THE DANA VIEWPOINT

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Dow: 24,962

Vol-Pocalypse

This was a catchy description of the early February market in a recent article. Investors learned that the market can be a roller coaster, not just an upwardly sloped conveyor belt. It turns out that the market has once again shown resiliency and is now up for the year on most indices. It makes sense to look back at some other short market shocks to put this one in context. Hurricane Katrina wiped out large portions of New Orleans in 2005; the population is 20% below where it was in 2000 and at about the same level it was in 1920. Nevertheless, this disaster had virtually no effect on the markets. The NYSE closed for five days after the World Trade Center attack on September 11, 2001, but was higher one month after the attack. We would presume that had you asked someone if the market could close higher one month after multiple attacks where 3,000 people were killed, many would have thought it impossible. The market had an 8.7% intraday move during the flash crash on May 6, 2010, but closed higher four days later. The move that was most similar to our current situation in terms of price movement was in August of 2015, when the S&P 500 fell 11% in five days. The market recovered that loss in ten weeks. In the nine trading days from January 26th through February 8th, the market has finally given us a 10% correction.

It appears that low volatility strategies played a significant role in this market correction. These funds and strategies known as 'sell volatility' or 'short volatility' collect a premium if market volatility stays low. Volatility has been extremely low and has moved lower over the last few years. Volatility is negatively correlated with short term market returns in that it goes down as the market climbs and rises when the market declines. Many of these funds and strategies turned out to be more sensitive to market declines than many thought, and there is no doubt that other forms of portfolio insurance and risk controls triggered market sells as prices fell on February 5th. Two of the most widely held short volatility ETFs, SVXY and XIV, fell 15%-20% from January 26th through February 2nd, even though the S&P 500 was down less than 4% over the same time period. On Monday, February 5th, things really got ugly for these strategies as the market lost 4%, triggering orders to purchase VIX contracts to cover shorts at much higher levels, driving the VIX even higher on February 6th, and prompting more equity selling. During the first full week of February, these funds lost an additional 90%. The market is extremely efficient in making fools of those who think they have it figured out.

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In these short volatility strategies, investors were essentially selling insurance. They collected a stream of income as long as the VIX stayed tame. It seems ironic to us that some of the buyers of this insurance were large institutional investors and insurance companies. It is certainly possible that the individual investing in one of the ETFs listed above could have been providing insurance that covered some equity losses at firms like Warren Buffet's Berkshire Hathaway. These strategies that collect premiums over time but suffer if there is a rare market event are said to be similar to "picking up quarters in front of a steamroller" - sounds like the opposite of a viable investment strategy to us.

One firm that was on the other side of the short volatility trade was a hedge fund from Denver, Ibex Investors. It is a common behavioral trait for people to overweight the recent past when making forecasts, and underweight the chance of change or the occurrence of an infrequent event. Ibex was reportedly buying out of the money put options on the short volatility ETFs, betting against the investors in those funds. During the second week of February, their investment of $200,000 generated a profit of over $17 million. Score one for the contrarians.

Similar to some of the previous sharp drops that happened in the middle of bull markets, stocks have recovered roughly two thirds of their losses, and most indexes are now positive for the year. We are completing one of the best quarters for earnings in the last five years, with the revenue surprises from S&P 500 companies also running at record highs. Economic reports have generally been strong, with indexes of housing activity moving to 13-year highs. It is important to note that the market rebound has been happening as interest rates have continued to increase. There will be a level where rates interfere with stock price gains, but we are not there yet.

The market provided one of its recurring lessons to investors this month: if an investment strategy seems too good to be true, it probably is.

Random Thought for February 2018: "If everyone is thinking alike, then no one is thinking."
- Ben Franklin

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