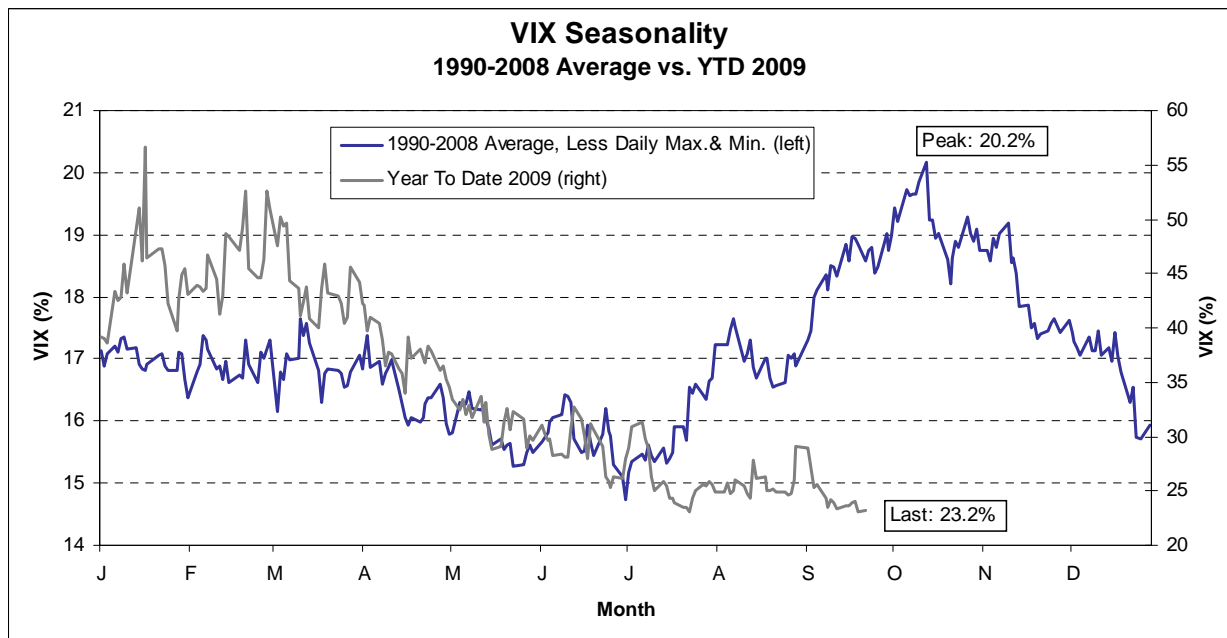


Bedtime For Volatility?

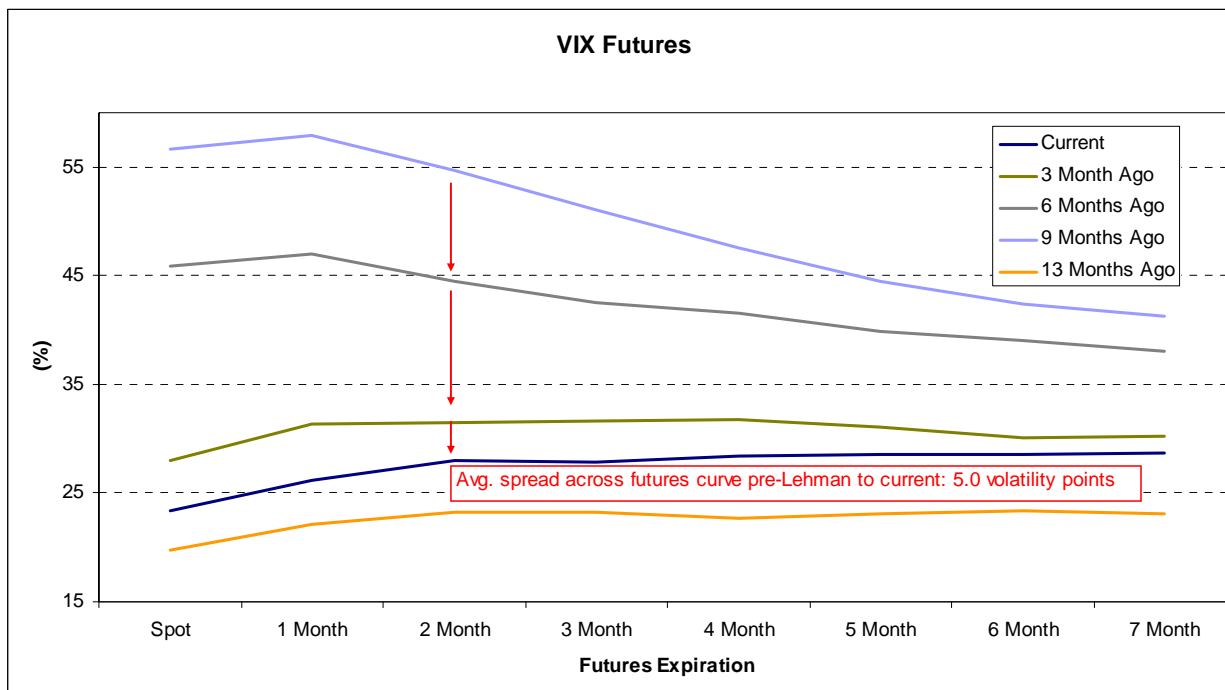
We recently addressed the complacency in equity markets as measured by S&P 500 Index 10-day realized volatility that last week dipped to almost half of its 15% long-run average ([“The Seasonality of Volatility”](#)). In contrast, following the four prior volatility super-spikes back to 1930, it took over 3 years for realized volatility to reach the single digits. Coupled with the impending mid-October seasonal peak in the VIX and an historic 58% rally from the March lows, we recommended zero cost collars in one month tenor to protect gains in long index and single stock positions.



Source: Bloomberg

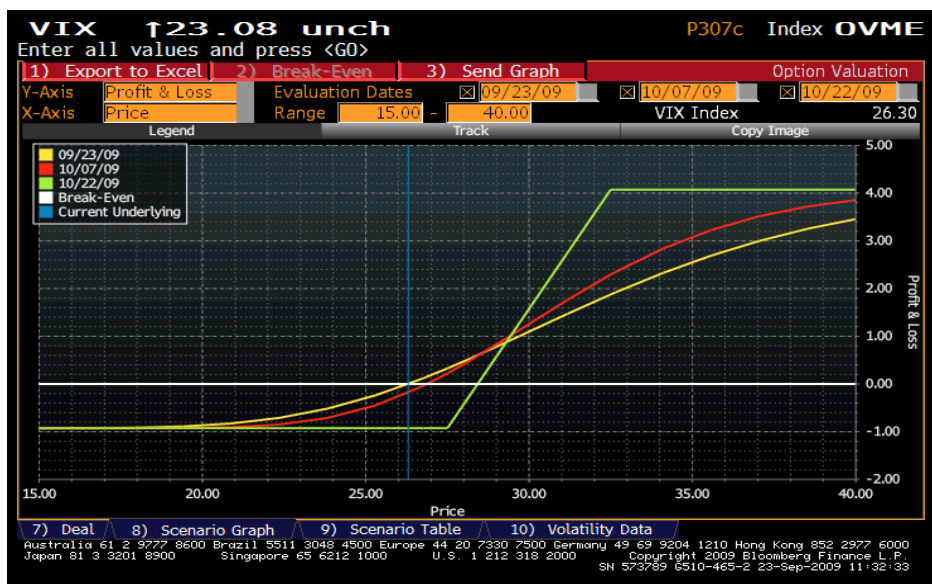
Investors who assign a high probability to a seasonal volatility spike or who have participated in the equity rally and want a broad portfolio hedge can look beyond collars and get direct volatility exposure via VIX options. VIX spot has dropped sharply since its November 2008 peak above 80%, but has recently failed to close below 23% which was its level in July when the S&P 500 Index was at 973, or 8.6% lower. Meanwhile, 1-month implied volatility of the VIX (volatility of volatility) recently dipped under 60%, well below the 78% average since options were introduced in February 2006. Concurrent with the decline in VIX spot, the futures curve has flattened and shifted lower with the 1-month to 7-month curve currently 5.0 volatility points higher on average than the corresponding levels in August 2008 when the S&P 500 Index was ~1300. Although the appropriate futures curve spread to the pre-Lehman bankruptcy level is subjective, 5 volatility points seems like a reasonable buffer until equity markets gain conviction that the U.S. economic recovery is sustainable. Collectively, the

evidence suggests that equity volatility has found a near-term floor and that VIX options are inexpensive on an historical basis.



Source: Bloomberg

Investors who believe that currently unforeseen catalysts will induce volatility to replicate its seasonal pattern



and want exposure for either a speculative trade or as a broad portfolio hedge, can look at VIX call spreads. Given the mean-reverting nature of the product, the tenor of the call spread should be matched to the historical mid-October peak in VIX. With the VIX October future at 26.0 the 27.5/32.5 call spread is offered for \$1.00 and makes \$4.00 with futures 32.5% or higher at expiration. The maximum risk on the trade is the premium paid, or \$1.00.

MKM Trade Idea

Long Oct09 VIX 27.5/32.5 call spread. Buy 27.5 call for \$1.50, sell 32.5 call at \$0.50. Net debit of \$1.00 to make \$4.00 with October VIX future 32.5% or higher at expiration. All prices as of 9/23/09.

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“Buy” Security is expected to appreciate 15% or more on an absolute basis in the next 12 months.

“Neutral” Security is not expected to significantly appreciate or depreciate in value in the next 12 months.

“Sell” Security is expected to depreciate 15% or more on an absolute basis in the next 12 months.

Distribution of Ratings for Reports Issued by MKM Partners LLC as of September 24, 2009:

Buy 44%; Neutral 47.5%; Sell 8.5%.

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