Corriere del Ticino 2009/10/01

LET'S TALK ABOUT...
FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Fear Indices

(Part Six) The most used tool in assessing the volatility (and hence the "fear" level) of the fixed income market (indeed the US one, as representative of the global whole), the MOVE, being the acronym of *Merrill Option Volatility Estimate*. Such index has been promoted by a major financial institution and is based on the implicit volatilities, weighted according to different expirations, of the option prices on the US Treasuries Bonds with one month maturity. In this case too, just as remarked with reference to the equity market, the principle is that options' price evolutions, both calls and puts, may be a good indicator of the market expectations in terms of uncertainty, as the uncertainty itself, in the form of volatility, is the main feature in determining the option's price itself at a certain moment. Of course the already mentioned cautions apply to this index too, in that Treasuries, being Government and highly-rated securities, are well different from other bond categories, such as corporates, high-yielding instruments, junk bonds and so on. That is the reason why in the fixed income market other risk indicators are widely employed, such as the CDS (Credit Default Swaps), simply definable as the premium to be paid by an investor in order to insure the payment of principal at expiration by a certain bond issuer. When using this tool, the specific situation of the issuer is of great relevance, but the average level of different CDS for a certain category may be a reliable gaugle of the state of the market as a whole. A proof of this is the erratic movements such indicators have shown during the different phases of the recent financial crisis. Finally, the level of market "fear" may also by monitored through the levels of interest rates that banks apply in lending money one another. At the most critical and dramatic points of the financial storm such rates were largely, if not even hugly, higher than the officially defined ones, being that a clear sign not just of poor liquidity, but also scarce reciprocal trust and reliability, thus of uneasiness and fear in a pretty real sense. *(end)- GLT*

Corriere del Ticino 2009/09/24

LET'S TALK ABOUT...
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Fear Indices

(Part Five) Volatility is not just a feature of the equity environment, but dominates the fixed income market too. Of course it could be said that volatility itself, together with the expected dividends, is the essence of any equity investments, as the difference between purchase and selling prices is the main source of return. On the contrary, for most bond investors, the prevailing and traditional strategy is more oriented to buy the instrument for its coupon – better its real yield if compared with its market price – and then hold it until maturity, when it will be repaid at par value. Here volatility is not a main issue indeed. But more and more investors pursue a different strategy, in that they look for price differences and arbitrage opportunities well before the time of expiration, often "riding" the yield curves: in this case the volatility factor becomes relevant. As most readers already know, the fixed income market volatility is mainly fuelled by evolutions in interest rates as well as rate expectations, as consequences of evolving monetary policies and macroeconomic outcomes. And here too, just in the case of equity, more uncertainty takes to higher volatility, although the concept of volatility itself has different shades in the fixed income environment: the share has no predefined expiration and no repaid value. The bond's price can not go to a zero value, except in the case of the issuer's default, and whilst the share is normally priced in terms of earnings' multiples, within a very changing framework, the bond's cash flows are substantially well defined and foreseeable. Thus the gauging method for bond volatility is pretty different. Moreover, what we have said for equity volatility indices is valid for bonds too: as the measure of volatility applied to a major stock index as a whole may be not so much meaningful, due to diverging trends in its component sectors and single listed shares, so a bond volatility index may not take into sufficient account the diverging volatilities of the various bond categories, such as government, supranational, corporate, high yielding, junk bonds, and so on. *(to be continued) - GLT*

Corriere del Ticino 2009/09/17

LET'S TALK ABOUT...
FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Fear Indices

(Part Four) We have reviewed the VIX index as a valid tool aimed at gauging the equity market mood in a synthetic way, and its historical averages, ups and downs, highs and lows through the many market phases; for such purpose it uses the options' prices on the Standard & Poor 500 within a 30 days expiration range. According to many, such limited time horizon is a critical feature of the VIX itself and limits its significativity, failing to include options' expirations up to 3 or 6 months ahead. However such enlargement could have made the index's calculation even more complex. A perhaps more grounded criticism refers to the S&P500 index's volatility being considered as a whole, with no attention for the different economic sectors' own volatility levels. Actually the financial history shows that different areas have different average volatilities: suffice it to remind how healthcare or food sectors are less volatile than technology, industrial or transportation domains. The extremely synthetic value that the VIX express could then be not too much reliable again. The criticism may be correct but it is also worth noting that, along with the years, the correlation among the different sectors has constantly increased, together with the correlation among the major international markets. Moreover the specific volatilities of some sectors have changed: we may just consider the biotech area, which was supposed to be particular speculative and volatile, but has recently become a "quasi-defensive" one.
The VIX index not only exists for the S&P500: it has been created for the NASDAQ market, particularly oriented to medium caps and advanced sectors, and the Dow Jones's more traditional blue chips.
Also the fixed income markets have their "fear" gauges, whose volatility has increased in time, sometimes resulting as much high as the equity markets' ones. But bonds' volatility is different and is then calculated in different ways. *(to be continued) - GLT*

Corriere del Ticino 2009/09/10

LET'S TALK ABOUT...
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Fear Indices

(Part Three) The VIX, likely the most important and renowned among "fear indices" or, in better terms, volatility indices, being linked to the options' values of the Standard & Poor 500, shows an interesting evolution along time, as options' values reflect the current market actors' mood and stances for the time being and the very short future. The index value is expressed as a percentage and the higher it is, the higher the experienced and expected volatility within 30 days. At the moment (September 9) its value is 25.62. Just a look at its historical evolution. The VIX was conceived in 1993 not by the Street but a US University, elaborating options' prices back from 1990, and in 2003 the method of calculation was improved. The average VIX value from 1990 to October 24, 2008, that is the day the index reached its all times high, due to the current dramatic market conditions, is just above 19. It was see-sawing until 2003, and a pretty long lowering phase followed which was fuelled by the diffused complacency which took to the then following speculative bubbles. But on October 24, 2008, it was to skyrocket up to 89.53, lifted by the uncertainties and fears which dominated the financial markets on those fatal days. The historical low, 9.31, was reached in December 1993, when markets were pretty stabilized and their trend well defined. During the latest years some new instruments have been created, options and futures, having the VIX index as their underlying value, so enabling investors to "play" the market volatility in an easy and synthetic way. The VIX index has then become widely recognized and used by market operators as a major mood-assessing tool, despite some critical remarks it has received. *(to be continued) - GLT*

Corriere del Ticino 2009/09/03

LET'S TALK ABOUT...
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Fear Indices

(Part Two) Having discussed the main features of these indices of "fear", which actually just show the level of volatility, instability and uncertainty within a financial market, let us consider how the most renowned among them is calculated: it is the VIX index of the Chicago Board Options Exchange and refers to the volatility as expressed by the options on the most traded and significant US equity index, the Standard & Poor 500. We have already noted how volatility is the most important factor in determining the options' prices, as these are some sort of insurance instruments against undesirable market moves. Thus, as the index involve the options' values, the higher the index itself , the more expensive the options' prices, and the greater the market volatility and uncertainty. The formula which is used in gauging the VIX index evaluates the current prices of all calls (rights to buy at a certain expiration and defined price) and puts (rights to sell) which "are out of the money". That means the market price of the underlying share is below the fixed striking price, or above it in the case of a put option, for the current and just next expiration dates. The VIX value, whose formula is pretty complex indeed, is expressed as a percentage value, that is the expected move of the S&P 500 over about the next 30 days. A high VIX level means a high degree of expected market volatility, while low figures indicate states of substantial market stability. It is worth noting that high volatility does not necessarily mean a bearish market attitude, as such instability may also take to uptrends, even if crooked in their paths. Thus the VIX value will be high when market operators expect wide movements, whichever their directions. Its average figures along time, as well as extreme values it reached during special market conditions may be of interest, and will be reviewed in the next article. *(to be continued) - GLT*

Corriere del Ticino 2009/08/27

LET'S TALK ABOUT...
FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Fear Indices

(Part One) One must not be fooled by the fancy headline: “fear” indices actually and technically are no more than volatility indices applied to the financial markets. However their definition at least partially involve such extended meaning, as wide and sudden ups and downs in financial prices certainly are also indicators of instability, turbulence and uncertainty within the market and the overall scenario it represents. Moreover the way in which such indices are calculated may justify an association with the concept of “fear”, at least in general if not scientific terms. A good example is the most renowned of such indices, the VIX, being the Reuters symbol (ticker) of the Chicago Board Options Exchange Volatility Index, as related to the options’ volatility of the most traded and significant equity index of the US market, that is the Standard & Poor 500. But be careful in noting that it does not consider the S&P’s volatility or the ones of its component shares, but the related options’ ones. The difference is relevant, because options themselves are among the major instruments of risk management and “fear” protection in the markets. We have already reviewed them previously and now we just remind that they involve the right (and not the obligation) to buy (call option) or to sell (put option) a certain financial asset (shares, commodities,…) at a certain future date (or within a certain period of time until such expiration date) at a predefined price, by paying a premium (the option’s price). They are thus sorts of insurance contracts, call options being aimed at bullish strategies and put options at bearish ones. The option’s price depends on many elements: time duration, that is its expiration, the nature of underlying values, the interest rates and primarily the current market volatility. That is the reason why an index based on options is a good indicator of volatility, or fear, in more fancy terms.
(to be continued) - GLT