Quantum
INVESTING

## Few Observations on February - March 2020

*"Only when the tide goes out do you discover who has been swimming naked"* ***Warren Buffett***

The period of February-March 2020 was a very testing period for many portfolios as it came after a prolonged period of relatively calm market conditions. This has exposed many known but hidden risks that can be present in portfolios leading up to such change in market conditions. Below we highlight some of our observations on inherent individual strategy risks, and portfolio construction and risk management considerations that are key to surviving such episodes:

1) Usually periods of low volatility are perceived as a low risk environment, but periods of extended low volatility tend to lead to increased leverage and accumulated hidden risks which make the portfolio risks higher not lower. For example a number of strategies are inherently short volatility because they rely either directly or indirectly on historical volatility to size their positions (risk parity for example). This can lead to a very high portfolio leverage because of the perceived low historical risk. Portfolios need to account for this risk as it's not directly observed in the immediate history. Also highly skewed strategies such as volatility selling are particularly exposed to such sudden change in volatility regime.

2) Systematic Strategies are calibrated around historical data but it is really important to analyse and understand the actual performance drivers and risks behind these strategies. A good example of this would be some of the trend following strategies that a lot of portfolios rely on for tail risk hedging. As we have highlighted in previous notes, while these strategies may provide good protection in a prolonged market downturn, they won't necessarily work in the context of a very benign risk environment that is followed by sudden sharp reversals.

3) When analyzing individual strategies it is important to be aware of what strategies exhibit the wrong versus the right way around asymmetry of returns. A strategy like FX Carry has what we would consider wrong way asymmetry because it suffers in a flight to quality and dollar shortage

scenario which are often seen during stressed market conditions while Commodity Curve Carry is the right way around because it performs well in energy downside shock scenarios.

4) Changing macro environments especially around fast cyclical turning points can have material impacts on portfolio performance and do require active strategy allocation tilts and risk management. Certain strategies tend to behave very differently when heading toward an economic downturn and this has to be incorporated into the portfolio construction. As well, Long/Short equity strategies can experience realised hedge ratio moves between the long and the short portfolio that are much higher than what is observed in normal periods, thus effectively creating a delta bias in the portfolio.

5) Diversification is truly tested during periods of forced liquidation as things don't behave as you would normally expect them to. In the rush through the exit door market participants sell what they can and not necessarily what they want. The key to avoiding severe drawdowns in such periods is a robust portfolio construction that ensures good balance between the various strategies in the portfolio (no single strategy should dominate no matter how high the conviction is), appropriate leverage and not being short convexity. Also the ability to easily value positions with observable market data is not in the front of investors minds during normal times but it is a hidden risk that bites hard when liquidity dries up. The combination of leverage, sudden big changes of mark to market, the retracement of trading counterparties from providing market liquidity, and any resulting large margin calls can lead to forced liquidation and a negative feedback loop that is very hard to stop.

6) Historically market corrections of the magnitude that has happened over the past couple of months create interesting opportunities in systematic strategies across the various asset classes. It is important that the portfolio is not a forced seller at the end of these corrections and is well positioned to be able to benefit from such dislocations.

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