



PRISMA CAPITAL PARTNERS

Low Volatility, Incentives & Public Policy*

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“Is there any point to which you would wish to draw my attention?” [Inspector Gregory]

“To the curious incident of the dog in the night-time.” [Sherlock Holmes]

“The dog did nothing in the night-time.” [Inspector Gregory]

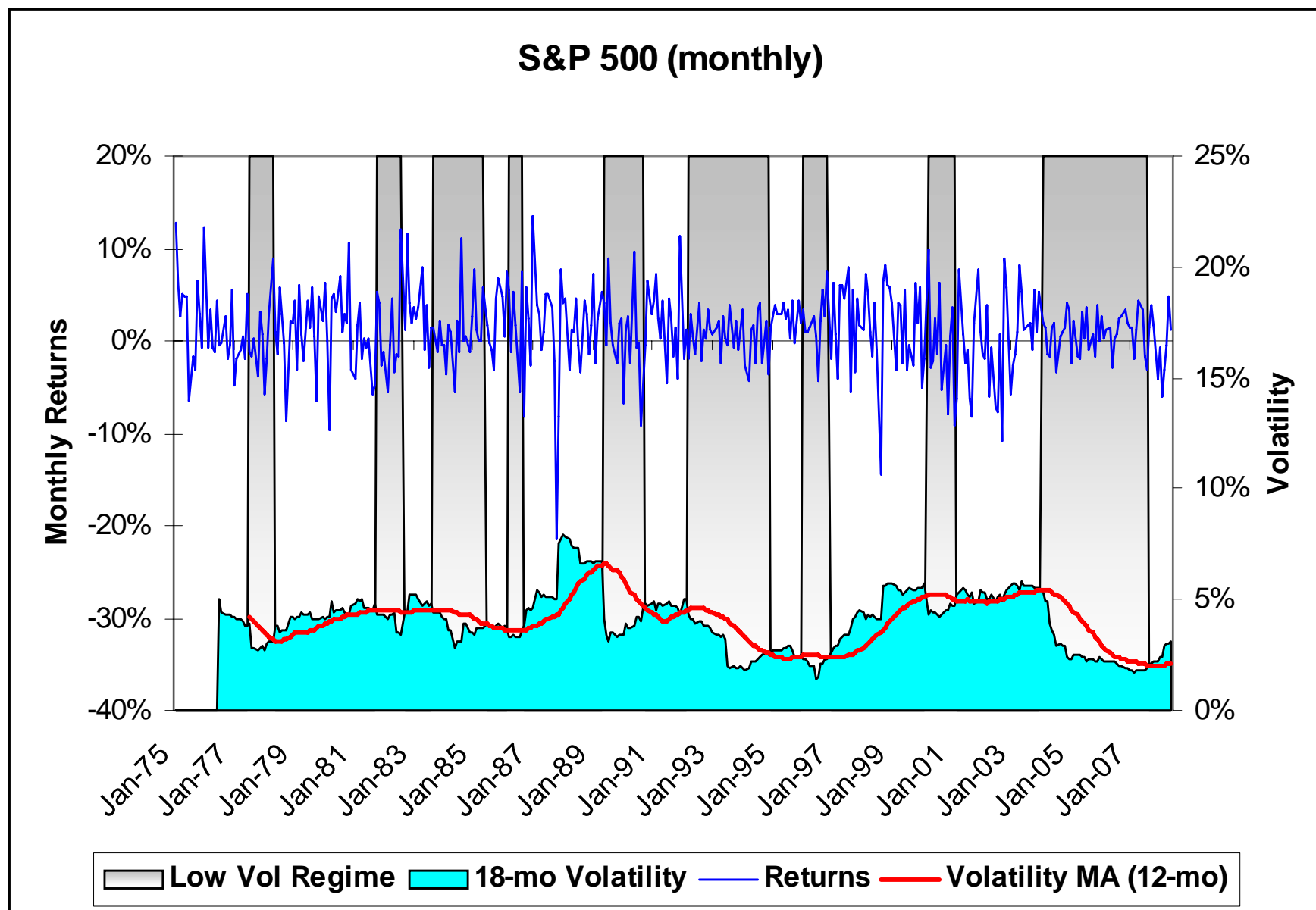
“*That* was the curious incident,” remarked Sherlock Holmes.

Arthur Conan Doyle, "Silver Blaze" in *The Memoirs of Sherlock Holmes* (1893)

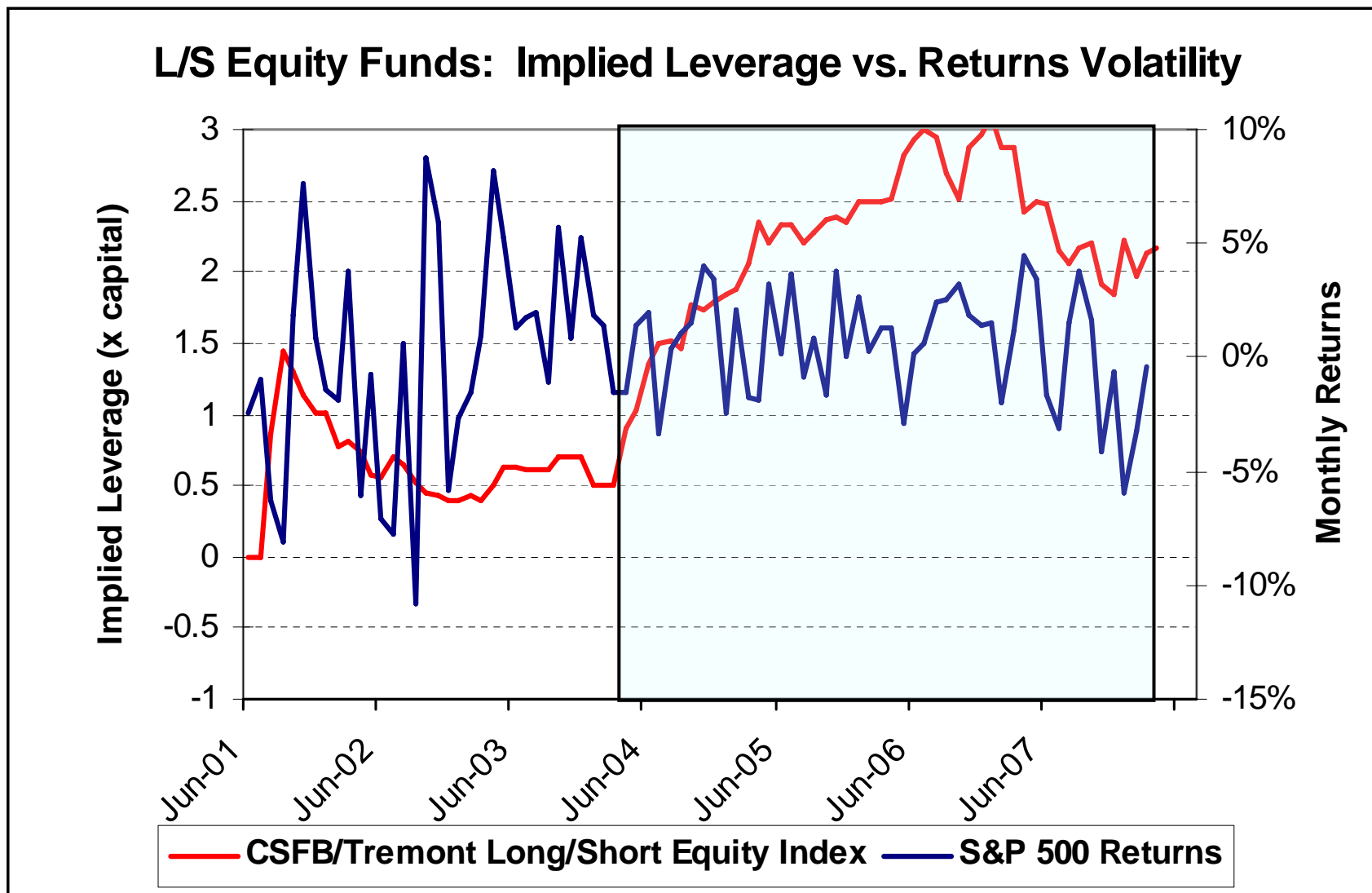
Research on Volatility

- ◆ Much attention is usually paid to measuring and risk managing High Volatility states
- ◆ Not enough focus on where there is little action – the Low Volatility regimes
- ◆ Lots of information contained in Low Vol regimes, but not necessarily in the price/return data

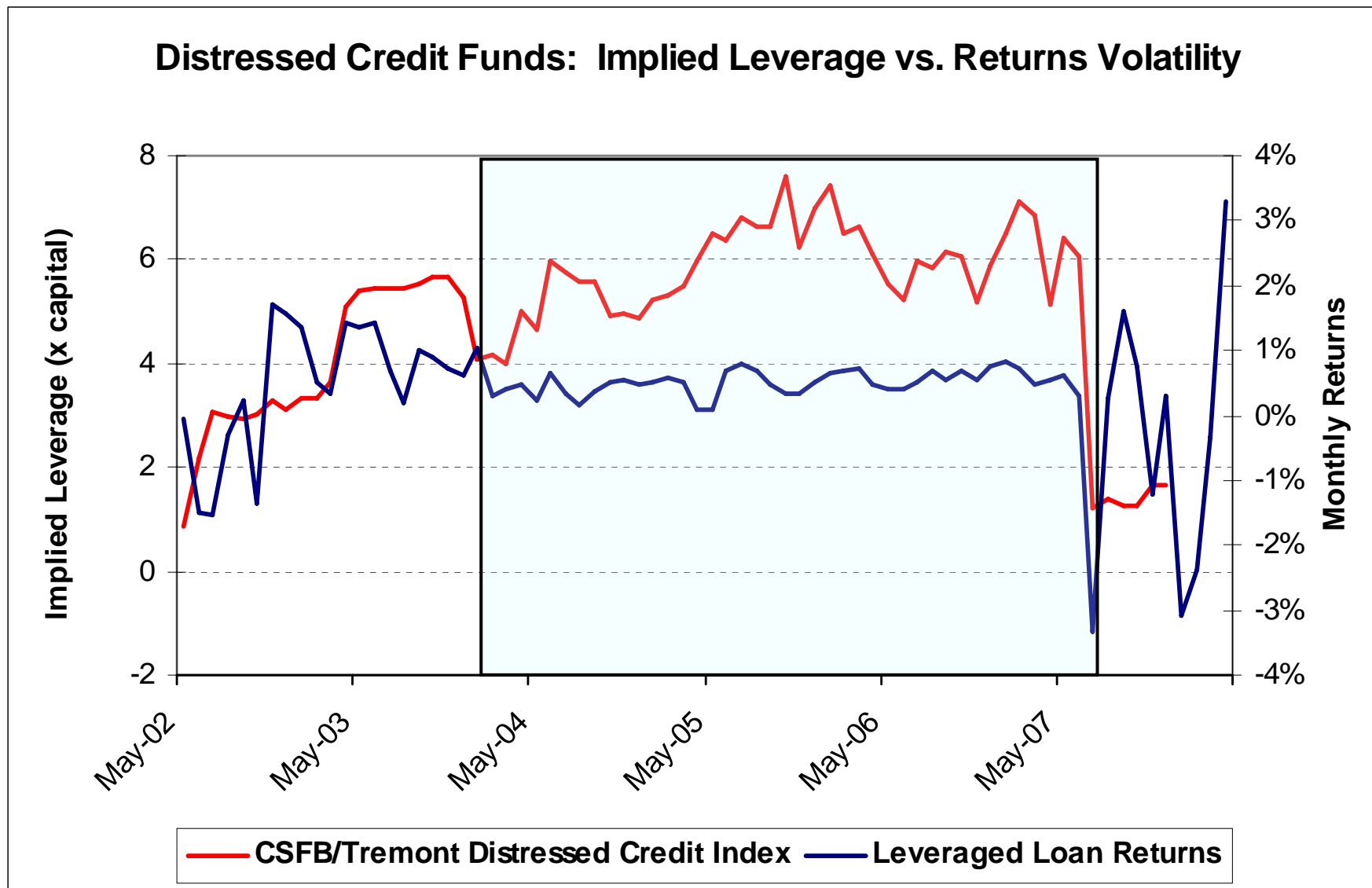
Why is Volatility Low?



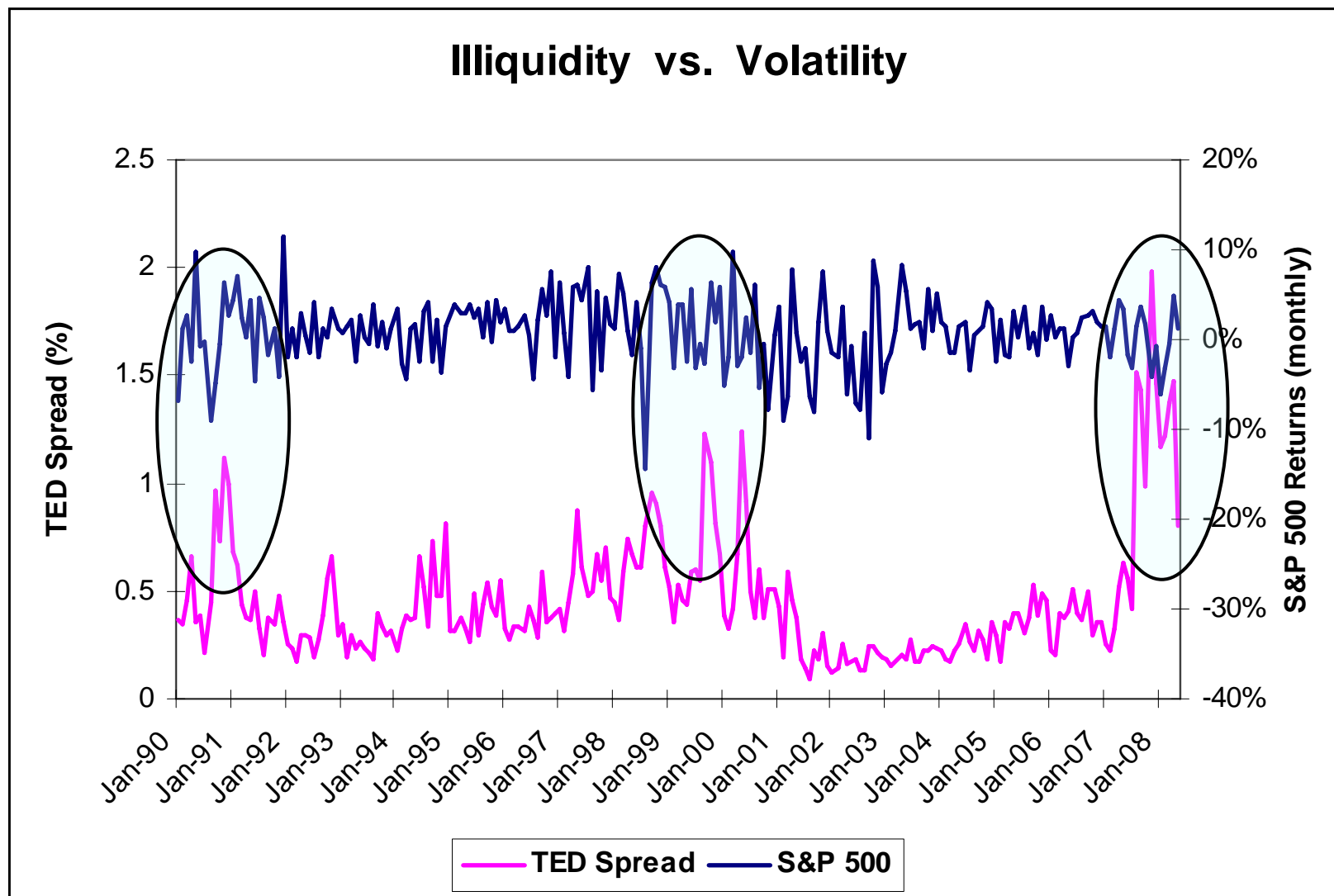
I. Equity Long/Short Hedge Funds: Low Volatility → Increasing Leverage



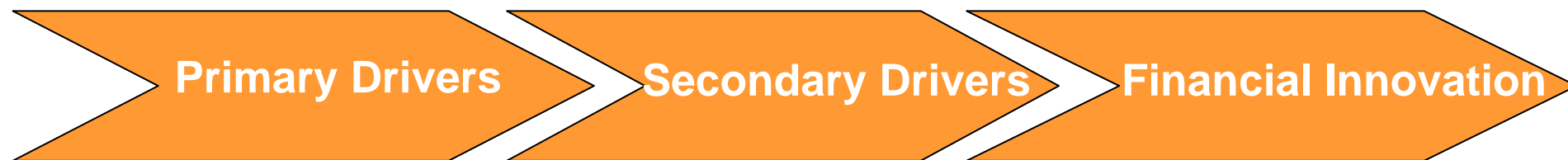
II. Distressed Credit Hedge Funds: Low Volatility → Increasing Leverage



III. System Illiquidity → Volatility



Financial Innovation: The Academic View



**Risk
Preferences**

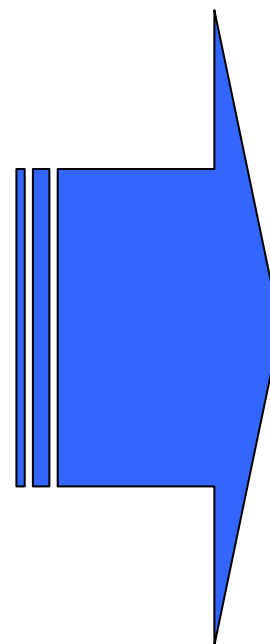
**Tax
Constraints**

**Informational
Asymmetries**



**Incomplete
Markets**

**Transactions
Cost**



Derivatives

Financial Innovation: The Wall Street View



**Tax
Laws**

**Accounting
Rules**

**Ratings
Methodology**

**Regulatory
Requirement**

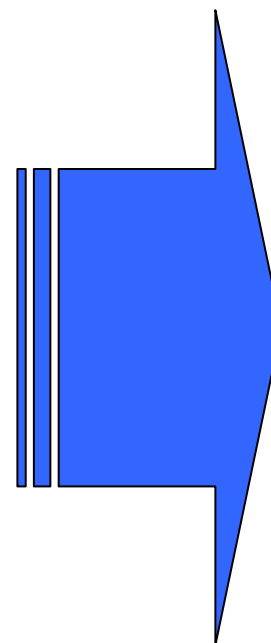
**Legal
Environment**



**Risk
Transfer**

**Transactions
Cost**

**Market
Opportunity**



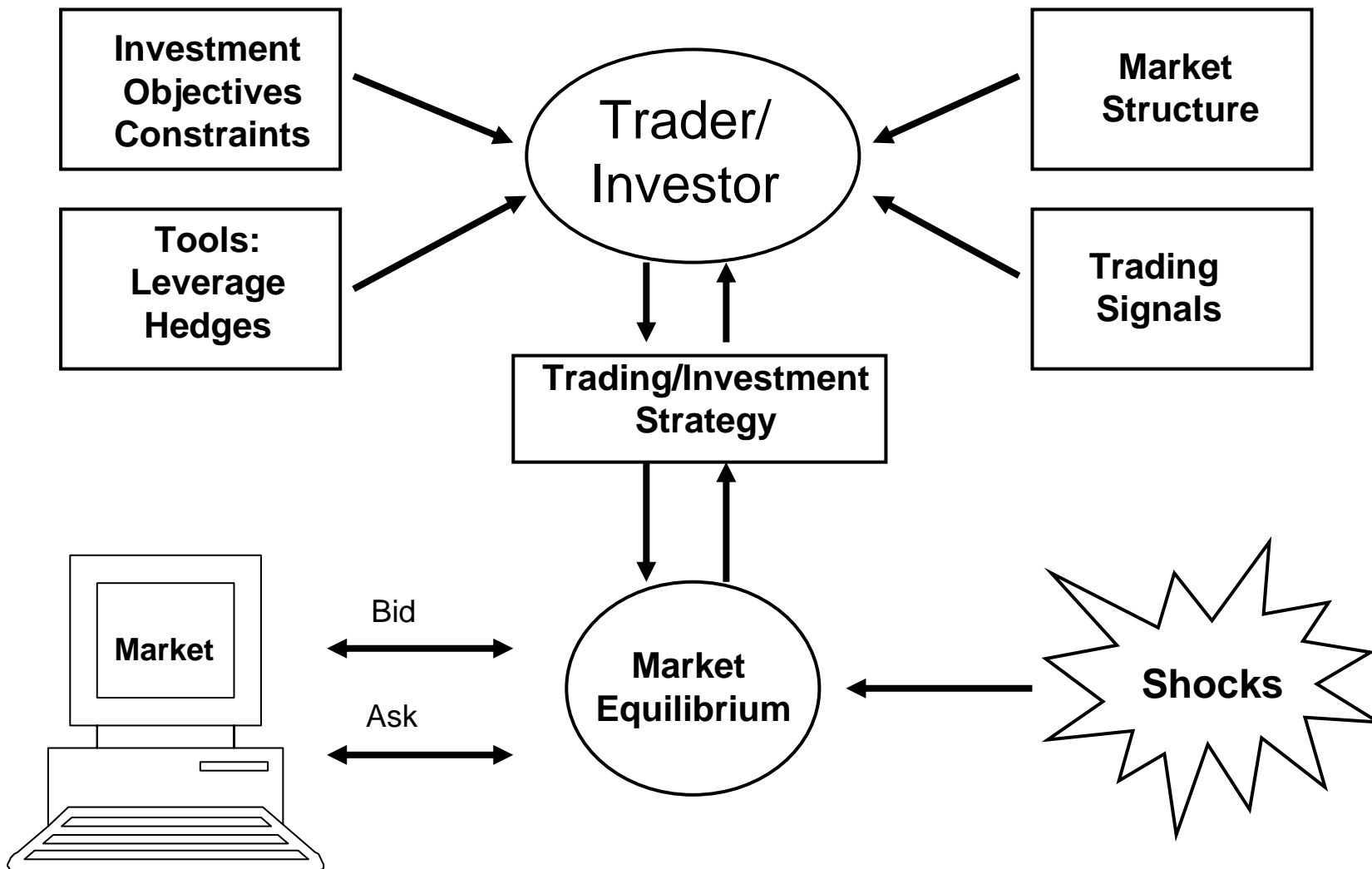
**Tax
Arbitrage**

**Accounting
Arbitrage**

**Ratings
Arbitrage**

**Regulatory
Arbitrage**

Endogenous Volatility Regime Model



Key Insights

- ◆ Traders' capital allocation strategy is a function of market structure, balance sheet, fundamental signals, conditional forecasts of future volatility and exogenous shocks
- ◆ Low volatility forecasts increase the incentive to add balance sheet leverage and vice versa
- ◆ Increased (levered) allocation to risky assets competes away scarce alpha, leading to even higher leverage in some (optimistic) states to maintain the required rate of return
- ◆ Low Volatility run equilibrium is broken when a super-critical exogenous shock forces de-leveraging and the cycle repeats
- ◆ Persistent low volatility and high volatility regimes are endogenous, equilibrium outcomes

Public Policy/Research Agenda

- ◆ Extract non-price information contained in Low Volatility regimes
- ◆ Need to go behind the scenes to understand the complex causes and consequences of Low Volatility states
 - New Market Structure
 - New Players (HFs, PE)
 - New Products
 - Arbitrage strategies
 - Leverage Levels
 - Stealth Institutions (Investment Banks, SPEs, HFs, PE)
- ◆ Goal is to predict transition to economically painful High Volatility regimes
- ◆ **Regulation:** Superficial Compliance vs. Meaningful Supervision
 - Do regulators really understand what's under the hood in financial institutions?
- ◆ Resist temptation to fight past Wars

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Comparative Indices

The statistical data regarding below indices has been obtained from sources believed to be reliable. The investments of any Prisma's funds or portfolios are not limited to the investments listed by these indices. These indices are not subject to any of the fees or expenses to which any Prisma's funds or portfolios would be subject. It is not possible to invest in these indices. These indices are being presented for comparison purposes only to show how performance of Prisma's funds or portfolios compares to the broad global markets.

The **S&P 500 Index** ("S&P 500") is comprised of a representative sample of 500 large-cap companies. The index is an unmanaged, float-weighted index with each stock's weight in the index in proportion to its float, as determined by Standard & Poors. The S&P 500 is one of the most widely used benchmarks of U.S. equity performance.

The **Lehman U.S. Aggregate Index** ("Lehman Aggregate Bond Index") covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, CMBS and ARM sectors. Bonds included in the index have maturities of one year or more, and must meet certain minimums with respect to the amount outstanding (depending on the type of bond).

The **Merrill Lynch 3-Month Treasury Bill Index** ("ML 3-month T-bills") tracks the performance of the 3-month U.S. treasury market. The index is unmanaged and is comprised of a single issue purchased at the beginning of the month and held for a full month. At the end of the month, that issue is sold and rolled into a newly selected issue. The issue selected at each month-end re-balancing is the outstanding Treasury Bill that matures closest to, but not beyond 3 months from the re-balancing date.

The **Credit Suisse/Tremont Hedge Fund Index** ("CSFB Hedge Fund Index") is an asset-weighted hedge fund index that consists of more than 900 hedge funds across a number of style-based sectors representative of the hedge fund industry. Funds included in the index have a minimum of US \$50 million under management, a minimum one-year track record, and current audited financial statements. Performance data in the index is net of all fees. The index is calculated and rebalanced monthly. Funds are reselected on a quarterly basis as necessary.

A fund in the **HFRI FOF Conservative Index** shows generally consistent performance regardless of market conditions. Fund of Funds classified as "Conservative" exhibit one or more of the following characteristics: seeks consistent returns by primarily investing in funds that generally engage in more "conservative" strategies such as Equity Market Neutral, Fixed Income Arbitrage, and Convertible Arbitrage; exhibits a lower historical annual standard deviation than the HFRI Fund of Funds Composite Index.

A fund in the **HFRI FOF Diversified Index** tends to show minimal loss in down markets while achieving superior returns in up markets. Fund of Funds classified as "Diversified" exhibit one or more of the following characteristics: invests in a variety of strategies among multiple managers; historical annual return and/or a standard deviation generally similar to the HFRI Fund of Fund Composite index; demonstrates generally close performance and returns distribution correlation to the HFRI Fund of Fund Composite Index.

Thank You



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