

# GRANT'S

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### For steeper and choppier

Low volatility and a flat yield curve are the steady states of being in fixed income today. The Interest Rate Volatility and Inflation Hedge ETF (IVOL on the Big Board), which started trading on Tuesday, is for anyone who expects, or dreads, a reversal of those familiar conditions.

“The main thing we’re doing,” the progenitor of the fund, Nancy Davis, tells colleague Fabiano Santin, “is options on the shape of the yield curve. So it is long fixed-income vol. We make money in a steeper environment or when interest-rate vol increases.”

Davis, an alumna of Goldman Sachs (where she once headed credit, derivatives and over-the-counter trading in the firm’s proprietary trading group), founded Quadratic Capital Management, LLC in 2013. Quadratic, of Greenwich, Conn., specializes in asymmetric options strategies—when you win, you win big, but when you lose, you lose small, is the theory of the thing.

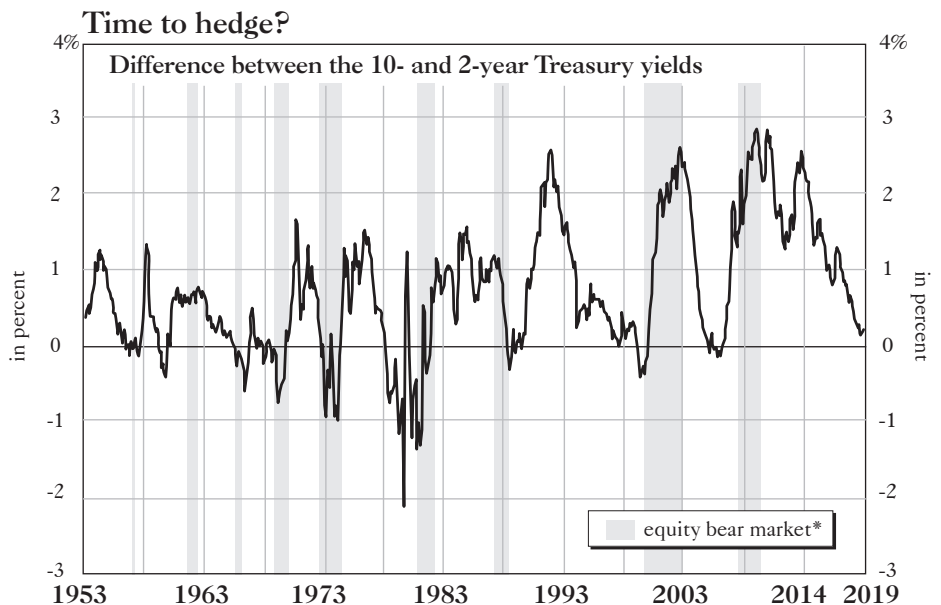
Davis says that IVOL will invest at least 80% of its assets in TIPS, the Treasury’s inflation-protected securities. It’s not something that she’s especially happy about, but, she says, to conform to the dicta of the Investment Company Act of 1940, a fund must hold substantial liquid assets. The business part of IVOL is the residual 20%, the portion devoted to options whose value varies with the shape of the yield curve.

IVOL charges a fee of about 1%. Investors can expect to receive a monthly check consisting of their pro rata share of the income generated by the TIPS and the capital gains (if any) thrown off by the options.

Santin provides some words of warning: “If the yield curve inverted or remained flat, those steeper options could expire worthless—perhaps, for that reason, the fund is better seen as a hedge than as an investment. Then, too, TIPS could sell off as inflation expectations rise. That would occur in the context of a rise in real yields from the 0.5% currently prevailing—a 100 basis-point rise in the yield on TIPS would cost the investors up to 7.4% based on the duration of the TIPS portfolio and the fund’s exposure to it. (Davis is using off-the-shelf TIPS exposure furnished through Charles Schwab’s TIPS exchange-traded fund, SCHP on the NYSE Arca.)

“Ideally, however,” Santin continues, “in such a scenario the investor would more than offset these losses with gains in the option portion of the fund—which would also consequently make the roughly 1% management fee look negligible.”

As the fund is actively managed, Davis is free to cherry-pick points in the yield curve that she thinks will widen. With that said, she tells Santin, she expects to concentrate on the difference between the 10- and 2-year Treasuries. As IVOL debuts and as *Grant’s* goes to press, that spread stands at 21 basis points, lowest since 2007. Historically, during heavy equity sell-offs, the curve steepens—the 1987 crash being a notable exception (see the nearby graph).



\*A market with a peak-to-trough greater than 20% over trailing one year of the S&P 500 Index.  
source: Quadratic Capital Management, LLC

A more hopeful precedent was the steepening between August and November 2007—in four months, the difference between the 10- and 2-year yields widened by 80 basis points, to a full percentage point. Such a lurch, should it occur today, could deliver a fourfold return on the option portion of the investment (even without reckoning on the gains to be harvested from a potential parallel increase in implied-options volatility). Or, if the gods frown, the curve could freeze and one's money could go to options heaven.

“The vol that we're buying is significantly cheaper than any of the

listed type,” says Davis, who spent a year designing the fund. “If you look at the listed options market for Treasuries, or the TLT (iShares Barclays 20+ Year Treasury Bond ETF), it's 2½ times more expensive than the vol that we're buying over the counter. It's the first ETF to access the OTC options market.”

For the pricing distortion between the OTC yield-curve options in which her fund invests, on the one hand, and the exchange-listed kind, on the other, says Davis, you may blame, or credit, yield-deprived people. High-net-worth Asians buy so-called range

accrual notes, Davis relates, securities that express the idea that interest rates will remain in place. The western Pacific income-seekers “think that they are buying a bond, but they are just selling vol.”

Of her own fund, Davis says, “You see that you can win by vol increasing, and you can win by the curve steepening, and it is wild asymmetry. The cool thing about this is its tail-like payoff in a normalization world. The curve steepening to 50 basis points or 75 basis points is not some radical black-swan event. It is just a normalization of reality.”



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