

CBOE Volatility Index[®] (VIX[®]) Options Strategy

“Reverse Collar”

Since 1990, VIX has moved opposite the S&P 500 Index 88% of the time, with a negative daily return correlation of -0.67 . On average, VIX has risen 16.8% on days when SPX fell 3% or more. Simply buying VIX call options, therefore, could be considered a hedge to protect against sharply falling stock prices. Yet, a unique property of VIX suggests a way to reduce the cost of implementing this hedge.

Despite historically low VIX levels since 2005, it is highly unlikely that VIX could ever go to zero, or even experience a prolonged period of very low values; in order for this to occur, there would need to be a market expectation of *virtually no daily change* in the level of the S&P 500 Index! In fact, the lowest closing level of VIX was 9.31 on December 22, 1993, and there have been only five days since 1990 when VIX has closed below 10.00.

Following are sample 3-month VIX option prices as of February 1, 2006. These hypothetical prices reflect the May *forward* VIX level - based on June SPX option prices - of 14.50, not the current, or “spot” VIX level of 12.75.

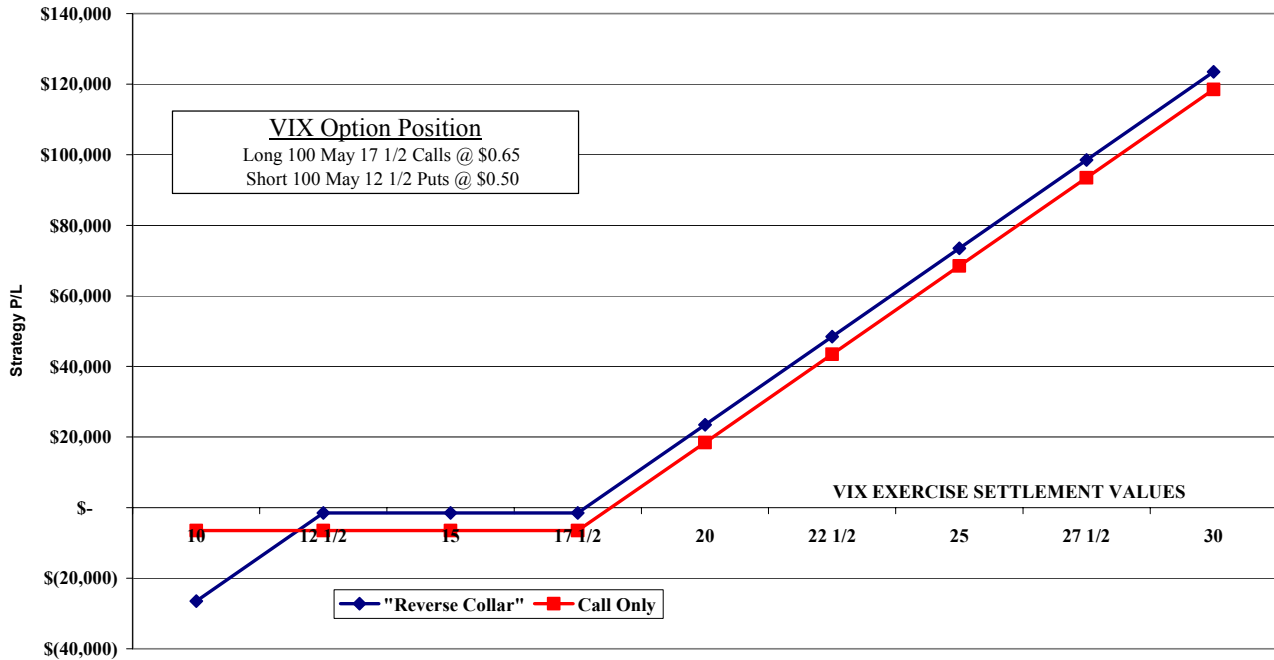
Spot VIX	12.75
May Forward VIX	14.50
May Expiration Date	May 17, 2006

May VIX Options - Hypothetical Values

Strike Price	Call		Put	
	Bid	Ask	Bid	Ask
10	\$ 4.30	\$ 4.70	\$ -	\$ 0.25
12 1/2	\$ 2.40	\$ 2.70	\$ 0.45	\$ 0.65
15	\$ 0.90	\$ 1.10	\$ 1.40	\$ 1.60
17 1/2	\$ 0.50	\$ 0.70	\$ 3.35	\$ 3.65
20	\$ 0.10	\$ 0.30	\$ 5.40	\$ 5.80

The proposed strategy involves buying VIX calls in order to hedge the risk of sharply falling stock prices, and selling VIX puts in order to reduce the overall cost. Specifically, we will buy 100 May 17 1/2 calls at \$0.65 and sell 100 May 12 1/2 puts at \$0.50, for a net debit of \$0.15, or \$1,500.

Assuming that the position is held until the VIX expiration date of May 17, 2006, the chart and table below summarize the profit/loss of the option position at various VIX settlement prices (excluding transaction and capital costs) and compares this with the profit/loss of buying the call alone. In this example, the break-even for the “reverse collar” position would correspond to a VIX exercise settlement value of **17.65**, while the break-even for the call alone would be at **18.15**.



	VIX Exercise Settlement Value								
	10	12 1/2	15	17 1/2	20	22 1/2	25	27 1/2	30
Call Price	\$ -	\$ -	\$ -	\$ -	\$ 2.50	\$ 5.00	\$ 7.50	\$ 10.00	\$ 12.50
Put Price	\$ 2.50	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Total Position Value	\$ (25,000)	\$ -	\$ -	\$ -	\$ 25,000	\$ 50,000	\$ 75,000	\$100,000	\$ 125,000
Cost	\$ (1,500)	\$ (1,500)	\$ (1,500)	\$ (1,500)	\$ (1,500)	\$ (1,500)	\$ (1,500)	\$ (1,500)	\$ (1,500)
Net P/L	\$ (26,500)	\$ (1,500)	\$ (1,500)	\$ (1,500)	\$ 23,500	\$ 48,500	\$ 73,500	\$ 98,500	\$ 123,500

It is important to note that the projected profit/loss in this example is applicable only on the expiration date for VIX options, which are *European-style* contracts that cannot be exercised early. Investors wishing to exit this strategy before the expiration date should expect VIX option prices to reflect the May forward VIX level based on June SPX option prices rather than the spot VIX level.

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