Putting Volatility Into Perspective

As spring training gets underway in earnest, so will the fantasy leagues. Here otherwise grown men – I assume the majority of participants are male – create in their dreams what they cannot achieve in reality. At least they have the good sense to stay off the field.

Maybe we should start a fantasy volatility trading league. There all the wannabes who fantasize themselves volatility traders can sit glued in front of their computers and shout, "Market's down! Vol's up! I knew it!" That would be a darn sight more effective than actually trying to trade volatility outright with the instruments available. The conclusion reached here last June that friends don't let friends trade the VIX stands and is reinforced by the experiences of last week.

Just The Facts
Let's say you are one of those many traders who in hindsight have perfect foresight. You smelled last Tuesday's plunge coming a mile away. At the close of business on Thursday, February 22nd, you decided to cash in on your clairvoyance by buying March VIX futures at 111.50 when the cash Jumbo VIX closed at 118.6. You couldn't wait for tomorrow, and for all I know or care to know, you slept on a bearskin rug all weekend underneath an autographed portrait of Stephen Roach to bring bearish tidings to the market.

Tuesday comes, and the bulls find themselves standing on a gallows with ropes around their necks and a crowd chanting "Moqtada!" at them. Not looking good, is it? How did your bearish position of buying the March VIX future do?

The Jumbo VIX jumped 64.5 points and your future gained 36.6, a mere 56.7% capture of the gain.

	22-Feb	27-Feb	Change	Capture
Jumbo VIX	118.6	183.1	64.5	
March Future	111.5	148.1	36.6	56.7%

Well, this is fantasy, isn't it, and while you left men on first and third with no outs, you still scored a couple of runs that inning, right? And besides, you have perfect foresight. You know – you know! – Tuesday was an overreaction and Wednesday will bring both a market bounce and the concomitant fall in the VIX. So you reverse your position and go short on Tuesday, looking to cover on Wednesday. How did this one do?

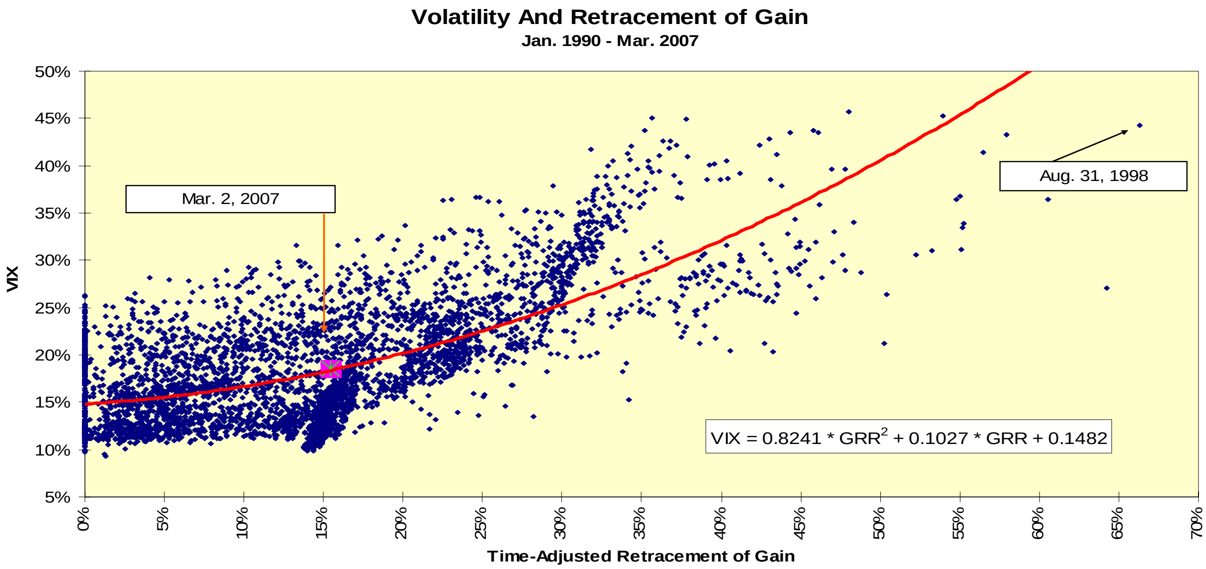
	27-Feb	28-Feb	Change	Capture
Jumbo VIX	183.1	154.2	28.9	
March Future	148.1	135.0	13.1	45.3%

The Jumbo VIX fell 28.9 points, while your March future fell 13.1, a mere 45.3% of the gain.

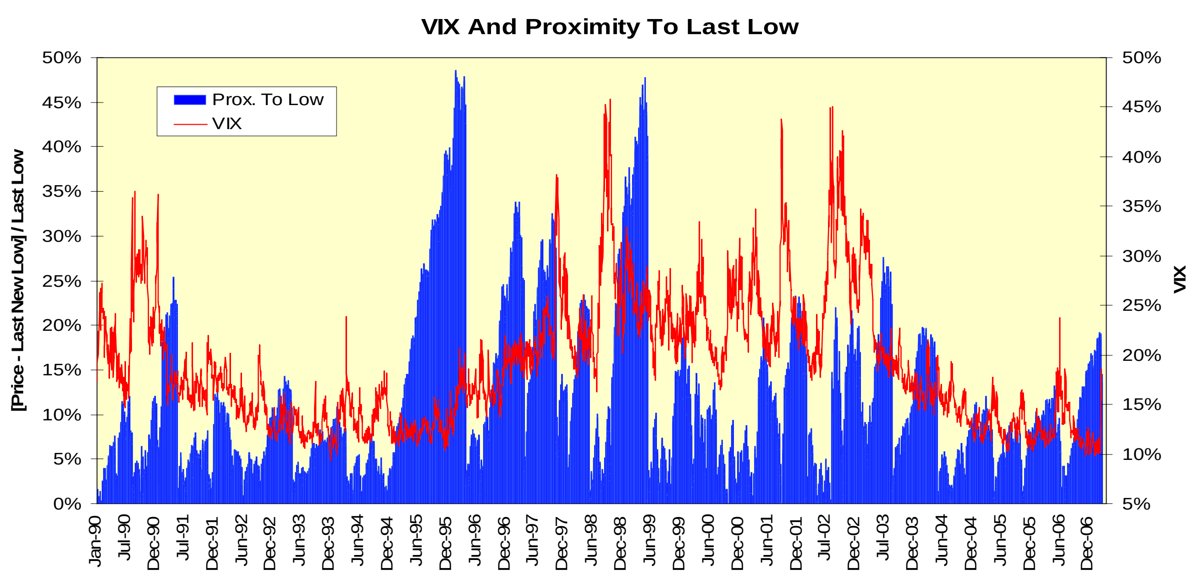
To put this in perspective, the minimum payouts for slot machines in Las Vegas and Atlantic City are 75% and 83%, respectively. No skill is required and the house will buy you a drink every now and then.

Historic Scale
How did last week rank in the annals of previous trapdoor openings? Let's return to an analysis first introduced in April 2000, one that maps the VIX against the market's retracement of gain adjusted for the time lapsed since the last high in the S&P 500. The idea here is simple: Anxiety and thus volatility builds as the market collapses, but time eventually heals all wounds. If, for example, any NASDAQ traders are still measuring their wealth levels from March 10, 2000, they should check into rehab.

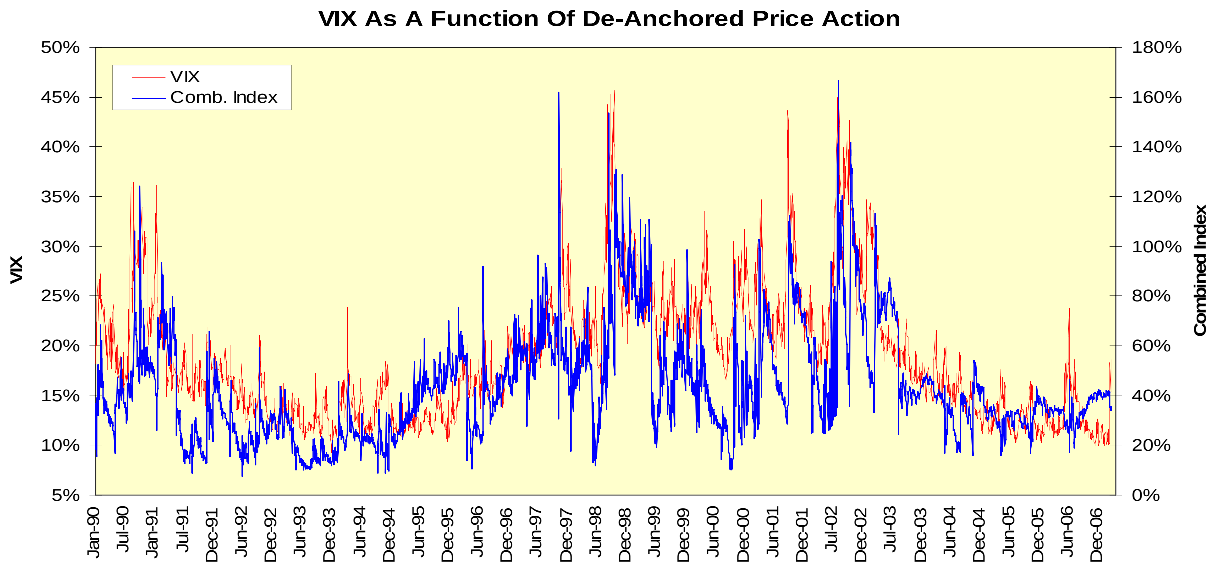
By last Friday, the market was exactly on its long-term trend curve; neither the VIX nor the retracement of gain was anything special. We are miles away from the August 31, 1998 point associated with the demise of Long Term Capital Management.



This psychological concept works the other way, too. The further away we are from a market low of significance, the greater our confidence level. We certainly qualified on that score by last week; many had noted how long we had gone without a 2% market correction. We can map the VIX against this proximity-to-low measure.



Finally, we can combine the two measures together in a little model and see where the VIX should be trading given market conditions. That index confirms what many felt, that the VIX had been unnaturally low from July 2006 into last week. It also suggests higher volatility and by implication a weaker stock market in weeks to come.

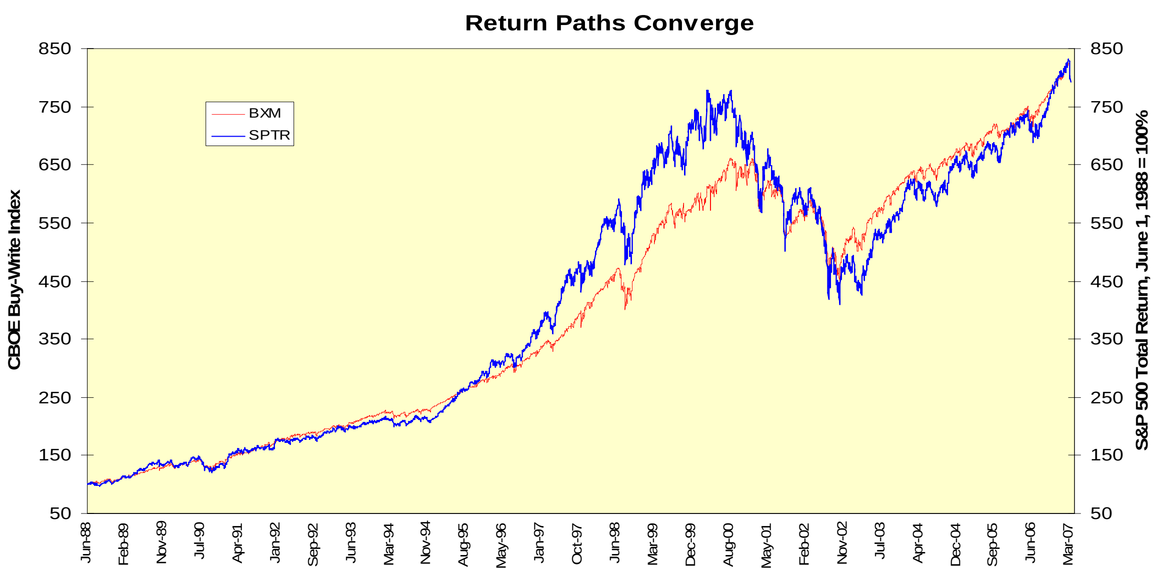


Combining Price And Volatility

Let's take a look at another volatility strategy, the Buy-Write index (BXM). After the market crashes of 1987, 1989 and 1997 even the most obtuse traders learned that while there are many ways to lose a lot of money in a hurry, writing index put options is one of the best. But anyone who has five minutes' experience on the sell-side of the industry knows traders are eager to sell options and loathe to buy them.

An index or a stock can be synthesized by buying a call and selling a put. If you sell the call option – that is, you bought the index and wrote the call, a buy-write – you are left with the short put option. Names matter: What used to be called the Patagonian toothfish was renamed to Chilean Seabass. You could not give the former away; the latter has been over-fished to the point of decimation.

The strategy of selling the call led to underperformance during the 1990s bull market, but worked well during the slow growth of 2003-2005. By 2006, the strategy of selling the upside at low volatility eroded performance again. If we index the S&P 500 total return index to the June 1988 start-date of the BXM, we find the two have almost equal performance after close to nineteen years, 794.48 for the BXM, 791.81 for the S&P total return, and that is before execution costs. If you lie awake at night wondering, "Why bother?" the answer will not appear to you in a dream.



The message is twofold: First, you cannot hit a 95 MPH fastball; stop fantasizing. Second, trading price is hard enough. Do not try to trade it via a volatility proxy.