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MARKETS

Volatility in Stocks Could Unravel Bets on Calm Markets

Computer-driven funds amassed big equity positions while markets were sleepy

By Michael Wursthorn and Akane Otani

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Recent swings in the stock market are threatening to unravel multibillion-dollar bets that rely on calm markets, potentially adding to investors' jitters over the past week.

Computer-driven volatility-targeting funds generally scoop up riskier assets like stocks during calmer periods, hoping to gain as markets grind higher. When volatility hits, it sends them scrambling to sell their stocks and move into safer assets like Treasurys. Asset managers like Vanguard Group and insurance companies run some of the bigger strategies of this type.

Because markets have been so quiet this year, with the exception of episodes like last Tuesday's trade-driven pullback, the funds are especially loaded up on stocks. That has left volatility-targeting funds carrying the highest level of exposure to U.S. stocks since the fall, a troubling sign for those who believe the funds exacerbated some of the market's worst selloffs in 2018.

Volatility-targeting funds had an estimated 44% equity exposure Tuesday. That marked their highest level of equity exposure since early October, when they had a more-than 60% exposure to stocks, according to Pravit Chintawongvanich, an equity derivatives strategist at Wells Fargo Securities.

After stocks tumbled Tuesday, Mr. Chintawongvanich estimates those funds sold about $10 billion in stocks a day later, knocking their allocations down to 41%—still around their highs for the year.

"If the next spike [in volatility] is higher, then you'll see a more extended downmarket and we'd remove equities. You can get easily whipsawed," said Duy Nguyen, a portfolio manager and chief investment officer of Invesco Solutions who helps manage these strategies.

That is especially true because analysts estimate volatility-targeting funds manage as much as $400 billion in assets—giving them considerable heft in the stock market.

To be sure, small bouts of volatility—like Tuesday's selling—wouldn't necessarily spur major changes within volatility-targeting funds, money managers said. Instead, they could actually boost returns because many of the funds tend to focus on stocks that have a lower level of volatility than the broader market.

And few analysts believe the bull market is necessarily in danger of an imminent end. U.S. economic data have pointed to steady, if moderating, growth. Inflation has also continued to be muted, which traders believe will allow the Federal Reserve to keep interest rates low.

Besides that, trade tensions ratcheted down by the end of the week after Treasury Secretary Steven Mnuchin said negotiations with Chinese officials were "constructive." The Cboe Volatility Index, or VIX, fell 16% Friday, while the S&P 500 added 0.4%. The S&P 500 still fell 2.2% over the week, its worst weekly performance since late December.

But critics argue that such funds, along with the growing prevalence of automated trading, have altered the market's natural tendencies, from sharpening moves in the S&P 500 to fueling historic stretches of tranquility, like in 2017.

With dozens of volatility-targeting funds employing similar, but nuanced, automated approaches around insulating investors from the stock market's shocks, they typically sell stocks simultaneously during the worst downdrafts, analysts said. The group's equity allocations swung from 83% in late December 2017 to 21% in February following 2018's early selloff, according to Wells Fargo. Allocations rose again in subsequent months, hitting 67% in early October, before the market's decline, and bottomed out at 16% in late December.

Those moves weren't spread over a long period. Instead, funds sold most of those assets over a few trading sessions, making their impact on the market that much more apparent, analysts said. If Tuesday's decline had been more severe, on the scale of a 3% pullback in the market, Wells Fargo estimates that volatility-targeting funds would have sold roughly $36 billion worth of stocks.

That pales in comparison to October, when stocks began their fourth-quarter plunge, draining more than $100 billion from volatility-targeting strategies in a short span, Mr. Chintawongvanich said.

"You can see these funds moving together," said Damian McIntyre, a portfolio manager at Federated Investors, who manages a volatility-targeting fund that is near the top of its equity-allocation range. "That can exacerbate any selloff and add a couple percentage points to the pullback."

In some ways, the worries cropping up about volatility-targeting funds reflect broader concerns that investors have gotten complacent after a broad market rebound.

Because investors have grown increasingly confident that risky assets will extend their rise, some traders worry that unexpected developments like a further breakdown of trade talks or disappointing economic data could send markets sharply lower.

Stocks, commodities and even ultrarisky assets like bitcoin have jumped this year, thanks to central banks signaling a pause in their rate-increase campaigns and global growth showing some signs of stabilizing. The S&P 500 has risen 15% this year, extending gains after logging its best quarterly performance since the financial crisis. U.S. crude-oil prices have soared 36%, and bond yields, which fall as prices rise, have retreated from the multiyear highs they hit in 2018.

The rally has encouraged investors to pour money into riskier corners of the market while betting on declines in so-called haven assets. Individual investors have also grown more confident that stock prices will continue climbing, according to the American Association of Individual Investors, whose most recent weekly survey showed above-average levels of bullishness.

“We may not be getting close to the top, but it looks like we’re getting close to the end of the pendulum where the market has gone a bit too far one way,” said Frank Cappelleri, senior equity sales trader and chief market technician at Instinet.

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