

[Quick Links](#)[CAPIS
in the News](#)[About
Us](#)[CAPIS
Website](#)

Options Landscape 2011

Options trading has grown tremendously over the past several years. Contributing to this growth is the increased transparency in the options market as well as an increase in money managers employing options strategies to capture alpha and to hedge their current investment portfolios.

When trading options, whether you know it or not, you are actually trading volatility. As we begin 2011, where will volatility go and what should we concern ourselves with? The following risk metrics are an excellent place to start.

The VIX:

The CBOE Volatility Index (VIX) is one of the more commonly used, and yet ill-defined metrics in the financial world. The VIX has often been misinterpreted simply as a measure of current volatility in the market with no specified time frame and no specific identifiable underlying market.

In reality, the VIX measures the **expected** volatility over the next 30 days of the S&P 500 Index (SPX). It is calculated by using non-zero bid-priced options weighted for a constant maturity of 30 days from the first and second month of the SPX option chain. All in all, it is a direct representation of the implied volatility of the options market which is a direct expression of **expected** volatility in the market place.

The higher the VIX number, the more volatile the market. The 20 year average for the VIX is 22. In 2010, the VIX dropped roughly 20% to 17.75. With all the considerable uncertainty surrounding sovereign debt, the economic recovery, and the possibility that we have come too far too fast in equity prices, we can reasonably expect a floor around a 15 level for 2011. The VIX is currently trading below its 20 year average of 22.02.

VIX Futures:

More meaningful than the VIX are the VIX futures. The most distant VIX future sits about eight months out. The term structure is consistently upward sloping in nature but recently we have seen some of the steepest slopes on record (9.75 point difference between the six-month and one-month futures). This tells us that there is still considerable fear in the near-term and that there is a premium being paid on protection for the second quarter relative to the first quarter.

Keep an eye on the term structure and you will have an insight into where relative demand is for protection and where uncertainty lies. It should flatten throughout 2011, albeit modestly.

Volatility Skew:

Skew is another metric to watch in 2011. Skew is commonly defined by the implied volatility difference between lower strikes (relative to spot) and higher strikes for the same underlying asset. It is a measure that ebbs and flows much like implied volatility. It increases in times of panic and decreases during times of complacency. It is a direct reflection of the bid for downside protection and more specifically, the collar market. Skew saw record levels in 2010 (flash crash) for the SPX and remains elevated in certain sectors. We expect this to continue throughout 2011, while getting increasingly moderate with time.

Implied Correlation:

When trading index options, you are not only trading the volatility of the single stock components but also the correlation among the components. The CBOE Implied Correlation Index (KCJ) is a disseminated, market-based estimate of the expected average correlation of the stocks in the SPX. The general levels of the KCJ may be a guide to general levels of systematic risk in the market place. During the panic of 2008/09, correlation spiked to an almost 1 reading, which is a near perfect correlation. KCJ provides insight into whether index implied volatility (perceived index risk) is coming from high component volatility or the implied correlation. 2010 saw macro issues still dominate the headlines and, as such, saw a market with a high degree of correlation. 2011 should see a decrease in the macro-centric market and a move back to a stock picker's market.

Conclusion:

Overall we would expect a 2011 to be somewhat similar to 2010.

- The VIX will be shocked by unforeseen corrections in the SPX, but will ultimately taper back to the 15-20 floor range.
- The VIX futures will remain in a steep upward slope (contango) while flattening over time and ending 2011 near historical averages (while slightly elevated).
- Skew, much like the VIX, will spike in times of panic. When skew is at historical averages or lower, however, collars will offer an excellent risk management tool.
- Implied correlation should continue to subside as macro issues fade and stock picking comes back into vogue.

For more information on the options market, contact your client service team or Ian Kindler, CFA, Director of Options Trading at 800-527-5756 or ikindler@capis.com.



Technology makes it work. **People make it happen.**

800.247.6729 | www.capis.com

Member: NYSE, FINRA, SIPC

The opinions are those of independent third party research providers. Information contained herein is based on information provided by a third-party research provider and is not guaranteed by us, nor should the information be construed as an offer or a solicitation to buy or sell the securities mentioned herein or provide investment advice. Any comments or statements made herein do not necessarily reflect the views or opinions of CAPIS, its employees, officers, or directors. CAPIS' directors, officers and employees and their family members from time to time may own securities of the publicly traded companies discussed in any referenced independent Third-Party Research report. CAPIS may have a marketing partnership with several Third-Party Research providers to market their research services to institutional clients. CAPIS is an agency-only broker. The firm does not produce proprietary research, nor does it engage in any proprietary trading. The user is responsible for verifying the accuracy of the data received. CAPIS does not have any ownership of the subject company's securities. CAPIS does not have any investment banking relationships with the subject company nor expects to in the next 3 months. CAPIS does not have any market making activities in the subject company's securities. CAPIS does not maintain an analytical relationship and is not a member of any distributing organization. CAPIS makes no claim as to its accuracy or completeness. CAPIS is not responsible for the content or comments of these independent third party research providers. Capital Institutional Services, Inc. accepts no liability for any errors or omissions arising as a result of transmission. Use of this communication by other than the intended recipients is prohibited.