

What Is the VIX Saying?

BY STEPHEN SOLAKA

One of the most hotly debated questions on Wall Street is whether the CBOE volatility index is too high or too low. At a recent 11, down from 21 earlier in the year, the key gauge of stock market fear is telegraphing two contradictory signals, and no one really knows which is right.

The VIX is either indicating that stocks will rally even higher, or warning that share prices are about to plummet because investors are too complacent in the fifth year of an epic bull market.

To make interpreting the message more difficult—and maybe crucial—one of the most brutal months for the stock market over the past few years is fast approaching. The S&P 500 has fallen in three of the past four Augusts, with the smallest decline being 3%. If past is prologue, the razor-thin trading range that has characterized the past few months has made many investors feel that a VIX volatility trade could turn out to be the greatest bet of their lives.

Given the recent muted price action in the equity market, the VIX's low level is hardly surprising. The S&P 500 index (ticker: SPX) hasn't experienced an up or down move of 1% or more in close to two months. As option dealers/sellers adjust their pricing according to the level of the market's volatility and try to gain a premium, some think that the VIX is overvalued.

Whatever your expectations for volatility or your views on the future course of the stock market, there are great opportunities to boost your returns by using calls or puts.

Let's begin with investors who want to lock in gains on their stocks, or think volatility will increase, or both. The good news for them is that the lower VIX has made creating hedges less expensive. A year ago, the cost of a 10% out-of-the-money six-month put on the SPY equalled 2% of the SPY. Today, with the market standing nearly 23% higher as I write, the tab is just 1%. So, even

as the value of many investors' stock portfolios has climbed, the cost of protecting the gains has fallen.

For those who see low volatility continuing, or who would like to buy stocks at lower prices, a trade using cash-secured puts could be attractive.

This trade involves writing (selling) put options below the market and collecting a premium on them. If the stock falls beneath the strike price, the put seller will have to buy it, and the cash on hand can be used to help make the purchase. Some investors have been selling puts on this year's stock-market laggards as a way to collect greater premiums. And if they're forced to buy these stocks or indexes, that might not be so bad. They theorize that these laggards might play catchup, if the market rises later.

LET'S LOOK AT THEiShares Russell 2000 small-cap call ETF (IWM) as an example. This year, the IWM has produced less than half of the S&P 500's return, as reflected in SPY. Small-cap stocks are historically more volatile, a reality reflected in their relatively hefty option premiums.

Focus on selling shorter-term puts. Pick an out-of-the-money put on an ETF that you'd be comfortable owning at a specific price, and set the strikes accordingly. Think of it as being paid to buy the market cheaper.

It's always tempting to try to forecast the stock market's future volatility. But planning can help investors more than predictions can. In the second half of 2014, the options market can enhance your returns, regardless of where the VIX goes.

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