Opinion **On Wall Street**

Trading volatility? Good luck catching that sharp knife

Despite the mounting worries about Vix ETNs, it is an increasingly vibrant market

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The dot-com crash, the 2008 financial crisis and the Chinese devaluation all led to spikes in the Vix index © FT montage; Getty Images; Reuters

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The father of the Vix index, Professor Robert Whaley, was becoming worried in early 2010 that the stock market was due for some turmoil, so he bought a newfangled exchange-traded note that tracked his famous invention. But it blew up in his face.

While equity market volatility did soon shoot up as the eurozone crisis began to rumble, Prof Whaley still lost a chunk of the $30,000 that he had invested in the iPath S&P 500 Vix Short-term Futures ETN, or VXX. “I think a lot of people, like me, assumed that they’re trading something like the Vix but it’s very different,” he notes, ruefully.

“Buyer beware” is a common refrain in the investment industry. Yet the fact that even the inventor of the volatility index, a professor who has spent of most of his life studying the derivatives markets, can be wrongfooted by a Vix ETN underscores just how toxic these products arguably are.

Even ETF enthusiasts dislike them. Matt Hougan of Inside ETFs argues that investors worried about volatility would be better off buying and drinking a case of beer. “When they recycle the bottles, they’ll still have more money left over than if they bought a Vix ETN.”

Despite the mounting worries about Vix ETNs, it is an increasingly vibrant market. There are now more than 40 exchange-traded products somehow based on the level of the Vix, with aggregate assets under management of almost $4bn and average daily trading volumes of $2.6bn in the first quarter, according to Goldman Sachs.

This week, VelocityShares launched two new ones to allow investors to trade European volatility.

Most are engineered to provide protection when volatility erupts. But, in practice, they amount to a bonfire of money.

Vix just reflects a bunch of short-term S&P 500 options, using them as a way to measure how volatile investors think the market will be over the next 30 days, so no one can trade its “spot” level.

Instead, Vix ETNs use Vix futures. But the Vix futures market is usually in “contango”, trader jargon that means that longer-term contracts are far more expensive than near-term ones.

This means that Vix ETNs are in a quasi-permanent state of dying, by constantly buying pricier longer-dated Vix futures and selling cheaper Vix futures about to come due. Few retail investors are aware of the pernicious effect of contango, which has been the case for 70 per cent of trading days going back to 2005.

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Roberto Croce, head of quantitative strategies at Salient

For example, if you had invested $1m in the VXX ETN that Prof Whaley bought when it launched at the beginning of 2009, you would have less than $600 today. Investors would have been much better off investing with Bernard Madoff's Ponzi scheme.

"You have to know certain things to fly a car or an aeroplane, and you should know certain things to trade volatility," laments Christopher Cole, the head of Artemis, a hedge fund.

On the other hand, the "inverse" Vix ETNs, which bet on Vix falling by selling longer dated volatility index futures, have been phenomenally lucrative. The VelocityShares Daily Inverse Vix Short-Term ETN has returned more than 700 per cent since launching at the end of 2010.

Goldman Sachs' options guru, Krag Gregory, estimates that being short volatility since the post-crisis nadir in 2009 would have netted an investor returns since then of 4,364 per cent.

But even inverse Vix ETNs can be dangerous. When volatility jumps the losses can be horrific — XIV lost over a quarter of its value in just one day after the UK voted to leave the EU — and *in extremis* investors can be obliterated.

XIV has a kill switch that can be flicked by the sponsor if it loses more than 80 per cent of its value in a day.

But the bigger worry is that the growth of the complex, interlinked Vix ETP ecosystem is not just sparking dangers for investors in individual funds but also the broader market.

This is something that "gnaws" at Peter Tchir, an analyst at Brean Capital. He points out that VIX ETPs are new products untested by severe turmoil, which could reveal pernicious weaknesses and feedback loops.

Not everyone thinks that Vix products should be kept away from retail investors. Roberto Croce, head of quantitative strategies at Salient, an asset manager, points out that there are myriad ways that investors can blow up and that the risks are disclosed.

"Shops aren't prohibited from selling sharp knives, even if not everyone is qualified to handle them," he points out.

Prof Whaley has certainly learnt a lot from his unhappy VXX experience in 2010. For the past two years, he has been betting against VXX through put options, providing a nice, steady income stream. "In retrospect, I learned a whole lot," he says.

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