

Convertibles, Volatility And Turning Points

An old friend and mentor used to say, “The worst is never when you can say, ‘this is the worst.’” Each and every market downturn we go through has the feel of being the worst, but when we look back at the charts with the benefit of hindsight, we often have to strain to remember the cause of that particular painful episode.

Indeed, high-volatility selloffs are just part of the game and have the odd contribution to the market’s ecology of culling the weak and wounded from the herd. A selloff ends when the strongest buyers and the weakest sellers transact. The end result is ownership is transferred to investors who presumably have a longer-term outlook and maybe even deeper insight into the firms they bought.

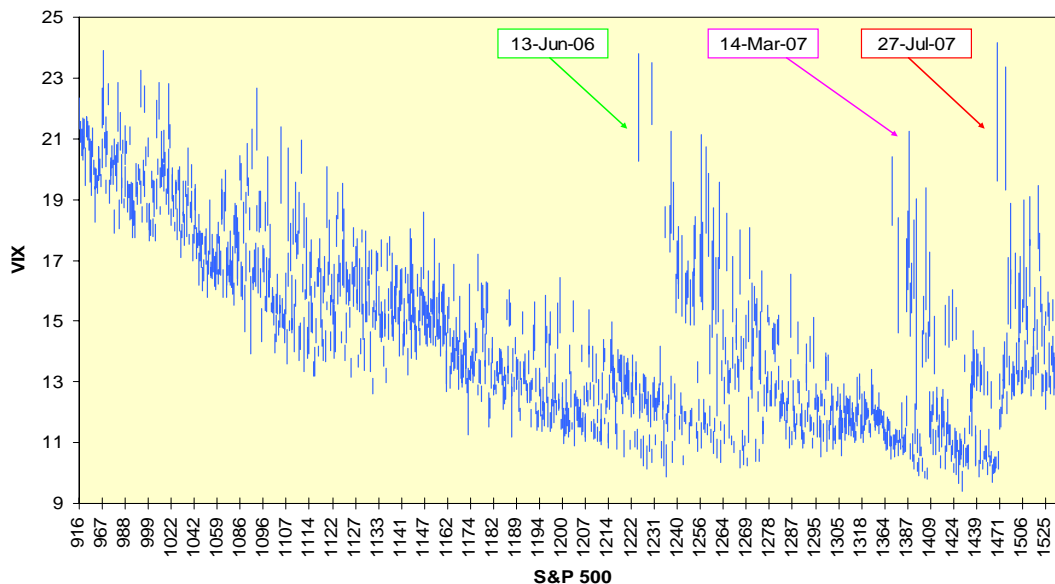
Regardless, high volatility contributes to a decline’s end by raising the cost of put option insurance. At some point investors look at the cost of the put options, calculate the time premium thereof and compare it to the potential decline in the stock to see whether buying puts makes sense. If the answer is no, they do not buy the put, and the option market makers who would have written those put options are not forced to sell the underlying stock as a hedge.

Price And Volatility Rising Together

A reporter asked me early last week to reconcile the rising level of the VIX with a stock market then just points away from its all-time nominal high. Implicit in the question was the oft-observed relationship between rising volatility and falling stock prices. I responded the 1995-1998 market was characterized by price and volatility rising together. Not only were many investors feeling nervous about the market’s level, options market makers were having to charge for the greater dollar risk they were assuming in their positions by virtue of the bull market. A one percent move in the market with the S&P 500 at 900 carried twice as much dollar risk as it did with the S&P 500 at 450.

I also recalled a chart I had done in early 1999 with the day’s range on the VIX mapped against the S&P 100 (OEX), then the basis for the volatility measure. It showed a very distinct pattern of a gradual decline in the VIX as price rose, a shock higher on some pullback now forgotten, and another decline as price rose. Here’s an updated version of that chart from May 1, 2003 onwards with the VIX’ range mapped against the S&P 500. Friday, July 27, is marked; Thursday, July 26 is to its immediate right.

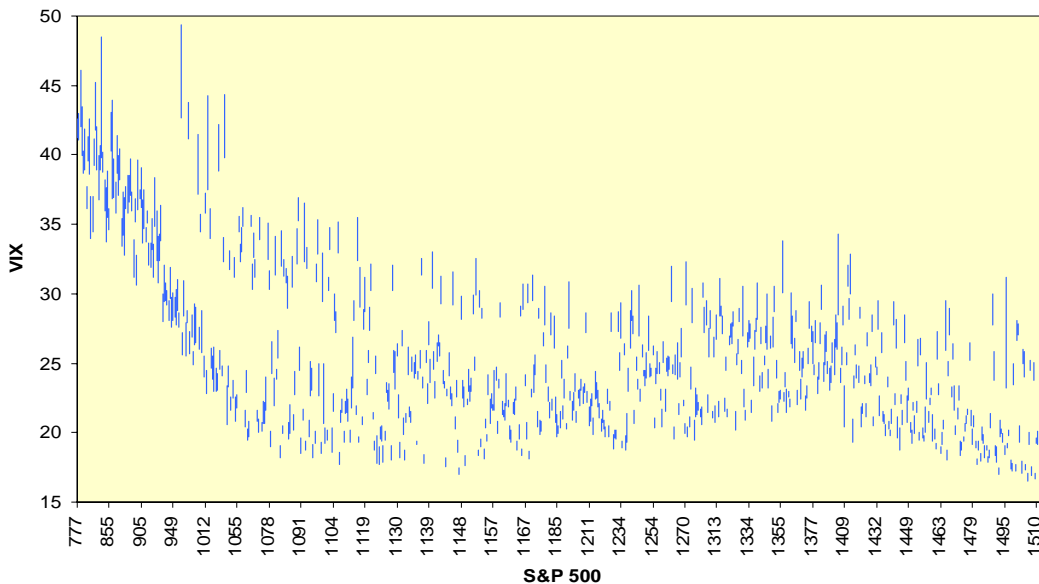
VIX Shock & Regress Since May 1, 2003



The pattern is identical to the one I constructed for the 1990s (not shown in the interests of space). Three pullback points in the market since June 2006 are noted; the previous two set the market up for the expected combination of volatility falling along with a rising index level. The post-March 2007 rally never saw the VIX decline to previous levels; like the 1990s market, option traders started to demand more insurance premium to ply their craft.

You may ask whether the pattern is different for a bear market, and the answer is, “Yes.” If we repeat the analysis for the March 24, 2000 – October 9, 2002 sample, we fail to see either the VIX jumps on pullbacks or the VIX declines on rallies seen in bull markets. Option traders are far less likely to sell volatility systematically when the next downturn could start tomorrow.

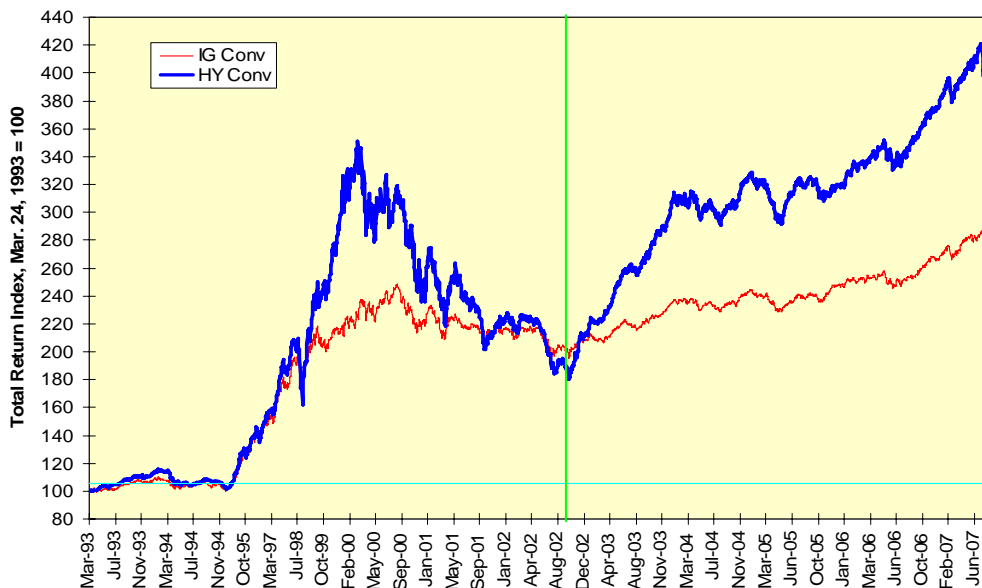
VIX Pattern During 2000 - 2002 Bear Market



Stocks And Convertibles

As promised in a [Columnist Conversation](#) posting, it is time to update an analysis from [June 2006](#) on the relationship between convertible bonds and stocks. As we are worried about credit spreads and deteriorating credit quality, let’s focus solely on high-yield convertibles as opposed to investment-grade convertibles. The two markets have performed very differently since October 2002. Investors in high-yield have been rewarded for their assumption of risk.

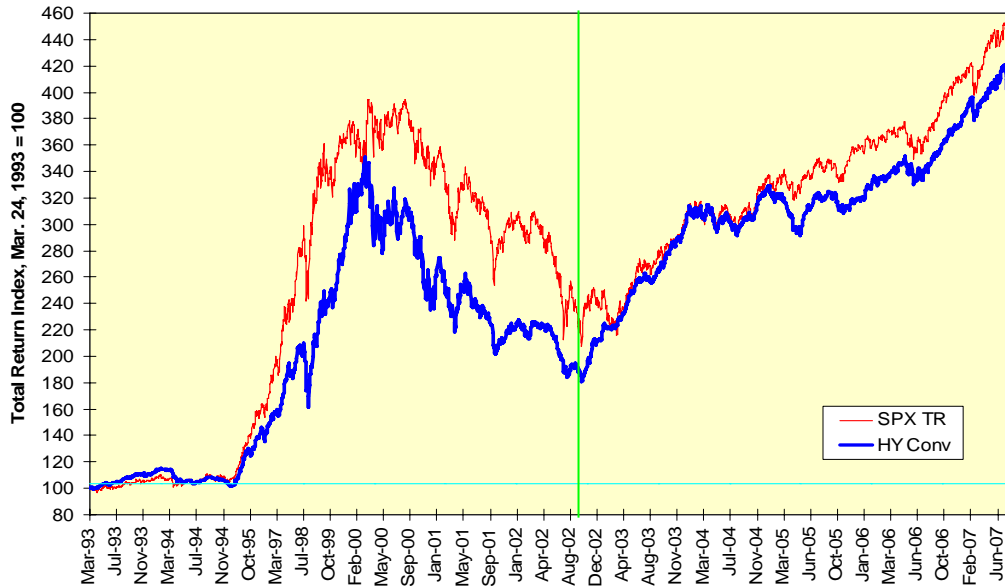
The Flight From Quality Worked



The average daily return for high-yield convertibles over this period has been .059%, more than twice the .027% return for the investment-grade index. The daily standard deviation of returns for the high-yield index was only 1.35 times as great as that of the investment-grade index, making high-yield convertibles a superior investment.

We can run the same comparison between the total return for the S&P 500 and that of the high-yield convertible index. The average daily total return for the S&P 500 over this period was .054%, and its daily standard deviation of returns was 1.75 times as great as the high-yield convertible index. Restated, the S&P 500 returned less and at a greater risk than did high-yield convertibles.

High-Yield Convertibles Outperformed Stocks In Bull Market



The key question at this stage becomes whether either stocks or high-yield convertibles lead the other. Over the entire available time sample, from March 24, 1993 onwards, the answer is, “No.” Over the set of “spike bottoms” in the S&P 500, the answer is different: Stocks bottom first and then lead the high-yield convertible market higher by an irregular interval, generally one to two weeks. This creates an interesting trading opportunity: Once stocks put in their characteristic spike bottom, you will have time to build into a position in high-yield convertible bonds.