



PATRONUS
PARTNERS LTD

Patronus Managed Futures Strategy

Quarterly Report
to 30th June 2017

3 Fitzhardinge Street
London W1H 6EF

t: +44 (0)20 3818 5300
e: info@patronuspartners.com
w: www.patronuspartners.com

Rather than run through the key events for the quarter, their impact on markets and the trading result as usual, in this quarter's report I will simply focus on the unprecedented conditions that currently exist in financial markets.

Volatility in equity markets has fallen to, and stayed consistently at, levels lower than have ever been witnessed before. There is a long list of statistics that support this statement. The subject, often reserved for the darker recesses of finance, has now found its way into mainstream financial media.

The chart below shows the recent history of the VIX (what the market expects volatility to be) and historic volatility of the S&P 500 (what volatility has actually been). In 2013 and 2014, the market was exceptionally becalmed and while realised volatility periodically fell below 10, it oscillated between 7 and 15. In 2017, it hasn't even got close to 10 once and stayed consistently around 7.



Historically, equity volatility was closely correlated to economic and political uncertainty as one might naturally expect. The current situation is particularly perplexing because measures of economic and political uncertainty are currently making new highs. This situation has caused much consternation and discussion in markets. But what is causing it? There have been a number of explanations put forward.

Firstly, the structure of the markets has changed dramatically in recent years. Quantitative strategists at JP Morgan note that passive (ETFs) and quantitative investors (computer algorithms trading on price action) now account for 60% of equity assets (up from 30% less than 10 years ago). They estimate that only around 10% of trading volumes originate from fundamental discretionary traders. This means that while the narratives attached to price action are still fundamentally driven, the vast majority of trading volume in quoted equities today is totally indifferent to what the underlying business actually does, let alone its fundamental value. As such, markets' traditional role of price discovery is, temporarily at least, suspended. It is possible that passive and quantitative investors have altered the way markets react to events.

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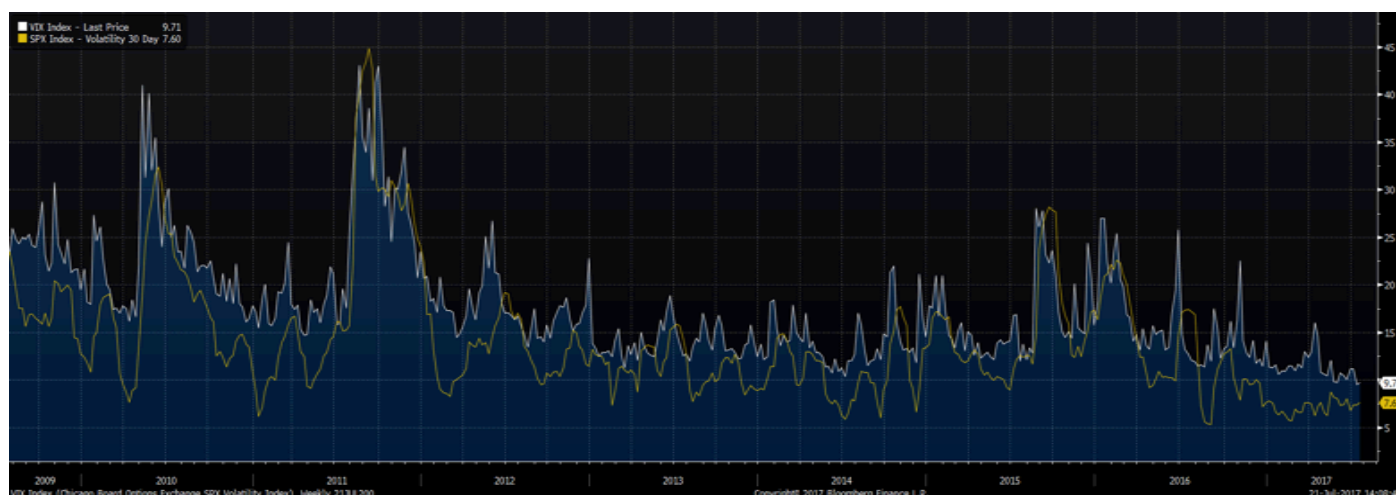


Secondly, central bank interest rates and liquidity injections have clearly had a massive impact. Central banks have added around \$2tn of liquidity per year since the financial crisis. This dampens volatility through a number of channels. Firstly, much of the new liquidity finds its way into equity markets, limiting the extent of any sell-offs. Secondly, it has encouraged companies to issue debt to buy-back their own stock, creating a further cushion. Thirdly, and perhaps most conclusively, it encourages investors to sell volatility to try and generate income. It is this overwhelming supply of

volatility sellers that is keeping the markets so subdued. This situation is not a “new normal” or fundamentally justified but it is for now the most important influence in markets.

Higher volatility does not guarantee success but it does provide opportunity. We continue to follow the only course of action that is open to us: be patient and trade extremely selectively until conditions change. The quarter, which contained minimal trading, ended with a gain of around 0.6%.

VIX Index (white) and Historic 30-Day Volatility



Source: Bloomberg



John Prior CFA, FCSI, BA (Hons)
Director, Chief Investment Officer

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