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THE HEART OF THE NATION

IT'S a question that many shy away from but Al Wilkinson doesn't hesitate in predicting the extremes to which Wall Street could go this year.

"I can see the S&P500 potentially 10 per cent lower. Then on the upside, up 15 to 20 per cent," he says on the market outlook for the next year.

Wilkinson has a clearer picture than most in making such calls: he measures fear in the market for a living. He was behind the creation of the volatility index -- the VIX -- which measures the market's expectation of future volatility and is now running one of the biggest volatility index funds in the world, the \$600million plus Pengana Global Volatility Master Fund.

At the time of our interview last week, the S&P500 index was trading at about 735points but shortly after plunged below 700 points. Wilkinson says: "If it breaks 700 on the S&P ... then all bets are off on the downside because there is a lot of uncertainty at that stage."

"The concern that you have out there as an investor is what are the real assets on these financial institutions," Wilkinson says, noting the US Government's further support to struggling investment bank Citigroup. "That's the concern going forward."

He also believes there is more bad news to come and that it will likely come from unemployment across the world, potentially further write-downs from financial institutions and more Government bailouts.


It was not long into his tenure as a director on the board of the Chicago Board Options Exchange that Wilkinson started looking at the idea of broadening the scope of the volatility index. At the time, the index was benchmarked against options on the S&P100 index but in 2003, it was changed to the S&P500 index.

"By many standards, it's probably the most innovative and successful product in the last 25-30 years in the derivatives arena," Wilkinson says.

The VIX measures the market's expectation of volatility over 30 days and is calculated on a range of S&P500 index options. Essentially, the higher the VIX value -- generally anything above 30 -- the greater the implied volatility or investor fear.

"It really is a great degree of measurement of uncertainty in the market place,' he says.

"People don't understand necessarily the true mechanics of how it works. They know that if that VIX is in the 30s, 40s, 50s, 60s or 80s, you're in an elevated volatility environment."



He said the VIX gave investors some sense of what the mood was like on Wall Street. At the height of the global financial storm in November the VIX was trading at about 80. That compares to more normal levels of pre- July last year of about 20.

Today the index has been precariously hovering around the 50 mark. Online financial journal The Deal last week reported that the VIX was indicating that "investors see a bear market lasting for another two years."

"I don't think we are out of the water by any means," says Wilkinson. He said this was an extreme uncertain period for everybody.

At the same time, he says: "I think there will be significant structural shifts, maybe not immediate but over the course of the year, where certain indices will have a tendency to outperform in Asia relative to the European and North American indices. I see situations where Asia over longer periods of time will stabilise and be stronger and perform considerably better than the North American indices and European indices".

So what is driving this fear, given the multiple government stimulus and bailout packages announced?.

"That's pretty straightforward," he says. "I don't think a lot of people think the stimulus package is going to do anything other than harm the economy more.

"People don't know where the end of this thing is."

He is more upbeat about the Australian market, largely because it doesn't have the same degree of exposure to sub-prime as the North American and European markets.

The GVMT fund Wilkinson runs at Pengana trades in equity index futures, options and other volatility-based instruments and "derives returns from mispricing of these instruments due to changes in volatility", the company says. It claims to take advantage of opportunities within equity index options that result from investors' mispricing of volatility.

It is non-directional, meaning it tries to structure its investments so that it makes a profit regardless of whether markets are rising or falling.

Since its inception in November 2007, the fund has delivered a net return of 18.5 per cent a year. In the calendar year 2008, the net return was a solid 19.3 per cent.

<http://www.theaustralian.news.com.au/business/story/0,28124,25148536-5001942,00.html>