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Seeds of Thought

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The Death of Vol Trading

I've been trading foreign exchange options, with a particular penchant for emerging markets and exotic options, since 1992. For the first 10 years, I was essentially the market maker to market makers, providing liquidity to the liquidity providers. Everyone needs a niche, right? Most of my counterparties had client flow that kept them busy all day long. I, on the other hand, had none, which meant I could sit back and watch markets, price action and observe behavior patterns. There were the big money center banks with all the large flows, the regional emerging market banks (locals) who had the inside track on major deals and policy decisions that would move markets, the brokers who played both sides and the hedge funds that terrified everyone. Without connections to clients or locals, I had to develop my own competitive edge if I was going to compete.

One thing I noticed early on, particularly in emerging markets, was that fx option vol was slow to react to what was happening in interest rates, and even spot and forwards. Since EM wasn't a 24 hour market, every morning the brokers would scramble to get starting runs. Few traders wanted to be the first, and so very often one of the brokers would make them up, just to get things going, and then another, and another would follow suit. When all the brokers had basically the same run, traders developed the confidence to provide their own contributions to it and to specific price requests. It was such an interesting phenomenon to me. The mere existence of a price, any price, gave the market substance. It provided a basis for confidence and validity. Every price request from clients, every book valuation and interbank trade was based on these runs. Runs that had little more to support them than the fact that it had closed around there the night before. These markets were rife with opportunity.

If I was going to capitalize on them, I would need to have a strong fundamental view, firm understanding of who the key players were and a complete picture of market positioning. My plan was to own these markets and the strong view was necessary because I would essentially be challenging counterparties to deal with me. I had very strict rules and adhered to them without wavering. I showed prices only on full amounts and just once, “fill or kill”. If I found out that the interest was not on the full amount, that a broker was less than 100% honest with me or any of the parties involved had disclosed details of our deal, I never spoke to them again. That happened just once, but it sent a powerful message.

My prices were always incredibly tight, often choice (no spread), very skewed and good for whatever size the counterparty needed. Since I was always the first price they saw, the price takers knew that if they passed on it, they would be vulnerable. With such a tight spread and extreme skew, a “pass” was the equivalent of them showing me their hand. Broker runs would vanish or shift dramatically, generating panic among market makers. Suddenly, they were out at sea without the north star to guide them.

As a result, I became the clearinghouse for nearly every interest that flowed through European crosses, then Latin America and eventually CEEMEA currency options. I, and others like me, knew where

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markets were vulnerable, what would trigger action on the part of those with, and without, positions. As a result, volatility of implied vols was exaggerated. When EM weakened, you could count on implied vols moving, no jumping, higher, and vice versa. The excessive movement in implied vols actually generated more interest in the vol markets, for they offered real opportunity, well beyond simply outperforming or underperforming actual vol.

The New Normal for Implied Volatility

So what's changed since the golden age of vol trading? A number of very important factors have changed, actually. First, hedge funds, the old initiators of the risk taking cycle no longer position in the same way (See When Macro Lost Its Way). Market makers are no longer incentivized to take on risk, so they'd rather have a small piece of an interest than the whole thing, making them less likely to have to unwind "no matter the cost". Prop desks used to pile on hedge fund interests, further exaggerating their impact, but they no longer exist. As for the role I played, essentially gasoline on the fire, the agitator, it too has disappeared.

Technology has played a part, as well. Used to be that it would take time to input the trades, run your risk reports, to see your greeks, especially when spot, rates, vols and skew all bounced around dramatically, on a regular basis. Positions morphed, hedging was active and tempers flared. Since the inputs don't gyrate around as much these days, and positions are updated instantly, calm begets calm.

Bottom line, the initiators, piggy backers, and agitators, all of whom played a part in generating excessive vol of vol, no longer exist, and even those that do are mere shadows of their former selves. Yes, I am arguing that the subdued nature of implied volatility is a structural phenomenon. You should not expect a return to the golden age of vol trading any time soon.

Postscript

One last point on the subject of volatility that I think is worth making. Uni-directional moves, no matter how extreme, in and of themselves, should not be used to argue for higher implied vols, for they are symptomatic of certainty. Plus, they're easy to hedge.

Implications

Risk reversals (skew), particularly in emerging market currencies, are too expensive. They are reflective of days gone by, not the world in which we exist.

In EM, historically, a lack of carry is reflective of stability, and results in lower implied vols and smaller skew. I would argue that the world is more carry sensitive today than ever before. That means the relationship between carry and vols/skew needs to be reassessed. I would be more inclined to buy upside vol in low carry EM than high.

About the Author

For nearly thirty years, Stephen Duneier has applied cognitive science to investment and business management. The result has been the turnaround of numerous institutional trading businesses, career best returns for experienced portfolio managers who have adopted his methods, the development of a $1.25 billion dollar hedge fund and 20.3% average annualized returns as a global macro portfolio manager.

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Mr. Duneier teaches graduate courses on Behavioral Investing and Decision Analysis in the College of Engineering at the University of California. His book, *AlphaBrain,* is due to be published by Wiley & Sons in the Spring of 2017.

Through Bija Advisors' coaching, workshops and publications, he helps the world's most successful and experienced investment managers improve performance by applying proven, proprietary decision-making methods to their own processes.

As a speaker, Stephen has delivered informative and inspirational talks to audiences around the world for more than 20 years on topics including global macro economic themes, how cognitive science can improve performance and the keys to living a more deliberate life. Each is delivered via highly entertaining stories that inevitably lead to further conversation, and ultimately, better results.

Stephen Duneier was formerly Global Head of Currency Option Trading at Bank of America, Managing Director in charge of Emerging Markets at AIG International and founding partner of award winning hedge funds, Grant Capital Partners and Bija Capital Management.

His artwork has been featured in international publications and on television programs around the world, is represented by the renowned gallery, Sullivan Goss and earned him more than 50,000 followers across social media. As Commissioner of the League of Professional Educators, Duneier is using cognitive science to alter the landscape of American K-12 education. He received his master's degree in finance and economics from New York University's Stern School of Business.

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