COMMENTARY

Short Volatility Strategies make Sense.

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The market distortions, caused by the COVID-19 pandemic have affected almost all asset classes and investment strategies. Due to their strategy-inherent characteristics, short volatility concepts also suffered, some incurred significant losses.

In the aftermath of recent events, some mutual funds were closed with different justifications. A particularly pithy reason, expressed in an attention-seeking manner is: Short volatility approaches would not „work" anymore and were therefore no longer suitable for institutional investors.

In this brief commentary we would like to transparently outline what a short volatility strategy is, where to pay attention and why it should have a permanent place in the asset allocation of institutional investors.

What is a short volatility strategy?

First, let us state what a short volatility strategy is not: It is not a total return strategy, not an all-weather concept and no guarantee of uncorrelated returns. Any such advertising paraphrases suggest a false expectation among investors and fail to reflect the nature of such a strategy.

The comparison with an insurance company may sound a little stale, nevertheless it remains valid for capital markets. The volatility risk premium represents a monetary compensation for the transfer of market price risks. Figuratively speaking, it is the „mother" of all risk premiums. It compensates exclusively for the risk transfer from the insured party to the insurer. Risk transfer is achieved through options, which are the equivalent of an insurance contract in the capital markets. The resulting performance characteristic can be illustrated in a picture: Stable premium income is achieved when markets are rising moderately, falling moderately or even in volatile sideways markets. This phase of premium collection can be compared to an *escalator moving upwards*.

In strongly falling or strongly rising markets the „insurance claim" occurs and the risk will be transferred. As option sellers these strategies then usually show abrupt, negative performance. This intense, generally rather short phase can be described with an *elevator riding downwards*.

The characteristics of a short volatility strategy imply that the *escalator ride upwards* is inevitably linked to the risk of a temporary *elevator ride downwards*. These are the two sides of the same coin.

The mid-term return of the short-volatility strategy represents the compensation for enduring short-term, sometimes considerably negative performance. Therefore, it is also clear that there is no worse short-term risk diversifier for the portfolio than a short volatility strategy. When the institutional portfolio suffers, the strategy suffers as well. It is neither suitable for risk diversification nor as an uncorrelated liquid alternative component.

Rather, the added value of this strategy lies in its mid-term diversification of the sources of return of an institutional portfolio. In the medium term, it can achieve an attractive performance irrespective of the performance of the equity or bond markets. The development of the volatility risk premium is not a result of market returns, but of their path dependency. In many market scenarios short volatility strategies offer a better performance than long-only investments, e.g. in long volatile sideways markets or slow crash scenarios. Due to these performance characteristics short volatility strategies are an attractive return diversifier.

What should be considered?

When analysing short volatility concepts, 7orca suggests that special attention should be paid to risk management, the knowhow of the team backing the concept as well as to the transparency and clarity of the strategy.

When comparing different strategies, it becomes clear that the performance dispersion and the performance differences are very pronounced, particularly in times of *elevator rides downwards*.

This is due to the different risk management concepts, which essentially all refer to the limitation of the *elevator ride*. However, they clearly differ in their impact, efficiency and costs. Investors should be completely aware of this.

In stressed markets, a short volatility strategy imposes particular challenges on portfolio management. The systematic and effective management of the strategy requires the seamless integration of a resilient and stringent risk management - especially in times of crisis.
A stress test of market distortions is not only a stress test for the quality of the short volatility concept, but also of its management team. In this phase, a professional team can prove its long-term experience in acting thoughtfully and in terms of operative implementation of the short volatility strategy.

Transparency is of essential importance for a short volatility strategy: Due to the lack of suitable benchmarks, the use of derivatives and the highly dynamic portfolio parameters the concepts can be difficult to understand.

The portfolio manager has the duty to continuously ensure a maximum of transparency and understanding. It is imperative to ensure that the investor is able to capture the strategy and ultimately gains trust in it. Trust is the basis for the endurance of the e*levator ride downwards*.

Do short volatility strategies have a future?

March 2020 events have revealed significant differences in short volatility concepts. Funds that have been performing poorly relative to their competitors over a longer period will be closed.

Most of the strategies still in place have already proven their merits in previously challenging market phases, such as in the final quarter 2018 and should look forward to a positive future.

Historically, pronounced *elevator rides downwards* were usually followed by a steep *escalator ride upwards*. Volatility is expected to stay at high levels, representing an attractive environment for short volatility strategies.

7orca is convinced that a well-selected strategy, equipped with a suitable risk budget represents an attractive return diversifier to an institutional portfolio.

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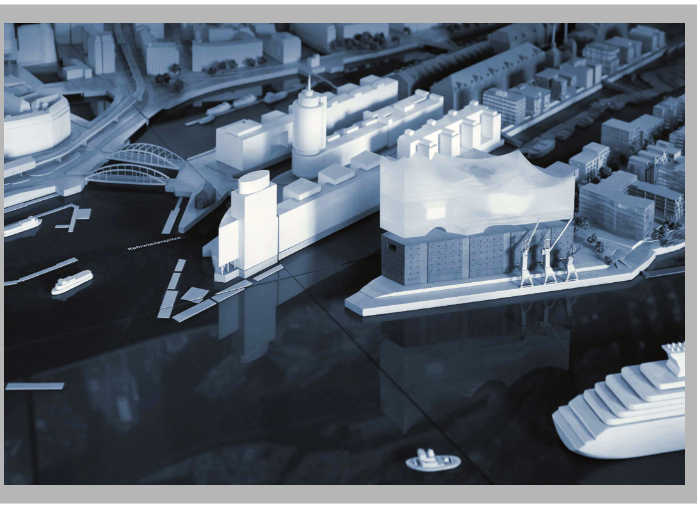

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The company's experienced team serves institutional clients with overlay management and short volatility strategies. More information on: www.7orca.com