Figure 1

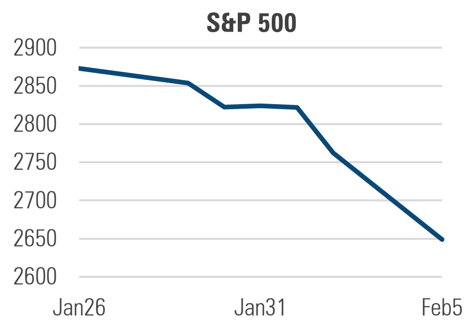


Figure 2

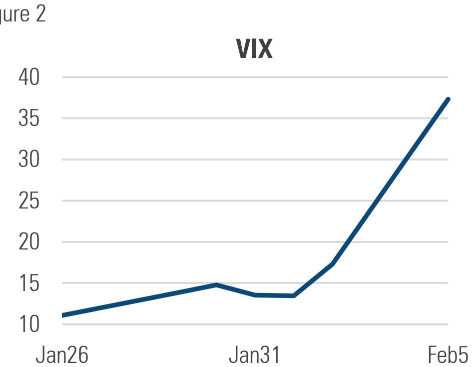
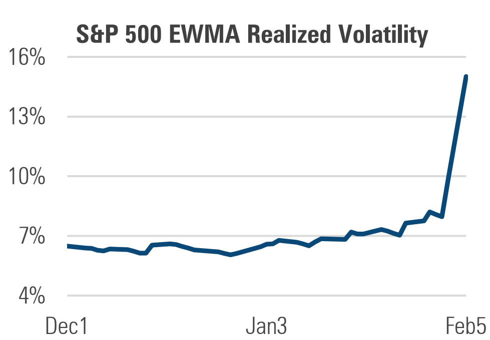


Figure 3



Breaking down February's market selloff and the implications for managed risk funds

Having returned 21.8% in 2017 amidst exceptionally low volatility, the S&P 500 roared out of the gate in January. After closing at an all-time high on Friday, January 26, and up 7.6% month-to-date, the rally was abruptly interrupted.

Over the course of the next four trading days the index fell 1.7%, as both realized and implied volatility edged gradually higher. The morning of Friday, February 2 is when it began to fall more precipitously. This coincided with the release of some surprising economic data; specifically, larger-than-expected growth in both payrolls and average hourly earnings are thought to have triggered fears that the Fed would begin to tighten policy at a faster rate than previously expected.

That first wave of selling on Friday pushed volatility higher, which is likely what triggered the second wave of selling on Monday. On Friday, Feb. 2, the VIX (figure 2) closed at its highest level since the Brexit vote in June 2016. This spike in vol quickly generated significant pressure on short-vol positions, which had grown considerably in size throughout the preceding months of low volatility. The covering of these short positions served as a catalyst to Monday's broader market selloff. Notably, two short-vol products fell approximately 95% and appear likely to be liquidated.

Managed Risk Funds

The low level of realized market volatility (figure 3) leading up to Friday and Monday meant that the majority of managed risk funds were fully allocated to their maximum respective equity levels.

Just as we did during the Brexit market turmoil, we would again remind our readers that a managed risk approach is not explicitly designed to protect against gap risk. As a long-term approach to risk management, buying put options to protect against gap risk poses challenges associated with both cost and timing that limit its viability. By contrast, a managed risk approach combines a capital protection mechanism (a manufactured put-like strategy) with volatility management. It is constructed to protect *not* against gap events, but against the instances when the initial gap turns into a volatile and protracted downturn.

Negative returns are often associated with higher levels of volatility. It is precisely by reducing equity exposure in volatile markets that managed risk strategies mitigate their participation in extended drawdowns. Should this gap turn into an extended drawdown with persistently higher volatility, managed risk funds will respond in a manner consistent with their volatility targets and risk management objectives.

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Established in 1998, the practice includes professionals operating from three trading platforms around the world (Chicago, London, and Sydney).

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