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With Risky Bets Back In Play, Stock Selloff Revives 'Volmageddon' Memories

By Trevor Hunnicutt
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NEW YORK - Months after he lost millions when an esoteric corner of financial markets cratered in February, former Target Corp store manager Seth Golden is betting against volatility again.

Golden, who says wagers on market calm earned him millions in the past six years, is among the investors who have kept trading complex financial products linked to the Cboe Volatility Index .VIX - Wall Street's "fear gauge" - in the months since some of those products blew up.

"The majority of 'vol sellers' were not damaged in February. It was the Johnny-come-latelies and people who shouldn't have been trading volatility in the first place," Golden said.

This market is back in focus after another rapid stock market slide pushed VIX to as high as 29 from early October lows under 12, and given a gradual rebuilding of trades betting the volatility will not last.

While many investors smarted, others kept coming and between March and September, more than $1.2 billion rolled into U.S.-based exchange-traded volatility products, according to Reuters calculations based on data from FactSet Research Systems Inc, which tracks the investments.

That compares with $1.7 billion the month before the early February "Volmaggedon" when stocks sold-off briefly on fleeting inflation fears, the VIX shot up to 50 on Feb. 6 from 18 the day before, and some investors lost over 90 percent of their investment.

Golden, who gained prominence after the New York Times profiled him in 2017 and now runs a website that offers advice to traders, said that he had already more than recovered his February losses as he kept borrowing VIX exchange-traded products, selling them and buying them back when the price goes down. Reuters could not independently verify his accounting.

Golden said he cashed in some of his profits before the latest volatility spike and now was waiting for the market to reverse to get back in.

"These are the days I live for," he said during the market selloff this week. [.N]

The February crash sparked a debate whether the VIX index and the related products were prone to manipulation and led to dozens of lawsuits and ongoing probes into the matter by U.S. regulators.

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Since then, both the Cboe exchange (CBOE.Z), which owns the VIX index, and issuers of some of the related products have made changes they say should make the market less prone to violent, hard-to-anticipate swings.

The exchange has modified its auctions that determine the price of VIX futures to boost liquidity while the backers of some of the volatility products tweaked them to reduce leverage.

For example, ProShare Capital Management LLC, backers of the widely used ProShares-brand vol products, restructured one product so it would aim to move less in response to changes in the market, losing 0.5 percent, instead of 1 percent, when the index it tracks increases by 1 percent.

So far, those steps seem to have worked.

The $370 million ProShares Short VIX Short-Term Futures ETF (SVXY.P), which tumbled over 80 percent in a single day in February, sank 8.3 percent on Wednesday, lost 4.6 percent on Thursday and rebounded 3 percent on Friday morning.

Early this month, Barclays Plc analysts who argued the February plunge was "technical in nature" wrote that a strong U.S. economy and so far limited economic impact from trade conflicts, emerging market currency declines and upcoming congressional elections should support the short-vol trade.

This week, however, they said their views have changed given an increased chance of a Federal Reserve policy misstep and investors' increased focus on the effects of a trade war between the United States and China.

"We expect volatility to remain elevated in the short term and do not recommend buying this dip," they wrote.

"The difference is that this time there are some genuine catalysts we can point to," one of the authors, Maneesh Deshpande, told Reuters.

While investors trade VIX futures to guard against market declines and turmoil, those derivatives have a tendency to lose value in steadily rising markets as demand for such protection declines. Inverse-vol products launched and listed on exchanges after the 2007-2009 financial crisis allowed investors to take advantage of that and profit during extended spells of market calm.

Originally designed as a sophisticated hedging tool for professional investors to help manage their daily market exposure, inverse-volatility products became popular among small investors when the products listed on exchanges and took on a new life as a lucrative bet on market calm.

Gains of nearly 600 percent over two years up to February vaulted the products onto various lists of top performing investments and made them the subject of excited conversation on social media and financial websites.

"The pros, a lot of them were right back in there a week or two after February," said Russell Rhoads, head of derivatives research at TABB Group LLC.

"There's lots of people trying to pick stocks. The major hedge funds are all doing the same thing, and the volatility space has opened things up for people that are willing to do the work to find a new way to speculate on the market."

Some analysts blamed the severity of the crash in part on excessive leverage and over-confidence of ill-prepared retail investors.

"It's more or less a substitute for going to Las Vegas - you can do it from your home office," said Robert Whaley, a professor at Vanderbilt University who developed VIX.

Whaley stands by VIX as a market gauge but is concerned that volatility-themed exchange-traded products pose risk to retail investors.

There is no record of how many retail investors are in the trade, but available data suggests they still play a sizeable role in the market.

Institutions required to report certain holdings, typically traders and fund managers overseeing more than $100 million, account for between 3 percent and 62 percent of U.S. volatility exchange-traded funds' assets, with the balance held by those who do not make such filings, including smaller funds and retail investors, Refinitiv data shows.

Stuart Barton, managing partner at Invest in Vol LLC, an investment adviser, which uses the products, said those investors are taking big risks again.

"The moves by the surviving products to lower their leverage has been a good move but that's only half the story," he said. "People just take twice the position."

Reuters

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