Generating Yield via Options

Obtaining yield in the current market environment is challenging. Bonds offer historically low yields that are unlikely to keep pace with inflation. Dividend stocks are often hidden value traps to be avoided. Our preferred way to generate yield in the current environment is via strategic selling of equity index options.

Why Sell Equity Volatility?

Three factors supporting generating yield through selling equity volatility:

1. Taking the other side of put buyers in hedged equity strategies.
2. The merging of monetary & fiscal policies with a dovish bias supports lower realized volatility.
3. Premium intake remains attractive with implied volatility elevated.

Selling Put Options > Buying Expensive Protection

Selling equity volatility has a natural edge because you are taking the other side of retail investors who buy put options to hedge their equity positions. These retail buyers of put options pay up for options beyond their implied intrinsic value. As a result, index puts often trade at a steep premium to what realized volatility would imply. Why would investors buy puts that they know are overpriced? They do it because they view the puts as portfolio insurance. Therefore, they accept entering a trade with negative expected value because they view it as a sunk cost that allows them to remain long equities.

The smart trade is to take the other side of this uneconomic put buying and sell these puts. **Whenever there are participants in the market who are doing trades without expecting profit, there is an edge in taking the other side of this trade.**

Don't Fight the Fed!

When the Fed is actively engaging in Quantitative Easing (QE), risk assets are directly supported through the portfolio balance channel. While the Fed is not buying stocks directly, their purchases of Treasuries and mortgage-backed securities cause other investors to sell these securities and push out the risk spectrum within their portfolios. Hence, there is a waterfall effect whereby equities become less risky because of central bank balance sheet expansion. This was the biggest lesson following the 2008 financial crisis and it is why VIX grinded down to the low teens and stayed there for most of the following decade.

In hindsight, 2010 would have been a great time to start selling equity volatility. Being short volatility worked until well after the **first** Fed hike in December 2015, as equities historically perform well up until the **last** Fed hike in their hiking cycle, which occurred at the end of 2018. Thus, the last time the Fed started QE in 2009 it coincided with a 9-year span during which shorting equity volatility worked well.

QE can be thought of as a substitute for rate cuts. Since the start of COVID-19, the Fed's balance sheet has expanded from $4 trillion to $8 trillion and is on pace to expand another $1.5 trillion per year at the Fed's current $120 billion monthly pace of asset purchases. This balance sheet expansion means the Fed is still easing monetary policy despite the economy rebounding meaningfully. **When the Fed is aggressively expanding its balance sheet, selling equity volatility is attractive.**

Monetary policy drives the financial economy, which drives the real economy. Yet, under Janet Yellen's new Treasury Secretary appointment, fiscal policy has now been linked with monetary policy and both share a dovish bias as lowering unemployment is more of a priority than preventing inflation. This turbocharges the need to be in assets over cash. Accordingly, it also reduces the odds of an outsized move lower in assets, which directly constrains equity volatility.

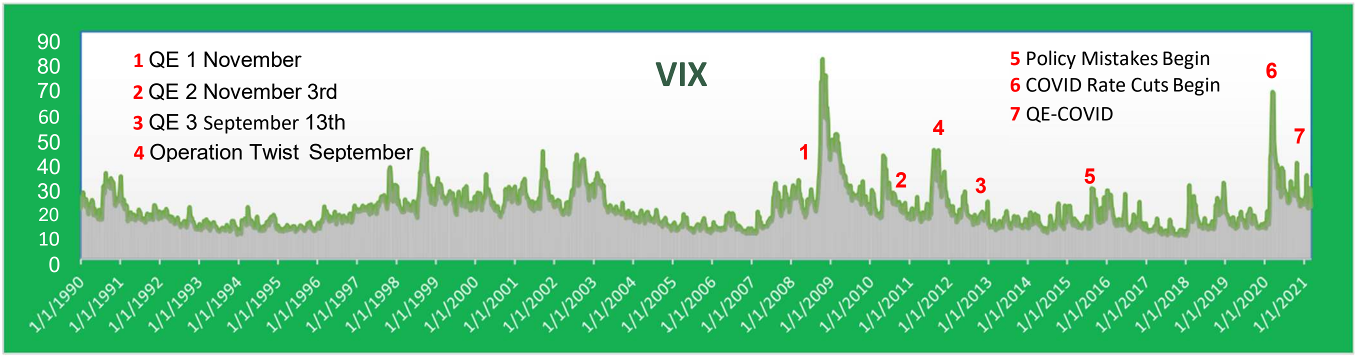
Fed balance sheet expansion certainly has unintended side effects such as increased wealth inequality and misallocation of resources. The ultimate impact on inflation should also be higher. Yet, the most certain dynamic is that the Fed is going to keep expanding their balance sheet for the foreseeable future.

Investors are therefore resigned to play the game based on the rules presented to them. **The current market dynamic is akin to playing the board game Monopoly, but having players start with 3x the amount of money as usual.** The most logical game theory application to such a game adjustment is that properties should be bought more rapidly. Even though Boardwalk still charges the same rent and projects to the same earnings, the opportunity cost of not owning it and instead holding cash is now greater. The supply of money increased while the supply of investible assets remains constrained.

While Fed policies do not directly increase corporate earnings, they result in more money chasing a finite amount of investible assets, thereby creating a reinforced safety net for asset prices.

Elevated VIX

The VIX is a CBOE volatility index of S&P 500 options that gauges 30-day forward projected volatility. For most of the last decade, the VIX traded in the low teens. VIX spikes occur into large market corrections as investors overpay for protection to hedge their portfolios. In the financial crisis of 2008 and the coronavirus crash of 2020, the VIX spiked to 80.



Source: https://www.federalreserve.gov/ and CBOE.com

Yet, VIX spikes tend to be short in length and the index mean reverts lower because implied volatility cannot deviate from realized volatility too meaningfully over long periods of time.

As realized volatility drops, implied volatility is dragged down with it. The volatility drop often becomes a self-enforcing dynamic as lower volatility begets lower volatility, and this brings in a flywheel effect of institutional vol sellers who jump in the trade as it starts working. After all, there is a dearth of yield in the current environment.

The time to start shorting VIX is therefore early in the move, which we believe is right now. VIX has likely started a multi-year move down towards low teens, just as occurred during the prior Fed QE period.

Objects in the Rear-View Mirror are Further Away than they Appear

Investors have the tendency to overestimate the odds of the event reoccurring. The riskiest times to short volatility were in 2008 & 2020, when the stock market was elevated, the economy was late-cycle, and the Fed was tightening monetary policy.

When the Fed shifted dovish following the financial crisis in 2009, it was an ideal time to start shorting volatility as the Fed was supportive and the economy was early in the recovery. **We are likely similarly at the start of another multi-year period that will be supportive of lower realized volatility.** Fed Chair Powell has made it clear that the Fed desires an overshoot of their 2% inflation target. This is because their new inflation targeting framework fears deflation more than inflation. Accordingly, Powell has recently stated that Fed is not even “thinking about thinking about” raising rates. First, they will have taper their QE purchases towards an eventual stop which is likely years away. Beyond that, they have stated they seek to let inflation run hot for multiple years before starting to hike rates.

The 2020 market crash has created a psychological boogeyman for many investors that has resulted in them fearing another crash and thus being underweight in equity exposure, or even completely in cash. Yet, when the Fed is aggressively expanding their balance sheet, investors should be playing for asset price volatility to be continually reduced and fear premiums to be removed from the market.

Where Most Volatility Selling Strategies Go Wrong

Most volatility selling strategies fail because they are systematic rather than strategic. Systematic short volatility strategies always have positions on and are therefore exposed to big drawdowns when large volatility spikes occur. This is like a boxer that does not try to move his head to avoid punches.

Many volatility selling strategies also emphasize premium intake over loss prevention, which can ultimately lead to their demise when a big market move occurs.

The Axis Point Edge

The Axis Point Capital short volatility strategy addresses the 2 big flaws of most vol selling programs via active risk management and improved trade structuring.

Our strategy only sells volatility strategically when implied volatility is elevated, and premium intake is high. Being patient and waiting for the absolute best opportunities to sell volatility means that there can be periods of time in which the strategy has no positions on. This is an approach we are comfortable with, and our fee structure is aligned with investors such that there is no management fee for sitting in cash and waiting for the best opportunities.

From a trade structuring standpoint, all trades are done on spread to make them limited loss. No trade is ever done with an unlimited loss profile. This is a necessity with any vol selling program as it ensures that capital preservation remains a number one priority. Delta is actively tracked on all positions and trades are rolled when delta exceeds given parameters. This reduces the size of losses and ensures that our trades realize minimum loss when they do go against us.

Finally, we use a proprietary framework that combines sentiment, trading ranges and volatility metrics to identify when opportunities are ideal.

A sample of this sentiment framework can be seen below:

Axis Point Sentiment/Positioning Scorecard		
Measure	**Current Reading**	**Prior Reading**
CFTC Commercials vs Spec Volatility Futures Positioning	4	4
Axis Point Blended Market Maker Gamma Exposure	2	5
Equity Darkpool Buying Pressure[1]	3	3
10y vs SPX Rich/Cheap	3	4
Axis Point Blended Daily Nasdaq Sentiment	1	4
Option Buyer Sentiment	4	3
Short Term Tactical Trading Model	3	4
Aggregate Risk Score	57%	77%

Scale: 1(Bearish Extremes)-5(Bullish Extremes)

[1] https://squeezemetrics.com/monitor/dix?

2021 Returns (as of April)

- The Axis Point Capital volatility selling strategy was launched at the end of January 2021. As of the beginning of April (in just over 2 months), it is up +4.1% with a Sharpe ratio of 5.2.
- A high Sharpe ratio proves that by being selective in entries, a short volatility strategy can be an effective way to generate yield with limited downside exposure.
- Furthermore, because the strategy takes in premium up-front, it can be run as an overlay on top of existing portfolios to generate incremental yield.
- The strategy is offered via separately managed account (SMA) formats, which means it can be customized and tailored relative to each investor's personal needs and risk tolerances.

Summary

Now is an exceptional time to short equity index volatility to add incremental yield in portfolios.

Retail investors have crowded into the long volatility trade overpaying for money losing puts and the Fed has strongly reinforced that it is committed to keeping financial market volatility low.

Most short volatility strategies are systematic and lack structured risk management. The Axis Point Capital strategy addresses these issues, thereby creating a safer way to strategically short equity volatility.

Please contact us for more details on how the short volatility strategy can be customized for your portfolio.