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Close Gate House, 47 High Street, Salisbury, Wiltshire, SP1 2PB United Kingdom
Tel: 1722 336388 Fax: 1722 339537 Email: info@oxeye.co.uk Website: www.oxeye.co.uk

The Long Volatility Opportunity - December 2017

Implied Volatility is at historical lows

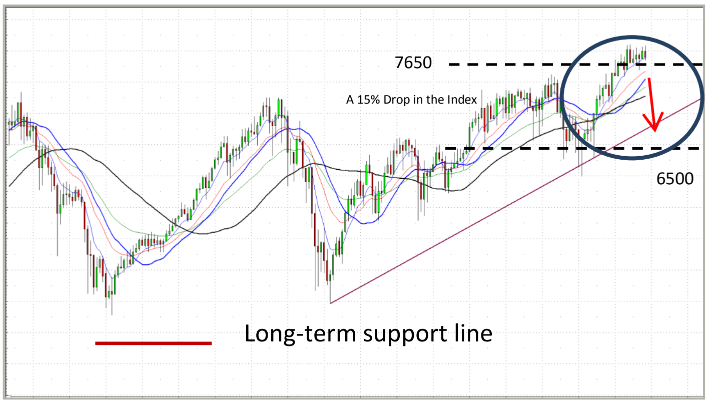
Figure 1 shows the Implied Volatility (IV) cycle back to 1997. Option premium levels are below our target comfort level as denoted by the red line and we have significantly reduced our "short" volatility exposure. Volatility may continue to fall in the near-term, but historically it has always risen to the 20% level within a year. With IV so low, this note examines the potential for a "long" volatility trade (last recommended in December 2006).[1]

Figure 1: Leading UK Equities Index IV 1997 to Present

How far could the UK Index fall?

A decline to the long term line as shown in Figure 2 would constitute a 15% drop in the index and a rise to 20% in IV.

Figure 2: Monthly UK Index 2000 to date



The simplest way to profit is to buy Puts

Figure 3 shows an analysis of the cost of Put options at various levels of IV over four different durations, factoring in a market drop of 15% .

Figure 3: Cost of Buying Put Options

	Duration			
	3 month	6 month	9 month	12 month
IV Pre-Fall	Mar-18	Jun-18	Sep-18	Dec-18
9%	96	199	290	404
IV Post-Fall				
15	812	882	951	1027
20	863	963	1056	1150
30	920	1049	1166	1277

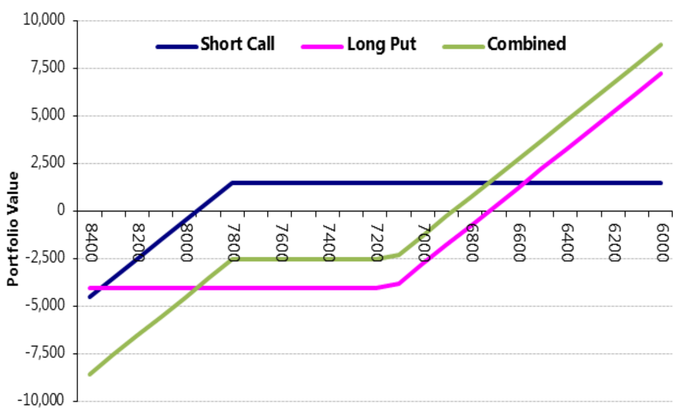
Example Trades:
(1) Long Volatility Trade: Buy Puts

The Option used for this example is the 7125 Dec 18 Put which is 5% out-of-the-money (OTM). This can be purchased for 404 (£4,404) and with IV spiking to 15% the Put may rise to 1027 (£10,270). With a rise to 20% IV and the Put increases to 1150 (£11,500) and at 30% IV to 1277 (£12,770).

(2) Reducing the Cost: Sell Calls, Buy Puts

The cost of the Put could be financed partly by selling a Call. For instance selling a December 2018 7800 Call (5.5% higher than the current market @ 7400) for a premium of 150. If the index were to remain below 7800 then the cost of the long volatility trade would be 404–150= 254. This would give a return profile such that the combined position will lose if the index rises above 7800, a fall in the index to 6375 would yield a profit of £5,200. A fall in the index to 5800 and the strategy realises £10,710.

Figure 4: Risk Profile on Expiry of a Long Put combined with a Short Call



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Volatility will rise again

With Central Bank stimulus still huge, creating imbalances in demand for and supply of quality assets, bond yields globally at record low levels and even negative in some cases, the stock market artificially valued through stock buy-backs, the global short volatility trade is at record levels and feeding on itself.[2] The need to rebalance portfolios in line with rising market capitalisations is forcing investors to keep buying to maintain their target weightings and inevitably a feeling of complacency is setting in. To the extent that commentators are questioning if volatility can ever rise again.

Oxeye believes it will occur within a 12 month time frame

As shown in Figure 1, periods of low volatility have always come to an end. Each time volatility rose from below 10% to at least the 20% level. In our view, some time in the next 12 months volatility will rise sharply again. In this instance, carefully planned long volatility trades such as the ones outlined above will be extremely profitable.

Oxeye Capital Management Limited

is an award winning absolute return manager specialising in volatility risk premium harvesting through derivatives trading. Oxeye runs both managed accounts and funds for its clients. It has managed its Option Premium (short volatility) Strategy (OPS) since 1997. OPS profits come from selling short options and holding mainly through to expiry. Below are listed OPS lifetime performances:

5X Leveraged
Annualised return: **20.74%**
Total Cumulative Return: **4518.04%**

Unleveraged
Annualised return: **7.01%**
Total Cumulative Return: **393.18%**

J. Moss/H. Pomeroy December 2017

Managed Option Strategies

The examples shown above are quite simplistic. Here at Oxeye we design and manage bespoke strategies for clients who want to generate absolute returns or to hedge their portfolios against a rise in volatility. There are a number of other strategies which we can suggest, but these are more complex in nature as the aim is to reduce the cost of the long volatility position to as close to zero as possible. Please contact us for more information about our services.

[1]Please see *Oxeye Traded Options Strategy: Hedging A Fall In UK Equities* for our 2006 note: https://static1.squarespace.com/static/59e1d4d59f8dce639786d4b8/t/5a1be3ddc83025aa86867e69/1511777249230/Thornhill+FTSE+Hedge+%28tampered%29+2006+PDF.pdf

[2]Please see *Volatility and the Alchemy of Risk*, Artemis Capital Management for further analysis of the global short volatility trade: https://static1.squarespace.com/static/5581f17ee4b01f59c2b1513a/t/59e8a9b0e9bfdfb287faa3d2/1508420022032/

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