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Risky and Uncertainty Wreak Havoc on Stocks

Options Trading
In This Market
Is a Tough Sell
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History may judge these recent months in the options market as the most difficult trading environment since the Chicago Board Options Exchange introduced exchange-traded options 25 years ago.

Options give investors the right, but not the obligation, to buy or sell stock at a specific price. But option prices are currently so volatile and stock prices are so erratic that this generation of market makers and specialists is finding it difficult to hedge their risk after they sell defensive **put options** to scared investors trying to hedge their own stock portfolios.

"I think a lot of people are waiting for a final 1987-style decline," says Jay Shartsis, R.F. Lafferty & Co.'s director of options trading.

Investors are so scared of the financial markets, all of which are experiencing record volatility, that many want to buy defensive put contracts (an option to sell a security at a specified price within a limited period).

Anytime an investor buys a put option to hedge a portfolio, market makers create the contract by selling stock and buying a call (an option to buy a security at a specified price within a limited period). This three-sided trade is supposed to produce a nearly riskless profit in normal market conditions.

The Chicago Board Options Exchange Market Volatility Index, or VIX, has more than doubled since the Dow Jones Industrial Average peaked at 9337.97 on July 17. On that day, the VIX closed at 16.87. The VIX closed down Tuesday 0.30, or 0.7%, at 43.11. That's below Thursday's intraday high of 60.63, which marked the highest level since the 1987 stock-market crash. The index tracks the daily price swings of various S&P 100 index options.

These dynamics have left many market makers and specialists in tenuous positions. They are having difficulty establishing positions because few people want to sell call options. The stock market is so unpredictable that it is almost impossible for market professionals to maintain the proper stock-to-options ratio needed to hedge the **put options** that they have sold.

With prices changing so quickly each session, a lot of market professionals are stuck buying and selling stock at the worst time and prices to try to hedge their own order books. All of this serves to further increase the volatility in the equity and options markets.

Many traders use the CBOE's volatility index as a proxy for option prices, but this traditional barometer has lost some of its usefulness because people are having difficulty predicting its reactions. Under normal conditions, the VIX falls when the stock market rises, and rises when the stock market falls, but this hasn't always happened in the past few weeks.

And because of this, Michael Pickert, who manages the Eileen Brenner & Co. hedge fund, has the smallest options position that he has ever had in his 18 years of trading. "I'm not sure if I have to adjust to a new, higher level of volatility, or if it's going to go back to the old range on the VIX of 18 to 27. Until I know, I have to wait," says Mr. Pickert.

Meanwhile, depth and liquidity is drying up in the options market because few besides market makers and specialists are selling options. And they have no choice, because they are required by exchange rules to maintain orderly markets.

The demand to buy puts, which increase in value as the underlying stock price decreases, coupled with volatility in the financial markets, has pushed option prices to historically high levels.

Indeed, options are so expensive that some traders are debating if options are even cost-effective. Other traders think the high cost of hedging could cause some money managers to liquidate their portfolios because the stock market would have to fall an additional 15% for some option hedges to produce a profit.

Market professionals are charging high option prices to minimize their risk of redeeming options at levels above the sale price, while the volatility in the stock market provides another reason for them to keep option prices at lofty levels.

Trading through this stretch of the market may be the most difficult experience in many traders' careers. Compared with the long, slow bleed of the 1998 market, the last stock market crash, in 1987, was quick. "This is prolonged agony," says one trader who started working in the options business before the CBOE was established in 1973.

Problems with volatility are affecting other core businesses, such as underwriting, arbitrage, fixed-income and emerging markets. To compound the stress, many traders are worried about losing their jobs, as Wall Street firms announce layoffs.

The volatile markets hobbled LongTerm Capital Management LP, a hedge fund operated by John Meriwether, once a star bond trader at the former Salomon Brothers, and Myron Scholes and Robert Merton, who won Nobel Prizes in economics for developing the now-standard BlackScholes option-pricing model.

"Bottom line, if Merton and Scholes screwed up, who are we to have an opinion?" Mr. Pickert, the hedge-fund manager says.

Some seasoned traders are using the extreme fear in the market to their advantage. Their strategies involve selling one option and buying another or buying a certain percentage of stock that is determined by the option's "delta," a mathematical measure of an option's expected sensitivity to changes in the underlying stock.

These traders' combinations take advantage of high options prices and low stock prices. At the same time, these combinations limit the risk in the market and create positions that can produce returns of 20% or more. These positions aren't recommended for nonprofessional traders because they must be monitored each session and adjusted if the market makes a sharp move.

The strategies are premised on the belief that option prices are too high and that investors are more scared about the market than warranted. These traders hope to sell the contracts high and buy low when the financial markets resume their historical behavior.

(See related article: "Worries Over Growth, Profits Hit Valuations" -- WSJ Oct. 14, 1998)