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Changing as conditions shift

TRADING volatility made Artradis an astonishing amount of money; at its peak with nearly US\$5 billion in assets in 2008, it was Singapore’s largest hedge fund. But that strategy ceased to work post-crisis, and remains unsustainable today, thanks to a number of structural conditions in the market.

Says Artradis co-founder Stephen Diggle: “There were specific conditions between 2005 and 2008 that allowed Artradis to do so well. Not only are those conditions not coming back, we almost have the opposite conditions now. Volatility isn’t really an asset class, but like currency it can be turned into an asset class... you can (take a long position) or short it.”

Artradis employed a market neutral strategy, with a long bias on volatility. Its flagship fund was called Barracuda, and it had a leveraged version in AB2. Specifically in 2007, the firm was long on volatility and short on credit. Both positions paid off dramatically as volatility soared and credit plunged.

The two funds were closed in 2010. Artradis has evolved into Vulpes Investment Management, which invests in a mixture of real and financial assets. Vulpes has assets under management of US\$300 million.

Recalls Mr Diggle: “In 2005, the price of volatility was incredibly cheap. People thought stability would last forever, so selling the chance of something bad happening was free money. We weren’t the only sceptics, but we were very much a minority.

“We saw that underneath this Goldilocks economy – neither too hot nor too cold, decent growth, financial stability, a strong stock market – were very significant signs of excess and the seeds of a disaster. The beautiful thing for us in 2005 to 2007 is we didn’t need to get the timing right. You could buy options for such a little money and you had an awful lot of time. The big enemy for the buyer of options is time – options decay with time. But with the low prices in 2005/2006, we didn’t have to be perfect in our timing. We were at least two years too early.”

Today, conditions have changed significantly. Option prices, for one, are much higher as a degree of fear appears ingrained in investors post-crisis. “The problem now is everyone feels a bit uncomfortable with the level of the stock market. The US market is at or near an all-time high and so is Europe. No one can justify that with the strength of earnings or the economic outlook which is decidedly tepid around the world.

“If you want to buy an out-of-the-money option, the price is many times higher than what you would have paid in 2006. This raises the pressure – you

have to be right in a short space of time. Option prices decline as the time to maturity shortens.

“A second problem is governments’ penchant to intervene in stock markets to forestall a collapse, by injecting liquidity, for instance. On one hand, (options) are more expensive. On the other hand, you have a powerful, well-financed group fighting against you. Put those together, and I don’t think the conditions for doing what we did at Artradis exist.”

With family money, Mr Diggle set up a pilot fund Lava, with a strategy similar to Barracuda, to monitor the market. “After a year, I strongly felt it was a market we didn’t want to be involved in anymore. After watching the market for 12 months, I decided we didn’t want our capital in it because the chances of it leading to significant success was very low. I have no strong temptation to get back into it despite the fact that that’s what Artradis was known for and made its investors a great deal of money.”

External capital

Meanwhile, while the majority of Vulpes’ assets comprises Mr Diggle’s family wealth, the firm also takes in third-party funds. This is despite the fact that capital is increasingly fickle and thus not conducive for long-term planning. Mr Diggle sees three significant advantages of having third-party investors.

“One is a much higher level of accountability. I honestly believe that people are better managers of other people’s money than they are of their own.”

A second plus point is that smart investors are a source of good ideas. “Looking back on our experience at Artradis, it’s undoubtedly true that some of our best ideas came from our investors... If you take money from smart people, they have a financial incentive to make you smarter. For us at Artradis, that was a genuine competitive advantage – that we had very smart investors and they helped us to be better managers of our money.”

A third advantage is the ability to attract the best talent. “If we grow to be a good-sized business, we can hire better people and offer those people a chance to grow their own business. Working for a pure family office is a great job, but it’s hard to grow your business out of that. You’re always subservient to the family... We have some very ambitious people here, and they have the ability to grow their business by bringing in third-party capital alongside ours.”