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Markets

Volatility Quant Soars 64% as Fear Goes Missing on Wall Street

- ABR fund systematically shorts futures on Cboe's vol gauge
- VIX falling near four-year lows defies Fed-induced selloffs

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A New York money manager has netted a 64% gain from a strategy riding the big plunge in volatility across the stock market in this expectations-busting year on Wall Street.

With the Cboe Volatility Index falling to post-pandemic lows in the great 2023 risk revival, the ABR Enhanced Short Volatility Fund has made outsize gains thanks to a simple systematic approach that includes shorting futures on this so-called fear gauge. That's proved a slam-dunk trade given price swings on equity benchmarks have stayed curiously low, including during Federal Reserve-related bouts of market panic.

A quarter of ABR Dynamic Funds LLC's $500 million assets under management are concentrated in trades that wager on market calm. Money managers with specialized short-volatility strategies are a rarer sight these days after a cull induced by the virus-spurred market rout in 2020 and 2018's "Volmageddon" episode.

"It's time that people start learning that short volatility is a wonderful partial equity replacement," said Taylor Lukof, who founded the money manager in 2010.

The Enhanced Short Volatility Fund which tracks the broader strategy ranks at the top of more than 500 alternative funds tracked by Kepler Partners this year.

The firm surfs asset trends using quantitative methods and dynamically reduces and increases volatility bets. When there's a period of market turmoil, ABR's short-volatility strategies move into cash and long-dated US Treasuries to limit losses.

Short-volatility strategies often take the form of selling a put on a stock or index while investing in a risk-free asset like Treasuries. They typically ride bullish market sentiment, like the 23% advance in the S&P 500 this year, but backfire when a rapid selloff ignites volatility.

This year, betting against equity price swings hardly seemed like a surefire bet in the grip of the most aggressive interest-rate hikes in a generation, a steady erosion of corporate profits and the failure of regional banks. Yet for all that, the VIX has still tumbled to near four-year lows.

The short-volatility strategy is a roller-coaster ride. Last year, ABR's trade fell 40% after soaring in epic fashion in 2021. Overall, the strategy has lost money in two of the seven years since its launch.

The CBOE Eurekahedge Short Volatility Hedge Fund Index is up nearly 9% this year, heading for a third straight annual gain and beating the broader Eurekahedge Hedge Fund Index. Yet according to a Eurekahedge index, the number of hedge fund strategies devoted to the short-volatility investing style has shrunk to just seven from 15 in 2015.

Still, equity strategies that involve selling volatility are booming in the exchange-traded fund industry this year. ETFs that have drawn inflows include the JPMorgan Equity Premium Income ETF (ticker JEPI) and Global X Nasdaq 100 Covered Call ETF (QYLD).

"The short volatility strategy has just taken a new appearance," said Daniel Kirsch, head of options at Piper Sandler & Co. "After 2020, the strategy became out of favor and with the growth of active ETFs/mutual funds writing options."

For Lukof at ABR, the best way to use the strategy is to complement funds that act as a buffer to volatility during market turmoil. ABR offers a 50/50 and a 75/25 volatility fund. The former splits exposure between long- and short-volatility strategies, while the latter has a bigger tilt toward long vol.

"We never recommend using 100% pure short-volatility exposure as a standalone," Lukof said. "Long-term investors are better off having exposure to both long volatility and short volatility trades."