

# Discussion of "Volatility Risk Premia and Exchange Rate Predictability" by Pasquale Della Corte, Tarun Ramadorai and Lucio Sarno

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Moscow, November 8, 2013

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  - ② DCRS provide empirical evidence that excess currency returns generated by the VRP strategy can be explained by the limits to arbitrage mechanism. Using proxies for funding liquidity and proprietary data on fund flows in the FX market DCRS demonstrate that VRP returns are significantly related to time-varying limits to arbitrage

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- Using JP Morgan data on OTC FX options on 20 currency pairs over Jan. 1996 - Aug. 2011 DCRS report negative volatility risk premium (-0.62 per cent) on the FX market. This is consistent with results on VRP for other asset classes

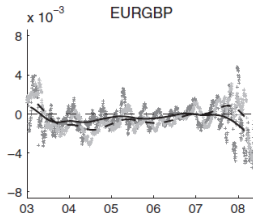
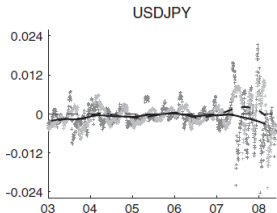
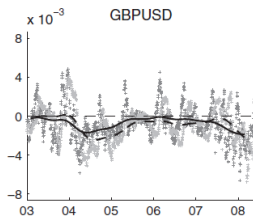
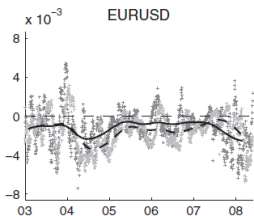


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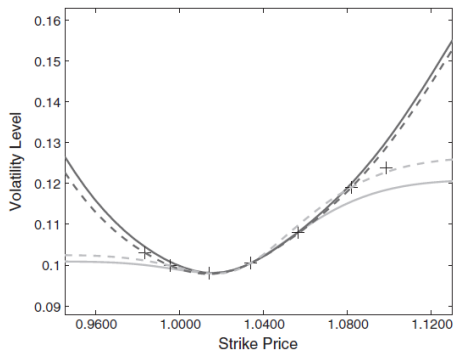
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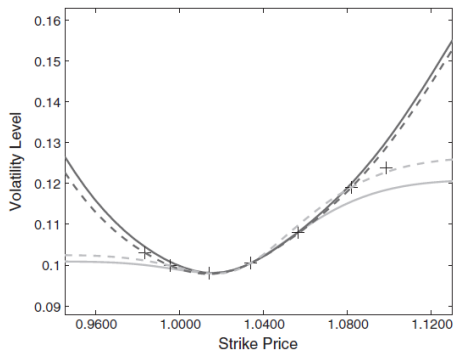
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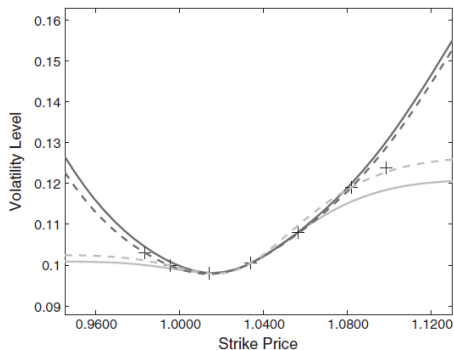


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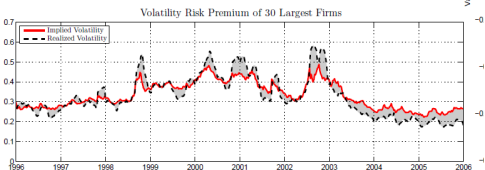
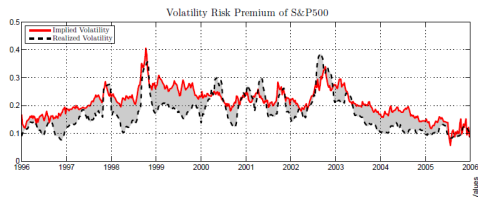
- DCRS use cubic spline and Garman and Kohlahagen (1983) valuation formula.
- Comment 1.** Perhaps as a robustness check of the baseline results authors could experiment with other methods of calculating the synthetic volatility swap rate

# Stock market volatility risk premia studies

- Carr and Wu (RFS, 2009); Driessen, Maenhout and Vilkov (JF, 2009), Buraschi, Trojani and Vedolin (JF, 2013) demonstrate that volatility risk premium is significantly negative for options on stock indices, however it is not very significant for options on individual stocks

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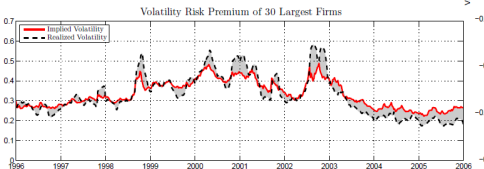
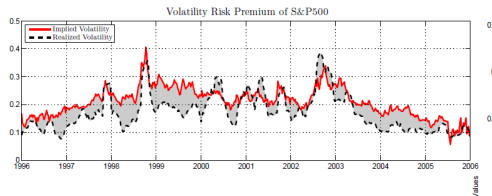
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- **Comment 2:** DCRS (and AB) demonstrate that VRP is significantly negative for individual currencies. It would be interesting to see the VRP for The MSCI Global Currency Indices. Sizable and significant VRP for individual currencies could be further investigated in another paper

# DCRS's baseline empirical result

- A trading strategy of buying currencies with cheap volatility insurance and shorting currencies with expensive volatility insurance and rebalancing the currency portfolio monthly generates an excess return of 4.03 per cent for the developed countries sample with Sharpe ratio 0.48

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- A trading strategy of buying currencies with cheap volatility insurance and shorting currencies with expensive volatility insurance and rebalancing the currency portfolio monthly generates an excess return of 4.03 per cent for the developed countries sample with Sharpe ratio 0.48
- The excess returns of the VRP trading strategy are modest compared to other common currency strategies but mostly come from the spot exchange rate predictability

# Limits to arbitrage mechanism

- Following Acharya, Lochstoer and Ramadorai (JFE, 2013) DCRS identify a group of "natural speculators" and a group of "natural hedgers". They argue that an exogenous shock to speculators' capital can generate observed empirical regularities between VRP and currency returns

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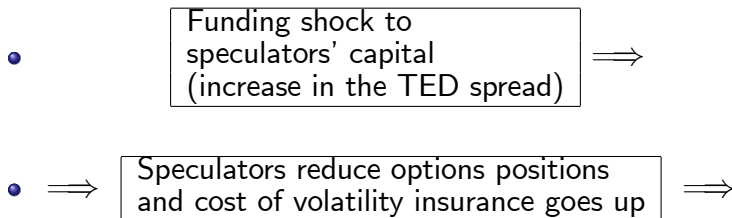
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| Funding shock to speculators' capital<br>(increase in the TED spread) |
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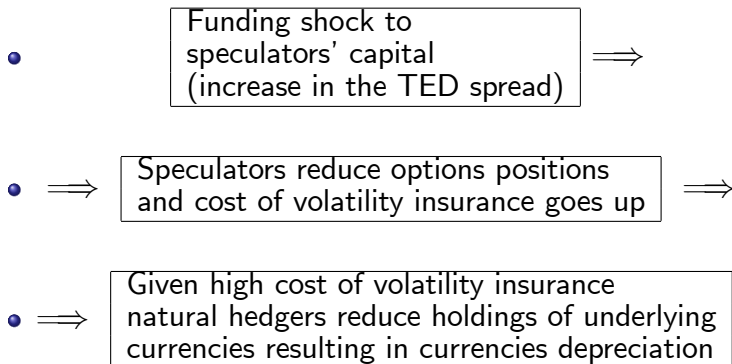
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## One more alternative explanation

- Nyborg and Osberg (forth., JFE) identify "liquidity pull-back phenomenon" in stocks. Tighter interbank market (funding shortage) is associated with selling pressure in more *liquid* stocks and transitory negative returns of more *liquid* stocks.

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- **Comment 3:** Can one control for currency liquidity in baseline regressions?

# FX Order Flow Data

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- **Comment 4:** An additional identifier of investors' country of origin will provide information on the currency in which they report their consolidated balance sheet. This would more precisely identify the direction of their hedging demand