# Comprehensive Study Guide: Relative Value, Volatility, and Derivatives

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# Contents

# 1 Introduction to Relative Value (RV) Trading

## 1.1 Conceptual Foundations

Relative Value (RV) trading focuses on identifying assets that are mispriced *relative* to each other, rather than taking directional bets on the market as a whole. The core philosophy is to exploit the convergence of these prices to their "fair" value or historical relationship.

**Key Characteristics:**

- **Market Neutrality:** Portfolios are often constructed to be insensitive to broad market movements (Beta neutral).

- **Quantitative Heaviness:** Relies on statistical correlation, cointegration, and mean reversion.

- **The "Spread":** Profits are generated from the spread between two instruments narrowing or widening.

## 1.2 Hierarchy of Complexity

Based on the difficulty of understanding and execution, RV strategies can be ranked as follows:

1. Index Arbitrage (Easiest)

2. Statistical Arbitrage (Pairs Trading)

3. Volatility Term Structure Arbitrage

4. Volatility Skew Arbitrage

5. Merger Arbitrage

6. Capital Structure Arbitrage

7. Convertible Arbitrage

8. Variance Swap Arbitrage (Hardest)

# 2 Fixed Income Mathematics: The Prerequisite

Before understanding structured products, one must grasp the mechanics of the underlying fixed income components.

## 2.1 Bond Pricing Fundamentals

Bond pricing is the summation of the present value (PV) of future cash flows.

$$P = \sum_{t=1}^{n} \frac{C}{(1+r)^t} + \frac{FV}{(1+r)^n}$$

Where:

- $P$: Price of the bond

- $C$: Coupon payment

- $r$: Discount rate (Yield to Maturity)

- $n$: Number of periods to maturity

- $FV$: Face Value (Par)

## 2.2 Sensitivity Measures

**Duration:** A measure of interest rate sensitivity. It is the first derivative of price with respect to yield.

**Bond Convexity:** The second derivative of price with respect to yield.

- **Positive Convexity:** As yields fall, prices rise *faster* than they fall when yields rise. This is standard for non-callable bonds.

- **Negative Convexity:** Prices are capped as yields fall (often due to call provisions, as issuers refinance).

# 3 Volatility Dynamics and Arbitrage

## 3.1 The Three Pillars of the Volatility Surface

Volatility is not a single number; it is a 3D surface defined by Strike ($K$) and Time to Expiration ($T$).

### 3.1.1 1. Volatility Skew ("The Smirk")

In equity markets, Out-of-the-Money (OTM) puts generally trade at higher implied volatilities (IV) than OTM calls.

- **Driver:** Institutional hedging demand (buying puts) and the "Fear Gauge."

- **Strategy (Long Skew):** Buy OTM Puts / Sell OTM Calls. Used if one expects fear/downside protection cost to increase.

- **Strategy (Short Skew):** Sell OTM Puts / Buy OTM Calls. Used if one expects the market to calm and the "fear premium" to dissipate.

### 3.1.2 2. Volatility Smile

Observed often in Forex markets, where deep OTM calls and puts both trade at higher IV than At-the-Money (ATM) options. This reflects "Fat Tails" (extreme events occur more often than a normal distribution predicts).

- **Arb Strategy:** Butterfly Spreads (Short Wings/Long Body if smile is too steep).

### 3.1.3 3. Volatility Term Structure

The relationship between IV and Time ($T$).

- **Contango (Upward Sloping):** Short-term IV < Long-term IV. Normal market state (uncertainty increases with time).

- **Backwardation (Downward Sloping):** Short-term IV > Long-term IV. Occurs during market stress/crises.

- **Arb Strategy:** Calendar Spreads (e.g., Short front-month / Long back-month).

## 3.2 Deep Dive: Convexity and Concavity in Volatility

This refers to the second-order derivatives of the option price relative to volatility itself.

### 3.2.1 Volatility Convexity (Gamma of Vega / "Vomma")

This measures how the Vega ($\nu$) of an option changes as volatility ($\sigma$) changes.

$$\text{Vomma} = \frac{\partial \nu}{\partial \sigma} = \frac{\partial^2 V}{\partial \sigma^2}$$

**Positive Volatility Convexity (Long Vanilla Options):**

- As $\sigma$ increases, your Vega increases.

- You profit from volatility rising at an *accelerating* rate.

- **Analogy:** Buying insurance where the payout multiplier increases the worse the disaster gets.

**Negative Volatility Convexity (Short Options / Variance Swaps):**

- As $\sigma$ increases, the position loses value at an increasing rate.

- This leads to "Volatility Crushes" or "Gamma Pumping" losses, where hedging becomes increasingly expensive as the market moves against you.

# 4 Commodities: Market Structure and Curve Dynamics

## 4.1 The Theory of Storage and Pricing

Commodity futures pricing differs from financial futures due to the costs and benefits of holding the physical asset.

$$F_t = S_t e^{(r+u-y)T}$$

Where:

- $r$: Risk-free rate

- $u$: Storage cost

- $y$: Convenience Yield (The benefit of physical possession)

## 4.2 Market States: Contango vs. Backwardation

### 4.2.1 Contango (Normal Market)

- **Definition:** Futures Price > Spot Price ($F > S$).

- **Curve Shape:** Upward sloping.

- **Cause:** Plenty of supply. Cost of carry (storage + insurance) dominates.

- **Roll Yield: Negative**. An investor rolling a long position sells low (expiring contract) and buys high (next month), losing money over time.

### 4.2.2 Backwardation (Scarcity Market)

- **Definition:** Futures Price < Spot Price ($F < S$).

- **Curve Shape:** Downward sloping.

- **Cause:** Short-term supply shortage. The *Convenience Yield* is high (market participants pay a premium to have the commodity *now*).

- **Roll Yield: Positive**. An investor rolling a long position sells high and buys low.

# 5 Advanced Derivatives: Exotics and Structured Notes

## 5.1 Structured Notes

A Structured Note is a hybrid instrument: **Zero-Coupon Bond + Derivative Component**.

- **Zero-Coupon Bond:** Provides the principal protection (capital guarantee) at maturity.

- **Derivative (Option):** Uses the discount from the bond (the "coupon" that wasn't paid) to purchase options for upside exposure.

**The "Grind":** The compounding fees and pricing inefficiencies embedded in the derivative component that erode returns over time.

## 5.2 Exotic Option Types

Strategies applicable to vanilla options (e.g., simple Butterflies) cannot be directly mapped to exotics due to path dependency.

1. **Barrier Options:**

   - *Knock-In:* Becomes active only if price $S$ hits barrier $B$.
   - *Knock-Out:* Dies if price $S$ hits barrier $B$.
   - *Note:* Highly sensitive to "Barrier Risk"—hedging becomes binary and difficult near the barrier level.

2. **Asian Options:**

   - Payoff depends on the **average** price over time.
   - *Feature:* Reduced volatility (averaging smooths the path). Hard to hedge with vanilla instruments.

3. **Cliquet Options (Ratchet):**

   - Strike price resets periodically (e.g., monthly).
   - Locks in gains periodically. Common in structured products for retail investors.

4. **Variance Swaps:**

   - Pure play on realized variance ($\sigma^2$) vs. implied variance.
   - *Convexity:* Short Variance Swaps have extreme negative convexity (shorting "fear").

# 6 Practical Application: Adaptation and Risks

**Trading Vanilla Strategies on Exotics:** While conceptually similar (e.g., wanting a "Butterfly" payoff profile), you cannot simply execute a vanilla Butterfly using Barrier options.

- **Why?** The "Greeks" behave differently. A Barrier option's Delta can flip signs or become infinite near the barrier.

- **Solution:** New strategies must be engineered specifically for the path-dependent nature of the exotic, often requiring Monte Carlo simulations to price and hedge.