GFG CAPITAL

A FAMILY OFFICE

VIEWS FROM THE BRICK

SOMEBODY LIED

We've stated our grievance with headlines on this blog and in client communications in the past. Sensationalized all caps chyrons rub us the wrong way as well. "MARKETS IN TURMOIL" might be the most played out example we can give of these. Who do they think they're helping? There's one topic that chronically makes its into investors' inboxes with attention-grabbing subject lines that often leads them to be proactive (which we applaud in practice), and that's volatility. But there's one issue: they're being misled.

For those of you questioning yourselves, this is a chyron:
(we're also not blaming Pete and John)

WHAT IS THE VIX?

Volatility as measured by the VIX, often referred to as the "Fear Index", has reached multi-decade lows (see chyron above) in recent months which would lead investors to think "this can't be sustainable: buy low, sell high, right?" You're not wrong if this is your thought process, but let's breakdown what the VIX is before you rush to buy one of the many widely marketed and distributed vehicles that *try* to mimic the index.

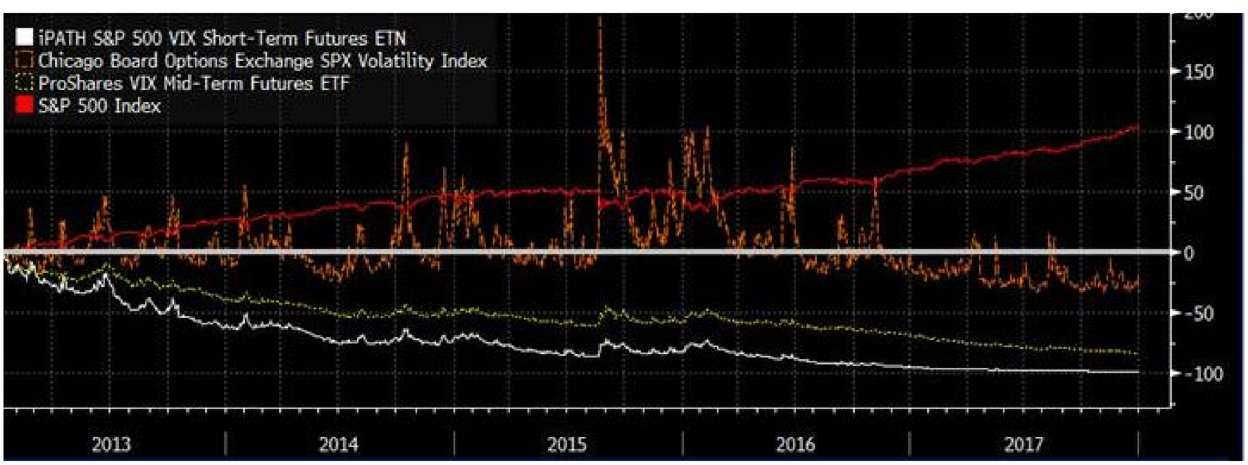
The actual calculation of the VIX is a relatively complex process, but the end game of the index is to measure how much volatility investors *expect* to see in the S&P 500 Index over the next 30 days, based on prices of S&P 500 Index options. The index uses the prices of these options and futures contracts to estimate how volatile those options will be between the current date and the option's expiration date. Voila, you have the VIX. The nature of the underlying assets, coupled with the short-dated horizon, is what makes purchasing protection through some of these ETFs for your portfolio a much riskier proposition than many realize.

TIME DECAY

Buy low sell high. Simple. Got it. You heed the warning shouted at you by the chyron and call up your advisor, or log into your trading account and search for one of the many exchange traded vehicles to help you place your bet on volatility reverting. But when you try to put this philosophy into practice when dealing with the VIX there are a few caveats that come into play. The first is an inherent quality of all options: time decay. You're about to buy an investment vehicle that tries to mimic an index, not own the index (because that's impossible), that measures the price volatility of an asset that will cease to exist in 30 days. As the lifespan begins to approach the execution date of the option, the end result of the option is more clearly anticipated and will be rendered profitable or not. Then, the vehicle repeats the process. You don't own a set of assets at a certain valuation when you purchase this vehicle, like you would say an equity index. The assets you hold continue to turnover completely and are replaced with freshly priced options. Higher or lower from where you think you entered the investment. This leads us to caveat number two.

HOW LOW CAN YOU GO? CONTANGO

Imagine that your goal is to always have a certain part of your portfolio invested in VIX futures. If the futures contracts are continuously more expensive than the current VIX level (a characteristic of flat or low levels of volatility), then you pay a premium every time you buy futures. This concept is called contango. Effectively, you're buying high and selling low, which erodes the value of your investment over time. Below we highlight the five-year performance of the VIX, VXX (short term VIX futures ETF), VIXM (medium term VIX futures ETV) and the S&P 500. As you can see, the ETFs have lagged significantly behind the value of the VIX index. Just because an investment is tied to the VIX index, does not mean that it will move in line with the index. What this contango effect has on the investment is illustrated perfectly by the churn lower in value of the ETF matched with a relatively consistent value of the VIX index itself. In turn, remaining invested in equities throughout this period (albeit relatively tamed from historical volatility measures) would have outpaced the return of the VIX and the strategies of options that attempt to track its value.



And what did 2017, one of the lowest years for volatility on record, look like for long volatility strategies like the ones above? According to ETF.com, seven of the 20 worst-performing exchange-traded securities during the year were long VIX and other volatility measures.

SOURCE: Graph provided by Bloomberg. This presentation is solely for informational purposes and should not be taken as investment advice. For further information, please contact one of our investment adviser representatives.

SO HOW DO I PROTECT MYSELF?

We aren't telling you that volatility is this unstoppable force for which you can't attempt to hedge yourself against. But we are saying purchasing one of these products designed to track the index is not a recipe for success. What has been a better approach is implementing two pillars to your investment approach: remaining diversified and adhering to a set rebalancing schedule. Maintaining a diversified, and invested, portfolio sets investors up for their best chance for an attractive risk adjusted return and smoother ride. Volatility regimes will come and go, and trying to anticipate when they change is not a game we're interested in playing. Another way to make sure your portfolio does its best to protect you in times of turbulence is setting and sticking to a rebalancing schedule. This *actually does* give you the chance to buy low and sell high. Therefore, following an extreme run-up in some markets while others struggle, your portfolio can continue to expose itself to the opportunities you intended to capitalize on.

Moral of the story? Be careful what you allow to enter your thought process when trying to make your investment decisions. We'd venture to say it's more important than what ends up in your portfolio itself. Noise for noise sake will always be something we combat as investors, what we're tasked with is to decipher the noise for the signals.