How to seize the opportunity of investing in equity volatility ?

Emmanuel Bourdeix
Head of quantitative management

LOOKING BACK OVER A DECADE OF VOLATILITY

For over a decade, volatility among equity markets was structurally low, resulting from the zero interest rate policies put in place by the central banks, which had driven investors towards an all-out search for yield. Under this scenario, the slightest downturn in equities was capitalized upon to gain further exposure, limiting the average daily variation in the major equity indices to around +/- 0.5%. On the flipside however, short-lived spikes in volatility occurred occasionally.
More recently, the central banks have been obliged to begin aggressively hiking their rates, in order to combat inflation. As a result, equity volatility has trended towards a regime which is more in line with long-term averages (in principle +/- 1% to 1.5% average daily variation for the major indices). Generally, a hike in interest rates translates into equity price variability with a lag of 24 months but, this time around, the trend has been accelerated by the unusual pace and scale of the central banks' intervention. This change in paradigm is gradually creating opportunities in volatility. Investors have once again started buying hedging options for their equity portfolios. The counterparty market makers who are selling these options are demanding increasingly higher premiums to accept the downside risk being transferred to them. Lastly, for both buyers and sellers, the volatility asset class is regaining an appeal it has not enjoyed for a long time.

Axel Botte
International market strategist

ASTONISHING EQUITY VOLATILITY RESILIENCE

Volatility primarily depends on the uncertainty surrounding the formation of financial asset prices. Monetary tightening, by reducing available liquidity, can hinder price formation and cause abrupt price adjustments and thus excessive volatility. The confidence crisis in the US regional banking system has added a dimension to this phenomenon of uncertainty but the volatility of equities has remained relatively reduced compared to previous stress episodes. In the common horizons of 1 to 3 months, the implied volatility of equities quickly returned to its average close to 20%. The banking risk did not spread despite fears of a hard landing caused by bank credit rationing. The low volatility of equities is all the more paradoxical as the volatility of interest rates has soared. While persistent inflation may prolong the monetary cycle, it also protects corporate profits by increasing revenues and provide room for maneuver in pricing of goods and services. This raises questions about the hierarchy and relative risk differences in an environment of sustained inflation. That said, the volumes of 0-day to expiry options (0DTE) traded on the markets have exploded. On this very short-term horizon, volatility appears much stronger resulting in sharp market intraday turnarounds. The horizon of hedging strategies has shortened to a degree. This also explains the apparent weakness in the most popular volatility indices.

Simon Aninat
Volatility portfolio manager

HOW TO INVEST IN EQUITY VOLATILITY ?

The volatility risk premium represents the premium that investors are prepared to pay to gain protection against major market movements. The current uncertainty among investors, regarding future inflation outlook and over global growth, exacerbates this bias and tends to increase the volatility risk premium.
To capture this, we are focusing on the main international equity indices (via highly liquid listed options) and proposing a quantitative approach based on a model with a clear contrarian bias, aiming to be less impacted by market drawdowns than we capitalize on rallies. Depending on market conditions, the model allocates between two short volatility strategies: either a non-directional premium accumulation strategy, known as a carry strategy, which mitigates the impact of a potential fall in the market; or a short put option directional strategy to capitalize on market rallies. At the end of March, we were clearly in favour of the directional strategy, but the carry strategy may become more attractive once again if the markets revert to a low volatility regime in the future.
With our Volatility Risk Premium strategy, investors seek to capitalize on opportunities generated through dynamic volatility management. The aim is also to diversify their allocations, with a risk profile in the income product family, evolving between equities and high yield credit, but without duration risk, which is relatively rare for an income product.

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