Market Indicators: The Best-Kept Secret to More Effective Trading and Investing

Richard Sipley
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Market Indicators

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Richard Sipley

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Acknowledgments

Now for the page that’s least likely to be read in any book, and yet most important to its author. After this project, I promise that I will actually read other writers’ tributes.

Thanks to all the bloggers who share their ideas, insights, and opinions. They have helped me shape my own. Thanks also to all the writers and editors who find good stories and angles and go to the trouble of vigorously fact-checking their material.

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My love and gratitude to my parents for their guidance and encouragement through the years.

And finally, my love and thanks to my wife, Stephanie and my children Jack, Ava, and Lila. Yes, the book is done. No, the Cubs haven’t won the World Series. We moved to Boston to save you from your father’s fate.
Introduction

Beware of geeks bearing formulas.
—WARREN BUFFETT, in his 2008 annual letter to shareholders

Some people suggest that investing is a form of gambling, complaining that they can do as well playing the Pick-3 lotto or betting on roulette. Nothing could be further from the truth. In Las Vegas, the house always has the edge. In the stock market, you can have the edge, if you wait until conditions are right.

Only poker, in which individuals compete to outwit each other, really compares to investing. At its most basic, poker is about making decisions based on imperfect and incomplete information. Players each hold a few cards that only they can see. Every other player must make educated guesses about who holds what. No one knows which card will be dealt next.

An ability to read other players is the skill that sets master poker players apart. The best poker players notice that the man with the loud shirt plays conservatively; if he bets aggressively, it’s likely he has a really good hand. They see that the player in the corner plays with her chips when she’s bluffing. In poker, these are known as tells, signals that give observant competitors slightly better odds and help them win more often over the course of many games.

That’s the goal of this book. The following pages will describe a variety of signs, or tells, that many market professionals consider. These signs don’t replace good, old-fashioned homework—but they will enhance your ability to make better stock decisions over time.

You can observe a lot by just watching.
—YOGI BERRA

If you approach the market solely by doing fundamental research, this book probably won’t be of much interest. If you have found your
introducing niche by concentrating only on technical analysis, this book is not for you. But if you agree that you can learn a lot just by looking around, then you’ll likely find some useful nuggets here.

Economist John Maynard Keynes has compared the stock market to a beauty contest, but with a twist. Rather than voting for the prettiest girl, the goal is to pick the contestant the judges believe is prettiest. Keynes, who was a very successful stock investor in his own right, read newspapers to learn what others were reading and thinking. He believed that market success requires looking around and observing how other market participants feel and act.

This insight is not unique to Keynes. Professional investors of every era have developed indicators and other rules of thumb that help them navigate naturally chaotic markets. You’ll see some of these indicators when excessive fear or greed enters the marketplace. Others arise when well-informed insiders tip their hands and hint at their views of the future. These signals are largely numerical, can be charted, and lend themselves to deep study.

The best and brightest are constantly trying to develop more complex and sophisticated indicators. Careers can be focused on just one signal. Sometimes, however, simple is best. Many of the most reliable indicators have been around for many years, and have stood the test of time. In this book, we’ll cover a wide range of indicators, offering the reader a handbook of market “tells.”

The Outline

I understand now that the financial future is a closed book, that prophecy is usually profitless, and that the best an investor can generally hope to do is identify extremes of sentiment and valuation as they periodically present themselves.

—James Grant, in his final Forbes column, February 25, 2008

At its core, of course, the future is unknowable. But as long-time market commentator Jim Grant said, investors can better their odds by identifying extremes of sentiment in groups of real people with real foibles and emotions, who buy and sell stocks in the world markets every day.

There are three sets of indicators that may signal opportunity. We will first focus on data that reveals what market participants are doing. Normally, there is an ebb and flow in the price and volume of specific securities, and in the market as a whole. A significant, measurable
activity spike may suggest market panic or euphoria and, therefore, potential opportunity.

The second section will explore the ways investors, as a group, signal their areas of focus, feelings, and general outlook. At market tops and bottoms, surveys and media coverage reflect investor sentiment. When the media universally portray an issue in a certain way, or when commentators portray the (unknowable) future as clear, it suggests that emotion has trumped rational analysis—and that securities are incorrectly priced as a result.

The third and final section will explore the dynamic between “smart money” and “dumb money.” Because of their roles, some people know more than others about specific market sectors. A global grain conglomerate executive knows more about corn crops than does a dentist, for instance. Most of the time, insiders and the general public take similar actions. When their opinions diverge, however, it’s wise to follow the insiders. We’ll discuss how to find and interpret that moment of divergence.

**A Few Warnings**

*Take what you can use and let the rest go by.*

—KEN KESEY

These indicators don’t replace economic analysis, or save you the trouble of reading a company’s financial statements. In fact, they work best for investors who already endeavor to understand companies, sectors, markets, and their real-world contexts. These indicators are a supplement to the hard work of knowing the stocks you own.

Many of these indicators have been tested for their predictive value, and all fall short in some way. No single or combined indicator will give you a foolproof route to riches.

Instead, I emphasize the importance of considering a broad cross-section of indicators and information to get a sense of what market signals might mean, deciding for yourself how much weight to give any single factor. Take what you can use and let the rest go by.

**About Me**

*Whoever undertakes to set himself up as a judge to Truth and Knowledge is shipwrecked by the laughter of the gods.*

—ALBERT EINSTEIN
No book can escape its author’s natural leanings. I graduated with degrees in finance and computer science from Miami University in Oxford, Ohio, in 1988, received my MBA at Kellogg School of Management at Northwestern University in 1997, and became a CFA charter holder in 1998.

In nearly fifteen years, I’ve held positions for ten seconds (once or twice) and ten years (once or twice). I’ve done paired spreads, warrant spreads, preferred spreads, merger arbitrage, straight longs, and unhedged shorts. I’ve ridden a stock from fifty cents to sixty dollars and from five dollars to zero. I’ve sat on cash while everyone around me was minting money. I’ve gotten into a cab to see a former coworker, who was minting money a year earlier, sitting in the driver’s seat.

I’m currently a portfolio manager at Boston Private Bank, where my colleagues and I work with both individual and institutional investors, doing our best to help clients navigate the market.

I’ve looked at most every indicator out there, considered every nuance I could find, but I also recognize the karmic danger of portraying myself as an expert. I urge you to consider other voices and opinions. Many of the charts in this book come from people who have made interpreting market signals their life’s labor. In many ways, this book is an introduction to their work.

Entrepreneur and now-billionaire Mark Cuban wrote that, while he was starting out, he slept on the floor of a shared apartment and ate mustard and ketchup sandwiches. But he figured the more he learned, the better chance he had of beating the competition. Cuban has said that just one good idea from a three-dollar magazine or a twenty-dollar book is a bargain. I hope you find at least one actionable indicator or intriguing concept in the pages that follow. And that you’re not eating mustard and ketchup sandwiches. Thanks for reading.
As a general rule, the most successful man in life is the man who has the best information.

—BENJAMIN DISRAELI

Money doesn’t flow—it sloshes. Like water in an overfull bathtub, money moves in waves, as investors process information and balance the competing desires to grow wealth and protect capital. Traders use connections and quick thinking to react to new information, deciding how it may (or may not) affect capital returns. Thoughtful investors try to proactively position portfolios, rather than reacting impulsively to each new data point and market development.

As it sloshes, money creates a variety of measurable results, which signal how investors currently view risk and where they are placing bets. This first section reviews a variety of real-time indicators that point to capital allocation and reveal traders’ general levels of risk tolerance. Our first stop: the options market.
Clues from the Options Market

Successful investing is anticipating the anticipations of others.
—JOHN MAYNARD KEYNES

It can be tough enough to do well in the stock market. The options market, with its additional layers of complexity, might appear to be an even more challenging place to gain an advantage. Some of the smartest, quickest pros operate in the options market where, like traditional chess grand masters, they are slowly being outsmarted by computer algorithms. But there’s no need to battle the options pros or the computers to glean useful information from the options market.

The Basics
At its most basic, an option is simple. It’s the right to buy (call) or sell (put) a stock at a stated price (strike) until a certain point in time (expiration date). It’s not hard to understand, but it is hard to correctly value.

Though the mathematical specifics are beyond the scope of this book, traders use a few pieces of information to calculate an option’s price. These include the risk-free cost of money (due to the underlying loan that’s typically present), the stock price, the option’s strike price, and the amount of time left on the option. These are all known numbers. An unknown variable, called implied volatility, ties these known numbers together.
An option’s implied volatility measures how much the market thinks a stock’s value will change—in either direction—in the future. A boring company often has an established business base that probably won’t change much. An electric utility, for instance, has locked-in customers who provide a stable demand for product, although a state agency usually limits what the utility can charge. Relatively speaking, a utility’s future cash stream is predictable and will probably create a steady price for that utility’s stock, and therefore a relatively low implied volatility. Traders will not pay a high price for the right to buy the stock at a much higher level—a right known as a call—because traders think the stock has only a small chance of achieving that higher level. On the other hand, a technology stock such as Google has a much higher implied volatility. After all, the stock’s value has changed significantly in the past, and Google’s future business and cash flow is more unpredictable than that of a utility. A call option—a bet that the stock will go up—on Google, therefore, is more expensive than a call option on Consolidated Edison.

For ease of use across option durations, sources state implied volatility in annualized terms. Note that implied volatility does not imply direction; it merely indicates the perceived magnitude of future price changes, both up and down.

**What is the Volatility Index?**

There is no need to independently calculate implied volatility. The Chicago Board Options Exchange (CBOE) introduced the Volatility Index (VIX) in 1993, and it became a popular media topic—albeit, one commentators often discuss oversimplistically. The VIX considers stocks traded on the S&P 500 Index and continuously calculates their implied volatility on a constant, forward-looking 30-day basis. In less technical language, the VIX measures the market’s price movement expectations over the next thirty days on the S&P 500. See more detail on the history of the VIX and its underlying calculations, as well as the current VIX and associated values, at the CBOE Web site (www.cboe.com).

**WHY INVESTORS AND TRADERS LOOK AT THE VIX**

The market essentially serves as a discounting mechanism for investors’ collective best guess of what the future holds. When investors
disagree more than usual over the path of things to come, prices often bounce around as the market seeks equilibrium. At these moments, the VIX runs at relatively higher levels.

The VIX is also known as the investor fear index, because upward spikes are associated with bouts of market turmoil and uncertainty. Market participants are generally reluctant to put hard-earned cash to work in the market when the future seems murky and unsettled. Other investors may see reluctance as an overreaction to current news events and, therefore, as a buying opportunity.

At relatively low levels, the VIX suggests less disagreement over general stock prices. At these times, the VIX could be called the complacency index. Sustained low VIX levels resemble a quiet and placid lake, smooth as glass. Just a pebble can cause a disturbance. And so it is with the market. If investors expect a quiet market, any news event might cause a stir. Some investors therefore see low VIX levels as an opportunity to sell some stock and reduce market exposure.

STUDYING THE VIX
The VIX is based on data and has been around for many years, so it lends itself to academic study. Many academics are fascinated with the VIX, because it seems to dispel the notion of market efficiency.

In their December 2006 paper “Implied Volatility and Future Portfolio Returns,” Prithviraj Banerjee, James S. Doran, and David R. Peterson came to the following conclusions:

• They confirmed that the VIX had a statistically valid track record of forecasting stock market returns over one- and two-month time periods.
• This predictive ability was stronger for highly volatile stocks than for less volatile stocks. The forecasting effect was similar across stock type (growth and value) and company size (large and small).
• The authors were careful to conclude that the VIX was predictive, but did not state that VIX-based trading or investing would lead to market-beating returns.

Another study looked at using the VIX to beat the market. In their November 2007 paper “Can the VIX Signal Market’s Direction? An Asymmetric Dynamic Strategy,” Alessandro Cipollini and Antonio Manzini looked for a VIX strategy that beat a buy-and-hold
approach. They stayed long to the market only when the VIX was at a relative high, and kept their account in cash at other times. They derived relative VIX levels by 1) finding high and low VIX values for a rolling twenty-four-month period, 2) dividing that range into twenty-two equal-value “buckets,” and 3) finding the forward three-month market returns for each day, and examining which bucket the VIX was in for each. They found that

- The VIX signals market direction, but is much more useful at high relative levels. Spikes are an especially reliable signal of market direction.
- Low VIX levels have much less predictive ability.
- The VIX had significant skews at its tails. The VIX spent only 0.82 percent of the study period (January 2, 1992 to December 31, 2004) in the highest VIX bucket, and 12.4 percent in the lowest, consistent with the argument that the VIX is better at finding market bottoms than market tops.
- Their constructed model beat a standard buy-and-hold model. The authors felt results would have been even better if the model had allowed more aggressive trading at the highest VIX readings.

A note from market research firm Bespoke Investment Group confirmed the finding that the VIX is more predictive at its highest values than at its lowest. The note discussed insights gathered from a study of more than thirty short-term VIX declines of more than 25 percent between January 1990 and April 2008. The authors concluded that “while sharp increases in the index have historically been a positive for the short-term performance of the market, sharp declines in the index do not necessarily have the opposite effect of negative short-term returns.”

**USING THE VIX**
These and other studies demonstrate that, as a predictor, the VIX is most accurate when it spikes from a relatively high level. This phenomenon can be used to time the market to some degree, particularly in short-term trading strategies, as the VIX considers only the next thirty days. Traders and portfolio managers use the VIX in different ways, with varying levels of conviction, as they seek out approaches that fit their needs and time frames.
We will focus on using VIX spikes to find periods of market dislocation. There are many possible approaches to consider.

MOVING AVERAGES
It can be dangerous to consider any indicator in absolute terms. Many investors tend to find an indicator level that has seemingly worked well in the past, and arbitrarily use that level as a future trigger point. But times and conditions change. It’s better to use the VIX by considering it in relation to the trends and trend deviations in its recent past.

One way to look at relative trends and trend deviations is to use moving averages. A 10-day moving average for the VIX is very common, though this can be shortened or lengthened as desired. **FIGURE 1.1** shows a 10-day VIX moving average (solid black line) for 2007, and the circled points at which the VIX spikes by at least 20 percent above those values. Such a relatively large deviation from a given moving average can signify short-term fear.

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**Figure 1.1** VIX 20 percent spikes away from 10-day moving average during 2007

Source: Chart courtesy of StockCharts.com (http://stockcharts.com)
BOLLINGER BANDS

Bollinger Bands, created by John Bollinger, is a charting tool that expands on moving averages and adds a trading range that’s based on a security’s historical volatility. This charting technique normally uses a 20-day moving average and adds bands representing two standard deviations above and below the moving average. If future volatility matches the 20-day historical volatility, stock price should fall within the two bands 95 percent of the time.

Bollinger explains that the bands’ width will expand in a trending market and contract in a sideways market. One can view widening bands as periods of increasing market tension and uncertainty—represented by a more volatile VIX—and tightening bands as times of decreasing market tension and stabilizing VIX values. When the VIX breaks out of a narrow band and heads higher, creating a wider band, one can argue that a new period of uncertainty is underway.

Bollinger Bands changes don’t typically occur in a vacuum. Bands usually change width in response to news or other events that affect the market.

Traders use Bollinger Bands in a variety of ways. One approach is to wait for widening bands to develop, then wait for the moving average to crest and begin its decline. The technique won’t catch the market’s bottom but will increase the probability of finding a point at which the worst of the crisis has passed and the market is rebounding into a new, intermediate-term uptrend.

FIGURE 1.2 shows 2007 VIX data with Bollinger Bands. Periods in which the bands expanded and then the 10-day average ran up and crested are shown in rectangles (roughly March 15, 2007, August 23, 2007, and November 16, 2007).

Note two points circled (February 27, 2007 and August 16, 2007) where the VIX spikes more than 10 percent above the Bollinger Band and is more than 50 percent above the 10-day average. These dates saw marketwide sell-offs—and in retrospect marked good buying opportunities.

DIVERGENCES

Market participants may also use a VIX moving average to find instances where the VIX and the stock market diverge. They might
look for a situation in which the market has made a fresh low and the VIX moving average has not reached a new high. This combination suggests that the general market conditions that spurred the recent market action are starting to moderate.

In Figure 1.2, note that the November market low matches the August low, but that the 10-day VIX line peaked at a slightly lower level. This suggests that market fear was generally dissipating.

In a market downturn, a new low that occurs without a fresh VIX high can be one sign that the market is nearing a bottom. In a market upturn, a new high without a fresh VIX low can signal an intermediate-term top. As we’ve seen, low VIX levels are less predictive than are abnormally high VIX readings.

PREDICTING VOLATILITY
The VIX uses options to track 30-day stock price volatility expectations, considering investors’ collective reaction to current events
as well as their emotional responses to the pleasure of gains and pain of losses. Another index, the CBOE S&P 500 Three-Month Volatility Index (VXV), measures the same thing on a longer time frame, charting the three-month implied market volatility of S&P 500 index options. In a sense, this index helps traders anticipate other investors’ anticipation.

By comparing the VXV to VIX, market participants can compare the views of shorter-term and longer-term options traders. When the VIX is at a relative high and the VXV is much lower, it suggests that longer-term options traders believe that shorter-term traders are having a temporary panic attack, and the current market storm will soon blow over. However, a relatively high VIX and VXV suggest that longer-term options traders agree that their colleagues are panicking with good reason (it’s been said that those who panic first, panic best), and storm clouds will linger. **FIGURE 1.3** shows this ratio for 2008.

![Figure 1.3 Ratio of 30-day to 90-day implied volatility](http://stockcharts.com)
Bill Luby, on his blog Vix and More (vixandmore.blogspot.com) has suggested that a level of 0.9 suggests a need to decrease stock exposure, and that a ratio of 1.1 suggests that investors increase stock exposure. (The October sell-off blew through the 1.1 buy point. Luby suggests that this indicator will work in many markets over the course of time, but will not do well in a market dislocation.)

Another approach is to wait for extremely high or low ratios to appear and then retreat, waiting until the ratio declines below 1.1 in the previous example. Because the VXV indicator is so recent, it will need to be tested through several market environments before its usefulness will more fully be known.

OTHER VOLATILITY INDICATORS
The CBOE offers other volatility indexes, each tracking a different underlying index. The Nasdaq Volatility Index (VXN) measures volatility expectations using options on the Nasdaq 100 index. The Russell 2000 Volatility Index (RVX) tracks volatility expectations using options on the Russell 2000; and the DJIA Volatility Index (VXD) follows the same expectations for the Dow Jones Industrial Average. There are also volatility indexes for several European indexes.

VIX RESOURCES
Many financial data providers offer subscribers the VIX and other volatility indicators and allow users to tinker with various moving averages, Bollinger Bands, and data-smoothing techniques. The CBOE carries basic data on its Web site for free, or with advanced streaming data for a fee. Bloomberg users can find all world volatility indexes by typing WVI <Go>.

Of all the topics in this book, the discussion of VIX and how to use it is the most technical and most open to individual interpretation. The concepts used here are at an admittedly basic level. A blog search on “VIX” will reveal an abundance of individual approaches and commentary on the VIX’s usefulness across all market time frames. The blog vixandmore.blogspot.com specifically focuses on the VIX in Bill Luby’s market outlook.

Finally, the CBOE Web site (www.cboe.com) offers a comprehensive review of VIX history, its construction methodology, historical data, and real-time readings.
More Options: The Put/Call Ratio

The put/call ratio is the other common indicator to come from the options market. It represents a comparison between all the puts and all the calls purchased on any given day. Known as the aggregate put/call ratio, it facilitates overall market analysis. (Investors can also analyze specific pockets of options activity, in ways discussed later in this chapter.)

There tends to be a balance between investors who are bullish and those who are bearish on specific stocks or the general market. Professionals using options to hedge other positions don’t necessarily have an opinion about the direction of a stock or market index. Their strategies don’t change much during market extremes, and so have little effect on the relative high and low put/call readings that are the most useful.

Most market participants bet that the market will go up after the market shows a strong advance. (The brain naturally projects recent trends into the future and calls that projection a forecast, a phenomenon called recency bias.) When the market goes up, many participants buy calls, in anticipation of further advances. The put/call ratio goes down. For instance, a given day might show a put/call ratio of 0.9, or 90 puts purchased for every 100 calls. If investors buy more calls in response to an advancing market, the put/call ratio might move to 120 calls to a steady 90 puts, or 0.75.

By the same logic, investors typically buy more puts if they are nervous about a market decline. Some even enter the options market to buy puts as insurance against further market losses. At times of maximum fear and uncertainty, the put/call ratio ratchets up.

Over time, other forces can also affect the baseline put/call ratio. Inverse exchange-traded funds (ETFs), which go up in value when the underlying index goes down, offer an alternative to options for institutions who cannot short stocks or individuals who are unsure about options mechanics. Their growing popularity among investors who can buy puts may have reduced the total number of puts that market participants purchase.

These kinds of structural changes require a flexible approach to the put/call ratio. One possible strategy involves looking for large outlying spikes as indications of market extremes. FIGURE 1.4 reviews the consolidated equity put/call ratio for 2007 and highlights instances