



Volatility

Understanding the Volatility Risk Premium

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The volatility risk premium (VRP) represents the compensation that investors earn for providing protection against unexpected market volatility. This paper first describes the VRP and the reasons why it may exist. We then explore its historical performance with a simple option-selling strategy and conclude by discussing approaches for including it in a portfolio.

What's Inside?

- The volatility risk premium (VRP) represents the reward for bearing an asset's risk (e.g., equity downside risk). Such protection in financial instruments is best represented by option contracts. The insurance risk premium in options reflects investors' risk aversion and their tendency to overestimate the probability of significant losses.
- We believe an investor can systematically exploit these risk preferences and behavioral biases through an option-selling strategy and we show how it may benefit investor portfolios over the long run.
- **Investors interested in adding the VRP to their portfolios can do so in a variety of ways. The strategy can be a stand-alone portfolio, one of multiple sleeves of a multi-alternative portfolio, part of a buy-write strategy, or part of a volatility-enhanced equity strategy.**

Conclusion

The VRP is the compensation that investors earn for providing protection against market losses. In doing so, they are underwriting insurance — primarily option contracts — and as with all insurance, the underwriter seeks a risk premium. We show that the VRP has historically tended to deliver strong risk-adjusted returns and that it may provide useful diversification within an investor's portfolio. Interested investors could consider adding the strategy alongside traditional long-only strategies or use it in conjunction with other non-traditional return sources.

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