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

September 2019

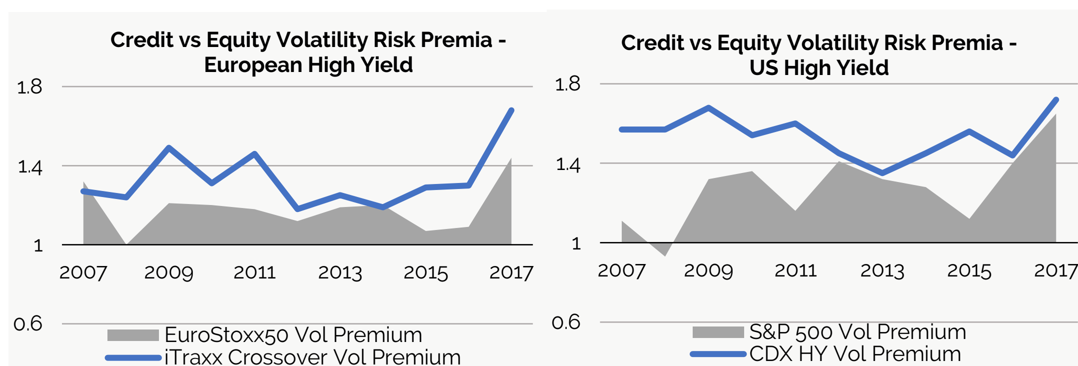
TABULA

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 drawdowns.

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 realized 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

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.

Incorporating credit volatility in high yield and mixed bond portfolios

We examined the impact of replacing a portion of a) a simulated high yield portfolio and b) a 60% investment grade /40% high yield simulated 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).

Replacing 20% of the high yield component with credit volatility resulted in lower drawdowns in both portfolios

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

10 year	Return (Ann.)	Vol	Sharpe Ratio	Max Drawdown
Pure HY	7.06%	5.98%	1.17	-9.50%
80% HY/20% Credit Volatility	6.84%	5.51%	1.23	-7.73%
5 year				
Pure HY	3.28%	4.00%	0.90	-4.61%
80% HY/20% Credit Volatility	2.92%	3.62%	0.89	-3.46%

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

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	5.55%	3.50%	1.55	-3.28%
60% IG/20% HY/20% Credit Volatility	5.32%	3.18%	1.64	-2.92%
5 year				
60% IG/40% HY	3.32%	2.80%	1.28	-3.02%
60% IG/20% HY/20% Credit Volatility	2.95%	2.50%	1.29	-2.70%

Data: Tabula/Bloomberg, for 10 and 5 years to 30th August 2019. Past performance (actual or simulated) is not a reliable indicator of future returns.

Accessing credit volaility 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

Visit tabulaim.com for full details.

Contact us

Phone +44 20 3909 4700
Email info@tabulaim.com
Tabulaim.com

Important Information

This ocument is issued by Cheyne Capital Management (UK) LLP ("Cheyne Capital") authorised and regulated by the Financial Conduct Authority ("FCA"), a limited liability partnership registered in England and Wales (Registered no. OC321484) Registered address: Stornoway House, 13 Cleveland Row, London, SW1A 1DH, United Kingdom. Tabula Investment Management Limited ("Tabula IM") is an Appointed Representative of Cheyne Capital. Tabula IM is a private limited company registered in England and Wales (Registered no. 11286661). Business address: 6th Floor, Denham Building, 27 St James's Street, London SW1A 1HA, United Kingdom. The Tabula J.P. Morgan Global Credit Volatility Premium Index UCITS ETF (EUR) (the "Fund") is an open-ended investment Fund with variable capital having segregated liability between their funds organised under the laws of Ireland and authorised by the Central Bank of Ireland. This material is for distribution to Professional Clients (as defined by the FCA or MiFID Rules) and Qualified Investors only and should not be relied upon by any other persons. Tabula has not considered the suitability of this investment against your individual needs and risk tolerance. The data displayed provides summary information, any decision to invest must be based solely on the information contained in the Fund's Prospectus, Key Investor Information Document and the latest half-yearly report and unaudited accounts and/or annual report and audited accounts, when available, free from your broker, financial adviser or Tabula Investment Management Limited. It is the responsibility of every person reading this document to satisfy himself as to the full observance of the laws of any relevant country, including obtaining any government or other consent which may be required or observing any other formality which needs to be observed in that country and which might be relevant to the subscription, purchase, holding, exchange, redemption or disposal of any investments. No provider of information presented here, including index and ratings information is liable for damages or losses of any type arising from use of their information nor breach of such legislation or for any losses relating to the accuracy, completeness or use of information in this communication, including consequential loss. No warranty of accuracy is given and no liability in respect of any error or omission is accepted. No sale will be made in any jurisdiction in which the offer, solicitation, or sale is not authorised or to any person to whom it is unlawful to make the offer, solicitation or sale. This document does not constitute an offer to sell or solicitation of an offer to buy interests in any product and may not be used to make such an offer. The information contained in this document, especially as regards portfolio construction/parameter-type information, reflects the current thinking of Tabula IM and may be changed or modified in response to its perception of changing market conditions, or otherwise, without further notice to you. Accordingly, the information herein, in respect of investment products and services, should be considered indicative of Tabula IM current opinion and should not be relied on in making any investment decisions. This document is not, and under no circumstances is to be construed as an advertisement or any other step in furtherance of a public offering of shares in the United States or Canada. This document is not aimed at persons who are resident in the United States, Canada or any province or territory thereof, where the Fund/securities are not authorised or registered for distribution and where no prospectus has been filed with any securities commission or regulatory authority. The Fund/securities may not be acquired or owned by, or acquired with the assets of, an ERISA Plan. Investment in the products mentioned in this document may not be suitable for all investors. Past performance is not a guide to future performance and should not be the sole factor of consideration when selecting a product. The price of the investments may go up or down and the investor may not get back the amount invested. Your income is not fixed and may fluctuate. The value of investments involving exposure to foreign currencies can be affected by exchange rate movements. We remind you that the levels and bases of, and reliefs from, taxation can change. In respect of the products mentioned this document is intended for information purposes only and does not constitute investment advice or an offer to sell or a solicitation of an offer to buy the securities described within. In Switzerland, the Fund may only be offered or distributed to qualified investors. The Fund's Representative in Switzerland is Oligo Swiss Fund Services SA, Av. Villamont 17, 1005 Lausanne, Switzerland, Tel: +41 21 311 17 77, email: info@oligofunds.ch. The Fund's paying agent is Banque Cantonale de Genève. Any Fund Documentation may be obtained free of charge from the Swiss Representative. In respect of the Shares distributed in or from Switzerland, the place of performance and jurisdiction is Lausanne (Switzerland).

Benchmark source: the J.P. Morgan Global Credit Volatility Premium Index referenced herein is the property of J.P. Morgan Securities PLC and is used under license. The J.P. Morgan Global Credit Volatility Premium Index (the "Index") has been licensed to Tabula Investment Management (the "Licensee") for the Licensee's benefit. Neither the Licensee nor the Tabula J.P. Morgan Global Credit Volatility Premium Index UCITS ETF (the "Non-JPM Product") is sponsored, operated, endorsed, recommended, sold or promoted by J.P. Morgan Securities plc ("JPMS plc") or any of its affiliates (together and individually, "JPMorgan"). JPMorgan makes no representation and gives no warranty, express or implied, to investors in or those otherwise taking exposure to the Non-JPM Product. Such persons should seek appropriate professional advice before making any investment. The Index has been designed and is compiled, calculated, maintained and sponsored by JPMS plc without regard to the Licensee, the Non-JPM Product or any investor. JPMS plc is under no obligation to continue compiling, calculating, maintaining or sponsoring the Index. JPMorgan may independently issue or sponsor other indices or products that are similar to and may compete with the Index and the Non-JPM Product. They may also transact in assets referenced in the Index (or in financial instruments such as derivatives that reference those assets). These activities could have a positive or negative effect on the value of the Index and the Non-JPM Product.

© 2019 Tabula Investment Management Limited.