

VOLATILITY WATCH

Equity Option Traders Don't Expect European Bank Bailout

European bank shareholders aren't likely to get government bailouts in the event of a bank collapse, equity option skews suggest.

Options investors are more bullish on the market as a whole than European banks. The difference between implied volatilities of out-of-the-money put options and call options for the largest European banks has increased since July and is wider than at the beginning of August. At the same time, the skew increased less for European equity index options and remains at the level of the first week of August. The average skew over the 12 largest European banks by market capitalization for 1-month 120 and 80 percent moneyness options was negative 30 percentage points on Sept. 29. For the Euro Stoxx 50 Index options, the skew was negative 21. Given that the index includes banks, the skew should be less than negative

21 for the non-financial sector. As of Aug. 1, the skew of 1-month options had similar level for both Euro Stoxx 50 and the average of European banks with a value about negative 18 percent points.

— Alberto Fuentes

Emerging Market Implied Volatility Diverges From S&P 500

The price of options to protect against losses on equities from China to India and Brazil has surged to its highest since 2009 relative to U.S. contracts.

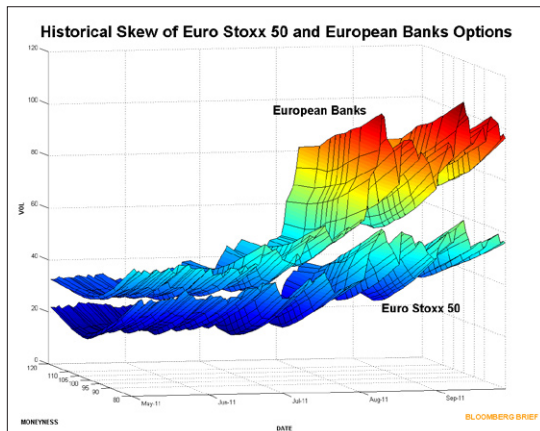
The spread between implied volatility for three-month options on the iShares MSCI Emerging Markets Index and the SPDR S&P 500 ETF Trust has doubled to 13.19 this month. It reached 14.92 on Sept. 26, the highest level since June 2009.

Investors are trying to lock in gains after the emerging markets gauge rallied 84 percent since March 9, 2009, beating the Standard & Poor's 500 Index by 13 percentage points.

The MSCI Emerging Markets Index plunged 12 percent last week, the biggest drop since November 2008, and on Sept. 26 touched its lowest level in two years. Emerging markets stocks underperformed advanced-nation shares during times of financial stress that sparked global losses during the past two decades including Latin America's "Tequila Crisis" in 1994 after Mexico's peso devaluation and Russia's default on \$40 billion of debt in 1998.

The peak-to-trough drop in the emerging-market index was 12 percentage points bigger on average during the six retreats. During the 2008 crisis, when the bankruptcy of Lehman Brothers Holdings Inc. spurred the worst contraction since the Great Depression, the emerging-markets ETF fell as much as 67 percent from its record, while the S&P 500 fund dropped up to 61 percent.

— Cecile Vannucci and Jeff Kearns



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RESEARCH ON THE WEB

News Sentiment Predicts Stocks Better Than Fundamentals

The Efficient Market Hypothesis has been criticized in the wake of findings from behavioral finance. In a working paper, Matthias W. Uhl uses a data set with sentiment values obtained from 3.6 million news articles to show that behavioral factors, such as sentiment can better explain stock returns than fundamental factors such as the Conference Board Index. He also finds that negative sentiment has much higher explanatory and predictive power than positive sentiment in news stories.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1924867

Realized Skewness and Kurtosis Predict Equity Returns

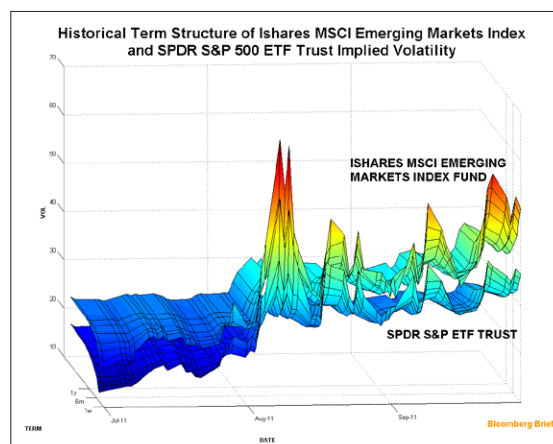
If markets are inefficient, the realized higher moments of individual stocks might be a good place to find predictive information. In a working paper, Diego Amaya, Peter Christoffersen, Kris Jacobs and Aurelio Vazquez use intraday data for U.S. listed stocks and find that realized skewness and realized kurtosis predict next week's stock returns but realized volatility does not. They also find that realized kurtosis is positively related to future stock returns while realized skewness is negatively related.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1898735

Making Money From Mutual Fund Herding Behavior

The irrational herding behavior of mutual fund managers can be profitable, research shows. In a working paper Lizang Zhong, uses data on quarterly equity holdings of U.S. mutual funds from 1979 to 2010 to compute a measure of fund manager optimism: the ratio of the number of mutual fund managers holding the stock divided by market capitalization. He shows that this measure predicts reduced returns. Long-short hedge fund managers can exploit this effect to generate a 17% annualized compound return.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1915159



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