Markets volatility

How Korea's yield-seeking pensioners are shaking world markets

Analysts warn that popular 'auto-callable' products could exacerbate turbulence

South Korean regulators says they will step up supervision of so-called auto-callables due to 'concerns of market failure' among local investors, almost half of whom are over the age of 60 © Getty

Robin Wigglesworth in New York, June Yoon in Hong Kong and Song Jung-a in Seoul
11 HOURS AGO

Complex savings products with names such as Super Lizard, Cobra or Boosters are flying off the shelves in South Korea, as retail investors try to juice returns while interest rates are low. But analysts warn they are causing market anomalies, and potentially fuelling wider turbulence at times of stress.

So-called auto-callables are structured notes that offer fixed returns like a bond while selling options on equity indices, delivering a higher yield than can be earned from more conventional savings products.

Such investments have long been popular with Japanese savers who have struggled with low interest rates since the 1990s, and have in recent years grown in popularity in Europe for similar reasons. But South Korea has emerged as the powerhouse of the auto-callables industry. At about Won110tn ($93.2bn), the market is now almost as big as equivalents in Europe and the US put together, according to analysts.

However, some investors argue that while the equity derivatives embedded in auto-callables mostly dampen market volatility, their complex structure can exacerbate turbulence when markets are particularly rocky — as banks that structure and sell them have to constantly hedge their exposure. For example, the French bank Natixis suffered a $293m loss linked to Asian auto-callables in the fourth quarter last year.

“They are actually very stabilising for markets ... [but] they can create pandemonium when they break,” said Russell Clark, the chief investment officer of Horseman Global, a hedge fund. “They create stability, and then instability . . . The history of these types of products is that they always eventually blow up.”

These are the types of products that seem to cause a lot of trouble for buyers and for the dealers who sell them in times of market stress

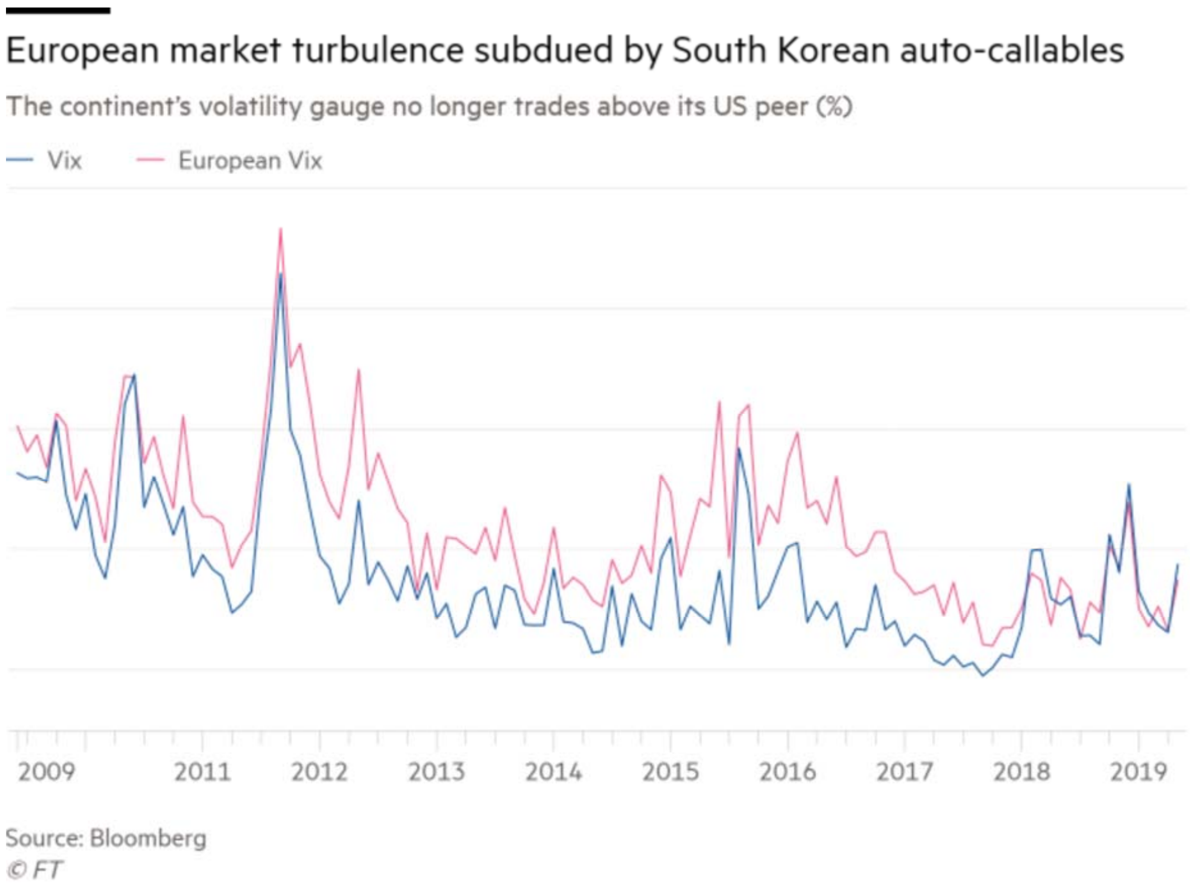
Peter van Dooijeweert, Man Group

An official at South Korea’s Financial Supervisory Service said regulators had stepped up their monitoring of the market, noting the risk of losses for local securities firms caused by “herd behaviour” from customers. “If a stock index drops, we can see a large amount of futures sold, which will drag down the index further,” the official said. “We’re looking into this.”

For now, though, analysts claim that auto-callables are subduing market turbulence far beyond the shores of South Korea.

Auto-callables typically include both “put” and “call” options. The extra yield they offer is generated by selling calls — the right to buy an asset at a certain price within a certain time period — on the indices or securities they reference, effectively capping gains in exchange for a steady premium. When the index rises above a certain level, the product automatically comes due. Similarly, put options — the right to sell — generate premiums by selling insurance against steep sell-offs.

However, the huge supply of the embedded options in auto-callables appears to be dragging down popular volatility gauges such as the Vix index, which are based on option prices. This, in turn, has a dampening effect on the actual volatility of stock markets.



This is becoming particularly noticable in some markets. Eurostoxx, the European equities benchmark, has become a popular reference for South Korean auto-callables because the region has historically been more turbulent than the US stock market, and there are therefore higher coupons to collect through selling puts.

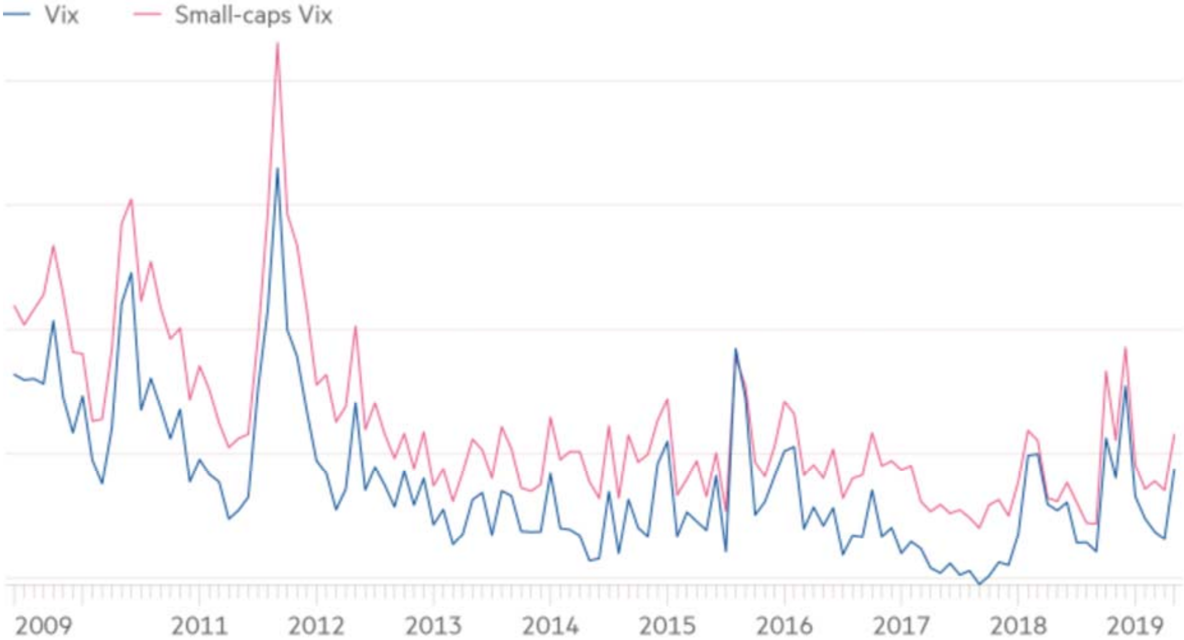
The European "Vstoxx" index of expected volatility was on average 4.57 points above its more famous US equivalent, the Vix index, between 2000 and 2018. But since then the Vstoxx has been lower than the Vix on average, suggesting that the rising supply of options built in to auto-callables is keeping the gauge subdued.

Similarly, the volatility gauge of the Russell 2000 small-caps index in the US has since 2004 been 5.6 points higher than the Vix, which tracks the volatility of the large-cap S&P 500. But since the beginning of 2018 this spread has fallen by half. The average difference between the Japanese Nikkei volatility index and the Vix has also halved since the beginning of 2018.

"South Korean auto-callables have managed to go global," said Peter van Dooijeweert, head of institutional hedging at Man Group, the hedge fund. "The volume is suppressing volatility in these markets."

US 'small-caps' volatility premium declines

The difference between the Vix index and the Russell Vix index is narrowing (%)



Source: Bloomberg
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However, the dynamics around derivatives at times of market turbulence can be treacherous to navigate.

The puts are typically heavily "out of the money" — in other words, they are triggered only when the referenced index tumbles by a significant amount. But as markets slide and get closer to the "strike price", banks that structure the auto-callables have to hedge their own exposure, which can in extreme circumstances result in a panic.

Even when banks do not ultimately lose money, managing the exposure can be very tricky, as Natixis's big loss last year highlighted. Inadequate hedging, meanwhile, continues to drag on the profits of local banks. The market regulator said last year it would step up supervision due to "concerns of market failure" among local investors, almost half of whom are over the age of 60.

"It could become a bit of a wreck," Mr van Dooijeweert warned. "The market is just so big now. As we saw in December, these are the types of products that seem to cause a lot of trouble for buyers and for the dealers who sell them in times of market stress — adding fragility to the system exactly when no one needs them to be problematic."