Protect your oil exposure against volatility: using short ETPs as hedge overlays

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Of late, volatility has increased across asset classes, and this has been most noticeable in WTI Crude Oil, with implied volatility surpassing 50% - levels not seen since last year's crash in prices and representing a sizeable risk premium over other risk assets, including equities. It is likely to remain elevated for longer if China, the world's 2nd largest economy, cannot switch into a higher gear, fear will continue to grow amidst failed policy intervention so far. This has been largely ignored by markets in the second half of 2014, when crude oil futures fell almost 49% after OPEC raised production and geopolitical crises in the Middle East and Ukraine didn't not disrupt oil supplies.

Speculative positioning on crude oil has since remained historically elevated: about 27% of open interest in WTI Crude Oil on NYMEX is currently speculative, which is effectively more than doubling outstanding futures and options contracts held on a non-commercial basis since crude oil prices troughed at 45 USD/BBL in late 2008. Moreover, the hedge funds and prop desks remain overwhelmingly bullish on crude oil, as almost 70% of the 716K non-commercial futures and options contracts are held as long positions (i.e. commercial traders such as oil wholesalers/distributors are net short).

Amidst a clouded outlook on the direction of crude, an unwinding of speculative positions (currently 269K contracts are net long) or a significant build-up of bullish bets as a result of the sharp correction in oil prices is likely. Either scenario means that a significant portion of new money entering the NYMEX exchange to gain oil exposure to crude oil or existing money seeking an exit from oil exposure is likely to be driven by short term positioning.

There is reason to believe that against the uncertain macro backdrop, with China as the epicentre and the relative large speculative net long positioning, volatility in crude oil may stay elevated.

Investors with a strategic orientated long exposure to crude oil may consider creating a hedged overlay to protect their portfolios in this environment. Simple alternatives to derivatives such as options and futures are short ETPs, which can offer leverage factors of 1 or higher. Like is the case for all investment solutions, they are never free of costs, as there is no such thing as a free lunch. A short ETP tracking crude oil with a high leverage factor (such as -3x) requires less upfront capital to hedge the long exposure than short ETPs with a lower leverage factor (such as -1x). However, due to compounding, the former also requires monitoring and more frequent rebalancing to sustain the hedge than with the latter. Hence there is a trade-off between capital efficiency vs the frequency of rebalancing.

The chart above showcases an example of how a long position in crude oil could be hedged using a 1x short ETP tracking WTI crude oil. In this example, the long position in WTI crude oil is being fully hedged using the Boost WTI Oil 1x Short ETP (OILZ) as at 1 June 2015.

The capital invested in OILZ is equivalent to the long position, or a hedge ratio of 0.5 (Capital in OILZ / value of long and short position). In a buy and hold strategy, (i.e. no rebalancing) the portfolio would have become progressively over-hedged as, underpinned by slumping crude oil prices over June to August 2015, the value of the short position increases by more than loss in value suffered on the long position. The net effect is a cumulative gain of around 8% on 24 August when oil prices bottomed at US$ 44/bbl.

This is with the benefit of hindsight, of course. Instead, an investor could have chosen to rebalance its portfolio once the hedge ratio drifts too far off from the target hedge ratio of 0.5. Assuming the hedge ratio cannot drift more than 5% off the target, then over time investors would have reduced some of their short exposure to crude oil. The result is that the investor has protected its portfolio with a simple rebalancing strategy (dark green line in above chart). Both leveraged and unleveraged short ETPs can offer investors useful hedge overlays on long positions. Investors sharing this sentiment may consider the following ETP tracking the inverse daily performance of WTI crude oil:

- Boost WTI Oil 1x Short Daily ETP (OILZ)
- Boost WTI Oil ETC (WTID)

All data is sourced from WisdomTree Europe and Bloomberg, unless otherwise stated.

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