HOW YOU COULD HAVE MITIGATED THE CORRECTION IN US EQUITIES IN THE FOURTH QUARTER OF 2018

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Last year finally broke the 9-year bull run in equity markets.

That length has only been matched once since 1950's[1]. Most of this bull run was accompanied by extraordinary low volatility for equities. In 2017, the Cboe SPX Volatility Index (hereafter VIX Index) – dubbed as a measure of markets expectation for forward volatility – traded at close to 10, which is about half its long-term average of 20. And then the end of 2018 happened.

Below I cover what measures could have been taken to avoid the bloodbath in equity markets that we have been seeing since Q3 of 2018.

The WisdomTree Cboe S&P 500 PutWrite UCITS ETF (ticker: PUTW) tracks the total return performance, before fees and expenses, of the Cboe S&P 500 PutWrite Index (hereafter PUT Index). This index, broadly speaking, is designed to sell European style put options with 1-month maturity on the S&P 500.

The PUT Index has an established track record of handling stress and potentially reducing significant risk when comparing to the volatility of the S&P 500.

Let's see how it performed in 2018.

Out of total 63 trading days in Q4 2018, the S&P 500 had 38 negative trading days. The true test of any volatility-reducing strategy lies in its relative performance on negative days. The following table compares the PUT Index's performance to the S&P 500.

[1] Dates: 31 December 1990 – 31 December 1999. Source: Bloomberg and Standard & Poors

FIGURE 1: CHARACTERIZING THE 4TH QUARTER OF 2018 BY POSITIVE & NEGATIVE TRADING DAYS OF THE S&P 500

	Days When S&P 500 Closed Negative	Days When S&P 500 Closed Positive
Total # Days	38	25
Days Where PUT Index Lagged S&P 500	4	22
Average S&P 500 Return	-1.10%	-1.14%
Average PUT Index Return	-0.86%	0.85%
Average Daily Downloads Protection by PUT Index Relative to S&P 500	-0.24%	

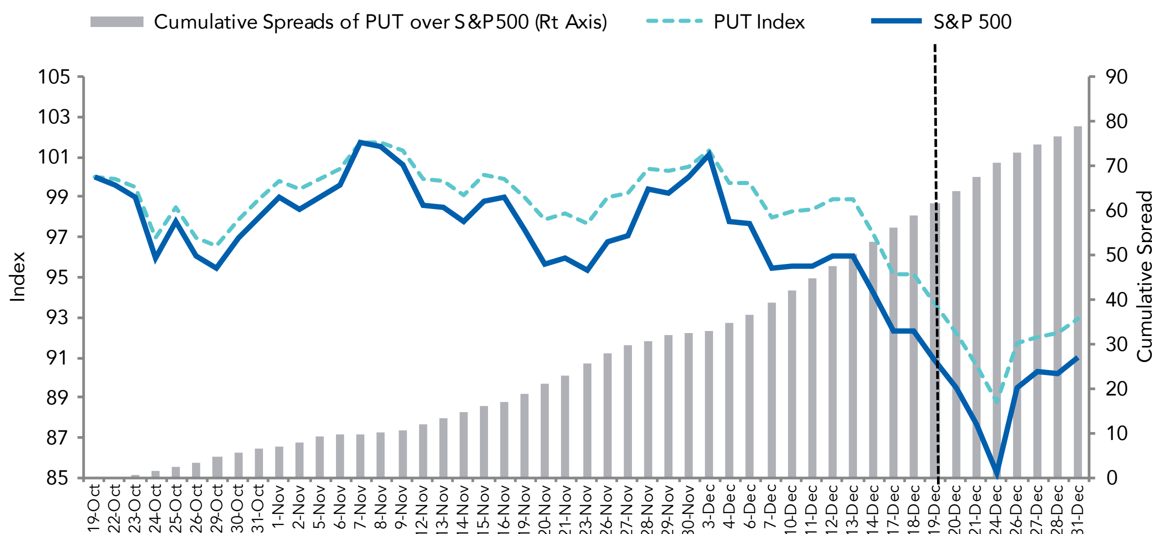
Source: Bloomberg, with data from 30 September 2018 to 31 December 2018. **Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly in an index.**

Quick takeaways:

- The PUT Index outperformed S&P 500 on 34 of 38 negative days.
- On an average it delivered a downside protection of ~24 bps each one of those down days. Taking a deeper look

Below figure shows the three phases of Q4 2018, specifically for the PUT Index and the S&P 500.

FIGURE 2: CHARACTERIZING THE CUMULATIVE DIFFERENCE IN RETURNS BETWEEN THE PUT INDEX & S&P 500 DURING THE 4TH QUARTER OF 2018



Source: Bloomberg, with data from 19 October 2018 (date of sale of first monthly option during the fourth quarter of 2018) to 31 December 2018. **Historical performance is not an indication of future performance and any investments may go down in value. You cannot invest directly in an index.**

- In Phase 1, volatility did increase, but the starting level and finishing level of the S&P 500 over this phase was not extremely different. It's important to consider that the S&P 500 hit its record high closing price on 3 October 2018, so after this date the VIX Index did tend to increase and the market started to exhibit a series of sharp corrections and recoveries, each a few days in duration.
- Phase 2, by rolling into the second option of quarter when the VIX has spiked (owing to the correction in October 2018), the PUT Index collected a richer premium, which helped the total return build over the S&P 500.
- Finally, in Phase 3, as the PUT Index sold its third option for the quarter, the buildup of previous outperformances and elevated volatility ensured that the PUT Index continued to outperform the S&P 500 Index, even when there was a mild rally in equities towards year's end.

CONCLUSION

There is a popular saying, "When the going gets tough, the tough get going." I think similarly true colors of any risk-reduction strategy are not revealed on days when markets are hunky-dory; rather they come on volatile and stressful days.

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