



Farm Creek Securities, LLC
Farmcreeksecurities.com
fc@farmcreeksecurities.com
89 Roton Avenue, Rowayton, CT 06853
(203) 838-1025

The Sound Investor Series #54

Watching the VIX
By Ed Hynes, CFA
June 21, 2006

The market has been bouncing up and down these past few months as investors scurry around and jockey for position ahead of changes in the Fed's interest rate policy. Describing the market, commentators refer to the VIX, so I want to explain this index in more detail.

The VIX is the symbol for the Chicago Board Options Exchange (CBOE) Volatility Index. It has been published since 1993, although a few years ago its underlying calculations were updated.

The VIX measures the price of short-term options on the S&P 500 index and moves higher or lower as the options' prices increase or decrease. Over the years the index has ranged from about 10 when options are cheaper to over 40 when they are very expensive.

One reason investors follow the VIX, often called the "Fear Index," is because it moves up and down with investor uncertainty. Anxious investors are willing to pay more for options to protect their investments and thus the VIX will move higher.

The VIX has been very calm for the past few years and spent the early part of 2006 in the lower end (10 to 14) of its long-term range. In May, uncertainty crept into the market and it started to move higher - last week it reached a high of almost 24. It has backed off this week and is around 15.

So how does the VIX work? The actual calculation is complicated, but after a few definitions are covered, it can be described in relatively simple terms. For example, look at the price of a put option on the S&P 500 index and assume the index is at 1250 and the option's strike price is also 1250.

First, a put option gives the owner the right, but not the obligation to sell the underlying index at an agreed upon price (the strike price) until the option expires. In our example, the strike price is 1250, so if the index is below 1250 at expiration, the owner will exercise his put and sell the S&P 500 at 1250. If the index is above 1250, the owner of the put will obviously not want to sell below what he could get in the open market and therefore, he will just let the option expire worthless.

Second, option prices can be split into various components. One of the major contributors to an option's price is the relationship of the strike price to the underlying

market. Our example has both the strike price and market price as 1250. If the S&P 500 fell to 1200, the put would be worth much more and if the market appreciated to 1300, the put would be worth less. It is easy to see why the option price changes as the underlying market moves up and down.

However, option prices can change even if the underlying market doesn't move. If a market-maker thinks the market will fall dramatically, he will charge more for the put than if he thinks the market will be dull. And nervous buyers will pay more than calm ones.

When option prices change as a result of shifts in the outlook for the market, we say the option's implied volatility has shifted higher or lower. The VIX index, in essence, combines the implied volatility of all the options on the S&P 500 index into one easy to observe number.

How should long-term investors use the VIX? I think it is just useful as a handy indicator of fear and uncertainty in the market. When the VIX languishes in the low teens, it indicates that investors are complacent and according to some traders, a fall in the market is coming. On the other hand, a VIX reading in the 30s and 40s shows the market is very nervous, and may indicate a market bottom. The last time we saw VIX in the 40s was when the market bottomed in 2002. But consider that it was also in the 40s late in 2001, a year before the market stabilized.

FYI, the CBOE Volatility index is difficult to locate on some data services. At the free Bloomberg.com site, the symbol is ^VIX.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203-838-1025/Farmcreeksecurities.com) Farm Creek is a registered investment adviser broker/dealer and Member of the NFA. Please call for more information.

© Copyright 2006