JANUARY 2012 | Vol. 2 No. 11

EXPIRING MONTHLY

THE OPTION TRADERS JOURNAL

2011

THE YEAR IN REVIEW
AND A LOOK AHEAD

2012

USDA Reports:
TAKING TRADERS TO THE LIMIT

A Softer Landing in China:
Analysis of FXI Options

AN INTERVIEW WITH
Kristi Ross, President of Tastytrade

EXPIRING MONTHLY
THE OPTION TRADERS JOURNAL

EDITORIAL
Bill Luby
Jared Woodard
Mark Sebastian

DESIGN/LAYOUT
Lauren Woodrow

CONTACT INFORMATION
Editorial comments: editor@expiringmonthly.com
Advertising and Sales
Expiring Monthly President
Mark Sebastian: marks@expiringmonthly.com
Phone: 773.661.6620

The information presented in this publication does not consider your personal investment objectives or financial situation; therefore, this publication does not make personalized recommendations. This information should not be construed as an offer to sell or a solicitation to buy any security. The investment strategies or the securities may not be suitable for you. We believe the information provided is reliable; however, Expiring Monthly and its affiliated personnel do not guarantee its accuracy, timeliness, or completeness. Any and all opinions expressed in this publication are subject to change without notice. In respect to the companies or securities covered in these materials, the respective person, analyst, or writer certifies to Expiring Monthly that the views expressed accurately reflect his or her own personal views about the subject securities and issuing entities and that no part of the person's compensation was, is, or will be related to the specific recommendations (if made) or views contained in this publication. Expiring Monthly and its affiliates, their employees, directors, consultants, and/or their respective family members may directly or indirectly hold positions in the securities referenced in these materials.

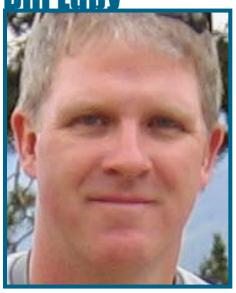
Options transactions involve complex tax considerations that should be carefully reviewed prior to entering into any transaction. The risk of loss in trading securities, options, futures, and forex can be substantial. Customers must consider all relevant risk factors, including their own personal financial situation, before trading. Options involve risk and are not suitable for all investors. See the options disclosure document Characteristics and Risks of Standardized Options. A copy can be downloaded at http://www.optionsclearing.com/about/publications/character-risks.jsp.

Expiring Monthly does not assume any liability for any action taken based on information or advertisements presented in this publication. No part of this material is to be reproduced or distributed to others by any means without prior written permission of Expiring Monthly or its affiliates. Photocopying, including transmission by facsimile or email scan, is prohibited and subject to liability. Copyright © 2012, Expiring Monthly.

CONTENTS

About the Expiring Monthly Team

Bill Luby



Bill is a private investor whose research and trading interests focus on volatility, market sentiment, technical analysis, and ETFs. His work has been has been quoted in the Wall Street Journal, Financial Times, Barron's and other publications. A contributor to Barron's and Minyanville, Bill also authors the VIX and More blog and an investment newsletter from just north of San Francisco. He has been trading options since 1998.

Prior to becoming a full-time investor, Bill was a business strategy consultant for two decades and advised clients across a broad range of industries on issues such as strategy formulation, strategy implementation, and metrics. When not trading or blogging, he can often be found running, hiking, and kayaking in Northern California.

Bill has a BA from Stanford University and an MBA from Carnegie-Mellon University.

Jared Woodard

Jared is the principal of Condor Options. With over a decade of experience trading options, equities, and futures, he publishes the Condor Options newsletter (iron condors) and associated blog.

Jared has been quoted in various media outlets including The Wall Street Journal, Bloomberg, Financial Times Alphaville, and The Chicago Sun-Times. He is also a contributor to TheStreet's Options Profits service.

In 2008, he was profiled as a top options mentor in Stocks, Futures, and Options Magazine. He is also an associate member of the National Futures Association and registered principal of Clinamen Financial Group LLC, a commodity trading advisor.

Jared has master's degrees from Fordham University and the University of Edinburgh.

Mark Sebastian

Mark is a professional option trader and option mentor. He graduated from Villanova University in 2001 with a degree in finance. He was hired into an option trader training program by Group 1 Trading. He spent two years in New York trading options on the American Stock Exchange before moving back to Chicago to trade SPX and DJX options For the next five years, he traded a variety of option products successfully, both on and off the CBOE floor.

In December 2008 he started working as a mentor at Sheridan Option Mentoring. Currently, Mark writes a daily blog on all things option trading at Option911.com and works part time as risk manager for a hedge fund. In March 2010 he became Director of Education for a new education firm OptionPit.com.

Editor's Notes

Mark Sebastian

Happy New Year from the Expiring Monthly team! We look forward to another great year of the timeliest, interesting, and informative content that is available in the options space. This month is an especially fun month, if not eclectic. Any time we do a year in review and look ahead it opens this magazine to all sorts of thoughts and ideas. For our feature, Jared, Bill, myself, and guest contributor Andrew Giovinazzi each give our take on the year that was and the year ahead.

Also in this month's issue is an intriguing analysis of a trade in FXI options. We follow that up with new guest contributor Zachary Fietsch who brings us an analysis on USDA reports and their effect on futures traders. Following Zach's piece, Mark Sebastian sits down with Kristi Ross, the president of the new internet financial network Tastytrade, which already seems to be making waves in the financial media.

Following our featured section, Bill continues his piece from last month with *Using VIX ETPs as Hedges: Part Two*, along with a great *Follow That Trade* that attempts to create an arb between VXX and VIX. This sandwiches a great 'floor story' from trading floor veteran and frequent guest contributor, Andrew Giovinazzi. Finally, in a first we bring in a non-trader, but expert fashionista to discuss women's retail shopping habits. My wife and popular blogger from BigBlondeHair.com, Lauren Sebastian basically lays out why she doesn't have to shop at Sears.

This is going to be a fun one to read this month, enjoy and happy trading.

As always, readers are encouraged to send questions, comments or guest article contribution ideas to editor@expiringmonthly.com.

Mark Sebastian
Contributing Editor

Ask the Xperts

The Expiring Monthly Editors

Q: *To avoid the decay effects due to the VIX futures contracts trading in contango, why not buy one-month OTM call options on the VXX ETN instead? This also provides more leverage as well, instead of owning the ETN itself. I'm not looking to hedge a portfolio, but simply to use a "break-even or better" strategy where I put 100% of my capital in cash, and use the interest generated to make small bets with OTM options.*

—Trevor B.

A: Here are some thoughts on the strategy you suggested:

1) Because being long a VXX call still leaves you long VXX delta, you will realize the same negative roll yield (which you wanted to avoid) in proportion to your delta.

2) VIX and VXX option implied volatility is usually pretty expensive relative to the subsequent realized volatility of the underlying products—even out of the money SPX puts typically have a lower volatility premium. So being a persistent buyer of VXX calls instead of using futures or the ETN looks like an extra cost.

3) Leverage doesn't improve the risk-adjusted return of any strategy.

4) When interest on cash is functionally 0%, even with a nominally profitable version of this strategy you'll have a hard time earning a positive return in real terms.

—Jared

.....

Q: *How can I tell if my brokerage platform has reliable option implied volatilities?*

—Andrew

A: The simple answer is that it is pretty tough. Regardless of the platform the model is probably an old one. That is not necessarily a bad thing. Old trucks are old, but they still are usually able to do a lot of heavy lifting and hauling . . . certainly for the average guys needs. That said, it's not good to drive an old truck that leaks oil and burns fuel, it might eventually cause the truck to blow up. So, here are a few tips to make sure the IVs you are looking at are somewhat reliable:

1) Make sure they update dynamically.

2) Make sure calls and puts line up.

3) Ensure they include cost of carry in their calculation.

4) Make sure VIX options are priced off of VIX futures, *not* VIX cash.

It sounds like a simple list, but almost no retail brokerage platform meets all four requirements.

Hope that helps.
—Mark

.....

Q: *On VIX expiration day in such a wide contango environment what is the probability that the VIX spot chases up closer to the expiring month's option as it did today (Tuesday, January 17)?*

—Jerry A.

A: When the VIX futures are in steep contango, the odds do favor the spot/cash VIX moving up toward the front month futures. The problem with this analysis is that when you get down to the last session prior to expiration, I give much less credence to the shape of the VIX term structure. As I see it, whatever catalyst that traders are expecting to eventually return the term structure to a flatter slope is highly unlikely to hit during the last few hours of Tuesday's pre-expiration trading session.

So . . . yes, on balance the cash VIX bias is slightly upward in pre-expiration trading with steep contango, but for me at least, that slight bias is not sufficient to get me to trade on that expectation. Moreover, the gap between cash VIX and the front month VIX futures is much more likely to be closed overnight and in pre-market trading tomorrow than it was in

(continued on page 35)

A Softer Landing in China:
Analysis of FXI Options

Jared Woodard

MY BASELINE THESIS about China is that it is inscrutable for all of the familiar reasons, especially the lack of transparency in government operations and the size and complexity of the economy. What does seem clear is that the Chinese leadership has the will to take whatever actions are necessary to avoid bad economic outcomes, and I think any position involving China in 2012 is essentially a bet on whether intruding economic facts will be able to overcome the potency of the central leadership.

Debates over the last few years about the future of China have been focused on whether the leadership has not just the will but the means to avoid a "hard landing"—a deep recession triggered by the end of residential and commercial real estate speculation, the end of excess credit going to insolvent businesses, etc. Certainly, willful policy responses do not matter if they are ineffective, and let's grant just for the sake of argument that China bears like Michael Pettis, Patrick Chovanec, Jim Chanos, and Hugh Hendry will someday be proven right. The difficult thing about bubble-calling usually isn't the thesis itself but the timing. Pettis and Chanos have been warning about China for years, and while 2011 was a moderate vindication with FXI down 15% versus a small gain for SPX, we still have not seen the collapse for which so many have been looking. Better than expected GDP data released in January is making China bulls feel more vigorous (8.9% annualized versus expectations of 8.7%), especially since strength was evident in growing retail sales. Investment bank economists are shifting their outlooks toward a stance that can best be characterized as "soft landing with meaningful tail risks."

> A continuing normal trading environment should favor "curve flattener" trades like long time spreads.

If we adopt an outlook on China that is neutral-to-positive with room for low-probability, extreme downside, the options market presents some interesting opportunities.

CSI data, Amibroker

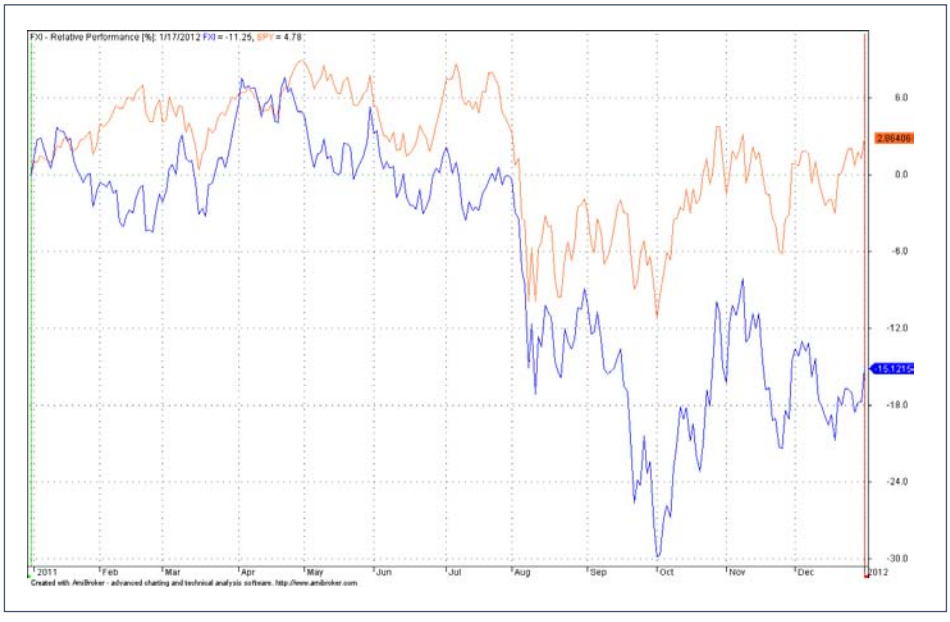


FIGURE 1 *2011 FXI and SPY Returns*

Implied Volatility Level and Term Structure

First, the nominal level of implied volatility is still climbing down to where it has been during other recent periods of quiet trading. Fig. 2 illustrates how, in the absence of market dislocations attributable to the European debt crisis, FXI 90-day implied volatility has moved in a range of 24–28%. It is currently at the top

of that range, suggesting a premium of at least four points on the short side if normal markets persist.

Second, the term structure of implied volatility is rather flat, which means that near-term options are priced higher relative to longer-dated options than is usually the case. At the start of 2012, there was a difference of nearly seven percentage points between the implied volatility of front-month options and the that of the January 2012 LEAPS. That difference remained in place for much of the year until, by October, the term structure was backwardated, with a difference of negative 23 points between January 2012 and January 2013 option IV. At the time of writing, the curve has flattened again with a difference of 2.5 points between January of this year and next.

A continuing normal trading environment should favor "curve flattener" trades like long time spreads, betting that near term option implied volatility will decline more quickly than long-dated option IV. To reduce the impact of adverse moves caused by short-term spikes in volatility, traders could sell third or fourth-month

FIGURE 2 *FXI 90-day Implied Volatility, 2010–2011*

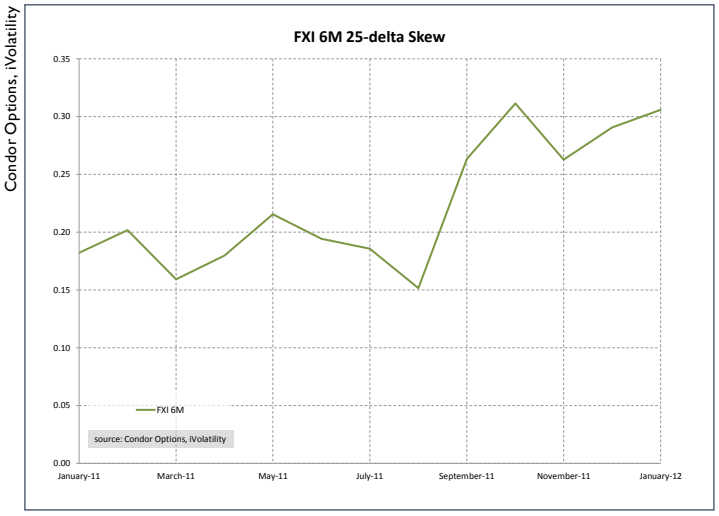


FIGURE 3 *Six-Month FXI Implied Volatility Skew*

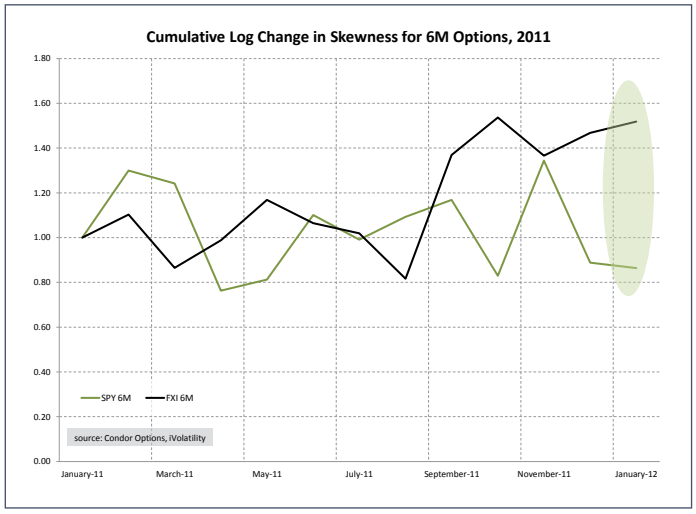


FIGURE 4 *Cumulative Log Change in Skew for SPY and FXI Six-Month Option Implied Volatility*

options against options owned in further-dated series.

Skewness: What About the Tail Risk?

While implied volatility for Chinese stocks has declined in nominal terms, medium-term volatility skew is still quite high. At the start of 2011, the implied volatility skew at a six-month weighted horizon was just over 18%. That level climbed as high as 31% by October and despite a holiday reprieve, the skew for FXI options at a 6-month horizon are still above 29%. That means that out of the money put protection is still quite expensive in relative terms. This is not true across-the-board for equity index options. SPY skew is still high in nominal terms, but is nowhere near the highest levels we saw in 2011. Fig. 4 shows the gap that has opened up between FXI and SPY option skewness. This gap is already closing at shorter-term horizons, so rather than paying up for expensive FXI long-term protection now I would look for a further weakening in implied vol and add protection at that time. Alternatively, investors wishing to hedge long exposure to China and/or emerging markets (EM) could buy (highly-correlated) SPX/SPY puts and sell FXI puts at the same delta and duration on a vega-neutral basis. The new VXEM emerging market volatility futures trading at the Chicago Futures Exchange have also attracted a good initial audience of traders, and since the current skew picture at a 30-day horizon does not favor the same long-SPX/short-EM exposure, VXEM futures look more fairly priced than longer-dated EM protection. EM

DEFINITION

Weighted 25-delta skewness *Measures the difference of the 25 delta put and call option implied volatilities against the average at the money implied volatility. The advantage of this method over some alternatives is that it eliminates noise attributed to changes in the absolute level of implied volatility. The formula is (25-delta put implied volatility – 25-delta call implied volatility)/(average at the money implied volatility). cf. Mixon 2010*

OPTION PIT
For Information Call (888) TRADE-01
Visit Our Website
www.optionpit.com
Specializing in Trade Structure, Risk Management and Capital Efficiency

USDA Reports: Taking Traders To the Limit

Zachary Fietsch, Guest Contributor

WITH AN INCREASE IN the desire of traders to participate in agricultural commodities markets there is a need to cover some basic features that can make a huge difference in the effectiveness of risk management. Ag markets are very different creatures from equity markets and financial asset futures markets. Today I would like to discuss two of the more pronounced differences: daily limit moves and USDA reports. Equities markets have both earnings reports and circuit breakers. These, in theory, are similar to USDA reports and daily limit moves in commodities markets.

The first problem with a comparison is that major USDA reports are much larger in terms of impact on their observed subject than earnings announcements. The major annual USDA reports are akin to having an entire S&P 500 sector release earnings on the same day. Daily limit moves frequently accompany these report releases. USDA reports cover the global yield and purchase data for a slew of agricultural products. Estimates for: commercial consumption, yield/acre, acres under cultivation, livestock on feed, ethanol usage, and many other key factors are released. Unlike analyst reports, the forward looking statements contained in USDA releases are to be considered gospel truth on the day of a release. The USDA may well be wrong, but that is a position to be taken on another day.

Given the less mercurial nature of yield/acre vs. deferred tax assets, USDA reports contain more concrete fundamental data. Since there are large numbers of grain market participants who tend to be very active technical traders, a flood of fundamentals can really throw a wrench in the works.

The major report-releasing entities in the USDA are as follows:

- **NASS** (National Agricultural Statistical Service)—Releases backward-looking reports on prior domestic production and consumption data.
- **AMS** (Agricultural Marketing Service)—Collects data on sale prices of domestic agricultural products and promotes U.S. agricultural products for export.
- **FAS** (Foreign Agricultural Service)—Releases data on U.S. exports/imports as well as summaries of production in foreign markets.
- **ERS** (Economic Reporting Service)—Releases projections of yield, supply/demand and price for domestic and foreign products.

If theses sound like divisions that could release overlapping reports, you are correct. Also, bad weather, in any part of the world, will magnify the effect of any USDA report. It is essential to be very aware of scheduled USDA report dates through calendars such as the Hightower Report or USDA email subscription services. Grain stock reports, foreign production, foreign supply/demand projections, corn reports, and wheat reports are the larger events. Annual reports are especially important, six of the last seven annual reports in corn have triggered limit up or limit down moves. Clusters of reports obviously lead to larger moves. Again, the importance of being informed with regard to crop report release dates cannot be overstated.

The daily limits can have huge impacts on someone managing an options position.

As for circuit breakers, in the stock markets the breakers are very infrequently triggered and do not have many implications on existing

positions, beyond not being able to trade them, in the event they are triggered. Daily limits in ags are unusual but, by no means extraordinary events that cluster around USDA reports. The daily limits can have huge impacts on someone managing an options position. This is especially true for gamma scalpers or any traders requiring positions in the underling.

What Exactly Happens When Daily Limits Are Hit?

The most obvious feature is that trading stops in the futures. If the market is limit down, you may not sell and visa versa. On USDA report days the daily limit can be reached very rapidly. On 1/12/2010 the two front months of corn opened at 9:30 and were both limit down before 9:35. Each option strike has a daily price limit equal to the futures contract. Naturally the daily limits in options tend to be hit later than the futures. Do not count on the availability of ITM options on limit move days. Thus, it is possible to be caught with no underlying to trade and a wildly fluctuating options position.

Another issue to be weary of is that stop orders on the CME exchanges are not pure stops. If you are using stops to leg into/out of certain positions you must be careful. If there is a stop which would be filled at a gap of 20 ticks or more it is converted to a limit order at 20 ticks from initial stop or better. For example, a sell stop is placed in corn at 633, the market opens at 625. Your stop will convert to a limit sell at 628 and your futures position will continue bleeding until the daily limit or 628 is reached.

Market	First Future	Last Future
CBOT Wheat	July	May
CBOT Corn	December	September
CBOT Oats	July	May
CBOT Soybeans	September	August
CBOT Soybean Oil	October	September
CBOT Soybean Meal	October	September
CBOT Rough Rice	September	July
KCBT Wheat	July	May
MGE Wheat	September	July
CME Lean Hogs	December	October
CME Frozen Pork Bellies	February	August
NYBT Cocoa	December	September
NYBT Coffee C	December	September
NYBT Cotton No.2	October	July
NYBT Frozen Conc Orange Juice	January	November

TABLE I

After the close there are even more fun side effects of the limit close. Say you somehow managed to get your scalps off and your position is looking great . . . and suddenly you notice that you're getting a margin call because the margin requirement on your scalps increased by 150%. Limit closes generate margin increases of 150% because the daily limit increases by 150% on the day following a limit close.

What Is the Scalper To Do?

It might be advisable to keep at least 150% extra capital on hand. Do not count on good-til-cancelled stops to function unless they are quite wide. Having a data feed that displays both pit and electronic markets is a life saver in the immediate pre-open. On January 12th it was possible to see a comic disparity of opinion with the pit down 28 cents/bu and the electronic market up 3 ¼ cents/bu just before 9:30, a very useful piece of information.

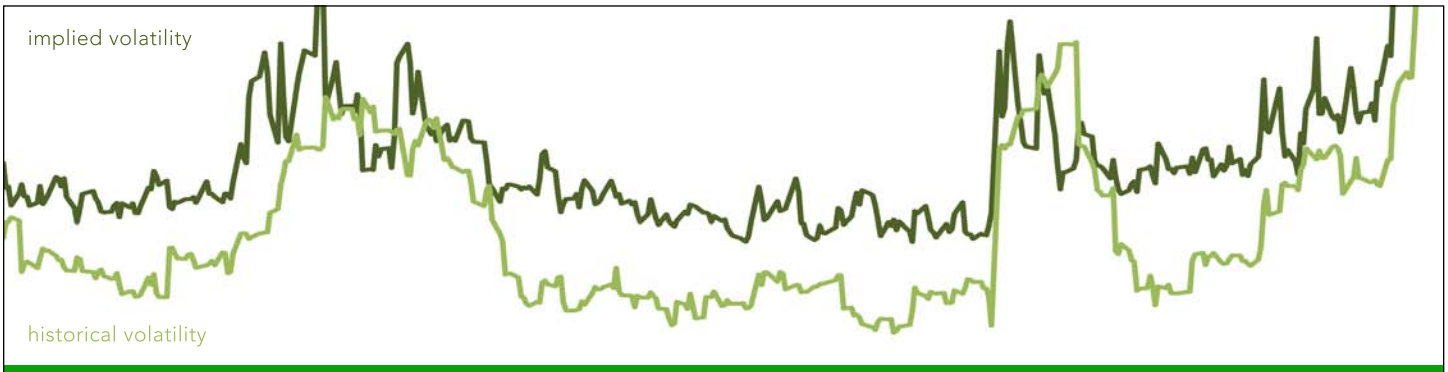
Unlike in stock markets, where it is possible to buy a fraction of the underlying (less than 100 shares) to fine tune a position, most options on futures have an underlying of a single contract. In order to

buy less than 100 deltas you must go further out in the term structure and purchase a less responsive contract month. The deltas of further out contracts must be calculated and reassessed frequently, as these deltas are subject to change.

There is a complication with going out on the curve that involves crop years. If a report is released near the end of a crop year (Table 1) the underlying for further out months is not the same as for the current trading month. A perfect example would be wheat near this year's annual corn report on Jan 12th. The wheat crop year ends in May and starts in July. Since there are only two months left in the crop year it can be difficult to go out beyond the May contract to buy a reliable source of deltas.

Clearly, the agricultural commodities markets are a different creature than other asset classes. The points examined here barely scratch the surface, but hopefully lead to more careful consideration of factors unique to the ag markets. I will delve deeper into some of the topics presented in future articles. *Next month: The Weather and IV* EM

Mr. Fietsch is currently a broker with Price Futures Group on the dairy, tropical, and feed products desk. He earned his M.S. in Financial Risk Management from Loyola University Chicago and is a Level 2 candidate for the CFA designation.



Fearful investors: keeping option premiums artificially high since 1987.

Condor Options
EFFECTIVE STRATEGIES
admin@condoroptions.com
www.condoroptions.com
(212) 203-0693

- Condor Options Advisory Newsletter (iron condors)
- Calendar Options Advisory Newsletter (time spreads)
- Backtesting & Research
- Mentoring & Consulting

Expiring Monthly Interview with
Kristi Ross

Mark Sebastian

Kristi Ross, President of tastytrade, has been in and around the trading business for more than 20 years. Previously, as CFO of online brokerage thinkorswim, Kristi either led or actively participated in numerous mergers and acquisitions and integrations.

Prior to that Kristi was CFO of Automated Trading Desk Specialists (formerly CSG), and CFO of Chicago Securities Group (CSG), a stock specialist on the Chicago Stock Exchange (CHX). Kristi started her career in public accounting, specializing in financial services industry clientele including individual traders; prop, market makers, specialists, discount brokerage and advisory firms. She is also a certified public accountant.

If Tom Sosnoff is the king of the option brokerage industry, Kristi Ross is the castle, the scepter, the royal scribe, head noble and in many ways co-king. Call her the Key to Tom's Kingdom. It is no wonder that when Tom left thinkorswim to start tastytrade he insisted that Kristi, his backbone for all those years at TOS come with him. Smart and driven, yet kind and pleasant I sat down with tastytrade's President, Kristi Ross, to discuss the effect tastytrade is having on the financial industry.

Expiring Monthly: *Tell us about you and your background and your position here at tastytrade.*

Kristi Ross: I am the President of tastytrade, an online financial media network. My background is in finance and accounting, I am a CPA by trade. I was first introduced to the trading industry right out of college, many years ago, doing tax returns for trading firms and brokerage firms. I loved the energy and the egos . . . I was drawn to the strong environment. Years later I became the CFO of a stock's specialist firm on the Chicago Stock Exchange floor. We did a couple of acquisitions. I loved the chase and the kill. It was a great experience for me.

We were eventually acquired by ATD. Great company! But it was difficult for me to increase my travel at the time with small kids. Once I started putting feelers out there, I met Tom Sosnoff (founder of thinkorswim) and he needed a CFO. This was right after thinkorswim took venture capital money. Perfect timing, perfect match of personalities.

When I interviewed, I told him that I would love to come on board, but if there is not enough going on, I would probably leave in three years. Generally, three years is my max. I get bored easily. Ha! Seven years later . . . not even a chance to get bored. Tom kept it interesting every step of the way.

So, naturally, when Tom told me about his idea for tastytrade, I jumped onboard knowing it would be fun and challenging literally every day. Tom has strategic game-changing vision and I'm here to execute it for him.

EM: *How does tastytrade go from Tom's idea to what it has become, which is a popular internet television program? Talk about the original plan and what has changed. Also, what need does the network fill?*

KR: Believe it or not, the initial form we thought we would launch with was a high end version of internet radio. That was in the very early stages. That changed in about two weeks. We need to be out there, we need to be visible, and we need to make sure people see Tom. A lot of people know who Tom is in the industry, but we also wanted to expand the retail investor audience. We brought in Second City comedians to help make the markets entertaining. Successful traders are mechanical and anyone can trade, and anyone can find time in their busy day to trade . . . even me. A lot of financial media is dry and not entertaining. We give viewers a reason to turn the sound back on. We have financial experts delivering the content, talking about everything they have done, their whole life experience, and then we add some comedy in there.

The idea is bringing financial media to the masses, and making it entertaining and fun. Not only do we do that, we bridge the gap from someone just listening to actually making them active investors. This works because on top of the show, we provide members with the trade ideas and the discounts that gives an incentive to try it. We have really retained the initial vision but we simply continue to build on it.

EM: *Based on the fact that tastytrade is founded by financial guys, not broadcasters, how does this affect the operational aspect with advertisers/guests?*

KR: tastytrade is unique. Founded by traders who traded in the pit, taught trading on the street, and now effectively delivering that message in the financial media space . . . there is no one out there more credible that is doing this. When they talk about trading, people listen. There is a reason to "turn the sound back on." They know the space, they own the space. They have the depth of knowledge that many financial broadcasters don't. Those broadcasters are asking the questions, but there isn't a connection. When a guest is interviewed and there is a connection on the topic, it allows the host and the guest to have a deeper dialogue. Viewers can make the connection. A fully engaged guest and host allows the viewer to be fully engaged.

EM: *Let's talk financial industry as a whole, and how tastytrade is moving it. What was your evaluation of what the financial media is and what do you do differently and better?*

KR: First of all, what I will say is, 10 years ago, it was a technology play. Right now, it is really a content play. I can't say technology is all the same, but for the most part, technology is easily accessible to traders and anybody in the financials space today. As far as content and media goes, this is where we differ. We bring content to this space that viewers can use. We give a different perspective and challenge our viewers to think about the markets and trading in a different way than others. Tom has been speaking for years all over the country about trading, but he has always made it challenging and entertaining. He has built tastytrade based on that concept. The financial space has been missing this. The financial media space without tastytrade is dry and rarely is entertaining.

EM: *You just pitched me Jim Cramer. What's the difference?*

The idea is bringing **financial media to the masses,** and making it entertaining and fun.

KR: First of all, he has a certain delivery, and he is one show. What he teaches a lot of the time cannot be repeated again. Tom's theory is trading is mechanical and don't get emotional about it. If you apply the same basics over and over again, you increase your probability of success. I like Jim Cramer, and he is entertaining, but Jim Cramer doesn't appeal to everybody. Our shows are wrapped around those personalities, talking about things truly at the personal level, where you can get to know them. You can get an insight into them and their lives, and what they are doing. We have a number of different shows, and each one of those shows appeals to a different audience. Get tasted, taps into their personalities, what they do, how they view the world, what their experience is. People can start to relate. It is that direct connection. It's almost like being in the pit . . . although the pit is like a locker room sometimes. The show moves through the pits, their experience, the news, their market views, and helps the viewers make the connection between everyday life and their trading account.

EM: *You don't accept advertisers. Is this something you need to change?*

KR: That's a fair question. We believe eventually we will probably take in sponsorships and advertising revenue. We wanted to be fully agnostic initially. I don't think we will always function that way.

We did the same thing when we were in the brokerages industry by thinking we were right in not taking payment for order flow. It turns out customers didn't care if we took payment for order flow. Likewise, we think the tastytrade customers will not care, as long as the ads aren't intrusive, but we want to look out for our customers and merchants.

EM: *Let's talk about the superstore.*

KR: On January 21st we are actually are releasing a redesign for our store, which will make it easier for customers to get in there, buy a voucher, and redeem a voucher. When we launched the superstore in August, we simply wanted the job done as quickly as we could. We wanted to get our concept, distribution, our message, and the benefits out to our members. They spend $1 and it gets them $2 of financial products and services in our superstore.

Now we are going back and perfecting what we have done. I believe a company has to be constantly moving forward. If you're not, someone else will catch up. We are constantly improving, ever changing. We just expanded our live programming to six hours a day and plan to add more in the next quarter. There will be some exciting things coming out of tastytrade over the next few months.

EM: *Let's talk the direction of tastytrade and financial media. What is tastytrade's role in the financial media as a whole?*

KR: Since we launched in May, we already know there are a lot of different networks out there watching what we are doing. We have seen a few things popping up that are a direct result of what we are doing. They have had to adjust their delivery on some things to engage the end consumer.

EM: *Do you see tastytrade simulcast on TV, internet, radio?*

KR: I think it is a natural progression. We have a number of firms already interested in taking our content. We have been very guarded on exactly who and how we will distribute it. Again, month after month you will see us in a number of different forums. Much more to come from tastytrade! Stay tuned . . .

EM: *Thanks, Kristi.* EM

The Tale of Two Years

Andrew Giovinazzi, Guest Contributor

THE TRADING YEAR of 2011 was really more like two totally different trading years rolled into one. The first seven months or so of trading held the spark of higher equity values and, in general, lower implied volatilities as the market believed in a recovery. Bellwether stocks like AMZN, NFLX and GMCR all jumped to all-time highs, as the momentum darlings of the moment. The only real volatility spikes were for brief but tragic events, like the Tsunami in Japan and subsequent potential nuclear meltdown that cast a pall over the market for several weeks. Euro worries were just a shiver. Even with that, the 50-day moving average of the VIX touched the low 18 level in mid-July. Then things took a turn.

Normally the problems don't come when they are telegraphed in advance. The failure of Congress to create meaningful fiscal reform was not a total surprise to the market. While the volatility got bid up slightly into the budget negotiations, that was only a partial cause of the problems. The one-two punch of the S&P downgrade of U.S. Government Securities and the slow unraveling of the Greek financial situation caused stocks to crater. As a result, it sent the VIX to well over 40 for a +100% move in a week's time. Every twist in Europe became a reason to sell stocks. Strangely enough, after the S&P downgrade, treasuries hit yearly highs. The second trading year of 2011 had begun.

The strength of the Euro pretty much led the U.S. equity market for most of the 2nd half of the year. If the Euro is up, stocks are up and vice versa. Then by Thanksgiving in late 2011, the Euro and stocks started to move in opposite directions. The ECB stepped in to get European Banks to start lending again with hundreds of billions in credit facilities to help spur inter-bank lending again. While this did not do much for the strength of the Euro, the Euro TARP move has been a boon to equities, as the stock market finished flat to slightly up (after cratering) for the year and the VIX near 21.

2012 Starting Just Like 2011 Ended

One of the most startling actions in the 2nd half of 2011 was the change in leadership of two governments. Both the Greek and Italian leaders went down as a result of disappointing the bond market. In recent memory, reach back to Suharto in the late 90s in the Asian Currency Crisis for the fall of an entrenched leader due to sovereign financial issues. This says a lot about the lack of politicians' ability to cope with issues of this size. The old way, which they know, no longer works. The good, if painful, news for equities is that the bond market now has no trouble flexing its muscles on these issues. Debt markets will not lend without asking for big premiums, and governments used to very low interest rates will have no choice but to change. That leaves 2012 in an interesting position of extremes.

The big issues of 2011 have yet to be solved. As the Europeans cope with a new Euro Zone legal document, these issues are on the radar. The temporary expansion of credit does not solve anything; it just keeps the banks floating. The best thing I can say is the problem is farther along than it was before. Will following the playbook of 2011 help in 2012?

Trading in 2012

The original spike in volatility in mid-summer was caused by a succession of near unprecedented moves in equity prices. In periods like 2009, 2001, and 1988, implied volatilities came down steadily from those very high perches and extreme underlying movement. That is what 2012 is shaping up to look like early in the year. Note that the recent lows in the VIX (Figure 1) were more of a ceiling in implied volatility for the first half of 2011. Buyers of broad

Livevol Pro

FIGURE 1 *The VIX in 2011*

market volatility run the real risk of 20%, or so, declines in market implied volatility by mid-February. The numbers traders see now look cheap relative to October but in the grand scheme are slightly above the long term VIX averages of around 20. Right now, the 30-day historical volatility is trending below the 30-day implied for the SPX. Underlying gravity is pulling index implied volatility down.

Balance the above with the unsolved sovereign debt problems for 2012. As things get dicey again with fiscal dithering, there will be more short term spikes in volatility, probably hitting around 30. The extended period of higher volatilities—like in late 2011—will be hard to sustain since the bank credit is flowing. The market now has this risk issue on its radar and has been gradually adjusting.

A passing glance at U.S. corporate earnings will note pretty solid numbers for 2011. Revenues were not great, but earnings grew at a brisk clip. Stocks (except for a select few) ignored this, as the big indexes finished near flat. The pressure is upward for equities to equalize this. Note that any breath of positive news out of Europe sent the S&P 500 up on 2% gaps in the last quarter of 2011.

10-year treasuries are yielding over 100 basis points less than the rate of inflation. How long this can stay is anyone's guess. Look back to Depression era pricing, when folks were paying the government to lend it money. This is happening in Germany already, and is not sustainable for the future. Equity prices should firm, as equities look cheap relative to bonds.

Geopolitics is the last wildcard for 2012. Iran is trying to be a player in a U.S. presidential election year. It is very hard for a president to stand down in an election year from a fight, even a small one. The last president to do that was Jimmy Carter and look what happened to him. Follow the CBOE Crude Oil Volatility Index for sentiment in this area. Right now it is at 35.6 after coming out of a short term spike last week.

Trading 2012

On balance, the view for equities in 2012 is slightly positive, even though it feels like a hard trade. Relative to most measures, stocks are reasonably priced and pay very good dividends. That is still a good story for stocks. Relative to the safe haven countries' (U.S., Germany and Japan) sovereign debt, stocks look downright cheap. It most likely will remain that way through a good part of 2012. It is too hard to bet against the Fed holding rates down, so I would only selectively fade rallies in the bond ETFs.

Market volatility measured by the VIX should head to lower levels (to the high teens), followed by the occasional spike to 30 or so on fiscal and geopolitical issues. We are bound to get one, if not two, this year. Since the general backdrop of 2011 is still in play, I would look to buy select volatility in some of the ETFs, as they make lower volatility numbers this year. Right now the trend is pushing volatility lower, so be ready for opportunities as they present themselves. EM

THE YEAR IN REVIEW AND A LOOK AHEAD

Bill Luby

For those whose trading universe revolves around volatility, 2011 was an interesting year. In many respects, the year was almost like two different years rolled into one, with a relatively placid first half followed by huge waves of volatility during the second half of the year.

The year started off not just quietly, but with record low volatility in some corners. During the first week of the year, 20-day historically volatility in the S&P 500 index hit its lowest level since April 1971, plummeting all the way to 4.57.

As the year wore on, volatility seemed almost defiantly low, with the Asian spring barely moving the VIX and the Japanese earthquake, tsunami and nuclear meltdown triggering a relatively mild and short-live VIX spike. Even the U.S. debt ceiling crisis had only a moderate influence on volatility.

Volatility finally began to pick up when the European sovereign debt crisis took center stage. At first the focus was on Greece, but as the year wore on, questions about the viability of Spain, France and Italy became the much more pressing concern. The VIX spiked as high as 48 and persisted as elevated level for such a long time that the VIX futures set a new record for the most consecutive days in backwardation.

The crisis atmosphere helped propel 2011 options volume to a new record of 4.6 billion contracts, including a record month in August.

In an effort to capitalize in the increased interest in volatility, new products were rolled out rapidly, particularly in the VIX-based exchange-traded product space, which began the year with 12 products and ended the year with 31 ETPs. Some of these products saw spectacular moves, notably TVIX, which jumped from 15 to 109 in just three months during the height of the crisis. Other products showed growing sophistication in their construction. Perhaps the most intriguing product of the year was XVZ, which dynamically allocates between short-term and medium-term VIX futures, with long and short positioning.

The VIX brand continued to strengthen, with the CBOE/CME partnership resulting in the launch of a corn volatility index and a soybean volatility index. Volatility indices are also starting to appear outside of the U.S., Europe and Canada and are now in place in Japan, South Korea, India, Australia, Mexico, Russia and South Africa.

My predictions from a year ago were a mixed bag in terms of results. While volatility as an asset class still faces an uphill battle, the explosion in VIX ETPs is helping to accelerate that movement, which should continue to grow going forward. The move to what I call

The CBOE's decision to focus on the highly **volatile emerging markets area** with a VXEEM index and futures is an **important development** to watch.

"atomic volatility" (a more narrowly focused underlying and shorter options durations) picked up steam as the CBOE added six ETP volatility indices (VXEEM, VXFXI, VXEWZ, VXGDX, VXSLV and VXXLE) based on the VIX calculation methodology to the existing five single stock volatility indices. Weekly options are also gaining traction, with short-term options volume now accounting for more than 8% of all U.S. options volume. While there were no new products based on the small cap volatility index, RVX, there was some parallel movement in emerging markets, with the launch of VXEEM and the announcement of VXEEM futures, which did not begin trading until earlier this month. Another area where I had mixed results was with XIV and XVIX. XIV became hugely popular, yet interest in XVIX lagged. Neither product established themselves as attractive buy and hold investments, though I continue to like the long-term outlook for XIV.

Looking ahead to 2012, I captured some of what I see as the key evolving trends in volatility in November in *Four Evolving Volatility Themes* when I talked about the increasing importance of globalization, politics, correlations and overnight volatility to the macro volatility picture.

The quiet start to the new year notwithstanding, I expect the markets to be more turbulent than usual in 2012. The average annual high VIX reading is just below 37.50 and I expect there will be little difficulty topping this number in 2012, with a maximum VIX of 45 a strong possibility.

I also see the atomic volatility trend accelerating. What I would really like to see would be VIX-based volatility indices for some of the U.S. ETPs like XLF, XHB and XLY that are highly sensitive to economic factors. These would not only be of interest to the speculative crowd, but could also help to spawn targeted risk control products. In the same vein, it would be nice to see something similar with a European ETP flavor (VGK, EWI, EWQ, etc.), but I suspect relatively low liquidity is likely to prevent this from happening.

In terms of other new products, I see the pattern of new indices followed by futures, then ETPs and options continuing. Two of the indices that I believe have the potential to support some interesting volatility-based ETPs are:

- S&P 500 VIX Futures Long/Short Strategy Index Series
- ISE Bear/Bear Option Overlay Index

The former could serve as a foundation for rules-based VIX ETP strategy products, while the latter has an ever broader potential to support vertical options strategies in ETP format. Whether the appropriate regulatory hurdles can be navigated could turn out to be the key question here.

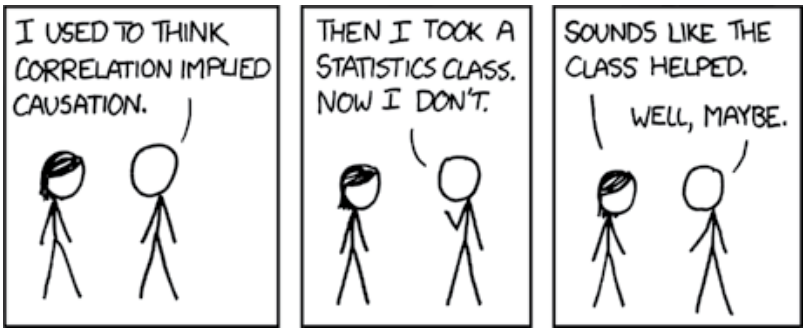
Finally, the CBOE's decision to focus on the highly volatile emerging markets area with a VXEEM index and futures is an important development to watch. For now VIX futures are the platform for almost all the volatility ETPs. Should VEXXM futures and related ETPs prove to be successful, this will support the idea that the VIX product family has the potential to be replicated across additional underlying securities, which would revolutionize the volatility product space. **EM**

Further Reading

Four Evolving Volatility Themes, *Expiring Monthly*, November 2011.

The Year in Review and a Look Ahead, *Expiring Monthly*, January 2011.

XKCD



national markets themselves, or intra-market correlation. Since the early 1990s, the factors that investors have traditionally relied on to provide diversification—growth, value, capitalization, and geography—have become less and less significant when it comes to the correlation of returns. Fig. 1, from a report by Factor Advisors, illustrates the problem well.

Correlation and Volatility Risk
For the Year Ahead

Jared Woodard

In the mid-2000s, one of the hottest topics around was the notion of decoupling, the idea that global equity markets would and might already have established some independence from one another, such that severe problems in one country would not affect stock markets in others. In a less dour mood, decoupling also provided the justification for large capital inflows into BRIC equities: if growing emerging markets were less likely to drag developed markets along with them as they advanced, it made sense to shift capital from the laggards to the leaders.

Decoupling turned out to be a fantasy generated in part by easy credit and speculative fervor, and the crash in 2008 brought the truth of correlation back into focus. If 2008 was the angry younger sister to 2006's pollyanna, 2011 was their dark, nervous cousin. Last year, correlation was present not just among different national equity markets—what we might call inter-market correlation—but among constituents of

Should we expect more of the same for 2012? Let's first examine the information implied by options markets about what can be expected for the year ahead.

The implied correlation among two or more assets can be derived from observed option prices. While earlier research raised doubts about whether implied correlations were even as informative as the historical data (Walter & Lopez 1997), a more recent study concludes that market-implied betas are predictive of future realized correlation and are not duplicative of other option-based factors (Buss & Vilkov 2011). The most widely followed

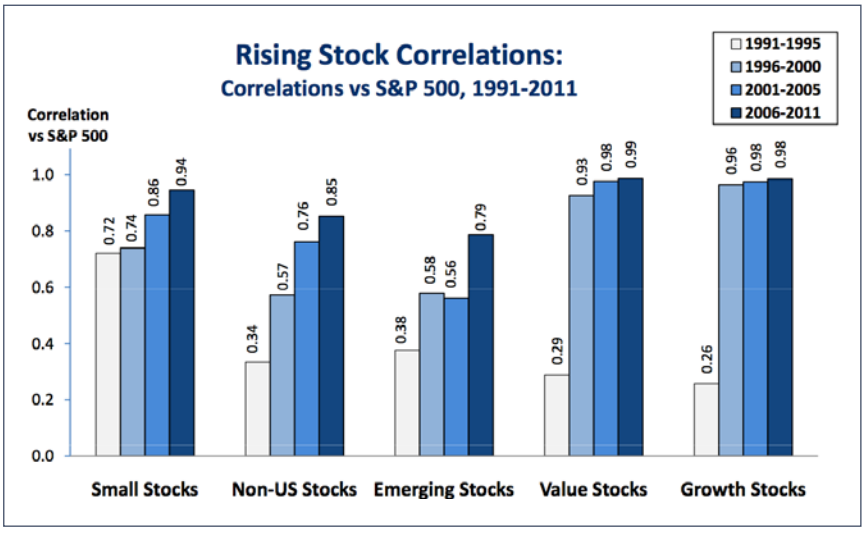


FIGURE 1 *Rising Stock Correlations: Correlations vs. S&P 500, 1991–2011*

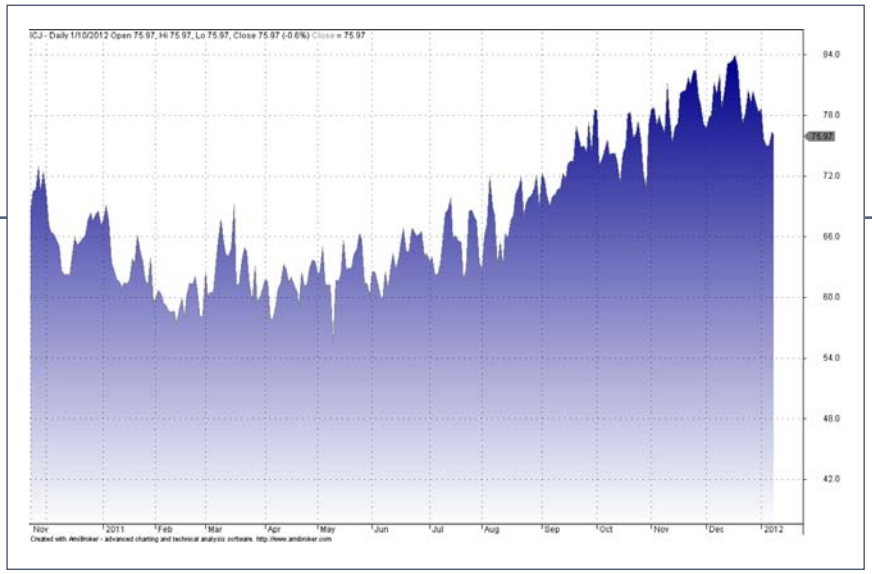


FIGURE 2 *CBOE® S&P 500® Implied Correlation Index for January 2013*

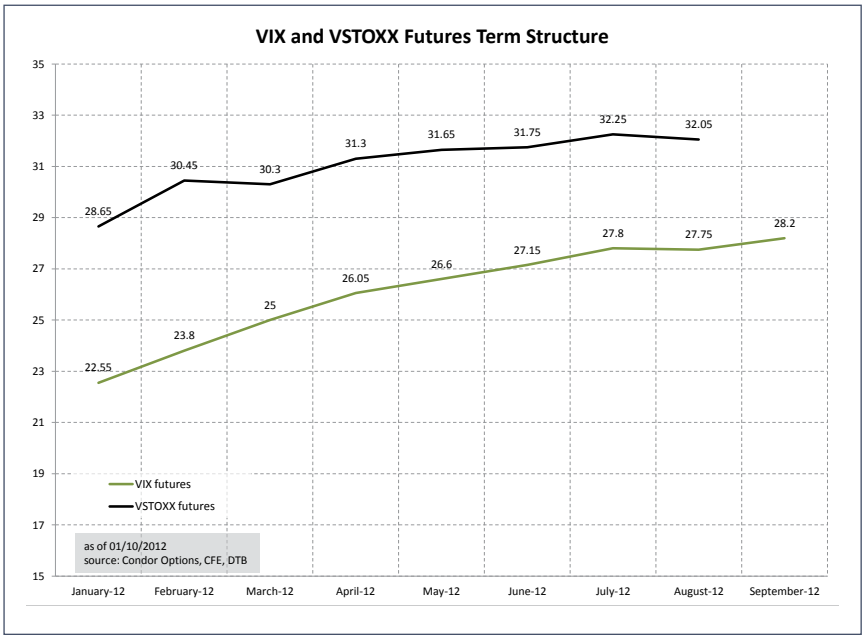


FIGURE 3 *VIX and VSTOXX Futures Term Structure, January–September 2012*

estimate of implied correlation, the CBOE® S&P 500® Implied Correlation Index, uses options data from the 50 largest stocks in the index to arrive at correlation estimates at annual maturities. The chart for ICJ, the January 2013 estimate, is at Fig. 2.

The current estimate is off its highest levels, but is still above any reading prior to September of 2011—meaning that the expected greater correlation of U.S. stocks has not returned to where it was prior to the acute phase of the European sovereign debt crisis. I would also note that readings of 60 and greater are all excessive from the perspective of a pre-crisis investor (e.g. prior to 2008). For stock and options traders alike, high correlation makes trade selection more difficult.

Since the debt and banking problems in Europe were evidently the catalyst for higher stock correlations, we should also look at market expectations on that front for the year head. Fig. 3 compares the term structures of VIX and VSTOXX futures using all listed contracts. (VSTOXX futures are VIX-style contracts on the DJ Euro STOXX 50 Index.) The premium of 6.65 volatility points between February VSTOXX and February VIX futures is attention-grabbing enough, but notice that the premium persists all the way out to August (4.3 percentage points). That is evidence of steady concern that European stocks will be more volatile than their American counterparts. If we look beyond 2012 and compare the implied volatilities for at-the-money straddles on futures, the European risk premium remains (fig. 4).

Notice that the STOXX term structure is backwardated while ES/SPX options are in their usual contango.

That's what the market is implying: what should we make of it? Here are some circumstances under which the Euro-vs-U.S. volatility premium would be unjustified. Consider, first, any sort of bad outcome in which ECB operations are unsuccessful, one or more countries exit the eurozone in a sloppy fashion, etc. As we learned in 2011,

Interactive Brokers

Implied Volatility for ATM Straddles		
	ESTX50	ES/SPX
Dec-12	27.06%	22.50%
Dec-13	26.12%	23.00%
Dec-14	25.21%	23.69%

FIGURE 4 *Implied Volatility for At-The-Money Straddles on Euro Stoxx 50 and E-Mini S&P 500 Futures*

domestic exposure to European sovereigns and banks can turn up in all sorts of places, and even the expected exposure—according to Standard & Poor's, 14% of sales among SPX companies come from Europe—is enough to worry about. Implied volatilities converged immediately in August when the debt crisis intensified, and I expect they would do so again in any future exacerbation. So for any bad outcome, SPX options / VIX futures are underpriced. In the best-case scenarios, widespread pro-cyclical fiscal austerity will somehow become a recipe for stability and growth for the first time in human history. In that case, European stocks can be expected to soar and ESTX50 options / VSTOXX futures are overpriced. For either extreme outcome, traders should bet on the Euro-U.S. volatility gap closing.

What about the massive middle, the likely set of outcomes in which Europe limps along, sustained by occasional injections from the ECB and conciliatory policies from the U.S. and China? In that case the consensus forecast for 2012 is hard to dispute, with U.S. stocks flat to higher, European stocks flat to lower, oil and gold higher, and room for some volatility shocks now and again to keep policymakers from getting too comfortable. If we assume a troubled auction or two, larger-than-expected Greek haircuts, and so on against a backdrop of otherwise unremarkable growth in the U.S. and recession in Europe, then 2012 implied volatility looks fair enough.

What about correlation? Inter-market correlation should decline as emerging markets look more attractive than they have for awhile. I don't know what to think about gold, except that loose monetary policy is intact, QE3 in the U.S. is being suggested, and the only vocal bearish cases I've heard for gold (e.g. Wang Tao at Reuters) have been based on some wooly chartology. I expect the China/Brazil/Australia/base metals linkage to remain intact, I don't have any expertise where oil is concerned, and I expect U.S. Treasuries to remain as negatively correlated to stocks in 2012 as they were last year (-0.60 to -0.80 on a one-year rolling basis). However, intra-market correlation should be less fierce as more investors pick up on the dividend and defensive themes that worked so well in 2011 (e.g. XLU up 17% with SPY flat).

I do a pretty thorough review each year of all the year-end forecasts and sell-side reports I can find, and this year I was surprised by the bearishness of many of the big research teams. There are as many plausible crisis scenarios as ever, and it is hard to shake the feeling that in May or June we may look back on this holiday respite with fondness. I am happy to be a selective net option seller in one to three month timeframes with an active delta hedging regime, but if I had to buy or sell and then hold a December 2012 variance swap or volatility futures contract, I can't see myself doing any selling. EM

References

Christian Walter & Jose Lopez, 1997. "Is implied correlation worth calculating? Evidence from foreign exchange options and historical data," Research Paper 9730, Federal Reserve Bank of New York.

Buss, Adrian and Vilkov, Grigory, Measuring Equity Risk with Option-Implied Correlations (November 17, 2011). EFA 2009 Bergen Meetings Paper. Available at SSRN: http://ssrn.com/abstract=1301437

What Causes Volatility?

Mark Sebastian

Listening to the talking heads, one would assume that 2011 was volatile at a level of 2008 proportions. It is incredible how short our memories can be. Let's think about what the market did for the first six months of the year: absolutely NOTHING. Despite a tsunami and nuclear meltdown the VIX essentially held below 20 the entire first half of the year. It wasn't until close to the 4th of July that the market finally began to react to anything going on in Europe. Even that failed to push VIX much above 20 for any extended period of time. It took a near collapse of the Euro and a U.S. downgrade to get the market to do anything.

Once the SPX reacted, the market really moved, like a rubber band snapping. That snap of the band can put an impression in a traders mind, and even more so the nitwit talking head media types that do not understand financial markets. Traders, here is a tip, if the person delivering financial news has a degree in communication studies or journalism; they are probably more interested in ratings than the financial markets. So was the market THAT volatile for the 2011, looking at the average closing price of the VIX in Figure 1:

Bloomberg and CBOE

FIGURE 1

One would say, the market was volatile but not nearly as volatility as many traders might think. Remember 30 days of a VIX of 16 or 17 will really pull down the average VIX when it can only stay above 40 for a few days. Looking at realized volatility (historical volatility) in Figure 2:

Livevol Pro

FIGURE 2

21% is not what I would call an insane amount of movement over a given year. Yes, the year was above average, but again, not nearly as blowout crazy as talking

heads would make us believe. I have found that our memories are way too short both as traders and even as investors. It won't be three months of the VIX below 20 before the talking heads are cheerleading a rallying market that can't be stopped. The lesson here:

As a person who is on TV somewhat regularly now, there is no need to listen to people like me most of the time. What am I saying in two minutes that will fundamentally change anything? Not much . . . and I am one of the smart ones! As a trader the best thing you can do is read the smart ones—read Condor Options, VIXandMore, and the Option Pit blog and many of our other guest contributors. Now before this turns into a diatribe on the media, let's move onto what I think is coming up in the next year.

In evaluating 2012, let's ask ourselves an important question: what causes volatility? Many traders make the mistake of thinking that bad news is the root cause of volatility. It isn't. Unexpected bad news is the root cause of volatility. Want a clear example? Take a look at what happened when Standard and Poor's downgraded the U.S. debt to AA+. A move that despite S&P's threat no one truly believed, now compare that to how the markets reacted to the downgrade of almost the entire Eurozone. What do traders notice?

Many traders **make the mistake** of thinking that bad news is the **root cause of volatility.**

The market sold off in an incredible move when S&P downgraded the U.S., and barely sneezed when Europe got downgraded. And less than a day later the markets were rallying above downgrade levels. The key to this story lies in expectations. The market had been expecting the euro downgrade for some time and had actually priced in the downgrade. This is a clear case of the same bad news causing totally different reactions.

So where is 2012 going to lead us? My gut tells me that 2012 looks a lot like a mini version of 2009. The market might have one more push down, but I could see a scenario where we rally off of 2011's lows all the way past 2011 highs of 1370 and possible near 1500. That is my best estimate but not something that I think has any 'edge' to it. Here is something that I do know, though: if the VIX breaks above 25 again it is not going to be because of Greece, Spain, or probably even Italy. It will be because of something that we do not see on the horizon right now.

It could be a war, it could be oil prices, and it could be a whole host of things. However, I highly doubt it will be caused by something we are unaware of at this point. Markets don't tank and VIXes down pop because of bad news, they tank and pop because something happens that we had no idea could happen. EM

Livevol Pro

FIGURE 3

Using VIX Exchange-Traded Products as Hedges

Bill Luby

LAST MONTH, in *Using VIX Exchange-Traded Products as Hedges (Part One),* I introduced five categories of VIX-based ETPs which are well-suited to serving as hedges for a long equity portfolio. I examined the performance of these hedges during the March 2011 Japanese earthquake/tsunami disaster and the July-October 2011 selloff that was triggered by concerns about the European sovereign debt crisis. I also briefly touched upon the issue of sizing these VIX ETP hedges.

The VIX ETP hedge categories are as follows:

1. Short-term long VIX futures ETPs (VXX, VIXY, etc.)
2. Mid-term long VIX futures ETPs (VXZ, VIXM, etc.)
3. VIX futures ETPs with a dynamic long VIX futures allocation (XVZ)
4. Self-hedging products, with dynamic long SPY and long VIX futures components (VQT)
5. Leveraged short-term long VIX futures ETPs (TVIX, UVXY)

While last month's analysis focused largely on the relatively straightforward VIX futures products in categories 1, 2 and 5, this time around I am going to shift my emphasis to two more complex VIX ETPs, VQT and XVZ, which utilize a rules-based approach to evaluate volatility and associated risk, then dynamically allocate their exposure to short-term and/or mid-term VIX futures accordingly.

The Importance of Contango and Roll Yield

Before delving in to the dynamic allocation approaches, a brief review of the VIX futures term structure is in order. The key fact is this: in the eight years since they were first launched, the front month VIX futures contract has traded at a discount to the second month VIX futures contract more than 75% of the time, while the fourth month VIX futures contract traded at a discount to its seven month counterpart approximately 65% of the time. This tendency of the VIX futures term structure to slope upward, which I refer to as "persistent contango," means that the daily rebalancing used to maintain a weighted average maturity of one month (in the case of VXX) or five months (VXZ) typically is a net drag on the ETP's net asset value, as the VIX futures being purchased are more expensive than the VIX futures being sold. This so-called "negative roll yield" is somewhat analogous to time decay and has a substantial impact on performance over time. In fact, the performance of VIX-based ETPs is most sensitive to changes in the VIX futures in the short-term, but is dominated by changes in the VIX futures term structure and associated roll yields over a long-term time horizon.

Historically, contango has been the most severe following periods of a sharp decline in the VIX and more generally during low levels of volatility. Contango is also weakest or flips into backwardation (downward sloping term structure, with front month VIX futures more expensive than back months) following upward spikes in the VIX or generally high levels of volatility.

Enter Dynamic Allocation

Recognizing that negative roll yield is a serious performance drag on securities that will be rolling VIX futures on VIX ETPs, issuers have implemented rules-based approaches that offer minimal exposure to VIX futures during periods of low volatility and high contango, while offering maximum exposure to VIX futures during periods of high volatility and either backwardation or mild contango. This "dynamic allocation" approach is somewhat analogous to a trading system that reduces long equity exposure when the S&P 500 index falls below its

200-day moving average or some other signal that the bears may be in control of the market.

The VQT Approach: Portfolio Replication with SPY

Rather than create a VIX-based ETP that could serve as a hedge against an existing portfolio, the initial dynamic allocation product offered by Barclays utilized more of a portfolio replication approach than a portfolio augmentation approach. Specifically, VQT (Barclays ETN+ S&P VEQTOR ETN), has an allocation of SPY that ranges from 60-97.5% of the portfolio, with the .25–40% balance set aside for the equivalent of VXX. (See Figure 1 for details.) The ETP evaluates volatility and risk based on measures of the absolute level of realized (historical) volatility. The highest (40%) VIX futures allocation is reserved for extremely high levels of realized volatility in combination with implied volatility that is trending higher or stable. In contrast, the lowest (2.5%) VIX fiurues allocation occurs when realized volatility is at historically low levels and implied volatility is trending lower or stable.

No matter what the volatility environment, there is money to be made – and hedged – with VIX ETPs.

While VQT was a very strong performer during the August 2011 downturn, many investors found portfolio replication to be cumbersome and expensive to implement.

The XVZ Approach: Portfolio Augmentation with a Long-Short Twist

Rolled out in the middle of the August 2011 volatility shock, XVZ (iPath S&P 500 VIX Mid-Term Futures ETN) was a product introduced by Barclays which targeted investors who were interested in benefitting from a sharp increase in volatility, while minimizing

Barclays

Realized Volatility (RV_{t-1})	Target Equity Component / Volatility Component Allocation (w_t^{eq} / w_t^{vol})		
	Implied Volatility Downtrend (IVT_{t-1} = -1)	No Implied Volatility Trend (IVT_{t-1} = 0)	Implied Volatility Uptrend (IVT_{t-1} = +1)
Less than 10%	97.5% / 2.5%	97.5% / 2.5%	90% / 10%
10% ≤ RV_{t-1} < 20%	97.5% / 2.5%	90% / 10%	85% / 15%
20% ≤ RV_{t-1} < 35%	90% / 10%	85% / 15%	75% / 25%
35% ≤ RV_{t-1} < 45%	85% / 15%	75% / 25%	60% / 40%
More than 45%	75% / 25%	60% / 40%	60% / 40%

FIGURE 1 *VQT Allocation of SPY and VIX Short-Term Futures*

Implied Volatility Term Structure ($IVTS_{t-1}$)	Target Short-Term Volatility Allocation on Index Business Day *t* (TS_t)	Target Mid-Term Volatility Allocation on Index Business Day t (TM_t)
Less than 90%	-30%	70%
90% ≤ $IVTS_{t-1}$ < 100%	-20%	80%
100% ≤ $IVTS_{t-1}$ < 105%	0	100%
105% ≤ $IVTS_{t-1}$ ≤ 115%	25%	75%
More than 115%	50%	50%

FIGURE 2 *XVZ Allocation of VIX Short-Term and Mid-Term Futures*

ETFreplay.com

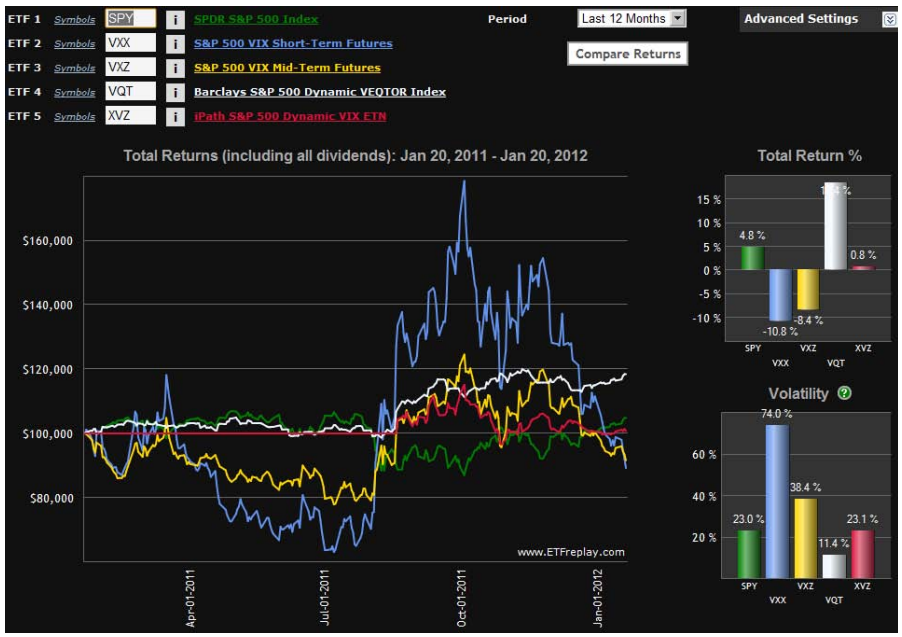


FIGURE 3 *Performance Comparison of SPY, VXX, VXZ, VQT and XVZ*

contango-related losses when the VIX futures term structure mad long VIX futures positions particularly unattractive. The result was a product that invests in both VX short-term futures and mid-term futures, with the flexibility to be positioned either long or short in the VIX short-term futures leg. In other words, XVZ is the equivalent of a 50–100% long position in VXZ, with a VXX position that can range from 50% long to 30% short.

XVZ also elected to measure the VIX futures term structure directly and essentially have maximum long exposure to VIX short-term futures during periods of extreme backwardation and maximum short exposure to VIX short-term futures during periods of extreme contango. Said another way, XVZ attempts a market timing approach to trading VXX long-short, using the degree of contango and backwardation as the key indicator and rounding out the portfolio with a long position that is at least a 50% long exposure to VXZ.

Part of the appeal of XVZ is that it can easily augment an existing portfolio of long holdings. Additionally, while XVZ stands to benefit during periods of VIX futures backwardation, it is also structured to break even or sometimes earn a small profit during periods of extreme contango.

DEFINITIONS

Roll Yield *The amount of return generated rebalancing a portfolio of futures contracts to maintain a constant maturity. Typically an ETP will rebalance its portfolio on a daily basis by selling near-term contracts and buying an equal amount of longer-term contracts. If the near-term futures are less expensive (contango) the result is a net loss and is known as negative roll yield; if the near-term futures are more expensive (backwardation), the rebalancing results in a gain and termed positive roll yield.*

Contango *An upward sloping futures term structure in which the front months are less expensive than the back months.*

Backwardation *A downward sloping futures term structure in which the front months are more expensive than the back months.*

Constant Maturity *A weighted average of maturities in a portfolio that is constant from day to day, due to continuous selling of shorter-dated instruments and buying of longer-dated instruments.*

Conclusion

Investors who are interested in hedging long equity positions with VIX-based ETPs have likely already experimented with first generation products such as VXX and VXZ. As part one of this article illustrated, persistent contango makes these products less than ideal choices for someone seeking a permanent, always on hedge.

Both VQT and VXZ use rules-based dynamic allocation approaches to maximizing exposure to VIX futures when volatility is high or when the VIX futures term structure is in backwardation. Due to the manner in which they were constructed, VQT is better suited to a portfolio replacement approach, while XVZ is better suited to a portfolio augmentation strategy.

While historical performance data for all VIX ETPs is very thin, both VQT and XVZ, have been profitable over the course of the last year, in contrast to losses across the board for term-structure ravaged VXX, VXZ and TVIX. This suggest that these two products are not just appropriate as tactical or structural hedges, but also as long-term or perhaps even permanent hedges

Whether or not investors ultimately warm up to VQT and XVZ, there is considerable value just in understanding the strategies and techniques they employ and observing their performance in a variety of market conditions. Better yet, those who trade volatility on a regular basis may be interested in tweaking some of the ideas incorporated into VQT and XVZ, as well as exploring some of the adjacent strategic spaces. Finally, expect issuers of ETPs to roll out more VIX products with rules-based strategies and dynamic allocation approaches in 2012 and beyond. No matter what the volatility environment, there is money to be made—and hedged—with VIX ETPs. EM

Further Reading

Using VIX Exchange-Traded Products as Hedges (Part One), *Expiring Monthly*, December 2011.

The VIX ETNs: VXX and VXZ, *Expiring Monthly*, March 2010.

Exploring the VIX Futures Term Structure, Part I, *Expiring Monthly*, August 2010.

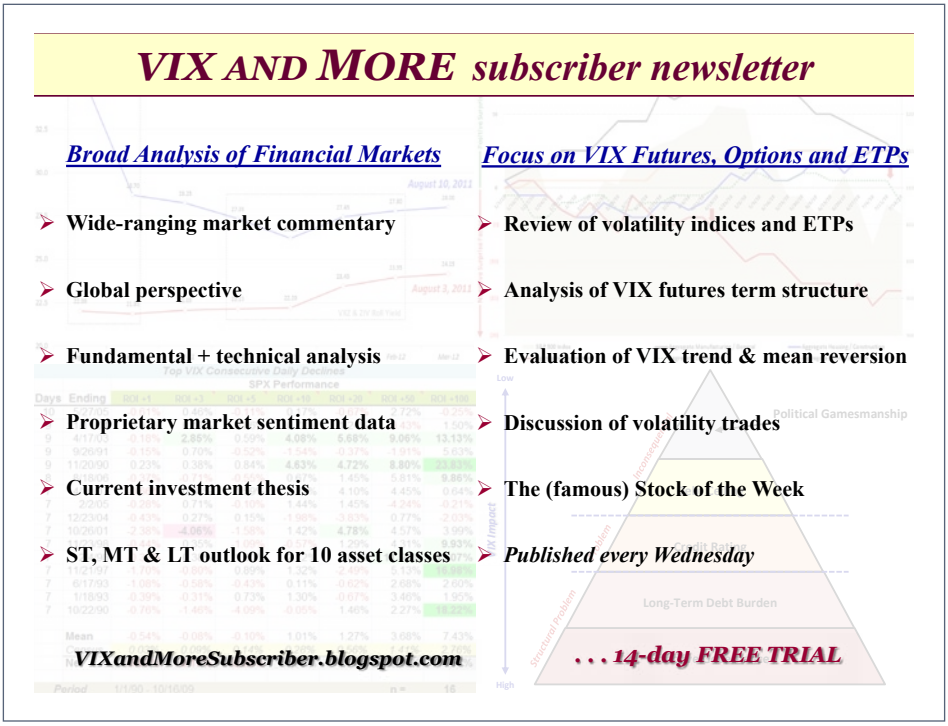
An Interpretive Framework for VIX Futures (Second in a Series), *Expiring Monthly*, September 2010.

VIX Futures: Putting Ideas into Action (Third in a Series), *Expiring Monthly*, October 2010.

Cheating with Partial Hedges, *Expiring Monthly*, May 2011.

VIX Convexity, *Expiring Monthly*, June 2011.

Trading the Expanding VIX Products Space, *Expiring Monthly*, September 2011.



Trading Wars

Andrew Giovinazzi, Guest Contributor

THE SABER RATTLING in Iran over the New Year made me think back to Gulf War I in 1991. I was monitoring a pit that I was about to go into as a member on the PSE Options Floor, and I was a bit nervous. Besides the impeding coalition invasion (more on the market conditions later), standing behind the pit as a clerk waiting for the exchange to approve my seat was a little nerve-wracking. All of the traders were eyeing me, since one more trader in a pit means more work and less money for the crowd that is already there. No new trader is ever welcomed into a trading crowd. The run up to the war gave the crowd extra time to plot my demise, especially since trading going into war is generally a by-appointment, low liquidity affair. When it came time for my first day on a seat, I had already religiously studied my trading sheets looking for my first trade. After about two hours of painful waiting in the back of the crowd, I leapt into trading by lifting a put offer in Dayton Hudson, DH. The whole crowd yelled, "Soooold!" The crowd also informed me (in loud tones that would wake the dead), I could buy all I wanted there just to make sure I knew I had screwed up. My legs turned to this strange jelly-like material, as I realized I had made a mistake. I dutifully bought one contract from five crowd members and shrank back to discover what I did wrong. It turns out I had been reading my sheets $1 off, so the puts looked pretty cheap to me. I will blame my nerves. I was right about the crowd plotting my entry. They had decided to fade my first trade no matter what. It is just the way new guys are welcomed. I did make markets and ended up in a good spot in the crowd when I left for the CBOE 10 month later, but the first day stayed in my memory for a long time.

> In the **shadow of war,** messing with the new guy was comic relief to a **stressful situation.**

Most of my adult professional life was spent on option trading floors. The niceties of business—meetings, group discussions, and phone calls—have a different pitch and feel on a trading floor. The key difference, of course, is time. There normally is no or little time to make a decision. Most things have to be pre-thought out to a large degree. This action also defines the type of clerks you hire, and the members that occupy the trading pits. They have short attention spans. So when things get a little slow, those same people think of interesting things to do with their time. When a new trader enters a crowd, they become, well, the focus of attention. It is easy to understand my welcome now. In the shadow of war, messing with the new guy was comic relief to a stressful situation.

Hey kid, where's your badge?

The singular piece of identification on an option trading floor is the badge with your acronym on it. This lets the brokers know who you are, so they can write your name down on a trading ticket. Without a badge, you don't exist in the minds of the brokers, so they ignore you. I was on two floors, the CBOE and the PCX. The CBOE badge had a pin on it and was near impossible to remove without the wearer noticing. However, on the PCX it was an annoying little clip that was easy to lift. My first couple of weeks, I would be quick enough to get on a trade, and the broker would ignore me. I would protest, and he told me I needed a badge to trade. Sure

(continued on page 35)

A Seasonal Synthetic VIX–VXX Arb

Bill Luby

I AM ALWAYS IN SEARCH of the sure thing and when the historically low volatility associated with the end-of-year holiday season rolls around, it seems as if there are a handful of trades that are screaming for attention. Perhaps one of them might even be a sure thing.

This year I came up with a somewhat convoluted idea that I had not previously attempted to implement, so I thought it would be appropriate to run it through as what I call a "proof of concept trade" in the Follow That Trade column so I could provide some real-time comments and conclusions.

Background and Rationale

I am aware there are no sure things in trading, but when it comes to volatility, there is a strong historical precedent for volatility to subside in December, particularly during the second half of the month. Another interesting artifact of this pattern is that the lower volatility expectations are generally limited to December and do not impact future volatility expectations for January and beyond. What this means is that the VIX futures also generally reflect lowered volatility expectations for the December expiration, with volatility increasing sharply into January. This also means that the difference between December and January VIX futures generates substantial negative roll yield for VIX short-term futures products, such as VXX. During the December 2010 VIX expiration cycle, this negative roll yield was a 14% drag on net asset value of VXX; during the December 2009 VIX expiration cycle, the negative roll yield was a 14.7% drag on NAV.

The question I have is whether the market prices in sufficient negative roll yield to differentiate between the expected decline in the VIX due to lower volatility expectations vs. a presumably greater decline in VXX due to lower volatility expectations plus the effect of anticipated negative roll yield.

My intent was to use the full December VIX expiration cycle and keep the position open through the second trading day of January, which is statistically the most likely end of the Santa Claus rally period. This translated into opening the positions on November 16th and holding them (assuming no significant adverse moves) though January 4th.

In terms of structuring the trade, since I am seeking to capture the difference between VIX and VXX, I elected to establish synthetic short positions in VIX and VXX, using slightly in-the-money options with January expirations (January 18 for the VIX; January 20 for VXX), with equal dollar allocations, $10,000 for each leg.

DEFINITIONS

Roll Yield *The amount of return generated rebalancing a portfolio of futures contracts to maintain a constant maturity. Typically an ETP will rebalance its portfolio on a daily basis by selling near-term contracts and buying an equal amount of longer-term contracts. If the near-term futures are less expensive (contango) the result is a net loss and is known as negative roll yield; if the near-term futures are more expensive (backwardation), the rebalancing results in a gain and termed positive roll yield.*

Contango *An upward sloping futures term structure in which the front months are less expensive than the back months.*

Synthetic Short *A position that has the same profit and loss graph as a short position in the underlying and is established by selling calls (usually at-the-money) and buying an equal number of puts (again, usually at the money) on the same underlying, at the same strike and with the same expiration date.*

Date	Front mo	2nd mo	1m-2m	VIX Jan30c	VIX Jan30p	VXX Jan42c	VXX Jan42p	*VIX-syn S*	*VXX-syn S*	VIX-VXX	$ P/L
11/15/11	32.05	30.70	1.35								
11/16/11	32.65	33.60	-0.95	6.100	3.100	8.575	5.000	-3.000	-3.575	0.575	110
11/17/11	33.75	34.65	-0.90	7.700	2.500	10.975	3.850	-5.200	-7.125	1.925	2,790
11/18/11	32.35	33.75	-1.40	6.700	2.700	9.150	4.200	-4.000	-4.950	0.950	660
11/21/11	32.95	34.35	-1.40	6.800	2.525	9.050	3.900	-4.275	-5.150	0.875	313
11/22/11	32.30	33.85	-1.55	6.600	2.600	8.600	4.000	-4.000	-4.600	0.600	(320)
11/23/11	33.60	35.05	-1.45	7.100	2.375	9.125	3.475	-4.725	-5.650	0.925	228
11/25/11	34.50	35.60	-1.10	7.650	2.075	10.625	3.110	-5.575	-7.515	1.940	2,645
11/28/11	32.00	33.70	-1.70	6.600	2.375	8.475	3.675	-4.225	-4.800	0.575	(502)
11/29/11	31.35	33.20	-1.85	5.900	2.550	7.600	3.900	-3.350	-3.700	0.350	(695)

FIGURE 1 *Synthetic VIX–VXX Arb through 11/29/11*

Setup and Entry

After a wild ride during August, September and the very beginning of October, the VIX showed signs of stabilizing during the second half of October and into November, spending most of its time in the low to mid-30s. On November 16th, the VIX futures and options settled at 33.36, just a hair above the October settlement of 33.15. With the holiday season approaching, it looked as if a VIX in the mid to upper 20s by Christmas might not be an unreasonable expectation. With this in mind I pulled the trigger on synthetic shorts on both VIX and VXX just before the close. The VIX closed the day at 33.51, with the VIX January futures at 33.60. VXX ended the session at 46.29. Considering that I had a target decline of about 10% in mind for the duration of the trade, I used the January 30 puts and calls to establish the VIX synthetic short and the January 42 puts and calls to establish the VXX synthetic short. In order to equalize the investment, I used 34 contract for VIX and 28 contracts for VXX. The details of the opening position are highlighted in the top row (gray shading) in Figure 1 (above).

Position Management

Synthetic shorts are volatility neutral trades in that if volatility increases, the gains in the puts and calls are generally offsetting. In managing this trade, my main focus is to see the extent to which VIX and VXX move together and whether the position profit and loss correlates with the VIX futures roll yield.

November 17—Just one day into the trade and I am already up $2,790. I am a little concerned that the profits come on a day in which both the VIX and VXX rose, but as long as the net movement is in my favor, I should be directionally agnostic.

November 18—The VIX futures negative roll yield has widened from -0.90 to -1.40, so this should be beneficial to the strategy, but the VIX falls 7.3% while VIX only falls 3.2%, so my paper profit drops sharply to $660. The good news is that statistically, it is unusual for the VIX to fall more than twice as rapidly as VXX for an extended period.

November 25—With the Thanksgiving holiday now in the rear view mirror and Christmas exactly one month away, the holiday season is officially at hand. Position profitability is back up to $2,645 and even though the VIX futures are up from their starting position, the trade looks promising once again.

November 28—The VIX briefly falls below 30 for the first time in over two weeks, but with the VIX futures back almost where they were when the position was opened, the P&L is now down $502.

November 30—A major disappointment as VXX falls 8.9% and the VIX declines 9.3%, yet the P&L is going in the wrong direction in a hurry, down $3,855. The good news is that the VIX futures roll yield has ballooned to -2.55, so VXX should start to see a substantial benefit from this development as the calendar flips to December. See Figure 2 for the details.

December 8—The VIX spikes back above 30 for the first time in seven sessions. The P&L improves to -$2,235 to its best level since November 30. The VIX futures roll yield continues to favor continued declines in VXX and yet the aggregate position only seems to improve when the VIX spikes. Something is not right here and while I have not yet been able to firmly establish what is at the root of the problem, the position is not behaving as I had planned. I exit the position and cut my losses here, but will continue to track the "proof of concept" trade to see what else I can learn about what went wrong and why.

December 20—For the last eight trading days the negative roll yield has been penalizing VXX at a rate of 10.2% per month. The VIX has fallen all the way down to 23.22, with VXX at 36.22. In short, the VIX is declining so rapidly that even with the benefit of the negative roll yield, VXX is not able to keep up. The result is a P&L that has steadily deteriorated to where it is now down $6,096.

The VIX is declining so rapidly that even with the benefit of the negative roll yield, VXX is not able to keep up.

Date	Front mo	2nd mo	1m-2m	VIX Jan30c	VIX Jan30p	VXX Jan42c	VXX Jan42p	*VIX-syn S*	*VXX-syn S*	VIX-VXX	$ P/L
11/30/11	28.35	30.90	-2.55	4.200	3.350	5.025	5.400	-0.850	0.375	-1.225	(3,855)
12/1/11	27.90	30.15	-2.25	3.750	3.650	4.400	5.750	-0.100	1.350	-1.450	(4,110)
12/2/11	27.80	29.90	-2.10	3.650	3.800	4.150	5.700	0.150	1.550	-1.400	(3,845)
12/5/11	27.80	29.70	-1.90	3.700	3.600	4.275	5.350	-0.100	1.075	-1.175	(3,340)
12/6/11	28.10	29.95	-1.85	3.400	3.800	3.900	5.550	0.400	1.650	-1.250	(3,300)
12/7/11	28.60	30.60	-2.00	3.850	3.350	4.350	4.900	-0.500	0.550	-1.050	(3,190)
12/8/11	30.15	32.10	-1.95	4.700	2.750	5.550	4.050	-1.950	-1.500	-0.450	(2,235)
12/9/11	27.20	29.55	-2.35	3.550	3.500	3.825	5.250	-0.050	1.425	-1.475	(4,155)
12/12/11	27.60	30.10	-2.50	3.700	3.300	3.900	4.850	-0.400	0.950	-1.350	(3,980)
12/13/11	27.10	29.90	-2.80	3.650	3.350	3.700	4.900	-0.300	1.200	-1.500	(4,350)
12/14/11	27.10	30.10	-3.00	3.700	3.300	3.600	4.800	-0.400	1.200	-1.600	(4,680)
12/15/11	26.35	28.90	-2.55	2.875	3.900	2.585	5.600	1.025	3.015	-1.990	(5,060)
12/16/11	26.10	28.85	-2.75	2.750	3.800	2.470	5.550	1.050	3.080	-2.030	(5,159)
12/19/11	25.60	28.35	-2.75	2.500	3.700	2.260	5.500	1.200	3.240	-2.040	(5,112)
12/20/11	23.85	26.55	-2.70	1.725	4.850	1.315	7.175	3.125	5.860	-2.735	(6,096)
12/21/11	24.50	25.85	-1.35	1.100	6.000	0.750	8.950	4.900	8.200	-3.300	(6,790)

VIX and More

FIGURE 2 *Synthetic VIX–VXX Arb through 12/21/11*

January 4—The final tally for this trade is a remarkable loss of $6,764. From November 16 through January 4, the VIX falls 36.2% (!) and VXX is able to decline 'only' 30.1%. Unfortunately, that 6.1% differential dooms the trade and proves that a sharp drop in the VIX can overwhelm the additional negative roll yield benefit that accrues to a falling VXX. For the record, the VIX front month futures decline 26.4% during this period and the second month futures decline 27.0%, so the (synthetic) short position in VXX means that VXX has fallen 14% more than a continuous investment in the front month VIX futures—just not enough to keep pace with the VIX.

Epilogue and Takeaways

Just for fun, I continue to tabulate the results in this position through Friday, January 13, which brings an unofficial end to the holiday season, just before the Martin Luther King holiday. In this instance, both the VIX and VXX continued to fall, with the VIX down another 5.9% and VXX down another 4.6%. As a result, the position P&L now is showing its largest loss ever, at -$8,089.

This is exactly why I like the idea of "proof of concept" trades. An idea might sound attractive—even have a whiff of a sure thing—but until you put it through the paces in a real trade, you never know what sort of surprises and complications are going to crop up.

In retrospect, the trading thesis made sense and the position would likely have generated an attractive return in an environment with a rising VIX, a flat VIX or even a VIX that was declining slowly, but a sharp decline in the VIX was just too much for the synthetic short in VXX to overcome.

Ironically, had I not attempted to find a riskless trade by pairing VIX and VXX, it would have been easy to take advantage of the declining VIX and lock in substantial profits with a synthetic short on either VIX or VXX or perhaps another directional short involving options, such as a long put, short call, bear put spread, bear call spread, ratio put spread, etc.

I will keep all this in mind when the holiday season approaches in another ten months. EM

Further Reading

Follow That Trade: VIX–VXX Minotaur, *Expiring Monthly*, December 2010.

Date	Front mo	2nd mo	1m-2m	VIX Jan30c	VIX Jan30p	VXX Jan42c	VXX Jan42p	*VIX-syn S*	*VXX-syn S*	VIX-VXX	$ P/L
12/22/11	**25.10**	26.00	-0.90	1.100	5.900	0.735	8.900	4.800	8.165	-3.365	**(7,022)**
12/23/11	**25.70**	26.40	-0.70	1.200	5.500	0.830	8.250	4.300	7.420	-3.120	(6,586)
12/27/11	**25.45**	26.20	-0.75	1.075	5.500	0.705	8.350	4.425	7.645	-3.220	(6,804)
12/28/11	**26.70**	27.10	-0.40	1.500	4.900	1.030	7.350	3.400	6.320	-2.920	(6,476)
12/29/11	**25.95**	26.55	-0.60	1.275	5.300	0.810	7.900	4.025	7.090	-3.065	(6,570)
12/30/11	**26.70**	27.15	-0.45	1.300	5.000	0.820	7.500	3.700	6.680	-2.980	(6,494)
1/3/12	**24.80**	25.80	-1.00	0.800	6.000	0.415	8.850	5.200	8.435	-3.235	(6,458)
1/4/12	**24.20**	25.30	-1.10	0.625	**6.250**	0.305	**9.350**	**5.625**	**9.045**	-3.420	(6,764)
1/13/12	*22.50*	*24.05*	*-1.55*	*0.050*	*6.800*	*0.070*	*10.900*	*6.750*	*10.830*	**-4.080**	(8,049)

VIX and More

FIGURE 3 *Synthetic VIX–VXX Arb through 1/4/12 Plus*

The Trouble with Sears

Lauren Sebastian, Guest Contributor

I should have seen Sears missing sales a mile a way. Lauren Sebastian (my wife and famed fashion blogger) had been talking about how bad the store was for several months. She has been right over and over again with retail stocks. If she likes the stores, the company is going higher. With that in mind, here are her thoughts on Sears. —Mark S.

IT'S NO SECRET that your wife/significant other is the one out spending your money, so why don't you take a few retail trading lessons from her?

The Problem

A few months ago the Kmart sign at the location nearest to my childhood home was removed. The city's eyes widened with childlike hopefulness, we dreamed of what would replace the downtrodden retailer. Would a Target replace it? Would a Costco move in? It was almost a parade-worthy event.

And then a Sears sign was hoisted up to replace it. 100,000 people groaned.

What is Sears good for? The parking spot within the closest walking distance to a mall entrance on a cold or rainy day. And that is the only reason I am able to give you any insight on the happenings inside the big white, 1950s-era walls of the giant mess of a retailer.

I am hardly one to turn my nose up at a retailer for its prices being cheap. Although I'm a fashion writer, I thrive off of getting a good deal and spend a lot of time tracking down inexpensive pieces that stay consistent with current trends. But everything at Sears, aside from the appliances and tools, just looks cheap. And as a woman, I don't mind either of those, nor will I want to stop and look at them with my better half when I actually get him to the mall.

And it's not that I haven't tried. After seeing online that Sears carried a pair of boots I *had* to have, I stopped to see if I could pick up a pair there. After fighting my way through one messed up, poorly-merchandised center aisle display after another, I made it to the shoe section. The aisles were narrow and it was a mess. The shoes were out of order and of course, they didn't stock the style I was looking for or anything similar. And everything looked like I could BOGO it at Payless if I really wanted something with a similar look.

While I was there I thought I would also check out their latest promotional venture, the Kardashian Collection. While I'm not a huge Kardashian fan, I do like their style so I wanted to see what Sears had done with their clothing line collaboration. I was pleasantly surprised as I would actually put a lot of the clothing on my body. And then I looked at the price tags. The day I pay 60+ dollars for any item of clothing stocked at Sears is the day after I win the lotto.

I'm willing to bet that the Margherita Missoni has stepped foot in a Target, even if it was just to buy milk, so their collaboration is somewhat believable. But I'm pretty sure every time a Kardashian has stepped foot in a Sears, a seven-figure check greeted them at the door.

The Solution

My picture of a Sears Corporation board meeting involves six males above the age of 60 with white, short-sleeve button-down shirts, red and blue ties (some of the men have stripes on their ties incorporating both), rectangular glasses, pocket protectors and white ceramic mugs of coffee sitting around a wooden table under fluorescent lights. No recent college graduate or a person with any sort of retail or merchandising background is in sight; which, if accurate, would explain why their stores look like something out of the mid-20th century.

They need to take a page out of the Target book and update, and start at the bottom. When I was a senior in college I was flown to Minneapolis and put up in a hotel for two days to interview for an assistant buyer position at Target. Travel was arranged for me and I was put up in the nicest hotel room I had stayed at to date (it doesn't take much to impress a college senior)—white robe, slippers, and the whole she-bang. There were at least 50 kids in my group that were taken into interviews, put through a math test, hosted to networking events, and taken on a tour of the Twin Cities to view what they had to offer.

And they didn't hire me, which is how I knew they were headed to in the right direction (math: not my strong suit). They looked for the brightest and best to keep their company on trend, not the girl who was dressed trendiest that couldn't make it through sophomore statistics (cough). People who know what the trends would be because of the lives they are living, what designers would be hot to collaborate with, and how a 30-something would want to decorate their Christmas tree. And they do it inexpensively.

Sears does have a good thing going in that it isn't just focused on clothing. And there is a way to do one stop

They need to take a page out of the **Target book** and update, and **start at the bottom.**

shopping right. Theoretically they could get both men and women to shop there together if they stepped things up in the clothing, accessories, and shoe departments. I'd love to say "Hey honey, I'll be upstairs in the shoe department, have fun looking at tools." If Nordstrom carried tools, we'd go there every weekend.

And Sears doesn't have to have to start carrying Louis Vuitton to upgrade, they just have to have clothing that works. Forever 21 clothing is made in sweatshops for nothing, yet even Hollywood celebs incorporate pieces in their wardrobe. Start recruiting from FIT, Parsons, or even the local Chicago design schools like Columbia. It might take them awhile to wrangle that fashion forward student, but getting some young, innovative minds in is the way to go. There are so many young talented people that want an opportunity to find their place in the "fashion industry." Or just get someone to read a celeb fashion magazine for inspiration. Most of what young Hollywood is wearing now will just be getting popular in other parts of the country once it makes it to stores. Target's shoes always look pretty similar to last season's Steve Maddens, and it works.

Make the shopping experience better by updating the stores to look contemporary. There is no excuse. 18-year-olds make their dorm rooms look contemporary on $100. If you've ever been in an Ikea, you know it doesn't take much. You're in malls with Nordstrom, do something and you can even attract those shoppers.

Hire a consultant to re-merchandise the store. Get rid of the free-floating displays with things piled on them in the center of the aisles. It's clutter. It ruined Macy's, it will ruin you.

Bottom Line

If Sears was a middle school student it would be grounded for its messy room and bad report card.

Sears needs to start updating somewhere if it isn't going to go the way of tight rolled jeans.

What does some ditzy fashion writer know, you're asking? If I'm not shopping there, your average Jane isn't either. EM

today's session—and even then, it may be the futures that come down to meet the cash VIX (as was the case in dramatic fashion during the December expiration) rather than the cash VIX moving up to meet the futures.

Your questions has me thinking that for a future article, I should address the broader question of VIX and VXX movements just prior to expiration—and the implications for options traders.

—Bill

enough I had to go looking. Some guys would panic at losing their badge, and others would just look around until it turned up. Most likely that spot was clipped to the bottom of a trading coat. So I started using a safety pin to keep my badge on, and I finally started trading. The partners that ran the firm I worked for said I got off pretty light, so I just kept doing what I was doing. A little hazing is a way for the crowd to weed out the guys who could not take adversity. There is plenty of adversity in trading.

If we get another market like pre Gulf War I or Gulf War II, the equity markets generally lose liquidity, and volatility drifts up as most market players sit and wait on the sidelines. Very few are willing to take a new position, so volatility drifts upward and stocks sag as uncertainty prevails. Once the guns start firing, the markets rally and implied volatility fades, as the outcome of the war looks more evident. Thinking back to my start on the PCX in the shadow of Gulf War I, maybe the crowd had more important things on their mind than a 24-year-old newbie. Lucky for me is all I have to say. EM