

**AUTOCALLABLES, VOLATILITY  
COMPRESSION AND EUROSTOXX**

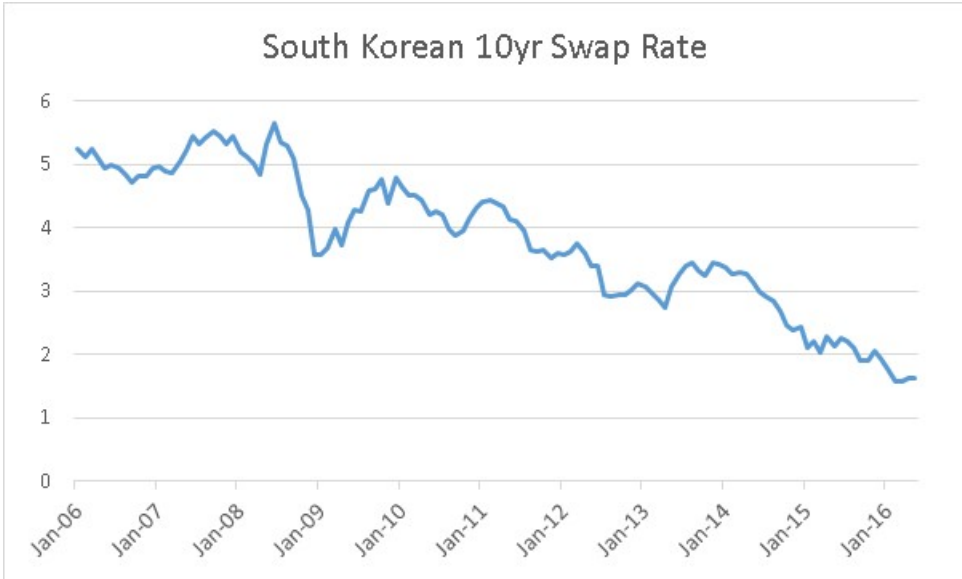


Russell Clark's  
Market Views

“Autocallables (or reverse convertible securities) are products that first gained popularity in Japan in the 1990s. They are short-term coupon bearing notes, which are designed to enhance yields. Autocallables can be fiendishly hard to understand, as they often have various barriers based on an index which will determine the payout.”

Autocallables (or reverse convertible securities) are products that first gained popularity in Japan in the 1990s. They are short-term coupon bearing notes, which are designed to enhance yields. Autocallables can be fiendishly hard to understand, as they often have various barriers based on an index which will determine the payout. The simplest way to describe them is that investors use the structured note to sell insurance on the market. As long as the market does not fall too far, the investor keeps the insurance premium. However, if the market falls too far the investor loses both the yield and underlying capital. Autocallables are a feature of a market where domestic interest rates are very low and likely to stay low. Hard data on autocallables is hard to come by, but we have some data from Korea and the US.

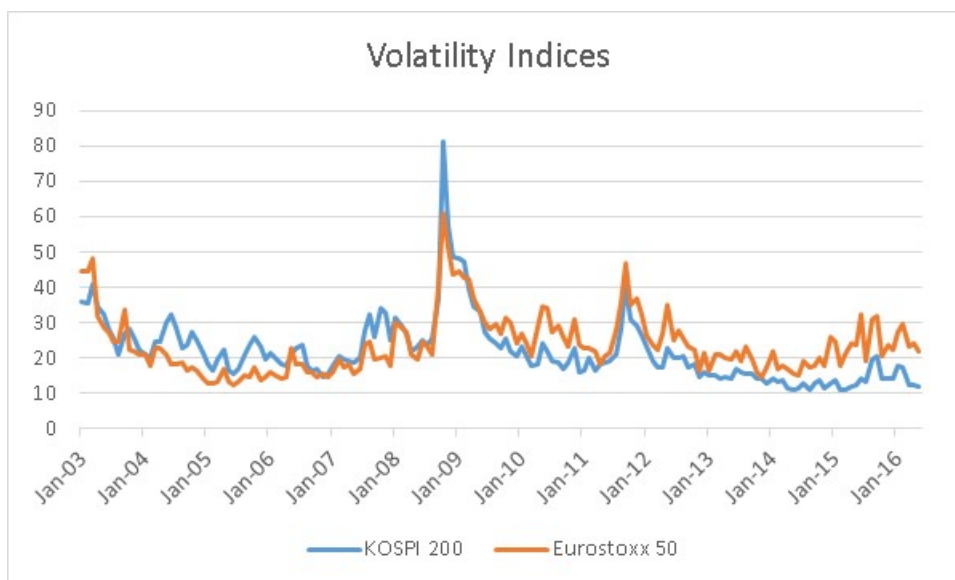
Like much of the world, Korea has seen interest rates move relentlessly lower since the financial crisis. In 2007, 10 year Korean bonds offered rates about 5%. Now they are well below 2%. The graph below shows the swap rate which tracks South Korean Government bond yields.



One feature of the autocallable market is that the higher the market price of volatility, the higher the yield that can be offered on the product. Large issuance of autocallables (or the selling of volatility) can depress market volatility. Korea, which was a famously volatile equity market, now resembles a sea of tranquillity.



As can be seen below, the volatility of the Korean Composite Stock Price Index (KOSPI) rarely was below 20 prior to 2012, but since 2012 has rarely traded above 20 annualised volatility. In contrast volatility in the Eurostoxx has remained relatively high.

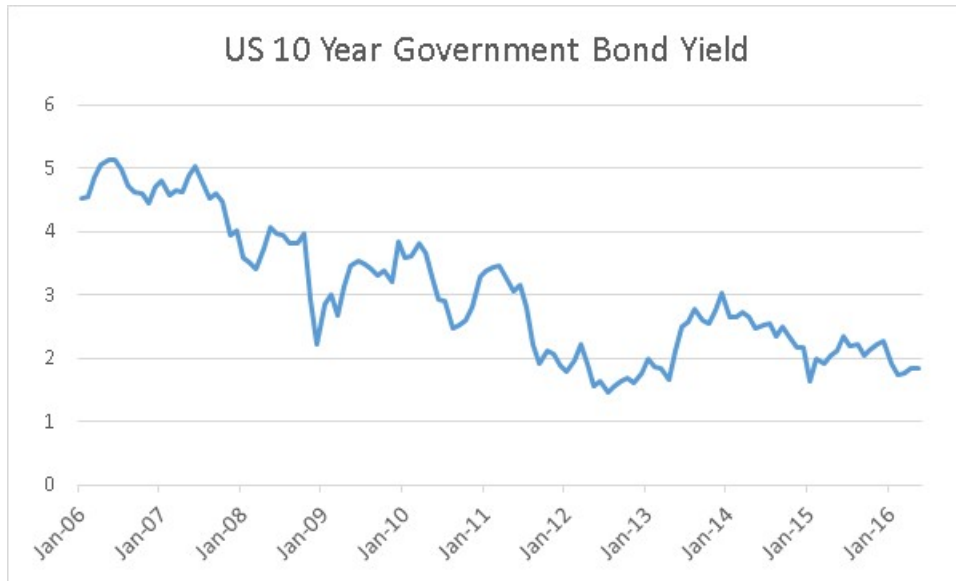


One of the upshots of still declining interest rates in Korea and ever lower volatility in the KOSPI is that as a result, yields have suffered with the decreasing volatility and so Korean autocallable structurers have had to find other ways to sell volatility. Anecdotally the two markets that have been most popular for Korean autocallable structurers have been HSCEI and Eurostoxx 50. The size of flows into HSCEI has been commented on by Bloomberg.

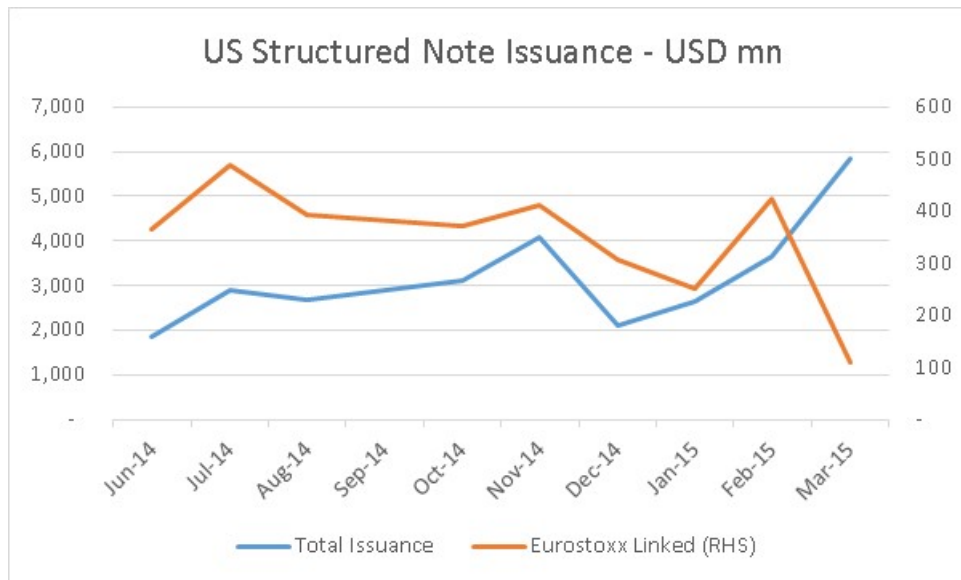
<http://www.bloomberg.com/news/articles/2016-01-21/again-won-t-somebody-please-think-of-the-asian-structured-products->

Bloomberg quotes that Koreans may have USD 12bn of HSCEI exposure via autocalls. Data that we have seen suggest similar sized flows in the Eurostoxx market in recent years.

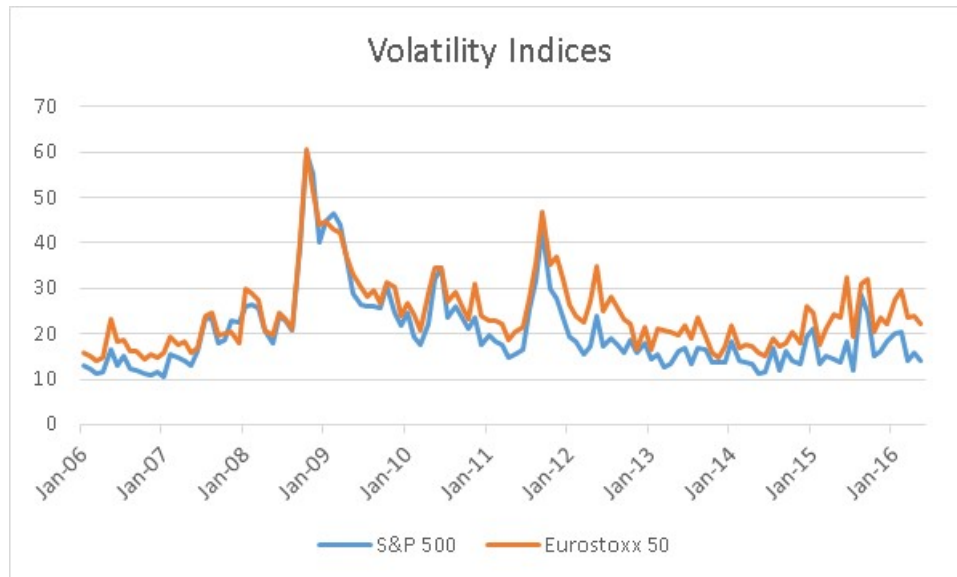
Like Korea, the US has seen available interest rates decline substantially since the financial crisis.



The US has also seen a surge in structured note products; data available from the SEC and gatick.com shows that volume of issuance has tended to increase. Also we started to see a large issuance of Eurostoxx linked products.



Just like Korea, we see that Eurostoxx volatility is higher than S&P 500 volatility which encourages structured note issuers to use the Eurostoxx as an underlying in structured products. We can see in July 2014, peak issuance of Eurostoxx products was 500m USD. We can also see that overall issuance was increasing into the last data point we have in 2015.



The interesting thing about structured products are that they are designed to provide investors with yield and similar to bonds, as the price falls, the yield on the products rise. Unfortunately, if the underlying market falls too much, then the product converts from a fixed income product to an equity product.

This leads to structured products normally being a stabilising feature of the market, as they naturally compress volatility, but in moments of extreme stress they amplify volatility as products convert to equity. With products in both US and Korea using European volatility, a European crisis has the potential to spread contagion via autocalls.

## INFORMATION

Issue Date: 29<sup>th</sup> June 2016  
 Source: Bloomberg, unless otherwise stated  
 Investor Relations: Alain Zakeossian, Carol Brown  
 Email: [info@russellclarkim.com](mailto:info@russellclarkim.com)  
 Telephone: +44 (0)20 7838 7580  
 Website: [www.russellclarkim.com](http://www.russellclarkim.com)

Business and registered address: Russell Clark Investment Management Limited, 9 Chester Close, London SW1X 7BE, United Kingdom. Registered in England and Wales - Company number: 04034280

## DISCLAIMER

This Market View has been prepared and issued by Russell Clark Investment Management Ltd (the "Firm") authorised and regulated by the Financial Conduct Authority. It has been approved as a financial promotion by the Firm and as such is intended **for professional clients and eligible counterparties only and is not intended for retail client use**. It is not intended for distribution to any country where such distribution or use would be contrary to local law or regulation.

This Market View is provided for information purposes only and should not be regarded as an offer to buy or sell any investments or related services that may be referenced herein. No guarantee is made as to the accuracy of the information provided which has been obtained from sources believed to be reliable. The view expressed in this Market View are the views of the portfolio manager at time of publication and may change over time. Nothing in this Market View constitutes investment, legal tax or other advice nor is it to be relied upon in making an investment decision. No recommendation is made positive or otherwise regarding individual securities mentioned herein. Past performance is not indicative of future performance. The price of investments can go up as well as down and can be affected by changes in the rates of exchange. The information contained in this document is strictly confidential and is intended only for the use of the person who has been provided the Market View by the Firm. No part of this Market View may be divulged to any person, distributed, resold and or reproduced without the prior written permission of the Firm.

Where "forward looking" information, including estimates, projections and subjective analysis and judgement are provided no representation as to the accuracy of such projections or estimates or that they may be realised. Certain assumptions used in formulating such "forward looking" information may differ materially from actual events or conditions.