Fusion Global Volatility

Absolute return: long-biased volatility strategy

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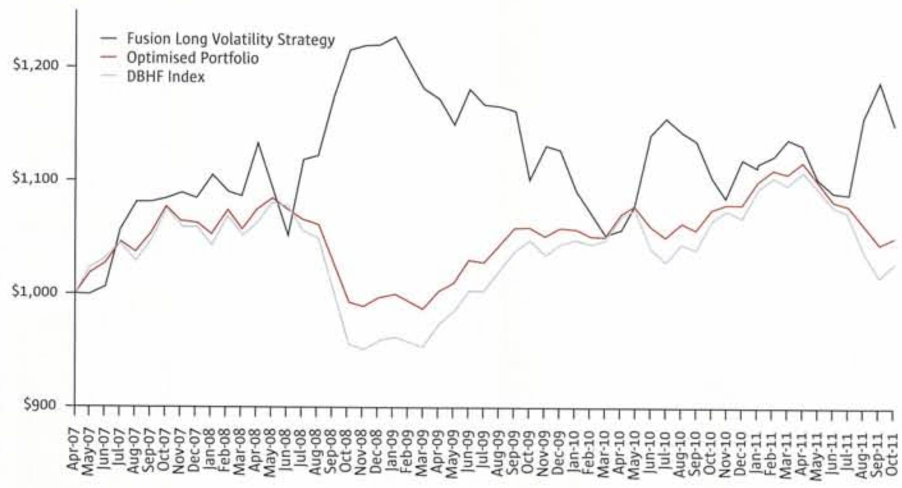
Fusion Global Volatility is an absolute return strategy targeting 15-20% return per annum with an 18-month track record. The strategy is designed to perform throughout the market cycle and is long-biased in order to achieve particularly strong returns during periods of market stress and volatility.

The strategy has outperformed during the recent uncertainty on global markets, achieving a return of more than 11% in the two month period August-September 2011. This result has placed the fund well up the league table for long/short volatility strategies in 2011.

Masters in volatility

We have been running long volatility strategies since setting up Fusion in 2004, and my own research into the topic began even earlier. Fusion Long Volatility has more than five years' track record, and in that time we have seen several of our competitors rise and fall – some of them spectacularly! Long volatility trading is very challenging and can be expensive, but our investment approach has made us one of the most consistent performers in this space (See Fig.1).

Fig.1 Performance of Fusion Long Volatility strategy vs. DB HF Index and optimised portfolio (85% DB HF Index/15% Fusion Long Vol on HFR)



The Fusion Long Volatility Strategy emerged as a long-gamma analogue of the optimal gamma hedges that I developed for the J.P. Morgan Index Options desk in London in 2001-2002. I built on this when I set up my own fund in 2004. The long gamma component within the fund generated a 20% return on capital employed within the strategy in one day, during the 7/7 London bombings in 2005.

Following this success, we decided to develop the long gamma component into a stand-alone strategy and Fusion Long Volatility was born. It was clear to us that it would be necessary to diversify across asset classes as well as within asset classes to run an effective volatility strategy, not only because stress events become contagious, but also because the pain can begin in the most unlikely places before it spreads. Hence our philosophy, 'you need to be everywhere'.

Thus, Fusion Long Volatility takes positions across the asset classes, and we are always invested in at least two asset classes at any one time. My trading background prior to Fusion had focused on equity and credit derivatives, and I have brought together a five-person trading team comprising investment professionals with specialisations and experience in specific asset classes including FX and commodities.

Fusion Long Volatility is a pure long optionality strategy; long implied volatility, long realised volatility, long crash protection and no short optionality trades allowed. It is a protective strategy designed to deliver strong returns during market stress. This has proved to be the case, with the strategy delivering market-leading performance during periods of high volatility in 2008, 2010 and again in August-September 2011, when it became the number one strategy on the HFR managed account platform and delivered returns of more than +20%. The attributes described above, plus a negative correlation to underlying asset classes, make Fusion Long Volatility an ideal portfolio protection component.

Fusion Global Volatility was launched in 2010 (See Key Details in Fig. 2) in response to demand from one of our investors for a long-biased strategy that retained the protective nature of Long Volatility, but with a smoother absolute return profile. Thus Global Volatility is better suited for investors looking for a stand-alone strategy, rather than a portfolio protection component. It tracks the long volatility share class within Fusion Fund in 2x levered format, and also has a short volatility component in order to maximise returns during quiet markets and enhance the carry of the overall strategy.

Fig.2 Fusion Global Volatility Fact Box

KEY DETAILS	
Full Fund Name	Fusion Feeder A Fund SPC - Class A4
Fund Jurisdiction	Cayman
Fund Currency	USD
Investment Manager	Fusion Asset Management LLP
Management Company	Fusion Investment Advisors Ltd.
PERFORMANCE	
YTD (as of 31 Oct 2011)	4.91%
Bloomberg Ticker Code	FUSGVA4 KY
FEES	
Management Fee	2% per annum (monthly)
Performance Fee	20% per annum (semi-annually)
High Watermark	Yes
SERVICE PROVIDERS	
Prime Broker	UBS AG
Administrator	Citi Hedge Fund Services (Ireland), Limited
Legal Advisors	Dechert LLP, Walkers

Four-part portfolio construction

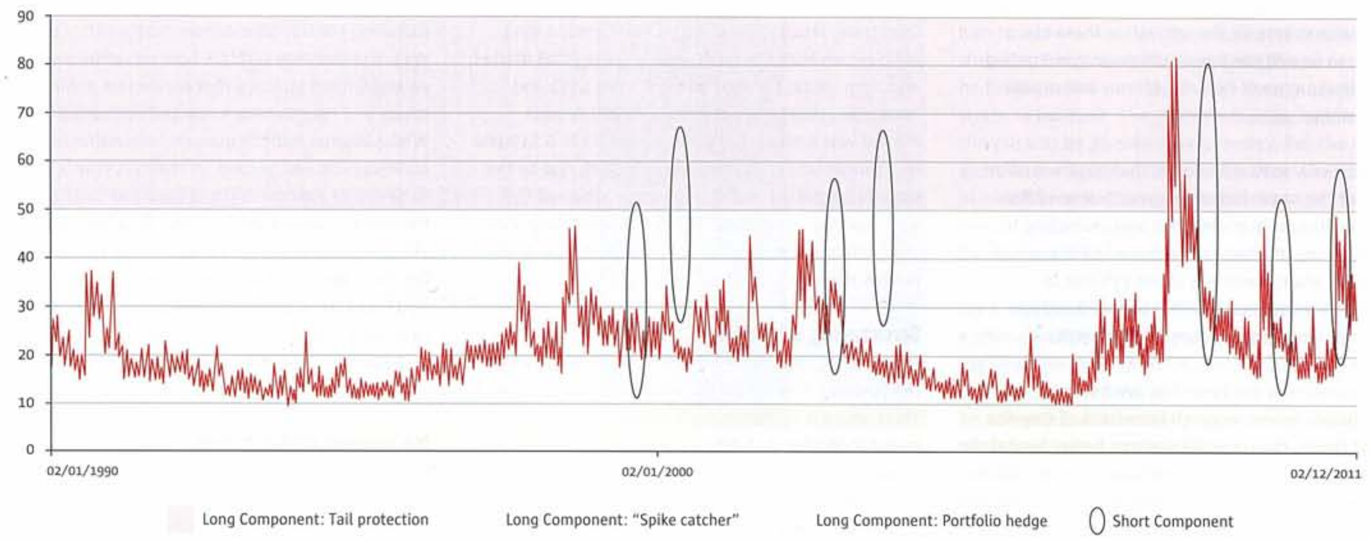
As a long/short volatility play, Fusion Global Volatility has a unique four-part portfolio construction (See Fig. 3). On the long side, there are three components: the 'spike catcher', the tail component and portfolio hedge. On the short side, we implement trades designed to assist in the enhancement of returns throughout the market cycle.

The 'spike catcher' component has been at the core of Fusion's volatility strategies for more than five years. This part is designed to capitalise on small, isolated spikes and is essentially a call spread on volatility. Just to take one example, it is the component that makes money when the VIX (volatility index) goes to 30, such as during the sovereign debt crisis in 2010. As with all the parts of the portfolio, the 'spike catcher' has positions in multiple asset classes and geographies.

Following the unprecedented events of 2008 we developed a tail component, which has become a key part of the portfolio. Unlike spike catcher positions, tail trades are not designed to activate during small moves, but to generate large returns (5-10% each) during crisis events. We work hard to ensure that

Fig.3 Fusion Global Volatility: 4-part portfolio construction

Source: Fusion



our tail positions are not costly, as they will be left in place for a long time (the whole nature of a tail event means that one cannot reliably predict when it will occur!) Some of our tail positions began to activate during August-September 2011 and contributed to the strong returns during that period for both Fusion Long Volatility and Fusion Global Volatility.

As is clear, we structure the portfolio in order to make money for our investors when volatility is on the move and have devised components to capture both small and large moves. However, we do not want to leave our investors exposed in the quiet months when nothing happens. For that reason we also have a portfolio hedge component in place, employing positions designed to deliver returns during months of consistent risk rally, leading to a squeeze in risk premium.

The short component of Fusion Global Volatility also invests across the asset classes, and ensures the strategy retains its attractive absolute return characteristics. The two key types of trades are positions undertaken during stress environments in order to capitalise on elevated levels of volatility, and carry-style positions during quiet times to maximise returns and offset the cost of the long portfolio.

Dynamical tail protection

A key part of the tail protection we provide is the FX Liquidity Hedge, added in 2010. This unique trading programme developed by Fusion uses a combination of long vanilla and barrier options to protect against large downside moves. The FX Liquidity Hedge is utilised within Fusion Long Volatility and Fusion Global Volatility, and is also offered as a stand-alone advisory service for financial institutions and corporates.

We all remember only too well the liquidity crisis of 2008, when FX hedgers (who had "perfectly hedged" their market risk with currency forwards) were left facing cash crisis when the mark-to-market on their forwards became largely negative. This exposed some hedgers, such as funds of funds, to margin calls on their forwards and others, such as corporates, facing threats to their credit lines.

The FX Liquidity Hedge is a natural development in our portfolio of products and services, which aim to provide our clients with low-cost crisis protection. Demand for Fusion's bespoke tail hedging and liquidity management services continues to grow, and we currently manage more than $500 million in this manner. We have doubled the size of our client services team over the last six months, in order to cater to the demand we see in this area.

Ways to invest

Fusion aims to create solutions to fit an investor or client and this approach is reflected in how we develop our products and also in how we structure them. All our investment products are available via investment in the Fusion Fund (Cayman) or in a managed account format. We also offer advisory services in which we develop bespoke hedging portfolios for clients' specific needs.

Fusion holds close relationships with several managed account platforms, both in Europe and the US. Fusion Long Volatility is available in 2x levered format via the HFR Managed Account Platform. Fusion Long Volatility was the best performing fund on the platform in August and September 2011, and is one of the of the top performers year-to-date.

Fusion Global Volatility will be offered to investors via the Wilshire Managed Account platform from early 2012. Wilshire plans to invest in Fusion Global Volatility as a portfolio hedge for their macro fund of funds, due to launch on the platform in the first quarter of 2012. One of the world's largest pension fund advisors, Wilshire Associates is a diversified financial services firm with combined assets exceeding $6 trillion.

Fusion Global Volatility has developed a track record and is well placed to deliver superior returns throughout the market cycle. We believe it offers investors a strong choice in volatility trading and protection in the challenging conditions that are expected to feature in global markets for the foreseeable future. **THFJ**

ABOUT THE AUTHOR

Kirill Ilinski is founder and Chief Investment Officer of Fusion Asset Management, an independent investment manager and advisor established in 2004 with assets of $700 million. The firm specialises in providing portfolio management and bespoke advisory services to institutional, corporate and private investors.