Kendrick Wakeman, CFA
kwakeman@badonhill.com
203-542-0588

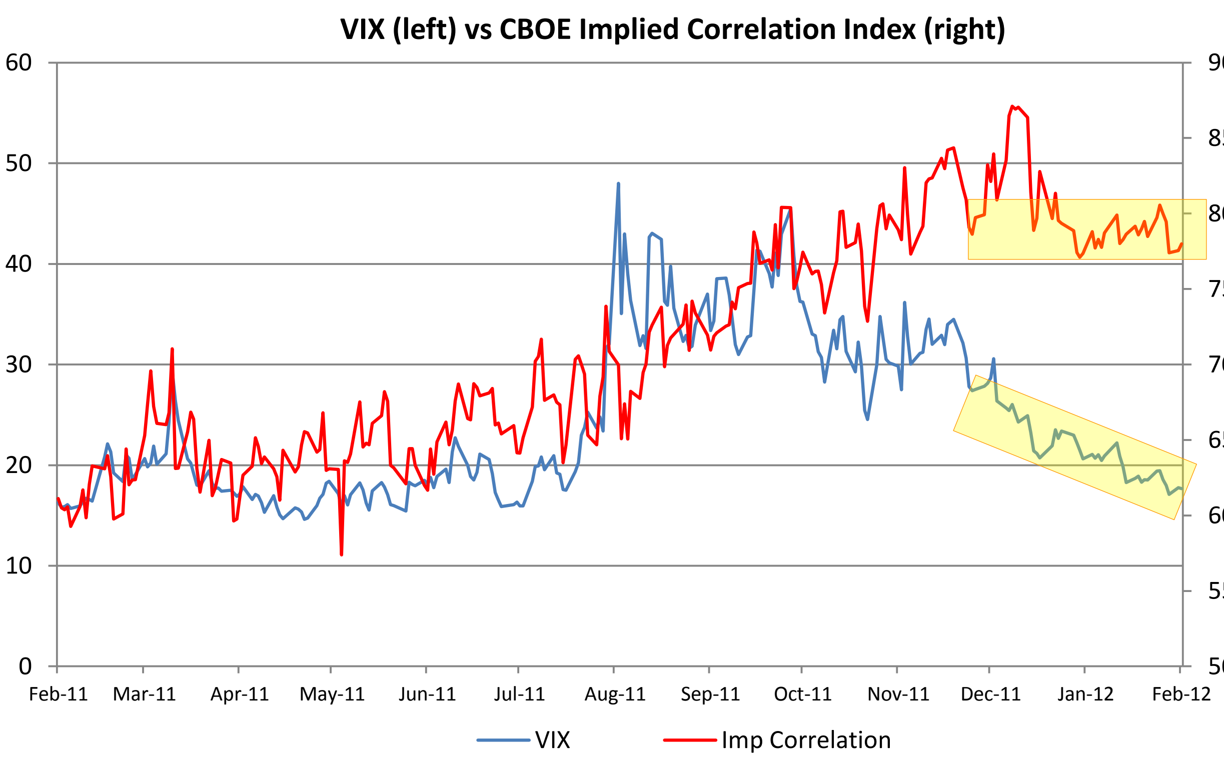
VIX BACK TO PRE-GREECE LEVELS, BUT IMPLIED CORRELATION STILL HIGH: TIME TO CONSIDER SINGLE STOCK OPTION HEDGES INSTEAD OF SPX OPTIONS?

Quick Summary:

1. The investor struggle between improving fundamentals in the US and potential contagion in Europe seems like a reasonable application for hedging a portfolio with equity options.

2. VIX is essentially back to pre-Greece levels, which may lead some to consider S&P index options.

3. Not so fast: Implied Correlation is still high so single-stock option hedges may represent a better value than index options.



Source: www.cboe.com, Badon Hill calculations

We see the current struggle between the desire to participate in a US economic recovery and the fear of getting caught in a European contagion as something along the lines of the 1964 battle of Godzilla vs Mothera: it is not entirely clear to us who is going to win, but we know that there is likely to be considerable despair in the process. With two fairly radical outcomes at hand, equity options might be considered a reasonable risk management tool. Furthermore, with the VIX essentially back to pre-Greece levels, hedge fund managers may be considering swapping some of their equity hedge for S&P options. This may be logical under the circumstances, but we would also encourage managers to consider single-stock option hedges at the position level.

As a whole, we see single-stock options as a better value than index options at the moment (individual options will vary). Although the VIX has generally come back down to pre-Greece levels, Implied Correlation has not. Implied Correlation can be thought of as an indicator representing the relative price of index options versus single stock options. The higher the Implied Correlation, the more expensive index options look vs. single-stock options and vice-versa. For a more detailed discussion of this, give us a call or click on this link to the CBOE.

Although we have found that Implied Correlation is not a good predictor of where the VIX will go next, we feel it can serve as tool for making tactical decisions on portfolio hedging. There is a monetary arbitrage called “dispersion trading” whereby large investment banks and hedge funds seek to profit by the increase and decrease of Implied Correlation. When the Implied Correlation is high, they will sell index options and buy a basket of individual stock options. It is a complicated and capital intensive process which we do not recommend to anyone who is not an expert in the field.

However, if a hedge fund manager or other sophisticated, single-stock option enabled investor is looking at the drop in the VIX and considering S&P options as a portfolio hedge, we would encourage them to first scan through their holdings and see if there are any single-stock option hedges that may be more attractive. Good candidates would either have implied volatilities that are at or below July 2011 levels or have some compelling catalyst that warrants otherwise.

For investors that are not well versed in single-stock options strategies, we might recommend trying a few paper trades to build this skill set. There are certain considerations around single stock options that are not as prevalent in index options. Liquidity is typically the largest consideration, but there are also enhanced dividend and catalyst issues that need to be address as well as larger premiums than can be lost. We are happy to walk investors through some of these more subtle issues should there be a need.