

**IFR**

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**FINANCING**  
*review*

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## DERIVATIVES

**Low volume in S&P**

S&P 500 futures traders discovered last week that it really is lonely at the top of a major market move. Despite the market's new all-time front-month highs one week earlier, volume averaged less than 35,000 lots ahead of Friday's unemployment report.

September futures lingered near and mostly below fair value until Thursday. Although hedging was evident, they never moved far enough above or below cash to lure pure spread arbitrageurs. Locals traded defensively, buying near highs and selling near lows and cutting losses more quickly than usual.

The all-time front-month high, 425.05, hung tantalizingly above the market, like a carrot before a starving rabbit, and 420.20, the previous cycle high, dangled equally as temptingly below. Further down lay a possible breakaway gap between the previous Tuesday's 417.50 high and the previous Wednesday's 419.15 low.

The short interest ratio climbed to 4.62:1, which means the total number of short positions in the cash is now 4.62 times daily volume. This normally means that a lot of cash market shorts are getting squeezed and may have to buy back soon; but a high percentage of these are not *bona fide* shorts but short legs of hedged

arbitrage positions, and are thus not affected by market moves.

Put/call volume and premium figures remained neutral, but most of the irresponsible speculation was on the put side. The expiring 400 and 375 August puts bloated from 1/8 to 13-1/2 and from 7/16 to 19-3/4 respectively on Tuesday, as free-wheeling amateurs positioned themselves for the big crash. Their bubble, however, burst on Wednesday, and their options shrank back to reality.

September futures broke to an early 422.95 low on Monday, then drifted higher behind strong cash. Tuesday offered more of the same. Futures traders again followed cash on Wednesday and bought enthusiastically, when a late sharp break failed to reach 422.50 or push decisively below spot. September traded above cash all day Thursday, despite finishing 1.60 lower.

Friday saw the most activity as the much anticipated unemployment figure was out of the way. The market moved higher until the 424.00 mark was hit. Premium reached high levels approaching +100 tempting in the arbs. The last hour saw futures trade off. The premium moved from +100 to -100 with futures closing at 417.75. Merrill and Shearson Lehman were big buyers early on in the day, with many big funds noted selling into weakness on the way down.

**Amex examines volatility options**

The American Stock Exchange is conducting a feasibility study on a volatility index, the Sigma Index (SI). SI would be an underlying asset for futures and options that investors would use to hedge against the risk of volatility changes in the stock market.

SI was conceived five years ago by Menachem Brenner, finance professor at Hebrew University in Jerusalem and New York University, and Dan Galai, finance professor at Hebrew University. The explosion in over-the-counter equity derivatives volume in the past couple of years has led Amex to take another look at the index. The attraction to Amex is that investors would be able to lay off volatility risk through a listed product.

SI would have the same role as other market indices for options and futures. As with a stock index, each percentage point of standard deviation would equal 10 index points. Each percentage point

of standard deviation would equal US\$100.

The index is in its final stages of development, according to Brenner, but products based on the index have not been completed yet. When Brenner conceived the volatility index, he suggested that it might be based on the standard deviation obtained from historical observations, with more weight given to recent observations, i.e. implied volatilities that have just traded. Alternatively, it might be constructed by a combination of historical and implied volatilities, so that there is a balance between long and short-term trends.

Brenner cited the large swings in stock market volatility over the past few years, especially since the Crash, as proving a need to hedge changes in volatility. In 1987, stock market volatility jumped 5.87% after the Crash, or 90% on an annualised basis.

**US clears path for equity swaps**

The US Internal Revenue Service ruled on July 29 that pension funds that are governed by the Employee Retirement Income Securities Act (ERISA) should not pay tax on income earned from equity swaps. The ruling took more than a year of deliberation and was widely expected, since the IRS had proposed that income from unrelated business, like equity swaps, be tax-exempt.

This move is expected eventually to lead to an increase in client business in equity swaps and several major participants in the market have reported an increase in inquiries from pension funds. However, as one options professional pointed out, it will take time. "Many of these pension funds have yet to use interest rate swaps, never mind equity swaps."

**Nikkei rates fall**

With the Japanese stock market in the doldrums and posting the lowest turnover for 10 years on two days last week, client deals in Nikkei swaps, by far the largest constituent of equity index swap business, is slower than usual. However, with prices having moved so much recently, trading activity has picked up in the last month, as Nikkei participants with dynamic hedges re-hedge and speculators take a play on the market.

Nikkei stock index futures have traded at a major discount to the cash level for a month, causing the price of Nikkei swaps to fall dramatically from the Libor + 150 level they stood at six months ago to Libor flat last week for one-year maturity.

As a result Nikkei swaps now look much more attractive, which has led to a frenzy of inter-dealer broker activity. Traders said they were inundated with callers attempting to sell them swaps on the basis of the lower price, seemingly unaware that it is only the negative basis and climbing Nikkei yield which are behind the cheaper levels. "I can only hope they don't understand the product," said one trader. "Otherwise it is rather more sinister. These instruments are not suddenly better value."