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THE VALUE LINE
Daily Options Survey
On Line at the Opening Bell, Every Trading Day

The Weekly Option Strategist

March 22, 2004

Options Market Review: The Return of Volatility?

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For more than a year now, volatility and premiums have been on the decline. Is this about to change? This week, we take a long-term view of the options market. Whatever your forecasts for the future, it appears that many premiums are cheaply priced, given uncertainties in the market.

The Past 10 Years

In Graph 1 on page 2, we show the rolling 30-day historical volatility of the S&P 500 and the VIX, which is the average 30-day implied volatility of options on that Index. The last time volatility and premiums were this low was in the mid-1990s, when the 1987 crash and the turmoil of the first Iraq war were becoming distant memories.

Over the past year, following the speedy victory in the second Iraq war, stocks began to recover from very low levels. This recovery has been helped, at least up until now, by generally better-than-expected earnings outcomes. Thus, stock market volatility and premiums have contracted partly because valuations (P/E ratios) have been perceived to be reasonable in light of longer-term expectations.

At the same time, there has been fairly continuous hedging with lower strike puts. This has been especially true in the S&P 500 (SPX) and in the NASDAQ 100 (NDX) and in the later index's Exchange Traded Fund (ticker code QQQ). This hedging has kept the VIX a bit higher than it might have been otherwise. These puts have also provided a floor under the markets, at least up until quite recently.

Market Expectations and Our Volatility Forecasts

Where does the market expect volatility to go from here and how do these expectations compare with our volatility forecasts? The dashed line in Graph 1 shows the current implied volatility (as of 3/15/04) of S&P 500 options out to December 17, 2005, while the dotted line shows our model's forecasts for volatility to that date.
Clearly our model, which looks at S&P 500 behavior over the past 10 years, expects higher volatility than does the market. Which is right, the market or our model? Obviously the market is responding to the past year, while our model uses a longer memory. While the market is not likely to return to 2001, 2002 and early 2003 levels of volatility and premiums, our model tells that a reversion to long term average levels is likely. At present, many option premiums definitely seem to be a bargain, especially when looking at the longer maturities.

Looking for Opportunities

As we have often noted in this Survey, the pricing of options can vary a lot depending on the options' strike prices. For the past several years, there has been a tendency for the lower strike price options to be a good deal more expensive than the higher strike ones. In Graph 2 on page 2, we compare the implied volatility of February 2004 calls and puts on the S&P 500 with our *Adjusted Volatility Forecasts*. These are our volatility forecasts adjusted for the empirical likelihood that higher and lower strike prices can actually be reached. As can be seen in the graph, many of the implied volatilities are well below our adjusted volatility forecasts. The exceptions are the lower and extreme higher strike prices. Over the past year, this skewed pattern has been typical of many stocks as well, and has created actual writing opportunities in the lower and in some cases the higher strike prices. Considering the risks that might be present, investors might consider using bear put or call spreads as cost-efficient hedges to stocks in their portfolios.

Prepared by **Lawrence D. Cavanagh**
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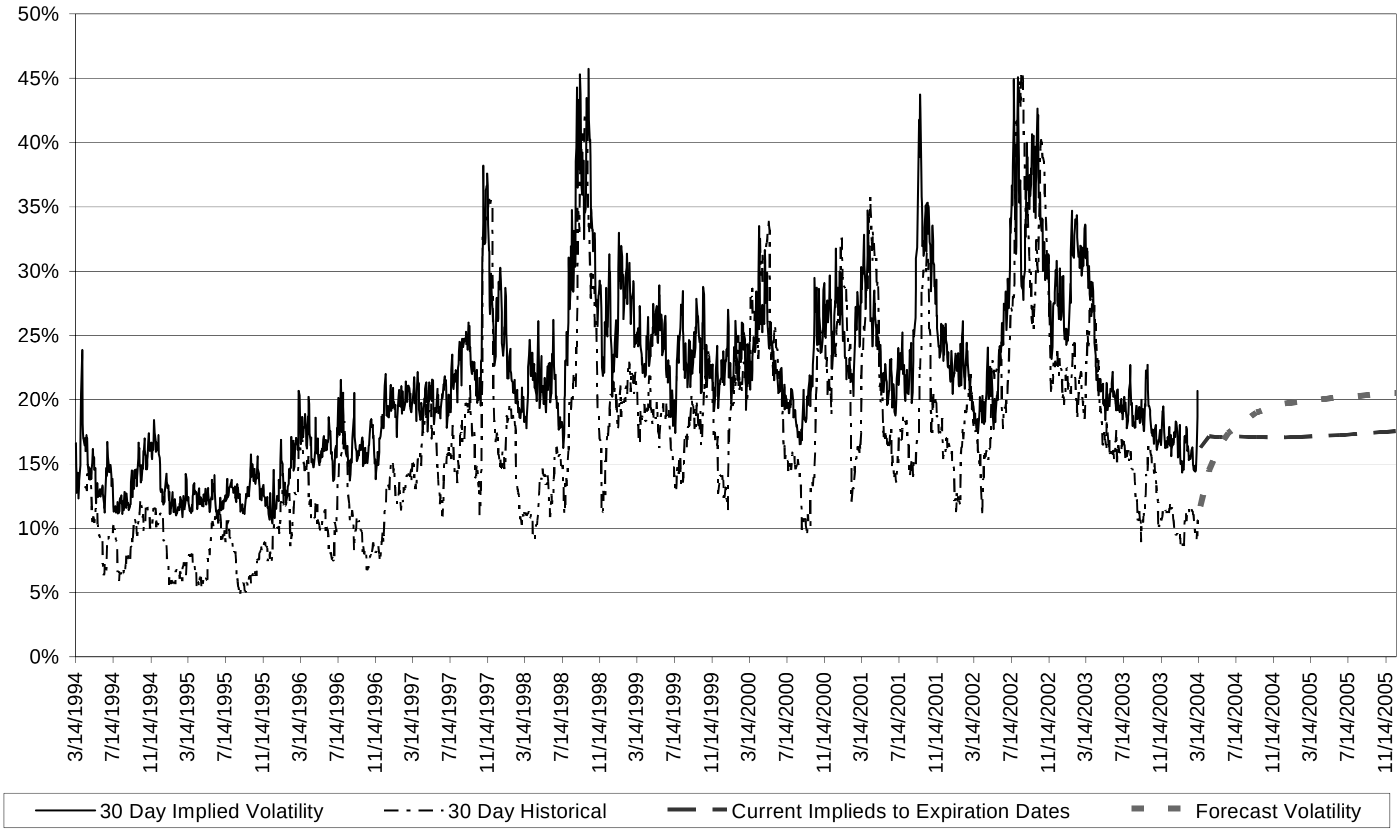
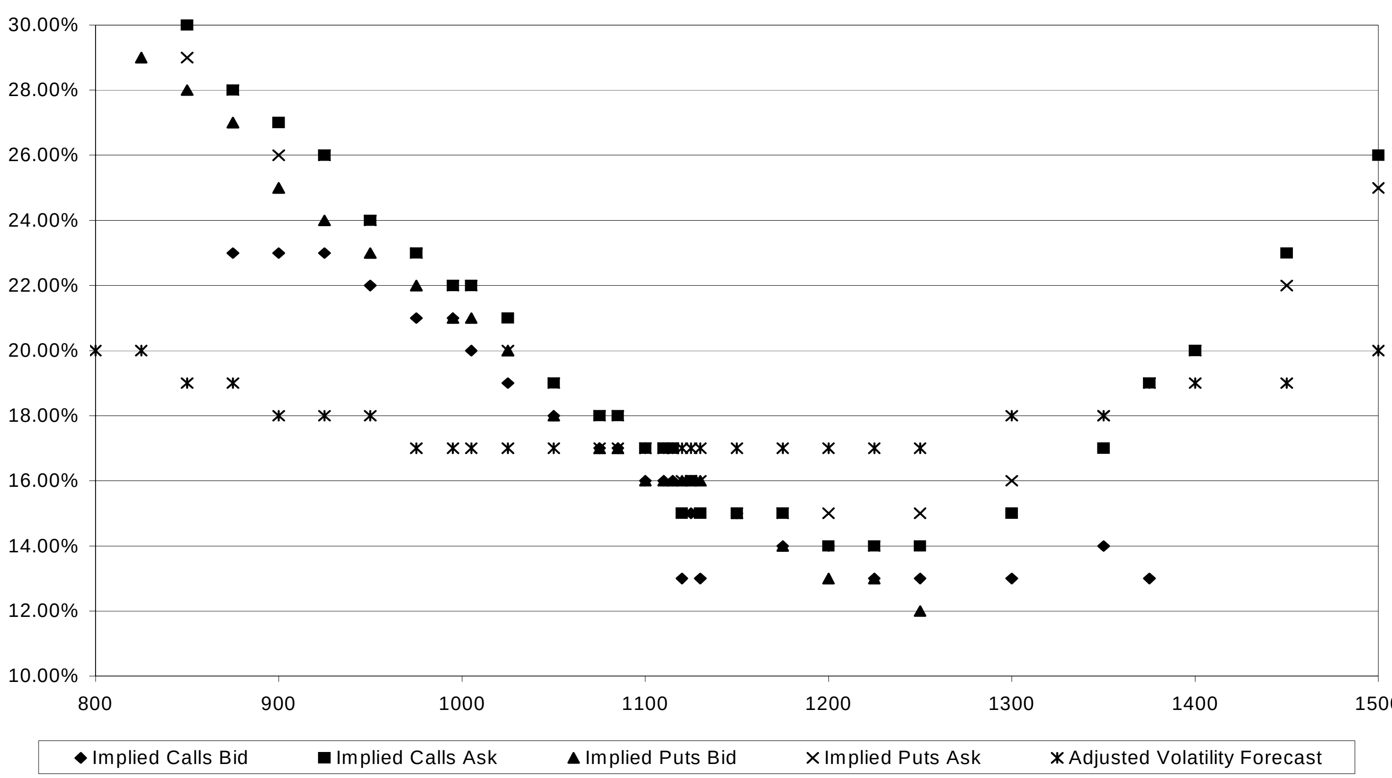
vloptions@valueline.com

Graph 1 - A Long Term Volatility View:
30 Day Historical, 30 Day Implied (VIX), Current Implieds and Forecast Volatility of the S&P 500



Graph 2 - Implied Volatility of June 2004 Call and Puts on the S&P 500, Compared to our Adjusted Volatility Forecasts



Spring 2004 Options Seminar Schedule

Register by phone 1-800-654-0508 or go to www.valueline.com

We are pleased to announce our Spring 2004 Options Training Seminars. We designed these sessions to teach you how to use options as an investment tool and how to get the most out of *The Value Line Daily Options Survey*.

Continental Breakfast (8:30 to 9:00)

Morning Session (9:00 a.m. to 12:00 noon)

We start with an introduction to options and an overview of the options market. We then discuss the basic option strategies (Call & Put Buying, Call & Put Writing, Covered Call Writing and Married Put Buying) and we will review the recent performance of our option ranks. We will then show you how to get started with our new, interactive, online service. We will cover such topics as what to look for in an option and how to find options that suit your objectives.

Coffee & Tea Break (10:00 a.m.)

Lunch (12:00 Noon to 1:00 p.m.)

Afternoon Session (1:00 p.m. to 4:00 p.m.)

We will show you how to use our daily download files for advanced option queries. We will walk you through our templates for portfolio tracking, position evaluation and strategy allocations. We will show you how to build a market neutral portfolio, designed to make money in bearish as well as bullish markets. Finally, we will show you how to use option spreads to make optimum use of your capital with limited risk.

There is a registration fee of $145 for the day, which includes a copy of the presentation. You must make hotel reservations directly with the hotel, phone numbers are provided below. In addition, lunch will be provided. As space is limited, pre-registration is required, and we cannot offer refunds. You may, however, designate someone to attend in your place. You must make hotel reservations directly with the hotel.

Locations:

Las Vegas, NV
***Sunday, April 18, 2004**
MGM Grand Hotel & Casino
3799 Las Vegas Blvd. South
Las Vegas, NV 89109
702-891-7777
For hotel reservations, go to
www.mgmgrand.com

White Plains, NY
Saturday, May 15, 2004
Crowne Plaza
66 Hale Avenue
White Plains, NY 10601
914-682-0050
For hotel reservations, go to
www.crowneplaza.com

Market Review - Week Ending 03/16/04

Market Indexes	Close	% Change	Volatility Indexes*	% Change
Dow Jones Industrial	10,184.67	-2.59%		
Nasdaq 100	1,407.07	-2.11%	27.34	3.17%
S&P 500	1,110.70	-2.62%	20.34	22.53%

Performance Tables

Common Ranks	% Change	Count	Percent
Rank 1	-4.15%	8207	8.17%
Rank 2	-3.50%	19822	19.73%
Rank 3	-3.46%	55304	55.04%
Rank 4	-3.11%	13079	13.02%
Rank 5	-2.94%	4071	4.05%
Call Buyer's Ranks			
Rank 1	-17.21%	3591	7.14%
Rank 2	-15.73%	9212	18.32%
Rank 3	-14.81%	37480	74.54%
Call Writer's Ranks			
Rank 5	16.55%	2288	7.00%
Rank 4	14.69%	5076	15.54%
Rank 3	14.36%	25303	77.46%
Covered Call Ranks			
Rank 1	-0.76%	2553	7.82%
Rank 2	-0.44%	5523	16.91%
Rank 3	-0.89%	15647	47.90%
Rank 4	-1.28%	6109	18.70%
Rank 5	-0.91%	2835	8.68%
Put Buying Ranks			
Rank 1	15.91%	4750	9.44%
Rank 2	21.25%	8938	17.76%
Rank 3	30.86%	36648	72.81%
Put Writer's Ranks			
Rank 5	-10.96%	2458	7.13%
Rank 4	-13.28%	5582	16.19%
Rank 3	-13.87%	26433	76.68%
Married Put Ranks			
Rank 1	-0.80%	3618	7.19%
Rank 2	-0.73%	9401	18.68%
Rank 3	-1.10%	22415	44.53%
Rank 4	-1.51%	7812	15.52%
Rank 5	-1.90%	7090	14.09%

* - VIX for the S&P 100 and VXN for the Nasdaq 100