Market Psychology – what is it?

- The consensus of fear and greed among market participants – often referred to as “market sentiment”.
- Also, the measure of fear and greed personally experienced by individual market participants.
- Always contrarian at market extremes
Measuring Market Psychology

- Surveys
- Option Put/Call Ratios
- Option Premium Skews
- Volatility Indexes
- Options on Volatility Indexes
- Mutual Fund Flows
- Short Interest
- Insider Trading
- Futures
- Anecdotal Evidence
- Market Performance
- Market Valuation
- Market Cycles
AAII, Investors Intelligence, Market Vane, Consensus Index and many others

• Important at market extremes, otherwise neutral
• Extremely bearish readings occur at major market bottoms
• Extremely bullish readings occur at major market tops
Investors Intelligence and S&P 500

Martin Capital Advisors, LLP

S&P 500 Composite Index

12/11/12: 16
Put/Call Ratios

• Generally, the greater the ratio, the greater the fear, and vice versa.
• As with other sentiment indicators, put/call ratios are most useful at extremes.
• A number of factors should be considered in the evaluation of put/call ratios, such as daily volume, open interest, relative pricing between puts and calls (skew), historical volume, trades to open versus trades to close, futures hedging, and strike price values and volumes.
CBOE Total Put/Call Ratio
Recent CBOE Equity Put/Call Ratios
Premium Skews

• You can gauge market sentiment of an index or a stock by looking at the cost of puts and calls, i.e., the premium for puts and calls for the equivalent relative strike prices.

  **Simple Supply and Demand:**
  
  • If premiums on puts are high, market anticipates a selloff.
  • If premiums on calls are high, market anticipates a rally.
  • The market is always eventually wrong at extremes.
QQQ current price: $64.69

The cost is $1.37 for the 60 puts that are $4.69 out of the money compared to a cost of $0.82 for the 69 calls that are $4.31 out of the money. Puts are much more expensive than calls.
Volatility Index

• VIX – designed to show expected market volatility through a formula measuring prices on S&P 500 index options.

• As with other indicators of market psychology, the VIX is most useful at market extremes.

• When Put/Call ratios spike upward, the VIX spikes, too.
Options on the VIX

• You can also look at the options on the VIX specifically.

• Put/call ratios and skews reflect the opposite sentiment of other options, e.g., long calls on the VIX are the equivalent of long puts for other options.
VIX Options for March 2013
Closed at 17.00 on Friday

Call Options

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Mutual Fund Flows
Short Interest

Measures short positions in stocks and indexes
Insider Trading

- Available from a variety of sources
- Often difficult to interpret
- More valuable for individual securities than market in general
- Only non-contrarian sentiment indicator
Futures

- Can be a useful sentiment indicator
- Affect index options statistics
Market Performance

Markets are driven by buying and selling. Although stocks eventually go higher, in the short-term they often over-react to both positive and negative information.
Market Valuation

Always expensive at long-term major market tops and cheap at bottoms
Anecdotal Evidence

• Gauging media sentiment – not easy most of the time, but it is fairly apparent at market extremes.
• When most people seem adamant about the direction of the market, it’s a good time to think about taking the other side of their trade.
• When you personally feel very worried about your stock market position, you’re probably on the verge of being right, if you can stay with it.
Market Cycles and Market Psychology

- Bull Markets are born in pessimism, grow on skepticism, mature on optimism, and die of euphoria – Sir John Templeton
- Bull markets climb a wall of worry – market maxim
- Be fearful when others are greedy, and greedy when others are fearful – Warren Buffett
Where are we now?

Investor Sentiment During Market Cycles

Market Peak (Risk)

Euphoria

Thick

Anxiety

Denial

Fear

Desperation

Panic

Capitulation

Despondency

Market Trough (Opportunity)

Optimism

Relief

Hope

Depression
Contrarian Considerations

• Timing the market is always a game of probabilities.
• The strange world of bubbles: *The market can remain irrational longer than you can remain solvent* – attributed to John Maynard Keynes
• Be aware of market psychology and what it tells you about risk, but focus on investing for the long-term.
• The stock market is biased to the upside, with about a 10% annualized total return since 1926.
Market Psychology

Presented by
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