

Volatility

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After 9 years of trading, Singapore hedge fund Artradis is shutting its doors. At peak Artradis ran over 4 billion USD. Today with assets of just over 500 million Artradis has decided to close.

Artradis is basically a volatility fund which seeks to buy cheap convexity where it can find it. It is a structurally long volatility fund. And it has become tired of volatility falling steadily since the crisis of 2008.

Meanwhile investors continue to sell volatility. Especially retail and high net worth private investors. So strong is the thirst for yield that anything that vaguely resembles yield, such as option premia, is quickly snapped up.

Investors are selling FX vol, equity vol, commodity vol, credit vol, usually in the form of some structured product. So structured that they often don't realize that they are in fact selling short vol, i.e. selling vol they don't already own.

The hedge fund industry has an apt analogy for short vol strategies, its called picking up pennies in front of a steam roller.

How much lower can vol go? Let's look at the VIX index. Vols have a peculiar trading pattern. They tend to trend downwards over long periods and then spike up in times of stress. So shorting vol is a bit like playing the game of chicken. How long are you happy to career towards that oncoming car before you (or it) veer away? Too much courage ends in a blaze of glory.

The VIX spent the first half of the 1990s slowly receding to 10 before picking up in 1996 and spiking to 35 in 1997 on the back of the Asian crisis. It spiked again to 44 when LTCM imploded in a puff of leverage. It stayed elevated through the Dotcom

bust, 9-11, peaking in 2002 at 40 amid accounting scandals and sagging equity markets. As the economy recovered from its wounds the VIX went into decay mode once again reaching a low of 10 in early 2007 before the US non-conforming mortgage market began to unravel. When global markets stared into the chasm in Sep 2008, the VIX hit a high of 60. It has spent the next 2 years receding to a level of 17 in Jan 2011.

With a global economy as unstable as it is today, granted in recovery mode, a strategy of shorting vol is simply risky. Shorting vol is equivalent to providing insurance. Premia are low. The compensation for providing insurance is therefore not commensurate with the risks. In such environments the safer trade is buying insurance, not selling it.

Its time to be long volatility. Unfortunately, for some habitually long volatility traders like Artradis, 2 years of receding vols have been too much to bear. And its usually when the 800 lb gorilla has left the room that the party begins.