LongTail alpha

December 2015

# A Look Back at 2015

A lot happened in 2015. With the surprise devaluation of the Swiss Franc in the early part of the year that sent shock waves through the currency markets, to the Federal reserve raising interest rates for the first time in a very long time, markets were buffeted by events that foreshadowed much volatility in the year to come. We also had the drama in Greece, where both creditors and debtors engaged in a game of chicken and brinkmanship that finally resulted in a new government coming to power. Crude oil kept plunging, and the beggar thy neighbor policies of oil producers resulted in a decline in energy not anticipated by anyone. Then there was the realization that negative interest rates – yes, where depositors pay for the privilege of lending money, is a reality. There was the problem with liquidity in a high yield fund, that is certain to bring more concern and perhaps well deserved increase in regulation.

Many, including myself, think that these events are interrelated, and the trip to the ultimate destination will not be smooth.

For me the time also came to focus on what I do best, to anticipate and position for events that are out of the ordinary, and whose risks are not appreciated broadly. When I started LongTail Alpha on the 23rd of December, 2015, I was quoted in Bloomberg and my local newspaper that "considering where the market is in terms of volatility and risk, this is very much an optimal time." My comments followed a few days after the first rate increase by the Fed, and having lived through a few tightening cycles and market corrections, it just did not seem to me that the market was rationally pricing the risks ahead.

Little did I know that my forecast of volatility would actually be surpassed by a mini melt-down in the markets. In the ensuing two weeks global stock markets fell close to ten percent in two weeks, a record, credit spreads widened, and emerging market currencies fell to new lows. The culprits were widely agreed to be China and oil, both of which entered the zone of capitulation. I received a request from China to permit them to translate my book "Tail Risk Hedging" into Chinese. Suddenly it seemed that the excesses that have been building up for many years came to a head (for more on this please see my recent Forbes article titled "Normalcy of Deviance").

**Vineer Bhansali, Ph.D.**
*Founder & CIO*

It is a matter of physics that energy and matter is conserved, and squeezing a balloon at one end too hard often results in the balloon blowing up in other places, and sometime just exploding under the pressure. Financial markets are not that different. Our job as investors is to step back and use a wide angle lens to see where distortions are building up, and tilt our portfolio exposures to avoid the accidents and harvest the returns from what for the time being is stable.

There are whole areas of financial markets that have never witnessed a major market correction or the challenges of illiquidity (ETFs and especially levered ETFs). Combine this one sided dynamic with the hunger for yield and the apparent liquidity that can vanish in a flash, and a less than calm picture of what may lay ahead emerges. More than security selection, and more than asset allocation what then becomes critical is basic portfolio construction. This basic portfolio construction does not require advanced mathematics, but simply a realization that robust portfolios are made up of a common sense mix of assets that provide investment return, and assets that provide safety. The sooner we realize that this mix is critical for long term portfolio stability, the sooner we can tilt away from extreme risks that can expose the flaws in portfolio construction encouraged by a decade of easy money.

LongTail Alpha, LLC 18021 Cowan Irvine, CA 92614 LongTailAlpha.com (949) 258-9630