On Wall Street, Eyes Turn to the Fear Index

By Michael M. Grynbaum

Oct. 19, 2008

Fear is running high on Wall Street. Just look at the Fear Index.

With all those stomach-churning free falls and sharp reversals in the stock market recently, traders are keeping a nervous eye on an obscure index known as the VIX.

The VIX (officially the Chicago Board Options Exchange Volatility Index) measures volatility, the technical term for those wrenching market swings. A rising VIX is usually regarded as a sign that fear, rather than greed, is ruling the market. The higher the VIX goes, the more unhinged the market looks.

So how scared are investors? On Friday, the VIX rose to 70.33, its highest close since its introduction in 1993. To some experts, that suggests that the wild ride is far from over.

“Right now, it’s an extremely important part of the puzzle,” Steve Sachs, a trader at Rydex Investments, said of the VIX. “It’s showing a huge amount of fear in the marketplace.”

The VIX is hardly a household name like the Dow. But lately, it has become a fixture on CNBC and other financial news outlets, with commentators often invoking an index that most of the general public was blissfully unaware of only a few weeks ago.

Some traders think all the publicity has only added to the anxieties that the VIX is intended to reflect. “The VIX is a self-fulfilling prophecy,” said Ryan Larson, head equity trader at Voyageur Asset Management. “It’s almost adding to the problems.”

Speaking on Thursday, when the VIX hit an intraday high of 81.17 before closing lower, he said:

"You see the VIX trade north of 80, and of course the media starts to pick it up." Mr. Larson continued, "It's blasted on the TV, and for the average investor sitting at home, they think, oh, my gosh, the VIX just broke 80 I've got to go sell my stocks."

Put simply, the VIX measures the degree to which investors think stocks will swing violently in the next 30 days. It is calculated in real time throughout the trading day, fluctuating minute to minute.

The higher the VIX, the bigger the expected swings and the index has a good track record. It spiked in 1998 when a big hedge fund, Long-Term Capital Management, collapsed, and after the 9/11 terrorist attacks.

Mr. Sachs, with some incredulity, said that the swings in the stock market have reflected the volatility implied by the VIX.

"We had a 17 percent peak-to-trough trading range this week," he said. "It should take two years under normal circumstances for the S.& P. 500 to have that type of trading range."

The VIX had its origin in 1993, when the Chicago Board Options Exchange approached Robert E. Whaley, then a professor at Duke, with a dual proposal.

"The first purpose was the one that is being served right now find a barometer of market anxiety or investor fear," Professor Whaley, who now teaches at the Owen Graduate School of Management at Vanderbilt University, recalled in an interview. But, he said, the board also wanted to create an index that investors could bet on using futures and options, providing a new revenue stream for the exchange.

Professor Whaley spent a sabbatical in France toying with formulas. He returned to the United States with the VIX, which gauges anxiety by calculating the premiums paid in a specific options market run by the Chicago Board Options Exchange.

An option is a contract that permits an investor to buy or sell a security at a certain date at a certain price. These contracts often amount to insurance policies in case big moves in the market cause trouble in a portfolio. A contract, like insurance, costs money specifically, a premium, whose price can fluctuate.

The VIX, in its current form, measures premiums paid by investors who buy options tied to the price of the Standard & Poor's 500-stock index.

In times of confusion or anxiety on Wall Street, investors are more eager to buy this insurance, and thus agree to pay higher premiums to get them. This pushes up the level of the VIX.

"It's analogous to buying fire insurance," Professor Whaley said. "If there's some reason to believe there's an arsonist in your neighborhood, you're going to be willing to pay more for insurance."

The index is not an arbitrary number: it offers guidance for the expected percentage change of the S.& P. 500. Based on a formula, Friday's close of around 70 suggests that investors think the S. & P. 500 could move up or down about 20 percent in the next 30 days an almost unheard-of swing.

So the higher the number, the bigger the swing investors think the market will take. Put another way, the higher the VIX, the less investors know about where the stock market is headed.

The current level shows that "investors are still very uncertain about where things will go," said Meg Browne of Brown Brothers Harriman, a currency strategist who was keeping a close eye on the VIX as the stock market soared last Monday.

Since 2004, investors have been able to buy futures contracts on the VIX itself, providing a way to hedge against volatility in the market. Options on the VIX have been available since 2006.

"You have seen more and more investors using it as an avenue toward hedging their portfolios," said Chris Jacobson, chief options strategist at the Susquehanna Financial Group. In times of crisis, "while you're losing your portfolio, you could make some money on the increase in volatility," he said.

Some investors are skeptical about the utility of the index. “If you’re trading the markets, you pretty much know the fear, you know the volatility. I don’t need an index to tell me there’s volatility out there,” Mr. Larson said.