Don't Fear the Riskier: How to Start Embracing Market Volatility

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Many commonly think of volatility, in general life, as a bad thing: when someone is volatile, they're unpredictable, sometimes even aggressive. In truth, though, the word "volatile" stems from the Latin volare, meaning "to fly". In its French and Italian derivatives, the word is still neutral, even romantically evocative in its promise of soaring among clouds.

But in English, we've grown scared of it: we think volatility is dangerous. This is just as true in the equities market as anywhere else.

The fact is, flying high presents us with opportunities as well as risks. Investors have long lived by reading the Chicago Board Options Exchange (CBOE) as a measurement of fear in contrast to safe liquid assets. Now, the market is seeing a shift towards embracing long volatility exposure as an indicator of sound financial investment.

How (and Why) Volatility Investment Hasn't Yet Worked

Exposing investors to some amount of volatility is nothing new—but it has always been challenging. Past products would try a passive

formula that relied on watching the CBOE Volatility Index (VIX) futures curve on a monthly basis, which is problematic because the contango associated with the VIX futures curve would often cost investors big-time due to unforeseen fluctuations.

To address this problem, some funds began mitigating such costs by predicting precisely when investors should require volatility exposure, and handling it on a case-by-case basis. But this, too, quickly faced new hurdles, because these funds left their investors without protection against unpredictable drops in the equity market, even though they could precisely bring down net volatility exposure when the model predicted a strong market showing.

Investing alongside the CBOE

Investors are familiar with the VIX as a method of measuring the implied volatility of the S&P 500 Index (SPX). It does this by analyzing a combination of factors, including put and call options tied to the SPX. In 30-day segments, the CBOE shifts its outlook expectation of whether

the SPX will shift up or down: when the VIX shoots up, investors traditionally start to sweat, because it means the next 30 days may see major unpredictable market prices swings.

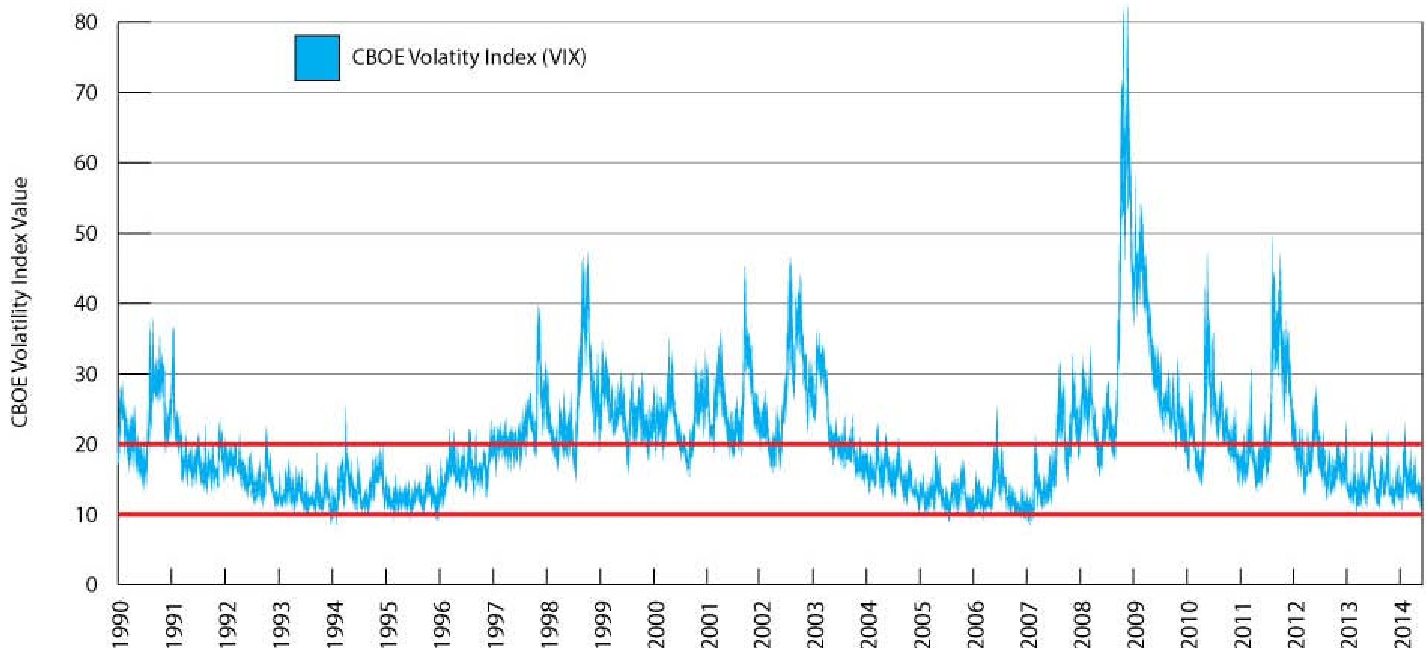
The problem is that most swings shoot downward, and when they shoot down they plummet much faster than they rise back up. This has traditionally caused investors to worry and associate a skyrocketing CBOE with increased market risk, which causes a chain reaction of panic to varying degrees.

But there's more to the story than that. According to KKM Financial, an alternative asset management firm based out of Chicago, volatility has evolved into a glimmering new investment tool—one, they claim, that's actually perfect for investors hoping to diversify and safeguard their portfolios.

KKM Financial takes a unique approach to investing in volatility, and their model hinges on diversification. They base their findings on the intense and consistently negative correlation volatility has with equity markets.

During strong market months, most asset classes show low correlations to U.S. equities. But the opposite is true during the market's weaker moments, when correlations rise up tremendously despite investors crossing their fingers for correlations to stay down.

This translates back into that negative correlation between volatility and equities: the correlation gets stronger when the market is dipping. With proper foresight and an accurate reading, allocating volatility can potentially protect diversification when investors are looking for it most.



It takes two to contango

One of KKM Financial's two main funds, the KKM ARMOR Fund (RMRAX, RMRIX), draws its calculations from the two most efficient long volatility exposure options: the VIX futures complex and the S&P 500 options complex. This ensures that the fund is not just reacting to the VIX analyses, but also the source of the VIX data itself.

There are two key aspects to tackling contango, according to KKM: efficiency and calculated prediction. Long exposure to volatility must be efficient, which is why calculations are required every 24 hours, not monthly, to determine the most efficient long volatility exposure across both the VIX futures complex and S&P options complex. This keeps investors in the loop, and invites them to see which securities are moving well in the ARMOR index over any span of time.

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The calculated prediction allows investors to take advantage of contango and miss-pricing in these same complexes. By shorting components that grow overpriced via daily recalculations, the ARMOR index actually helps investors recoup some time decay that most long position VIX futures holders pay.

The second fund, the KKM U.S. Equity Armor Fund (UMRAX, UMRIX) is similar—it offers superior, low risk monthly rebalances between equities and volatility. It uses the SPDR S&P 500 ETF (SPY) for exposure and peeks into its sibling, the ARMOR Index, for corresponding long volatility positioning.

Same tools, new outlook

High-volatility is a phrase that has long scared away investors, especially in the last decade. But this is perhaps a misunderstanding of the word and concept itself. With a low-risk approach to volatility investment, watching efficiently over small securities can have major benefits, including growth in volatile times that offsets dips elsewhere in a given portfolio, and even sizeable market sell-off gains.

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