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"It is not certain that everything is uncertain." – Blaise Pascal (b. 1623 - d. 1662)

Is volatility an asset class? If so, when did it become one? In the modern investment portfolio, managing volatility is a high priority. In this month's letter we investigate the history of mitigating volatility, through hedging, and what it means for market participants today.

The mainstream financial media frequently reminds us of the multitude of risks investors should expect to navigate over the coming years: a potential hard landing in Chinese real estate, Japan's ability to carry its debt obligations, European sovereign credibility, the fragile U.S. housing and job market recovery, and the impact of Iran's nuclear policies on the geo-political environment. With all of this uncertainty, prudent investors will take action to reduce their exposure to underlying price volatility. Tail-risk hedging programs along with a host of new volatility exchange-traded products are just the newest product innovations of an age-old activity. The real story surrounding hedging activity is its mainstream *accessibility*.

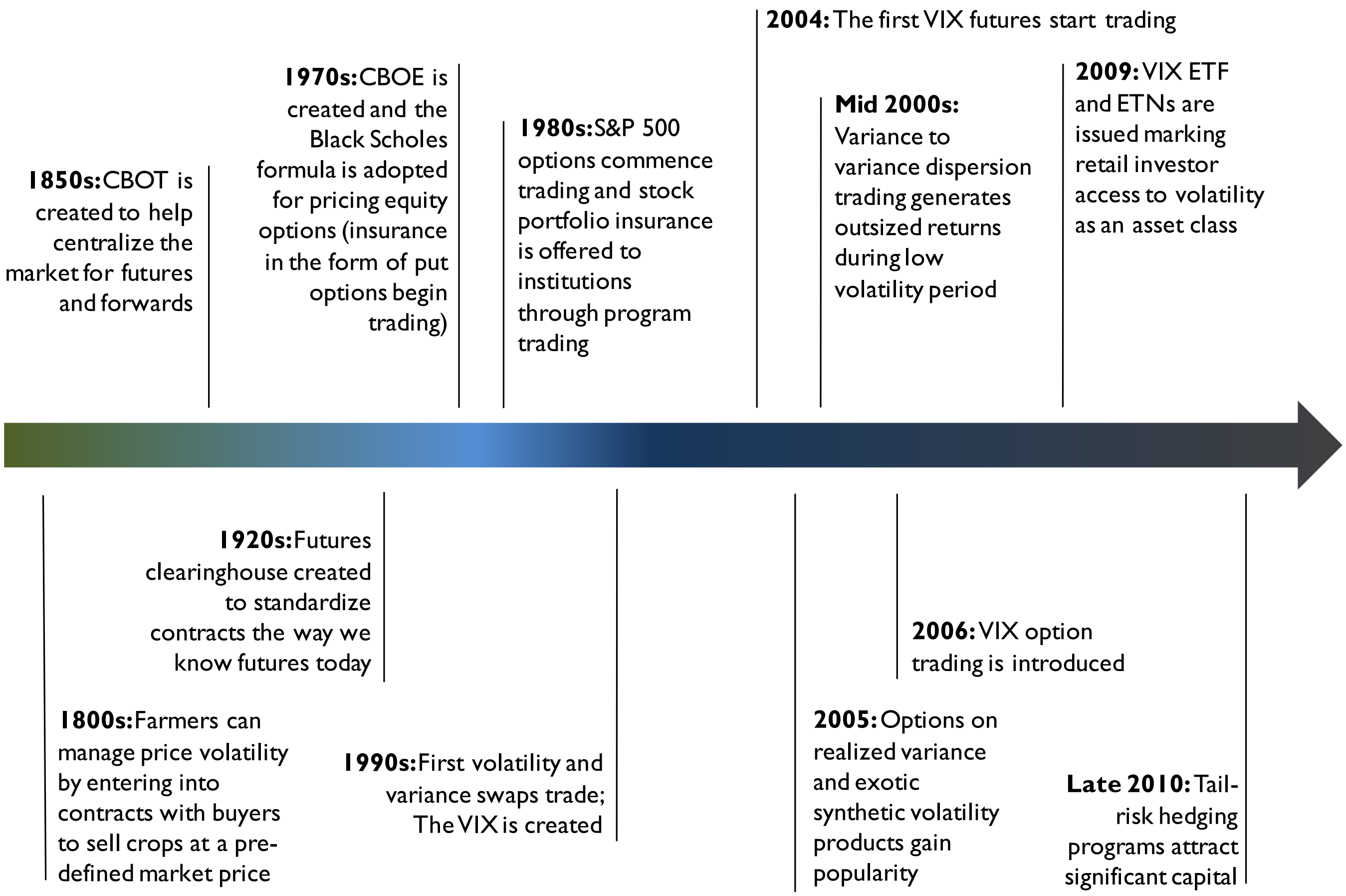
We thought it might be helpful to look at how hedging has evolved over time. Hundreds, if not thousands of years ago, individually negotiated contracts were used to help people alleviate risks whereas today it has become as simple as clicking a button.[1] In the 1800s wheat farmers could use futures and forward contracts to hedge the price volatility associated with their crops. In the same way farmers looked to derivatives markets to ensure a fair value for their crops, investors have longed for a similar type of insurance for portfolios. Over the past century, product innovation and customization allowed sophisticated investors to hedge portfolios more directly and efficiently.

Hedging as we know it today made its greatest advancements in the past 30 years with the introduction of equity and index options and futures. Most hedging programs were designed for and marketed to institutional investors as they were more suited to understand the complications and nuances of derivatives trading. Leading up to the crisis of 2008, it appeared as though the complexity of hedging had no ceiling as banks clamored to offer cheaper and more exotic forms of insurance. Over-the-counter (OTC) products like binaries, knock-outs/ins, and best/worst-of options traded actively in the mid 2000s during a period of low volatility. Additionally, investors used convex products like variance swaps and options on variance swaps to express views on volatility.

Once the crisis hit, institutional investors feared the counterparty risk, opaqueness of pricing and illiquidity associated with many of the OTC products they carried. Concurrently, banks were uncomfortable with the leverage embedded inside many derivatives strategies and required higher collateral on exotic products. Institutions responded by shying away from many of the complex hedging products and went back to basics: exchange-traded options, futures and ETFs.

[1] *In researching the history of hedging we found examples from biblical times, but for the purposes of this letter we will stick to the past couple of centuries.*

Below we show the evolution of hedging using derivative products by highlighting the major milestones since the 1800s.



After periods of extreme volatility during the past four years, the financial services industry met an increased demand for hedging vehicles by introducing volatility ETFs and ETNs. These products were aimed at both retail and institutional investors that required an easy-to-understand and highly accessible hedging solution. The response has been significant. In the past two years, assets under management of volatility exchange-traded products have jumped to the billions of dollars as these products have become widely marketed alongside perceived risk of catastrophe on the horizon.

The advent of new market participants in the volatility and hedging space creates greater demand for insurance products. In turn, absorbing this newfound demand for risk transfer will undoubtedly create structural imbalances. As banks reorganize prop trading efforts under the Volcker rule and become more capital conscious, broad-based intermediaries such as market-makers and volatility investment managers have an opportunity to participate more meaningfully in the hedging space.

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