



Theme: Equity Dispersion

JUNE 2025

Overview

This strategy aims to make high single digit returns by investing in “equity dispersion” trades. Dispersion means analysing how stocks (or sectors) perform differently than the market predicts.

This may be different from their own expected price movements or from their movements in comparison with those of the broader equity index. An equity dispersion strategy compares the historic volatility of the stock against its future implied volatility, as priced in the options market. Realised volatility, meaning the volatility that actually occurs, tends to end up being lower than the level implied in the price of the option.

The thesis behind this approach is that single stock volatility (e.g. Tesla, JNJ) tends to trade cheaply compared to index volatility (e.g. S&P 500). An equity dispersion fund will therefore buy the “cheap” single stock volatility and sell the “expensive” index volatility (of which the stock itself forms a part). Profiting from the difference in price is known as arbitrage, and because the difference in prices is due to differences in volatility, the strategy is known as “volatility arbitrage”.

It follows from the above that careful stock selection can add value. This is particularly the case when volatility on a single stock is extreme. The Information Technology and Healthcare sectors have therefore been happy hunting grounds for this strategy in recent years, since stock prices have been extremely volatile. This is especially true when important news-flow occurs, for example around capability and demand levels (e.g. Nvidia) or news of new drug approvals (e.g. Biogen).

Equity dispersion strategies are usually implemented by using Total Return Swaps (TRS), which are traded with multinational banks. One notable characteristic of TRSs is that they only require the manager to post margin. This means that as much as 80-85% of the fund's cash will sit in short dated Treasury-bills earning an attractive risk-free yield. This is particularly attractive in the current high interest rate environment - a characteristic also shared by our allocation to Trend Following funds.

During benign equity markets, an equity dispersion strategy can expect to generate reasonable returns of cash +3-4%. In more challenging and volatile markets, returns can be higher, although the risks are obviously higher too. For example, in 2022 the Fulcrum Equity Dispersion fund posted a 13% return, despite both equity and bond markets falling in value.

Finally, an Equity Dispersion strategy typically exhibits a low correlation with the major traditional asset classes, so as well

as the appealing potential returns it improves overall portfolio diversification.

The theme can be summarised as follows:

What? Equity Dispersion is a strategy that benefits from differences in implied volatility compared to realised volatility

Why? Adds diversification, especially given expensive equity markets. Attractive yield on cash balances

How? Specialist Equity Dispersion active managers

Holding Period? 3yrs+

A more detailed explanation of why investing in Equity Dispersion strategies is attractive in balanced portfolios follows.

What is Equity Dispersion?

An Equity Dispersion strategy aims to generate returns from stocks or sectors behaving differently than expected within an equity index such as the S&P 500.

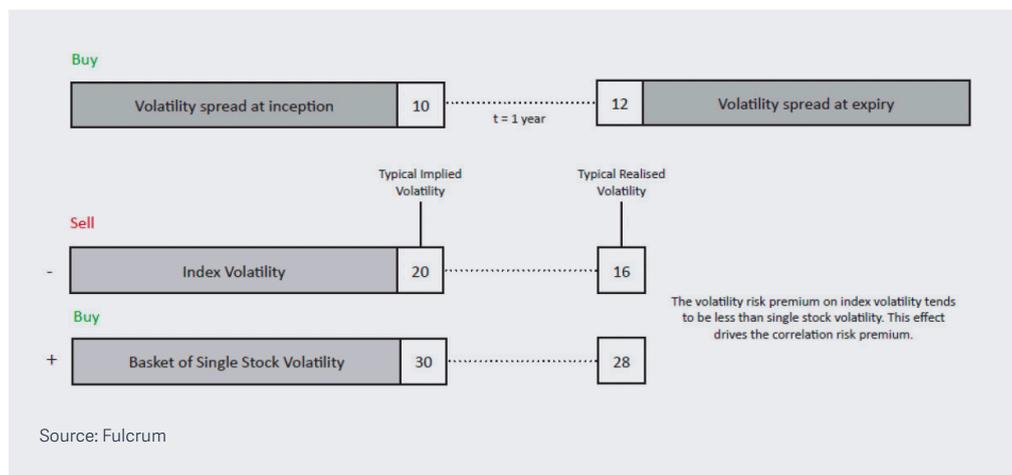
“The Strategy is primarily driven by the positive long-term premium between implied and subsequent realised correlation between equities within an index, which can be extracted via exposure to index volatility and single stock volatility. There is also significant scope for additional alpha to be added from our proprietary stock selection filter which has been developed and enhanced over two decades.” (source: Fulcrum)

The basic thesis is that single stock volatility trades cheaply compared to overall index volatility. Investors can profit from this difference, also known as volatility arbitrage. Structural market forces such as risk aversion can explain the continued availability of this pricing discrepancy: many investors are somewhat price insensitive when faced with a need or desire to hedge their positions. They often use put options where the price of the option is small compared to the size of their main investment. As a result, pricing implies one level of potential volatility, whereas in actuality the realised volatility turns out to be lower. If so, there is money to be made by a specialist manager in arbitraging away that price differential as and when it arises.

Implementation

The fund manager buys, or goes “long”, cheap single stock volatility and sells, or goes “short”, expensive index volatility.

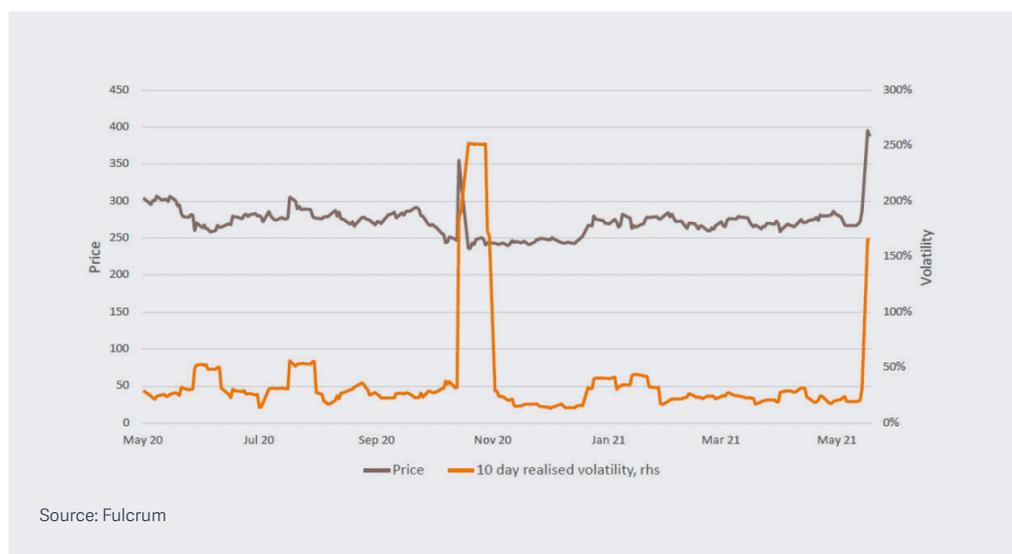
A typical dispersion swap aims to make 1.5-2 volatility points per trade on average, a combination of the correlation risk premium and stock selection. An illustration of how this works is set out in the diagram below, which shows the volatility spread of 10 at inception and of 12 at expiry. The difference of 2 is the profit gained.



A typical dispersion trade

The trade is implemented using financial derivatives called Total Return Swaps (TRS), which are structured with large multinational banks and where both counterparties agree to pay the difference in return between the two different instruments, or group of instruments. A typical trade will be long the volatility of a basket of 15-20 stocks and short the volatility of an overall index. These are known as variance or volatility swaps.

The biotech stock Biogen is a good example of how being long single stock volatility can prove beneficial. The company share price has seen several share price spikes linked to news of drug approvals, which act as a tailwind to a dispersion strategy.

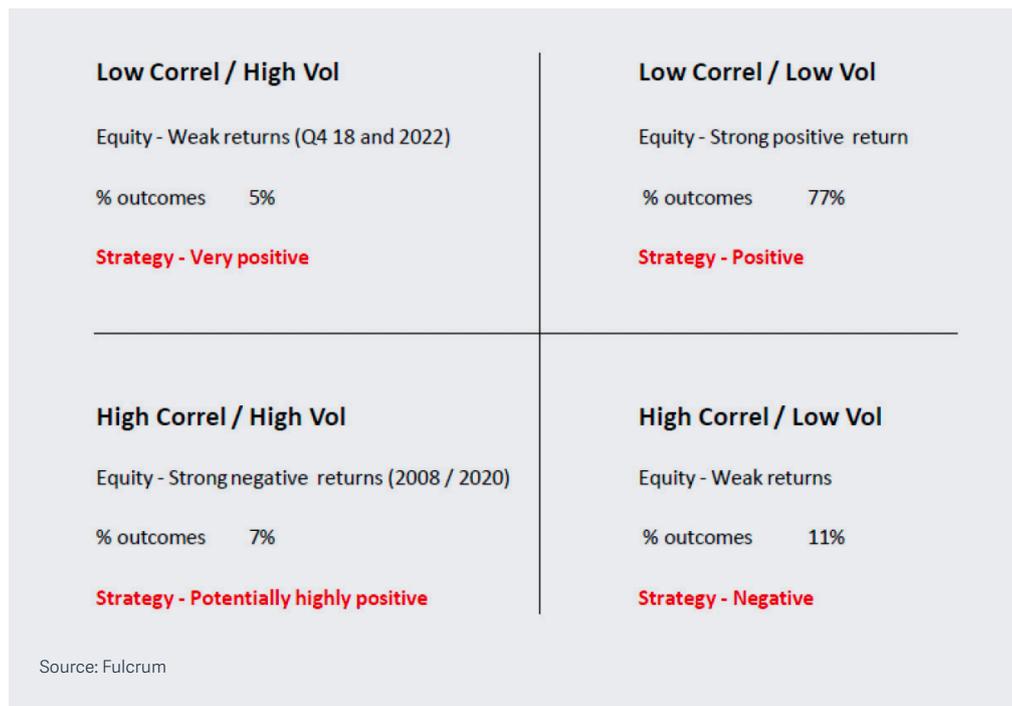


Spikes in single stock volatility are good for the equity dispersion strategy

We have accessed the Equity Dispersion strategy through fund manager Fulcrum. The manager implements trades and then holds them to maturity, typically around one year. Since inception, the fund has tended to implement one trade per month. The manager does not use stop profit on trades but rather expects the investor to take profits or rebalance, rather than Fulcrum adjusting the portfolio themselves. This allows investors to retain discretion over when to take profits or rebalance, aligning with Fulcrum’s philosophy of transparency and investor control (Equity Dispersion – The Greeks, by Stephen Crewe, 8 June 2021)*

Investor Outcomes

The diagram below helps explain the investor outcome based on various equity market scenarios:



The strategy can perform well in several different market environments

Three of the four scenarios above result in positive predicted outcomes for the strategy. The Top Left is very positive, meaning returns of cash + 3-4%, exactly the kind of return we target in our Alternatives allocation, especially with a strategy that has lower correlation to the broader equity market. In the bottom left scenario, the strategy would initially lose money (see below) but the longer-term return is potentially highly positive.

How does the strategy perform during bouts of volatility?

Spikes in volatility tend to be associated with drawdowns in the region of 3-5% although they can be higher. The chart below shows the performance of the Fulcrum fund (white line) against the VIX index (yellow line), which is an index of implied volatility. Spikes in the VIX index coincide with a small drawdown in the return of the fund.



Source: Bloomberg

Short spikes in index volatility cause a small drawdown

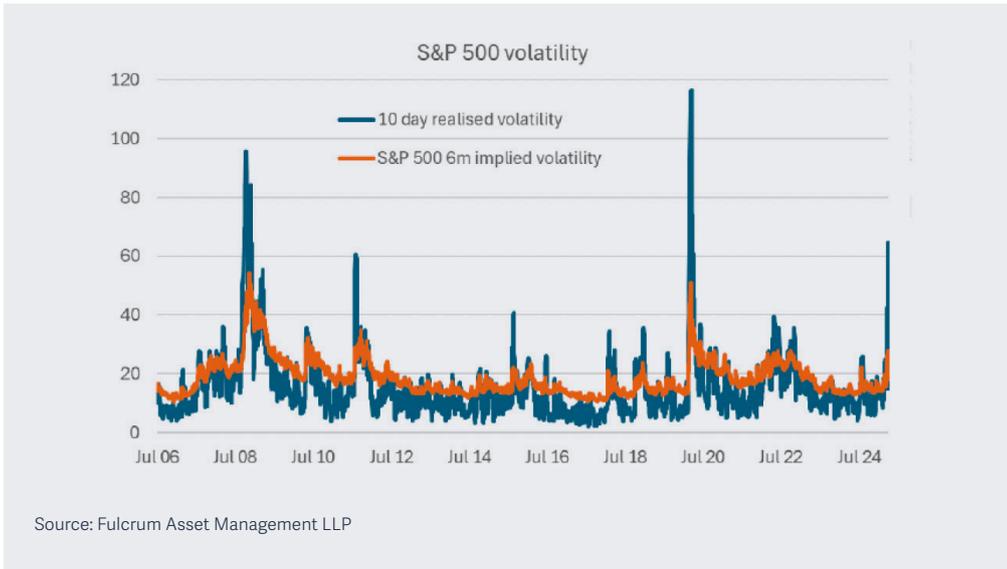
The strategy tends to earn back these drawdowns reasonably quickly if a normal market environment resumes, as volatility declines. In more extreme environments where volatility persists, the fund makes money from being long volatility exposure. A good example of this was in Q1 2020 when the fund fell -5.7% in February before gaining 13.1% in March, just as equity markets collapsed in response to the first Covid outbreak. This is demonstrated by the chart below, where trades on the S&P 500 and Eurostoxx 50 both made money in March 2020 at a time when equity markets declined very sharply.



Source: Fulcrum

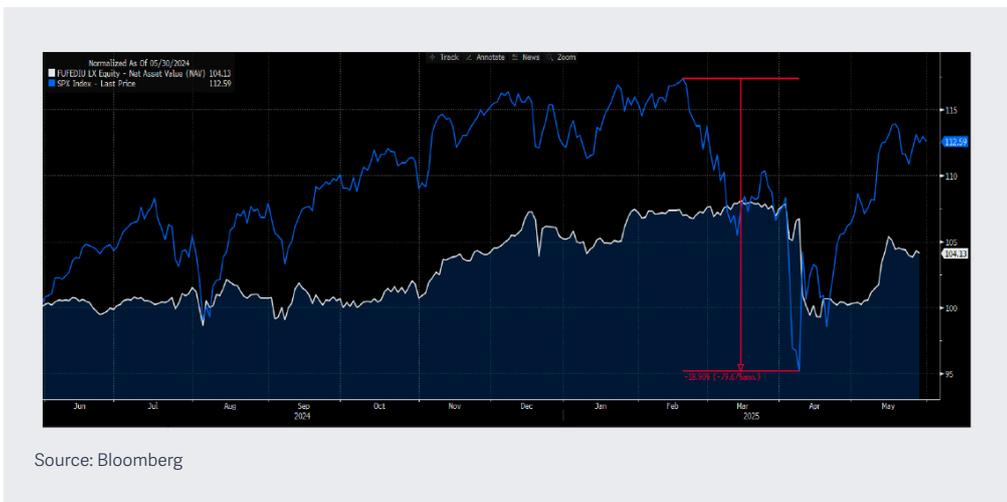
Dispersion can make money in crisis moments

April 2025 was another good example of very volatile investment markets. The S&P 500 peaked on 19 February 2025 before falling 19% in response to President Trump's tariff announcements, which he dubbed 'Liberation Day'. S&P 500 realised volatility approached levels last seen during the 2008 Global Financial Crisis and the 2020 Covid outbreak. Bond markets also fell as credit spreads widened from historically tight levels.

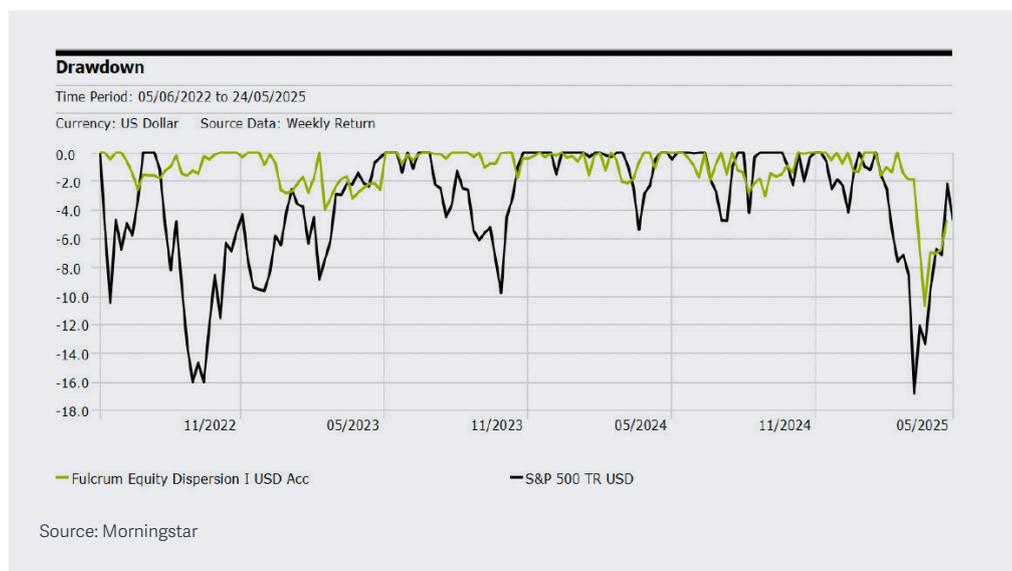


Volatility spiked in April 2024 on "Liberation Day"

The strategy (chart below, white line) held up well during the initial equity market sell-off. However, on 9 April, the index (blue line) rose 9.5% in a day, the largest one day rise since 2008. In volatility terms, this is an extreme outcome with 494 of 500 stocks up on the day: a very high realised correlation move. The strategy lost money during this period. It has since started to recover those initial drawdowns, which it should continue to do either via a return to more normal levels of volatility (top right quadrant above) or via sustained volatility leading to significant equity drawdowns such as those seen during a bear market (bottom left quadrant above, as occurred in 2020).



Dispersion protected during the initial April 2024 equity sell-off



Drawdowns at different time to equities, with initial drawdowns usually clawed back

Importantly, an equity dispersion strategy can help reduce overall portfolio volatility by protecting capital whilst equity markets fall. This risk-off profile is particularly useful in today’s environment where equities are arguably expensive and political uncertainty is likely to result in periodic bouts of extreme volatility.

Diversification

One of the main attractions of the strategy is its low correlation to equity and bond markets.

The table below shows the performance of Fulcrum’s Equity Dispersion strategy since 2017**. The strategy delivered a positive absolute return in each of the last seven calendar years, including 2022, when both equity and bond markets fell significantly in value.

Monthly Returns (%)													
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2025	1.9	0.4	-0.1	-6.5									-4.6
2024	0.1	1.0	0.3	1.3	1.3	-0.4	1.6	-0.8	-0.1	0.0	3.5	1.0	9.0
2023	-2.0	0.9	-0.3	-0.5	3.4	0.8	0.4	0.8	0.2	1.5	0.0	0.5	5.7
2022	2.0	1.5	0.7	1.6	1.5	1.7	-0.1	0.6	-0.3	2.0	0.6	0.9	13.2
2021	-1.8	0.6	2.8	-4.1	1.0	1.6	-1.1	1.1	-0.1	2.0	1.0	0.9	3.7
2020	-0.3	-5.7	13.1	-3.1	2.5	-1.3	-2.8	-1.1	0.4	-2.7	5.5	0.2	3.7
2019	0.4	-0.3	2.9	1.9	1.0	1.2	-2.8	-0.9	1.3	0.0	0.2	-3.4	1.3
2018	0.1	-1.2	-2.2	0.5	2.2	-0.5	0.5	2.2	3.9	4.0	5.2	0.6	16.3
2017									-0.1	0.4	-0.2	0.3	0.3

Source: Fulcrum

Positive returns each calendar year

Over the past 3 years to end April, the strategy has shown a negative correlation to both equity and bond markets.

Correlation Matrix

Time Period: 01/05/2022 to 30/04/2025

Currency: US Dollar Source Data: Monthly Return

	1	2	3
1 Fulcrum Equity Dispersion I USD Acc	1.00		
2 FTSE All World TR USD	-0.20	1.00	
3 Bloomberg US Treasury TR USD(1987)	-0.28	0.70	1.00

Source: Morningstar

Low correlation to equities and bonds

Counterparty Risk

Equity Dispersion funds implement their strategy using over-the-counter (OTC) swaps with a variety of multinational banks. For example, there may be 10 or so ISDA legal agreements signed with counterparties, although the manager will tend to use fewer of these banks for the majority of trades. They formulate each trade themselves, show it to 4-5 banks, and then allocate purely on a ‘best execution’ basis.

Typical margin requirements are 15-20%, with the remainder of cash invested in short dated government bonds with an average maturity of three months, hedged back to USD. Variation margin (arising from any unsettled P&L) is managed on a daily basis, subject to a minimum amount to help control counterparty risk.

*<https://fulcrumasset.com/insights/investment-insights/white-papers/equity-dispersion-the-greeks/>

**The Fulcrum Equity Dispersion fund launched in July 2020 but the strategy was managed as a sleeve in another Fulcrum fund from 2017.

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