When Volatility Knocks | August 2017

"Using volatility as a measure of risk is nuts."
Charlie Munger

The future is full of possibilities, some good some bad. Risk comes from not knowing which of them will come to pass. Given it's impossible to imagine and consider every potential outcome, we focus our energy on the most likely ones.

In market speak, the 'probable' range of outcomes is expressed as volatility. A useful metric that fits nicely into models and gives an indication of the ups and downs one can expect to endure. The trouble investors run into is when they use it as a proxy for risk.

While investment risks are both broad and personal, they typically fall into the categories of losing money or not making enough of it. Both of which are more a function of valuation and sound fundamentals rather than of mercurial markets.

The best way to protect and grow capital is to buy quality assets at attractive prices. Given its propensity to spike after significant equity declines, high volatility often indicates the opportunity to do just that. To 'be greedy when others are fearful.'

Conversely, periods of stability can lead to an underestimation of uncertainty in the market and the odds of the 'improbable' occurring. Often when it is prudent to be 'fearful when others are greedy.'

So how should investors use and interpret volatility?

The first step is in recognizing what volatility is and is not. It is not a substitute for risk but is one measure of a particular type of risk. For those with short-term horizons or trading with leverage, it is a real concern, and substantial variations in value need careful management.

But for the majority of us, portfolio fluctuations are tolerable as long as the overall trend is up. After all, one would prefer an investment that generates positive but erratic returns, rather than one that consistently and steadily loses money.

Perhaps then volatility's appropriate value is as a measure of fear, or the lack thereof. As a gauge of investor sentiment, it can provide both an indication of near-term threats and longer-term opportunities. The natural question is whether the level of complacency or fear is warranted. When valuations and fundamentals do not support the 'wisdom of the crowd,' it might be time to be either prudent or aggressive.

It's not that volatility is not a useful and valuable risk metric. We are not ones to throw the baby out with the bath water. But taken in isolation, the picture is imperfect and incomplete. After all, quantitative metrics can help us understand risk, not define it.

The Fund

It seems we spent the month dodging missiles of one kind or another. A sleepy mid-summer market was jolted with a sharp escalation in rhetoric between the US and North Korea causing credit to give up some ground.

Just as the war of words appeared to abate, the new issue supply floodgates opened. Pembina got the ball rolling, but it was Apple's inaugural Canadian deal, a $2.5B record-breaker, that caught everyone by surprise. To absorb the supply, investors took the same approach one does when confronted with eating an elephant; one bite at a time!

Just as the deal flow had been digested, another North Korean missile test frayed everyone's nerves. By the time August was over, credit spreads were 4 to 10 bps wider on the month. Furthermore, activity on the Korean peninsula meant little in the way of active trading opportunities.

Although the fund was positioned defensively in very short-dated securities, the carry earned just wasn't enough to cover losses from widening spreads. As a result, the fund experienced a modest loss of (0.09%).

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2017	1.73%	1.30%	0.44%	1.03%	(0.22%)	0.53%	0.94%	(0.09%)	-	-	-	-	5.80%
2016	0.19%	1.49%	5.32%	3.51%	0.60%	0.54%	1.73%	1.63%	1.01%	1.86%	1.60%	1.62%	23.15%
2015	-	2.29%	2.51%	1.27%	2.46%	0.25%	0.73%	(0.25%)	1.68%	1.71%	1.37%	0.87%	15.86%

The Algonquin Debt Strategies Fund LP was launched on February 2, 2015. Monthly returns are based on **'Series 1 X Founder's Class'** NAV as calculated by SGGG Fund Services Inc. and are shown in Canadian dollars, net of all fees and expenses.

Credit

August is a notoriously difficult month for trading credit with many bank desks short staffed due to summer holidays. Fortunately, once September hits, the market often comes alive with new deals and increased flow.

The combination of geopolitical risks and new supply could create a volatile landscape. But the recent widening of spreads offers more attractive entry levels and the pick up in activity can lead to interesting opportunities. After having played defense through the summer, we are watching closely for chances to strike.

Rates

While the missile tests did not faze equity folks, the bond crowd opted for safety driving yields 4 to 20 bps lower across the curve. The various central banks continue to lean towards a reduction in stimulus, including the Bank of Canada. Perhaps the most perplexing observation is that despite increases in the overnight rates and imminent exits from quantitative easing, long-dated yields remain low.

To be fair, inflation data is benign, and wage growth has been surprisingly weak despite low unemployment rates. Although interest rate volatility is low, valuations are high, so we remain cautious.

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