VIX Trading Falling Most Since 2008 as Hedges Retreat: Options

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Oct. 30 (Bloomberg) -- Confidence that U.S. stocks will extend gains is spurring investors to pull back on hedges that protect against volatility, leading to the biggest drop in VIX options trading in five years.

About 437,000 contracts on the Chicago Board Options Exchange Volatility Index changed hands yesterday, 25 percent less than the average this year, according to data compiled by Bloomberg. Approximately 161,000 options traded on Oct. 28, the fewest for a full day since December 2011. That represents a 91 percent decline from a record on Oct. 8, the largest drop since August 2008.

Stocks are heading for the biggest monthly rally in two years after Congress voted to raise the U.S. debt limit and weakening economic data boosted speculation the Federal Reserve will maintain stimulus. Earlier this month, traders who piled into exchange-traded funds that profit with rising stock swings saw their bets backfire for the fifth time this year.

"There is low uncertainty, so hedging is not at the top of the agenda," Manish Singh, who helps manage $2 billion as head of investments at Crossbridge Capital in London, said yesterday. "Congress has agreed to funding the government and tapering is now probably pushed to end of the first quarter of 2014."

VIX Options

The Standard & Poor's 500 Index has risen 7 percent to a record since Oct. 8, advancing in 13 of the past 15 sessions as companies beat earnings estimates and economic reports signaled the U.S. economy isn't expanding fast enough to withstand a reduction in the central bank's bond-buying program. The VIX, a gauge of options prices on the S&P 500, has fallen 34 percent since then to 13.41 yesterday. It gained 1.8 percent to 13.65 today. Europe's VStoxx Index rose 6.4 percent to 16.15.

VIX options volume has tumbled after reaching a record 1.78 million options on Oct. 8 after traders piled into contracts that rise when stock swings increase.

The 16-day government shutdown earlier this month took at least $24 billion out of the economy and will spur the Fed to wait until March to taper, a Bloomberg survey showed this month. The central bank's policy makers are meeting today.

"The low volumes are basically reflecting the underlying sentiment," Frederic Ruffy, a Chicago-based senior options strategist at Trade Alert LLC, wrote in an e-mail on Oct. 28. "There's not much fear out there. Probably a lot of people are tired of seeing all their VIX upside calls expire worthless every month."

Cheap Derivatives

Investors should take advantage of inexpensive equity derivative prices to protect against losses, said Philippe Trouve of Bank of America Corp. in New York. The VVIX Index, which tracks the cost of options on the volatility gauge, slipped 39 percent since its one-year high on Oct. 9 to 68.52, the lowest level since January 2010.

"It is surprising that investors would get long equity here and not hedge it, given how inexpensive options to protect such investments are," Trouve, VIX options trader and director for equity derivatives at Bank of America, said in an interview.
"The level of confidence in this rally seems very high."

The cost of bearish S&P 500 options has dropped relative to bullish contracts since June. Puts protecting against a 10 percent decline in the index cost 7.1 points more than calls betting on a 10 percent rally, according to three-month implied volatility data compiled by Bloomberg. The price relationship, known as skew, is down from a one-year high of 10.93 on June 20.

Volatility Note

Traders have increased bets on securities linked to U.S. equity volatility. The shares outstanding on the iPath S&P 500 VIX Short-Term Futures ETN have almost tripled to 91.6 million shares this year, data compiled by Bloomberg show. Last month, total shares reached a record 107 million.

The ETN is the most-traded security linked to VIX futures, with an average volume of 56.7 million shares changing hands on average in the last 30 days. The fund has slumped 60 percent this year to $12.83, an all-time low.

In five instances since the end of 2012, the VIX has swung up and down at least 18 percent within seven days, data tracked by Bloomberg show. That handed losses to investors that bought VIX securities after volatility surged.

There were 2.45 million outstanding VIX puts for 4.54 million calls as of Oct. 25, according to the data. The ratio of puts-to-calls was 0.54-to-1, near the highest level since July.

"Volatility tends to be low towards the end of the year," Anthony Benichou, a cross-assets salesman at Louis Capital Markets in London, said in an interview yesterday. "Investors don't see risks in the short term, and the Fed will probably delay tapering."

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