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AHEAD OF THE TAPE
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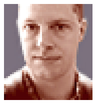


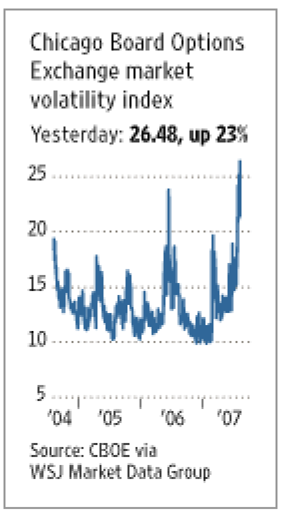
Bets on Calm Now Come Back To Cost Investors

August 10, 2007; Page C1

What had been a remarkably calm spell in the financial market has come to an abrupt halt. That is bad news for the many investors who have been betting against a return of volatility.

For years now, investors have been enjoying something Fed Chairman Ben Bernanke liked to call the "Great Moderation." An economy that has experienced swings that are less sharp seemed to give way to markets that didn't go through very volatile swings.

But that could be changing. Financial markets are the choppiest they have been in years. Yesterday, as the Dow Jones Industrial Average tumbled[1] 387.18 points, the Chicago Board Options Exchange's implied-volatility index rose to its highest levels since 2003.



Better known as the VIX, the index is based on prices for S&P 500 put and call options, which let investors buy and sell the S&P 500 at prearranged prices. When stocks get more volatile, options become more valuable, driving the VIX higher. Implied volatility for corporate bonds, currencies and emerging-market debt has also been rising. It is a far cry from January, when the VIX hit its lowest level since 1993 and implied volatility in other markets was similarly low.

The change could mess up some very popular trading strategies. For example, many investors have been selling "out of the money" put options on stocks. As long as stocks didn't fall sharply, the puts would be worthless on their expiration date. The sellers pocketed the money from selling the options -- much as an insurance company gets to keep the money it makes selling hurricane insurance when there are no hurricanes. Now, though, the hurricane is hitting; if you sold a put option, you pay a price.

Other investors, while they weren't actually engaged in selling puts, were involved in trades that came down to bets against volatility.

Carry trades -- in which investors borrow money in countries with low interest rates, such as Japan, and buy higher-yielding assets elsewhere -- are effectively bets against currency volatility. All is well unless the currency of the country where you invested money falls against the currency of the country where you borrowed money. Over the past month, the dollar has fallen 4.2% against the Japanese yen.

Collateralized-debt obligations -- pooled-together debt instruments -- that held subprime-mortgage-backed bonds, were bets against volatility, too. They paid decent money but ran the risk of failing spectacularly when subprime defaults rose sharply. Similarly, lenders who asked for no money down on subprime mortgages were basically selling puts on the U.S. housing market. When housing prices fell, borrowers owed more on their homes than they were worth.

In a 2004 paper, Georgia State University business professor Vikas Agarwal and London Business School professor Narayan Naik analyzed the returns for a variety of stock hedge funds and found that, in essence, the funds were making bets against volatility, too. "If you look at all these hedge-fund strategies, they look similar to somebody selling out-of-the-money put options," says Mr. Agarwal.

The long period of financial quiescence may have prompted many hedge funds to double down on their investments by using more borrowed money. The strategy worked nicely, as long as volatility stayed low. Now they are suffering for it, like many others, who thought the Great Moderation was permanent.

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