

January 31, 2013

“If it looks like a duck, and quacks like a duck, we have at least to consider the possibility that we have a small aquatic bird of the family anatidae on our hands.”

— Douglas Adams

Today there is over \$55 trillion of market capitalization globally, with almost a third of that value represented by U.S. equities. Stock markets have surged to new 5-year highs and fund flows suggest sentiment may be thawing. However, investors remain very cautious and hedging demand remains extremely high.

Exchange traded S&P 500 index options have been, and continue to be, the “clearinghouse” of all hedging products. Innovations such as VIX futures, options and other volatility ETPs offer additional hedging alternatives, and volumes in these new products are breaking records. Last month, we observed one of the largest VIX trades ever as more traders choose to hedge, particularly with the VIX in the low teens. Even with all the new products, this increased volume and “risk transfer” demand ultimately flow back into the S&P 500 options market for the purposes of replicating and deriving price.

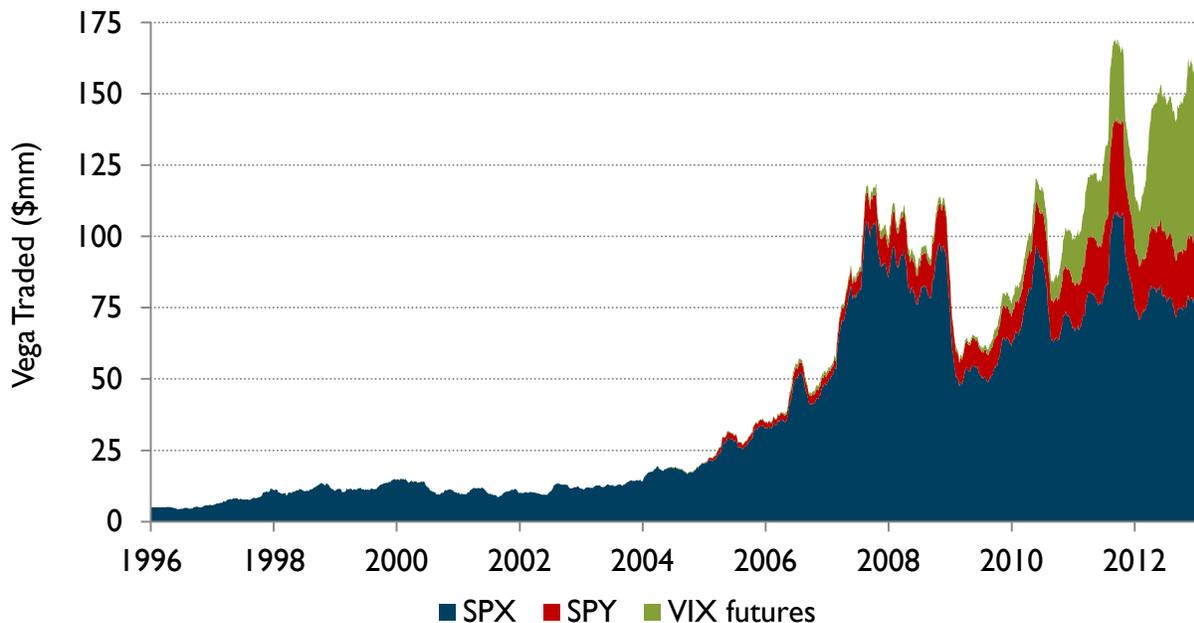


Figure 1: Vega of volume traded (3-month moving averages).

Some traders use VIX options, futures and other ETPs interchangeably with equity index options, futures and ETFs. The increased volumes in volatility products validate the success of these instruments. Heightened demand for novel hedges only partly explains the surge in activity. New market participants may explain the rest. For example, new mandates from many asset managers as well as easy access for retail investors are also driving volumes.

The many available products make it challenging to identify which hedging alternative to select. Choosing the right portfolio hedge is similar to choosing from the endless array of available life or health insurance policies: different deductibles, term life versus universal life, premiums paid relative to benefit, etc. For portfolio hedges, one can decide between S&P 500 options, other index options, ETF options, VIX futures and options, volatility ETPs and more. Then there are the multitude of different combinations of strikes, spreads and maturities to consider in order to evaluate the cost of each strategy with respect to the expected payoff.

The relative value between all of these different hedges is difficult to gauge. If using volatility products, there are many assumptions about how the VIX will behave relative to the S&P 500 in extreme periods. While most hedgers are trying to protect against a decline in the equity markets, the wrinkle comes with how a decline occurs. A sudden 10% market crash is a very different volatility event than a slow 10% grind down. Even though the net decline in the market is the same, the performance of the hedge may be drastically different than expected.

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