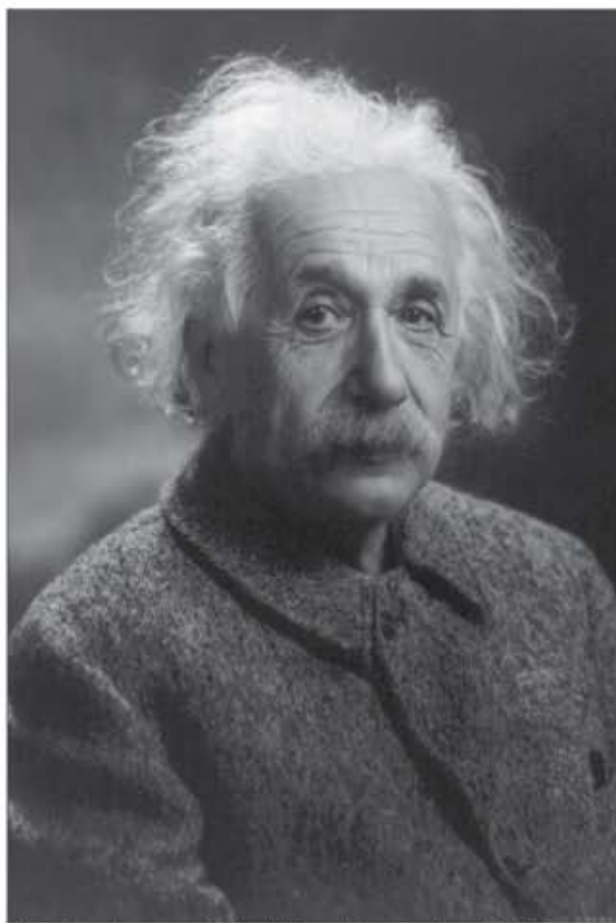
The secret is to find out what options will benefit from the current volatility, says **David Miller**

IN MARKETS like this, I am reminded of a story about Albert Einstein. One year he set an exam for his students that was identical to the previous year. One of the more honest students pointed this out and Einstein's reply was that, although the questions might be the same, the answers were different.

These are uncertain times. Investors are faced with a range of outcomes ranging from rapid recovery to long-term recession, with an inflation mixer. As a result, financial markets are suffering significant short-term mood swings. Good news and bad news days follow on from each other in rapid succession.

Last month, we saw the Dow Jones Index of American shares rise 416 points when the Federal Reserve announced that it would lend up to \$200bn (£100bn) of Treasury securities to primary dealers in exchange for mortgage-backed securities and then fall 194 just a few days later when Bear Stearns collapsed.

A good measure of uncertainty is the Chicago Board of Options Exchange Volatility Index, usually referred to as the VIX, which is a "weighted average of option implied volatility". Don't ask. After three and a half years in hibernation, volatility started to rise in the middle of last year and is rapidly regaining levels last seen during the run up to the market peak in 2000 and



Albert Einstein: aware that instability and time can change 'right' answers

the subsequent decline.

Only the Russian debt crisis and Thai currency collapse caused greater uncertainty.

Uncertainty and, therefore, volatility is likely to be with us for quite some time and so the interesting question to address is what to do and even better, what investment strategies will actually benefit. During periods of high stress and volatility, selling options can prove effective.

As markets have declined, investors also naturally look for protection and structured products are a popular solution. Unfortunately, standard structured products providing 100pc capital protection and upside participation to a market recovery have become much

less attractive in recent months. Lower interest rates make the protection more expensive and higher volatility increases the cost of the options held to provide the gain.

Both traded options and structured products are beneficiaries of uncertainty, but investors need to understand properly the factors that drive pricing.

Simplistic concepts like "buying insurance" or "full capital protection", come at a high price during periods of uncertainty.

We hear a lot about hedge funds at present, either as instigators of volatility or because of over leverage. Those trading in illiquid markets using a lot of

borrowed money are suffering a painful squeeze and there are likely to be further casualties to join Peloton and Carlyle Capital.

There are also a number of hedge fund strategies that tolerate volatility and some that positively thrive. Long/short equity hedge funds make up a substantial proportion of the hedge fund sector. Most use relatively little leverage and, in theory, should benefit from volatility.

In practice, current conditions are particularly tough and the results so far this year suggest that the average long/short fund is merely breaking even, which is satisfactory given that equity markets have fallen by about 10pc.

The real beneficiaries of volatility in the hedge fund arena are funds which invest in a range of strategies designed to extract value from changing interest rates, foreign exchange, equities and commodities.

The current environment is ideal for them and average returns so far this year have exceeded 7pc.

It is clear that during a market setback, volatility rises, but no advance warning is given and so VIX is not particularly useful as a lead indicator. What is, however, worth noting is that once volatility moves up, it stays high for quite a while, which means that the strategies outlined are likely to keep working for some time.

On reflection, this makes sense because investors lose their nerve collectively and only regain their courage individually.

So, while we grapple with the challenges of the credit crunch and a general slowdown of economic activity, investors prepared to search out valuable opportunities will find plenty to do.

David Miller is head of alternative investments at Cheviot Asset Management