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MONEYBEAT

Volatility Is Low But Ambiguity Is Sky High

New York University's Prof. Menachem Brenner, whose work aims to quantify ambiguity in financial markets, shown on the NYU campus in New York City on March 2 PHOTO: PHOTO: MICHAEL BUCHER/THE WALL STREET JOURNAL

By Ben Eisen

Dec 11, 2017 9:25 am ET

Two academics are rolling out a new measure of market fear that suggests investors aren't nearly as complacent as they seem.

The gauge of so-called ambiguity, meant to chronicle the degree of uncertainty investors have in the probabilities they use to make decisions, has been at all-time highs in recent months, indicating that there's more fear built into the stock market than common measures of volatility suggest. The Cboe Volatility Index, a popular metric for tracking fear in the market, has been idling near record lows this year.

In separating out ambiguity from common measures of risk, Menachem Brenner of New York University and Yehuda Izhakian of Baruch College are picking up on a concept that traces back nearly a century. Economist Frank Knight in 1921 wrote about the difference between risk and uncertainty.

If volatility measures the uncertainties for which one can determine a probability, or the "known unknowns," ambiguity measures the "unknown unknowns," to use a term popularized by former Defense Secretary Donald Rumsfeld, according to Mr. Brenner.

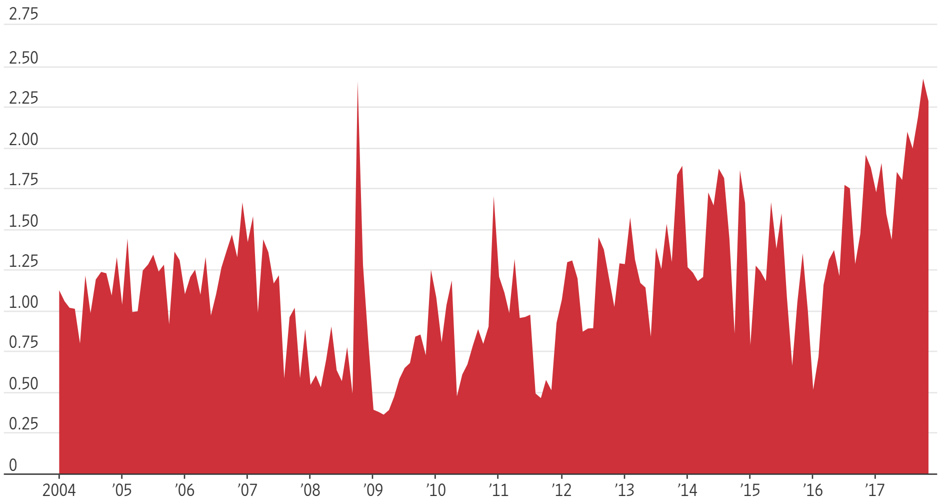
Mr. Brenner, a early pioneer of volatility research whose work was profiled in The Wall Street Journal in March, and Mr. Izhakian are turning the concept into a gauge of current market conditions that they hope will be useful for market watchers. They came up with the measure by analyzing market returns in five-minute increments. Their research is due to be published in the Journal of Financial Economics.

In October, the gauge hit 2.42, its highest reading in monthly data that extends back to 1993. That's above the gauge's previous peak of 2.41 at the height of the financial crisis in October 2008. Last month, it retreated a bit to 2.28, the third-highest reading on record, the data show.

That's in sharp contrast to the Cboe Volatility Index, or VIX, an options-based measure of expected stock swings over the next 30 days. The decline in the VIX this year has befuddled investors and traders of all stripes, given the host of geopolitical uncertainties in locations like North Korea and political skirmishes in Washington. Not to mention, stocks have been rising relentlessly for years, unnerving some investors who say that stocks are trading too high relative to expected earnings.

Ample Ambiguity

A new measure of risk that's not captured by traditional gauges of volatility, called ambiguity, suggests investors aren't as complacent as they seem.



Source: "Asset Pricing and Ambiguity: Empirical Evidence" by Menachem Brenner and Yehuda Izhakian

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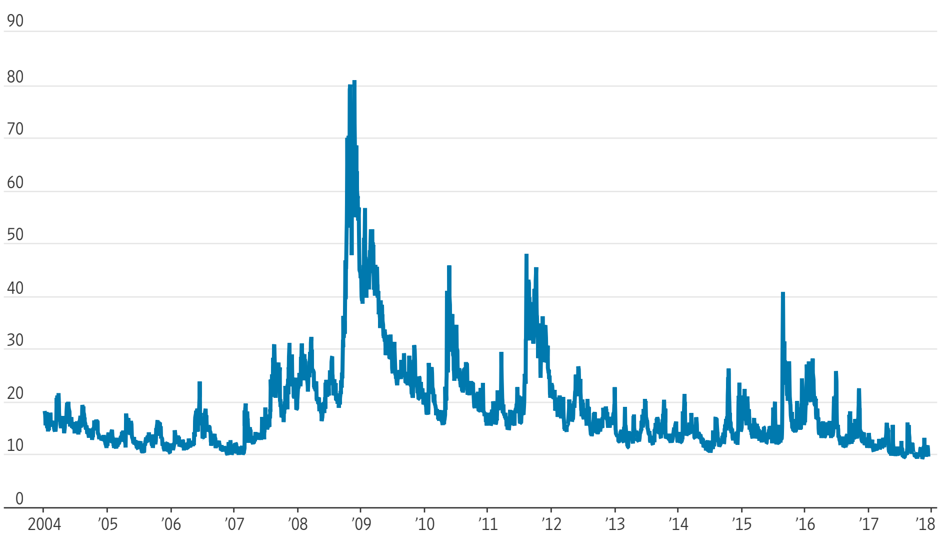
Falling Vol

The Cboe Volatility Index, a widely watched measure of market fear, is near record lows.



Source: FactSet

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Mr. Brenner, however, notes that's part of the point. Their research found that ambiguity tends to rise alongside the market. In other words, the higher stock prices get, the more uncertainty investors feel about where it's going in the future. In that sense, the high levels of ambiguity don't necessarily suggest an imminent decline in the stock market.

In some ways, Mr. Brenner says, ambiguity looks a lot like it did between 2004 and 2006, when the measure was on the rise alongside stocks, Mr. Brenner says. The main difference, however, is that ambiguity is a lot higher now.

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AMBIGUITY STOCKS VOLATILITY

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