The ABCs of VIX

How to use the new "fear gauge" futures

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Most new products come with extensive instruction manuals. Not so the futures on the VIX, which have attracted considerable buzz and are scheduled to begin trading later this month. Because enough readers have asked (and Striking Price aims to please), here's a how-to guide of sorts explaining the use of VIX futures and some technical specifications, so that you, too, may try this at home.

VIX, the Chicago Board Options Exchange volatility index, is a sentiment indicator that measures anticipated stock-market volatility over a 30-day period. It rises when traders bid up the prices of short-term Standard & Poor's 500 index options. Because that tends to happen when stocks skid and when traders are bracing for big stock-price swings, VIX has earned the nickname "the fear gauge." And because it rises when stocks fall, many traders believe owning volatility—say, in the form of VIX futures—can help diversify and hedge a stock portfolio.

But VIX futures could become a crossover hit in other markets as well. For one thing, convertible bonds contain embedded call options and, with that, a volatility component. So fixed-income investors who hold a lot of convertible bonds can end up with substantial exposure to volatility. VIX futures, by providing a simpler way to buy or sell volatility, can provide these investors with another tool to manage their volatility risk, says Sandy Rattray of Goldman Sachs' equity derivatives group, which helped the CBOE devise VIX futures.

"VIX futures can also potentially be used to hedge credit risks, given the strong correlation between credit spreads and volatility," says Barry Colvin, president and chief investment officer of Tremont Capital Management. To some traders, credit or corporate bond spreads work like the bond market's fear gauges—they measure the extra yield corporate bond investors demand over safer government bonds, and increase when traders smell danger. Given the strong link between the credit spreads and volatility, money managers with credit exposure could find the new derivatives handy.

When VIX futures begin trading on the CBOE's electronic platform, they will be denoted by the symbol VX. Unlike listed options, which generally expire after the third Friday of each month, VIX futures trade their final session on the Tuesday before Expiration Friday. The value of VIX will be multiplied by 10 to produce an index called the VXB, and each futures contract will be $100 times the VXB.

Why the confusing multiplier? The CBOE plans to list options on VIX futures one day, and the VXB's larger numerical range gives more flexibility when inserting different strike prices, explains Joe Levin, the exchange's vice president for research. Currently, only a few options under a pilot program have strike prices at one-dollar increments. Besides, VIX could hover between, say, 16 and 17 for weeks and option traders would have only two near-the-money strike prices to choose from. With the VXB, there would be strike prices at 160, 165 and 170. The bottom line: a move of one full point in the VIX should translate into a theoretical gain or loss of $1,000 in the VIX futures.

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And what of VIX's temperament and tendencies? The negative correlation between VIX and stock prices is well-documented. But less obvious is how volatility shocks tend to occur to the upside. "Rarely, if ever, do we see volatility shocks to the downside," says Mika Toikka, Credit Suisse First Boston's head of option strategy. "In a rapidly declining stock market, when the probability of experiencing a spike in volatility is at its highest, long volatility positions can pay off handsomely."

VIX also tends to revert to a mean, traders say, and rarely remains at extreme highs for too long. Even if the market were to stay choppy, investors can develop enough of a tolerance to risk that anticipated volatility eventually eases. On the other hand, VIX can stay muted for longer stretches, although it does eventually reward patience with a rise.

Case in point: VIX has slumped near a seven-year low for much of the past six months, and traders betting on an inevitable rise suffered as the stock market stayed stubbornly calm despite jitters in the bond and currency markets. The mean reversion just would not come.

But just when many option buyers seemed resigned to a quiet spring, VIX made its grand entrance. It's hard to pinpoint the precise cue. Data showing dismal job growth in February was released March 5, and VIX hadn't budged then. But mounting concerns about stock valuations and terrorism sent the S&P 500 down 4.3% the first four days last week. VIX, in one of its upward surges, jumped 43%. ■

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