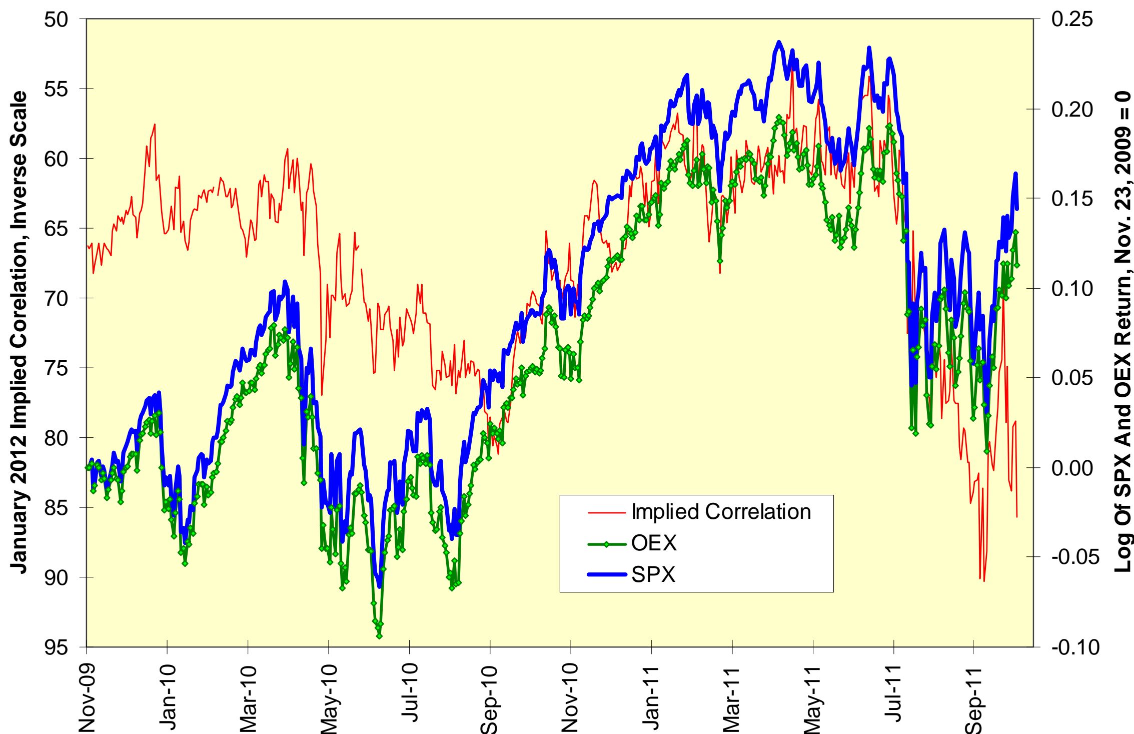
Implied Correlation Has Led To High Returns

Those of a libertarian bent, a category inclusive of bent Libertarians, know if society does not have enough real crime it will endeavor to create crimes by putting people in the pokey for character flaws such as reaching into the wrong medicine jar.

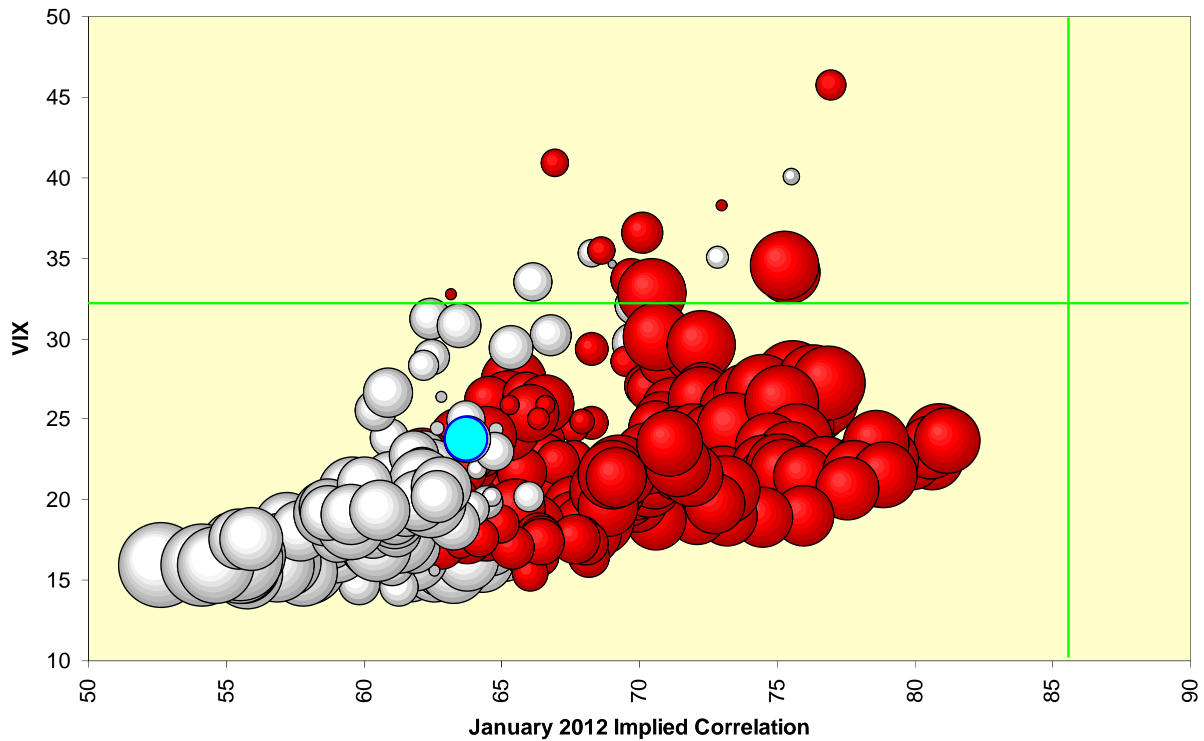
Really, though, how different is this from professional fund managers who, when they are not getting enough real frustration in the markets endeavor to create risks for themselves for the sole purpose of trading it? I had always placed variance swaps into this category; these are instruments you can employ to raise or lower the variance of your portfolio for no purpose other than to meet a completely arbitrary benchmark.

A cousin of these instruments is implied correlation as measured by a CBOE index of same you can read about here if you choose. The correlation mentioned is not the familiar correlation of price returns, but rather the, "changes in the relative premium between index options and single-stock options." Because the internal calculation of this measure expands exponentially with the number of stocks involved, the index is based on the fifty-largest capitalization stocks within the S&P 500 and therefore has price returns a little closer to the S&P 100 (OEX).

In addition, while the VIX is refreshed continuously by a roll-forward methodology, the implied correlation indices have finite forward dates. The one with the longest continuous history at present expires in January 2012. The implied correlation indices differ enough from the VIX in concept and methodology that I thought it would be useful to illustrate how it does not have as direct of an inverse relationship to either SPX or OEX returns presented on a logarithmic scale.



What it does have, at least in the two-year sample involved, is an apparent state-dependent ability to signal prospective returns. This ability increases with the lead-time involved; i.e. the three month-ahead relationship is stronger than the one month-ahead relationship and with the level of the VIX. Let's take a look at the three month-ahead returns for the SPX as a function of implied correlation and the VIX. Positive returns are depicted with red bubbles; negative returns with white bubbles and the diameter of the bubbles correspond to the absolute magnitude of the return. The current environment is marked with a green bombsight and the last datum used is highlighted in turquoise.



The moral of the story is high volatility and high implied correlation provide good entry points into the market; the opposite holds true as well, at least since November 2009. This is nothing more than a fancy way of saying "buy low and sell high." You do not need an overwrought implied correlation index to reach that conclusion yourself, nor do you need to trade manufactured risks. We should have learned where all of this fancy footwork leads, but we most certainly have not done so.