Q&A: EMMANUEL BOURDEIX

The effects of volatility

Emmanuel Bourdeix, head of convertible bonds and derivatives at Crédit Agricole Asset Management in Paris, speaks about the effect of volatility on equity markets and how to seize opportunities for investors

What is the relationship between volatility and the equity markets?
Volatility has a negative correlation with equity markets. Generally, when equity markets fall, volatility increases. This negative correlation explains what makes investors fearful of volatility. They associate its strengthening with market declines. When times are good, it seems to go away.

But one can utilise this relationship instead of merely fearing it. For example, volatility is usually a good hedge if a correction occurs. Some of our clients currently want to secure profits after three good years on the equity markets and going long volatility is one way to achieve this. We say it is one of the best kinds of alternative investment because it offers genuine diversification. Equity investors can earn money from volatility while the equity markets are falling.

But volatility levels of equities have been remarkably low recently – below 15 per cent in late 2005. But are you sure they will rise during 2006?
We believe so, which taking into account our positive view on equity markets, would result in a positive correlation. This kind of positive correlation has already been observed in Japan in 2005: with Japanese equities breaking psychological upside resistance levels, many investors who had underestimated the strength of the equity market increased its volatility trying to catch up with the market. In 2006, stronger than expected equity markets coupled with a lot of merger and acquisition activity might similarly trigger a regular rise of volatility. Crédit Agricole Asset Management puts historic average volatility between 20 per cent and 25 per cent, so we are far south of that at the moment. The figure is based on the largest European stocks; we are trading options on the Dow Jones EuroStoxx 50 index and its components. In essence we buy stock options and isolate the volatility. We are not interested in the other characteristics because they are for traditional equity investors to evaluate. So, we systematically hedge the underlying equity risk of options, which allows us to capture their implied volatility.

© Ghierry Ledoux

Bourdeix: pure exposure to volatility

Since you think that volatility will increase, how will investors catch this potential opportunity?
Recently, we launched a fund providing a pure exposure to this volatility. It offers a positive beta to eurozone equity volatility up to 25 per cent (remember in 2005, we were around 15 per cent).

Typically, if volatility increases from 15 per cent to, say, 20 per cent, the net asset value of the fund would roughly take 10 per cent. There is a gradual drop of the indexation as volatility reverts to the level of 25 per cent, and the indexation even turns negative beyond that point, in order to take profit from excessive levels.

Visit our website:
ca-assetmanagement.com

Crédit Agricole Asset Management is the asset management subsidiary of Crédit Agricole SA, with €479.3bn in assets under management at 31 December 2005 making it France's largest fund manager and one of the top 5 players in continental Europe. A staff of 2,063 includes 530 professionals specialising in fund management and analysis across eight asset management centres worldwide (Paris, London, Milan, Madrid, Hong-Kong, Singapore, Tokyo, Seoul) for institutional investors as well as fund users. Crédit Agricole Asset Management's key areas of expertise are Euro & Global fixed income, European equities, Asian equities, Structured investments, Absolute return, Funds of Hedge Funds, Employee savings schemes.