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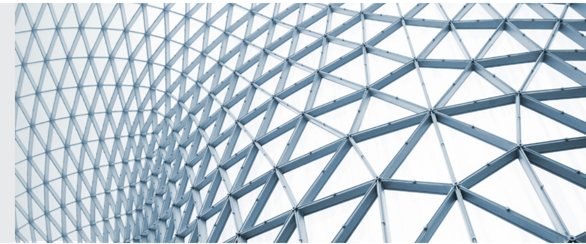

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Volatility hedging: from theory to reality

Downside protection really paid off in 2020. But it's not as simple as buying the VIX

Key Takeaways:

- If you were long volatility in Q1 2020 your portfolio is probably a lot healthier than the average. However, simplified views of how to protect against volatility are misguided.
- The cost of carry in volatility strategies means long periods of being "wrong" are expensive. Some investors try to sidestep the cost of carry by timing the market, but volatility shocks are faster and more intense than in the past, so trying to time market corrections is dangerous.
- Seeyond's Long Volatility strategy seeks to protect against equity market volatility without paying so much in carry and without trying to second-guess markets. Hedging volatility efficiently allows investors to increase risk elsewhere in their portfolios to maximise returns.

Investors who were long volatility in March 2020 experienced substantially less pain than the majority of the market. In fact, depending on their volatility exposures, their portfolios may even have increased in value.

The lesson for the future would seem to be to buy the VIX (a proxy for volatility) and sit tight until the next crisis. Unfortunately, it's not quite that straightforward. In fact, buying and holding the VIX – the so-called "fear index" – could actually cost investors considerable money and heartache.

Here's why, and what investors can do about it.

Simon Aninat
Senior Portfolio Manager
Seeyond

The high costs of carry

The VIX is widely misunderstood. It is viewed as a simple gauge of investor fear which can be bought and sold like other securities. When the VIX spikes, you sell it and reap your reward.

This simplified view of how to protect against volatility does not work in practice. The problem is the VIX index is not directly tradable so investors must purchase VIX futures. The futures trade at a premium to the VIX and converge with the VIX over time.

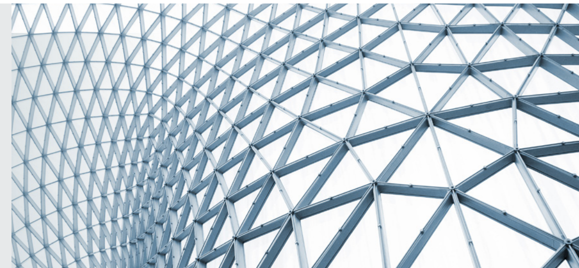
This means there is a cost to buying volatility. This cost is widely known as the cost of carry, which is common to all convex strategies. (Convex strategies are those that generate higher performance when you are right than when you are wrong.)

The cost of carry for the VIX is relatively high compared with other convex strategies, so long periods of being "wrong" are expensive. That is, if volatility does not spike for years, investors lose material capital. An investor wishing to protect against volatility and allocating $100 to the VIX index at the end of 2016 would have lost 90% of their capital by February 17 2020 (just before stock market investors started to panic about COVID-19). Even after the huge spike in volatility in March, an investor cashing in would have made a loss on the volatility investment of 50%.

"Many investors have played the VIX, got stung and concluded that holding volatility is a bad idea," says Simon Aninat, portfolio manager at Seeyond, an affiliate of Natixis Investment Managers. "We think that's a pity."

The market timing myth

One way that investors try to avoid the cost of carry is by seeking to time downturns. They buy protection against volatility once they believe they have identified a potential inflexion point in the market.



This typically entails detecting early signs of a future market crash by building macro-economic models and watching price-driven factors. This approach will indeed reduce the costs of carry, but also risks missing the signals that the economy is turning. "By the time they want to buy, volatility has already risen and the VIX becomes too expensive," says Aninat.

Alternative ways to time the market include investing in active strategies such as commodity trading advisors (CTAs). CTAs are trend-following: as equities head downwards CTAs follow, providing returns all the way down to the bottom of the market as the last equity bulls capitulate. At least, that's the theory.

In practice, CTAs in aggregate have lost money over the last five years. Why? Because markets do not behave in a predictable way today. Smooth transitions upwards and downwards are rare. March 2020 is a case in point: the market took just 23 trading sessions to fall around 35%. In the 2008 crash, which many market participants feared would devastate the financial system, the market took around 50 trading sessions to fall 35%.

"Something is broken in the market," says Aninat. "We don't know if it's connected to central bank actions or structural changes in the market, but we do know that volatility shocks can be faster and deeper. Trying to time market corrections is a lot more dangerous than in the past."

A better way to play volatility

There is a way to protect against equity market volatility without paying too much and without trying to guess the future.

In essence, it involves buying longer-term volatility. Rather than buying three-month volatility, the strategy buys 1-year volatility, for which the cost of carry is considerably less.

Seeyond also sells short-term volatility to profit from carry, although this has to be carefully calibrated so as not to impair the overall performance profile. The strategy is very defensive from an investor's point of view, but the cost of carry is considerably less.

This is still not the whole story though. With the defensive strategy in place, the question then becomes when to take profits.

In the past, volatility shocks were relatively rare and a volatility investor would have taken profits on each one. Today, however, micro-corrections are almost too numerous to mention and it is more challenging to know when to sell. "You can take all your profits when volatility rises from 15 to 20 and make a good return," says Aninat. "But then you risk missing the real crisis and the ride from 20 to 40," he adds.

Volatility hedging frees up risk budget

These returns indicate that even when long volatility strategies don't pay out for extended periods, they can still deliver attractive long-term returns.

"This is really important when people think about downside protection," says Aninat. "Some say they can't suffer small losses every year over a multi-year period. We say it is important to think about the portfolio as a whole."

Looking at the portfolio as both return-seeking and defensive, a volatility hedging strategy allows the portfolio managers the freedom to add alpha to equity beta. In strong markets, this helps to increase the chances of outperforming the index.

And if the index plummets, losses are partially or totally offset.

Conclusion: where now for volatility hedging?

Long-volatility strategies are inherently contrarian: they buy volatility when markets are stable or trending upwards, and sell volatility when markets crash and the VIX spikes.

The Seeyond strategy successfully completed its mission in 2020, but that doesn't mean its job is done. Equity investors will eventually get some visibility over future corporate performance. When that happens, regardless of whether future market returns are viewed as strong or weak, volatility starts to calm down and the strategy starts to buy 1-year volatility once again.

"We like to say: fix the roof while the sun is shining," says Aninat. "It is fairly sure that the sun will shine again. It is just as sure, however, that it will rain again."

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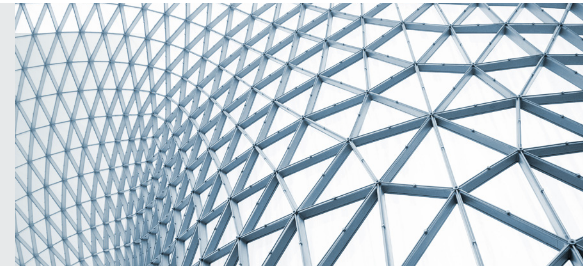
Written on May 2020



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