

Tabula insights: Adding credit volatility risk premia to a bond portfolio

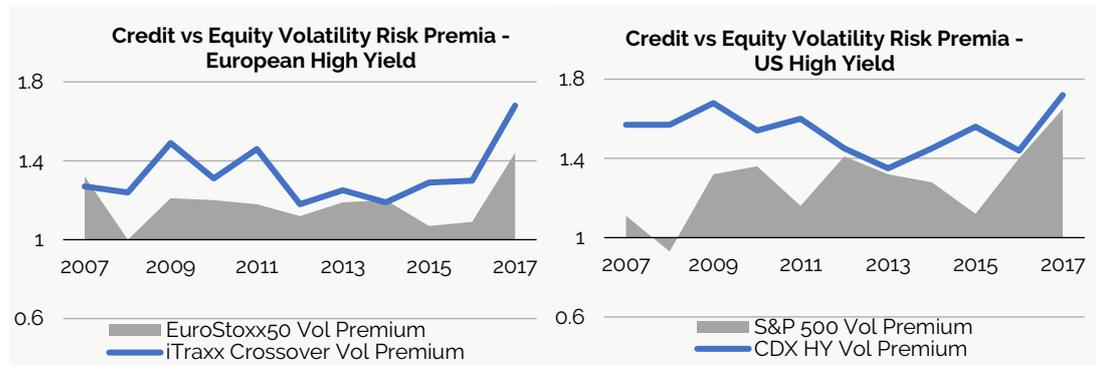
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The volatility risk premium is a structural feature of credit markets. It has been inaccessible to most investors but can now be captured via a Tabula ETF. Here, we see how adding this premium to a bond portfolio could improve risk-adjusted returns.

A persistent volatility risk premium in CDS markets

Although the CDS index options market is highly liquid, with daily turnover of over \$20bn, buyers typically outweigh natural sellers. Buyers include asset managers, bank CVA and loan desks and insurance companies seeking to hedge credit risk or meet regulatory capital requirements. Sellers are limited by high barriers to entry: CDS options trade OTC and are not centrally cleared, so they require ISDA contracts and specialist execution capabilities. As a result, implied volatility is typically higher than realised volatility. This differential in implied vs realised volatility constitutes the volatility risk premium, and tends to be higher than in equities, where options are listed and are widely traded by systemic strategies:

The volatility risk premium is consistently higher for credit than for equity



Source: J.P. Morgan/Bloomberg, March 2019

Capturing the credit volatility premium

Despite the high barriers to entry, credit volatility is becoming more accessible via specialist indices and ETFs. The J.P. Morgan Global Volatility Premium Index (JCREVOLP) seeks to capture the implied versus realised premium by selling option strangles on the iTraxx Crossover and CDX HY indices. To minimise market risk, it delta hedges daily.

A credit volatility premium strategy can be used to diversify an existing bond portfolio

Incorporating credit volatility in bond portfolios

We examine the impact of replacing a portion of a) a high yield portfolio and b) a 60% investment grade / 40% high yield portfolio with the JCREVOLP. In our model portfolios, which were rebalanced monthly, investment grade is represented by the Bloomberg Barclays Euro Aggregate Bond Index (LBEATREU), and high yield by the Markit iBoxx EUR Liquid High Yield Index (IBOXXMJA). The table shows 10 and 5 year performance characteristics for the three components:

10 year	Return (Ann.)	Vol	Sharpe Ratio	Max Drawdown
LBEATREU	4.25%	3.35%	1.23	-4.53%
IBOXXMJA	9.91%	7.63%	1.19	-9.50%
JCREVOLP	7.20%	6.32%	1.15	-9.00%
5 year				
LBEATREU	2.91%	3.03%	1.1	-4.35%
IBOXXMJA	3.01%	3.83%	0.91	-4.61%
JCREVOLP	2.94%	4.97%	0.72	-5.32%

Data: Tabula/Bloomberg, for 10 and 5 years to 28th February 2019. Past performance (actual or simulated) is not a reliable indicator of future returns.

Incorporating a credit volatility premium strategy resulted in higher risk-adjusted returns in both high yield and mixed portfolios

Case study 1: replacing 20% of a pure high yield bond portfolio

10 year	Return (Ann.)	Vol	Sharpe Ratio	Max Drawdown
Pure HY	9.91%	7.63%	1.19	-9.50%
80% HY/20% Credit Volatility	9.41%	6.70%	1.40	-7.73%
5 year				
Pure HY	3.01%	3.83%	0.91	-4.61%
80% HY/20% Credit Volatility	3.02%	3.50%	1.00	-3.46%

Data: Tabula/Bloomberg, for 10 and 5 years to 28th February 2019. Past performance (actual or simulated) is not a reliable indicator of future returns.

Case study 2: replacing half of the high yield component of a 60/40 investment grade/high yield bond portfolio

10 year	Return (Ann.)	Vol	Sharpe Ratio	Max Drawdown
60% IG/40% HY	6.55%	4.01%	1.54	-3.28%
60% IG/20% HY/20% Credit Volatility	6.02%	3.39%	1.67	-2.92%
5 year				
60% IG/40% HY	2.97%	2.64%	1.26	-3.02%
60% IG/20% HY/20% Credit Volatility	2.97%	2.46%	1.35	-2.70%

Data: Tabula/Bloomberg, for 10 and 5 years to 28th February 2019. Past performance (actual or simulated) is not a reliable indicator of future returns.

The first passive solution for tapping into credit volatility risk premia

Accessing credit volatility via ETF

The Tabula J.P. Morgan Global Credit Volatility Premium Index UCITS ETF allows a broader group of investors to take a position in credit volatility as a building block for diversified portfolios.

J.P. Morgan Global Credit Volatility Premium Index

- Sells options on iTraxx Crossover (75 European sub-investment grade names) and CDX HY (100 North American sub-investment grade names)
- Delta hedges daily to minimise market risk
- Rebalances monthly to an equal weight between iTraxx Crossover and CDX HY

Tabula J.P. Morgan Global Credit Volatility Premium Index UCITS ETF

- Tracks the performance of the index less fees
- Trades on the London Stock Exchange
- Transparent, liquid UCITS ETF enables medium to long-term positions
- First and only pure passive credit volatility risk premia fund

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