The Bridge Research Article:

The Short Vol Trade

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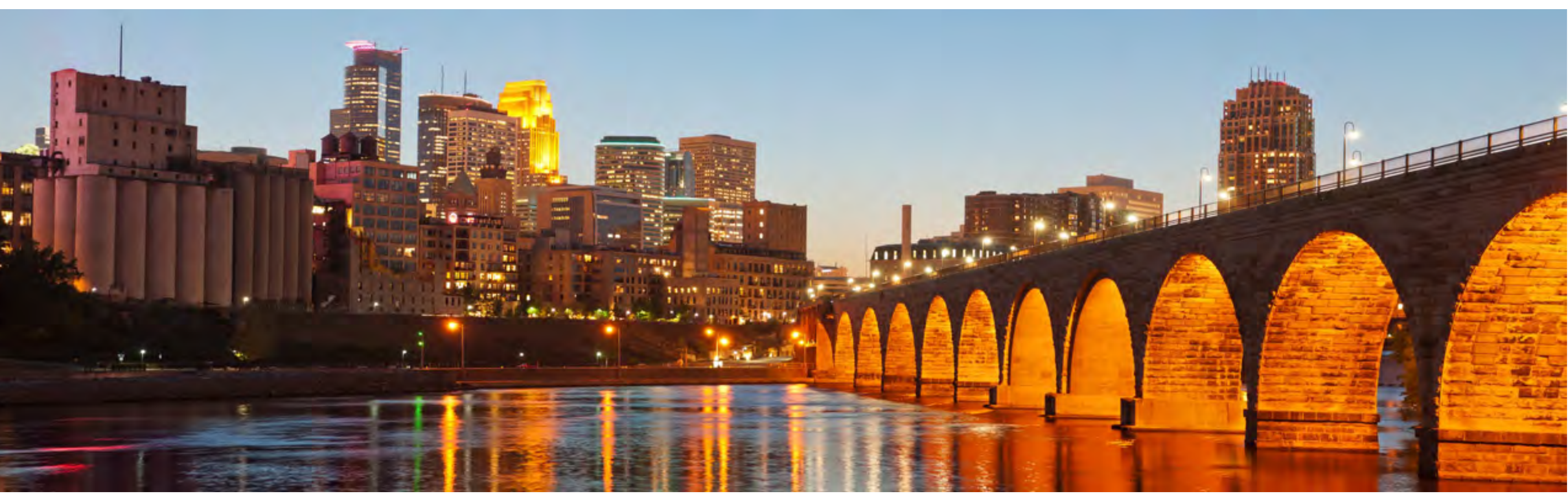

Volatility, VIX and the Short Vol Trade

The US stock market experienced a relatively remarkable period of low volatility. For nearly two and a half years, the market had a clear downward trend of price fluctuation (Chart 1). The VIX index is the most popular measurement of volatility in the stock market. Specifically, the VIX measures future implied volatility of S&P 500 index options. Like other indices, investors can trade options and futures contracts speculating the forward price of the index.

All New Market Highs and the return of Volatility

On January 26th, 2018 the S&P 500 hit an all-time high (Chart 2). Soon after, an equity correction began. As stocks began to sell off and the market capitulated, volatility returned to the market in a dramatic fashion. In a single day, the VIX index saw an increase of nearly 200%. This meant the strategies that were betting against volatility saw their underlying investments lose nearly all their value in a 24-hour period.

Chart 1

One of the most successful investing strategies over the previous two and a half years was betting that overall volatility in the market would continue to trend lower. Several funds, both in the structure of exchange traded funds (ETFs) and mutual funds, posted incredible returns, such as XIV +218%, in approximately 18 months. However, this easy trade all came to an end in a matter of 2 days.

Volatility sustained itself long enough for these strategies to give back all of their performance and in some cases, completely eliminate the funds' assets forcing closure of the strategy.

Chart 2

Several managers were adversely affected by the reversal of volatility. Two notable publicly investable strategies were forced to close and liquidate their entire funds. There was an ETN (similar to an ETF) managed by Credit Suisse with the ticker XIV that had approximately $1.9 billion in assets. In a single day, the fund went from being a top performer for the previous 12 months to approaching a complete loss, forcing closure.

In addition to XIV's liquidation (Chart 3), a similar implosion happened with LJM's Preservation & Growth Fund (Chart 4). Do not let the name of this mutual fund distract from the ultimate possibility of complete loss. This fund too was forced to close, losing nearly $800 million in assets in the same period.

Chart 3

Chart 4

Conclusion

Individual and professional investors alike fall victim to several emotional and cognitive biases. When a strategy consistently outperforms for years, the ultimate downside possibilities become unfathomable. While it is nearly impossible to understand the full probability of returns with 100% accuracy, it is important investors understand the potential downside of their investments. Exotic instruments such as levered inverse strategies utilizing futures contracts might prove to be very successful for a period of time. However, investors are constantly reminded of the importance of understanding the true nature of the strategy and the underlying securities. The market seems to have an uncanny ability to deliver the low probability scenario that leads to the implosion of exotic strategies.

Sources:
All data and charts sourced through Bloomberg.