What you need to know before buying a vol trading fund

By **Terri-Ann Williams** / 19 Jul, 2018 at 11:00

The universe of volatility strategies is extremely heterogeneous, according to Lupus alpha's Mark Ritter.

'On the one hand, there are funds that work as a crisis hedge. These funds are structural buyers of volatility. One the other hand, there are strategies where the objective is to harvest the volatility risk premium (VRP),' he told *Citywire Selector.*

Ritter, who manages the Lupus alpha Volatility Invest fund, said his team employs the VRP strategy, which systematically shorts volatility.

‘Short volatility strategies have an asymmetric pay-off profile. This is the main reason for the existence of VRP. Because of the asymmetric characteristics, the scaling of the derivative positions and appropriate risk management is key.

‘A negative example in this context are systematic/passive volatility products like the XIV ETN. These products achieved extraordinary returns in the past but at the cost of enormous risks. In February 2018 they lost over 95% due to their extreme high leverage.’

In addition to scaling the absolute level of risk, Ritter said there are other important factors to consider, such as position sizes and the instruments used.

‘There are different sizing methods for short volatility strategies and each behaves different during volatility regimes. Here it is particularly important to take advantage of the mean reversion of volatility. The instruments used must always be analysed in the context of the current market environment.

‘There are long-term effects, for example, regulation or structural flows that have a major impact on different parts of the volatility market. Therefore it is important to analyse the underlying value drivers in detail to avoid unwanted risk factors or pay off profiles and to trade the most attractive instruments.’

Popularity in the market

While volatility continues to rise in the market, some investment professionals believe this is causing a rise in popularity in volatility trading strategies. Ritter said this is explained by two things.

‘A key question for many investors in the current environment of low interest rates is how to generate sufficient returns to meet their long term goals.

'This increases the number of investors looking at alternative asset classes in general. In addition, volatility concepts have built up attractive track records and volatility is now recognised as an independent asset class.

‘By investing in this asset class it is possible to collect an independent, economically-justified risk premium VRP. As the number of independent risk premia is limited, it makes sense to add short volatility strategies to a broad portfolio of risky assets.’

It’s clear from Ritter that the rise in volatile markets has helped the fund’s performance and bolstered assets.

‘Due to our performance over the last years we have seen growing interest in our volatility strategies. In particular, as a result of the volatility spike at the beginning of 2018 we have seen inflows at very attractive levels for selling volatility.

‘We are currently managing more than €2 billion in volatility strategies. Most of these assets are managed in customised segregated accounts.’

Over the three years to the end of May 2018 the Lupus alpha Volatility Invest fund returned 4.6% in euro terms. This compares with a 2.4% loss by the average manager in the sector over the same time period.