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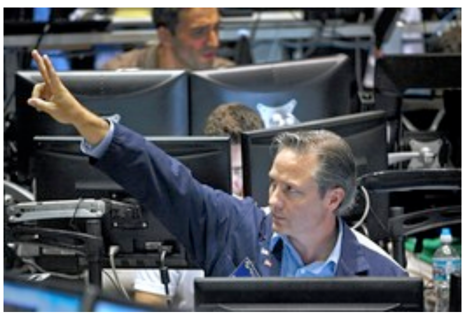
A Contrarian View on Fear

Some Investors Say Surge in VIX Futures Volumes Driven by Bigger Risk Appetites

By CHRIS DIETERICH

Stock bulls are drawing support from an unlikely corner: the market for fear.

Amid a debate over whether stocks will keep rising, investors are piling into futures contracts on the Chicago Board Options Exchange Volatility Index, known as the VIX. Daily trading volume last month was the second highest on record, at 1.34 million contracts, up 65% over January.



Bloomberg News

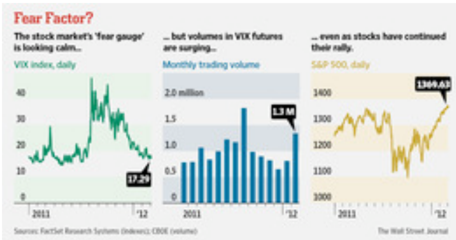
Trading volumes on the VIX are up 65% over January. Above, a trader at the CBOE's VIX pit last year.

The record was set in August, when the market was roiled by fears over Europe's sovereign-debt crisis and a downgrade of the U.S.'s credit rating. But unlike that time, this latest surge has coincided with a period of strong gains for stocks. The Standard & Poor's 500-stock index is up 8.9% this year, near a four-year high, and the Dow Jones Industrial Average this week closed above the 13000 level for the first time since May 2008.

The VIX measures stock-market volatility, using options prices on the S&P 500. Futures are the main way to wager on where the VIX is headed. Because the index tends to rise when stocks fall, investors often use VIX futures to protect against a downdraft.

To be sure, some analysts caution that a volume surge in volatility futures could reflect greater expectations for a market shock that derails the rally in stocks.

But some investors are telling a different story. They say the surge in VIX futures volumes this time is being driven by an appetite for stocks and the need to hedge those positions, not panic over a sharp selloff. The surge in demand for VIX futures "is stemming less from concern the market will fall apart" and more from the fact that there are simply more risky investments to hedge, said Phil Rapoport, volatility specialist at Macro Risk Advisors LLC, a New York derivatives-strategy and execution firm that serves hedge funds and institutional investors.



Christian Wagner, chief executive at Longview Capital Management LLC, in Wilmington, Del., said he is buying more stocks, and subsequently more VIX products, because he is confident that the acute phase of Europe's sovereign-debt crisis has passed and has faith in the economic recovery in the U.S.

"We've doubled our exposure to equities compared with where we were when we closed the year, and in doing so doubled our exposure to [VIX-related] risk products as well," Mr. Wagner said.

History seems to support such bullish sentiment. The gap between the VIX and near-term futures has been unusually wide in recent weeks. The April contract is up 2.2% over the last month and on Friday ended at 23.65. The VIX index closed at 17.29, up 0.2% on the day.

On its face, strategists said this unusually wide gap appears to be a warning sign of an increase in market volatility ahead, as traders pay a higher premium to protect against risk further out.

But historically, when VIX futures trade this much above the VIX, a modest rise in stocks follows. That has happened 36 times since 2004, and, on average, the S&P 500 traded about 1% higher 50 days after the initial signal, according to data from Schaeffer's Investment Research. The VIX itself has stayed steady amid a rise in stocks world-wide, falling from a two-year high of 48 in August, when markets were swooning on worries that Europe's economy would fall victim to a credit crunch. Meanwhile, activity in VIX futures has accelerated.

In large part, VIX futures volumes are rising because a wide swath of investors finally has access to an instrument that allows them to trade the market.

Much of the increase comes from the proliferation of exchange-traded products, which trade like stocks, that are tied to VIX futures. Since their introduction in 2009, the daily notional trading value of all VIX-related products has surged to $3.4 billion as of last year, compared with $471 million in 2008, according to research firm TABB Group.

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