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THE ONLY THING WE HAVE TO FEAR...

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On June 6th the Chicago Board Options Exchange Volatility Index (VIX) closed at a multiyear low of 10.73.[1] The VIX, also referred to as the Fear Index, has garnered a lot of attention in the financial media lately. Investors might be wondering what the VIX really is and why it is attracting so much press. Let's make a brief examination of the VIX so we can better understand its implications for markets as well as how we might apply it to our portfolios.

First, the VIX is a measure of market risk or more specifically, a measure of the expected volatility in the S&P 500. The VIX is calculated using the call and put option prices of the S&P 500 index. Option prices reflect where investors are willing to buy or sell an underlying security at some time in the future. The more investors think the S&P 500 will move, the higher the prices will be in the underlying call and put options. Call options are contracts to buy a security at a certain price and within a certain time frame while puts options are contracts to sell a security at a certain price and within a certain time frame. When investors expect big moves, option prices generally go up and as a result so does the VIX.[2]

The VIX is quoted as an annualized percentage. It represents a +/- percentage move, annualized for one standard deviation (occurring 68% of the time). For example, a VIX of a 10.73 represents an expectation of 10.73% gain or loss in the S&P 500 over the next year, 68% of the time. The point of this newsletter is to educate but also to simplify the concept of the VIX so I will not attempt to explain the complicated math that goes into these calculations but instead focus on their meanings. I will add, however, one quick tip. If you divide the VIX by the square root of 12 you can calculate the expected change, within one standard deviation, in the S&P 500 over the next 30 days (non-annualized). 10.73/sqrt12=3.10%. A VIX of 10.73 implies an expectation of a 3.1% gain or loss in the S&P 500 over the next 30 days, 68% of the time.[3]

The term "Fear Index" can be a bit misleading. A high VIX reading means investors are expecting big moves in the market but that can be in either direction. Option prices will be high for both puts and calls when investors expect big sudden moves. When the market is doing well for an extended period of time, investors tend to feel comfortable with their portfolios and often subscribe to a "steady as she goes" mentality. Comfort often leads to complacency and as a result investors might neglect regular portfolio reviews and rebalancing. They hold stocks with the belief that the market will continue climbing with little regard for a possible correction, or worse. Option prices tend to be lower during these periods because investors are not expecting surprises and the premiums investors pay for options tend to be lower. A low VIX, as a result, often corresponds to market highs. A high VIX, on the other hand, tends to correspond to market lows because greater losses increase fear which often leads to panic. The greater the uncertainty, the greater the expected moves in the market. As a result, option premiums go up and so does the VIX.

Fear and greed are undoubtedly the greatest drivers of investor behavior. The VIX is considered to be a good indicator of the level of fear and greed in the market. While a low VIX doesn't necessarily mean sell and a high VIX doesn't necessarily mean buy, the VIX can be a good indicator of general investor sentiment. The best opportunities to buy tend to be when others panic and the best times to sell tend to be when investors are riding high. The VIX, therefore, is useful tool to the contrarian investor.

Currently, the VIX is near record lows and the market is near record highs. This trend can and often will continue. This can simply reflect a healthy and steadily improving market. On the other hand, a low VIX also reflects comfort and complacency. Is a bout of volatility just around the corner? Are you prepared for it in case it comes? Are you diversified? Are you rebalancing? With stocks doing so well, perhaps take some profits, sell some winners and reinvest in some overlooked opportunities. Nobody knows exactly when this rally will end but if you rebalance into areas that may not have left the ground yet, you may ultimately have less room to fall.

Let's review your portfolio and take a proactive approach. In my experience, it is always easier to review when the market is high and we have more choices.

1. http://www.bloomberg.com/quote/VIX:IND
2. http://www.investopedia.com/terms/v/vix.asp
3. http://en.wikipedia.org/wiki/VIX

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