Arbitrage Opportunities In The Age Of Machine-Made Volatility

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Investors are entering a brave new world. The machine-made crash we saw in the early part of the year was illustrative – one market misstep can create a vortex of selling. As herding in ‘smart beta’ ETFs drives increasing correlations, we could witness another snap back in a market showing signs of diminishing support. After a decade of directionality, allocators are now looking to strategies with uncorrelated sources of return – of which, some will find their diversification claims tested in potentially ultra-bearish conditions.

Against this backdrop, the scene is set for the return of relative value arbitrage strategies. The rise of the machines, combined with the decline of investment banking trading, has led to an unprecedented level of event-driven opportunities. From mispricing around new capital raises to regulatory change, shareholder buybacks, security issuance and capital restructuring, there has never been more fertile ground to unearth sources of uncorrelated alpha.

Flight of investment banks

At the heart of the reshaped landscape for arbitrage investors, is the diminished role of investment banks. Higher capital charges and reduced staff numbers, precipitated by Dodd-Frank and other regulations, have created a twin headwind for the industry. In the mid-2000s, the arbitrageurs were in the ascendency, with hundreds of traders scouring individual global opportunities. Now, not only have investment bank aristocracy, such as Goldman Sachs, reduced their presence, but smaller regional European banks have also scaled back operations.

This retrenchment has destroyed the culture of arbitrage within investment banking and fractured dialogue within existing market players. The US does not speak to

Europe and Europe does not speak to Asia. And poor communication between international branches is not the only concern. Even within branches, there is significantly diminished communication between different desks.

These banks are simply not undertaking anywhere near the same depth of arbitrage analysis. We are now operating in an era of accelerating structural change in the banking industry and as proprietary trading desks have wound down, it has led to an unprecedented level of exploitable opportunities.

The source of an arbitrage opportunity could be a soft catalyst, a regulatory change, earnings, rights issues – typically around the equity and corporate levels of the capital structure – though generally not M&A. I will then look at a selection of related securities and see if there is a way I can find value in a nimble way, which is often in options or hybrids.

Canary in the coal mine

Without experienced traders to iron out the edges, we are also increasingly seeing odd dislocations in the market. An example is the overpriced Carrefour deal. The underwriters claimed after the deal was allocated the syndicate had not broken, and as such they were unable to make secondary markets in the security. This is the first time I have ever witnessed this behaviour.

I view this as a canary in the coal mine event, where major investment banks do not intend to provide liquidity even in their own investment banking-led business. I feel this could result in much-increased volatility if the broad market went through a period of weakness. Our own book is positioned to avoid this, and is very liquid, so a rise in volatility would not have much of an impact, but I am concerned about the impact on broader markets.

Rise of the robo traders

Accelerating this trend is the rise of machines across the broader financial industry, which is creating fresh inefficiencies within bank securities and other assets. Across the globe’s trading floors, traders have given way to algorithms. While this is certainly driving necessary innovation, we, as an industry, are also losing something vital in delivering alpha – the human component.

Without this, there is no insight and judgement, which could have calamitous consequences. It is not about being anti-technology, but we need to appreciate the Law of Unintended Consequences. My belief is the next time we get a volatility event, it will be a lot worse than the recent spike because there will be no-one to step in on the other side of the trade.

I have seen multiple instances of trading on incorrect models, where the dataset has not been updated and there is insufficient human oversight. From quant programmes replacing humans, to firms trading on outdated or incomplete datasets, these disruptive trends are rapidly creating the potential for steeper sell-offs but also arbitrage opportunities.

Wrong side of the trade

During the Lehman Brothers liquidity crisis in 2008, there was actually a large degree of trading. The market was down, but volumes were strong. The next significant event will strike with a lot less liquidity, because it is going to be driven by algorithms trading along similar lines. As the influence of algorithms grows and everyone is on the same side of the trade, we run the risk of a hyper crash with no theoretical floor.

We have seen a sustained focus by investors on the three or four risk premia opportunities. Money has flowed into these strategies, and into less liquid credit 'carry' strategies. While these currently look great in Sharpe ratio terms, given prevailing levels of low volatility, the question remains how this allocation strategy will hold up in more challenging conditions.

We are already seeing a shift in investor attitudes amid the aftermath of February's volatility spike. The robustness of AI-driven risk premia and factor-related strategies is beginning to be questioned by some investors. Since the sell-off, there has been a startling rise in interest from asset allocators seeking relative value traders, event traders, even macro traders: anyone who is not market beta factor-focused.

Source of uncorrelated return

We have not suffered a single down-month, even during February when much of the hedge fund industry was rocked by the violent market volatility and strategies of all variation went south.

The reality is investors are approaching unchartered territory, as the world braces itself for the unwinding of the greatest monetary experiment in history. As markets wean themselves off QE and unconventional monetary policy, we could see a seismic impact on correlations across asset classes. The recent volatility we saw represents the early tremors of potentially a much deeper market repricing and asset allocators should be adapting their portfolios to the new environment and focusing on risk-adjusted returns.

In the current environment, relative-value arbitrage strategies are a true uncorrelated solution that offers both stable returns and reduced volatility. When investors are moving with the tide, relative arbitrage offers a universe of uncrowded trades and a strategy that is extremely difficult to replicate and inaccessible to big data and quant funds.

Oliver Dobbs is CIO and Founder of Credere Capital