This week, our CIO Richard Seamans has been speaking with individual and institutional investors across the US who are concerned about the impact that the volatile markets have been having on their portfolios. We have been through similar periods of angst in 1994 with the Orange County muni bond default and the 2010 Flash Crash. We expect the markets to rebound as they did then; they just need to settle down. Below, please find our assessment of the recent market moves. We hope our guidance is helpful in addressing any concerns you may have.

Too Much of a Good Thing: Unwinding the Short Stock Market Volatility Trade

(February 9, 2018)

When markets move up relentlessly as the U.S. stock markets did in 2017, speculators feel more and more comfortable embracing leveraged strategies to capture the rise. One of the most popular strategies was to short the stock market volatility index (VIX) on a leveraged basis. The VIX has been falling relatively steadily since 2015, as speculators added more to their short VIX positions on periodic market corrections, which they viewed as opportunities to increase their positions. The VIX fell below 9% in early 2018 (less than half its average in recent years) and was, over the past year, at its lowest annual average in decades. The graph below shows a chart of the double long VIX Index, a popular vehicle to short to implement this strategy.

Investors become complacent when a trade works repeatedly and that trade becomes crowded. Markets and securities tend to be mean-reverting. When the pendulum shifts in the other direction and against the crowd, the correction is often abrupt and very sharp, which is what we have witnessed this past week.

Double Long VIX Index

By the end of January 2018, there were too many speculators invested in the short volatility strategy for the available liquidity in the market. As the VIX moved higher, investors began to cover their shorts, which served to push the VIX even higher. The ensuing panic caused a further rush to the exits as investors liquidated their positions. The two largest ETNs with this embedded short volatility strategy were XIV and SVXY. The assets of these two funds, which totaled $3.6 billion on January 31st, plunged to $136 million on February 6th. Credit Suisse is liquidating its XIV ETN, effectively forcing the underlying investors to be bought into the market.

It is reported that there are more than $2 trillion in investment products linked to a short VIX strategy. One strategy, which is affecting the market, is a targeted volatility strategy known as risk parity where reportedly $500 billion was invested. Under this strategy, investments in large cap stocks were increased as the volatility declined. The strategy also works in reverse - as volatility increases, stocks need to be sold in order to rebalance positions. It has been suggested that this rebalancing required $225 billion in stock sales and contributed to the declines in the Dow and S&P. A much larger strategy involved embedding the short VIX indices in “yield enhancement” products sold to large pension funds and other institutional investors. We would not be surprised to see this result in lawsuits and settlements similar to the $400 million paid out by Merrill Lynch to Orange County, CA in early 1994 because of misrepresentation.

Events such as these tend to be painful, but thankfully short lived. They also have a knock-on effect on the surrounding markets, such as what we have witnessed over the past week. While much of this short VIX trade has been unwound, the demand for VIX futures to cover the trade is still large enough to suggest that it will take a little longer for the markets to return to normal.

Despite the recent turmoil, we remain bullish on equities. Corporate earnings, given the boost from recently enacted tax reform, should exhibit strong growth in 2018 and promise to show one of the strongest increases in recent years. Corporate repatriation of offshore monies will support stock buybacks, mergers and acquisitions, and dividend increases, all of which support further stock market gains. Rising interest rates will put pressure on sovereign and corporate debt and further encourage a rotation from debt to equities.

Summary

Long term investors should consider whether the stock market’s current weakness offers them the opportunity to increase their equity exposure over the next month or two.

We are focused on those companies whose technological advantages represent the backbone of the economy’s emerging growth and are well-positioned for a world in transition.

Please feel free to contact our Investor Relations team at 781-890-5225 at any time with questions and comments. We welcome the opportunity to further share our thoughts with you.