Opportunities to use volatility are likely to rise in the years to come

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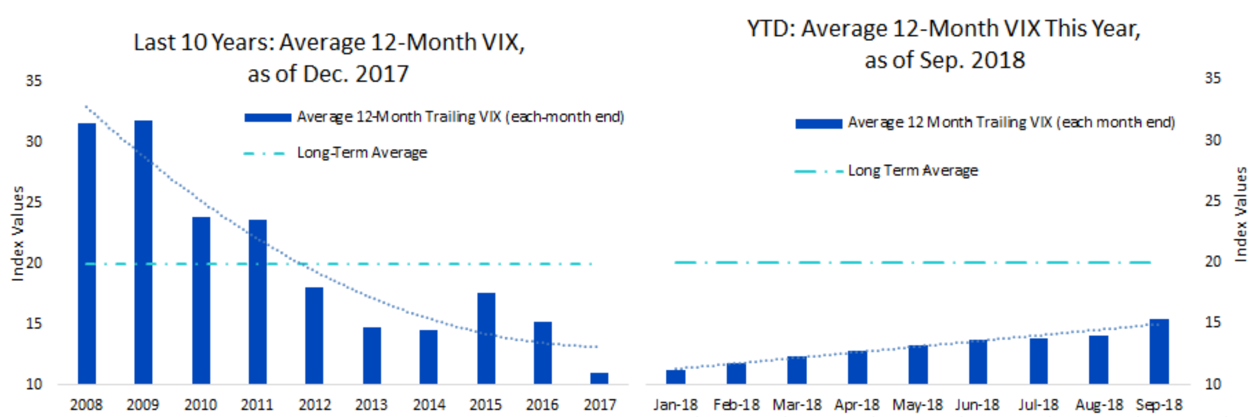
"Greed is a bottomless pit which exhausts the person in an endless effort to satisfy the need without ever reaching satisfaction." Erich Fromm

Background

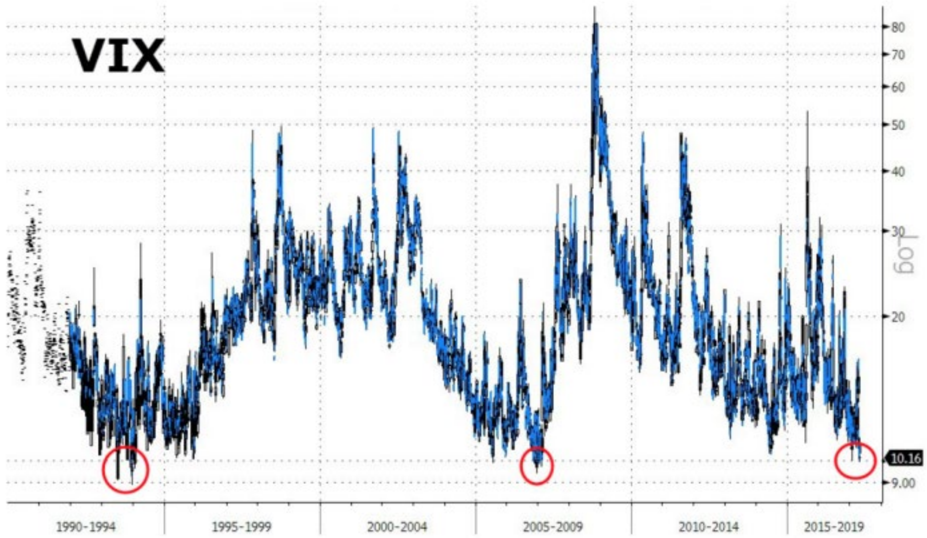
Greed and fear have driven human behavior since the beginning of time. This irrational behavior in markets and investing creates volatility, which this paper will explore, is its own underutilized asset class. This opportunity has tactical and macro implications. Moreover, after years of declining volatility, the heads of both the European and US Central banks have warned that volatility is likely to increase with government deficits and interest rates.

As the chart shows below, the last 10 years have shown a decline in volatility. However, in 2018, that trend has reversed and we are starting to come back to normal levels of volatility in the market.



Sources: Bloomberg, Cboe. Period covered, left chart: 12/31/07–12/31/17, right chart: 12/31/18–09/30/18. Past performance is not indicative of future results. You cannot invest directly in an index.

The VIX is considered the "Volatility Index" and as you can see in the chart the trend since 2009 has been down. As the chart illustrates, the VIX has historically risen after going below 10 for a period of time.



(Source: Zero Hedge)

Why Does Volatility Matter

Volatility matters because it provides a way to receive returns from an asset class that is not solely reliant on interest rate policy, dividends, or necessarily price appreciation. All investors experience volatility in long-only equity portfolios and long-duration bond portfolios. So the question becomes, "if investors know they are going to experience volatility, why don't they use it to the benefit of their portfolios?"

Will Volatility Rise

Similar to Fed Fund futures or a commodity futures curve, volatility also has a future curve where investors' current exceptions of implied volatilize at those times. The trailing 12-month average VIX is trending higher this year in contrast to the last nine years (source: wisdomtree.com).

Secondly, popular investments vehicles like ETFs rely less on managers and more on computers for buying and rebalancing. According to a new research study by UCLA, market movements over the last 5 years have become distorted due to the rising prominence of ETFs.

Since most ETFs passively track a benchmark index comprised of tens, hundreds or even thousands of individual securities, these ETFs often exaggerate selling regardless of a company's individual prospects. The researchers at UCLA argued that ETFs passive approach diminishes the "price efficiency" of individual stocks, thus adding to volatility.

So it's likely that volatility will be ever-present in future markets.

Volatility Investors

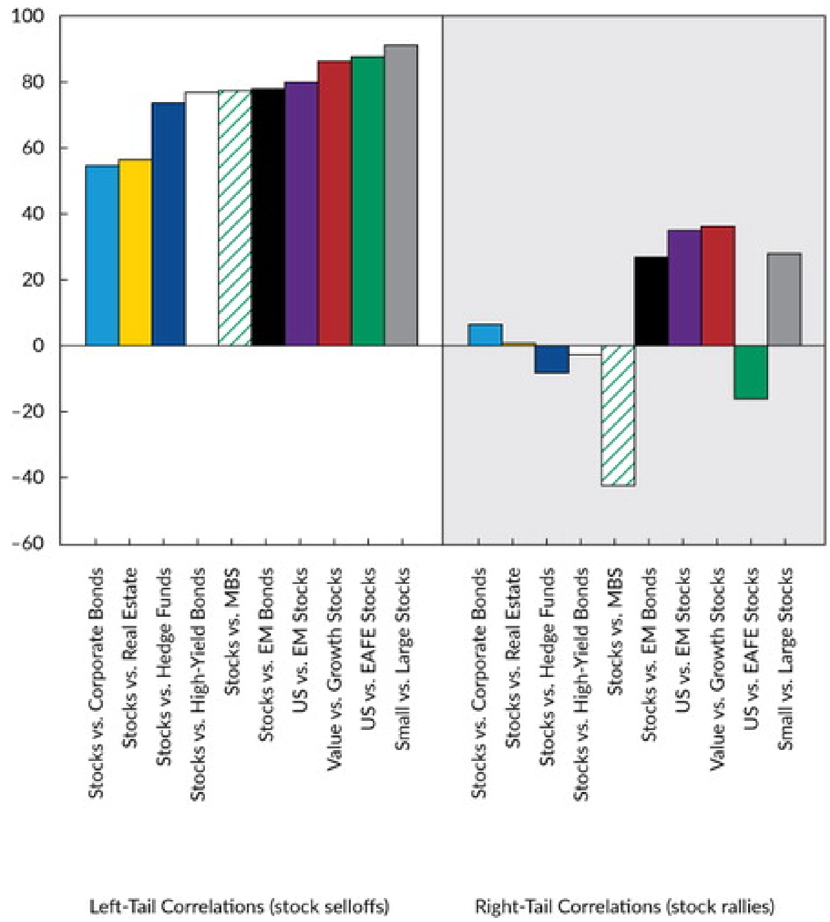
Investors who use volatility will generally fall into three categories; pure hedgers, relative value (RV) traders, and total return investors.

Hedgers will generally buy options, VIX index futures or ETFs (as a form of “insurance”) against their portfolios. Relative value (RV) traders will use those same investments, but they are buying those investments based on timing (relative value trade). Both of those investors (if used correctly) will use those investments as short-term trades because the long-term drag of using those products cost investors approximately 13 basis points per day (note: that decay example is with the SPVXSTR - source ABR Asset Management). Total return investors will use volatility as a core holding and will allocate by using ETFs or mutual funds that have a dynamic algorithm that will move from S&P futures to VIX futures rebalancing depending on market-based signals. All can be successful, if used correctly.

Diversification

Over the years investors have been told the simple way to limit volatility has been through diversification of assets. One of the more vexing problems for investors is that diversification seems to disappear when investors need it the most. Correlations don’t go to 1 in a “crisis,” but it has been well documented (source: FA Journal) that correlations tend to increase in down markets, especially during crashes (i.e. “left-tail events”). Studies have shown this effect to be pervasive for a large variety of financial assets, including individual stocks, country equity markets, global equity industries, hedge funds, currencies, and international bond markets (source: Ang, Chen 2002, Longin and Solnick 2001, Cappiello, Engle and Sheppard 2006). All of the studies on diversification source in this paper were published before the 2008 global financial crisis. Yet, the failure of diversification during the crisis, when left-tail correlations jumped significantly, seemed to surprise investors. This is not to say that diversifying holdings isn’t a valuable way to invest. It is. Instead, the point is to illustrate the value of including volatility as one of those asset classes.

The chart below comes from the CFA Institute and highlights a left-tail (sell-off) versus a right tail (stock rally) event. As readers of this paper can see, correlations rise as markets often times will “throw the baby out with the bathwater.” Capitulation (panic selling) often evokes more capitulation among a broad range of assets.



(Source: CFA institute)

The chart below shows that even lower correlated assets have a tendency to increase during a sharp sell-off.

Asset Class	**Long-term Asset Class Correlation to S&P 500**	**Financial Crisis Asset Class Correlation to S&P 500**
Commodities	0.35	0.48
Fixed Income	-0.29	0.00
Real Estate	0.79	0.83
Currencies	0.26	0.55
Volatility	-0.71	-0.88

(Source: David Skordal PhD.)

Static vs. "Smart" Volatility Trading

For most investors, using volatility as an asset class is a new (but needed) concept. It also does not make much sense for an investor to try and "time" their entry into buying volatility. This would be very expensive and is likely not to be profitable over a longer period of time.

Secondly, as discussed earlier in this paper, a long-term allocation into a static volatility investment can create a cost drag on the portfolio. Like a tire that eventually goes bald from driving on the road, holding an investment instrument like SPVXSTR, a long-term cost is inherent because of the options that roll inside of that product. So even through static volatility holdings can increase sharply in a crisis and complement a portfolio, they can also create decay in the long run.

So we believe that investors need to work with advisors to seek the use of "smart" volatility investment tools. There are both Exchange Traded Funds (ETFs) and Mutual Funds that can move in or out of the volatility market depending on certain characteristics that can trigger that allocation. Hopefully, the investments selected by an investor (and their advisor) are not subject to the whims of feelings by an individual manager. Instead, they are driven by proven algorithms that rebalance in a systematic manner according to various quantitative principals of volatility behavior. The right one depends on your particular risk tolerance and time frame.

Conclusion

Since correlations are a critical metric that can provide useful information to the long-term success of investors, it's surprising to this author as to why volatility is not used in more portfolios. Nevertheless, there is still a window of opportunity for investors to work with their advisors to look at this asset class and reconstruct their portfolios after years of low volatility in both equities and bonds; it's likely that we see more traditional market moves over the next several years. Prudence would suggest that investors review their portfolio sooner rather than later.