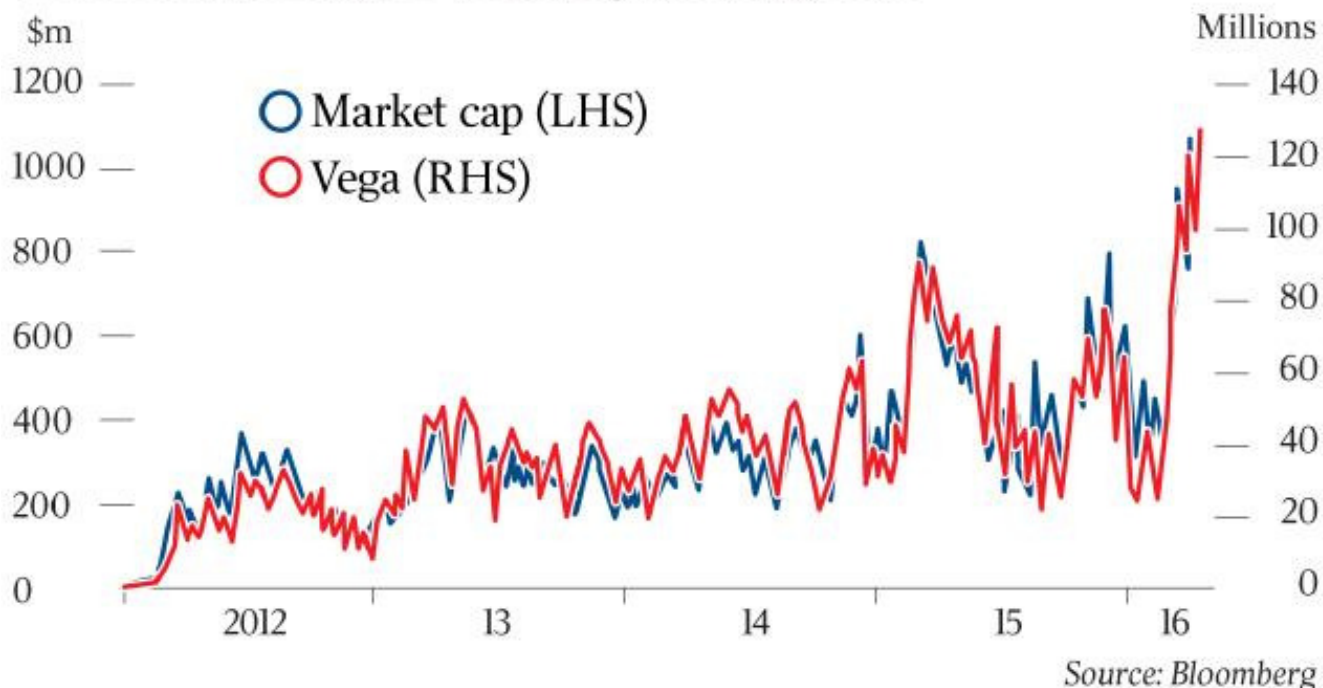


## THE AUSTRALIAN

### Volatility signals a way forward for the far-sighted

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#### UVXY: Investing in volatility is rising fast



With few safe harbours, there exists a proactive way to remain “alone in the crowd” during May, and in so doing, precipitate the wilder market movements foreseen.

This pre-emptive portfolio trading strategy centres around the Chicago Board Options Exchange Volatility Index, commonly referred to as the VIX or “fear gauge” index.

This index was developed to communicate the US market’s expectation of 30-day volatility.

It has been constructed using the implied volatilities of a very wide range of S & P 500 index options.

The reading that it provides us is meant to be forward-looking.

It is widely used to quantitatively assess contemporary market risks.

Appreciating this goes a long way towards understanding why a lot of money has recently been piling into geared long VIX exchange-traded products in the US.

These are the double-levered ProShares Ultra VIX Short-Term Futures ETF (UVXY: US) and the VelocityShares Daily 2x VIX Short Term ETN (TVIX: US), as well as the ungeared iPATH S & P 500 VIX Short-Term Futures ETN (VXX: US) and the ProShares VIX Short-Term Futures ETF (VIXY: US).

With the US VIX at moderately low levels, there is a natural tendency for proactive, sophisticated investors to seek volatility-rewarding trades.

This may explain why, as the graph clearly highlights, that in April this year the market cap of the UVXY: US topped a staggering \$US1 billion for the first time.

Those who are concerned about this recent trend argue that this activity is in fact a double-edged sword, because even though American ultra high net worth individual (not institutional) investors are proactive on the way up for market volatility participation, they are also most often the first to exit when tables turn.

This is evidenced by a popular research paper published in February by the Universities of Ohio State and Michigan, which claims that American affluent investors with the highest incomes exited from stocks disproportionately on the worst days of the financial crisis during 2008 and 2009, and their share of selling rose “sharply” in days following spikes in volatility.

The researchers revealed — after examining millions of sales transactions in both stocks and funds — that when these trades from affluent investors were measured against volatility fluctuations — as signalled by the Chicago Board Options Exchange volatility index — these investors got out of the market quicker than others.

So as a proactive Australian global investor, the question today remains: do we seek participation in volatility instruments which are currently priced for low volatility, justifiably knowing that volatility will rise over the coming months? And as tempting as these trades may appear, Goldman Sachs recently published a paper arguing that it is not always that simple.

With low VIX levels signalling complacency and high levels flagging market capitulation or a buy signal, the old adage “When the VIX is high it’s time to buy, when the VIX is low it’s time to go” is not as logical as it may first appear.

This is because, similar to commodity trading over iron ore or coking coal, we cannot directly trade the spot VIX index.

Access to the VIX market comes from trading listed VIX products — such as

those exemplified earlier — and the performance of VIX ETFs, ETNs and VIX options is dependent on the listed VIX futures market, so understanding the dynamics of VIX futures is crucial for successful trading.

When VIX futures began trading on March 26, 2004 and VIX options on February 24, 2006, they created a viable way for investors to converge VIX index expirations with VIX futures and this provided a tradeable, market-based expectation for where the VIX will be on the expiration date of each future.

However, Goldmans highlight that even if VIX futures can be much higher or lower than the current VIX level, if the VIX is low and VIX futures are trading high relative to VIX spot, your view may already be priced in.

They demonstrate this via an interesting and informative historical example:

Since 2006, the maximum difference between the front-month VIX future and spot index occurred on December 23, 2011.

The VIX was trading at 20.7, on par with its 20-year average of around 20, but the January 2012 VIX future was at 25.7, five points (or 24 per cent) higher.

Suppose an investor thought volatility was headed higher and went long the January 2012 VIX future.

The VIX actually did go up over the next month, but settled at 23.64 in January for a loss as the VIX future actually rolled down the curve, simply because that view had already been priced in.

This example shows us that term structure matters when trading VIX views and that forward risk expectations priced into the VIX futures curve can vary significantly from the spot VIX level.

At the end of the day VIX products are “mean” reverting assets, making them extremely helpful as bellwethers for future market expectations of turbulent times ahead.

They are also a highly effective portfolio trading tool but must be well understood so as not to become the source of negative volatility themselves.

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