Contango In UVXY Explained One More Time

Apr. 28, 2016 4:01 PM ET | **ProShares Ultra VIX Short-Term Futures ETF (UVXY)** | SPY |
24 Comments

The Mad Hedge Fund Trader
13.19K Followers

Summary

> There’s nothing like a swift kick in the shins, a slap in the face and a good boxing of the ears to give you a healthy dose of humility.
>
> That’s how holders of the ProShares Ultra VIX Short-Term Futures ETF feel right about now. This is the popular ETF that rises when the S&P 500 falls.
>
> “Markets can remain irrational longer than you can remain liquid,” as my mentor, the legendary economist and early hedge fund trader, John Maynard Keynes, used to say.

There's nothing like a swift kick in the shins, a slap in the face and a good boxing of the ears to give you a healthy dose of humility.

That's how holders of the ProShares Ultra VIX Short-Term Futures ETF (BATS:UVXY) feel right about now. This is the popular ETF that rises when the S&P 500 (SPY) falls.

"Markets can remain irrational longer than you can remain liquid," as my mentor, the legendary economist and early hedge fund trader, John Maynard Keynes, used to say. I know this because it is inscribed on a post it note taped to my screen.

This was only made possible by the Volatility Index falling to the $12 handle, the low for the year.

To see this happening with stocks at an all time high is nothing less than amazing. The VIX seems to be telling us that stocks are going sideways to up for the rest of the year.

I'll believe it when I see it. Trees don't grow to the sky.

The reason this fund can only fall over the long term is because of the ***contango*** that permanently haunts it. While the front month Volatility Index (VIX) is trading at $13.92 today, three-month volatility is at a lofty $20.

The buys three month volatility and runs it into expiration. It then exacerbates this negative impact with 2X leverage. The guaranteed loss on this trade is therefore $3.37 X 2, or 43.5%. It is a perfect money destruction machine.

Do this every month, and eventually you use up all your capital. You see this most clearly on the long-term split adjusted chart below, which has it going from $30,000 to $42.33 in only three years, a loss of 99.9%.

This is why you should only hold the position for a few days or weeks at the most, and even then to hedge long positions in other stock or indexes.

You only want to own and the VIX during the brief, frenzied volatility spikes that occur, as we did with the last trade.

You might want to ask the question, "Why aren't we shorting this thing?"

The VIX is prone to sudden, extreme moves to the upside whenever an unforeseen geopolitical or economic event takes place, such as a terrorist attack or a bad monthly nonfarm payroll number.

It can double in days, as traditional long side investors who are unable to sell short stocks or futures rush to buy some downside protection. It has done this a few times in the past year. During the crash, the VIX ratcheted all the way up to $90.

Often you get large moves of 20% or more right at the opening, as professional traders, who are almost always short volatility, rush to cover short positions, all at the same time. As a result, many of the people who try this strategy often go bust.

On top of this, your broker is unlikely to extend the margin you need to put on a decent position, especially to beginners.

The concern is that when the customer wipes himself out, they will take a piece of the broker's capital with it. Customers who lose money in this way often end up suing their broker, another turn off.

The people who do make money at this tend to be large teams of very experienced traders with massive computer and programming support executing complex, state of the art risk control algorithms.

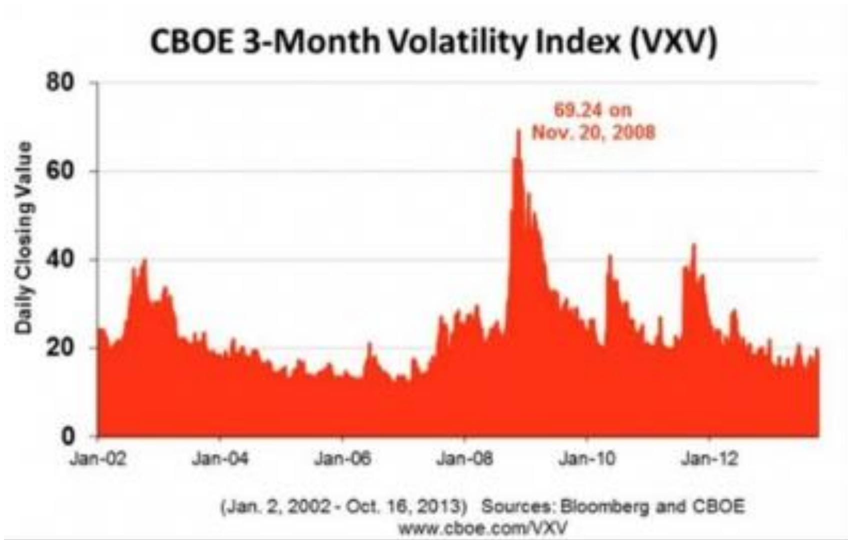
It costs millions of dollars to put all this together.

Needless to say, you should not try this at home.

Maybe the market is trying to tell me something. Like, quit looking for a seat after the music stops playing. Don't trade if there is nothing there.

This is why I have backed off to a very rare 90% cash position, which I hate. Nobody pays you to hold cash.

It looks like it is going to be a long summer.




$VIX Volatility Index - New Methodology INDX
©StockCharts.com
26-Apr-2016
Open 14.01 High 14.43 Low 13.66 Close 13.92 Chg -0.16 (-1.14%)
RSI(14) 45.56
$VIX (Daily) 13.92
MA(50) 16.27
MA(200) 18.54
Volume undef
MACD(12,26,9) -0.713, -0.846, 0.133
26 Nov 9 16 23 Dec 7 14 21 28 2016 11 19 25 Feb 8 16 22 Mar 7 14 21 28 Apr 11 18 25


UVXY ProShares Ultra VIX Short-Term Futures ETF NYSE
© StockCharts.com
26-Apr-2016
Open 15.51 High 15.72 Low 15.00 Close 15.24 Volume 28.7M Chg -0.65 (-4.09%)
RSI(14) 33.75
UVXY (Daily) 15.24
MA(50) 26.31
MA(200) 34.99
Volume 28,682,746
MACD(12,26,9) -2.959, -3.181, 0.221
Nov 9 16 23 Dec 7 14 21 28 2016 11 19 25 Feb 8 16 22 Mar 7 14 21 28 Apr 11 18 25

This article was written by

The Mad Hedge Fund Trader

13.19K Followers

John Thomas is a 50-year veteran of the financial markets. He spent 10 years as a financial journalist, ten more years trading for a major investment bank, and another decade running the first dedicated international hedge funds. Seeing the incredible inefficiencies and severe mispricing offered by the popping of multiple bubbles during the Great Crash of

Show More

Analyst's Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it. I have no business relationship with any company whose stock is mentioned in this article.

Comments (24)

Newest

aresquared 10 May 2016

Comments (867)

"Hey, how about short selling the UVXY with a long time approach? Not too much, so you are able to sit out spikes to the upside, but in the end you would always win. There must be a catch however,"

The catch is simply the excess margin held has an opportunity cost.
You must balance your return on capital vs risk of blowing up.
Blowing up here is not limited to your whole portfolio, those dollars are in competition with your other investment ideas for the life of your continuous short.

Reply Like

theblackorwhite 10 May 2016

Comments (3)

Hey, how about short selling the UVXY with a long time approach? Not too much, so you are able to sit out spikes to the upside, but in the end you would always win. There must be a catch however, even though I can't see one. Any ideas why this shouldn't work?

Reply Like (1)

Scoe 15 May 2016

Comments (419)

"Short and Hold" UVXY strategy has produced a lower Sharpe ratio than just buy and hold SPY.

"But in the end you would always win."

Really? How about that VIX of 151 in October of 1987? Or Vix of 85 in Oct 2008?

Being 10xSPY in those scenarios will be curtains.

If you trade it super-small, you won't make any money. If you trade it bigger, you'll go broke.

Reply Like

B **ben markuson** 21 May 2016

Comments (2)

if you have the stomach and the capital, then your target will ultimately be zero. Just look at CVOL which is redeeming this week at. 30 a share. I mainly trade options, but if you we're to short, short with cash and no margin on a spike and run a spread or protective strat to give yourself room (time) for the backwardation to flatten and head back towards contango. the times I have done exactly what you mention I have used 3 to 6 months of protection while I leg into a bigger short position depending on the VIX futures near the middle of the curve.

Reply Like

B

Brian Manuel

30 Apr. 2016

Comments (5)

Keynes was his mentor? yikes!!

Reply Like (2)

GreenPirate

29 Apr. 2016

Comments (10.39K)

Short term investments whenever markets fall. That's what its useful in. Nothing more.

Reply Like (2)

Scoe

29 Apr. 2016

Comments (419)

First, the VIX is not denominated in dollars. It is an index.

Second ... "...The guaranteed loss on this trade is therefore $3.37 X 2, or 43.5%. It is a perfect money destruction machine."

There is nothing at all guaranteed about this...The vix is already up to 17 today from the 12 you cite and can easily make the futures target of 19 in the next couple of months.

Reply Like (1)

Surfman007

29 Apr. 2016

Comments (12)

Obviously there will be spikes, the author pointed this out. He is absolutely correct about how contango perpetually screws UVXY. This and a few other leveraged etf's suffer this perpetual downtrend, even with those spikes which make novice investors salivate. These etf's are the roulette of investments, and the house always wins.

Reply Like (2)

aresquared 30 Apr. 2016

Comments (867)

In this case "uvxy" Proshares is the house but there's no reason they should be the only ones to profit from it.

It's nothing like roulette unless you insist on being long only.

Quite frankly it's been my experience, most of the time that people compare investing with games of pure chance:they have that disposition out of pure ignorance and sometimes people rather revel mightily in their ignorance than be educated out of it.

esp with respect to leveraged products.

Reply Like (1)

Scoe 01 May 2016

Comments (419)

"He is absolutely correct about how contango perpetually screws UVXY"

No he isn't. If that was the case then shorting UVXY would have a higher Sharpe ratio than being long SPY. But it doesn't.

UVXY has a beta of about -10. In a bull market, that is a "money destruction machine".

Reply Like (2)

See More Replies

BenBminnesota 29 Apr. 2016

Comments (390)

I would respect you more if you would proof read your posts although I know enough to read around the mistakes it is a little unprofessional. This is the second time I have had to interpret your stuff. I think it is good but Please check for a missing words or reference. If you want examples I say just try reading what you wrote.I think you mean the (UVXY) you wrote The buys three month volatility and runs it into expiration.see dangerous and just sloppy. Pretty sure you shoot form the hip.Not a lot of stuff here.

Reply Like (3)

Advill 29 Apr. 2016

Comments (2.4K)

Really?....if you think things are business as usual, wait and see,

Will write to you then,

Reply Like

Mamm0n 28 Apr. 2016

Comments (101)

Another empty piffle, there are many good articles on uvxy - this piece isn't worth reading.

Reply Like (9)

Scoe 29 Apr. 2016

Comments (419)

Agreed

Reply Like (1)

bobtcat2 28 Apr. 2016

Comments (3.71K)

Best case scenario for UVXY longs is a move to 32-34 area by September I think. Might happen on a double from here, or could go to 11 first then triple. I stand by 34 as the high for the rest of the year going forward.

Reply Like

M **minast** 28 Apr. 2016

Premium Comments (5)

Options can help one control UVXY risk.

Reply Like

VIX Strategies 28 Apr. 2016

Comments (225)

"You only want to own and the VIX during the brief, frenzied volatility spikes that occur, as we did with the last trade." - how do you time this?

Reply Like (2)

Bezerkeley Economic Insights 28 Apr. 2016

Premium Comments (304)

Great article, although your comment about being "90% cash" seems contrary to an article you posted just days ago about the bull market having 2 years to run. Let me just say that I'm much more aligned with being heavy cash right now.

Reply Like (1)

L

Lump Coal 28 Apr. 2016

Comments (175)

It's very good that finally someone mentions contango. This guy explained it well and across many assets - http://bit.ly/1T6UbJ4
good job with your article

Reply Like (2)

snowcoat 28 Apr. 2016

Comments (75)

That is an excellent speech, thanks for sharing !

Reply Like

Denis III 05 May 2016

Comments (8.7K)

Not in English, you like this author (sic) and Lump Coal. 3 strikes.

Reply Like

Disagree with this article? Submit your own. To report a factual error in this article, click here. Your feedback matters to us!